CHAPTER – I
INTRODUCTION AND DESIGN OF THE STUDY

In any nation, banking system plays a vital role in the development of its sound economy. India is not an exception. Bankers are the custodians and distributors of the liquid capital of the country. The foremost function of the banking system is to mobilize the savings of the people by accepting deposits from the public. The banker becomes the trustee of the surplus funds of the public. Herein lies the onerous duty of the banker in stimulating and mobilization of surpluses. Well knit banking system secures a good foundation for a nation’s industrial and economic progress. The role of banking in promoting development and growth especially in the context of planning and breaking the vicious cycle of poverty and to retrieve the economy from the trap of underdevelopment is a matter of paramount importance, particularly when our country is on the way of development.

The banking sector is an indispensable financial service sector supporting development plans through channelizing funds for productive purpose, intermediating flow of funds from surplus to deficit units and supporting financial and economic policies of government. The importance of bank stability in a developing economy is noteworthy as distress affects the development plans thereby the economic progress. The Indian banking sector accounts for a major portion of financial intermediation and acknowledged as main vehicle for monetary policy signals, credit channel and facilitator for payment system.

Even though the banking sector in India has shown spectacular progress since nationalization, there has been significant decline in productivity and efficiency resulting in erosion of profit. To face the global challenges and to maintain the
liquidity and profitability, it is essential to maintain the non-performing assets at low level through efficient recovery of loans before they become bad.

In India the magnitude of the problem of bad debts was realized only in early periods. Subsequently following the recommendation of Narasimham Committee and Verma Committee some steps have been taken to solve the problem of nonperforming assets (hitherto will be referred to as NPA) in the balance sheet of the banks. It is continuously expressed from every corner that there has rarely been any systematic evaluation of the best way of tackling the problem. There is no consistency in the application of NPA norms, ever since these have been recognized. NPA of individual banks which is expressed as a mathematical average for the entire bank cannot convey a dependable picture. The scenario is not so simple to be generalized for the industry as a whole to prescribe a readymade package of common solution for all banks and for all times.

The Indian banking system has undergone significant transformation following financial sector reforms. It is adopting international best practices with a vision to strengthen the banking sector. Several prudential and provisioning norms have been introduced and these are pressurizing banks to improve efficiency and trim down NPAs to improve the financial health in the banking system. In the background of these developments, this study strives to examine the state of affairs of Non-Performing Assets of public sector banks, private sector banks and foreign banks.

**EVOLUTION OF BANKS**

The development of “Banking” is evolutionary in nature. Before the establishment of banks, the financial activities were handled by money lenders and individuals. At that time interest rates were high. Again there were no security for
public savings and no uniformity regarding loans and interest rates. To overcome such problems the organized banking sector was established which was fully regulated by Government. The organized banking sector works within the financial system to provide loans, accept deposits and provide other services to their customers.

The main functions of the bank are

- To accept deposits and to provide loans
- To provide security to the savings of customer
- To control the supply of money and credit
- To encourage public confidence in the working of the financial system
- To avoid concentration of financial powers in the hands of few individuals and institutions
- To set equal norms and conditions i.e. rate of interest, period of lending to all type of customers to name a few.

**BANKING SYSTEM IN INDIA**

The banking system, one of the pillars of the Indian economy is moving towards greater stability and efficiency after its deregulation. The introduction of innovative and diversified product and services, coupled with mechanization and computerization has made banking a vital part of life. These multiple changes happening one offer other has a ripple effect on a bank trying to graduate from completely regulated sellers market to completely regulated customers market. Needless to say every person is a beneficiary of banking services.

A well built banking system is significant for a prosperous economy. Banking system in India is headed by the Reserve Bank of India (RBI), the Central Bank of the country. The Indian banking system comprises the following institutions.
Reserve Bank of India

Scheduled commercial banks

Scheduled co-operative banks

Non-banking financial companies

Public sector banks

Private sector banks

Foreign banks

Regional Rural Banks

LIC

CHITFUNDS

NITHI

SBI & its associates

Nationalised banks

Urban cooperative Bank

State cooperative Bank

District cooperative Bank

Old private sector banks

New private sector
THE RESERVE BANK OF INDIA

The RBI is the Central Bank and was established in April 1, 1935 in accordance with the provisions of Reserve Bank of India Act, 1934 and was setup on the basis of the recommendations of Hilton Young Commission. The central office of RBI is located at Mumbai since inception. Originally the RBI was privately owned. Since nationalization in 1949, RBI is fully owned by Government of India.

The bank was constituted to

Regulate the issue of bank notes

Maintain reserves with a view to securing monetary stability and

To operate the credit and currency system of the country to its advantage

An interesting feature of the RBI was that at its very inception, the bank has been playing a special role in the context of the development, especially agriculture. The bank was also instrumental in institutional development and has helped to set up institutions like the Deposit Insurance and Credit Guarantee Corporation of India, the Unit Trust of India, the Industrial Development Bank of India, the National Bank of Agriculture and Rural Development, the Discount and Finance House of India to name a few to build the financial infrastructure of the country. With liberalization, the banks focus has been shifted back to core central banking functions like Monetary Policy, supervision and regulation of the payment system and developing financial markets.

The key roles of RBI are

Regulator and supervisor of the financial system
Manager of exchange control
Issue of currency
Banker to the government
Bank to banks: maintaining banking accounts of the scheduled banks
Controller of credit
TYPES OF COMMERCIAL BANKS

Commercial banks occupy very significant position in the Indian banking structure. Commercial banks are working in public sector as well as in private sector. Nationalized banks and banks of State Bank Group are public sector banks. Private sector bank includes Indian as well as foreign banks functioning in India. The RBI has classified the commercial banking system in India into two categories: scheduled and non scheduled commercial banks.

A) Scheduled Commercial Banks

The second schedule of RBI Act contains a list of banks which are described as scheduled banks. A bank which has a paid up capital and reserves prescribed by the Act, Sec 42(6) of the RBI Act 1934, of Rs 5 lakh is a scheduled bank. However, at present, RBI has prescribed the minimum capital of Rs 100 crores to start a commercial bank. Its business must be managed in a manner which is not detrimental to the interest of the depositors. The scheduled banks are also required to maintain deposits in the form of cash reserve based on its demand and time liabilities at the specified rate with RBI.

The scheduled banks enjoy several privileges like refinance facility, currency chest facility and obtain finance from RBI during its temporary finance difficulties. Furthermore, the settlement of accounts between the scheduled banks is facilitated by the use of bankers “Clearing House procedure”. On the other hand, scheduled banks have to submit several returns to the RBI and are obliged to comply with the directions received from the Reserve bank. The affairs of schedule banks are closely watched and controlled by RBI, in order to safeguard the general health of the banking industry as a whole.
B) Non-Scheduled Commercial Banks

The commercial banks, not included in the second schedule of the Reserve Bank of India Act are known as Non-Scheduled Banks. Usually those banks, the paid-up capital of which are less than 5 lakhs or the banks which do not conform to the norms of the Reserve Bank of India are called as non scheduled commercial banks. Certainly these banks do not enjoy the facilities enjoyed by scheduled banks; they are under obligation to maintain a minimum deposit of five percent with the RBI or with themselves under information to the RBI. They are not entitled to get facilities like refinance, rediscounting of bills etc from RBI. They do not get prestige like scheduled banks. They are mainly engaged in lending money, discounting and collecting bills and various agency services. They insist higher security for loans. The Reserve Bank may help these banks in case of need, if these banks are keeping their deposits with the RBI. Non-scheduled banks may be listed in the Approved List maintained by the Reserve Bank. If a bank is included in the list it starts enjoying the facilities of postal concession for their remittances etc. For inclusion in such an approved list the non-scheduled banks must:-

i) be registered under Indian Companies Act ;
ii) engage itself in banking business ;
iii) have a minimum paid-up capital of Rs. 50,000.

As on Dec 1999, there was only one non scheduled bank namely Sikkim Bank Ltd. RBI currently does not encourage the opening of Non- Scheduled Banks. Efforts are made to merge Sikkim bank Ltd with Union Bank of India.

C) Nationalization of Commercial Banks

The expansion of branches and changes in mode of operation were found to be unsatisfactory in many areas and continued to go unserved. As a result, number of economic activities in priority sectors ranging from agriculture to small scale
industrial units did not have proper access to banking facilities. Measures taken by Social Control Act remained inadequate and did not yield results as expected. This resulted in the Government of India taking a historic decision to nationalise fourteen private sector banks having deposits of more than Rs 50 crores. On 20th July 1969, the banks were taken over by the Government of India under the Banking Companies (Acquisition and Transfer of Undertakings) Act of 1969. On 15th April 1980 six more banks having demand and time liabilities of not less than Rs200 crores were nationalized under the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980.

The banks are nationalized during the tenure of the then Prime Minister Smt. Indira Gandhi and the reasons for nationalization are

- To remove few large banks to reign control of the banking sector.
- To prohibit the use of credit for speculative and unproductive purposes.
- To build public confidence and maximize mobilization of savings of people.
- Provision of credit facilities to agriculture, rural, small scale industries and exports.
- Encouragement of new entrepreneurs and self-employed professional groups.
- Provision of adequate training as well as reasonable terms of service for bank staff.
- To make bank management professional to develop modern managerial practices.
- The changes brought out by nationalization of banks are
  - Commendable growth in banking facilities in terms of branches, number of ATM, average population per bank and deposits.
  - Reorientation of banking policy
  - Social responsibility amongst banks
➢ Credit to priority sectors.
➢ Speedy transfer of funds from one place to another.
➢ Ensuring adequate and timely credit for agricultural activities and farming operations.
➢ Providing job opportunities to educated youth.
➢ Taking banking service to rural and remote areas.
➢ Helping the rural poor from the clutches of money lenders.
➢ Ensuring credit to various industrial activities.
➢ Remove regional disparities in economic development.
➢ Helping export sector to obtain cheap credit.

NON PERFORMING ASSETS

A historic change in the field of Indian financial system is the financial sector reform as a result of economic liberalization policy of the Government of India. The Government of India set up a high level committee headed by Sri M.Narasimham as chairman to examine all aspects relating to the structure, organization, functions and procedures of the financial system. The Committee submitted its report in November 1991, which contains number of recommendations for toning up operational efficiency of the banking system. The term NPA has come into prominence as a result of the recommendations. The most prominent realization of the Committee was that the books of account of banks should be transparent and there should be full disclosure as recommended by the International Accounting Standard Committee. Therefore it is felt that banks and financial institutions should adopt uniform accounting practice, particularly with regard to income recognition and provisioning the debt and accounting practice to correspond to international standard. Income recognition in respect of NPAs should be on the basis of record of recovery, not on
accrual principle. Similarly provision should be made as per proper classification of assets into standard, sub-standard, doubtful assets.

The high level of NPA in banks and financial institutions has been a matter of serious concern because bank credit plays an important role in the economic growth of a country. One of the difficult challenges faced by the banking system is the high level of NPA, which is a bottleneck in the smooth flow of credit. While these NPAs where increasing at a rapid rate there has been little anxiety to control them. High NPA means that banks have to raise more deposits to serve deposits raised earlier. Banks, thus, need more deposits and consequently have to offer higher deposit rates, increasing their cost of fund. According to former RBI Governor Mr.Bimal Jalan1“the high NPA level is pre-empting funds for provisioning and eating into the performance and profitability of financial institutions”. As a part of the financial sector reform, the initiatives undertaken so far to contain NPA such as debt recovery measures and assets reconstructing initiative have not been responding. The Narashimham Committee had set the target of “zero net NPA level” for each bank which has proved elusive so far. The legal system in the country is too lethargic to resolve this problem.

At present the NPA level in Indian banks is much higher than in the banks of various western countries. The problem of non-performing assets has shaken the entire Indian banking sector. The main reason of high percentage of NPAs is the target – oriented approach, which deteriorates the qualitative aspects of lending. With the globalization of Indian economy and the liberalization taking place, it is now necessary for Indian banks to come up to international standards and to bring down the NPA level. NPA management now becomes an important term for better banking. Table 1.1 gives bank wise ratios of Net NPA to Net Advance of the banks for the past 17 years from 1996-1997 to 2012-2013.
### TABLE 1.1
**RATIO OF NET NPA TO NET ADVANCES OF COMMERCIAL BANKS**

<table>
<thead>
<tr>
<th>YEAR</th>
<th>PUBLIC SECTOR</th>
<th>PRIVATE SECTOR</th>
<th>FOREIGN BANKS</th>
<th>SCB</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996-97</td>
<td>9.18</td>
<td>5.37</td>
<td>1.92</td>
<td>8.08</td>
</tr>
<tr>
<td>1997-98</td>
<td>8.15</td>
<td>5.26</td>
<td>2.25</td>
<td>7.3</td>
</tr>
<tr>
<td>1998-99</td>
<td>8.13</td>
<td>7.41</td>
<td>2.94</td>
<td>7.63</td>
</tr>
<tr>
<td>1999-00</td>
<td>7.42</td>
<td>5.41</td>
<td>2.41</td>
<td>6.77</td>
</tr>
<tr>
<td>2000-01</td>
<td>6.74</td>
<td>5.44</td>
<td>1.82</td>
<td>6.17</td>
</tr>
<tr>
<td>2001-02</td>
<td>5.82</td>
<td>5.73</td>
<td>1.89</td>
<td>5.5</td>
</tr>
<tr>
<td>2002-03</td>
<td>4.53</td>
<td>2.85</td>
<td>1.73</td>
<td>4.02</td>
</tr>
<tr>
<td>2003-04</td>
<td>3.06</td>
<td>2.42</td>
<td>1.54</td>
<td>2.83</td>
</tr>
<tr>
<td>2004-05</td>
<td>1.99</td>
<td>2.2</td>
<td>0.85</td>
<td>1.95</td>
</tr>
<tr>
<td>2005-06</td>
<td>1.32</td>
<td>1.01</td>
<td>0.83</td>
<td>1.22</td>
</tr>
<tr>
<td>2006-07</td>
<td>1.05</td>
<td>0.97</td>
<td>0.73</td>
<td>1.01</td>
</tr>
<tr>
<td>2007-08</td>
<td>0.99</td>
<td>1.09</td>
<td>0.77</td>
<td>1</td>
</tr>
<tr>
<td>2008-09</td>
<td>0.94</td>
<td>1.29</td>
<td>1.81</td>
<td>1.05</td>
</tr>
<tr>
<td>2009-10</td>
<td>1.09</td>
<td>1.03</td>
<td>1.82</td>
<td>1.11</td>
</tr>
<tr>
<td>2010-11</td>
<td>1.09</td>
<td>0.54</td>
<td>0.61</td>
<td>0.97</td>
</tr>
<tr>
<td>2011-12</td>
<td>1.52</td>
<td>0.44</td>
<td>0.61</td>
<td>1.28</td>
</tr>
<tr>
<td>2012-13</td>
<td>1.8</td>
<td>0.47</td>
<td>1</td>
<td>1.5</td>
</tr>
</tbody>
</table>

Source: RBI Bulletin
The problem of NPAs arises either due to mismanagement or due to change in business cycle. The net NPA as percentage to net advance has significantly reduced across all groups of banks from 1996-97 to 2008-09 as shown in Table 1.1. However, in case of private sector banks and foreign banks there was an increase in the net NPAs as percentage of net advance in the year 1998-99 as compared to other years of the study. The net NPA as a percentage of net advances of scheduled commercial banks and public sector banks were around 8 to 9 percent in 1996-97 which declined to around less than one percent in 2008-09. In case of private sector banks and foreign banks there is significant change over the period of study. The net NPA of public sector banks has increased from 0.94 percent to 1.80 percent during 2008-09 to 2012-13. On the contrary net NPA of private sector banks has declined from 1.29 percent to 0.47 percent during the same period. In case of foreign banks and scheduled banks the net NPA percentage showed fluctuating trend during 2008-09 to 2012-13. So even after implementation of prudential norms in early nineties and serious concern raised by government about growing size of NPAs, public sector banks paid least attention to all these warnings, which subsequently led to turning fresh loans of banks into non performing category.

Very often lending by banks is not linked to productive investment and the recovery of credit is not linked to product scale. The borrowers are mainly farmers and SSI owners whose financial conditions are generally weak. The volume of bank credit in sick industries is the evidence of this malady. Sometimes based on advice given by Board for Industrial and Financial Reconstruction (BIFR) as well as the directives given by the courts to banks, the banks are forced to provide loans to sick industries.

Faulty lending policy is also responsible for mounting NPAs. There are many other causes which are also responsible for accumulation of NPAs. Faulty credit
management like defective credit recovery mechanism, lack of professionalism in the work force, time lag between sanction and disbursement of loan, unscientific repayment schedule, mis-utilisation of loans by user, untimely communication to the borrower regarding their due date, politics at local levels and waive off policy of loan by government (in 1991 and 2008) have also been contributing to mounting NPAs in SCBs in India. People, who have got loan as priority sector advance, feel that loans given to them will be waived off with the passage of time by one political party or the other, so willful default induced by officially announced loan waiver scheme vitiates the payment culture among the borrowers. Weak monitoring of loan accounts also lead to this problem of NPAs in banks. Lack of technical and managerial expertise on the part of the borrower is the next important factor. Moreover wrong identification of beneficiaries and weakness in credit appraisal system are the other important reasons for this problem.

Banks also have much discretion in granting of loan to priority sector because targets are fixed under directed priority sector lending irrespective of recovery potential. Banks have also been facing the problem of NPA from non-priority sector advance. Lack of systematic credit appraisal system for assessing the returns from the activities being financed, repaying capacities, risk bearing ability of the borrower has also resulted in NPAs. Also slow disposal of recovery cases is major factor contributing towards accumulation of NPAs in non-priority sector advance. The recovery process through legal measures is very lengthy and tedious process. NPAs of Indian banking sector have also been increasingly rising due to economic slowdown, high interest rates, new reporting system and ailing aviation sector.

There is a general slackening of domestic economic activity in India both in manufacturing and the services sectors. A sluggish economy will have a direct impact on the balance sheets and profitability of many firms who have availed loans from the
banking industry. Over a period of time, some of the hard hit firms will be compelled to default their loans. In India NPAs are more an outcome of economic factors rather than any internal systemic failures.

It is a known fact that interest rates have been revised upwards, ten times in the past two years with a view to curb inflation. High interest rate increases the cost of funds to the credit users and has a debilitating effect especially on the repayment capacity of small and medium enterprises. Banks need to maintain their net interest margin and hence pass on any interest rate hike to the borrowers. A high rate of inflation dilutes the quality of assets of the banking sector. Weak supply demand scenario, high borrowing or leveraging and intense competition contribute to loan defaults.

Indian banks are to report NPAs from April 2012 in a computer recognized / identified format. It is stated that almost 90 percent of all banks' loan portfolio is under the computerized system of NPA reporting or system based reporting. The discretion of bank managers in classifying assets according to their local judgment is eliminated. This change in reporting pattern makes identification of NPAs a machine driven objective activity. However, credit risk analysis does have a subjective and judgmental element to it.

The Indian banking system has a total exposure of around Rs. 40,000 crores to the ailing aviation sector. SBI alone has an exposure of 5,000 crores to the aviation industry. It is common knowledge that many airlines are marginally profitable. According to an RBI Report, nearly three-fourths of the top banks’ loans to the aviation sector are either impaired or restructured. Kingfisher airlines and Air India have been the significant aviation borrowers whose performance is below par.
TABLE 1.2
NON PERFORMING LOANS-SUIT FILED ACCOUNTS-AS ON 30-09-2013

<table>
<thead>
<tr>
<th>State</th>
<th>No: of Accounts</th>
<th>Amount(in crores)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maharashtra</td>
<td>1076</td>
<td>26921</td>
</tr>
<tr>
<td>Delhi</td>
<td>484</td>
<td>10055</td>
</tr>
<tr>
<td>Andhra/Telengana</td>
<td>413</td>
<td>6525</td>
</tr>
<tr>
<td>Tamil Nadu</td>
<td>378</td>
<td>5003</td>
</tr>
<tr>
<td>West Bengal</td>
<td>437</td>
<td>4967</td>
</tr>
<tr>
<td>Gujarat</td>
<td>180</td>
<td>4928</td>
</tr>
<tr>
<td>Karnataka</td>
<td>181</td>
<td>2886</td>
</tr>
<tr>
<td>Punjab</td>
<td>163</td>
<td>1494</td>
</tr>
<tr>
<td>Uttar Pradesh</td>
<td>138</td>
<td>1145</td>
</tr>
<tr>
<td>Haryana</td>
<td>66</td>
<td>871</td>
</tr>
<tr>
<td>Madhya Pradesh</td>
<td>54</td>
<td>795</td>
</tr>
<tr>
<td>Kerala</td>
<td>73</td>
<td>592</td>
</tr>
<tr>
<td>Assam</td>
<td>59</td>
<td>413</td>
</tr>
<tr>
<td>Odisha</td>
<td>55</td>
<td>384</td>
</tr>
<tr>
<td>Uttaranchal</td>
<td>36</td>
<td>514</td>
</tr>
<tr>
<td>Jharkhand</td>
<td>46</td>
<td>281</td>
</tr>
<tr>
<td>Rajasthan</td>
<td>42</td>
<td>225</td>
</tr>
<tr>
<td>Jammu Kashmir</td>
<td>40</td>
<td>209</td>
</tr>
<tr>
<td>Himachal Pradesh</td>
<td>15</td>
<td>125</td>
</tr>
<tr>
<td>Goa</td>
<td>16</td>
<td>123</td>
</tr>
<tr>
<td>Other States</td>
<td>133</td>
<td>2181</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>4085</strong></td>
<td><strong>70637</strong></td>
</tr>
</tbody>
</table>

Table 1.2 indicates that the state of Maharashtra has high loan suit filed account of 1076 followed by Delhi and West Bengal with 484 and 437 accounts respectively. Tamil Nadu ranks fourth in suit filed with 378 accounts. The state of Himachal Pradesh has 15 suit filed accounts. As regards the amount of non-performing loan, the state of Maharashtra has the highest loan of 26,921 crores followed by Delhi with 10,055 crores and Tamil Nadu with 5003 crores. The state of Goa has lowest NPA loan of 123 crores.

SCOPE OF THE STUDY

Commercial banks essentially being commercial organization, their primary objective would be to enhance the profitability of their operations, generate surpluses adequate for ensuring growth and increase shareholder value. In today’s competitive scenario, profit is the index of efficiency and the banks rating is decided on the basis of return on assets, return on equity and profit generated per employee. Only profitable banks are perceived to be rewarded by the investors with their funds.

RBI emphasizes banks profitability and suggest various methods to reduce the NPAs. With change in the social and economic objectives of Indian commercial banks, it becomes extremely essential to assess their profitability performance and find remedial measures to reduce NPA in the wake of new banking philosophy. Standard assets are treated as performing assets and remaining three categories, sub-standard, doubtful and loss assets are known as NPA. Therefore, it is high time to concentrate on analyzing the profitability performance of scheduled commercial banks in terms of NPAs and factors leading to NPA. The biggest ever challenge that the banking industry now faces is the magnitude of NPA.

STATEMENT OF THE PROBLEM

In a fast changing environment of today the very survival of a banking organization depends on level of income generated through optimum use of assets after paying the cost of funds for acquiring them and other administrative costs.
involved therein. Once the assets cease to contribute to income, they are termed as NPA, which not only have cost of fund involved but also require to be operated as per prudential norms.

Non-performing assets of banks are one of the biggest hurdles in the way of socio-economic development of India. The level of NPAs of the banking system in India is still too high. It affects the financial standing of the banks and it is a heavy burden to the banks. A vigorous effort has to be made by the banks to strengthen their internal control and risk management systems and to set up early warning signals for timely detection and action. The NPAs problem also requires great accountability, great disclosures in the case of default and an efficient credit information system. This is an area which requires urgent consideration as the present system involves delays in arriving at a legal solution. The absence of a quick and efficient system of legal redress constitutes an important „moral hazard” in the financial sector, as it encourages imprudent borrowers.

Indian banking industry which had a glorious phase once upon a time, has been facing lots of challenges due to non performing assets at present. Many banks have kept their NPAs under control but some banks are not able to control their NPA levels. There can be various reasons behind this NPA. Non performing assets has been hitting the profitability of the banks or it can be said that due to NPA, the profitability of the banks are getting down day by day. Debt Recovery Tribunal (DRT) is a judiciary for the bank for recovering the amount from the default customers. Hence to analyze the reasons for NPAs and also to suggest measures to reduce the quantum of NPAs, the present study has been undertaken.

**TYPES OF NPA:** There are two types of NPA. They are

- Gross NPA
- Net NPA
**Gross NPA:**

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

\[
\text{Gross NPA} = \frac{\text{Gross NPA}}{\text{Gross advances}}
\]

**Net NPA:**

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

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

**CAUSES FOR NPA**

The Indian Banking System which was operating in a closed economy since the late 80's, now faces new challenges of an open economy. Banks started getting concerned about NPAS with the introduction of the prudential accounting norms. NPAs reflect the performance of banks. A high level of NPAS indicates large number of credit defaulters that would affect the cash flows. Thus, rising NPAS are a matter of concern for banks.
The NPA management policy has to indentify the causes for the occurrence of NPAS. These causes may be attributed to either the borrower or the bank itself or may be due to factors beyond the control of both. Again these may be internal or external for either the borrower or the bank.

**Causes attributable to borrowers:**

**Internal**

- Wrong/improper borrower identification
- Willful defaults
- Incompetent management
- Financial indiscipline/diversion of funds
- Non-submission of requisite data or Submission of wrong/inadequate data
- Time/cost overruns due to delayed project implementation
- Differences/disputes among company promoters
- Technological obsolescence and low priority to technology upgradation
- Inadequate attention to Research and Development
- Poor location choice
- Funds borrowed for a particular purpose but not used for the said purpose
- Business failures
- Diversion of funds for expansion/modernization/setting up new projects/helping or promoting sister concern
- Excess capacities created on non-economic costs.
- Too ambitious project
- Lack of expertise
- Improper working capital management
- Heavy borrowings
- Poor credit collection
- Lack of quality control.

**External**

- Poor stake/contribution of borrower
- Poor inventory/receivable management
- Delayed settlement of receivables of borrower by large industrial houses, Government departments, PSUs etc.
- Inability to compete in the market because of smaller size and new brand name.
- Entry into business at an inappropriate time of business cycle.
- Adverse exchange fluctuations
- Non-availability/irregular supply of critical raw material or other inputs.
- Transport bottlenecks.
- Industrial recession
- Natural calamities
- Government policies like excise duty changes, import duty changes etc.

**Causes attributable to Banks**

**Internal:**

- Poor pre sanction appraisal/unrealistic projections
- Poor assessment of commercial inability (due to lack of inadequate data/knowledge on market industry)
- Delayed decision-making at operative level itself or due to multiplication of processing tiers
- Delayed disbursements
- Non-compliance of terms of sanction
- Incomplete/Defective documentation
- Inadequate supervision, absence of effective monitoring (Post disbursement) and delays in detection of symptoms and initiation of remedial measures.
- Over-stress on long relationships/family/group connections even at the cost of commercial viability of projects.
- Ritualistic reviews (without proper or objective assessment of risks and requirements)
- Non availability of audited financial statements in time and too much reliance on provisional/un-audited data.
- Lack of Networking/Information system amongst branches/Banks enabling borrowers to misuse Bank funds.
- Wrong selection of borrower
- Lack of trained staff
- Lack of delegation of work

**External**

- Changes in regulatory prescriptions causing change in norms for classification.
- Long drawn legal processes for recovery of loan
- Delay in action for rehabilitation of accounts and finalization of rehabilitation package either at bank level or at the BIFR level
- Non-Compliance or delay in compliance of terms of rehabilitation package by borrower
Lack of exchange of information/co-ordination between financial institution and bank.

Non-availability of powers for enforcing securities’ (Possession and Sale) unlike those enjoyed by SFCS

**Causes beyond both the borrower and the bank**

General slowdown in the economy/Recessionary trends.

Depressed capital markets and consequent delay in arrangement of funds for the project.

Frequent adverse changes in the government policies, excise and customs duties, decategorisation of items reserved for SSI, price preferences, cash incentives, product reservation quota system etc.

Changes in policies regarding pollution control including legal decisions as in case of aquaculture and few chemical industries, which virtually ruined them, resulting in huge NPA with banks.

General Law and order problem resulting in stoppage of industrial production and movement of goods.

Inadequacy of infrastructure, in particular power resulting in high cost of production and hence lesser marketability of products

Political uncertainties leading to ineffective functioning of BIFR/DRT

Outdated laws, labour unrest, riots, lockouts,

Cascading effect of debt relief schemes resulting in poor loan repayment environment.

Insensitivity of Government towards non-payment of dues by PSUs and procedural delays in invocation of government guarantees.
Slow disposal of recovery cases.

Poor selection of schemes and proponents under government sponsored schemes by the different government agencies.

Delayed release/Non-payment of subsidies allocated by Central/State government which have been factored into the project cost at the time of appraisal.

Adverse court judgment

Adverse market conditions.

Changes in consumer preferences

Increase in material cost

Changes related to banking amendment.

**Causes of NPAs under the priority sector.**

Lack of experience managerial expertise/technical competence.

Infrastructure constraints and non-availability of adequate and timely extension of support from the government agencies and public bodies.

Slow disposal of recovery cases under the public Debt-Recovery Act or non-enactment of the relevant Act.

Adverse effect of general waiver of loan by the government on the repayment culture resulting in a large number of willful defaulters

Unrealistically ambitious targets set under directed priority sector lending.

Non-settlement/Rejection of DICGC/ECGC claims by the corporation.

Delay in realization of bills by small units for supplies made to larger units.

**IMPACT OF NPA**

The effect of NPA on the bank is as under.

There is loss of interest income

The current profit is reduced, as banks have to make provisions for NPA.
Capital Adequacy Ratio is also affected as it is directly related to the quality of assets.

It also affects the liquidity position of bank as also recycling of funds due to asset liability mismatch

Banks at times have to borrow at high cost to fulfill their commitment or obligation, which increases the cost of funds.

The high level of NPAS also affects the image of the bank in the public.

The NPA has an adverse effect on the moral of the staff and may shy away from doing credit business due to the fear of NPA.

The bank cannot remain competitive in the market due to various adverse effects on the balance sheet and profit.

NPAS bring down the profits, affect the shareholder value and thus adversely affect the investor confidence.

It also affects the ability of the bank to start other business ventures.

EARLY SYMPTOMS:

The symptoms by which one can recognize a performing asset turning into non-performing asset are many and varied. There are four categories of early symptoms. They are

1. FINANCIAL:

- Non-payment of the very first installment in case of term loan.
- Bouncing of cheque due to insufficient balance in the accounts.
- Irregularity of operation in the accounts.
- Unpaid overdue bills.
- Declining Current Ratio
Payment which does not cover the interest and principal amount of that installment.

While monitoring the accounts it is found that partial amount is diverted to sister concern or parent company.

2. OPERATIONAL AND PHYSICAL:

- If information is received that the borrower has either initiated the process of winding up or not doing the business.
- Overdue receivables.
- Stock statement not submitted on time.
- External non-controllable factor like natural calamities in the city where borrower conduct his business.
- Frequent changes in plan.
- Non-payment of wages.

3. ATTITUDINAL CHANGES:

- Use for personal comfort stocks and shares by borrower.
- Avoidance of contact with bank.
- Problem between partners.

4. OTHERS:

- Change in Government policies.
- Death of borrower.
- Competition in market.

OBJECTIVES OF THE STUDY

The study is addressed to the following objectives:

- To study the nature and causes of NPAs
- To analyze the extent and magnitude of NPAs of scheduled commercial banks in India
➢ To find out NPA under the priority and non priority sector lending in commercial banks
➢ To evaluate the impact of NPA on profitability with other variables
➢ To analyze the recovery performance of Indian banks through various recovery channel.
➢ To suggest measures for the efficient and effective management of NPA.

HYPOTHESIS

➢ There is no sharp increase in the non-performing asses during the study period.
➢ Government policies and directives of RBI do not affect the non performing assets and advances of commercial banks.

METHODOLOGY

This research has utilized both primary data and secondary data. Primary data have been collected by using a structured questionnaire from bank executives. The questionnaire is divided into four sections. The first section includes questions on demographic characteristics of the sample taken for the study. The second part includes questions relating to various causes of the NPA, the third part includes questions related to the impact and the fourth part includes questions relating to the management of NPA. To measure the reliability, the data collected have been entered and analyzed in SPSS 20 and its reliability is measured.

The primary emphasis of this research is focused on analyzing non performing assets of scheduled commercial banks in India during the period 2002 to 2013. The secondary data is obtained from statistical hand books and brochures published by Reserve Bank of India. Detailed information have been collected mainly from various volumes of the “Statistical Tables Relating to Banks in India” "Indian Institute of
Bankers and RBI bulletin covering the period from 2002-2013 which were published by the Statistical Department of Reserve Bank of India, Mumbai and from the website www.rbi.org.in. Major portion of data is extracted from report on trend and progress of banking in India from 2002 to 2013. Secondary data have also been collected from various books, journals, and websites.

**Sampling Frame**

The sample size of the study includes 27 Public sector, 25 private sector banks and 29 foreign banks. And also 180 officers working in commercial banks. The respondents with experience in credit division is considered for the purpose of data collection.

Random sampling method is adopted to select officers for the study. While selecting sample, the employees working in the bank are classified into officer, manager, clerks and other administrative staff.

**Tools of Analysis**

In order to achieve the objectives, the data collected are entered, arranged and presented using Microsoft Excel and SPSS 20.

- Standard Deviation indicates the ranges and size of deviation from the mean. It is used to analyse the quality of data for its variability with regard to NPA variables such as gross NPA, net NPA, classification of assets, profitability variables.
- Coefficient of variation indicates the consistency level of bank group with regard to NPA variables and profitability variables of SCBs.
- Factor analysis is a multivariate statistical technique used to condense and simplify the set of large number to smaller number of variables called factors. It is used to analysis the reduced NPA variable is systematic in explaining the elements of NPA.
Karl Pearson’s coefficient of correlation is used to find the relationship between variables. It is used to analysis whether NPA variables and assets classification such as standard, sub standard, doubtful and loss assets are related to each other.

Regression is the measure of average relationship between two or more variable in terms of original unit of the data. With help of this analysis unknown values of one variable can be predicted from the known variable. In the present study it used to analyse the relationship between dependent variable loans and advances and independent variable such as standard, sub standard, doubtful and loss assets. and also with dependent variable and independent variable such as gross advance, net advance, provision, net profit and operating profit.

Parametric paired sample t-test, analysis of variance (ANOVA) is used to find the significant difference among means of NPA variables.

Non-parametric chi-square test is used to find the association between NPA variables

Z Score used in order to validate whether the variable identified is statistically significant reason for NPA.

Discriminant analysis is to study the differences between two or more groups with respect to several variables on the impact of NPA

In order to test the association among the selected variables and significance of difference between different levels of management Chi-Square test is applied.

To establish the relationship between various performance indicators in managing NPA, regression equations are used.

To study the pattern of trend of the financial parameters during the study period, the polynomial trend equation namely, cubic trend equation is framed. The F-values indicate the overall significance of the trend equation fitted. The $R^2$ the coefficient of determination indicates that to what extent the trend coefficients are able to explain the variations of the dependent variables under study.
LIMITATIONS OF THE STUDY

The following may be taken as the limitations of the study:

1. The study is limited to scheduled commercial banks (only public, private and foreign banks) for a period of 12 years from 2002 to 2013. If longer period has been taken for analysis, the result may differ.

2. The study assesses the position of NPAs and their effect on financial efficiency and not on the overall financial performance of the bank.

3. Any generalization of this study for all types of bank in India may lead to misleading results.

CONCEPTS USED

NPA

NPA is an advance where payment of interest or repayment of principal or installment of principal or both remain overdue for a period of 90 days or more.

PRUDENTIAL NORMS:

Prudential norms are the guidelines and general norms issued by the regulating bank of the country for proper and accountable functioning of bank and bank like establishments. And all the banks are expected to follow. Most usually these norms relate to cash reserves, overnight call rates, capital adequacy ratio etc..

The NPA concept was introduced in India by the RBI with effect from 1st April 1992 and certain prudential norms were issued as to the methods of NPA identification, asset classification, provisioning and income recognition so as to move towards greater consistency and transparency in published accounts.

NPA Identification:

The basis for identifying NPAs would vary depending on the nature of the loan asset i.e. term loan, cash credit, bills etc. It has become necessary for a banker to recover the interest or installments within 180 days from its due date, failing which he has to classify the loan account as NPA where further charging of interest is not permitted.
With a view to moving towards international best practices and to ensure greater transparency, it has been decided to adopt 90 days overdue norm for identification of NPAs, from the year ending March 31, 2004. Accordingly, with effect from March 31, 2004, a non performing asset shall be a loan or advance where:

- Interest and/or installment of principal remain over due for a period of more than 90 days in respect of a term loan.
- the account remains „out of order“ for a period of more than 90 days, in respect of an over draft/cash credit.
- the bill remains over due for a period of more than 90 days in the case of bills purchased and discounted.
- interest and/or installment of principal remains over due for two harvest seasons but for a period not exceeding two and half years in the case of an advance granted for agricultural purpose and
- any amount to be received remains overdue for a period of more than 90 days in respect of other accounts

**ASSET CLASSIFICATION**

All performing assets are classified as standard assests. Nonperforming assets are classified into substandard, doubtful or loss assets.

**Standard assets:**

A standard asset is a performing asset. Standard assets generate continuous income and repayments as and when they fall due. Such assets carry a normal risk attached to the business.

**Provisioning Norms:**

- From the year ending 31.03.2000, the bank should make a general provision of a minimum of 0.40 percent on standard assets on global loan portfolio basis.
- The provision on standard assets should not be reckoned for arriving at net NPAs
- The provisions towards standard assets need not be netted from gross advances but shown separately as ‘Contingent Provisions against Standard Assets’ under other Liabilities and Provisions-Others in Schedule 5 of the balance sheet.
Sub-standard assets:

A sub-standard asset is one which has remained NPA for a period, not less than or equal to 12 months. In such cases, the current net worth of the borrower or value of securities charged is not enough to ensure full recovery and leads to loss to banks if deficiencies are not corrected.

Provisioning Norms:

A general provision of 10 percent on total outstanding should be made without making any allowance for DICGC/ECGC guarantee cover and securities available.

Doubtful assets:

With effect from 31.3.2005 an asset is to be classified as doubtful if it has remained NPA for a period exceeding 12 months. It has all inherent weaknesses as sub-standard asset with an added weakness that make collection highly questionable.

Provisioning Norms:

- 100 percent of the extent to which the advance is not covered by the realizable value of the security to which the bank has a valid recourse and the realizable value is estimated on a realistic basis
- In regard to the secured portion, provision may be made on the following basis, at the rates ranging from 20 percent to 50 percent of the secured portion depending upon the period for which the asset has remained doubtful.

Loss assets:

A loss asset is one which is considered as uncollectible. It is one where the bank or internal or external auditors or the RBI inspection has identified loss but the amount has not been written off.

Provisioning Norms:

The entire asset should be written off. If the assets are permitted to remain in the books for any reason, 100 percent of the outstanding should be provided for.
Income recognition:

The policy must be objective and based on the record of recovery as done by International Standards. The banks should not charge and take to income account interest on any NPA. However, interest on advance against their deposits like KVPS,IVPs may be taken to income account on the due date, provided adequate margin is available. Interest realized on NPA may be taken to income account provided the credits in the accounts towards interest are not out of fresh/ additional credit facilities sanctioned to the borrower concerned.

CHAPTER ARRANGEMENTS

Chapter-I deals with introduction, evolution of banking, NPA in Scheduled commercial banks reasons for growing NPA, scope of the study, statement of the problem, objectives, hypothesis, methodology, statistical tools used, limitations of the study, chapter scheme.

Review of literature surveyed and abstracted from academic journals, conference proceedings, technical reports, books, RBI bulletin, news papers is presented in Chapter-II.

Chapter-III portrays the growth and development of banking in India.

Chapter - IV gives the analyses and interpretation of data with the help of statistical tools viz., Annual Growth Rate, Analysis of Variance, Factor Analysis, Paired t-test, Multiple Regressions, Correlation, Discriminant analysis, Z value and the results are presented.

Chapter-V presents the summary of the findings and suggestions to mitigate the effects of NPA.