M Narasimham's Contribution - The father of banking reforms

What is the issue?

With the demise of M Narasimham, former RBI Governor, it is imperative to reflect on his contribution to reforms in the financial sector.

Who is M Narasimham?

- Maidavolu Narasimham (1927-2021) was the thirteenth governor of the RBI [from May 1977 to November 1977].
- He was the only governor of the RBI to have risen to the position from the central bank's ranks.
- He is most recognized for the role he played in liberalizing India's banking and financial system.
- He is rightfully the architect of modern Indian banking.
- What is seen in the banking system today in terms of the struggle to bring about change, had its genesis documented in Narasimham's epochal reports.

How did the banking system take in these recommendations?

- **BIS** - The first was bringing in prudential concepts as propounded by the Bank for International Settlements (BIS).
- These were regarding income recognition, capital adequacy, quality of assets, provisioning, etc.
- These concepts took time to digest, and the RBI played a stellar role in bringing them in a calibrated manner so that the system was not disrupted.
- Basel II and Basel III were extensions of the same course.
- To note, the RBI took time to bring the 90-day concept for recognising non-performing assets (NPAs) so that the system was able to absorb this rule.
- **Private banks** - He had propagated the concept of having more private banks.
- This was a timely recommendation as the system was typified by public sector banks (PSBs), given the shadow of nationalisation.
- Getting in new private banks has brought about a technology revolution in the banking sector.
- They have now permeated all banks, making the system globally comparable.
- Along with this suggestion was the extended frame provided to foreign banks

to operate in India.
- There was also a firm signal that there would be no further nationalisation.
- **Interest rates** - The interest rates on deposits and loans were to be freed.
- This was significant because until that point of time all decisions came from the 'above'.
- Here, RBI had gradually moved towards giving banks the freedom to fix their rates on the deposits side.
- However, the lending side is once again back to the fold of partial regulation, with the central bank asking them to follow a formula.
- **CRR & SLR** - The reports argued for sharp reductions in the CRR (Cash Reserve Ratio) and the SLR (Statutory Liquidity Ratio) of banks.
- While banks argue against having a CRR, the system had a rate of 15% in 1989 and again in 1994, after which it has been brought down to 4%.
- The SLR at its peak was at 38.5% in 1990.
- The move to lower these pre-emption reserves owes a lot to the recommendations.
- **Government securities** - The concept of marking-to-market the portfolio of government securities was again a takeaway from the report.
- This was a way of making them market-oriented and also ensuring that the real value of bonds was accounted for by banks.
- **Four-tiered structure of banks** - Narasimham had suggested creating a four-tiered structure of banks, which is seen for the past three decades.
    i. large banks that can be globally competitive
    ii. regional banks that serve specific purposes
    iii. niche banks that cater to communities
    iv. new small banks and payments banks
- This was subsequently strengthened by an RBI committee where differentiated banks were spoken of.
- **Weak banks** - The identification of weak banks and putting conditions was again a concept from the reports.
- It is from this that the RBI has drawn the PCA (Prompt Corrective Action) policy.
- The report suggested ways to tackle such banks and get them out of the mess with narrow banking being an intermediate route.

- **Transparency** - The reports recommended introduction of transparency in bank accounts.
- Today, all annual reports include all disclosures and follow fixed formats.
- It is thus now possible for one to analyse any aspect pertaining to all banks in a uniform manner.

- **Mergers** - The concept of mergers across the financial sector was envisioned

in terms of synergies being created.
- The report also spoke of mergers between PSBs, which is now a reality.

What are the key recommendations yet to be fulfilled?

- **Privatisation of PSBs** - This is something that the government is looking at seriously, as per the Union Budget of 2021-22.
- Banks are being targeted for full disinvestment.
- Given that PSBs that have been merged are out of this loop, it looks like the candidates would be smaller ones.
- These may not have the best financials, though are bestowed with strong infrastructure and processes.
- **Remuneration** - The remuneration factor was something that Narasimham had spoken of for PSBs as recruitment was to be made independent.
- There has been no attempt here on the pay structure, which is still a bargaining process.
- The Indian Banks' Association (IBA) plays a vital role here.
- However, in a rather feeble manner, lateral hiring with market-related salaries for specialised posts has come in from the backdoor.
- Now, even some of the large PSBs have a lateral recruit as a CFO.
- **Priority sector** - The reports recommended reducing the amount of lending that had to go to the priority sector from 40% to 10%.
- There has been no change in this regard and it looks unlikely that this issue will ever be discussed.
- Given the political economy, it looks expedient for governments to retain this limit to show that they are pro-poor.
- There can be arguments on the legitimacy of such lending.
- However, the fact is that if 40% of lendable resources are to be directed at pre-decided sectors, there is less flexibility for banks when it comes to lending.

- **Deposit insurance** - The reports had also recommended differentiated deposit insurance premium for banks.
- This is notable because banks carrying a higher risk on their lending portfolio would be made to pay a higher premium for cover on their deposits.
    - [This is based on the CAMELS (capital adequacy, asset quality, management quality, earnings, liquidity, and sensitivity to market risk) score of RBI.]
- This will be quite appropriate to ensure that banks pay more attention to the quality of assets.
- In all, three decades down the road a lot had changed, albeit gradually.
- On the whole, the progress made is satisfying, given the socio-economic conditions in the economy, but structural changes take time.

Source: Financial Express