e-Resources Module-IX

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Course: B.A. (Hons.) Economics, Sem.-VI Students of S.R.C.C.

BANKING SECTOR REFORMS IN INDIA

Banks occupy a prominent position in the Indian financial system due to the crucial role played by them in the growth process of Indian economy by being instrumental in converting saving into investment. With the launching of economic reforms in India based on liberalisation, privatisation and globalisation way back in 1991, the government soon realised the need to supplement them by associated reforms in the banking and financial sectors as well. Accordingly, banking sector reforms in India have followed the road map laid down by two expert committees appointed by the monetary authority viz., Narasimham Committee-I (1991) and Narasimham Committee-II (1998). The underlying principle of both these high-powered committees was to make Indian banks more healthy, efficient and competitive so as to provide a strong, safe, stable and sound banking system in India. Towards this end, some of the prominent recommendations of these committees that were implemented in a phased manner by the monetary authority were the progressive introduction of risk-based capital adequacy norms along with income recognition, asset classification and provisioning norms for Indian banks. Likewise, allowing for private sector banks, interest rate deregulation, cutting down on statutory pre-emption of public funds, laying stress on fiscal consolidation and moving towards "convergence" of traditional banking and non-banking services are some other important banking reforms that were guided by these expert-committees in India.

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Banks continue to play a major role in the growth process of Indian economy as by acting as a link between ultimate lenders and ultimate borrowers in the economy, commercial banks are instrumental in the conversion of *saving* into *investment*. In view of their prominent position in the Indian financial system in particular, and Indian economy in general, it becomes imperative to ensure a *strong*, *safe*, *stable* and *sound* banking system in India.

When the reforms of real sector of Indian economy based on the multipronged strategy of *liberalisation*, *privatisation* and *globalisation* was carried out way back in 1991, it was soon realised by the government that economic reforms *i.e.*, reforms of the real sector cannot reach their logical culmination till the supplementary reforms in the banking and financial sector were also carried out. It was this realisation of *interdependence* between real and financial sectors that paved way for banking and financial reforms in India.

As far as banking sector reforms in India are concerned, they have largely followed the road map laid down by two high-powered committees appointed by the monetary authority under the chairmanship of the former governor of RBI M. Narasimham in 1991 and 1998 *viz.*, the Committee on the Financial System (1991) and the Committee on Banking Sector Reforms (1998) popularly known as Narasimham Committee-I and Narasimham Committee-II respectively.

Both these expert committees aimed at making Indian banks more healthy, efficient and competitive. Towards this end, it was envisaged that banks in India would follow the best banking practices at the international level as suggested by the Basel-I norms set by the Basel Committee on Banking Supervision. More specifically, in line with the basic spirit of *prudential regulation* of the financial sector, the Narasimham Committees progressively introduced risk-based capital adequacy norms along with income recognition, asset classification and provisioning norms for Indian banks. The setting up of Asset Reconstruction Fund so as to take over stressed assets from banks was also very much a part of reforms agenda for banking and financial sector of the Indian economy.

In order to give a market-orientation to banking, the Narasimham Committee-I recommended that there shall be no more nationalisation of any commercial bank and even allowed public sector banks to raise 49% of their equity in the capital market along with advocating the setting up of private sector banks. Side-by-side, it was suggested that there shall be no more expansion of any bank branch in hitherto backward areas if it was found to be *commercially non-viable*.

Likewise, the Narasimham Committee-I professed that in order to enhance profitability of commercial banks in India, the *statutory pre-emption of public funds* through Statutory Liquidity Ratio (SLR) and Statutory Cash Reserve Requirement (CRR) shall be cut down and interest rates shall be deregulated. In fact, it was essentially on the advice of Narasimham Committee-I that monetary authority gradually moved from *direct* to *indirect* instruments of monetary control as the latter were more compatible with market-logic and did not have an element of statutory compulsion in them. The acceptance and eventual implementation of these recommendations of Narasimham Committee-I since 1992 marked the beginning of the first generation of financial reforms in India.

The second generation of banking and financial reforms, however, started with the coming in and acceptance of the recommendations of Narasimham Committee-II in 1998 whose main thrust area was “fiscal consolidation” and “convergence” of traditional banking and non-banking services from the perspective of *customer-oriented banking* that eventually paved way for *universal banking* in India.

The Narasimham Committee-II was governed by the basic philosophy that competition is a stern taskmaster and there is no room for laxity in its lexicon. Accordingly, this committee insisted on strong legal and technological reforms with a view to further raising the efficiency of Indian banks and making them globally competitive.