CHAPTER I
INTRODUCTION AND DESIGN OF THE STUDY

1.1. INTRODUCTION

The role of banks in the economy is very important for the sustainability of the economic development. In general, banks act as financial intermediaries for the transfer of capital from those that have extra money or savers, to those that need more money or borrowers. Moreover, banks serve customers in both retail and corporate banking services in many different types of services-from foreign exchange transactions to lending.

The banking industry in India is one of the most important industries for economic development and its crucial roles provide sources of funds for individual, private firms and governments in order to support their operations. It is expected that the Indian banking and finance system will be globally competitive. For this the market players will have to be financially strong and operationally efficient. Capital would be a key factor in building a successful institution. The banking and finance system will improve competitiveness through a process of consolidation, either through mergers and acquisitions or through strategic alliances.

The activities of banks can be broadly categorized in terms of a range of products and services, including lending services, bank accounts, such as time deposit accounts and internet banking. Competition among banks and the volatility economy have forced banks at all levels, including branches, to strive to achieve their goals, from survival to continuous growth. In addition, the focus on resources for operations at the branch level is a key to success for all banks.

Banks will increasingly act as risk managers to corporate and other entities by offering a variety of risk management products like options, swaps and other aspects of financial management in a multi currency scenario. Banks will play an active role in the development of derivative products and will offer a variety of hedge products to the corporate sector and other investors.1

1.2. BANKING SYSTEM IN INDIA

A banking system also referred as a system provided by the bank which offers cash management services for customers, reporting the transactions of their accounts and portfolios, throughout the day. The banking system in India should not only be hassle free but it should be able to meet the new challenges posed by the technology and any other external and internal factors. For the past three decades, India’s banking system has several outstanding achievements to its credit. The Banks are the main participants of the financial system in India.

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The Banking sector offers several facilities and opportunities to their customers. All the banks safeguard the money and valuables and provide loans, credit, and payment services, such as checking accounts, money orders, and cashier cheques. The banks also offer investment and insurance products. As a variety of models for cooperation and integration among finance institutions have emerged, some of the traditional distinctions between banks, insurance companies, and security firms have diminished. In spite of these changes, banks continue to maintain and perform their primary role—accepting deposits and lending funds from these deposits.

Before the establishment of banks, the financial activities were handled by money lenders and individuals. At that time the interest rates were very high. Again there were no security of public savings and no uniformity regarding loans. So as to overcome such problems the organized banking sector was established, which was fully regulated by the government. The organized banking sector works within the financial system to provide loans, accept deposits and provide other services to their customers. The following functions of the bank explain the need of the bank and its importance:

- To provide the security to the savings of customers.
- To control the supply of money and credit.
- To encourage public confidence in the working of the financial system, increase savings speedily and efficiently.
- To avoid focus of financial powers in the hands of a few individuals and institutions.
- To set equal norms and conditions (i.e. rate of interest, period of lending etc) to all types of customers.

The first bank in India, called The General Bank of India was established in the year 1786. The East India Company established The Bank of Bengal/Calcutta (1809), Bank of Bombay (1840) and Bank of Madras (1843). The next bank was Bank of Hindustan which was established in 1870. These three individual units (Bank of Calcutta, Bank of Bombay, and Bank of Madras) were called as Presidency Banks. Allahabad Bank which was established in 1865 was for the first time completely run by Indians. Punjab National Bank Ltd. was set up in 1894 with head quarters at Lahore. Between 1906 and 1913, Bank of India, Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank, and Bank of Mysore were set up. In 1921, all presidency banks were amalgamated to form the Imperial Bank of India which was run by European Shareholders. After that the Reserve Bank of India was established in April 1935.

At the time of first phase, the growth of banking sector was very slow. Between 1913 and 1948 there were approximately 1100 small banks in India. To streamline the functioning and activities of commercial banks, the Government of India came up with the Banking Companies Act, 1949 which was later changed to Banking Regulation Act 1949 as per amending Act of 1965 (Act No.23 of 1965). Reserve Bank of India was vested with extensive powers for the supervision of banking in India as a Central Banking Authority.

After Independence, Government has taken some important steps with regard to Indian Banking Sector reforms. In 1955, the Imperial Bank of India was nationalized and was given the name "State Bank of India", to act as the principal agent of RBI and to
handle banking transactions all over the country. It was established under State Bank of India Act, 1955. Seven banks forming subsidiary of State Bank of India were nationalized in 1960. On 19th July, 1969, major process of nationalization was carried out. At the same time 14 major Indian commercial banks of the country were nationalized. In 1980, another six banks were nationalized, and thus raising the number of nationalized banks to 20. Seven more banks were nationalized with deposits over 200 Crores.

With the second step of nationalization, the Government of India (GOI) controlled around 91 per cent of the banking business in India. Later on, in the year 1993, the government merged New Bank of India with Punjab National Bank. It was the only merger between nationalized banks and resulted in the reduction of the number of nationalized banks from 20 to 19. After this, until the 1990s, the nationalized banks grew at a pace of around four per cent, closer to the average growth rate of the Indian economy.

In the early 1990s, the then Narsimha Rao government embarked on a policy of liberalization, licensing a small number of private banks. These came to be known as New Generation tech-savvy banks, and included Global Trust Bank (the first of such new generation banks to be set up), which later amalgamated with Oriental Bank of Commerce, Axis Bank(earlier UTI Bank), ICICI Bank and HDFC Bank.

This move along with the rapid growth in the economy of India revolutionized the banking sector in India which has seen rapid growth with strong contribution from all the three sectors of banks, namely, government banks, private banks and foreign banks. The next stage for the Indian banking has been setup with the proposed relaxation in the norms for Foreign Direct Investment, where all Foreign Investors in banks would be given voting rights which could exceed the present cap of 10 per cent, at present it has gone up to 49 per cent with some restrictions.

The new policy shook the banking sector in India completely. Bankers, till this time, were used to the 4-6-4 method (Borrow at 4%; Lend at 6%; Go home at 4) of functioning. The new wave ushered in a modern outlook and tech-savvy methods of working for the traditional banks. All this led to the retail boom in India. People not just demanded more from their banks but also received more. Currently banking in India is generally fairly mature in terms of supply, product range and reach—even though reach in rural India still remains a challenge for the private sector and foreign banks. In terms of quality of assets and capital adequacy, Indian banks are considered to have clean, strong and transparent balance sheets as compared to other banks in comparable economies in their region.

The Reserve Bank of India is an autonomous body, with minimal pressure from the government. The stated policy of the Bank on the Indian Rupee is to manage volatility but without any fixed exchange rate—and this has mostly been true. With the growth in the Indian economy expected to be strong for quite some time—especially in its service sector—the demand for banking services, especially retail banking, mortgages and investment services are expected to be strong².

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1.3. GOVERNMENT POLICY ON BANKING INDUSTRY

Banks operating in most of the countries must contend with heavy regulations, rules enforced by Federal and State agencies to govern their operations, service offerings, and the manner in which they grow and expand their facilities to serve the public better. A banker works within the financial system to provide loans, accept deposits, and provide other services to their customers. They must do so within a climate of extensive regulation, designed primarily to protect the public interests.

The main reasons why the banks are heavily regulated are as follows:

- To protect the safety of the public’s savings.
- To control the supply of money and credit in order to achieve a nation’s broad economic goal.
- To ensure equal opportunity and fairness in the public’s access to credit and other vital financial services.
- To promote public confidence in the financial system, so that savings are made speedily and efficiently.
- To avoid concentrations of financial power in the hands of a few individuals and institutions.
- Provide the Government with credit, tax revenues and other services.
- To help sectors of the economy that they have special credit needs for eg. Housing, small business and agricultural loans etc.

1.4. LAW OF BANKING

Banking law is based on a contractual analysis of the relationship between the banker and customer—defined as any entity for which the bank agrees to conduct an account.

- The law implies rights and obligations into this relationship as follows:
- The bank account balance is the financial position between the bank and the customer: when the account is in credit, the bank owes the balance to the customer; when the account is overdrawn, the customer owes the balance to the bank.
- The bank agrees to pay the customer's cheques up to the amount standing to the credit of the customer's account, plus any agreed overdraft limit.
- The bank may not pay from the customer's account without a mandate from the customer, e.g. cheques drawn by the customer.
- The bank agrees to promptly collect the cheques deposited to the customer's account as the customer's agent, and to credit the proceeds to the customer's account.
- The bank has a right to combine the customer's accounts, since each account is just an aspect of the same credit relationship.
- The bank has a lien on cheques deposited to the customer's account, to the extent that the customer is indebted to the bank.
- The bank must not disclose details of transactions through the customer's account—unless the customer consents. There is a duty to disclose, if, the bank's interests require it, or the law demands it.
• The bank must not close a customer's account without reasonable notice, since cheques are outstanding in the ordinary course of business for several days.
• These implied contractual terms may be modified by express agreement between the customer and the bank. The statutes and regulations in force within a particular jurisdiction may also modify the above terms and/or create new rights, obligations or limitations relevant to the bank-customer relationship.

1.5. REGULATIONS FOR INDIAN BANKS

Currently in most jurisdictions commercial banks are regulated by government entities and require a special bank license to operate. Usually the definition of the business of banking for the purposes of regulation is extended to include acceptance of deposits, even if they are not repayable to the customer's order—although money lending, by itself, is generally not included in the definition.

Unlike most other regulated industries, the regulator is typically also a participant in the market, i.e. a government-owned (central) bank. Central banks also typically have a monopoly on the business of issuing banknotes. However, in some countries this is not the case. In UK, for example, the Financial Services Authority licenses banks, and some commercial banks (such as the Bank of Scotland) issue their own banknotes in addition to those issued by the Bank of England, the UK government's central bank.

Some types of financial institutions, such as building societies and credit unions, may be partly or wholly exempted from bank license requirements, and therefore regulated under separate rules. The requirements for the issue of a bank license vary between jurisdictions but typically include:

• Minimum capital.
• Minimum capital ratio.
• 'Fit and Proper' requirements for the bank's controllers, owners, directors, and/or senior officers.
• Approval of the bank's business plan as being sufficiently prudent and plausible.

1.6. CLASSIFICATION OF BANKING INDUSTRY IN INDIA

Indian banking industry has been divided into two parts, organized and unorganized sectors. The organized sector consists of Reserve Bank of India, Commercial Banks and Co-operative Banks, and Specialized Financial Institutions (IDBI, ICICI, IFC etc). The unorganized sector, which is not homogeneous, is largely made up of money lenders and indigenous bankers.

An outline of the Indian Banking structure may be presented as follows:-

1. Reserve banks of India.
2. Indian Scheduled Commercial Banks.
   a) State Bank of India and its associate banks.
   b) Twenty nationalized banks.

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c) Regional rural banks.
d) Other scheduled commercial banks.

3. Foreign Banks
5. Co-operative banks.

1.7. FINANCIAL AND BANKING SECTOR REFORMS

The last two decades witnessed the maturity of India's financial markets. Since 1991, every government of India took major steps in reforming the financial sector of the country[^4].

1.7.1. FINANCIAL MARKETS

In the last decade, Private Sector Institutions played an important role. They grew rapidly in commercial banking and asset management business. With the openings in the insurance sector for these institutions, they started making debt in the market. Competition among financial intermediaries gradually helped the interest rates to decline. Deregulation added to it. The real interest rate was maintained. The borrowers did not pay high price while depositors had incentives to save. It was something between the nominal rate of interest and the expected rate of inflation.

1.7.2. REGULATORS

The Finance Ministry continuously formulated major policies in the field of financial sector of the country. The Government accepted the important role of regulators. The Reserve Bank of India (RBI) has become more independent. Securities and Exchange Board of India (SEBI) and the Insurance Regulatory and Development Authority (IRDA) became important institutions. Opinions are also there that there should be a super-regulator for the financial services sector instead of multiplicity of regulators.

1.7.3. THE BANKING SYSTEM

Almost 80 per cent of the businesses is still controlled by Public Sector Banks (PSBs). PSBs are still dominating the commercial banking system. Shares of the leading PSBs are already listed on the stock exchanges.

The RBI has given licenses to new private sector banks as part of the liberalization process. The RBI has also been granting licenses to industrial houses. Many banks are successfully running in the retail and consumer segments but are yet to deliver services to industrial finance, retail trade, small business and agricultural finance.

The PSBs will play an important role in the industry due to its number of branches and foreign banks facing the constraint of limited number of branches. Hence, in order to achieve an efficient banking system, the onus is on the Government to encourage the PSBs to be run on professional lines.

1.7.4. DEVELOPMENT OF FINANCIAL INSTITUTIONS

- FIs's access to SLR funds is reduced. Now they have to approach the capital market for debt and equity funds.
- Convertibility clause no longer obligatory for assistance to corporates sanctioned by term-lending institutions.

• Capital adequacy norms extended to financial institutions.
• DFIs such as IDBI and ICICI have entered other segments of financial services such as commercial banking, asset management and insurance through separate ventures. The move to universal banking has started.

1.7.5 NON-BANKING FINANCE COMPANIES

Until recently, the money market in India was narrow and circumscribed by tight regulations over interest rates and participants. The secondary market was underdeveloped and lacked liquidity. Several measures have been initiated and they include new money market instruments, strengthening of existing instruments and setting up of the Discount and Finance House of India (DFHI).

The RBI conducts its sales of dated securities and treasury bills through its open market operations (OMO) window. Primary dealers bid for these securities and also trade in them. The DFHI is the principal agency for developing a secondary market for money market instruments and Government of India treasury bills. The RBI has introduced a liquidity adjustment facility (LAF) in which liquidity is injected through reverse repo auctions and liquidity is sucked out through repo auctions.

On account of the substantial issue of government debt, the gilt-edged market occupies an important position in the financial set-up. The Securities Trading Corporation of India (STCI), which started operations in June 1994 has a mandate to develop the secondary market in government securities.

Long-term debt market: The development of a long-term debt market is crucial to the financing of infrastructure. After bringing some order to the equity market, the SEBI has now decided to concentrate on the development of the debt market. Stamp duty is being withdrawn at the time of dematerialization of debt instruments in order to encourage paperless trading.

1.7.6. THE CAPITAL MARKET

There has been a dramatic improvement in the country's stock market trading infrastructure during the last few years. Expectations are that India will be an attractive emerging market with tremendous potential. Unfortunately, during recent times the stock markets have been constrained by some unsavoury developments, which has led to retail investors deserting the stock markets.

1.7.7. MUTUAL FUNDS

The mutual funds industry is now regulated under the SEBI (Mutual Funds) Regulations, 1996 and amendments thereto. With the issuance of SEBI guidelines, the industry had a framework for the establishment of many more players, both Indian and foreign.

The Unit Trust of India remains easily the biggest mutual fund controlling a corpus of nearly Rs.70,000 Crores, but its share is going down. The biggest shock to the mutual fund industry during recent times was the insecurity generated in the minds of investors regarding the US 64 scheme. With the growth in the securities markets and tax advantages granted for investment in mutual fund units, mutual funds started becoming popular.
The foreign owned AMCs are the ones which are now setting the pace for the industry. They are introducing new products, setting new standards of customer service, improving disclosure standards and experimenting with new types of distribution.

The insurance industry is the latest to be thrown open to competition from the private sector including foreign players. Foreign companies can only enter joint ventures with Indian companies, with participation restricted to 26 per cent of equity. It is too early to conclude whether the erstwhile public sector monopolies will successfully be able to face up to the competition posed by the new players, but it can be expected that the customer will gain from improved service.

The new players will need to bring in innovative products as well as fresh ideas on marketing and distribution, in order to improve the low per capita insurance coverage. Good regulation will, of course, be essential.

1.7.8. OVERALL APPROACH TO REFORMS

The last ten years have seen major improvements in the working of various financial market participants. The government and the regulatory authorities have followed a step-by-step approach, not a big bang one. The entry of foreign players has assisted in the introduction of international practices and systems. Technology developments have improved customer service. Some gaps however remain (: lack of an inter-bank interest rate benchmark, an active corporate debt market and a developed derivatives market). On the whole, the cumulative effect of the developments since 1991 has been quite encouraging. An indication of the strength of the reformed Indian financial system can be seen from the way India not affected by the Southeast Asian crisis.

However, financial liberalization alone will not ensure stable economic growth. Some tough decisions still need to be taken. Without fiscal control, financial stability cannot be ensured. The fate of the Fiscal Responsibility Bill remains unknown and high fiscal deficits continue. In the case of financial institutions, the political and legal structures have to ensure that borrowers repay on time the loans they have taken. The phenomenon of rich industrialists and bankrupt companies continues. Further, frauds cannot be totally prevented, even with the best of regulation. However, punishment has to follow crime, which is often not the case in India.

1.7.9. DEREGULATION OF BANKING SYSTEM

Prudential norms were introduced for income recognition, asset classification, provisioning for delinquent loans and for capital adequacy. In order to reach the stipulated capital adequacy norms, substantial capital were provided by the Government to PSBs.

Government pre-emption of banks' resources through statutory liquidity ratio (SLR) and cash reserve ratio (CRR) was brought down in steps. Interest rates on the deposits and lending sides almost entirely were deregulated.

New private sector banks are allowed to promote and encourage competition. PSBs were encouraged to approach the public for raising resources. Recovery of debts due to banks and the Financial Institutions Act, 1993 was passed, and special recovery tribunals set up to facilitate quicker recovery of loan arrears.

Bank lending norms were liberalized and a loan system to ensure better control over credit introduced. Banks asked to set up asset liability management (ALM) systems. RBI
guidelines issued for risk management systems in banks encompassing credit, market and operational risks. A credit information bureau are being established to identify bad risks. Derivative products such as forward rate agreements (FRAs) and interest rate swaps (IRSs) introduced.

1.7.10. CAPITAL MARKET DEVELOPMENTS

The Capital Issues (Control) Act, 1947, was repealed, office of the Controller of Capital Issues were abolished and the initial share pricing was decontrolled. SEBI, the capital market regulator was established in 1992.

Foreign institutional investors (FIIs) were allowed to invest in Indian capital markets after registration with the SEBI. Indian companies were permitted to access international capital markets through euro issues. The National Stock Exchange (NSE), with nationwide stock trading and electronic display, clearing and settlement facilities was established. Several local stock exchanges changed over from floor based trading to screen based trading.

1.7.11. NARASIMHAM COMMITTEE – I (FIRST GENERATION REFORMS)

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 Financed 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 aimed at changes according greater flexibility to bank operations, especially in Pointing out statutory stipulations, directed credit program, 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 norms 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 reforms, the Narasimham Committee-I felt, will improve the solvency, health and efficiency of institutions. The measures were aimed at

- Ensuring a degree of operational flexibility.
- Internal 'autonomy for public sector banks in their decision-making process, and
- Greater degree of professionalism in banking operations.
1.7.12. NARASIMHAM COMMITTEE-II (1998) (SECOND GENERATION REFORMS)

The recommendations of Narasimham Committee-I (1991) provided blueprint for first generation reforms of the financial sector. The period 1992-97 witnessed laying of the foundations for reforms of the banking system. It also saw the implementation of prudential norms relating to capital adequacy, asset classification, income recognition, provisioning, exposure norms, etc. The difficult task of ushering in some of the structural changes accomplished during this period provided the bedrock for future reforms. In fact, India withstood the contagion of 1997 (South-East Asia crisis) indicates the stability of the banking system. Against such a backdrop, the Report of the Narasimham Committee-II in 1998 provided the road map for the second-generation reform process. Two points are worth noting at this juncture.

First, the financial sector reforms were undertaken in the early reform cycle, and secondly, the reforms in the financial sector were initiated in well structured, sequenced and phased manner with cautious and proper sequencing, mutually reinforcing measures, complementarily between reforms in the banking sector and changes in the fiscal, external and monetary policies, developing financial infrastructure; and developing financial markets. The Government appointed a second high-level Committee on Banking Sector Reforms under the chairmanship of Mr. Narasimham to "review the progress of banking sector reforms to date and chart a programme of financial sector reforms necessary to strengthen the Indian Financial System and make it internationally competitive. The Committee in its report (April 1998) made wide-ranging recommendations covering entire gamut of issues ranging from capital adequacy, asset quality, NPAs, prudential norms, asset-liability management, earnings and profits, mergers and acquisitions, reduction in government shareholdings to 33 per cent in public sector banks, the creation of global-sized banks, recasting banks boards to revamping banking legislation.

The second generation reforms could be conveniently looked at in terms of three broad inter-related issues:

- Measures that need to be taken to strengthen the foundations of the banking system.
- Related to this, streamlining procedures, upgrading technology and human resource development, and
- Structural changes in the system. These would cover aspects of banking policy, institutional, supervisory and legislative dimensions.

1.8. NON-PERFORMING ASSETS (NPA)

The performance in terms of profitability is a benchmark for any business enterprise including the banking industry. However, increasing NPAs have a direct impact on profitability of banks as legally banks are not allowed to book income on such accounts and at the same time banks are forced to make provision on such assets as per the Reserve Bank of India (RBI) guidelines on Performing Asset means, an asset or account of borrower, which has been classified by a bank or financial institution as sub-standard,
doubtful or loss asset, in accordance with the directions or guidelines relating to asset classification issued by RBI\(^5\).

An amount due under any credit facility is treated as "past due" when it has not been paid within 30 days from the due date. Due to the improvement in the payment and settlement systems, recovery climate, upgradation of technology in the banking system, etc., it was decided to dispense with 'past due' concept, with effect from March 31, 2001. Subsequent guidelines issued by RBI in line with international best practices in accordance with Basel standards, the prudential norms for income recognition, asset classification, capital adequacy and provisioning in commercial banks has been introduced.

These guidelines lay emphasis on regulatory and supervisory control of banks by RBI and enhancing the overall financial stability in the economy. It also expects the banks and financial institutions to be following capital adequacy norms, maintain capital provisioning on a risk-weighted assets basis along with operating on income recognition, asset classification and liquidity management. Further, all the commercial banks are subject to regulatory and supervisory frame work by RBI in accordance with switch over to Risk Based Supervision (RBS) in 2003-04 which has concurrently ushered in CAMELS (Capital adequacy, Asset quality, Management, Earnings, Liquidity, Systems and Controls) approach and Basel II norms. In accordance with asset classification norms brought in with effect from March 31, 2004, a non-performing asset (NPA) shall be a loan or an advance, where:

- Interest and/or installment of principal remain overdue for a period of more than 90 Days in respect of a Term Loan,
- The account remains 'out of order' for a period of more than 90 days, in respect of an overdraft/cash credit (OD/CC)
- The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted,
- Interest and/or instalment of principal remains overdue for two harvest seasons but for a period not exceeding two half years in the case of an advance granted for agricultural purpose, and
- Any amount to be received remains overdue for a period of more than 90 days in respect of other accounts.

Also, with increasing deposits made by the public in the banking system, the banking industry cannot afford defaults by borrowers since NPAs affects the repayment capacity of banks. Further, Reserve Bank of India (RBI) successfully creates excess liquidity in the system through various rate cuts and banks fail to utilize this benefit to its advantage due to the fear of burgeoning non-performing assets.

1.9. IMPORTANCE OF NPA

Importance of Non – Performing Assets has become more and more since the formation of Shri M. Narshimham Committee on banking sector reform in 1991. It is a second landmark in banking sector in India after nationalization of banks. After nationalization of banks it has been given much attention on the lending policy of nationalized banks but not much attention has been given to the recovery of advances of nationalized banks by Reserve Bank of India (RBI).

Recovery of non – performing assets has become critical performance area for all banks in India. There was a lack of specific and unanimous guideline which resulted in misallocation of (banks) huge funds and ruined the sustained economic growth of nation. So, it was high time to form some specific guidelines on this. Reserve Bank of India (RBI) introduced a new set of prudential norms in April, 1992 for commercial banks and subsequently it has been extended, in stages to urban co-operative banks as well, as per the recommendations of high power committee on urban co-operative banks constituted in May 1999 under the chairmanship of K. Madharaa as a need for strengthening the co-operative sector in order to enhance operational efficiency, productivity and profitability and with the objective of implementing international. best practices in Indian banks, it is compulsory for all banking institutions to comply with prudential norms of RBI.

1.10. HISTORY OF NPA IN INDIAN BANKING INDUSTRY

Reserve Bank of India introduced a critical analysis for a comprehensive and uniform credit and monitoring by way of the Health Code System, in banks, which provided information regarding health of individual advances in 1985 – 86. It was considered that such information would be of immense use to banking management for control purpose. Reserve Bank of India advises all commercial banks on 7th November, 1987 to introduce the health classification indicating the quality of individual advances in the following eight categories with Health Code assigned to each borrower account.

7. **DECREED DEBTS:** Accounts for which decrees have been obtained.

8. **BAD AND DOUBTFUL ACCOUNTS:** The accounts in which the recoverability is doubtful due to shortfall in the value of the securities and inability/unwillingness of the borrower to repay the banks dues partly or wholly.

1.11. **TYPES OF NPA**

The types of NPA are as follows:

1.11.1. **GROSS NPA**

Gross NPAs are the sum total of all loan assets that are classified as NPAs as per RBI guidelines as on Balance Sheet date. Gross NPA reflects the quality of the loans made by banks. It consists of all the nonstandard assets like as sub-standard, doubtful, and loss assets. It can be calculated with the help of following ratio:

\[
\text{Gross NPAs Ratio} = \frac{\text{Gross NPAs}}{\text{Gross Advances}}
\]

1.11.2. **NET NPA**

Net NPAs are those type of NPAs in which the bank has deducted the provision regarding NPAs. Net NPA shows the actual burden of banks. Since in India, bank balance sheets contain a huge amount of NPAs and the process of recovery and write off of loans is very time consuming, the provisions the banks have to make against the NPAs according to the central bank guidelines, are quite significant. That is why the difference between gross and net NPA is quite high. It can be calculated by following:

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\text{Net NPAs} = \frac{\text{Gross NPAs} - \text{Provisions}}{\text{Gross Advances} - \text{Provisions}}
\]

1.12. **MANAGEMENT/RESOLUTION OF NPAs**

A reduction in the total gross and net NPAs in the Indian financial system indicates a significant improvement in management of NPAs. This is also on account of various resolution mechanisms introduced in the recent past which include the SRFAESI (Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest) Act, one time settlement schemes, setting up of the Corporate Debt Restructuring (CDR) mechanism, strengthening of Debt Recovery Tribunals (DRTs).

The total number of resolution approaches (including cases where action is to be initiated) is greater than the number of NPAs, indicating some double counting. As can be seen, suit filed and Bureau of Industrial Finance & Reconstruction (BIFR) are the two most common approaches to resolution of NPAs in public sector banks. Rehabilitation has been considered/adopted in only about 13 per cent of the cases. Settlement has been considered only in 9 per cent of the cases. It is likely to have been adopted in even fewer cases.7

Many banks have come out with their own restructuring schemes for settlement of NPA accounts. State Bank of India, HDFC Bank Limited, M/s. Dun and Bradstreet Information Services (India) Pvt. Ltd. and M/s. Trans Union to serve as a mechanism for exchange of information between banks and FIs for curbing the growth of NPAs incorporated credit Information Bureau (India) Limited (CIBIL) in January 2001.

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Pending the enactment of CIB Regulation Bill, the RBI constituted a working group to examine the role of CIBs. As per the recommendations of the working group, Banks and FIs are now required to submit the list of suit-filed cases of Rs. 10 million and above and suit filed cases of wilful defaulters of Rs. 2.5 million and above to RBI as well as CIBIL. CIBIL will share this information with commercial banks and FIs so as to help them minimize adverse selection at appraisal stage.

CDR is a nonstatutory mechanism based on debtor-creditor agreement and inter-creditor agreement. Restructuring helps in aligning repayment obligations for bankers with the cash flow projections as reassessed at the time of restructuring. Therefore, it is critical to prepare a restructuring plan on the lines of the expected business plan along with projected cash flows.

The CDR process is being stabilized. Certain revisions are envisaged with respect to the eligibility criteria (amount of borrowings) and time frame for restructuring. Foreign banks are not members of the CDR forum, and it is expected that they would be signing the agreements shortly. However they attend meetings. The first ARC to be operational in India- Asset Reconstruction Company of India (ARCIL) is a member of the CDR forum. Lenders in India prefer to resort to CDR mechanism to avoid unnecessary delays in multiple lender arrangements and to increase transparency in the process. While in the RBI guidelines it has been recommended to involve independent consultants, banks are so far resorting to their internal teams for recommending restructuring programmes.

1.13. HIGH COST OF FUNDS DUE TO NPAs

Quite often genuine borrowers face the difficulties in raising funds from banks due to mounting NPAs. Either the bank is reluctant in providing the requisite funds to the genuine borrowers or if the funds are provided, they come at a very high cost to compensate the lender’s losses caused due to high level of NPAs.

Therefore, quite often the corporate prefer to raise funds through commercial papers (CPs) where the interest rate on working capital charged by banks is hitherto the enactment of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002. Banks can issue notices to the defaulters to pay up the dues and the borrowers will have to clear their dues within 60 days.

Once the borrower receives a notice from the concerned bank and the financial institution, the secured assets mentioned in the notice cannot be sold or transferred without the consent of the lenders. The main purpose of this notice is to inform the borrower that either the sum due to the bank or financial institution is paid by the borrower or else the former will take action by way of taking over the possession of assets. Besides assets, banks can also take over the management of the company.

Thus the bankers under the aforementioned Act will have the much needed authority to either sell the assets of the defaulting companies or change their management. But the protection under the said Act only provides a partial solution. What banks should ensure is that they should move with speed and charge with momentum in disposing of the assets. This is because as uncertainty increases with the passage of time, there is all possibility that the recoverable value of asset also reduces and it cannot fetch good price. If faced with such a situation than the very purpose of getting protection under the
Securitization Act, 2002 would be defeated and the hope of seeing a ‘must have growing banking sector ‘can easily vanish.

1.14. IMPACT OF NPA ON THE OPERATIONS OF BANKS

1.14.1. PROFITABILITY

NPA means booking of money in terms of bad asset, which occurred due to wrong choice of client. Because of the money getting blocked the profitability of bank decreases not only by the amount of NPA but NPA leads to opportunity cost also as that much of profit invested in some return earning project/asset. So NPA does not affect current profit but also future stream of profit, which may lead to loss of some long-term beneficial opportunity. Another impact of reduction in profitability is low ROI (return on investment), which adversely affects current earning of bank.

1.14.2. LIQUIDITY

Money is getting blocked, decreased profit leads to lack of enough cash at hand which lead to borrowing money for the shortest period of time which leads to additional cost to the company. Difficulty in operating the functions of bank is another cause of NPA due to lack of money.

1.14.3. INVOLVEMENT OF MANAGEMENT

Time and effort of management is another indirect cost which bank has to bear due to NPA. Time and efforts of management in handling and managing NPA would have diverted to some fruitful activities, which would have given good returns. Nowadays, banks have special employees to deal and handle NPAs, which is additional cost to the bank.

1.14.4. CREDIT LOSS

If a bank is facing problem of NPA, then it adversely affects the value of bank in terms of market for credit. It will lose its goodwill and brand image and credit which have negative impact on the people who are putting in their money with the banks.

1.15. STATEMENT OF THE PROBLEM

In the liberalized economy, financial and banking sector reforms assume high priority. Economic reforms have given a new thrust to the banking sector as a whole, and private sector in particular. Nearly 85 per cent of commercial banking operations in the country are in the hands of public sector at present. One of the important indicators of performance of banks is the quality of their assets.

The idea of quality of assets on the books of accounts of banks came in to prominence when the RBI introduced prudential norms in 1992-93 with regard to income recognition, asset classification, provisioning and capital adequacy based on the recommendations of the Narasimhan Committee on financial sector reforms.

Post liberalization in Indian Banking Sector has undergone a sea change. Reserve Bank of India has nationalized good number of Commercial Banks for providing socio economic service to the people of the nation. The public sector banks have also shown very good performance as far as the financial operation is concerned. However non- performing assets had been the single cause of irritation to the banking sector in India, especially the Public Sector Banks because increasing NPAs have a direct impact on banks’ profitability.
as legally banks are not allowed to book income on such accounts and at the sometime are forced to make provision on such assets as per the Reserve Bank of India (RBI) guidelines. Also, with increasing deposits made by the public in the banking system, the banking industry cannot afford defaults by borrowers since NPAs affect the repayment capacity of banks.

The level of NPAs is recognized as a critical indicator for assessing banks’ credit risk, asset quality and efficiency in the allocation of resources to productive sectors. The magnitude of NPAs has a direct impact on the banks’ profitability as legally they are not allowed to book income on such account and at the same time, banks are forced to make provision on such assets as per RBI guidelines. Banks should not recognize interest income on NPAs until they are actually realized.

NPA account not only reduces profitability of banks by provisioning in the profit and loss account, but their carrying cost is also increased which results in excess and avoidable managements’ attention. Apart from this, a high level of NPA also puts strain on a bank’s networth because banks are under pressure to maintain a desired level of Capital Adequacy and in the absence of comfortable profit level, banks eventually look towards their internal financial strength to fulfill the norms thereby slowly eroding the net worth.

Widely known for customer centricity, Canara Bank was founded by Shri Ammembal Subba Rao Pai, a great visionary and philanthropist, in July 1906, at Mangalore, then a small port town in Karnataka. The Bank has gone through the various phases of its growth trajectory over hundred years of its existence. Growth of Canara Bank was phenomenal, especially after nationalization in the year 1969, attaining the status of a national level player in terms of geographical reach and clientele segments.

Eighties was characterized by business diversification for the Bank. In June 2006, the Bank completed a century of operation in the Indian banking industry. The eventful journey of the Bank has been characterized by several memorable milestones. Today, Canara Bank occupies a premier position in the comity of Indian banks. With an unbroken record of profits since its inception, Canara Bank has several firsts to its credit.

Over the years, the Bank has been scaling up its market position to emerge as a major 'Financial Conglomerate' with as many as nine subsidiaries/sponsored institutions/joint ventures in India and abroad. As on June 2013, the Bank has further expanded its domestic presence, with 3765 branches spread across all geographical segments. Keeping customer convenience at the forefront, the Bank provides a wide array of alternative delivery channels that include over 3754 ATMs, covering 1431 centers.

Several IT initiatives have been undertaken during the year, which include Funds Transfer through Interbank Mobile Payment Services (IMPS) in ATMs, E-filing of tax returns and facility for viewing details of tax deducted at source, Terminal at select branches for customers to use net banking, SMS/e-mail alerts for all transactions done through ATM, net banking, mobile banking, online payments irrespective of amounts, online loan applications and tracking facility, generation of automatic pass sheets through e-mail and automatic renewal of term deposits.

Under Government business, the Bank has implemented internet based application for UGC Maulana Azad National Fellowship Scheme, Web portal for National Scheme for
Girl Child Secondary Education, Electronic Accounting Systems of e-Receipts-Customs (EASeR-C) for collection of customs duty and e-payment of commercial taxes module for UP, Karnataka, Delhi and Tamil Nadu.

The problem of non-performing asset (NPAs) in the Indian banking system is one of the foremost and the most formidable problems that have shaken the entire banking industry. NPA is a double-edged weapon. On the one side bank cannot recognize interest on NPAs accounts and on the other, it is a drain of the banks’ profitability due to high funding cost. Higher NPAs ratio shakes the confidence of investors, depositors, lenders etc. It also causes poor recycling of funds, which in turn will have deleterious effect on the deployment of credit. The non-recovery of loans effects not only further availability of credit but also financial soundness of the credit of organization.

The problem of non-performing assets has shaken the entire Indian banking sector. The main reason of high percentage of NPAs is the target-oriented approach, which deteriorates the qualitative aspect of lending. The other reasons are willful defaults, ineffective supervision of loan accounts and lack of technical and managerial expertise on the part of borrowers. NPAs put detrimental impact on the profitability, capital adequacy ratio and credibility of banks. The issue of Non-Performing Assets (NPA), the root cause of the recent global financial crisis has been drawing the attention of the policy makers and academicians alike. The problem of NPAs which was ignored till recently, has been given considerable attention after liberalization of the financial sector in India.

With this background, the present research is attempted to study, “Evaluation of the Performance of Canara Bank with Special Reference to Non-Performing Assets (NPAs)”, with the following objectives.

1.16. OBJECTIVES OF THE STUDY

1. To present Reserve Bank of India norms for classification of assets in banking sector.
2. To study the size and trend in non-performing assets in Canara bank in general and in Madurai circle of the bank in particular.
3. To probe certain special aspects of non-performing assets in priority sector and non-priority sector advances.
4. To identify, classify and elaborate the causes for non-performing assets.
5. To analyze the impact of non-performing assets on profitability of the bank and the trend in the statutory provisions made for non-performing assets.
6. To evolve certain preventive and curative measures to control of non-performing assets.

1.17. HYPOTHESES

1. There is no significant difference between Canara Bank in general and Madurai circle of the bank in particular with regard to size of non-performing assets.
2. There is no significant difference between non-performing assets in priority sector and non-priority sector advances of Canara Bank.
3. There is no significant difference between non-performing assets in priority sector and non-priority sector advances of Canara Bank Madurai circle.
4. There is no significant difference in causes of non-performing assets between employees and account holders of the Canara Bank.

5. There is a significant association between socio-economic status of account holder and the causes of non-performing assets.

6. There is no significant relationship between non-performing assets and profitability of Canara Bank.

1.18. SCOPE OF THE STUDY

Providing loans for economic activities is the social responsibility of banking. Credit dispensation activity is considered to be major part of funding apart from raising resources through fresh deposits, borrowings and recycling of funds received back from borrowers. Lending is generally encouraged because it has the effect of funds being transferred from the system to productive purposes, which results in economic growth. However, lending involves credit risk, which arises from default by the borrowers. The process of credit cycle is affected by non-recovery of loans along with interest. Thus, loan losses and requirement of provisioning for loss affect the profitability of banks on a large scale. Though complete elimination of such losses is not possible, banks can always aim to keep the losses at a low level.

The findings of the study would be useful for better understanding on the size and trend in non-performing assets in Canara Bank in general and Madurai circle of the bank in particular. The present study would help to identify the size and magnitude of non-performing assets of Canara Bank regarding both priority and non-priority sector advances. These findings would be useful to modify or reorganize the existing lending policies in order to achieve the growth and equity.

It would also be useful to identify and elaborate the causes for non-performing assets which pave the way to reduce the non-performing assets of bank and it would enhance the profitability of the bank. Besides, this study would help to formulate and implement the preventive and curative measures to control non-performing assets.

1.19. RESEARCH METHODOLOGY

The research methodology constitutes the blueprint for the data collection, measurement and analysis of data. It is the overall operational pattern or framework, of the research that stipulates what information is to be collected from which sources and by what procedures.

1.19.1. RESEARCH DESIGN

The descriptive research design has been employed for the present study. It is chosen for the present study in order to derive the meaningful relationship among the various components of non-performing assets of Canara Bank.

1.19.2. SAMPLING PROCEDURE

Among the different circles in Tamil Nadu, Madurai circle has been purposively selected for the present study. The simple random sampling technique has been adopted to identify the respondents for the present study. The 20 employees from a district have been selected. There are seven districts in Madurai circle. Hence, the total employee-respondents for the study are 140 in Madurai circle.
The branches are classified into three categories viz., very large branches, semi-urban branches and rural branches. The 150 respondents have been selected from very large branches, 75 each from semi-urban and rural branches have been selected as asset accounting holder-respondents for this study. Hence, the total sample size is 300.

Besides, the secondary data have been collected from the published documents of Canara bank, Reserve Bank of India and Economic Survey, Government of India.

1.19.3. METHODS OF DATA COLLECTION
1.19.3.1. PRIMARY DATA
The data and information are collected from the primary source of both bank employees and asset accounting holders through pre-tested structured questionnaire.

1.19.3.2. SECONDARY DATA
The data and information are collected from the secondary sources of journals, research papers, research reports, government reports, conference proceedings, magazines, newspapers and websites.

1.19.4. TOOLS OF DATA COLLECTION
The structured questionnaire is developed based on prior research studies, experts’ opinion and pilot study. The structured questionnaire consists different parts in order to study the objectives. A five point Likert scale (5=Strongly Agree; 4=Agree, 3=Neutral, 2=Disagree 1=Strongly Disagree) is used to study causes for the Non-Performing Assets.

1.20. FRAMEWORK OF ANALYSIS
In order to study the size and trend in non-performing assets in Canara bank in general and Madurai circle of the bank in particular and special aspects of non-performing assets in priority and non-priority sector advances and the trend in statutory provisions made for non-performing assets, the trend analysis has been applied.

In order to study the difference in size in non-performing assets in Canara bank in general and in Madurai circle of the bank in particular, difference between non-performing assets in priority sector and non-priority sector advances and difference in causes of non-performing assets between employees and account holders of the bank, the t-test has been employed.

The Chi-Square test is used to examine the association between socio-economic status of account holder and the causes of non-performing assets. The regression analysis has been applied to study the impact of non-performing assets on profitability of the bank. In order to examine the relationship between non-performing assets in priority and non-priority sector advances and profitability of the banks, the correlation analysis has been applied.

1.21. LIMITATIONS OF THE STUDY
The present study is confined to Madurai circle only. The present study is based on the primary data collected from the both bank employees and asset accounting holders. Hence, the drawbacks and limitations of the field level survey are very much applicable to the present research. The data and information collected from both the bank employees and asset accounting holders are subjected to recall bias.
1.22. CHAPTERISATION

The first chapter deals with the introduction, statement of the problem, objectives of the study, hypotheses, research design, scope of the study, framework of analysis and limitations of the study.

The second chapter deals with review of literature.

The Reserve Bank of India norms for classification of assets in banking sector is presented in the third chapter.

The fourth chapter deals with trend in non-performing assets in Canara Bank and Madurai Circle.

The fifth chapter deals with non-performing assets in priority and non-priority sector advances.

The sixth chapter deals with causes for non-performing assets in Canara Bank.

The seventh chapter comprises of findings, recommendations and conclusion.