

**REPORT**

**OF**

**THE COMMITTEE**

**THE FINANCIAL SYSTEM**

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**THE COMMITTEE**  
**ON**  
**THE FINANCIAL SYSTEM**

**NOVEMBER 1991**

**REPORT**  
of the  
**COMMITTEE ON THE FINANCIAL SYSTEM**

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M Narasimham

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November 8, 1991

Dear Mr Finance Minister.

I have pleasure in sending you the Summary of the Report of the Committee on the Financial System, along with a note by Prof M. Datta Chaudhuri and Shri M R Shroff.

The Committee is now engaged in finalising the Main Report and we hope to be able to submit it shortly.

With regards,

Yours sincerely,

*M. Narasimham*

(M Narasimham)

Encl: Summary of the Report

Dr Manmohan Singh  
Union Minister of Finance  
Government of India  
NEW DELHI

Report of the Committee on the  
Financial System

SUMMARY

1. The Committee's approach to the issue of financial sector reform is to ensure that the financial services industry operates on the basis of operational flexibility and functional autonomy with a view to enhancing efficiency, productivity and profitability. A vibrant and competitive financial system is also necessary to sustain the ongoing reform in the structural aspects of the real economy. We believe that ensuring the integrity and autonomy of operations of banks and DFIs is by far the more relevant issue at present than the question of their ownership.

2. The Indian banking and financial system has made commendable progress in extending its geographical spread and functional reach. The spread of the banking system has been a major factor in promoting financial intermediation in the economy and in the growth of financial savings. The credit reach also has been extensive and the banking system now caters to several million borrowers especially in agriculture and small industry. The DFIs have established themselves as a major institutional support for investment in the private sector. The last decade has witnessed considerable diversification of the money and

capital markets. <sup>3</sup> New financial services and instruments have appeared on the scene.

3. ~~Weakness~~ Despite this commendable progress serious problems have emerged reflected in a decline in productivity and efficiency, and erosion of the profitability of the banking sector. (The major factors responsible for these are: (a) directed investments; and (b) directed credit programmes. (1) In both these cases, rates of interest that were available to banks were less than the market related rates or what they could have secured from alternate deployment of funds. (2) There has been a deterioration in the quality of the loan portfolio which in turn has come in the way of banks' income generation and enhancement of their capital funds. (3) Inadequacy of capital has been accompanied by inadequacy of loan loss provisions. The accounting and disclosure practices also do not always reflect the true state of affairs of banks and financial institutions. (4) The erosion of profitability of banks has also emanated from the side of expenditure as a result of fast and massive expansion of branches, many of which are unremunerative especially in the rural areas, a considerable degree of over-manning especially in the urban and metropolitan centres and inadequate progress in updating work technology. Both management weaknesses and trade union pressures have contributed to this. (5) There have also been weaknesses in the internal organisational structure of the banks, lack of sufficient delegation of authority and inadequate internal controls and

deterioration in what is termed 'housekeeping' such as balancing of books and reconciliation of inter-branch and inter-bank entries.)

The DFIs also suffer from a degree of portfolio contamination. This is more pronounced in the case of the SFCs. Being smaller institutions the internal organisational problems of the DFIs have been less acute than those of the banks. However, both banks and the DFIs have suffered from excessive administrative and political interference in individual credit decision making and internal management.

The deterioration in the financial health of the system has reached a point where unless remedial measures are taken soon, it could further erode the real value of and return on the savings entrusted to them and even have an adverse impact on depositor and investor confidence. This diagnosis of the problems indicates the lines of solution which the Committee proposes with a view as much to improving the health of the system as for making it an integral part of the ongoing process of economic reforms.)

*Major steps*

4. The Committee is of the view that the SLR instrument should be deployed in conformity with the original intention of regarding it as a prudential requirement and not be viewed as a major instrument for financing the public sector.) In line with Government's decision to reduce the fiscal deficit to a level consistent with macro-economic stability, the Committee recommends that the SLR be brought down in a phased manner to 25 per cent over a period of about five years, starting with some reduction in the current year itself.)



5. (As regards the cash reserve ratio, the Reserve Bank should have the flexibility to operate this instrument to serve its monetary policy objectives. The Committee believes that given the Government's resolve to reduce the fiscal deficit, the occasion for the use of cash reserve ratio to control the secondary expansion of credit should also be less. The Committee accordingly proposes that the Reserve Bank consider progressively reducing the cash reserve ratio from its present high level. With the deregulation of interest rates there would be more scope for the use of open market operations by the Reserve Bank with correspondingly less emphasis on variations in the cash reserve ratio.)

6. The Committee proposes that (the interest rate paid to banks on their SLR investments and on CRR, in respect of impounded deposits above the basic minimum should be increased.) As discussed later, (the rates on SLR investments should be progressively market related while that on cash reserve requirement above the basic minimum should be broadly related to banks' average cost of deposits.) However, during the present regime of administered interest rates, this rate may be fixed at the level of banks' one year deposit rate.

7. With respect to directed credit programmes, the Committee is of the view that they have played a useful purpose in extending the reach of the banking system to cover sectors

which were neglected hitherto. Despite considerable unproductive lending, there is evidence that the contribution of bank credit to growth of agriculture and small industry has made an impact. This calls for some re-examination of the present relevance of directed credit programmes at least in respect of those who are able to stand on their own feet and to whom the directed credit programmes with the element of interest concessionality that has accompanied it, has become a source of economic rent. The Committee recognises that in the last two decades banking and credit policies have been deployed with a redistributive objective. However, the Committee believes that the pursuit of such objectives should use the instrumentality of the fiscal rather than the credit system. Accordingly, the Committee proposes that the directed credit programmes should be phased out. This process of phasing out would also recognise the need that for some time it would be necessary for a measure of special credit support through direction. The Committee therefore, proposes that the priority sector be redefined to comprise the small and marginal farmer, the tiny sector of industry, small business and transport operators, village and cottage industries, rural artisans, and other weaker sections. The credit target for this redefined priority sector should henceforth be fixed at 10 per cent of aggregate credit which would be broadly in line with the credit flows to these sectors at present. The Committee also proposes that a review may be undertaken at the end of three years to see if directed credit

programmes need to be continued. (As regards medium and large farmers, and the larger among small industries, including transport operators, etc., who would not now constitute part of the redefined priority sector, the Committee proposes that to further encourage banks to provide credit to these erstwhile constituents of the priority sector, the Reserve Bank and other refinancing agencies institute a preferential refinance scheme in terms of which incremental credit to these sectors would be eligible for preferential refinance subject to normal eligibility criteria.)

8. The Committee is of the view that the present structure of administered interest rates is highly complex and rigid.

This is so in spite of the recent moves towards deregulation.

(The Committee proposes that interest rates be further deregulated so as to reflect emerging market conditions.) (At the same time, the Committee believes that a reasonable degree of macro economic balance through a reduction in the fiscal deficit is necessary for successful deregulation of interest rates.) (Premature moves to market determined interest rates could, as experience abroad has shown, pose the danger of excessive bank lending at high nominal rates to borrowers of dubious credit-worthiness, eventually creating acute problems for both the banks as well as the borrowers. Accordingly, the Committee recommends that for the present, interest rates on bank deposits may continue to be regulated, the ceilings on such rates being raised as the SLR is reduced progressively) as suggested by us earlier.

Similarly, (2) the interest rate on Government borrowing may also be gradually brought in line with market-determined rates which would be facilitated by the reduction in SLR. (4) Meanwhile, the Committee would recommend that (5) concessional interest rates should be phased out. (5) The structure of interest rates should be a broad relationship to the Bank rate which should be used as an anchor to signal the Reserve Bank's monetary policy stance. (6)

(6) It would be desirable to provide for what may be called a prime rate, which would be the floor of the lending rates of banks and DFIs. (7) The spreads between the Bank rate, the bank deposit rates, the Government borrowing rates and the prime rate may be determined by the RBI broadly in accordance with the criteria suggested by the Chakravarty Committee so as to ensure that the real rates of interest remain positive.

9. (8) The inadequacy of capital in the banking system is a cause for concern. (9) While progress towards BIS norms is desirable, the Committee recognises that this will have to be phased over time. The Committee suggests that (10) the banks and financial institutions should achieve a minimum 4 per cent capital adequacy ratio in relation to risk weighted assets (11) by March 1993, of which Tier 1 capital should be not less than 2 per cent. The BIS standards of 8 per cent should be achieved over the period of the following 3 years, that is, by March 1996. For those banks with an international presence it would be necessary to reach these figures even earlier.

10. (1) The Committee believes that in respect of those banks whose operations have been profitable and which enjoy a good reputation in the markets, they could straight-away approach the capital market for enhancement of their capital. (2) The Committee, therefore, recommends that in respect of such banks, issue of fresh capital to the public through the capital market should be permitted. (4) Subscribers to such issues could include mutual funds, profitable public sector undertakings and employees of the institutions besides the general public. (3) In respect of other banks, the Government could meet the shortfall in their capital requirements by direct subscription to capital or by providing a loan which could be treated as subordinate debt.)

11. Before arriving at the capital adequacy ratio for each bank, it is necessary that the assets of the banks be evaluated on the basis of their realisable values. The Committee proposes that the (banks and financial institutions adopt uniform accounting practices particularly in regard to income recognition and provisioning against doubtful debts.) There is need also for adopting sound practices in regard to valuation of investments on the lines suggested by the Ghosh Committee on Final Accounts.

12. In regard to income recognition the Committee recommends that in respect of banks and financial institutions which are following the accrual system of accounting, no income should be recognised in the accounts in respect of non-performing assets.

An asset would be considered non-performing if interest on such assets remains past due for a period exceeding 180 days at the balance sheet date. The Committee further recommends that banks and financial institutions be given a period of three years to move towards the above norms in a phased manner beginning with the current year.

13. For the purpose of provisioning, the Committee recommends that, using the health code classification which is already in vogue in banks and financial institutions, the assets should be classified into four categories namely, Standard, Sub-standard, Doubtful and Loss Assets. In regard to Sub-standard Assets, a general provision should be created equal to 10 per cent of the total outstandings under this category. In respect of Doubtful Debts, provision should be created to the extent of 100 per cent of the security shortfall. In respect of the secured portion of some Doubtful Debts, further provision should be created, ranging from 20 per cent to 50 per cent, depending on the period for which such assets remain in the doubtful category. Loss Assets should either be fully written off or provision be created to the extent of 100 per cent. The Committee is of the view that a period of 4 years should be given to the banks and financial institutions to conform to these provisioning requirements. The movement towards these norms should be done in a phased manner beginning with the current year. However, it is necessary for banks and financial institutions to ensure

that in respect of doubtful debts 100 per cent of the security shortfall is fully provided for in the shortest possible time.

14. The Committee believes that the balance sheets of banks and financial institutions should be made transparent and full disclosures made in the balance sheets as recommended by the International Accounting Standards Committee. This should be done in a phased manner commencing with the current year. The Reserve Bank, however, may defer implementation of such parts of the standards as it considers appropriate during the transitional period until the norms regarding income recognition and provisioning are fully implemented.

15. The Committee suggests that the criteria recommended for non performing assets and provisioning requirements be given due recognition by the tax authorities. For this purpose, the Committee recommends that the guidelines to be issued by the Reserve Bank of India under Section 43 D of the Income Tax Act should be in line with our recommendations for determination of non-performing assets. Also, the specific provisions made by the banks and institutions in line with our recommendations should be made permissible deductions under the Income Tax Act. The Committee further suggests that in regard to general provisions, instead of deductions under Section 36 (1) (vii) being restricted to 5 per cent of the total income and 2 per cent of the aggregate average advances by rural branches, it should

be restricted to 0.5 per cent of the aggregate average non-agricultural advances and 2 per cent of the aggregate average advances by rural branches. This exemption should also be available to banks having operations outside India in respect of their Indian assets, in addition to the deductions available under Section 36 (1) (viii).

16. Banks, at present, experience considerable difficulties in recoveries of loans and enforcement of security charged to them. The delays that characterise our legal system have resulted in the blocking of a significant portion of the funds of banks and DFIs in unproductive assets, the value of which deteriorate with the passage of time. The Committee, therefore, considers that there is urgent need to work out a suitable mechanism through which the dues to the credit institutions could be realised without delay and strongly recommends that Special Tribunals on the pattern recommended by the Tiwari Committee on the subject be set up to speed up the process of recovery. The introduction of legislation for this purpose is long overdue and should be proceeded with immediately.

17. While the reform of accounting practices and the creation of Special Tribunals are essential, the Committee believes that an arrangement has to be worked out under which part at least of the bad and doubtful debts of the banks and financial institutions are taken off the balance sheet so that the banks



could recycle the funds realised through this process into more productive assets. For this purpose, the Committee proposes the establishment, if necessary by special legislation, of an Assets Reconstruction Fund (ARF) which could take over from the banks and financial institutions a portion of the bad and doubtful debts at a discount, the level of discount being determined by independent auditors on the basis of clearly stipulated guidelines. The ARF should be provided with special powers for recovery somewhat broader than those contained in Sections 29-32 of the State Financial Corporation's Act 1951. The capital of the ARF should be subscribed by the public sector banks and financial institutions.

18. It is necessary to ensure that the bad and doubtful debts of banks and financial institutions are transferred to the ARF in a phased manner to ensure smooth and effective functioning of the ARF. To begin with, all consortium accounts where more than one bank or institution is involved should be transferred to the ARF. The number of such accounts will not be large but the amounts involved are substantial to make a difference to the balance sheets of banks. Gradually, depending on the progress achieved by the ARF, other bad and doubtful debts could be transferred over time. Meanwhile, banks and institutions should pursue recovery through the Special Tribunals. Based on the valuation given in respect of each asset by a panel of at least two independent auditors, the ARF would issue bonds to the concerned institution carrying an interest rate equal to

the Government bond rate and repayable over a period of 5 years. These bonds will need to be guaranteed by the Government of India and should be treated as qualifying for SLR purposes. The advantage to banks of this arrangement would be that their bad and doubtful debts would be off their books though at a price but they would have in substitution of these advances bonds upto the discounted value with a certainty of interest income which would be an obviously important aspect from the point of view of income recognition, and further by making these bond holdings eligible for SLR purposes, banks' fresh resources could become available for normal lending purposes. We wish to emphasise that this proposal should be regarded as an emergency measure and not as a continuing source of relief to the banks and DFIs. It should be made clear to the banks and financial institutions that once their books are cleaned up through this process, they should take normal care and pay due commercial attention in loan appraisals and supervision and make adequate provisions for assets of doubtful realisable value.

19. Selling these assets to the Fund at a discount would obviously mean an obligation on the banks/DFIs to write off these losses which many of them are in no position to do now, given their weak capital position. We propose that to enable the banks to finance the write off represented by the extent of the discount, the Government of India would, where necessary, provide, as mentioned earlier, a subordinated loan counting for capital.

As far as the Government of India itself is concerned, we believe that the rupee counterpart of any external assistance that would be available for financial sector reform could be used to provide this type of capital to the banks and DFIs.

20. The ARF would be expected to deal with those assets which are in the process of recovery. In respect of sick units which are under nursing or rehabilitation programmes, it is necessary to work out a similar arrangement to ensure smooth decision making and implementation in respect of such nursing programmes. The Committee recommends that in respect of all such consortium accounts which are under a nursing programme or in respect of which rehabilitation programmes are in the process of being worked out, the concerned lead financial institution and/or lead commercial bank should take over the term loan and working capital dues respectively from other participating institutions and banks. Such acquisitions should be at a discount based on the realisable value of the assets assessed by a panel of at least two independent auditors as in the case of transfer of assets to ARF.

21. In regard to the structure of the banking system, the Committee is of the view that the system should evolve towards a broad pattern consisting of:

- (a) 3 or 4 large banks (including the State Bank of India) which could become international in character;

- (b) 8 to 10 national banks with a network of branches throughout the country engaged in 'universal' banking;
- (c) Local banks whose operations would be generally confined to a specific region; and
- (d) Rural banks (including RRBs) whose operations would be confined to the rural areas and whose business would be predominantly engaged in financing of agriculture and allied activities.

The Committee is of the view that the move towards this revised system should be market driven and based on profitability considerations and brought about through a process of mergers and acquisitions.

22. The Committee is of the view that the structure of rural credit will have to combine the local character of the RRBs and the resources, skills and organisational/managerial abilities of the commercial banks. With this end in view the Committee recommends that each public sector bank should set up one or more rural banking subsidiaries, depending on the size and administrative convenience of each sponsor bank, to take over all its rural branches and, where appropriate, swap its rural branches with those of other banks. Such rural banking subsidiaries should be treated on par with RRBs in regard to

CRR/SLR requirements and refinance facilities from NABARD and sponsor banks. The 10 per cent target for directed credit which we have recommended as a transitional measure should be calculated on the basis of the combined totals of the parent banks and their subsidiaries. The Committee proposes, that while RRBs should be allowed to engage in all types of banking business, their focus should continue to be to lend to the target groups to maintain at a minimum the present level of their lending to these groups. With a view to improving the viability of their operations, the Committee proposes that the interest rate structure of the RRBs should be in line with those of the commercial banks. The Committee would leave the option open to the RRBs and their sponsor banks as to whether the RRBs should retain their identity so that their focus on lending to the target groups is not diffused or where both the RRBs and the sponsor banks wish to do so they could be merged with the sponsor banks and the sponsor banks in such cases should take them over as 100 per cent subsidiaries by buying out the shares from other agencies at a token price, and eventually merge them with the rural banking subsidiaries which we have proposed. For those RRBs that retain their identity and whose viability would need to be improved, we propose that instead of investing in Government bonds as part of their SLR requirements, they could place the amounts stipulated under SLR as deposits with NABARD or some special federal type of agency that might be set up for this purpose. This would also be

consistent with the statutory requirements in this regard and NABARD or this agency could pay interest on such balances by investing or deploying these funds to the best advantage on their behalf and thus help to augment the income of the RRBs.

23. The Committee proposes that Government should indicate that there would be no further nationalisation of banks. Such an assurance will remove the existing disincentive for the more dynamic among the private banks to grow. The Committee also recommends that there should not be any difference in treatment between the public sector and the private sector banks. The Committee would propose that there be no bar to new banks in the private sector being set up provided they conform to the start-up capital and other requirements as may be prescribed by the Reserve Bank and the maintenance of prudential norms with regard to accounting, provisioning and other aspects of operations. This in conjunction with the relevant statutory requirements governing their operations would provide adequate safeguards against misuse of banks' resources to the detriment of the depositors' interests.

24. The Committee recommends that branch licensing be abolished and the matter of opening branches or closing of branches (other than rural branches for the present) be left to the commercial judgment of the individual banks.

25. The Committee also believes that, consistent with other aspects of Government policy dealing with foreign investment, the policy with regard to allowing foreign banks to open offices in India either as branches or, where the Reserve Bank considers it appropriate, as subsidiaries, should be more liberal, subject to the maintenance of minimum assigned capital as may be prescribed by the Reserve Bank and the statutory requirement of reciprocity. Joint ventures between foreign banks and Indian banks could also be permitted, particularly in regard to merchant and investment banking, leasing and other newer forms of financial services.

26. Foreign banks when permitted to operate in India should be subjected to the same requirements as are applicable to domestic banks. If, in view of certain constraints such as absence of branch network, the foreign banks are unable to fulfil certain requirements such as directed credit (of 10 per cent of aggregate credit) the Reserve Bank should work out alternative methods with a view to ensuring a level playing field.

27. The Committee is of the view that the foreign operations of Indian banks need to be rationalised. In line with the structure of the banking system visualised above, there would seem to be scope for one or more of the large banks, in addition to the SBI, to have operations abroad in major international financial centres and in regions with strong Indian ethnic

presence. Pending the evolution of a few Indian banks with an international character, the Committee recommends as an interim measure that those Indian banks with the largest presence abroad and strong financial position could jointly set up one or more subsidiaries to take over their existing branches abroad. The SBI operations abroad can continue and indeed be strengthened in the course of time. The Government may also consider the larger banks increasing their presence abroad by taking over existing small banks incorporated abroad as a means of expanding their international operations.

28. The Committee believes that (the internal organisation of banks is best left to the judgment of the managements of individual banks, depending upon the size of the bank, its branch spread and range of functions.) (However, (for the medium and large national banks the Committee proposes a three-tier structure in terms of head office, a zonal office and branches. In the case of very large banks, a four-tier organisation, as is the case with the State Bank, with head office, zonal office, regional office and branch may be appropriate. Local banks may not need an intermediate tier between the branch and the central office.)

29. The Committee endorses the view of the Rangarajan Committee on Computerisation that (there is urgent need for a far greater use of computerised systems than at present.)



Computerisation has to be recognised as an indispensable tool for improvement in customer service, the institution and operation of better control systems, greater efficiency in information technology and the betterment of the work environment for employees. These are essential requirements for banks to function effectively and profitably in the increasingly complex and competitive environment which is fast developing in the financial services segment of the economy.)

30. Consistent with the Committee's view that the integrity and internal autonomy of banks and DFIs is far more important than the question of ownership,) the Committee makes the following recommendations regarding recruitment of officers & staff and appointments of chief executives and constitution of the boards of the institutions:

31. The Committee recommends that instead of having a common recruitment system for officers (individual banks should be free to make their own recruitment.) (Thus there is no need for setting up a Banking Service Commission for centralised recruitment of officers nor for their recruitment, as at present, through Banking Service Recruitment Boards (BSRBs).) (This will provide scope for the banks to scout for talent and impart new skills to their personnel.) The Committee, however, predicates this recommendation on the assumption that the banks will set up objective, fair and impartial recruitment procedures and, wherever appropriate, they could voluntarily come together to

have a joint recruitment system. As regards clerical grades, the present system of recruitment through BSRBs may continue but we would urge that the appointment of the Chairmen of these Boards should be totally left to the coordinating banks.

32. The Committee believes that there has to be a recognition on the part of managements and trade unions that the system cannot hope to be competitive internally and be in step with the wide-ranging innovations taking place abroad without a radical change in work technology and culture, and greater flexibility in personnel policies. We have been reassured to know that organised labour is as much convinced of the importance of enhancing the viability and profitability of the banking industry and providing efficient customer service. It is equally incumbent on management of banks to adapt forward looking personnel policies which would help to create a satisfying work environment.

33. The Committee recommends that the various guidelines and directives issued by the Government or the Reserve Bank in regard to internal administration of the banks should be reviewed to examine their continuing relevance in the context of the need to ensure the independence and autonomy of banks. Such guidelines which relate to matters of internal administration such as creation and categorisation of posts, promotion procedures and similar matters should be rescinded.

34. The Committee believes that the Indian banking system, at present, is over-regulated and over-administered.) Supervision should be based on evolving prudential norms and regulations which should be adhered to rather than excessive control over administrative and other aspects of bank organisation and functioning. The Committee would also like to place greater emphasis on internal audit and internal inspection systems of banks. The inspection by the supervisory authorities should be based essentially on the internal audit and inspection reports. Their main concern should be to ensure that audit and inspection machinery (which will cover the credit appraisal system and its observance) is adequate and conforms to well laid down norms.

35. The Committee is firmly of the opinion that the duality of control over the banking system between the Reserve Bank and the Banking Division of the Ministry of Finance should end and that the Reserve Bank should be the primary agency for the regulation of the banking system.) The supervisory function over the banks and other financial institutions, the Committee believes, should be hived off to a separate authority to operate as a quasi-autonomous body under the aegis of the Reserve Bank but which would be separate from other central banking functions of the Reserve Bank. The Committee recognises that as long as the Government has proprietary interest in banks and financial institutions, it would be appropriate for the Ministry of Finance to deal with other Government departments and Parliament and

discharge its other statutory obligations but not to engage in direct regulatory functions.

36. (Central to the issue of flexibility of operations and autonomy of internal functioning is the question of depoliticising the appointment of the chief executive (CMD) of the banks and the boards of the banks and ensuring security of tenure for the CMD. The Committee believes that professionalism and integrity should be the prime considerations in determining such appointments and while the formal appointments have to be made by Government, they should be based on a convention of accepting the recommendations of a group of eminent persons who could be invited by the Governor of the Reserve Bank to make recommendations for such appointments. As regards the boards of public sector banks and institutions, as long as Government owns the banks, it would be necessary to have a Government director to take care of 'proprietary' concerns but we believe that there is no need for the Reserve Bank to have a representative on the boards.

37. (As regards development financial institutions, the main issue with regard to their operations are to ensure operational flexibility, a measure of competition and adequate internal autonomy in matters of loan sanctioning and internal administration.) The Committee proposes that the (system recommended for commercial banks in the matter of appointment of chief executives and boards should also apply to DFIs.) The

present system of consortium lending has been perceived as operating like a cartel. The Committee believes that consortium lending should be dispensed with and, in its place, a system of syndication or participation in lending, at the instance not only, as now, of the lenders but also of the borrowers, should be introduced. The Committee also believes that commercial banks should be encouraged to provide term finance to industry, while at the same time, (the DFIs should increasingly engage in providing core working capital.) (This will help to enhance healthy competition between banks and DFIs.) The Committee proposes that the present system of cross holding of equity and cross representation on the boards of the DFIs should be done away with. The Committee welcomes the removal of the tax concession enjoyed by IDBI as an important step in ensuring equality of treatment between various DFIs. As a further measure of enhancing competition and ensuring a level playing field, the Committee proposes that the IDBI should retain only its apex and refinancing role and that its direct lending function be transferred to a separate institution which could be incorporated as a company. (The infected portion of the DFI's portfolio should be handed over to the ARF on the same terms and conditions as would apply to commercial banks.)

38. In the case of state level institutions, it is necessary to distance them from the State Governments and ensure that they function on business principles based on prudential norms and have a management set-up suited for this purpose. We

propose that an action plan on these lines be worked out and implemented over the next 3 years.

39. As regards the role of DFIs in corporate take-overs, the Committee believes that DFIs should lend support to existing managements who have a record of conducting the affairs of the company in a manner beneficial to all concerned, including the shareholders, unless in their opinion the prospective new management is likely to promote the interests of the company better. In doing so we would expect the institutions to exercise their individual professional judgment.

40. The DFIs should seek to obtain their resources from the market on competitive terms and their privileged access to concessional finance through the SLR and other arrangements should gradually be phased out over a period of three years.

41. The last decade has witnessed a considerable growth in capital market operations with the emergence of new instruments and new institutions. The capital market, however, is tightly controlled by the Government whose prior approval is invariably required for a new issue in the market, the terms of the issue and its pricing. The process of setting up Securities and Exchange Board of India (SEBI) for overseeing the operations of the market is still not complete with the legislation for this purpose yet to be enacted. We

believe the present restrictive environment is neither in tune with the new economic reforms nor conducive to the growth of the capital market itself.

42. The Committee strongly favours substantial and speedy liberalisation of the capital market. Prior approval of any agency -- either Government or SEBI -- for any issue in the market should be dispensed with. The issuer should be free to decide on the nature of the instrument, its terms and its pricing. We would recommend, in this context, that the SEBI formulate a set of prudential guidelines designed to protect the interests of investor, to replace the extant restrictive guidelines issued by the Controller of Capital Issues (CCI). In view of the above, the office of the CCI will cease to have relevance. In the Committee's view, SEBI should not become a controlling authority substituting the CCI, but should function more as a market regulator to see that the market is operated on the basis of well laid down principles and conventions. The capital market should be gradually opened up to foreign portfolio investment and simultaneously efforts should be initiated to improve the depth of the market by facilitating issue of new types of equities and innovative debt instruments. Towards facilitating securitisation of debt, which could increase the flow of instruments, appropriate amendments will need to be carried out in the Stamp Acts.

43. In the last decade several new institutions have appeared on the financial scene. Merchant banks, mutual funds, leasing companies, venture capital companies and factoring companies have now joined hire purchase companies in expanding the range of financial services available. However, the regulatory framework for these new set of institutions has still to be developed.

44. The Committee recommends that the supervision of these institutions which form an integral part of the financial system should come within the purview of the new agency to be set up for this purpose under the aegis of the RBI. The control of these institutions should be principally confined to off-site supervision with the on-site supervision being resorted to cases which call for active intervention. The SEBI which is charged with the responsibility of ensuring orderly functioning of the market should have jurisdiction over these institutions to the extent their activities impinge on market operations. In regard to mutual funds there is a good case for enacting new legislation on the lines obtaining in several countries with a view to providing an appropriate legal framework for their constitution and functioning. The present guidelines with regard to venture capital companies are unduly restrictive, and affecting the growth of this business and need to be reviewed and amended.

45. As in the case of banks and financial institutions there is need to lay down prudential norms and guidelines governing the functioning of these institutions. These prudential guidelines



should relate, among other things, to capital adequacy, debt equity ratio, income recognition provisioning against doubtful debts, adherence to sound accounting and financial policies, disclosure requirements and valuations of assets. The eligibility criteria for entry, growth and exit should also be clearly stipulated so that the growth of these institutions takes place on proper lines.

46. The Committee would like to emphasise that a proper sequencing of reforms is essential. Deregulation of interest rates can only follow success in controlling fiscal deficits. Asset reconstruction, institution of capital adequacy and establishment of prudential norms with a good supervisory machinery have to be proceeded with in a phased manner over the next 3 to 5 years but, we believe, it is important that the process must begin in the current year itself.

47. The above set of proposals would necessitate certain amendments in existing laws which the Government should undertake expeditiously.

48. The Committee's approach thus seeks to consolidate the gains made in the Indian financial sector while improving the quality of the portfolio, providing greater operational flexibility and most importantly greater autonomy in the internal operations of the banks and financial institutions so as to nurture a healthy, competitive and vibrant financial sector. This will,

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above all else, require depoliticisation of appointments, implying at the same time a self-denial by Government and the perception that it has distanced itself from the internal decision-making of the banks and the financial institutions. The proposed deregulation of the financial sector and the measures aimed at improving its health and competitive vitality would, in the Committee's view, be consistent with the steps being taken to open up the Indian economy, enable the Indian financial sector to forge closer links with the global financial markets, and enhance India's ability to take competitive advantage of the increasing international opportunities for Indian trade, industry and finance.

Note by Prof M Datta Chaudhuri and Shri M R Shroff

The Summary Report starts with the following statements: :

"The Committee's approach to the issue of financial sector reform is to ensure that the financial services industry operates on the basis of operational flexibility and functional autonomy with a view to enhancing efficiency, productivity and profitability. A vibrant and competitive financial system is also necessary to sustain the ongoing reform in the structural aspects of the real economy. We believe that ensuring the integrity and autonomy of operations of banks and DFIs is by far the more relevant issue at present than the question of their ownership."

The Committee has thus rightly identified the question of "ensuring the integrity and autonomy of operations of banks and DFIs" as the principal concern of the Report. The Committee predicated its various recommendations on the belief that it is possible to achieve these objectives without bringing in the question of ownership. These recommendations go a long way in creating conditions whereby market disciplines can be brought into the functioning of the public sector banks and financial institutions. But we believe that in the prevailing political culture of the country, it is important to move further to make the autonomy of these institutions credible.

In line with the above and the concept of self-denial by the Government of its ownership rights, which the Committee has rightly advocated, we think that the Government should not

appoint its officials on the boards of public sector banks and financial institutions. The Banking Division of the Ministry of Finance, as at present constituted, should consequently be abolished.

We are conscious of the Government's accountability to Parliament and the public as owner of these institutions. But accountability need not mean involvement in functions which are the responsibility of boards and managements and can be ensured by an adequate system of reporting through the Reserve Bank which, the Committee has rightly stressed, should be the prime agency for the regulation of the banking system. The continuance of Government directors on the boards of the banks and financial institutions will come in the way of ending the duality of control between the Reserve Bank and the Banking Division as recommended by the Committee.

We think that a decision by the Government not to have its representatives on the boards of public sector banks and financial institutions will serve as a strong message of autonomy to the system and will create a climate conducive to the successful implementation of the other recommendations of the Committee.

M. Narasimham

Administrative Staff College of India  
Bella Vista  
Hyderabad 500 049

November 16, 1991

Dear Mr Finance Minister,

Further to my letter of November 8, 1991, I have pleasure in now submitting the Main Report of the Committee on the Financial System. A note by Prof M Datta Chaudhuri and Shri M R Shroff is also appended.

The Committee expresses its appreciation to the large number of representative organisations and individuals who submitted written memoranda to the Committee at its request on the subjects of the Committee's enquiry, and especially to those organisations who, at their request, tendered oral evidence to the Committee in addition to submission of their views in writing.

The other members of the Committee and I would like to place on record our appreciation of the contribution to the work of the Committee made by our Member-Secretary, Shri K Jayabharath Reddy, who brought to bear on the deliberations of the Committee his intimate knowledge of the issues pertaining to the financial sector. The Committee would also like to record its appreciation of the assistance received from Smt Anita Kapur and Shri K K Bhargava (of the Banking Division of the Ministry of Finance), S/Shri K Sivaraman and R J Fernandes (of the Reserve Bank of India), S/Shri D Basu and D J Kanvinde (of the State Bank of India) and Shri R Nangia of ICICI.

The Reserve Bank of India provided excellent logistic support and the Committee would like to convey its special appreciation for this to the Bank.

Shri Samuel Abraham of the Administrative Staff College of India bore the brunt of the stenographic and typing work and his services deserve special mention.

With best regards,

Yours sincerely,

*M. Narasimham*

(M Narasimham)

Encl: Report

Dr Manmohan Singh  
Union Minister of Finance  
Government of India  
NEW DELHI