Chapter 1

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Chapter 1

INTRODUCTION

Bank is the most important service of the commerce in industrial age that means we are living in the era where it is difficult to think the life without banking. All day to day transactions of the people are closely connected with the bankers. The whole world is converted into a global village due to development of the various technologies. Banking industry is also opting for the new and new technology and tries to satisfy the stake holders.

Almost 20 - 25 years ago, computer was a new machine in the Indian society and people were having the doubts about its success due to various reasons. Bank employees’ unions were also having objection in introducing the computers in to the bank, finally government has made it mandatory for the nationalised banks, and it was followed by the Private Banks, Foreign Banks and also by Co Operative Banks. Today it is difficult to imagine a bank without computers.

Similar is the situation in the banking industry accounting system. Up to 1994, all banks were calculating the interest on the loans granted irrespective of the recovery made on that so majority of the banks were making the huge profit on paper but in reality when principle amount itself is in danger there is no question of calculating interest on that. Government of India has decided to invite foreign banks in banking industry as well as has decided to permit private banks and co-
operative banks to play their own role in the development of the economy.

At international level, banking industry has accepted the norms of bifurcating loan assets into Standard assets, Sub Standard assets, Doubtful assets, Loss assets and calculation of interest on the above loans are made as per the well accepted international norms. Not only that, but provisioning for the sub standard assets, doubtful assets and loss assets were also in practice at international level well accepted by almost all the developed countries. In 1992, Reserve Bank of India has appointed Narsimhan committee and its recommendation on Non Performing Assets also made effective for the banks in 1994.

This has great impact on the accounting system of the banks and has directly affected the income of interest and making provisions has even more impact on the profit of the banks. Initially, substandard assets were calculated if principle or interest is outstanding for more than 365 days then it has been reduced to 180 days and on 31-03-2004 it has been finally reduced to 90 days. This has strait away affected the profit and financial stability of the banks which finally decides the stability of the economy and the nation.

At present, the whole world is passing through the worst ever recession after the Second World War. The recession has been started from USA and it has started from sub prime sector advances. Sub prime means advances given to the people who are having poor record of income and having more risk of recovery in future. USA banks
have started lending money in the sub prime sector for the purpose of housing. Initially, because the economy is developing at a faster rate, there was a booming in the housing sector too which has resulted into a benefit for the banks and the borrowers. But in 2007, the housing sector has started terrific decreasing trend and it has become even worst when loan borrowers have started becoming defaulters. Because loan borrowers have default the housing loan instalments, banks have started foreclosure of the loans by taking possession of the mortgaged house and started selling the same to recover the outstanding loan amount. This has put further pressure on the housing prices in USA and has started affecting the mortgaged bond market prices where almost all the banks of the world have invested money. No interest is paid on these bonds not only that but principle amount itself is in danger has made lot many investment bankers to declare bankruptcy. And finally, this has resulted into slowdown of the economy of USA then that of Europe and then that of the whole world.

All these put terrific pressure on the economy and prices of the commodities. Real estate market has also collapsed in India. Hence, real estate companies are worst hit so far share prices are concerned. Because of overall slowdown almost in all sectors of economy, it is expected that there will be more NPA than that of last few years' records.

In light of the above history, it is always interesting to study the trend of NPA, its impact on profitability and other areas of the economy. Reserve Bank of India is a regulatory body so far as financial
policies are concerned. And RBI too is taking lot many steps to control NPA and Government is also helping banks by making various changes in the legislation to manage the NPA well under control.

1.1 EVOLUTION OF BANKING:

Banking is as old as civilization itself. Records reveal that long before 2500 B.C. the Babylonians had developed a complex system of lending and borrowing, and holding money on deposit. In other parts of the ancient world financial and banking systems were developed as men found a need for a standard of value that the place of cattle, grain, cloth, weapons or other things which they used to barter or exchange.

At first bones, shells, stones feathers and crude metals were used as money. In India, Greece, Egypt, Italy, Asia Minor and a few other countries in that area Copper, Silver and Gold coins gradually replaced these and other materials. Then, as men began to accumulate wealth, they sought a safe place in which to store their money. Someone with a very practical mind thought of hiding his coins in the temple and thus the Greek Shrines at Delphi, Delos and Ephesus served as the earliest banks. Surely men reasoned no one would dare incur the wrath of the Gods by stealing money left inside the temple.

The priest, however, were not the only bankers. About the year 605 B.C. the Egiibi family in Babylon carried on a banking business that evidently thrived. A state bank at Troy attracted capital by paying as much as 10 per cent interest, and a banker in Egypt invited deposits on which he paid interest and permitted the depositor to withdraw his
money at will. The Chinese had invited paper cheques and paper money hundreds of years before they were used in the western world.

The Romans who copied the Greek Banks developed an advanced banking system that included facilities for transferring accounts, making loans, charging brokers' fees, writing cheques for withdrawal of funds and for various other services. These banking activities were in operation through the third century A.D., but with the fall of Rome all financial dealings ended. During the dark ages the banking business all disappeared in Europe although it continued in parts of Asia and North Africa.

Banks were re-established in Italy during the thirteenth and fourteenth centuries and grew quickly in importance and size, as Italians again became worldwide traders. It was from this period that the word "bank" came. Moneychangers carried on their business in the public squares, sitting behind portable benches, on which they displayed their coins. The word ban de (bench) symbolized the business and was carried over into the Italian word banca and the French noun banquet.

With the revival of trade between Italy (especially Venice) and other parts of the known world, banks sprang up elsewhere and intricate banking systems gradually evolved. Soon both family and national banks prospered throughout Europe and these great banking institutions played an important though often unknown role in Europe's growth during the eighteenth and nineteenth centuries.
The Reserve Bank of India came into existence on April 1, 1935. This represented the culmination of a long series of efforts to set up an institution of this kind in country. Perhaps the earliest reference to the need for setting up a central bank may be traced to a dispatch from Warren Hastings in 1773 recommending the establishment of 'General Bank of Bengal and Bihar'. The urgent need for a central banking
institution was recognized and when the three Presidency Banks were amalgamated in 1921 to form the Imperial Bank of India, it was hoped that this institution might develop into a full-fledged central bank. In fact, the Imperial Bank did perform certain central banking functions, such as, acting as banker to Government, although the issue of notes continued to be the direct responsibility of the Central Government.

In 1926, the Royal Commission on Indian Currency and Finance (Popularly known as Hilton Young Commission) felt that the dichotomy that then existed in the authority over currency & credit. This revived the proposal for setting up of a central bank. Accordingly, a fresh bill was introduced in the Indian Legislative Assembly on September 8, 1933 which was passed in due course, and received the Governor-General's assent on March 6, 1934. The Bank commenced operations on April 1, 1935. The separation of Burma from India and subsequent division of India into the Indian Union and Pakistan as well as the integration of the princely States with the Indian Union have, over the course of years, altered the area of operations of the Reserve Bank.

After the separation of Burma in April, 1937, the Reserve Bank of India functioned as the currency authority of that country till June 5, 1942 and as bankers to the Government of Burma till March, 1947. After the partition of the country, the Bank rendered central banking services to the Dominion of Pakistan till June 30, 1948.
The primary function of the Reserve Bank is to regulate the monetary system of the country so as to promote the maintenance of economic stability and to assist the growth of the Government. According to the preamble to the Reserve Bank of India Act, 1934, Bank is 'to regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage. "For the performance of its duties as the regulator of credit, the Bank possesses not only usual instruments of general credit control, such as, bank rate, open market operations and the power to vary reserve requirements of banks but also extensive powers to selective and direct credit regulation under Banking Companies Act., 1949. Another important function of the Bank, and historically the oldest, relates to the conduct of the banking and financial operations of the Government. The Bank has also
an important role to play in maintenance of the exchange value of the rupee in view of the close interdependence of international trade and national economic growth and well being. For the performance of this function, the Reserve Bank has the custody and management of the country's international reserves.

With the task of economic development assuming a new urgency and impetus, the range of functions of the Bank has come to be steadily enlarged. The Bank now performs a variety of developmental and promotional functions, which in the past were regarded as being outside the normal purview of central banking. Although the expansion of facilities for the provision of agricultural credit has been a statutory obligation of the Bank ever since its inception, progress in this field has become striking only during the last few years. The Bank has also taken the initiative for widening the facilities for industrial finance. By virtue of its position as regulator of currency and credit and bankers to Government, the Bank's role as adviser to Government on economic matters in general and on financial problems in particular has been of growing importance.

The Bank collects data on the operations of commercial and co-operative banks, on balance of payments, company and Government finances and security markets and the statistics and the analysis based on them are published periodically in the Bank's publications. The Bank brings out every month a Bulletin (with a weekly Statistical Supplement) and annually a number of reports reviewing general economic, financial and banking developments, including the Bank's operations and policies, such as the Report of the Central Board of Directors, the Report on Trend and Progress of Banking in India, the Review of the Co-operative Movement of Banking in India, and the Report on Currency and Finance. The Bank's functions are thus wide
and varied, representing the super-imposition of new lines of activity on orthodox central banking functions.

Organisational Structure of R. B. I.

RESERVE BANK OF INDIA

- CENTRAL BOARD OF DIRECTORS
- LOCAL BOARDS
- GOVERNOR
- DEPUTY GOVERNOR
- EXECUTIVE DIRECTOR
- CENTRAL OFFICE DEPARTMENTS
- TRAINING ESTABLISHMENTS

Chart 1.1

1.4 INDIAN BANKING SYSTEM:

The Indian banking system consists of scheduled banks in (1) Public Sector, (2) Private Sector, (3) Foreign Banks, (4) Cooperative Banks and (5) Regional Rural Banks.

A scheduled bank is one which conforms to the operational standards such as paid up capital and reserves, transfer to reserve funds and maintenance of cash reserves and other liquid assets laid down in the Banking Regulation Act. They are included in the second schedule of the Banking Regulation Act, others are non-scheduled banks. The scheduled banks enjoy financial accommodation and remittance facilities at concessional rates from RBI.
Nationalised Bank:

After the independence initially, banks were own by the private owners and bank advances were largely for the benefit of the private owners, which was against the socialist pattern of society. Hence, Central Government had taken the first step of taking the ownership of the banks from the private hands to their own hands.

Definition:

The bank in which Government is having controlling stack (more than 50%) then that bank is known as Nationalised Bank.

1.5 NATIONALISATION OF COMMERCIAL BANKS IN INDIA – 1ST PHASE:

The issue of bank nationalisation dates back to 1948. Soon after independence, the demand for the nationalisation of banks in India was raised by some of those members of the Congress party, who has pronounced leaning towards the left, and by some of the members of the Socialist and Communist Parties. They had been thinking about some means, which would hasten the very slow pace of the economic development of the country, and felt that the nationalisation of banks would be a valuable means of achieving this.

The nationalisation of Reserve Bank of India in 1949 was the first step in this direction. Another was the passing of the Banking Companies Act in 1949; these reforms concerned with placing the organization and working in Indian joint stock banks on a sound basis had been overdue. The Act gave extensive controlling powers to the Reserve Bank and the Government over joint stock banks.
These two measures silenced the champions of nationalisation for a while. After sometime, they raised their voice again and focused their attention on the nationalisation of the Imperial Bank of India, the management of which had continued to be largely in the hands of British officers. Initially, due to its lack of preparedness, the Government denied the need for nationalizing the bank. However, in 1956 it did so after the Rural Credit Survey Committee had recommended this step for the purpose of tackling the problem of rural credit in the required scale. Since then, the champions of nationalisation have been appeased partially by passing periodically fresh legislation, which has given the Reserve Bank and the Government greater and greater powers of control over the banking industry.

In some quarters, however, no amount of legislative control over banks was considered to be sufficient and desire was expressed for the total public ownership and control of the whole set up of the commercial banking system. It was even held by some that the nationalisation of banks would be the sole panacea for all ills that afflicted our economic life. In the field of commercial banking, the seeds of nationalisation were shown in 1955 when the Government nationalized the Imperial Bank of India, following the recommendation of the Committee of Direction of the All India Rural Credit Survey. Subsequently, in 1960, seven state associated banks were taken over as subsidiaries of the State Bank of India. The State Bank of India and its seven subsidiaries are as under:

1. State Bank of India
2. State Bank of Hyderabad
3. State Bank of Mysore
4. State Bank of Bikaner & Jaipur
5. State Bank of Indore
6. State Bank of Travankore
7. State Bank of Saurashtra.
8. State Bank of Patiala

The SBI group made considerable progress in achieving its goals of branch expansion in rural areas and catering to the credit needs of small-scale industries and agriculturists.

1.6 NATIONALISATION OF MORE BANKS IN INDIA – 2\textsuperscript{ND} PHASE:

Eventually, 14 major Indian scheduled commercial banks were nationalized on July 19, 1969. Saturday, July 19, 1969 was a fateful day in the current history of Indian banking. On that day the Government issued an Ordinance, promulgated by the then acting President, for the take over of 14 major scheduled commercial banks with more than Rs. 50 crores of deposits. The Nationalisation Bill was subsequently passed by Parliament as Banking Companies (Acquisition & Transfer of Undertakings) Act, 1969, which received President’s assent on 9th August 1969. The Ordinance was, however, challenged by a few, and a stay order of the Supreme Court was obtained. On the ground of violation of Article 14 (Discrimination) and Article 31 (Compensation on compulsory acquisition of property) of the Indian Constitution, the banking Companies (Acquisition & Transfer of Undertaking) Act, 1969, was declared invalid by the Supreme Court on 10th February 1970. It was observed that these 14 banks had been discriminated against in favour of other small banks and foreign commercial banks; also the method of compensating these companies for the acquisition of their shares did not accord with the constitutional determination of compensation for acquisition of undertakings. On February 14, 1970, the President of India promulgated the Banking
Companies (Acquisition & Transfer of Undertakings) Ordinance, 1970, which renationalized these 14 banks, removing the loopholes in the earlier Ordinance struck off by the Supreme Court. According to the new Ordinance, these companies were permitted to re enter the banking business under some statutory confinement, and provision was made for payment of compensation at a higher rate in cash or in government securities maturing at the end of 10 to 30 years, or partly in cash and partly in government securities as might be opted for by the companies concerned. Subsequently, the Banking Companies (Acquisition & Transfer of Undertakings) Act was passed on March 31, 1976 with retrospective effect, keeping the original nationalisation (of 19 July, 1969) intact.

1.7 NATIONALIZATION OF 6 MORE BANKS – 3RD PHASE:

On April 15, 1980 six more banks in the private sector, whose demand and time liabilities as on March 14, 1980 amounted to not less than RS. 200 crores have been nationalised. These banks are

1. The Andhra Bank Ltd.
2. Corporation Bank Ltd.
3. The New Bank of India Ltd.
4. The Oriental Bank of Commerce Ltd.
5. The Punjab & Sind Bank Ltd.
6. The Vijaya Bank Ltd.

The objective is “to control the heights of the economy to meet progressively and serve better the needs of the development of the economy and to promote the welfare of the people” With the addition of this six banks the number of public sector banks have been
Thus these trends of banking development leads to the following conclusion:

1. The expansion of bank-branches and deposit mobilization among the regions are almost of a uniform pattern. In these cases, Western region which is the most developed one among all indicate lowest percentage increase while North-Eastern and Central regions which are less developed shows highest percentage increase. This is a healthy trend which, if continued, may reduce the gap among developed and backward regions.

2. The credit disbursement trend does not follow the deposit trend. Here Northern region shows the highest percentage increase while Eastern region the lowest. North-Eastern region stood on 2nd position. But even then one can realize that the most backward region—North-Eastern—has shows a substantial improvement in credit disbursement in 1980 over 1969.

3. If we combine all the three trends of banking development that is, branch expansion, deposit mobilization and credit disbursement, the most backward region, namely, North-Eastern has stood on 1st and 2nd positions, and Western region which is the most developed one have remained on the lowest positions, except in case of credit disbursement where this region has stood on the 5th position.

4. Thus, the over all trend goes in favour of government policies. The widening disparities among the developed and backward regions are gradually reducing.
1.8 ORGANISATION STRUCTURE OF SCHEDULED BANKS IN INDIA:

Schedule Banks are divided into two division: One is Schedule Commercial Bank & Other is Schedule Co-Operative Banks.

Category under Schedule Commercial Banks can be separated as (1) Public Sector Bank which is a group of Nationalised Banks and State Bank of India & Its Associates; (2) Private Sector Banks – Old & New both; (3) Regional Banks and (4) Foreign Banks, while Schedule Co-Operative Banks comprise of Urban Co-Operative Banks & State Co-Operative Banks.
1.9 THE RENOVATED BANKING STRUCTURE:

1. The economic and financial sector reforms introduced after 1990s are the outcome of new problems related to investment banking, insurance, depository services, mortgage financing and accommodating with the e-banking, money substitutions, the World Trade Organisation (WTO) – effects etc. To prepare themselves for these challenges, banks are required to be
   a) more customer centric
   b) managing assets and liabilities according to risk and return
   c) introduce and expand in new technology for efficiency in customer service, funds management, risk-management, and fast communication
   d) increase profitability through cost reduction and increased income alternatives through
   e) efficient and trained Human resource

2. The renovated banking should discuss the matter related to
   a) structure and design of banks suitable to present operations;
   b) functional aspects of management, profitability and NPA control;
   c) governance aspects and supervisory reforms

3. The banking structure now needs more intelligent governance and transport reporting as expected by customers and desired according to norms of disclosure standards of banks.
1.10 FUNCTIONS OF THE NATIONALISED BANK:

The functions of a nationalised bank are
1. To change cash for bank deposits and bank deposits for cash,
2. To transfer bank deposits between individuals and/or companies
3. To exchange deposits for bills of exchange, government bonds, the secured and unsecured promises of trade and industrial units and
4. To underwrite capital issues. They are also allowed to invest 5% of their incremental deposit liabilities in share and debentures in the primary and secondary markets. The nationalised banks have set up the subsidiaries to provide capital market related services, advice on portfolio management or investment counselling. They also offer their constituents services to pay insurance, advice on tax problems and undertake executive and trustee services. They are also involved in the business of credit cards, insurance services as well as in the area of foreign exchange transactions.

1.11 BANKING LAWS:

Various legal reforms have been undertaken by the government to improve the legal framework is as follows:
LEGAL FRAME WORK FOR SECURED & UNSECURED CREDITORS

Legal Frame Work of Secured and Unsecured Creditors

Formal

- Lok Adalat
- Establish Debt Recovery Tribunals under Recovery of Debts due to Banks and Financial Institutions Act, 1993
- Formation of ARC / SC under SARFAESI, 2002
- Set up National Company Law Tribunals under the Companies (Second Amendment) Act, 2002
- Abolish Company Courts and Company Law Board Under Companies Act, 1956
- Amend Code of Civil Procedure to expedite and simplify proceedings in Civil Courts
- Abolish BIFR and AAIFR by repealing Sick Industrial Companies (Special Provisions) Act, 1985

Informal

- Corporate Debt Restructuring Scheme (Framed by RBI)

Chart 1.3
1.12 PROVISIONS FOR NPA BY RBI FROM 2001:

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. Accordingly, as from that date, a Non performing asset (NPA) shall be an advance where

1. Interest and/or instalment of principal remain overdue for a period of more than 180 days in respect of a Term Loan,
2. The account remains 'out of order' for a period of more than 180 days, in respect of an overdraft/cash Credit (OD/CC),
3. The bill remains overdue for a period of more than 180 days in the case of bills purchased and discounted,
4. 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
5. Any amount to be received remains overdue for a period of more than 180 days in respect of other accounts.

1.13 PROVISIONS FOR NPA BY RBI FROM 2004:

With a view to moving towards international best practices and to ensure greater transparency, it has been decided to adopt the 90 days overdue norm for identification of NPA, from the year ending March 31, 2004. Accordingly, with effect from March 31, 2004, a non-performing asset (NPA) shall be a loan or an advance where;
1. Interest and/or instalment of principal remain overdue for a period of more than 90 days in respect of a Term Loan,

2. The account remains 'out of order' for a period of more than 90 days, in respect of an overdraft/cash Credit (OD/CC),

3. The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted,

4. 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

5. Any amount to be repaid remains overdue for a period of more than 90 days in respect of other accounts.

'Out of Order'

An account should be treated as 'out of order' if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power. In case where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for six months as on the date of balance sheet or credits are not enough to cover the interest debited during the same period, these account should be treated as 'out of order'.

Overdue

Any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank.

In India, an asset is classified as a Non-Performing Asset (NPA) if interest or instalments of principal due remain unpaid for more than 180 days initially. However, with effect from 31st March 2004, default status would be given to a borrower if dues are not paid for 90 days. If any advance or credit facilities granted by a bank to a borrower
become non-performing, then the bank will have to treat all the advances/credit facilities granted to that borrower as non-performing without having any regard to the fact that there may still exist certain advances/credit facilities having performing status.

After nationalization, the initial mandate that banks were given was to expand their branch network, increase the savings rate and extend credit to the rural and SSI sectors. This mandate has been achieved admirably. Since the early 90's the focus has shifted towards improving quality of assets and better risk management. The 'directed' lending approach has given way to more market driven practices. The Narasimhan Committee has recommended Prudential Norms on Income Recognition, Asset Classification and Provisioning. In a change from the past, Income recognition is now not on an accrual basis but when it is actually received. Past problems faced by banks were to a great extent attributable to this.

Classification of what an NPA is has changed with tightening of prudential norms. Currently an asset is “Non-Performing” if interest or instalments of principal due remain unpaid for more than 90 days.
MANAGEMENT OF NPA

Chart 1.4
1.14 MANAGEMENT OF NPA:

Management of NPA is not merely a problem of recovery of irregular accounts. This incidence in the first place could be arrested through better selection of borrowers, more scientific credit appraisal and supervision. It has also ramifications in the comprehensive risk management strategy of banks. There is skewness in the exposure of various banks to major NPA accounts.

It is clear that while inviting deposits and increasing them involves certain risks, lending – money perhaps involves the highest degree of risk. The risk factor varies from customer to customer, industry to industry and trade to trade. It also varies according to the nature of security offered. An unsecured loan advanced to individuals under pressure of government for welfare and similar other purposes develop greater NPA in due course. However, from management point of view, every risk should be measured and managed.

The new-work effect is so striking that the banking services have become Information-Technology (IT) Driven. This services sector is now facing many challenges in competitive battlefield. Now, the concept of service and strategy of operation both have changed fast.

The new process needs a different starting point. Success of management depends now not only on extrapolation of trend but in developing imaginations under new dimensions and then folding the future too. It is to be highlighted that in near future, global and local transaction or dealings will go together where bank managers will need greater consciousness. Time has come that no one can stand longer with the prevailing values and systems that do not work in New World.
He must quickly decide and even develop foresightedness to leave obsolete values and systems as early as possible.

The approach to NPA management by the bank has to be multi pronged, necessitating varied strategies suited to different stages of the passage of credit facility. Close monitoring of the account, particularly the larger ones, is of prime importance.

Emerging weakness in profitability and liquidity of corporate, recessionary trends, recovery of instalment / interest with time lag, etc. should alert and caution the banks. The loan review mechanism is to be adopted as a tool to bring about improvements in credit administration. Banks should also adopt their own risk-through the Committee, which can assume the status of an 'Approval Grid'.

Exchange of credit information among banks would be to immense help to avoid possible NPA. The banking system ought to be so geared that a defaulter at one place is recognized as a defaulter by the system. The system will have to provide a mechanism to ensure that the unscrupulous borrowers are unable to play one bank against the other.

It is in this context that the facility of Credit Information Bureau (CIB) becomes relevant. A CIB provides an institutional mechanism for sharing of credit information on borrowers and potential among banks and Financial Institutions (FIs). It acts as a facilitator for credit dispensation and helps mitigate the credit risk involved in lending. Based on cross-country experiences, initiative has been taken in India to establish a credit information bureau.
The quality and performance of advances have direct bearing on the profitability and viability of banks. Despite the credit appraisal and disbursement mechanism, the problem often tends to manifest itself in an accretion to the stock of non-performing assets. Although the net NPA of the commercial banks in India have witnessed a decline over the past several years, they are still high as compared to developed country standards of around 2 per cent. Prompt remedial actions are, therefore warranted in this regard.

In market-driven systems, the seeds of credit excesses are often sown in an upswing when boom conditions prevail. Once financial excesses are unwound, however, there can be a tendency for loans to go bad, at the expense of the lender and the health of the financial system. In order to counter the benefits of faster credit growth in a boom against the costs of volatile economic cycles once the movements reverse, it is important that banks are not only equipped with balanced prudential norms, but also have forward-looking or dynamic provisioning so as to build-up a protective cushion in good times that can be drawn down in exigencies.

The cumulative provisions against loan losses of Public Sector Banks (PSBs) in India amounted to 42.5 per cent of their gross NPA for the year ended March 31, 2002. This is low compared to the international standards, where provisions against impaired assets are often as high as 140 per cent. There is, therefore, need for banks to improve their provisioning practices; full provisioning towards already impaired assets needs to be a priority corporate goal.
1.15 FUNCTIONAL ASPECTS OF MANAGEMENT OF NPA:

Improvement in functional areas of banks and their control is related to both supervision and governance. However, the new aspects cover Capital Adequacy, Credit Rating, Risk Rating, Market Discipline and the Timely Adherence to the banking guidelines and norms issued.

With increased sophistication of banks it is felt that greater flexibility should be provided to banks. They should be allowed to use their own credit-risk models. Since 'one-size models' does not suit to all banks. Reference may be made of Basel Committee 1999 on banking supervision where new frame work is based on 3 pillars namely.

(1) Minimum Capital Requirements of Banks and its Assessment.
(2) Supervision to review Banks’ Capital Adequacy and Internal Assessment Process; and
(3) Use of Market Discipline for Greater Transparency in context with the International Banking Practices.

The expected impact on functioning of banks is high lighted through the revision of rules, and guidelines issued by RBI, SEBI, BIFR. The concept of Asset securitisation for securing the receivables from retail sector has been the new dimension. The Rakesh Mohan Committee estimated that about Rs. 500 billion shall be demand for infrastructure financing. This would improve profitability, debt-equity ratio, capital to risk weighted Asset ratio of banks etc.

Now apart from housing loans, auto loans, investment in long direction schemes is increasing viz. deep discount bonds, government securities and other similar investments.
Among future recoverable possibilities of credit cards receivables, Videsh Sanchar Nigam Ltd. (VSNL) and Bharat Sanchar Nigam Ltd. (BSNL) bills, airline ticket recoverable, lease, rents etc. can be the items of securitisation. Actually the financial market has grown in no value.

Another expert committee on securitisation recommended that a legal and regulative frame should be prepared for undertaking securitisation transactions. Similarly in the case of advances for study loans and career progression clientele, The Voluntary Retirement Scheme (VRS) scenario is a heavy amount blockage of banks.

The need to develop an efficient Transfer Price Mechanism (TPM) is another dimension under globalisation. In nutshell, nationalising bank branches through varied operations is the need of the day.

Profitability and NPA controls are inter related issues of operational part of banking. If the important efficiency parameters like cost of deposit yield an advances, interest spread, business per employee burden (non-interest expenditure- non interest income) are not favourable, the branch will become loss making.

Losses may incur due to locational effect, branch-infrastructure and the socio-economic factors.

To convert losses into profits, the bank branches shall be required to improve performance and should watch over the following:-
NPA should be controlled by hook or crook.

- Manpower redeployment is to be done wherever feasible.
- Constant effort is to be made to reduce cost on deposits.
- Special emphasis is to be laid to reduce the 'burden' of the branch.
- Other factors affecting profits need be considered for necessary improvement.

The NPA can be reduced through refinement in operations i.e. (i) specific valuation model be practiced so that the validity of the project is tested on futuristic trends of inflation and market valuation; (ii) the magnitude of NPA in SSI sector can be touched by better monitoring of accounts through close working with entrepreneurs; and (iii) to support loanee-institutions quickly in times of crisis.

1.16 CAUSES OF NPA:

- Liberalised capital and current account and external borrowings with inaccurate assessment of exchange rate risk and risk of capital flight in a crisis.
- Directed credit: Protracted periods of interest rate control and selective credit allocations gave rise to an inefficient distribution of funds. The focus on increasing market share and pursuing diversification with little attention to profitability caused tremendous stress on the economy.
- The "compressed growth" policy via aggressive, leveraged expansion worked well as long as the economy was growing and the ROI exceeded the cost of capital. This strategy backfired when slowing demand and rising input costs placed severe stress on their profitability.
- Lack of Monitoring - Banks relied on collaterals and guarantees in the allocation of credit, and little attention was paid to earnings performance and cash flows.
- Legal mechanisms to dispose bad loans were time consuming and expensive and NPA remained on the balance sheet.
- Expansionary fiscal policy measures administered to stimulate the economy supported industrial sectors like construction and real estate, which may have further exacerbated the problem.
References:


