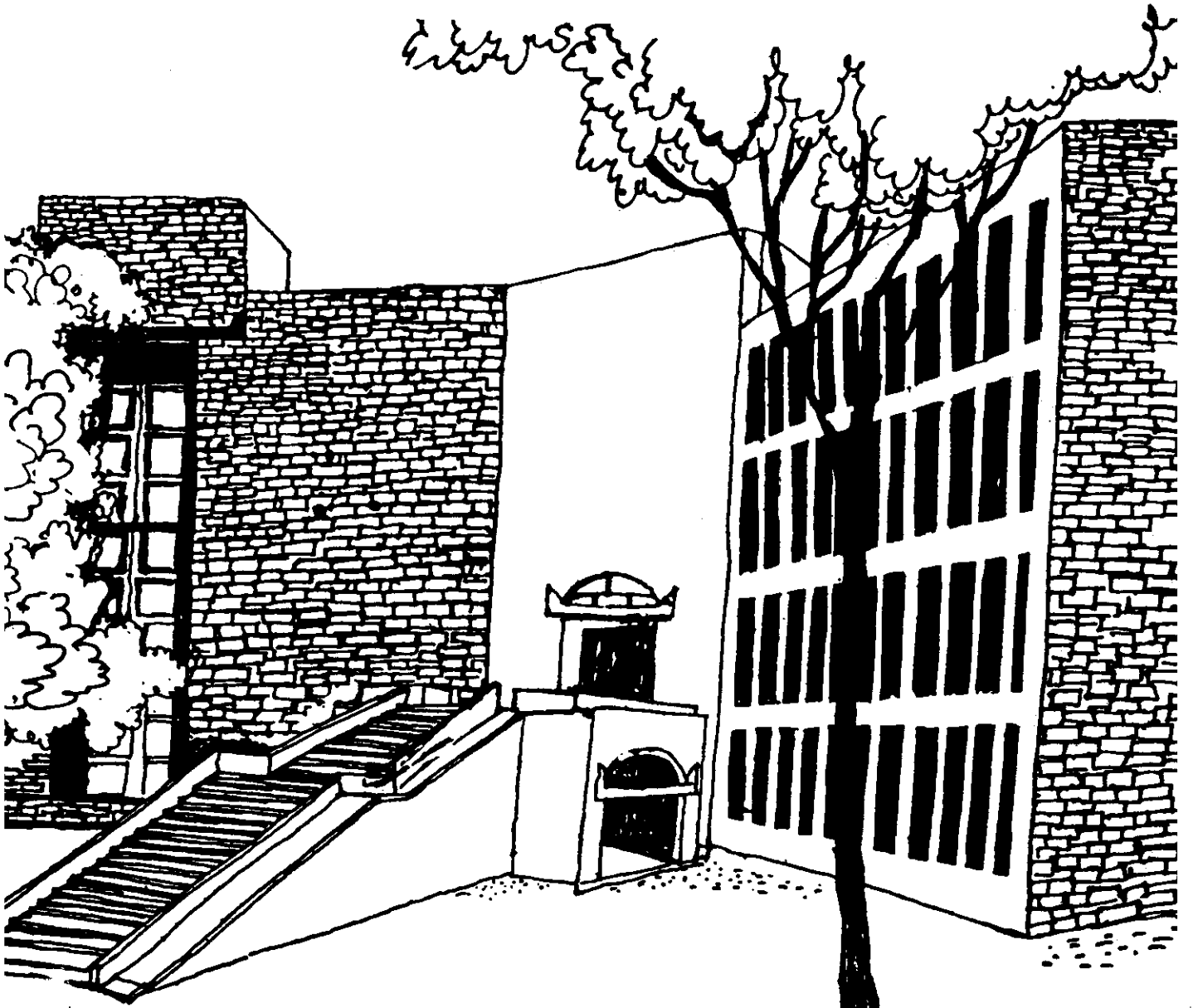




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**NARASIMHAM COMMITTEE REPORT - Some
Further Ramifications and Suggestions**

By

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And M.C. Bhatt

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ABSTRACT

This paper while agreeing with the general thrust of the Narasimham Committee Report, calls attention to some logical corollaries of the Report and analyses some possible fall-out from implementing the Report.

We agree with the view that control of banking system should be under an autonomous body supervised by the RBI. However at the level of individual banks, closer scrutiny of lending procedures may be called for than is envisaged in the Report.

In a freely functioning capital market the potential of government bonds is enormous, but this necessitates restructuring of the government bond market. The government bonds may then also be used as suitable hedging mechanisms by introducing options and futures trading. We recommend freeing up the operation of pension and provident fund to enable at least partial investment of such funds in risky securities.

In the corporate sector, we believe that the current 2:1 debt equity norm is too high and not sustainable in the long term. We envisage that high debt levels and higher interest rates, combined with higher business risk may result in greater incidence of corporate sickness. This may call for various schemes for retrenched workers and amendment to land laws for easy exit of companies.

On account of interdependencies across different policies, any sequencing of their implementation may be highly problematic. We therefore suggest a near simultaneity in the implementation of various reforms in order to build up a momentum which would be irreversible if people are to have confidence that the reforms will endure, and if we are to retain our credibility with international financial institutions.

Narasimham Committee Report - Some Further Ramifications and Suggestions

By: J.R. Varma, V. Raghunathan, A. Korwar, and M.C. Bhatt

The Narasimham Committee Report is without doubt a major path-breaking piece of work and deserves the support of all who yearn for a more rational and effective banking system in this country.

We strongly agree with the general thrust of the report and enthusiastically endorse its major recommendations. In particular, we welcome its proposals to delink the entire issue of concessional credit from the issue of banking operations, to reduce the SLR limits, to strengthen the capital base of banks, and to bring about a general freeing of interest rates. We also strongly endorse the call for greater transparency in banking reports as well as the proposal to strengthen the regulatory role of SEBI while abolishing the office of the CCI. The concept of ARF for bad debts and the idea of having special tribunals to expedite recovery of dues are also very practical and eminently implementable.

The intent of this note is not to comment paragraph by paragraph on the Committee Report or to attempt to pick holes in what is a welcome as well as a comprehensive set of recommendations to reform the banking system. Instead, what we shall attempt to do here is to call attention to some natural corollaries of the Report, and to speculate about some possible fall-out from implementing the Report which the Government and the financial system in general may want to look out for.

The note is structured as follows: in the first section, we shall begin with a few brief remarks about the structure of the banking system. In the second part, we examine the implications of the Report for the government bond markets. This will be followed by a look at the implications for the corporate sector. After this section, a brief look at the implications for the rural sector will be followed by a section on the requirements for globalization of the banking system. Next we offer some thoughts regarding the financial auditing and consulting sector. Finally, a look at the interlinkages between the financial sector and the real economy, and we conclude with a word about the pace of reform.

I. Structure and Control of Banks

We entirely agree with the Narasimham Committee that overall control of the banking system should be in the hands of a

* The authors are members of the faculty at IIM, Ahmedabad. The first two authors would like to acknowledge partial support by a research grant from IIM, Ahmedabad.

quasi-autonomous body under the aegis of the RBI. This autonomous body should focus on evolving very broad guidelines within which banks should function, and also specifically indicate where matters should be referred to it for advice or decision. We shall deal with the issue of supervision of individual banks in a later section.

We also agree with the opinion of two of the members of the Narasimham Committee that Government or RBI representation on the board is not necessary. We strongly feel that the boards of banks should draw upon experts from management and financial institutions, industry, and professionals to function as directors, especially those with wider experience in systems and business processes in different parts of the world.

II. Restructuring the Government Bond Market

Today, the government bond market is exclusively the province of banks and banking institutions. From the point of view of the banks, the chief function of government bonds is to satisfy the SLR requirements.

One likely consequence of the proposed reduction in SLR limits from 38.5% to 25% is that government bonds will increasingly be subject to some of the market pressures other bonds experience in financial markets. The government bond market is likely to be increasingly integrated into the mainstream capital market with investors comparing the yields on government bonds with yields available on comparable financial instruments elsewhere.

A considerable widening and deepening of the government bond market will be necessary to handle these changes. Currently, while government bonds are listed on the stock exchanges, they are not actively traded. Trading is essentially restricted to the inter-bank market.

The potential role of government bonds in a freely functioning capital market is enormous - one has only to observe that the U.S. treasury bill and bond market is the largest in the world, to recognize this fact.

Because of the virtual absence of default risk on government debts, government bonds have the potential to offer investors a riskless investment with which to manage overall portfolio risk. Private corporate funds, both large and small, would be attracted to such an investment as a place to park cash without undue risk. Mutual funds could use the government bond markets to manage the risk of their overall portfolios on a day to day basis - switching in and out of government bonds depending on their perception of the likely course of the stock markets.

Government bonds are also an excellent vehicle to manage inflation risk - in a freely functioning bond market, yields on gov-

ernment bonds would have high correlations with expected inflation rates. Forecasting of inflation rates would also become possible as the government bond market develops and matures. Various organizations including corporations, trade associations and trade unions could use such forecasts in pricing and bargaining.

Individuals would be able to use government bonds as part of their investment strategy, especially for trusts and legacies for their children.

To cater to such demands, a number of bond trading firms would probably arise, specializing in dealing in government bonds. Operating on thin, almost invisible margins, such firms would help keep the government bond markets efficient in the informational efficiency sense, rather like Salomon Brothers, for instance, in the U.S.

Public sector enterprises and government agencies may well find that an active, efficient bond market which attracts private capital could be a major source of much-needed funds.

SLR

It is clear that the SLR limits are intended mainly to ensure that banks maintain adequate liquidity to discharge their obligations. It is difficult to see how long-term bonds - government or otherwise - could qualify as liquid assets. At the same time, there are a number of other financial assets which could qualify - short-term corporate debt instruments like commercial paper of the highest quality, for instance. There is a need to rethink the meaning of liquidity, keeping foremost the basic intent of the SLR. This would be in line with the spirit of the Narasimham Committee Report - to return to sound banking practices. It would, in any case, be necessitated by the expected integration of the government bond market with the rest of the financial markets.

Trust Securities

Bringing government bonds into the mainstream of financial markets would also mean that they should compete openly with other high-grade securities for inclusion in the portfolios of provident funds and pension funds. These, and similar bodies, are currently required to invest only in approved Trust securities which are essentially government bonds. We believe that non-government securities of comparable risk should be permitted as investment vehicles.

In a further move to free up the operation of pension and provident funds, employees - the ultimate investors - should be permitted the option of choosing to have their funds deployed at least partly in equity securities. We believe such liberalisation of the investment activities of pension and provident funds will fuel an unprecedented boom in such funds. Strong funds of this

kind can help mobilize savings just as mutual funds have in the past few years.

Strong pension funds can serve two purposes - they can act as major sources of funding, both loans and equity, for companies in both the private and public sector. This would help alleviate some of the financing crunch so many companies are facing today. Secondly, well-managed pension funds can provide the banking system some healthy competition, which would force them to strive for greater efficiency and productivity.

Interest Rate Hedging

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With interest rates deregulated, there will be a need to develop suitable hedging mechanisms in the form of futures and options.

In the long run, these mechanisms may well be needed for all securities. However, since government bonds would be influenced by a relatively small number of factors such as inflation and the term structure of interest rates, they would provide an ideal vehicle to experiment and learn how to operate options and futures markets in the Indian context. We believe government bonds should be the first choice of securities exchange boards contemplating introducing options and futures trading.

III. The Corporate Sector

If we compare corporate debt levels in India with those elsewhere, we would find that Indian companies operate with an astoundingly high degree of borrowing. Debt levels of 2:1 and 3:1 are commonplace in India - whereas they would be unthinkable in most other financial markets of the world.

There are many aspects to this issue - a high debt level permits control of the company with a very small equity investment. The results of such 'control without commitment' are not always healthy for the company, to say the least. When major shareholders strip a company of its productive earning power and leave a shell behind, at least part of the blame must be ascribed to a system which allows such extraordinary levels of debt financing.

In economic downturns and recessions - inevitable in any economy - high levels of debt will often cause a company to fall when it should only stumble.

Why have such high debt levels been permitted? There are probably many reasons, rooted in the history of the growth pains of a developing economy. One such reason would be that government controlled financial institutions have often seen it as their duty to provide funds to an 'approved' company - namely, any company which has been able to secure a license. Even companies implementing the riskiest of projects have been able to find debt financing, often at concessional rates, once they have been able to get a license for the project.

With the reform of the financial system proposed by the Narasimham Committee, financial institutions will begin to move away from such concerns with developmental or societal objectives. One result will be that corporations will be forced to reduce their reliance on debt financing.

There are atleast three other reasons why the historical high debt levels of corporations cannot be sustained in the future. One is that, as the interest rates are deregulated, they are likely to rise, atleast in the short term. This is especially the case because so much of corporate debt has been obtained in the past at concessional rates from financial institutions. The increase in interest rates will increase the debt service burden sharply at current levels of borrowings. As the equity markets grow, equity financing will appear more and more attractive in comparison.

Further, with the greater reliance upon borrowing from the capital markets rather than from Development Finance Institutions, there will be less flexibility in terms of rescheduling of payments, since it is hardly practicable to convene a meeting of debenture-holders at every turn.

Finally, since high debt levels increase the overall risk of the corporation, companies will have to seek ways to control their financial risk as they struggle to cope with the increased business risks they will face in openly competitive product markets. With the risk of mistakes and stumbles greatly increased, companies will find their equity values depressed if they burden themselves with debt and thereby invite financial disasters. This is one of the likely but thus far unheralded consequences of the liberalization of industrial policy by the present government, which has left few protected markets for companies to keep harvesting as they have in the past.

Corporate Sickness

Until such time as the corporate debt levels are brought down to more manageable levels, the corporate sector will probably see a greater incidence of sickness on account of its inability to absorb the higher debt service charges. This is especially true of the older, more established companies which will, at the same time, find their hitherto profitable and protected markets invaded by new and more aggressive competitors. The erosion of profitability and the increase in debt service burden will be a vice many such companies will find themselves inexorably squeezed in. Needless to say, this brings up issues such as exit policy, which we address in the section on Interlinkages.

At this stage, however, we suggest that the debt equity norm should be reduced in a time-bound manner, say over a period of two years, from 2:1 to 1:1, in order to give the corporate sector some time to adjust their long-term financing mix. Eventually, ofcourse, the debt equity norm will have to be determined purely

on business considerations, and will vary in a complex manner from industry to industry if not from company to company. However, a phased move in this direction must be implemented as soon as the Narasimham Committee report itself is implemented in its final form.

IV. Rural Sector Banks

With the implementation of the Narasimham Committee Report, commercial banks will no longer be cross-subsidizing loans to the rural sector with earnings from the urban sector.

While this will certainly put an end to the strategic schizophrenia banks have been afflicted with in the past, it does mean that commercial banks, including their rural subsidiaries, will find it increasingly difficult to compete with specialized rural banks. We anticipate that the need and the demand for credit in the rural sector will only grow as the economy grows. To meet this demand, a number of such specialized banks are likely to arise, probably floated by entrepreneurs with strong rural roots.

Because such entrepreneurs are likely to perform much better than the rural subsidiaries of the existing commercial banks at the critical tasks of credit appraisal and understanding the real needs of rural people, we expect these new financial institutions to serve rural markets better. However, they will always suffer from two major problems: they will always be localized and therefore not adequately diversified, which will make them prone to failure with every local disaster; secondly, they will be short of capital in the short run.

We expect that government will have to find ways to provide capital to such new banks, preferably in the form of venture capital in the form of equity. It is hard to see what can be done to solve the problem of inadequate geographical diversification without jeopardizing the strong local expertise which will be the main competitive advantage for these new banks.

V. Globalization of Banking and Financial Institutions

As the Indian economy becomes more integrated with the global economy, the global role of banks will also have to keep pace. The role of banks will have to cover wider areas such as marketing efforts to attract foreign investment and NRI investment, financing and promotion of technology transfer into and out of the country, and resource mobilization for large projects by syndication of foreign investment.

Joint ventures between foreign banks and Indian banks should be actively encouraged in merchant banking, investment banking, and leasing, where Indian banks would have a lot to learn about international practices. Export of financial services may well become a major source of foreign exchange for India if we can forge alliances whereby India's enormous pool of educated professionals can be trained in world-class practices by such collabor-

rations. Developing countries in Africa, the Middle East, and Asia, as well as in Eastern Europe and Republic of Russia, could well benefit from such advisory services from Indian banks.

Indian banks such as Bank of Baroda, which already have a good track record in banking abroad, could be prime candidates for joint ventures with foreign banks. Such ventures could even be selectively localized - for instance, a joint venture in Belgium could focus on activities in the EC, including promotion of exports from India and joint ventures by Indian companies.

In short, there is considerable scope for enhancing both vertically and horizontally the activities of banks in much wider areas than their present function of purely banking.

VI. Financial Auditing and Consulting

We believe that the scheme proposed by the Committee for supervision of banks will be found to be inadequate, in as much as it relies strongly on self-regulation by banks with a small supervisory board for the entire banking system.

While we agree with the concept of having a quasi-autonomous body under the RBI setting broad policy parameters for the banking system as a whole, we believe that, at the level of the individual banks, closer scrutiny of lending practices is called for than is envisaged in the Report.

The main aim of bank supervision should be to protect the interests of depositors and to prevent any run on the banking system which may follow any significant bank failures.

We propose that the best way to ensure this would be a strong system of bank examiners, coupled with a system of insurance of bank deposits.

Bank examiners would be charged with the task of auditing the portfolios of individual banks, at a detailed level, and to assess the overall portfolio of the individual bank. Examiners should be able to provide an early warning system to the bank itself as well as to the RBI if the bank has excessive exposure to particular risks, for instance. Such examiners would need to be independent of both the bank and the RBI. Ideally, they would be professionals, trained in financial and investment management. We suggest that the RBI hire such professional services on a contract basis.

A number of other financial services would need to be developed. For instance, we have proposed in the section on government bonds that pension and provident funds be allowed to invest in 'high grade' debt securities other than government bonds. Naturally, then, there will be a need for a number of independent agencies specializing in the appraisal of debt securities.

VII. Interlinkages with the Real Economy

Strong interrelationships obviously exist between the banking system and the rest of the economy.

Exit Policy

Opening up the entries but keeping the exit clogged is clearly not a viable procedure. The need for a workable exit policy to go along with the liberal entry policies introduced by the current government, is a rather obvious one.

The point to be made here is that this need for a workable exit policy will be greatly increased by some of the fallouts from the proposed reform of the banking sector. Quite apart from the fact that some banks themselves will become unviable and will have to start downsizing or adopting a more regional focus, we expect that the incidence of corporate failures will also increase as the debt burden increases. We have dealt with this issue at length in a previous section.

Labour Laws

The retrenchment of workers arising from the sickness of firms could be taken care of by the following options:

- a) Rather than force sick units to continue retaining the labour force, which is not feasible in the long run in any case and results in a downward spiraling of morale and productivity in the short run, employers could be forced to find alternative employment for workers elsewhere. In practice, an employer who wishes to lay off workers may have to pay a new employer to take them on. Some form of insurance could be obtained by the old employer to help defray such costs in the event of sickness. We expect an active market in this area if this option is resorted to.
- b) An employment retrenchment insurance scheme wherein the employer pays an insurance premium to an insurance company to cover retrenchment payments to employees (not covering retrenchment on disciplinary grounds etc.) The insurance company could pay the retrenched worker directly to provide him or her some cushion or to finance any retraining which would be needed for him or her to find a new job.

Various combinations of the above schemes could also be worked out.

In any case, as sickness and layoffs become more common, workers also need to have a variety of insurance and pension schemes which would not be dependent on any one employer. We anticipate a growing demand for independent insurance and pension fund companies as the proposed reforms are implemented.

Land Laws

Certain restrictions on the sale of certain kinds of land properties have acted as major impediments in the way of sick companies which could otherwise have sold the land to raise funds to finance rehabilitation efforts. With the increased incidence of corporate sickness as a result of both the liberalized industrial policy and the reforms proposed in the Narasimham Committee report, some major amendments to land laws appear to be urgently called for.

VIII. Pace of Reform

Major economic reforms are being contemplated today. One issue which naturally arises is that of sequencing these reforms.

At first blush, it may appear that it would be logical to implement reforms in some logical order of priority, based perhaps on some sense of relative urgency. However, a closer examination reveals that there is some sort of circular sequencing requirement here, where each reform appears to be a precondition for the other.

For example, it would make little sense to reform the banking system first, since the real urgency driving this set of reforms comes from the need to rationalize the entire economic system. On the other hand, how feasible would it be to implement the reform of the industrial system first, if there is not a strong banking system to finance the new entrants into newly deregulated industries? Then again, how feasible would it be to implement an easy entry policy without an easy exit policy - and how would an exit policy work without a system of insurance for retrenched workers, which would require a reformed financial system as a precondition?

Indeed, reforms in industrial policy are hardly likely to win the enthusiastic support of industry if industry leaders did not have reason to believe that reforms in the financial system are imminent if not concurrent.

We believe the simplest way out of such a dilemma is to aim for a near simultaneity in these reforms. This will necessarily mean a rapid pace of reform in which time is measured in days, not years. Days as units connote a sense of urgency not communicated by months and years. At the same time, there is a need to build up a momentum which would be irreversible if the people are to have confidence that the reforms will endure. A slow pace of reform will breed a 'wait and see' attitude, which would neither bring the benefits of reform nor permit continued economic growth under the old rules of the game. The greatest danger is uncertainty - he who hesitates is indeed lost.

As we look around us, we see even more momentous reforms being introduced in the world today, especially in Europe and the erstwhile Soviet Union. India cannot afford to be slower in its transition to a freer market than these countries, especially if we are to retain our credibility with international financial institutions.

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