CHAPTER I

INTRODUCTION

1.1 Introduction:
In the economic growth of any country, the role played by financial system is considered to be very important and decisive as the financial system is the backbone of any economy. It is as essential in business as blood in human body. Every organization needs money to come into existence, to expand and to develop the business. The successful and smooth running of business depends on the proper availability of finance. Finance is the basic need of every organization and it is considered as the prime mover of economic growth. The survival as well as the success of any business depends on the existence of a sound financial system. It contributes a lion’s share in progress and development of a nation.

The financial system is considered to be a unique and the most important institutional as well as functional mechanism for economic transformation. Finance serves as a link between the present and the future. Financial system helps to mobilize the savings. These savings are used for efficient, effective and equitable allocations for the purpose of investment. The successful functioning and performance of financial system helps to accelerate the pace of development and also to achieve predetermined goals and objectives set by the nation to a greater extent.

1.2 Definition of Financial System:
1. Christy has opined that the objective of the financial system is to “Supply funds to various sectors and activities of the economy in ways that promote the fullest possible utilization of resources without the destabilizing consequence of price level changes or unnecessary interference with individual desires.”

2. According to Robinson, the primary function of the system is “to provide a link between savings and investment for the creation of new wealth and to permit portfolio adjustment in the composition of the existing wealth.”

3. Financial System is an information system, comprised of one or more applications, that is used for any of the following: collecting, processing, maintaining, transmitting, and reporting data about financial events; supporting financial planning or budgeting
activities; accumulating and reporting cost information; or supporting the preparation of financial statements.  

4. The American Heritage Dictionary defines the term as under-
   i: “The science of the management of money and other assets.”
   ii: “The management of money, banking, investments, and credit.”
   iii: “Finances Monetary resources; funds, especially those of a govt. or corporate body”
   iv: “The supplying of funds or capital.”  

5. Finance as a function (i.e. verb) is defined by the same dictionary as under-
   i: “To provide or raise the funds or capital for”: financed a new car.”
   ii: To supply funds to”: financing a daughter through law school.”
   iii: “To furnish credit to”.

6. Another English Dictionary, "Word Net defines the term as under-
   i: “the commercial activity of providing funds and capital”
   ii: “the branch of economics that studies the management of money and other assets”
   iii: “the management of money and credit and banking and investments”

7. The same dictionary also defines the term as a function in similar words as under-
   i: "obtain or provide money for; ‘Can we finance the addition to our home?’
   ii: “sell or provide on credit”

8. A financial system is a complex, well- integrated set of sub-system of financial institutions, markets, instruments and services which facilitates the transfer and allocation of funds, efficiently and effectively.

9. “Financial system is a set of complex and closely connected or interlinked financial institutions, or organized and unorganized financial markets, financial instruments and services which facilitate the transfer of funds.”

10. The term financial system is a set of inter-related activities/services working together to achieve some preset goals or objectives. “The system consists of individuals (savers), intermediaries, markets and users of savings. Economic activity and growth are greatly facilitated by the existence of a financial system developed in terms of the efficiency of the market in mobilizing savings allocating them among competing users.”
It means that, the financial system comprises of different markets, institutions, instruments, services and mechanisms. The financial system facilitates in generating savings, investment, capital formation and their growth. The basic and most primary function of the financial system is the mobilisation of savings, their distribution for industrial investment and influencing capital formation to speed up the process of economic growth.

1.3 The Concept of Financial System:
Generally financial institutions, markets, instruments and services are involved in the process of savings, financing and providing investment. In this connection, the proper supervision, control and regulation are equally necessary and important. In this way the financial management proves as an essential, decisive and integral part of the financial system. The inter-relationship between different segments of the economy relates to economic growth, goal, financial system, financial institutions system, financial markets, and financial instruments.

1.4 Importance of Financial System:
A financial system provides services that are vital and important in a modern economy. The stable and widely accepted means of exchange not only facilitates trade but also reduce the cost of transaction as a result of which specialization in production can be seen with more productivity. The financial assets with attractive yield, liquidity and risk factor encourage savings in financial form. Financial intermediaries always try to increase the efficiency of resources used by evaluating alternative investments and monitoring the activities of borrowers. Access to a variety of financial instruments enables an economic agent to pool, price and exchange risks in the markets. The efficient use of resources, saving and risk-taking are the cornerstones of a developing economy. In fact, the country could make this feasible with the active support of the financial system. The financial system has been identified as the most transforming agent for growth, progress of the economy and making it one of the chief contributor and key inputs of development.
1.5 Relationship between Financial System and Economic Growth:

![Diagram of Financial System](image)

1.6.1 The Financial System in India:

In India the role of Financial System is considered to be very crucial, significant and decisive as it pushes the growth and economy of the country. The structure and mechanism of financial system is such that, it mobilizes the monetary resources from a section of economy and used it to allocate it to some other needy sectors. “It
intermediates with the flow of funds between those who have a part of their income to those who invest in productive assets. It mobilizes and usefully allocates resources of a country.”

SCHEMATIC PRESENTATION OF FUNCTIONS OF THE FINANCIAL SYSTEM

The Indian financial system plays a significant role in converting the savings into investments, and facilitates in its consumption. The financial system is relatively more concerned about money, credit and finance. These three terms are interrelated but yet differ somewhat from each other. “Prof. Olson’s thesis is that markets, institutions and instruments are the prime movers of the economy. Economic growth depends on the existence of a well-functioning financial market. The development of the financial structure is actually a necessary condition to economic growth. Further, the development of the financial infrastructure helps in financial deepening. It is essential that financial institutions are developed sufficiently and the market operations be free, fair, competitive and transparent. Market efficiency would be reflected in wide dimension of information,
reduction of transaction costs and allocation of capital to the most productive uses. Freeing the financial sector from government interference has been an important element of market reforms.”  

Indian financial system consists of financial market, financial instruments and financial intermediation. These are briefly discussed below:

### 1.6.2 FINANCIAL MARKETS:

Financial Markets are important components of any financial system. A Financial Market can be defined as the place or market in which financial assets are created or transferred. It is like a real transaction that involves exchange of money for real goods or services. A financial transaction also involves in creation or transfer of a financial asset. Financial Assets or Financial Instruments represent a claim to the payment of a sum of money sometime in the future or periodic payment in the form of interest or dividend.

“In India, though the money market is still characterized by the existence of both the organized money market have grown significantly and are playing an increasing important role. The unorganized sector, comprising the money-lenders and indigenous bankers, caters to the credit needs of a large number of persons especially in the countryside. Amongst the institutions in the organized sector of the money market, commercial banks and co-operative banks have been in existence for the past several decades.”  

Financial markets comprises of: a) money market, b) capital market, c) forex market, d) credit market. They are summarized below:

#### 1.6.3 Money Market-

The money market is a wholesale debt market for low-risk, highly-liquid, short-term instrument. The securities are bought and sold in large denomination to reduce transaction costs. It facilitates a reasonable access to the users of short-term money for meeting their requirements at realistic prices. In this market funds are available for time duration ranging from a single day up to one year. This market is dominated mostly by government, banks and financial institutions.
1.6.4 **Capital Market** - This is a special type of market which is designed to finance long-term investments. In this market the transactions taking place will be for a time period over one year. It facilitates to mobilise long term savings to finance long term investment. Capital Markets are further classified into:

a) Primary Market and  b) Secondary Market

Primary Market is place where new issues are traded, but the volume, pricing and timing of new issues are affected by returns in the stock market. It helps in creating long-term instruments for borrowing.

Secondary Market is a market where outstanding issues are traded. It is like a stock market. It provides liquidity through the marketability of these instruments. It also provides the base for the determining price at which the new issues can be offered in the primary market.

1.6.5 **Forex Market** - This is much needed aspect of the financial system as it deals with the multicurrency requirements, which are met by the exchange of currencies. In this market transfer of funds takes place on the basis of applicable prevailing exchange rate. This is one of the most sophisticated, developed and integrated market functioning world wide in catering the needs of the economy.

1.6.6 **Credit Market** - Credit market is a place where banks, Financial Institutions and Non-Bank Finance Companies( NBFCs) supply short, medium and long-term loans to corporate and individuals.

1.6.7 **II) FINANCIAL INTERMEDIATION**

Financial Intermediaries are business organisations. They serve as a link between savers and investors that ultimately helps in credit allocation process. The issuer designs the instruments. After designing the instrument, it is the duty of the issuer to ensure that these financial assets reach the ultimate investor in order to acquire the requisite amount of money. When the borrower of funds approaches the financial market to raise funds, simply issue of securities will not be good enough. Some more and adequate information about the issue, issuer and the security should also be provided so that turnover may take
place. There should be a proper channel within the financial system itself to ensure such transfer. Therefore, the financial intermediaries came into existence to serve this very purpose.

In the organised sector financial intermediation is conducted by a wide range of institutions functioning under the overall supervision of Reserve Bank of India. In the primary stages, the role of the intermediary was mostly related to ensure transfer of funds from the lender to the borrower. This service was offered by banks, Financial Institutions, brokers, and dealers. However, as the financial system extended its area along with the developments taking place in the financial markets, the scope of its operations has also widened. Some of the important intermediaries operating in the financial markets include; a) investment bankers, b) underwriters, c) stock exchanges, d) registrars, e) depositories, f) custodians, g) portfolio managers, h) mutual funds, i) financial advertisers, j) financial consultants, k) primary dealers, l) satellite or city state dealers, m) self regulatory organizations, etc. Though the markets are different, but there may be a few intermediaries offering their services in more than one market e.g. underwriter. However, the services offered by them differ from one market to another.

The following Table indicates the type of intermediaries, market and their role:

**Table 1.1 Intermediaries, Market & their Role & Functions**

<table>
<thead>
<tr>
<th>Name of Intermediary</th>
<th>Market</th>
<th>Role and Functions</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Stock Exchange</td>
<td>The Capital Market</td>
<td>The Secondary Market to securities where outstanding issues are traded.</td>
</tr>
<tr>
<td>The Investment Bankers</td>
<td>The Capital Market, Credit Market</td>
<td>The Corporate advisory services, Issue of securities for short, medium and long term.</td>
</tr>
<tr>
<td>The Underwriters</td>
<td>The Capital Market, Money Market</td>
<td>Subscribe to unsubscribed portion of securities pertaining to low-risk and high liquidity.</td>
</tr>
<tr>
<td>The Registrars, Depositories, Custodians</td>
<td>The Capital Market</td>
<td>Issue securities to the investors on behalf of the company and handle share transfer activity.</td>
</tr>
<tr>
<td>Forex Dealers</td>
<td>Forex Market</td>
<td>Ensures exchange in currencies of all types.</td>
</tr>
</tbody>
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1.6.8 III) FINANCIAL INSTRUMENTS

Money Market Instruments:
The money market can be defined as a market for short-term money and financial assets that are near substitutes for money. The term short-term means generally a period up to one year and near substitutes to money is used to denote any financial asset which can be quickly converted into money with minimum transaction cost. Some of the important money market instruments are briefly discussed below:
1. Call/Notice Money
2. Treasury Bills
3. Term Money
4. Certificate of Deposit
5. Commercial Papers

1.6.9 Call /Notice-Money Market:
This is the market of borrowers and money lenders to transact their business. The procedure of transacting the business is very simple. When the money is borrowed or lent on demand for a very short period is termed as Call/Notice. When money is borrowed or lent for a day, it is known as Call or Overnight Money. For this purpose intervening holidays and/or Sunday are excluded. Thus money, borrowed on a day and repaid on the next working day, irrespective of the number of intervening holidays is called "Call Money". When money is borrowed or lent for more than a day and up to 14 days, it is ‘Notice Money’. No collateral security is required to cover these types of transactions.

1.6.10 Treasury Bills:
Treasury bills are issued by the RBI on behalf of the government. Treasury Bills are negotiable securities with high liquidity. Treasury Bills are short term borrowing instruments of the union government. Generally, the period is up to one year. “This instrument is used by the government to raise short-term funds to bridge the seasonal or temporary gap between receipts (revenue or capital) and expenditure. They form the most
important segment of the money market not only in India but all over the world as well."

It is a promise by the Government to pay a stated sum after expiry of the stated period from the date of issue such as 14, 91,182,364 days i.e. less than one year. At present, there is a craze for 91-day 364-day Treasury Bills. The 91-day Treasury Bills are auctioned on every Friday and 364-day Treasury Bills are auctioned every alternate Wednesday. They are issued at a discount to the face value, and on maturity the face value is paid to the holder. The rate of discount and the corresponding issue price are determined at each auction.

1.6.11. Inter-Bank Term Money:
Inter-bank market for deposits of maturity beyond 14 days is referred to as the term money market. The entry restrictions are the same as those for Call/Notice Money except that, as per existing regulations, the specified entities are not allowed to lend beyond 14 days.

1.6.12 Certificate of Deposits:
Certificates of Deposit are time deposit for a specific period like fixed deposits. They differ from fixed deposit. Certificates of deposit are bearer in form, tradable and freely transferable whereas fixed deposits are not. In June 1989, Certificates of Deposit were introduced for the first time. Initially only Commercial Scheduled banks were allowed to issue them, but since 1992, financial institutions are also allowed to issue.

Certificates of Deposit are unsecured and negotiable, short-term money market instrument and issued in bearer form as a Promissory Note either by the commercial banks or other eligible financial institution for a specified time period. The guidelines for issue of Certificates of Deposits are presently governed by various directives issued by the Reserve Bank of India, as amended from time to time. Certificates of Deposits can be issued by:

(i) Scheduled commercial banks excluding Regional Rural Banks (RRBs) and Local Area Banks (LABs); and
(ii) Selected all-India Financial Institutions that have been permitted by RBI to raise short-term resources within the umbrella limit fixed by RBI. Banks have the freedom to issue Certificate of Deposits depending on their requirements.

(iii) A Financial Institution may issue Certificates of Deposits within the overall umbrella limit fixed by RBI, i.e., issue of Certificates of Deposits together with other instruments viz., term money, term deposits, commercial papers and intercorporate deposits should not exceed 100 per cent of its net owned funds, as per the latest audited balance sheet.

1.6.13 Commercial Paper:

Commercial Paper is also known as finance paper, industrial paper or corporate paper. The RBI has introduced Commercial Papers in January 1990 in India for the first time. Commercial Paper is a note in evidence of the debt obligation of the issuer. Commercial Paper is an unsecured Promissory Note freely negotiable and transferable by endorsement and delivery with a fixed maturity period. In the beginning only leading and highly rated corporate could issue a Commercial Paper, but now it can be issued by primary dealers, satellite dealers and All India financial Institutions to access short term funds to a greater volume to help in increasing their activities in the secondary market. It can be issued as a promissory note or in a dematerialised form. The issuers and subscribers are advised to invest in only demat form. A company shall be eligible to issue Commercial Paper provided:

(a) It should have tangible net worth not less than Rs. 4 crore as per the latest audited Balance Sheet.

(b) The minimum maturity period of Commercial Paper is 15 days and maximum one year.

(c) The minimum credit rating shall be P-2 of CRISIL or such equivalent rating by other agencies.
1.6.14 Capital Market Instruments:
The capital market generally consists of the following long term period i.e., more than one year period, financial instruments; in the equity segment Equity shares, preference shares, convertible preference shares, non-convertible preference shares etc., and in the debt segment debentures, zero coupon bonds, deep discount bonds etc.

1.6.15 Hybrid Instruments:
Hybrid instruments have both the features of equity and debenture. These kinds of instruments are called as hybrid instruments. Examples are convertible debentures, warrants etc.

1.7 Liberalisation of the Financial System:
Liberalisation and reforms in financial system was initiated in post 1990s. It was recommended to reconstruct the economic system and accordingly, it was undertaken. The fundamental restructuring of the economic system consisting of industrial deregulation, liberalisation of policies relating to foreign direct investment, public enterprise reforms, reforms of taxation system, trade liberalisation and financial sector reforms were initiated in 1992-93. Financial sector reforms in the area of commercial banking, capital markets and non-banking finance companies have also been undertaken. The focus of reforms in the financial markets has been on removing the structural weaknesses and developing the markets on sound lines. The money and foreign exchange market reforms have attempted to make them wider. Reforms in the government securities market were attempted to:

i) Smoothen the maturity structure of debt.

ii) Raising of debt at close-to-market rates and

iii) Improving the liquidity of government securities by developing an active secondary market.
On the other hand in the capital market the focus of reforms has been on:

i) Strengthening the disclosure standards

ii) Developing the market infrastructure and

iii) Strengthening the risk management systems at stock exchanges to protect the integrity and safety of the market.

The elements of the structural reforms in various market segments are undertaken to introduce free pricing of financial assets such as interest rate on government securities, pricing of capital issues and exchange rate, the enlargement of the number of participants and introduction of new instruments.

The RBI has undertaken the banking reforms. As a part of banking reforms, RBI focused on improving financial soundness and credibility of the banks under the capacity of a regulatory and supervisory agency over commercial banks under the Banking Companies Regulation Act, 1949.

The improvement of financial health of banks needs to be achieved by capital adequacy norms in relation to the risks to which banks are exposed, prudential norms for income recognition and provision of bad debts. The removal of external constraints in norms of pre-emption of funds, benefits and prudential regulation and recapitalization and writing down of capital base are reflected in the relatively clean and healthy balance sheets of banks. However, attention has been drawn to remove inbuilt flaws and weaknesses of public sector dominated banking systems. There is a need to further improve financial soundness and to measure up to the increasing competition that a fast liberalizing and globalizing economy would bring to the Indian banking system.

In the area of capital market, the Securities and Exchange Board of India (SEBI) was set up in 1992. The main aim of setting up of SEBI is to protect the interests of investors in securities and to promote development and regulation of the securities market. SEBI has issued guidelines for primary markets, stipulating access to capital market to improve the quality of public issues, allotment of shares, private placement, book building, takeover of companies and venture capital. In the area of secondary markets, measures to control volatility and transparency in dealings by modifying the badla system, laying down insider regulations to protect integrity of markets, uniform settlement, introduction of screen-based online trading, dematerializing shares by setting up depositories and trading
in derivative securities (stock index futures). There is a sea change in the institutional and regulatory environment in the capital market area.

In regard to Non-Bank Finance Companies (NBFCs), the Reserve Bank of India has issued several measures aimed at encouraging disciplined NBFCs which run on sound business principles. The measures aimed at protecting the interests of depositors and providing more effective supervision, particularly over those which accept public deposits. The regulations lay down an upper limit for public deposits which NBFCs can accept. This limit is linked to credit rating by an approved rating agency. An upper limit is also placed on the rate of interest on deposits in order to keep away NBFCs from offering incentives and mobilising excessive deposits which they may not be able to service. The varied nature, number, size, functions (deployment of funds) and level of managerial competence of the NBFCs affect their effective regulation.

Since the liberalisation of the economy in 1992-93 and the initiation of reform measures, the financial system is getting market-oriented and customer familiar. Market efficiency would be reflected in the wide spreading of information, reduction of transaction costs and allocation of capital to the most productive users. Further, making efforts to free the financial system from government interference has been an important element of economic reforms. The economic reforms also focused on improving financial feasibility and institutional strengthening. The markets have been forced to improve the effective implementation of the monetary policy, linkages among money and foreign exchange.

**1.8 Definition of Bank:**

i) “The word ‘Bank’ has originated from German word ‘Bank’. It means joint stock reserved. It is said that king of Venice borrowed from the public in economic crisis in 1171. For this debt reserve the word ‘Bank’ was used and later on it developed as Banco, Banke, Bank.”

ii) As per Webster’s Dictionary, “A Bank is an institution which trades in Money, establishment for deposit, custody and issue of money, as also for making loans and discounts and facilitating the transaction of remittances from one place to another”.

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iii) The Oxford English Dictionary define bank as “A Bank as an establishment for custody of money received from or on behalf of its customers. Its essential duty is to pay their drafts on it. Its profit arises from the use of the money left unemployed by them.”

iv) “A banker or bank is a financial institution whose primary activity is to act as payment agent for customer and to borrow and lend money”

1.9 The Indian Banking System:
Indian banking sector has a history of over 200 years and the banks have grown over a period of time in size and variety of products, services and customers. The size ranges from small co-operative banks to Multi National Corporations. Now the public sector as well as private sector banks are engaged in developing their business as in the highly competitive globalised market.

The East India Company laid the foundation for modern banking in the first half of the 19th century with the establishment of three banks namely, Bank of Bengal in 1809, Bank of Bombay in 1840, Bank of Madras in 1843. These banks are also known as ‘Presidency Banks’.

Swadeshi Movement included the establishment of number of banks with Indian management during the last decade of 19th century and early phase of 20th century, such as Punjab National Bank Ltd. in 1895, The Bank of India in 1906, The Canara Bank Ltd. in 1906, The Indian Bank Ltd. 1907, The bank of Baroda in 1908, The Central Bank of India Ltd. in 1911 and so many other banks established on the same line. But most of the banks became bankrupt due to wrong policy decisions taken by the management and severe banking crises during the year 1913-1918, the period of First World War.

1.10 RBI
On the recommendations of Banking Enquiry Committee, the Reserve Bank of India Act 1934 was passed and accordingly Reserve Bank of India was constituted in 1935 to regulate the issue of bank notes, securing monetary stability in India and operate the currency credit system of the country to its economic development. On 1st January, 1949, The Reserve bank Of India was nationalized in the larger interest of the country. The
nationalization of 14 major banks in 1969 and 6 more banks in 1980 proved milestone and that not only lead to expansion of banks but also paved the way to social, political and economic growth and development.

The post-independence period was witnessed a vibrant revolution in industrial sector which made the country very noticeable in global context. Growth in industry resulted in growth in trade, which in turn has compelled the financial sector to both broaden and deepen itself. “The organized banking in India can broadly be divided in three categories, viz., the central bank of country known as the Reserve Bank of India, the commercial banks and the co-operative banks. As the supreme monetary and banking system in the country, RBI has the responsibility to control the banking system in country. It keeps the reserves of all commercial banks and hence is known as the Reserve Bank.”

The banking system is driving the economy of the country since ancient times. “In every country there is one bank which acts as leader of the money market, supervising, controlling and regulating the activities of the commercial banks and other financial institutions. It acts as a bank of issue and is in close touch with the government, as banker, agent and advisor to the later. Such bank is known as the central bank of the country”. The Reserve Bank of India as the apex and central bank of the country is at the head of this group. “The functions RBI performs are of three types: central banking functions, supervisory functions and promotional functions.”

The role of RBI in banking sector reforms is of immense importance as it strive hard not only to make them survive but also to retain them in the fray of competition. “The RBI has played a very important role in strengthening as well as preparing the Indian banks for the future. Through its guidelines, at different points of time, RBI has addressed the anomalies, if any, in the banking system. Also through its effective monetary management, it has put in place the right conditions to improve the economic growth. The good performance of the Indian economy in the world surely would not have been possible without RBI’s efficient monetary management and the important contribution made by the Indian banks.”

Commercial banks themselves may be divided into two groups, the scheduled and the non-scheduled.
1.11 COMMERCIAL BANKS:
The commercial banking system may be distinguished into:

1.12 A. Public Sector Banks
i) State Bank of India State Bank Group
ii) Associate Bank
iii) 14 Nationalized Banks (1969) Nationalized Banks
iv) 06 Nationalized Banks (1980)
v) Regional Rural Banks Mainly sponsored by Public Sector Banks

1.13 B. Private Sector Banks
i) Other Private Banks;
ii) New sophisticated Private Banks;
iii) Cooperative Banks included in the second schedule;
iv) Foreign banks in India, representative offices, and
v) Non-scheduled banks

1.14 Co-operative Sector
The co-operative banking sector has a very widespread and dense network in the country. The cooperative banking sector has been developed in the country to supersede the village moneylender. The money lenders are the predominant source of rural finance. The terms on which the moneylenders made finance available have generally been proved injurious and unfavorable to the development of Indian agriculture. Though the sector receives concessional finance from the Reserve Bank, it is governed by the state legislation. From the point of view of the money market, it may be said to lie between the organized and the unorganised markets. The structure of co-operative banking in India is as follows:
1.15 Primary Co-operative Credit Societies

The primary cooperative credit society is an association of borrowers and non-borrowers residing in a particular locality. The funds of the society are derived from the share capital and deposits of members and loans from Central Co-operative banks. The borrowing power of the members as well as of the society is fixed. The loans are given to members for the purchase of cattle, fodder, fertilizers, pesticides, equipment etc.
1.16 Central Co-operative Banks
These are the federations of primary credit societies in a district. These banks finance member societies within the limits of the borrowing capacity of societies. They also conduct all the business of a joint-stock bank.

1.17 State Co-operative Banks
The State Cooperative Bank is a federation of Central cooperative banks. It acts as a watchdog of the cooperative banking structure in the State. The main source of its funds is obtained from share capital, deposits, loans and overdrafts from the Reserve Bank of India. The State Co-operative Banks lend money to central cooperative banks and primary societies and not directly to farmers.

1.18 Land Development Banks
The Land Development Banks has three tiers, namely,

i) State

ii) Central and

iii) Primary level.

It fulfills the long term credit requirements of farmers for the purpose of development such as purchase of agricultural equipment like pump sets, tractors, other machineries and reclamation of land, fencing, digging up new wells and repairs of old wells etc. Land Development Banks are cooperative institutions. They grant loans on the security of mortgage of immovable property of the farmers.

1.19 District Co-operative Banks:
District co-operative bank appears as the heart of co-operative movement in India. These banks work as intermediary link between State Co-operative Banks and Primary Credit Societies. As a part of co-operative movement these banks provide some useful services. These banks operate according to RBI directives and Banking Regulation Act for co-operative banks. They also borrow money from RBI and commercial banks and make use of available funds for lending money for a short term period of maximum 18 months to
primary member societies. These banks advances loans on a large scale to the co-operative societies mainly for financing seasonal agriculture for a period of 12 months or less, medium term loans are given for a period of one year to three years for the purchase of a pair of bullocks, pumping sets and other agricultural needs. These types of loans are advanced mostly against promissory notes and personal securities.

Apart from these functions, these banks undertake other functions also which include:

i) Accepting deposits from the public.

ii) Discounting hundis and bills.

iii) Expansion of branches.

iv) Inspection of primary credit societies.

These functions are important in order to develop healthy relations between state co-operative banks and primary credit societies.

1.20 Banking Reforms and NPA:

The three letters “NPA” have frightened and created havoc in banking sector as well as in business circles nowadays. Even the Government of India and RBI have not spared from its impact. NPA is short form of “Non Performing Assets” The recovery of loans always been a problem for the banks and financial institutions. NPA may spill over the banking system and contract the money stock, which leads for economic contraction.

According to RBI, NPA is “An asset, including a leased asset, becomes non-performing when it ceases to generate income for the bank.”

The RBI has redefined the NPAs and has advised the banking sector to bifurcate their advances into four categories, viz: standard assets, sub-standard assets, doubtful assets and loss assets. The financial position and performance of the banks is reflected by the multi faced effects of the Non- performing assets and hence the NPAs have become a performance indicator of the banking sector.

The formation of Shri M. Narasimham Committee on banking sector reform in 1991 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 a critical performance area for all banks in India. There was a lack of specific and unanimous guidelines which resulted in misallocation of banks huge funds and ruin the sustained economic growth of nation. So, it was high time to form some specific guidelines on this issue. 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. Madharao 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.

The management of Non Performing Assets has been considered as crucial performance area for banks; it has in-fact became a performance indicator of the banks. “The primary objective of a bank is to enhance the profitability from its operations & generate surplus sufficient enough for ensuring an increase in stakeholders’ value. At macro level, NPAs have choked off a supply line of credit to the potential borrowers, thereby having a deleterious effect on capital formation and arresting the economic activities in the country. At micro level, the unsustainable level of NPAs has eroded profitability of banks through reduced interest income and higher provisioning requirements, besides restricting the recycling of funds leading to serious assets liability mismatches.”

The Reserve Bank of India has made a series of regulations in controlling the Non Performing Assets for Indian Banks, since the implementation of the recommendation of Narsimham committee report in 1991.

“During 1991 – 1992 Liberalization process was started. The reforms were initiated by a high powered committee headed by Mr. N. Narasimham, which submitted its report in two phases one in 1992 and other in 1998”.

The RBI guidelines focuses on following so long as the performance of the bank is concerned.

1) Keeping C.R.A.R. (Capital to Risk Adequacy Ratio) at least at 9%.
2) Keeping Loans and Advances Ratio between 65% to 70%.
3) Keeping Gross NPA below 15% and Net NPA below 10%.
4) All UCBs shall classify their loan accounts as NPA as per 90-day norm with effect from 1 April 2009.

The Co-operative Banks’ network in India is one of the largest banking networks of the world. These Banks are catering to the varying needs of population are hence called as Co-operative banks. The Co-operative Banks are also saddled with the problem of Non Performing assets.

The following are some of the causes of NPA:

1. The slow, inefficient and lengthy legal system.
2. Diversion of funds.
3. Demand recession.
4. Depressed capital market.
5. Changes in Govt. policies.
6. Fear psychosis among banks for compromise settlement.
7. Improper & inadequate credit appraisal.
8. Industrial sickness & labour problem.
9. Poor post loan supervision & follow up.
10. Political compulsion & corruption etc.

“The level of NPA of a bank is considered to be the measure of its assets the profitability & liquidity of the banks but also forces the banks to maintain more liquid assets which mean an increase in cost.”

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

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

Net NPAs are those type of NPAs in which the bank has deducted the provision regarding NPAs. Net NPAs shows the actual burden of banks. Since the Balance sheet of Indian banks contains a huge amount of NPAs, the provisions have to be made
against NPAs by the banks because the process of recovery and write off of loans is very time consuming, that is why the difference between Gross and Net NPAs is high. The Net NPAs can be calculated as follows:

**Net NPA = Gross NPAs – Provisions or Gross Advances – Provisions.**

The accumulation of huge non-performing assets in banks has assumed great importance. The depth of the problem of bad debts was first realized only in early 1990s. The magnitude of NPAs in banks and financial institutions is very huge. It means that Gross NPA used to reflect the quality of the loans made by banks while net NPA shows the definite feasible burden of banks. The banks and financial institutions are taking the initiatives to reduce NPAs in a time bound strategic approach. There is a concern in the industry and academic circles because it is generally felt that NPAs reduce the profitability of banks, weaken its financial health and erode its solvency. For the recovery of NPAs a broad framework has evolved for the management of NPAs under which several options are provided for debt recovery and restructuring. Banks and Financial Institutions have the freedom to design and implement their own policies for recovery and write-off incorporating compromise and negotiated settlements.

### 1.21.1 BASEL NORMS:

Basel is a place situated in Switzerland where the G-10 countries gathered to discuss the bankruptcy problems and to find an amicable solution in 1986. Accordingly BASEL I, II and III have come into existence.

In India measures are being taken from time to time to tackle the problem of recoveries by RBI by introducing various prudential norms, strict accounting standards, full disclosure norms and capital adequacy for Indian banks. These measures are similar to those followed by International Banks. “The Banking of International Settlement appointed a committee in 1988 to suggest capital adequacy and Risk Management Measures for international banks. This Committee is also known as ‘Basel Committee’. The Narsimham Committee I and II have recommended measures similar to Basel Committee’s recommendations with regards to prudential norm, capital adequacy etc. fro Indian banks. The Reserve Bank of India has issued instructions based on Narsimham Committee committee’s recommendations for commercial banks in India.”

27
1.21.2 BASEL I

In the United States From 1965 to 1981 was the era of bank failures or bankruptcies. In that duration around eight banks were declared bankrupt. Bank failures were particularly prominent during the 1980s, this period which is usually referred to as the savings and loan crisis. It was observed in the duration that banks throughout the world were lending extensively, while countries' external indebtedness was growing at an unsustainable rate. In order to prevent this risk, the Basel Committee on Banking Supervision, comprised of central banks and supervisory authorities of 10 countries (France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, the United States, and Luxembourg) agreed to meet in Basel, Switzerland in 1988. The G-10 countries felt the need to save banking sector by cooperation. It was the need of the hour to form such a committee which can help the banking sector in harmonizing banking supervision, its regulation, and capital adequacy standards across the G-10 countries of the Basel Group and many other emerging market economies. The committee drafted a first document in 1987 to set up 'minimum capital' that banks should hold internationally. This minimum amount is a percentage of the total capital of a bank, which is also called the minimum risk-based capital adequacy. In 1988, the Basel I Capital Accord (agreement) was implemented.

1.21.3 BASEL II

Basel II was initially published in June 2004. The intention was to create an international standard for banking regulators to control capital adequacy. It advocates that international standard could help to protect the international financial system from the types of problems that might arise and leads to series of banks collapse. Basel II attempted to accomplish this by setting up risk and capital management requirements. It designed to ensure that a bank has adequate capital for the risk the bank exposes itself to through its lending and investment practices. Broadly speaking these rules mean that the greater risk to which the bank is exposed, the greater the amount of capital the bank should have to safeguard its solvency and overall economic stability.
1.21.4 BASEL III

It is a global regulatory standard on bank capital adequacy, stress testing and market liquidity risk agreed upon by the members of the Basel Committee on Banking Supervision in 2010-11. The Third Basel Accords was developed in response to the deficiencies in financial regulation revealed by the financial crisis in late 2000s. Basel III strengthens bank capital requirements and introduces new regulatory requirements on bank liquidity and bank leverage.

1.22 LITERATURE REVIEW:

In the duration of research a number of banks, libraries and institutions of the region were visited and various sites were surfed, especially RBI’s sites for updating the current information about the prudential norms and other various regulations issued from time to time. The available information, related literature in these libraries, institutions and sites was studied. It proved very useful in getting an insight into the main objectives and finalizing the research methodology. An attempt is made to review the available literature on the topic of research. The books, articles, the reports on internet, research paper published in leading research journals were reviewed and studied at lengths. A brief review of the literature is presented below:

Dr. Nirmal Prasad & K. Chandradass J. [28] in their book, “BANKING AND FINANCIAL SYSTEM”, (2004), discussed about the changes of Indian financial systems during the last few years. They also focused on modern banking and system and also explained the banking law and financial services etc.

S. M. Padwal [29] in book “IT, MIS AND PRODUCTIVITY IN BANKS”, (1997), has discussed the various aspects of information technology in financial sector or especially in banks. He has described the banking and technology in India from 2001, Impact of liberalization and Computerization in Indian financial system, safety of Information Technology in banks, productivity in computerization environment, MIS in Indian banks, GIS for development banking in India and risk management etc.
S. Natarajan and R. Parameswaran in his book, “INDIAN BANKING”, (2006), have focused on how the world over, dramatic changes are taking place in banks and banking operations. The global financial integration has brought about bigger challenges to the Indian Banking and also discussed that how the complexities arise in the banking operation due to innovation in the banking products and services. They start the discussion from the basis of banking, evolutionary changes in the Indian banking system, its structure and purpose, the ongoing developments etc. the traditional banking helps us to understand the primary concepts of banking. Numerous tables, figures and examples are used to understand the operation of banking. The authors also focused on merchant banking, mutual funds etc. they have also discussed the functioning of various types of banks existing in India and especially discussed the electronic banking concepts.

Indian Institute of Banking and Finance in the book “Information System for Banks”, (2005), conducted the study on five different modules consisting of a) Technology in Banks, b) Technology System, Development, Process, Implementation, c) Security and Controls, Standard in Banking d) Community in business, e) Overview of legal frameworks. The primary objective is to understand the conceptual framework. There is a rigorous coverage of an analytical technique, substantial information about the operational risk that the banks are facing, and how those risks are managed by appropriate measures.

Indian Institute of Banking and Finance in the book “Know Your Banking-I, Basics of Banking”, (2005), has provided a comprehensive coverage of the principles of banking and other important aspects of banking in India. The subject matter is wide and covers the topics: Introduction of banking, Banking regulation, Banks-customer relationship, types of customer and their accounts, negotiable instruments, fee-based banking service, electronic banking, basics of accounting and bank marketing etc. it has focused on the role of DSA (Direct Selling Agents) and DMA (Direct Marketing Agents) in Marketing Bank Products.
Bharati V. Pathak, [33] in her book “Indian Financial System”, the writer has shown a current scenario of Indian Financial System which is under going a considerable change in recent past. The author emphasised on the system prevailing in the country, on challenges to be faced and opportunities to be grabbed.

P. N. Varshney, [34] in the book, “Indian Financial System & Commercial Banking”, (2003) had analysed the nature and problems of Indian Financial System. He also studied in depth, the impact of banking on rural and backward areas. He evaluated the role of financial system and banking in the development of rural India. He also discussed the fresh and critical appraisal in Indian Financial system, its achievements and potentials.

L. M. Bhole, in his book, [35] “Financial Institutions and Markets (2006)” the author focused on the major changes, development and innovations which have occurred in Indian Financial system since 1999. The approach of the writer has been not only to incorporate all the latest information and emerging trends, but also to retain the information which may be regarded by some as not being in tune with the current trends and fashion. Moreover, certain changes and developments in the field of finance using diachronic methods of study are also included.

P. N. Varshney and D. K. Mittal,[36] in their book, “Indian Financial System”(2006) the writers of the book focused on the undergoing changes, adopting new practices and policies in the Indian Financial System to suit the need of the economy. They have thrown light on successful merger of ICICI Ltd. with ICICI Bank Ltd., other leading financial institutions and intermediaries and role of SEBI in bringing reforms, introducing innovative practices and norms for the investors’ protection and efficient functioning of the security market.

(SMT.) T.H. Karnachi [37] in her research article in title, “Performance of Alnavar UCB” has highlighted the development of cooperative banking sector. She is of the opinion that the UCBs are self managed, reliant, built on their own strength, selfless cooperators engaged in banking business and shining in extending services their client.
The recent development in the form of women UCBs entirely managed by women is a recent bold step. The UCBs have become an integral part of the banking system by attaining socio-economic objectives. The UCBs have successfully designed and implemented a new plan wherein improving access distributed to poor artisans and weaker sections. The activities of UCBs are growing in volume and dimensions to suit the changing circumstances and the needs of customers. These have augmented the business even after globalization and are thrown out under the ambit of RBI by extending certain provisions of Banking Regulation Act 1949.

B. Selvarajan [38] in his article entitled “A Study of Financial Performance of Indian Banks with reference to non performing asset” emphasized non performing asset. According to him NPA is not only swallowing the profitability of the bank but also hampering their ability to recycle funds for productive purposes. He further reiterated to maintain both Gross and Net NPA.

The banking industries is facing yet another period of change, perhaps greater than one experienced in immediate past and there is no doubt that Indian banks has to manage its functions successfully and skillfully during the present era, replete with significant economic, competitive and technological challenges in order to improve its deposits, advances, profitability and to reduce non performing assets.

H.M. Thakar and V.S. Dubule [39] in their article, “An Article Study of NPA Management in Banks” wherein they have expressed their views on NPA, according to them NPA are the outcome of credit activity of the bank, which is their most important function to earn profit. The credit is associated with risk therefore the banks cannot avoid NPA. However strict compliance of lending norms, steady growth of credit spread over different systems and activities, careful planning, monitoring and follow up, banks can control the advances turning into non performing advances. Even in case of NPAs reduction is possible by adopting various strategies.

V.M. Chavan and N.B. Sangapur [40] “Dimensions of NPA in UCBs: Micro Study”. In this article the authors have focused on reduction in NPAs. According to them reduction
of NPA is necessary to improve profitability of banks and comply with capital adequacy norms. Bank should put rigorous and appropriate credit appraisal mechanism at initial stage of credit consideration. They further stressed to have a strong system to be implemented by RBI or any other central agencies by which central information can be pooled. This would help to reduce over lending to a customer and to reduce possible NPA. Reduction of NPAs requires proper selection of borrower accounts, financing of viable schemes, extending need based financing, ensure proper end use, proper post sanction follow up, regular monitoring of accounts, avoiding overdrawing extraneous debt, holding recovery camps etc.

Dr. Pradeep Singh [41] in his article published in Management Accountant, Oct-2007, entitled, “Banking Sector Reforms: NPA Management – Assets Reconstruction Company (ARC) in Indian Scenario” states that, it is essential to maintain NPA at lower level (before they become bad debts) in order to face global challenges and to maintain liquidity and profitability. He has made an attempt to study the banking sector reforms specially in the area of NPA management with special reference to Securitization and Reconstruction of Financial Asset and Enforcement of Security Interest Bill 2002 and establishment, operational procedure, accounting and tax aspects and unresolved issues related with Assets Reconstructions Company.

S. Aravanan and N. Vijaykumar [42] in his article published in The Management Accountant, July 2007, entitled, “Non performing assets – Un avoidable but not unmanageable.” The research scholars are of the opinion that the larger mounting of NPAs in banks deter their financial help in terms of profitability liquidity and economies of scale operations. The bank must ensure timely action against degradation of performing asset by a vibrant and visible operation. They further expressed that management of NPA has become a big task and challenges the banks resistance capacity. Occurrence of NPA may be unavoidable but they can be managed with the help of Securitization and Reconstruction of Financial Asset and Enforcement of Security Interest Act 2002.
Dr. Debabrata Mitra’s article entitled, “Effect of reforms process on financial performance: A Case Study of Indian Banking Sector” The author claims that the finance sector reforms have brought tremendous changes in the Indian Banking Sector operating in India, in comparison with foreign banks operating in India. The Indian Banks shifted their focus on retail banking so as to obtained access to low cost funds. Both public and private sector banks are trying their best to expand into relatively untapped potential growth area. This effort may bring Indian financial system closure to global standards.


Dermirguc – Kent and Detagiache (2000) in their article “Monitoring Banking Sector Fragility: A Multivariate Logic Approach”, have focused on a multivariate logical framework to develop an early warning system for banking crises and rating system for bank weakness.

Beck – Dermirguc – Kent and Levine (2005) “Bank Concentration and Fragility: Impacts and Mechanics”, cross checked the interlink between the bank concentration and banking system tenderness. The paper concluded that higher bank concentration is associated with lower probability of banking crises. Moreover, institutions and regulations that facilitate bank competition are associated with less banking system delicateness.

Fernandez de Lis, Martinez – Pages and Saurina (2000) “Credit Growth, Problem Loans and Credit Risk Provisioning in Spain”, in their study found at one end that GDP growth, bank size and capital had negative effect on the NPAs and on the other hand loan growth, collateral, net interest margin, debt equity, market power and regulation regime had a positive impact on NPAs.
Bloem and Goter (2001), [48] “The Treatment of Non-Performing Loans in Macroeconomic Statistics”, emphasised that NPAs may be caused by wrong and ineffective economic decision or by plain bad luck.

Rajaram, I. S. Bhaumic and N. Bhatia (1999) [49] in their study “NPA variation across Indian Commercial Banks: Some Findings”, explained variations in NPAs across Indian banks through differences in operating efficiency, solvency and regional concentration.6,7 Rajaram and Vasistha (2002) [50] in their research article “Non Performing Assets of Public Sector Banks: Some Panel Results”, focused on lack of administration at regional level, inefficiency and insolvency.

Das and Ghosh (2005) [51] in their study “Size, Non-Performing Loan, Capital and Productivity Change: Evidence From Indian State-owned Banks”, studied the association between risk-taking and productivity using data from public sector Indian banks over the period 1995-96 to 2000-01. They recognized that capital to risk-asset ratio and loan growths have significant negative effects on NPAs.

Das and Ghosh (2003) [52] in another study “Determinants of Credit risk in Indian State-owned Banks: An Empirical Investigation”, they studied the determinants of NPAs in Indian public sector banks and identified macroeconomic factors such as GDP growth and microeconomic factors such as real loan growth, operating expenses, and size as a main factor associated with NPAs.

Rajan and Dhal (2003) [53] in the article, “Non – Performing Loans and Terms of Credit of Public Sector Banks in India: An Empirical Assessment”, found that terms of credit and different measures of bank size also effect the level of NPAs.

variables as well as other firm characteristics affecting the default probability which identified in advance can help controlling the fresh accretion in NPAs.

**Mukharjee Paramita (2003)**, [55] “Dealing with NPAs: Lessons from International Experiences” discussed the sustainability model of asset reconstruction companies to solve the problem of NPAs.

**Sharma Meena (2002)** [56] in her article, “Managing Non-Performing Assets through Asset Reconstruction Companies”, suggested that the problem of NPAs can be solved by introducing suitable models by ARCs.

**Srivastava, Mohan Prasad and Kumari Nira (2001)**, [57] in their research “Second Phase of Banking Sector Reforms and NPAs: Relevance Mechanism, Management and Cost Structure of ARCs”, focused on solving the problem of NPAs by applying measures by government machineries like ARCs.

**Klingebiel Daniela (2000)** [58] “The Use of Asset Management Companies in the Resolution of Banking Crises: Cross – Country Experiences”, discussed the sustainability model of asset reconstruction companies to solve the problem of NPAs.

**Das Abhiman studied (1999)** [59] “Efficiency of Public Sector Banks: An Application of Data Envelopment Model”, Prajanan, Vol. 28, No. 2, September 1999 has compared the various efficiency model of public sector banks by applying data envelopment analysis model and concluded that the level of NPAs has significant negative relationship with efficiency estimates.

**Verma M. S. (1999)**[60] Chairman Reserve Bank of India, “Report of the Working Group on Reconstructing of Public Sector Banks”, RBI, Mumbai (Chairman M. S. Verma) has concluded that high level NPAs leads to operational failure of the banks.

**Berger, Allen N. and Robert De Young (1997)** [61] in their research “Problem loans and Cost efficiency in Commercial Banks”, has examined the relationship between problem
loan and banks efficiency by applying Granger-Casualty technique and found that high level of problem loans cause banks to increase spending on monitoring, working out and/or selling off these loans and possibly become more diligent in administering the portion of their existing loan portfolio that is currently performing.

**Gupta Debashish (1997) [62]** in the article “NPA Management: Innovation is the key”. has concluded that NPAs affects the profitability of banks that leads to liquidity crunch and slow down in the growth of GDP etc.

**Kaveri V.S. (1995) [63]** “Relationship between Recovery and Profitability of Banks A Study”, examined the impact of NPAs on profitability by taking profit making and six loss making banks and concluded that loss making banks maintain higher NPAs in the loan portfolio which led them to disclose losses.

**Kwan and Eisenbeis (1994) [64]** in their research paper “An Analysis of Inefficiencies in Banking: A Stochastic Cost Frontier Approach”, concluded that there is negative relationship between efficiency and problem loans.

**Toor N.S. (1994) [65]** in his article “Non-Performing Advances in Banks”, analyzed that poor recovery management leads to reduction in yield on advances, reduces productivity, loss in the credibility and put detrimental impact on the policies of banks.

**Murthi J. Viswanatha and A. Bayya Reddy (1988) [66]** in their article, “Defaults of Financial Institutions at What Cost”, has examined that default bring down the return accruing and to them, reduces effective rate of interest and reduces the funds’ recirculation and increases their dependence on external sources thereby increasing the cost.

Stanton Kenneth R. (2002)[68], in the research paper “Trends in Relationship Lending and Factors Affecting Relationship Lending Efficiency”, studied that managers are less efficient when facing large numbers of loans or smaller loans.

Barr, Richard and Siems Thomas (1994)[69] in their article, “Predicting Bank Failure using DEA to quantify Management Quality”, observed that the failing banks have often shown a level of bad loans. Such ailing banks are in no way near the best practice frontier.

Savita Saggar (2005)[70] in her study of “Non-performing assets and profitability of Scheduled Commercial banks in India” she concluded that there is inverse relationship exists between net NPA ratio and profitability ratio for all categories of banks.

Cheema and Agrawal (2002)[71] they opined that “Productivity in Commercial Banks: A DEA approach examined the factors determining profitability of banks in India.

Chandan L and Rajput (2002), [72] in their paper, “Profitability analysis of banks in India: A multiple regression approach”, focused on the aspect which are decisive in showing the profitability of the Indian banks.


Verma S and Verma S[74] in their article, “Determinants of Profitability of SBI Group, Other Nationalized and Foreign Banks in India”, attempted to determine the determinants of profitability of SBI group, other nationalized and foreign banks in India.

Das A. [75] in his paper, “Profitability of Public Sector Banks: A Decomposition Model”, compares performance of public sector banks for 3 years in the post reform period, 1992, 1995, and 1998. He notes that while there is e welcome increase in emphasis on non-
interest income, banks have tented to show risk averse behavior by opting for relatively risk free investments over risky loans.

Sarkar P.C. and Das \[76\] in their article “Development of Composite Index of Banking Efficiency: The Indian Case”, Compared performance of Public Sector Bank, Private Banks and Foreign Banks for the year 1994-95 on their profitability, productivity and financial management. They found that Public Sector Banks compare poorly with other two categories of banks.

Ram Mohan T.T. \[77\] in his research paper “Deregulation & Performance of Public Sector Banks”. He found that over these years the profitability of Public Sector Banks did improve in comparison to the Private and Foreign Banks, but they lagged behind in their ability to attract deposits at favorable interest rates and have been slow in technology up gradation and improving staffing and employment practices, which may have negative implications on their longer term profitability.

Bhist N.S., Mishra R.C. and Belwal R. \[78\] in their article “Liberalization & its Effect on Indian Banking”, in their study they found that the major reasons identified for declining level of profitability of Public Sector Banks are mismanagement, liquidity, credit policies, increased lending to priority sector & preferred sector, mounting agricultural over dues & incidences of sickness of industrial units, rise in operation cost, lack of efforts in manpower planning.

Ganeshan P. \[79\] in his paper “Determinants of Profit & Profitability of Public Sector Banks in India: A Profit Approach”, reveals by an empirical establishment of profit function that interest cost, interest income, deposit per branch, credit to total assets, proportion of priority sector advances & interest income loss are significant determinants of profitability of Indian public sector banks.

Sarkar J. \[80\] in his article, “Indian Banking Sector: Current Status, Emerging Challenges & Policy Imperatives in a Globalized Environment India” found that the foreign banks
were more profitable and efficient than Indian banks and amongst the Indian banks private banks were superior to the public sector banks. They also conclude that the non-traded private sector banks are not significantly different from the public sector banks with respect to profitability and efficiency, a result consistent with property right hypothesis.

Sathye M. in his article, “Privatization, Performance and Efficiency: A study of Indian Banks”, studied the impact of privatization on banks performance and efficiency for the period 1998-2002 and found that partially privatized banks have performed better than fully public sector banks and they are catching up with the banks in private sector.

Shanmugam K.R. & Das in their paper, “Efficiency of Indian Commercial Banks during the reform period”, reported that, in general, State bank group and private-foreign group banks have performed better than their counterparts during 1992-1999.

Pitre V. in his research article, “Measuring Banking Efficiency: Productivity verses Profitability”, reports while assessing productivity in terms of business per employee and per office that Foreign Banks are far better than nationalized and other scheduled commercial banks but in terms of the number of account per employee they are at the bottom of the list.

B. D. Awasthi & Rahul Singh, in their article, “Non-Performing Assets in Public Sector Banks- A Study”, they found that Since the reforms initiated in 1992, all the banks have making efforts to contain the NPAs level and they have succeeded in this task to a large extent. Loka Adalats, Debt Recovery Tribunals (DRTs) and scheme of Corporate Debt Restructuring have provided special thrust to banks to contain their NPAs, Establishments of Asset Reconstruction Companies has helped the banks to nullify their NPAs in a big way.

Rajendra Kakkar, in this paper, “NPA Management – Role of Asset Reconstruction Companies”, in his study of NPA management-Role of Asset Reconstruction Companies,
found that in absence of direct funding support by the Government, ARCs would be self-help mechanism of the banking system. The onus is with the banks/FIs/ARCs to clean up the NPAs. The banks/FIs have to be proactive in making realistic provisions based on assessment of realization from NPAs towards their dues.

Carlton Pareira\textsuperscript{[86]} in his article “Investing in NPAs—Will Investor Bite?” concluded that the SARFESI Act is an appropriate first step for driving investment in NPAs. Going forward, an appropriate set of consequential financial sector regulation clarity, including changes in tax laws has become an imperative. This will enable the banking system to get rid of their NPAs and investors can capitalize on the attractive investment opportunity.

Abhijit Banerjee & Esther Duflo\textsuperscript{[87]} in their article, “What Do Banks (not) Do?”, concluded that in many ways the banking system in India, including the regulatory apparatus, remains a product of the planning years. It seems to be a system that was conceived for a world where people were expected to do what they were told, and things happened as they were meant to.

Tamal Bandopadhaya\textsuperscript{[88]} in his study, “The Truth about Indian Banking NPAs”, found that the Net NPAs dropped substantially over the last few years but not because of any dramatic improvement in the quality of assets or better credit appraisal and monitoring but huge provisioning. The funds used for such massive provisioning was windfall of the low interest rates regime for which no banker can claim any credit.

B.S. Bodla & Richa Verma\textsuperscript{[89]} in their article, “Determinants of Profitability of Banks in India: A Multivariate Analysis”, has indicated that the variables such as non-interest income, operating expenses, provision and contingencies and spread have significant relationship with net profits.

Meena Sharma,\textsuperscript{[90]} in her paper, “Problem of NPAs and its Impact on Strategic Banking Variables”, makes an attempt to study the problem of Non Performing Assets in public sector banks and also its impact on the performance on these banks. Impact of NPAs on
the profitability of the banks is analyzed by applying multiple regression models. Impact of NPAs on the productivity, achievement of capital adequacy level, funds mobilisation and development policy of banks is also analyzed. NPA not only affect the performance of the bank but also puts irreparable harm to the entire economy. It endangers the very foundation of the credit system. Concentrated efforts are required at RBI, banks and judiciary level to control the menace of NPAs. Efficient legal framework, improvement in credit appraisal and monitoring skills of banks and strong political will could enable the Indian banks to find satisfactory solution to the problem.

G. Ramakrishna Reddy and T. Shree Bhargavi in their research article, “An appraisal of Indian Banking from NPA Perspective”, they opined on the post-sanctioning process that includes follow-up, supervision, monitoring and control regarding the performance of the units. Lack of appraisal and poor monitoring lead to an increase in NPA.

Kausick Saha, in this paper, “Can the Ordinance Recover NPAs?” concludes that the ordinance has the power to recover NPAs, provided a host of other things are put into place.

M. S. Verma, in his research “Is the NPA Ordinance too Harsh?” questioned that what the present ordinance will actually do is to change the mindset of the creditors as well as the barrower. It will remove from the minds of the creditors the sense of lack of control it gets as soon as the amount of credit is out of its door and from the minds of most barrowers remove the sense of total complacency which many of them have about meeting the terms of agreement under which credit has been extended.

Waseem Ahmed, in his paper, “Non-Performing Assets (NPA) In Banks: Causes, stress and Remedies”, found that with the liberalization of economy, the banking industry is facing enormous challenges in the open financial market; probably it is also giving rise to non-performing assets in banks. The concept of bank nationalization was misutilized by certain group of people in the name of liberalization, having directly contributing to
swelling NPAs. The origin of the problem of NPAs also lies in the quality of credit risk management of banks. 

**Gunjan M. Sanjeev**, [95] in his article, “Bankers’ Perception on causes of Bad Loans in Banks”, says this study has attempted to identify the critical factors, which are responsible for the loans to go bad in the Indian commercial banking system. The study reveals that the external factors have a higher influence as compare to the internal factors. Poor credit scoring skills of the managers, absence of suitable administrative penalties and target completion have been found to have a significant influence amongst factors related with the loan appraisal mechanism.

**Mrs. Meena Sharma** and **N.K. Bishnoi** [96] in their article, “Causes, Cure and Prevention of NPAs in State Industrial Development Corporation of North India”, made an attempt to analyze the quantitative trend and pattern in growth of NPAs in SIDCs. An effort has been made to analyze the cause of default by surveying defaulters of all the four corporations and officials of the corporations. Lenders and defaulting borrowers are surveyed through separate questionnaires made for the purpose.

**Chanchal Chatterjee** [97] in the research paper, “Future Trend and Challenges in Indian Banking: A Fresh Look”, makes an attempt to focus future trend and challenges in Indian banking system especially from the angle of Basel II implementation. Indian market will be opened for foreign banks this year. Maintenance of adequate capital adequacy ratio (CAR) for managing credit, market and operational risks has become mandatory. Due to this step, competition is likely to increase in the market which may lead to large scale consolidation among various banks for ensuring their survival and sustainable growth.

**K B L Mathur** [98] in the article, “Indian Banking Sector: Sound and Resilient”, states that A comprehensive self assessment of India’s financial sector by the committee of Financial Sector Assessment (CFSA) in its report jointly prepared and released by the GOI and RBI in March 2009 found that “Commercial banks have shown a healthy growth rate an improvement in performance as is evident from capital adequacy, asset quality, earnings and efficiency indicators. The key financial indicators of the banking
system do not throw up any major concern or vulnerability and the system remains resilient.”

Madhu Bhartia in the paper “Financial Reporting in Commercial Banks in India-A comparative study of SBI and ICICI Banks Ltd”, in this study financial reporting in commercial banks, it is subjective matter to decide whether any advance if “NPA” category. It only the bank manager to decide that what should go to NPA category. It is suggested that policy to decide NPA should be embedded in the accounting system of the bank taking into account number of days.

Debdas Rakshit & Sujit Kr. Ghosh in their article, “What Future is Awaiting Public Sector Banks-Bright or Bleak?”, they attempted to excavate the answers to the reforms in the financial system implementing Narsimham Committee Report (1991) was a significant move to nurse back the banking system to health painlessly but it also invited challenges to the public sector banks to prove its competitive survival due to arrival of the new players, the private sector banks in this arena. The alarming presence of the private sector banks has revolutionized the banking system as a whole and raised the question whether their rapid growth will soon outweigh the private sector banks in all the significant areas like performance, profitability and efficiency.

R. K. Singh & Mithilesh Kumar Singh in their study, “Profitability, Assets Quality and Capital Adequacy of Indian Banks in Global Perspective”, their paper aims at appraising the profitability, asset quality, and capital adequacy of Indian banks in global perspective. The paper reveals that the Indian banks have been able to perform better in comparison to selected Asian Countries. But at the same time the performance of Indian banks cannot be said to be very competitive in comparison to selected western advance countries.

N. Tejmani Singh & Th. Jitendra Singh in their study “Recovery Performance of RRB: An Analysis (A case study of Manipur Rural Bank)”, makes an attempt to analyze the recovery performance of MRB and the causes of defaults. The timely recovery of loans is a perquisite for any credit institutions, particularly for RRBs with their limited
funds for sustained growth and existence. The repayment of loans mainly depends on proper utilization of the loan amount, supply of quality assets, generation of sufficient income from schemes, availability to infrastructural and marketing facilities, willingness to repay, continuous supervision and follow-up visits, interest and initiatives taken by the banks staff and Govt. agencies and above all the recovery management of the bank concerned.

S. Sunderaraman [103] in the article, “Recovery of Non-Performing Assets: In Hot Pursuit of DRT Cases”, according to him a vigilant approach is warranted at the stage of identification of the borrowers and procession of the credit proposals, at which point of time the maximum details can be generated without much difficulty. Once account turns in to NPA, it may be difficult to gather details from the parties. A relentless follow-up should be undertaken at each stage of the DRT/ court cases through the advocates to expedite them with a reasonable period.

Kamal Das, [104] in his article “Management of Non-Performing Assets: Lessons from Swedish Experience”, observed that a systematic framework with a clear objective, flexibility and adequate financial support was required to resolve the distressed situation and for the strategy to succeed, adequate legal provision and supporting regulatory environment were pre requisite.

Manoj Pillai [105] in his study, “Asset Reconstruction Company (India) Limited and Management of Non-Performing Assets of Indian Banks”, found that, the presence of Non-Performing Assets has had an adverse impact on the productivity and efficiency of Indian banks which has resulted in the erosion of profits. Their continued amelioration in absolute terms proved the survival of Indian Banks very difficult. The NPA are the bad debt or non-recovered loans of the banks which now stand at over Rs. 50,000 crores.

Mayuri Patel [106] in her article, “Corporate Debt Restructuring: Mechanism to Manage NPAs”, concludes that the CDR mechanism is expected to aid financially crunched companies and banks / FIs to tackle their bloating non-performing assets (NPA) in an
effective manner. In India one of the reasons for the relative success of the mechanism has been almost all the big lenders are owned and controlled by the Government.

Rosy Karla\textsuperscript{[107]} in this paper “Non-Performing Assets of Public Sector Banks: Erosion in Profitability”, it examines the magnitude of non-performing assets of Public Sector Banks. The NPAs are considered as an important parameter to judge the performance and financial health of banks. The level of NPAs in one of the drivers of financial stability and growth of the banking sector. Besides the other factor affecting profitability of banks, NPAs, in the current scenario, have emerged as an important factor influencing the profitability of banks.

Srinivasan Umashankar\textsuperscript{[108]} in his study “Managing NPAs: A Three-pronged Strategy”, concluded that deposits are raw materials, loan is finished product and recovery is profit. A qualitative credit and deposit growth coupled with conductive recovery climate would ensure healthy sustainable business.

Harpeet Kaur & Pasricha\textsuperscript{[109]} in the article, “Management of NPAs- A Challenge before Public Sector Banks”, they opined that the formulation of ARCs has helped in the disposal of debt-redden assets in a very smooth manner. DRTs have speeded up the judicial process of reclaiming an asset to a great extent. The concept of settlement of dues between the banks and its creditors through Lok Adalats has also taken off in a big way. This has led to a decline in the level of NPAs of the Indian banking sectors. But lot more needs to be done.

Anand Singh Kodan, Shailendra Kumar & Narendra Kadian\textsuperscript{[110]} in their paper “Scheduled Commercial Banks: Growth Trends”, they found that agriculture plays dominant role in the Indian Economy providing employment for 70 percent of the people and contributing 542 percent to the Gross National Product. Agriculture has been and will continue to be the life line of Indian economy. Thus, smooth and sufficient flow of rural credit is must. Indian banking industry should change its attitude towards government security in context of investment portfolio.
N. Ramu in his study, “Dimensions of Non-Performing Assets in Urban Cooperative Banks in Tamil Nadu”, states that with the tightening of prudential norms, the banking sector has been consistently confirming to and adopting international prudential norms and accounting practices. Such strengthening of prudential norms has resulted in increased level of NPAs for the urban cooperative banking sector.

Manish Mittal & Aruna Dhole in this paper, “A Comparative study of various banks on their profitability and productivity”, compares various categories of banks on their productivity and profitability. While there is no remarkable difference in the spread Ratio, there is significant difference in Burden Ratio among the public sector and private sector and foreign banks. The key to profitability for public sector banks is increased productivity. Those public sector banks that have been able to increase the productivity found themselves at par with the private sector banks.

1.23 STATEMENT OF PROBLEM:
The Non-Performing Assets (NPAs) have become a crucial component as far as performance of the bank is concerned. In fact, it has become a performance indicator of the banks.

RBI implemented the recommendations of Narsimham committee for the better functioning and performance of the banks. As a part of banking reforms, the Reserve Bank of India framed prudential norms and made a series of regulations to control NPAs in Indian banks from time to time.

Since, NPA has became a major problem in all types of banks the RBI has made first attempt to tackle this major problem in 1991 on the recommendation of Narsimham’s Committee. Thereafter RBI has made provisions in the form of imposing regulations from time to time to improve the functioning of these banks.

The Co-operative Banks’ network in India is one of the largest banking networks of the world. These banks are catering to the varying needs of the population are hence called as Co-operative Banks. The Co-operative Banks are also saddled with the problem of Non-Performing Assets. In Marathwada Region more than 100 Co-operative Banks are registered of which few are Multi State Urban Co-operative Banks (UCBs) and majority
of such banks are having origin and operations in Maharashtra only. Presently only 83 banks are functioning in the entire region as per DDR.

1.24 HYPOTHESIS:

I.
HO. Null Hypothesis:
There is no relationship between Capital Adequacy Ratio and Net NPA of Bank.

H1. Alternate Hypothesis:
There exists a relationship between Capital Adequacy Ratio and Net NPAs of Bank.

II
HO. Null Hypothesis:
There is no relationship between the Advances and Gross NPA.

H1. Alternate Hypothesis:
There exist a relationship between the Advances and Gross NPA.

1.25 OBJECTIVES OF THE STUDY:-

i) To study the Non-Performing Assets of selected banks in Marathwada.
ii) To study and gauge the Non Performing Assets of banks over the period i.e. 2003-2004 to 2009- 2010.
iii) To make a comparative study of the cross section and time series analysis.
iv) To study the impact of Non Performing Assets of the bank.
v) To study the relationship between Non-Performing Assets and advances.

1.26 RESEARCH METHODOLOGY:--
The present research study is based on the secondary data collected from the selected banks of Marathwada region in the form of Annual Reports. The period under study is seven years i.e. from 2003-2004 to 2009-2010. The study comprises of NPA and its impact on the functioning of the bank. The analysis, interpretation and conclusions are drawn and the result revealed show the performance of the bank with regards to NPA on time series and cross section basis. The data collected from the selected banks has been classified, tabulated, analyzed, interpreted and presented on the basis of published annual
reports. In addition to this journals, magazines and web published material has been used. The interaction with the managers and officers of the selected banks was done to get needed details.

**SAMPLE:**

The area of present research is restricted to Marathwada region. All of these banks are co-operative banks. The sample banks are selected on purposive selection basis, giving equal weightage to all the districts of the region. From total 8 districts of the region having a universe of 83 UCBs, 3 banks from each district are selected making a total sample size of 24 banks.

The banks selected for the present study are as follows:

1. Deogiri Urban Co-operative Bank Ltd., Aurangabad.
2. Dr. Babasaheb Ambedkar Co-operative Bank Ltd., Aurangabad.
5. The People’s Co-operative Bank Ltd., Hingoli.

1.27 SCOPE & LIMITATIONS OF STUDY (AREA OF STUDY):
The study is limited to Eight Districts of Two Divisions of Marathwada Region namely: Aurangabad Division and Latur Division. Aurangabad Division comprises of Aurangabad, Jalna, Parbhani and Hingoli districts, whereas Latur Division comprises of Latur, Osmanabad, Nanded and Beed districts which falls under the jurisdiction of The Registrar Co-operatives. These banks are governed by Indian Co-operative Societies Act, 1965 and The Banking Regulation Act, 1949. There are 83 UCBs in all in two divisions of the region of Marathwada that are under the jurisdiction of Deputy Registrar of Cooperatives. The period of study is limited to seven years i.e., from 2003-04 to 2009-10. In Aurangabad Division there are 49 UCBs and in Latur Division have 44 UCBs are functioning.

1.28 CHAPTER SCHEME:
The first chapter presents the introduction of the topic, significance of Financial System and the importance and progress of Indian Banking System in brief. It also includes the Objective of the present study, Hypothesis, Research Methodology, Scopes & Limitations of the study etc.
The second chapter deals with the historical perspective of the Indian Financial System and the establishment of RBI. It gives a detailed account of the growth and development of Banking System in India along with the classification of banking institutions with their functions, constitution, objectives etc.
The third chapter includes the basic structure of co-operative sector. The classification of co-operative banks is presented. This chapter covers, its importance, functions and the role played by co-operative sector in Indian economy.
The fourth chapter presents the Non Performing Assets concept, philosophy and the purpose it has to fulfill. It provides a comprehensive detail of the regulations and the procedures to be adopted for substandard and loss assets by the Indian banks. The fifth chapter is devoted to the analysis and the interpretation of the data of the selected banks. For analysis the Financial and statistical tools are applied. The financial variables are used in addition to the statistical tools like Arithmetic Mean, Averages, Standard Deviation etc., for drawing inferences. It shows the Gross NPA, Net NPA, Provisions made by all the selected banks for NPA, Capital to Risk Adequacy Ratio, Net Profit, Advances, Interest and Discount, Statutory Reserve, Capital, Membership and Deposits in the period under study. It shows the time series analysis with interpretations. The chapter sixth presents the cross section analysis with interpretation of the data collected for the above items, in the form of combined (industry) average. The interpretations are made on the basis of average of all the individual banks and then compared with the combined average. The chapter also presents the Ratios, Correlation and Hypothesis Testing. The seventh chapter shows the finding and the conclusions drawn on the basis of the present study. In the last bibliography is appended.
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CHAPTER - I


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