CHAPTER 2

REVIEW OF LITERATURE
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2.1 Importance of Review of Past Studies

2.2 Studies
Chapter 2

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There is a great necessity of the study of literature so that we can avoid duplication of the unwanted research work and at the same time the finding of such studies provide the base for the future study & also gives directions for the further studies required in a particular area where no research is made or a very little research work has been carried out due to new developments in that area. The selection of the topic for the study has been undertaken after a brief review of literature and research available on the subject. An attempt has been made to refer to sum up the national as well as international journal publication.

2.1 IMPORTANCE OF REVIEW OF PAST STUDIES:

Non Performing Assets is the boiling question for the banks in India & at international level. Many of the American Investment Banks have failed due to Sub Prime Crisis. Sub Prime Crisis emerged due to heavy lending by the financial institutions to weak borrowers. Everything was moving smoothly because real estate prices were increasing but once it has started decreasing, weak borrowers failed to pay the outstanding loans & finally converted their loans in to NPA, these makes financial institutions failure & finally it has created the panic for the American Economy & because America is in trouble, they have started withdrawing money from the whole world. This resulted in to the Crisis of Confidence through out the world & even today whole world is passing through the ever biggest financial crisis since 1929-30. With this back ground the study of NPA becomes more interesting at the international level as well as at the Indian level.
Though many published articles are available in the area of credit management and non-performing assets, which are either bank specific or banking sector specific, there are hardly any state specific researches. Gujarat is one of the leading states of India in industrial development as well as in attracting foreign investments. Majority of the banks are having western zone which includes many states like Gujarat, Maharashtra, Rajasthan Madhya Pradesh, Goa in all or a portion of that. All banks are having data readily available on all over India basis but it is not possible to get the sectorial data for the particularly western zone. This work is therefore, an extension of the work done by the author.

2.2 STUDIES:

Study No.: 1
Title: Lending Rates of the Banks
Writer's Name : Mohan
Publication Year : 2003

In another study, Mohan (2003) observed that lending rates of banks have not come down as much as deposit rates and interest rates on Government bonds. While banks have reduced their prime lending rates (PLRs) to some extent and are also extending sub-PLR loans, effective lending rates continue to remain high. This development has adverse systemic implications, especially in a country like India where interest cost as a proportion of sales of corporate are much higher as compared to many emerging economies. The problem of NPA is related to several internal and external factors confronting the borrowers (Muniappan, 2002). The internal factors are diversion of funds for expansion/ diversification/ modernisation, taking up new
projects, helping/promoting associate concerns, time/cost overruns during the project implementation stage, business (product, marketing, etc.) failure, inefficient management, strained labour relations, inappropriate technology/technical problems, product obsolescence, etc., while external factors are recession, non-payment in other countries, inputs/power shortage, price escalation, accidents and natural calamities.

Study No.: 2

Title: An Empirical Study on Relationship between Operating Inefficiency problems of Loans of Public Sector banks

Writer's Name : Mohan
Publication Year : 2003

In the Indian context, Rajaraman and Vasishtha (2002) in an empirical study provided an evidence of significant bivariate relationship between an operating inefficiency indicator and the problem loans of public sector banks. In a similar manner, largely from lenders’ perspective, Das and Ghosh (2003) empirically examined non-performing loans of India’s public sector banks in terms of various indicators such as asset size, credit growth and macroeconomic condition, and operating efficiency indicators.
Sergio (1996) in a study of non-performing loans in Italy found evidence that, an increase in the riskiness of loan assets is rooted in a bank’s lending policy adducing to relatively unselective and inadequate assessment of sectoral prospects.

Interestingly, this study refuted that business cycle could be a primary reason for banks’ NPLs. The study emphasised that increase in bad debts as a consequence of recession alone is not empirically demonstrated. It was viewed that the bank-firm relationship will thus; prove effective not so much because it overcomes informational asymmetry but because it recoups certain canons of appraisal.

In a study of loan losses of US banks, Mc Goven (1993) argued that ‘character’ has historically been a paramount factor of credit and a major determinant in the decision to lend money.

Banks have suffered loan losses through relaxed lending standards, non guaranteed credits, the influence of the 1980s culture, and the borrowers’ perceptions. It was suggested that bankers should make a fairly accurate personality-morale profile assessment of prospective and current borrowers and guarantors. Besides considering personal interaction, the banker should:
(i) Try to draw some conclusions about staff morale and loyalty,
(ii) Study the person's personal credit report,
(iii) Do trade-credit reference checking,
(iv) Check references from present and former bankers, and
(v) Determine how the borrower handles stress. In addition, banks can minimize risks by securing the borrower's guarantee, using Government guaranteed loan programs, and requiring conservative loan-to-value ratios.

Study No.: 5
Title: Causes of Default in Rural Credit
Writer's Name : Khusro Committee, RBI
Publication Year : 1989

The Khusro Committee (RBI, 1989) identified several Causes of Defaults in Rural Credit, as reported by the borrowers. The categorization of causes as external and internal to the system indicates that the external factors are essentially related to non-viability of agriculture. Specifically those factors are related to natural calamities, inadequate income generation and factors contributed by other agencies. The Committee reported that in majority of rural areas, farmers fail to get remunerative prices for their produce due to the absence of infrastructural facilities and hence lack of forward and backward linkages within the existing markets. There is also a mismatch between the time of credit delivery and production period. Faulty government policies of debt relief measures, inadequate grace period, particularly in the case of longer period investments and interest/credit/subsidy/concessions, etc., are quite common. Internal factors like defective assessment of the loan, ineffective supervision...
and absence of timely action also contributed substantially to low recovery of loans.

Study No.: 6

Title: Causes of Non Performing Loans

Writer's Name : Bloem and Gorter
Publication Year : 2001

In the study they suggested that a more or less predictable level of non-performing loans, though it may vary slightly from year to year, is caused by an inevitable number of 'wrong economic decisions' by individuals and plain bad luck (inclement weather, unexpected price changes for certain products, etc.). Under such circumstances, the holders of loans can make an allowance for a normal share of non-performance in the form of bad loan provisions, or they may spread the risk by taking out insurance. Enterprises may well be able to pass a large portion of these costs to customers in the form of higher prices. For instance, the interest margin applied by financial institutions will include a premium for the risk of non-performance on granted loans.

Study No.: 7

Title: Factors behind Non-Repayment of Rural Loans

Writer's Name : Puhazhendhi and Jayaraman
Publication Year : 1999

Puhazhendhi and Jayaraman (1999) observed that consequent upon the introduction of prudential accounting norms, ageing of overdues have added another dimension to the problem of mounting overdues. At first, banks have to make provisions against the estimated amount. Other high transaction costs for funds coupled with lower financial margins are important factors behind non-repayment of
rural loans and accumulation of overdues. High transaction cost adds to financial cost of loans and makes the project unviable. An RBI study (1999) found that the higher proportion of NPA in priority sector advances was attributed to the directed and pre-approved nature of loans sanctioned under government-sponsored programmes, absence of any security, lack of effective follow-up due to large number of accounts, legal recovery measures being considered to be time-consuming and not cost effective, vitiation of loan repayment culture consequent to loan waiver schemes, etc.

Study No.: 8
Title: Study on Failure in Rural Credit
Writer’s Name : Gulati and Seema Bathla
Publication Year : 2002

According to Gulati and Seema Bathla (2002) a high level of incidence of overdues and the resultant bad debts in rural credit are associated with a large number of factors, both internal and external to the system. The major factors are natural calamities, inadequate income generation, high transaction costs, inappropriate financial policies, poor working of the Rural Financial Institutions (RFIs), imposition of prudential norms and provisioning for NPA.

The main factors responsible for increasing NPA in priority sector advances as reported by studies conducted by the PSBs were : poor management and failure to detect the causes of incipient sickness; lack of management capability of the borrowers; absence of regular visits to units by the branch staff to monitor the operations; and lack of proper infrastructure in the areas. Several Committees and Task Forces and research studies have identified more or less the same inhibiting factors.
factors causing the increasing incidence of overdues or nonperforming advances in the rural credit system.

Study No.: 9
Title: NPA in SSI Sector
Writer's Name: Kulkarni and Shete
Publication Year: 2001

Kulkarni and Shete (2001) found that NPA in SSI sector are significantly higher than that of other segments of priority sector. This is mostly because of faulty methods of financing and target-oriented perception. Banks are not serious about subsequent problems like quality of product, technology, expansion and modernization and credit-related problems as noticed in the study.

Study No.: 10
Title: Study on Problem of NPA
Writer's Name: Shete
Publication Year: 2001

A quick look at some of the reports and studies on NPA shows that the problem of NPA is perceived as post-sanction inadequacy in supervision, monitoring and follow-up of the end-use of the funds (Shete, 2001). This perception may not be altogether wrong, but the real problem lies elsewhere. According to many bankers who were and are associated with priority sector advances, felt that, the accounts becoming NPA is primarily due to undue delay in project appraisal and project implementation. The bankers feel that in many cases, the genesis of NPA could be traced to loan appraisal and loan assessment itself. The pressure at these stages could be political, social, technical, financial, managerial, economical, target-achievement
and other considerations (NIBM, 1998). The perception of few CEOs of the PSBs is different from that of the Chiefs of PSUs. The CEOs feel that "the external factors are by and large responsible for accumulation of NPAs in PSUs than the internal causes (Bank Economist's Meet, 1998). The studies conducted by the PSBs on Causes and Remedies on NPAs show that both external and internal factors contributed to increasing the NPA levels in priority sector advances. The causes of NPA external to banks as identified by these studies are factors beyond the scope of activities and operational control of the credit agencies. These are: (i) the environment in which the credit agencies function and extend finance to all the activities in the rural areas; (ii) the susceptibility of large parts of the country to repeated droughts in the rained areas, where agriculture is mainly dependent on monsoons, and of large areas under floods resulting in extensive crop damages impaired the repaying capacity of the borrowers and disrupt the credit delivery systems at all levels; (iii) the inadequate income generation capacity affects recoveries mostly in resource-poor and backward areas; (iv) the inadequacy of arrangements for marketing of agricultural / rural produce, and, lack of transportation also affects recovery of loans; and (v) the increasing participation of banks in weaker section financing mostly through government-sponsored programmes and also political interference undermine the credit discipline.

Findings and Suggestions

As far as factors internal to the credit systems are concerned, these studies found that the structural weaknesses of the credit agencies, deficiencies in the loan policies and procedures, ineffective supervision and improper monitoring of the end use of credit, poor customer service and lack of rapport with borrowers cumulatively lead to accounts becoming NPA. While granting loans, the integrity of the borrowers is not properly assessed; systematic recovery drive was
According to grassroots bankers, the main reasons for NPA are: lack of field staff to ensure follow-up supervision after the sanction of loans and heavy burden on the existing field staff since they have to cover large number of villages under the loan recovery programmes (Shete, 2002). Needless to state that default in lending adversely affected recycling of credit, squeezed-up the resources and is closely linked with the banks heading towards a state of financial unsustainability. In order to combat the problems of defaults as well as to ensure financial viability, the RBI and NABARD have brought out several policy and institutional measures. The major changes introduced, particularly after the financial sector reforms in 1991 relate to recapitalization of RRBs, liberalization of interest rates, increase in commercial freedom of RFIs, credit flows to the rural areas, development of local area banks, etc. All these were expected to reduce the burden of NPA in priority sector advances. At this time bank's non performing loans increase, profit declines & substantial losses may become apart. Eventually, the economy reaches a trough and turns towards a new expansionary phase, as a result the risk of future losses reaches a low point, even though banks may still appear relatively unhealthy at this stage in the cycle.
Organisation of Economic Cooperation and Development has organized a “Forum for Asian Insolvency Reform on 10th and 11th November, 2003 at Seoul, South Korea which was jointly organized by World Bank, Government of Japan and Asian Development Bank. The Ministry of Finance and Economy and the Financial Supervisory Commission of South Korea Co hosted it with the assistance from Korea Development Institute and Korea Asset Management Corporation.

Second Amendment and SARFESI

The Second Amendment and SARFESI are a leap forward in the direction of providing an effective and compatible enforcement system. However, there is a lot more required to make the said laws predictable, transparent and affordable enforcement of both unsecured and secured credit claims by efficient mechanisms outside of insolvency, as well as a sound insolvency system. The Second Amendment does little to expedite and simplify insolvency procedures. Unfortunately, no definite time frame has been provided for various stages during the liquidation proceedings. It is hoped that with professionals acting as liquidators, the proceedings will be conducted in a professional fashion maximising the value of assets and improving the efficiency of the entire process, which presently suffers from delay and inefficiency. It is now for the administrators of NCLT to enforce the provisions of law effectively and meaningfully.
Tribunalisation of justice and an over-burdened tribunal

Though, tribunalisation of justice is now a recognised trend, the Indian experiment with tribunals has been nothing to boast about. They have largely failed to serve the purpose for which they were set up. Flowing from such diverse dimensions of judicial functions, NCLT would be burdened with a workload of enormous magnitude and, in the process, would be likely to lose focus on revival and rehabilitation of sick entities. Change in eligibility criteria for making a reference would itself generate a greater workload.

Suggestions & Findings

International insolvency in India

Unfortunately, the Second Amendment ignores the recommendation of Eradi Committee and fails to provide a framework for cross-border insolvencies, with recognition of foreign proceedings. The Government of India though proposes to deal with the issue in the near future. In this area, the recommendations of Eradi Committee have been ignored in the bill. Indian insolvency laws do not have any extra-territorial jurisdiction, nor do they recognise the jurisdiction of foreign courts in respect of branches of foreign banks operating in India.

Need for an effective out-of-court restructuring mechanism

Presently the Corporate Debt Restructuring (CDR) Scheme of the Reserve Bank of India deals with out-of-court workout in India. The CDR Scheme has not been very effective and is hardly invoked by debtors. The CDR Scheme is presently under review. The INSOL Global Principles have been made available to the concerned authorities for their consideration and adopt on.
Bankruptcy proceeding for banks and financial institutions

Bankruptcy proceedings against banks and financial institutions have a very special significance as they affect the domain of the monetary system, management and financial stability. In several developed countries, there is a separate bankruptcy code for banks and financial institutions. In India, this is primarily the responsibility of Reserve Bank of India. The new law and procedures should be structured to handle the bankruptcy proceedings in the case of banks and financial institutions in consultation with the Reserve Bank of India.

Study No.: 12
Title: Developing Asian Market for NPA

Writer's Name : Ashwani Puri
Publication Year : November, 2003

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Organisation of Economic Cooperation and Development has organized a "Forum for Asian Insolvency Reform on 10th and 11th November, 2003 at Seoul, South Korea which was jointly organized by World Bank, Government of Japan and Asian Development Bank. The Ministry of Finance and Economy and the Financial Supervisory Commission of South Korea Co hosted it with the assistance from Korea Development Institute and Korea Asset Management Corporation."
The Asian Currency Crisis severely crippled the financial system in most Asian countries and brought to light the magnitude of Non-Performing Loans (NPLs) at Asian financial institutions. Driven by the need to proactively tackle the soaring NPL levels, the respective governments embarked upon a programme of substantial reform. This process involved the establishment of asset management companies (AMCs) for resolving the impaired assets held by banks and financial institutions. AMCs in countries such as Indonesia, Korea, Malaysia, and Thailand were initially structured as centralised government-owned entities, though banks in countries like Thailand subsequently set up their own individual entities to resolve distressed assets. Taiwan has gone a step further with large-scale portfolio sales and a number of foreign investor-owned AMCs dominating the NPL market. The process of establishing AMCs was often supplemented with the creation of out-of-court debt restructuring mechanisms in these countries. A number of factors influenced the successful resolution of NPLs in these countries.

A consortium lending approach has typically been followed in India. While development financial institutions have typically provided term loans to borrowers, the commercial banks have typically been working capital lenders. The resulting inter-creditor issues, and lack of an effective platform for resolution of the same, often caused delays by lenders in responding to borrower issues.
Recommendations for reducing NPAs

1. Effective and regular follow-up of the end use of the funds sanctioned is required to ascertain any embezzlement or diversion of funds. This process can be undertaken every quarter so that any account converting to NPA can be properly accounted for.

2. Combining traditional wisdom with modern statistical tools like Value-at-risk analysis and Markov Chain Analysis should be employed to assess the borrowers. This is to be supplemented by information sharing among the bankers about the credit history of the borrower. In case of new borrowers, especially corporate borrowers, proper analysis of the cash flow statement of last five years is to be done carefully.

3. A healthy Banker-Borrower relationship should be developed. Many instances have been reported about forceful recovery by the banks, which is against corporate ethics. Debt recovery will be much easier in a congenial environment.

4. Assisting the borrowers in developing his entrepreneurial skills will not only establish a good relation between the borrowers but also help the bankers to keep a track of their funds.
5. Countries such as Korea, China, Japan, Taiwan have a well functioning Asset Reconstruction/ Recovery mechanism wherein the bad assets are sold to an Asset Reconstruction Company (ARC) at an agreed upon price. In India, there is an absence of such mechanism and whatever exists, it is still in nascent stage. One problem that can be accorded is the pricing of such loans. Therefore, there is a need to develop a common prescription for pricing of distressed assets so that they can be easily and quickly disposed. The ARCs should have clear ‘financial acquisition policy’ and guidelines relating to proper diligence and valuation of NPA portfolio.

6. Some tax incentives like capital gain tax exemption, carry forward the losses to set off the same with other income of the Qualified Institutional Borrowers (QIBs) should be granted so as to ensure their active participation by way of investing sizeable amount in distressed assets of banks and financial institutions.

7. So far the Public Sector Banks have done well as far as lending to the priority sector is concerned. However, it is not enough to make lending to this sector mandatory; it must be made profitable by sharply reducing the transaction costs. This entails faster embracing of technology and minimizing documentation.

8. Commercial Banks should be allowed to come up with their own measures to address the problem of NPA. This may include waiving and reducing the principal and interest on such loans, or extending the loans, or settling the loan accounts. They should be fully authorized and they should be able to apply all the preferential policies granted to the asset management companies.
9. Another way to manage the NPA by the banks is Compromise Settlement Schemes or One Time Settlement Schemes. However, under such schemes the banks keep the actual amount recovered secret. Under these circumstances, it is necessary to bring more transparency in such deals so that any flaw could be removed.