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Impact of Banking Sector Reforms on CRR and SLR in Indian Banks

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Abstract: Financial reforms introduced in India as a part of trade and industrial policy liberalization. The reduction in the Cash Reserves Ratio (CRR) and the Statutory Liquidity Ratio (SLR) is being posed as an important part of these financial reforms. The Committee on the Financial System (Narasimham Committee) had recommended that the SLR should be reduced in a phased manner to 25 per cent over a period of about five years. The Reserve Bank of India (RBI) should consider reducing the CRR progressively from the existing level .The Committee argued that the government should reduce the fiscal deficit to a level consistent with macro-economic stability, there would be a greater scope for using Open Market Operations (OMO) and correspondingly, there would be a less need for using the CRR for controlling the secondary expansion of bank credit (RBI 1991). The CRR during 1992 to 2018 decreased from 15% in 1992 to 4% in 2018 and SLR decreased from 38.5% in 1992 to 19.5% in 2018.

Keywords: cash reserve ratio-Statutory Liquidity Ratio-Repo rate- Reverse repo rate- Base rate- Narasimham committee- Risk management- Market oriented system- Monetary policy.

1. Introduction:

One of the primary functions of Reserve Bank of India (RBI) is to control the supply of money in the economy and also ‘the cost of credit.’ Meaning, how much money is available for the industry or the economy and what is the price that the economy has to pay to borrow that money. ‘Availability of money’ is nothing but liquidity and ‘cost of borrowing’ is interest rates these two things (Supply of money and cost of credit) are closely monitored and controlled by RBI. These two factors will have considerable impact on inflation and growth. To control inflation and the growth, RBI uses certain tools like CASH RESERVE RATIO, STATUTORY LIQUIDITY RATIO, REPO RATE, REVERSE REPO RATE etc.,

1.1. Repo Rate:

Repo rate is the rate at which the RBI lends to commercial banks, typically, against government securities. When the RBI raises the repo rate, it becomes more expensive for banks to borrow from the central bank. When the RBI slashes the repo rate by 25 basis points, for instance it becomes cheaper for commercial banks to borrow from the RBI. So, when the RBI raises the repo rate, loans and advances interest rates usually rise and when the RBI cuts the repo rate, loans and advances interest rates usually fall. But, this is not necessarily true because in certain phases, commercial banks have adequate cash, and they do not rely on the RBI to receive money.

1.2. Reverse Repo Rate:

Reverse repo rate is the rate banks charge on funds they invest in government securities with the RBI. When the reverse repo rate rises, banks may raise loans and advances interest rates, because it becomes more profitable for commercial banks to invest in low-risk government securities instead of lending to People investing in property in India. When the reverse repo rate falls, loans and advances interest rates may fall.

1.3. Base Rate:

A base rate is lowest interest rate that a bank charges to its customers. The base rate is decided by the banks. It is within the rights of the bank management to change it. The RBI does not directly control it, though it influences through the repo rate and other instruments. When the RBI cuts the repo rate, for instance, banks may lower the base rate.

When the central bank cuts the repo rate, many banks pass on the benefit to customers by cutting their base rates. In 2015, many banks took long to cut the base rate even though the RBI cut the repo rate in January and March.

The base rate, however, is not the interest rate at which banks lend to home buyers. Though many public sector unit (PSU) banks tend to lend at base rates, many commercial banks add a margin to the base rate while lending. The interest rate that banks charge depends on many factors including credit worthiness.

1.4. Cash Reserve Ratio (CRR):

Cash reserve ratio is the percentage of bank deposits banks need to keep with the RBI. CRR is an instrument, the RBI uses to control the liquidity in the system. Currently, the CRR is 4 per cent, though the range of permissible CRR is between 3 and 15 per cent. If the CRR is four, this means that the banks will have to keep Rs 4 with the RBI whenever bank deposits increase by Rs 100. Higher the CRR, lower the amount of money banks can lend out or invest. So, when the CRR is higher, lower would be the liquidity and vice versa. It is not necessary that a hike in the CRR would lead to a hike in loan and advances interest rate. But, a hike in the CRR reduces the supply of credit, when the RBI hikes the CRR, banks would raise loans and advances interest rates.

1.5. Statutory Liquidity Ratio (SLR):

Statutory liquidity ratio is the percentage of funds banks need to maintain in the form of liquid assets at any point in time. But, banks need to maintain these funds in the form of government securities, bonds or precious metals, and not in the form of cash. Currently, the SLR is 19.5 per cent. These funds are largely invested in government securities. When the SLR is high, banks have less money for commercial operations and hence less money to lend out. When this happens, loan and advances interest rates often rise. When the SLR is low, similarly, loans and advances interest rates are likely to fall. Both the CRR and the SLR influence the extent to which commercial banks can lend out money to customers. If the RBI keeps both these rates too high for too long, banks would become cautious and lend less.

2. Narasimham Committee – I (First Generation Reforms) 1991

To restore the financial health of commercial banks and to make their functioning efficient and profitable, the Government of India appointed a committee called 'The Committee on Financial System' under the chairmanship of Sri M. Narasimham, ex-Governor of Reserve Bank of India which made recommendations in November 1991. The Committee laid down a blue print of financial sector reforms, recognized that a vibrant and competitive financial system was central to the wide ranging structural reforms. In order to ensure that the financial system operates on the basis of operational flexibility and functional autonomy, with a view to enhance efficiency, productivity and profitability, the Committee recommended a series of measures i.e. greater flexibility to bank operations, especially in Pointing out statutory stipulations, improving asset quality, institution of prudential norm, greater disclosures, better housekeeping, in terms of accounting practices. In the words of Bimal Jalan, ex-Governor of RBI, "the central bank is a set of prudential norm that are aimed at imparting strength to the financial institutions, and inducing greater accountability and market discipline. The norms include not only capital adequacy, asset classifications and provisioning but also accounting standards, exposure and disclosure norms and guidelines for investment, risk management and asset liability management." These recommendations are a landmark in the evolution of banking system from a highly regulated to more market-oriented system.

The reforms introduced since 1992-93 breathed a fresh air in the banking sector. Deregulation and liberalization encouraged banks to go in for innovative measures, develop business and earn profits. These will improve the solvency, health and efficiency of institutions. The measures aimed at improving the performance of banking system are;

2.1. Statutory Liquidity Ratio (SLR)

The SLR is a major instrument to mobilize funds for the government, and public sector financial institutions should be given up immediately. SLR should be reduced from the maximum 38.5 percent to 25 percent of net demand and liabilities of banks over the next five years.

2.2. Cash Reserve Ratio (CRR)

CRR is the principal instrument of monetary and credit control. "The committee proposed that CRR should be progressively decrease from its present high level of 15 percent to 3 to 5 percent and, RBI should pay interest on impounded deposits of banks above the basic minimum rate at a equal to the level of banks one year deposit rate.

2.3. Direct Credit Programmers

With regard to direct credit programmers, the committee proposed that:

(i) One system should not operate on regular, it should be changed for extraordinary support to certain weak sectors of the economy.
(ii) The system should be temporary not permanent.
(iii) The sectors e.g. agriculture and small industry were in mature stage so that they are not eligible for such support.
(iv) Two decades of assistance with interest subsidy was enough and confessional interest rates could be dispensed with.

2.4. Structured of Interest Rates

The Narasimham Committee (1991) recommended that the interest rates in the country should be determined by market force. The committee was against the control and regulation of interest rates. According to it, the interest rates on lending and deposits rates of banks and financial institutions, on debentures and company deposit etc. should be removed, concessional rates of interest on priority sector loans of small sizes should be phased out; subsidies in IRDP loans should be withdrawn. RBI which is the sole authority was advised to simplify the structure of interest rates. The bank rate should be the anchor rate and all other rates should be closely connected to it.

2.5. Structural Reorganization of the Banking:

According to the committee, board pattern of the public bank should be reduced in number through mergers and acquisitions. The board pattern should consist of (i) Three or four large banks including SBI should become international in character,(ii) Eight to Ten banks should be national banks with a wide network of branches throughout the country,(iii) The other banks could remain as local banks with operations confined generally to a specific region,(iv) RBI should permit the establishment of new banks in the private sector and restrict further nationalization banks, (v)To improve competitive efficiency the foreign banks should be allowed to open offices in India for fulfilling social obligation like the Indian bank.

2.6. Organization and Methods and procedures in Banks

In order to tone up the working of the banks, the committee recommends that:

(i) "Each bank should be free and autonomous.
(ii) Every bank should go for a radical change in work technology and culture that will generate the competition and innovative function.
(iii) To trust on internal audit and internal inspection.
(iv) "The appointment of the Chief Executive of a Bank and Board of Directors should not be based on political considerations but on professionalism and integrity

3. Objectives Of The Study

The objectives of this study are 1) to study the report of the committee of banking sector reforms (Narasimhan 1991).2) to study the impact of Narasimham committee recommendations on the performance of banking sector.3) to examine present position of cash Reserve ratio and statutory liquidity ratio of banking sector in India. .

4. Methodology

This study was mainly focused on the change of cash reserve ratio (CRR) and statutory liquidity ratio (SLR) after banking sector reforms in India. The secondary and time series data is collected from Handbook of Statistics on the Indian economy published by Reserve Bank of India, Report on trend and progress of banking in India ,magazines, books, journals ,research papers and internet.

5. Impact of Banking Sector Reforms

The impact of banking sector reforms on the performance of banking sector with reference to change in cash reserve ratio (CRR) and statutory liquidity ratio (SLR) is presented below.

Table-1

Impact of banking sector reforms (1991) on the bank's CRR and SLR in Indian banks.

Date	Cash reserve Ratio(CRR)	Statutory Liquidity Ratio (SLR)
Oct.1992	15	38.5
May.2001	7.5	25
Apri. 2011	6	24
Jan . 2015	4	22
Jun . 2015	4	21.5
Apri. 2016	4	21.5
Oct. 2016	4	20.75
Jan.2017	4	20.75
Apri.2017	4	20.5
Aug. 2017	4	20
Oct. 2017	4	19.5
Feb. 2018	4	19.5

Sources: Reserve bank of India, Annual reports.

Table-1. shows the change of CRR and SLR after banking sector (1991) reforms, during 1992 to 2018. A look at the table reveals that the CRR decreased from 15% in 1992 to 4% in 2018. As for as the SLR was concerned, it decreased from 38.5% in 1992 to 19.5% in 2018.

6. Conclusion

When the cash reserve ratio and statutory liquidity ratio decreased by the RBI, banks will have more money to invest in other businesses since the amount of funds that needs to be kept with the RBI is low. This shows that banks will have an excess of funds and hence, there will be a decline in the interest rates that are charged on loans and advances. When the cash reserve ratio and statutory liquidity ratios minimized, commercial banks will have more funds and hence, the money supply of the banking system will increase. When there is a rise in the money supply, excessive funds will result in high inflation. When the CRR and SLR minimized, funds are drawn out from the economic system excessively and then the money supply is affected negatively where in there is a shortage of funds. Since the money supply has declined in this situation, the inflation also reduces.

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