CHAPTER I

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In India, banking industry has been subject to a lot of changes as a result of liberalization, privatization and globalization. These dramatic policy changes are the outcome of the Structural Reform implemented from July 1991. The Structural Reform has several policy changes, of which Financial Sector Reform is an important one. The major thrust of the programme is to improve the operational and allocative efficiency of the system by reducing the exogenous and structural factors affecting the performance of the banks. Moreover, “substantial part of the agenda for reform of the Indian financial sector since 1991 has related to the problems facing the public sector banks, which have dominated commercial banking in India for the last three decades or so. Despite impressive widening and deepening of the financial system, there was no denying that banks had not grown into sound, vibrant financial institutions, so much so that by 1990 there was serious concern about the poor financial condition of public sector banks most of which had become unprofitable, under-capitalized and burdened with unsustainable levels of non-performing advances on their books, and part of the structural adjustment programme initiated in 1991”.

The reforms have taken root in the financial sector. The principle objective of the financial sector reforms is to bring about diversified, efficient and a competitive financial system. The major goals of the programme are:

1. To correct and improve the macro-economic policy setting within which banks operate. This involves monetary control reforms, including ratification of interest rates, redesigning direct credit programmes, and bringing down the levels of resource preemptions;
2. To improve the financial health and condition of banks, restructuring the

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weaker ones and improving the incentives under which banks function;
3. To build financial institutions and infrastructure relating to supervision, audit, technology and legal framework;
4. To improve the level of managerial competence and the quality of human resources by reviewing the policies relating to recruitment, training, placement etc.;
5. To improve access to financial savings;
6. To reduce intermediation costs and distortions in the banking system;
7. To promote competition through a level playing field and free entry and exit in the financial sectors;
8. To develop transparent and efficient capital and money markets.²

Financial sector reforms based on the recommendations of Narasimham Committee for the improvement of the financial system articulates for effectiveness, accountability, profitability, viability, balanced growth etc. A special emphasis has been made on the need to build a financial infrastructure relating to supervision, audit, technology and legal matters.³ In the banking sector reform the major thrust is given to improve the financial health of banks. The introduction of prudential accounting norms to banks have brought better financial discipline, cleansed the balance sheets and made them more transparent. The reforms incorporate income recognition, asset classification norms and banks are alert to the risk profile of their loan portfolios.⁴ It is observed that factors like greater specialization by banks in different aspects of the market, greater reliance by blue chip customers on direct, securitized access to debit (disintermediation), greater overlap in product coverage between commercial banks and non-bank intermediaries (heightening the importance of non-discriminatory regulation), and greater reliance on non-fund business.⁵

⁵TALWAR, S.P, op.cit. PP-103-104
Presently Indian banking system is in the beginning of the second banking revolution. This is to consolidate the gains and experiences derived from the first banking revolution of 1969. It is considered as “the refinement and clarification of economic theory and especially the accumulation of evidence from years of experience with various policy approaches, have been essential and often decisive factors behind political support for economic reform. They provide the understanding of the consequences of policies from which a consensus can be formed on what is in the general public interest. Such can then be used to oppose the often better-placed special interests that are protecting the status quo”. This change brings uniform effect to all the banks of our country. During the process of transformation the major burden is on the Indian public sector banks. These banks have to work under competitive pressure.

Public Sector Banks in India as financial intermediaries raise deposits and deploy those funds in various banking activities as defined in the banking regulation Act. The funds used and raised by banks are largely public money and hence a duty of care is cast on the banking sector to utilize the public funds properly and in accordance with the economic policies of the state. The financial sector in India has remained highly regulated since banks nationalization in 1969. The main regulations and the draw backs which it had caused to the banking sector by and large are summarized as following:

a) Entry restrictions on private banks –Due to the lack of competition among the public sector banks, the spirit of competition gradually disappeared from the banking sector of India

b) Credit allocation requirements including the priority sector lending requirements viz. Cash Reserve Requirements (CRR) and the statutory

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6 RANGARAJAN, C. op.cit. p112.
liquidity requirements (SLR) resulted in only 25 percent of the bank deposits left over to meet the needs of the remaining sectors.
c) Interest rate controls as the interest rates usually set by the RBI have been lower than market clearing level in the belief that it will stimulate investments, eventually led to reduced and a less productive investment.

In India, the earlier emphasis was on social banking and increase in the asset base without much accent on profitability. But the capital adequacy standards brought back the attention of the bank managements to profitability as the primary objective. RBI appointed a committee to come out with a system for rating of banks, which would be a basis for supervisory attention. The said committee recommended the assessment of banks on the basis of CAMEL, an internationally accepted rating measure based on capital, asset quality, Management, earnings and liquidity.

RBI as the governing and regulatory bank had codified “a health code system” for credit administration in banks. Under the health code system declared in the year 1980 the banks loan assets have been classified under eight categories viz, HC-1 (Satisfactory), HC-2 (Irregular), HC-3 (sick but viable), HC-4 (Sick and non-viable), HC-5 (Recalled), HC-7 (Decreed), HC-8 (Bad and Doubtful). The health code system did not furnish a transparent, uniform, and objective yardstick for measurement of the health of an advance. The important lacuna in the system is that it did not specify the time limit for the advance to be called up after being classified as sticky loan.

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8BANAMBAR SAHO, Banker’s Handbook on NPA Management,(Asia Law House, Hyderabad, 2002, p1.)
RBI has introduced policies with more objectivity for the assessment of bad
debts of the banks and to standardize the relative accounting norms as per the
international standards for maintaining sound banking system. The main role of any
bank is to achieve sustained profit by adapting international banking practices which
could be achieved by proper classification of priorities. The top most priority of any
Public sector banks, as on date in India is to manage its Non-Performing assets at the
international prescribed level of 5 percent on a gross basis and 2.5 percent on net
basis\footnote{BANAMBAR SAHOOP, ibid. p 11.}. Further if a balance sheet is to reflect banks actual financial health, a proper
system for recognition of income, classification of assets, and provisioning of bad
debts on a prudential basis is all the more important.

The term Non Performing Assets (NPA) has tremendous impact on the
performance of banking sector and financial institutions of any country. More over in
a developing country like India, it has become an alarming factor which ultimately
slows down the performances of the public sector banks in India. There has been
phenomenal increase in the NPA assets over the past one decade in India. This is the
major reason for the erosion of the profits of the banking sector in India.

As per RBI reports the Indian banking industry is burdened with high NPAs,
which are already at a staggering level of Rs.60, 000 Crores and constituting about 11
percent of the total loan portfolio. As per the report of "Ernst and Young Asia pacific
report on NPAs in Asia", the actual Non-performing Assets of Banks and Financial
Institutions of India lies in between Rs. 1, 15,000 crore and Rs 1, 40, 000 Crore,
much higher than official estimates of Rs 83,500 Crore.
World class banks do not have NPAs of over 2 percent of the total loan portfolio and NPA level of over 5 percent is considered as poor credit performance. The problem of NPA is multi-dimensional and it requires immediate scientific management to cure the malady. Non-performing assets constitute a real economic cost to the nation in that they reflect the application of the scarce capital and credit funds to un-productive uses. The moneys locked up in Non-performing assets are not available for productive uses and to that extent the banks seek to make provisions for Non-performing Assets by writing them off. It is a charge on their profits. To be able to tide over the difficulty, banks have to charge on their productive and diligent customers a higher rate of interest. It thus becomes a tax on efficiency. It is the customer who uses credit efficiently is the ultimate sufferer who subsidies the inefficiency represented by Non-performing Assets. This also raises the transition costs in the system thus denying the diligent credit customers the benefit of lower rates, which would help them to be more efficient and competitive. Non-performing Assets are not just a problem for banker but equally that of the borrowers also.

The present quantum of Non-performing Assets in commercial Banks has reached its peak and alarming levels. This is a matter of grave concern to the banking sector and as well as to the Public financial system. If allowed, NPAs might get converted into grave situation and result into a national economic crisis as happened elsewhere in developing countries. It is necessary to mention that NPAs ill effect is on both present and future growth of the banks.

Due to mounting NPAs, the smooth flow of bank credit that is the catalyst to the economic growth of the country is bound to suffer to a greater extent. This will have
an adverse effect on the growth of economy. It is not only the bank, which suffer due to this cancerous problem of NPA but equally the borrower also. NPA has a great impact on the performance of the Public Sector Undertaking Banks significantly affecting the efficiency in cost and return support to domestic economy.

The current level of interest rates on fixed deposits of PSU Banks are in line with international standards but the interest charged on loans are still very high, the major reasons being the loss suffered because of NPA. In India, 15 out of 16 PSU Banks covered for statistical purpose, have added fresh NPAs, which were higher than recoveries affected by them during the year 1999-2000\(^{10}\).

The loans issued to the priority sector are mainly directed towards agriculture, small-scale industries etc. These sector in terms of NPA are called “High risks sector” since the return of loans are doubtful and uncertain in most of the cases. The activities of priority sector are always at the mercy of the natural calamities and many other factors such as ever changing nature of market economy. In spite of these factors, it is worth mentioning that the NPA in the priority sector is not higher than the Non-priority sector.

The major causative factors for NPAs are classified as:

a) **External or environmental factors**
   - Market recession and Globalization i.e. changes in macro environment
   - Policies of Government
   - Socio- political pressures through govt. sponsored schemes
   - Lack of effective legal system for loan recovery
   - Change in commercial laws and practices
   - Non-cooperative attitude of Govt. agencies in recovery

b) **Borrowal factors**

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• Inefficient or Mis-management
• Diversion of funds
• Improper choice of project activity
• Adoption of obsolete technology
• Failure in Marketing
• Promoters inability to raise required capital
• Attitude to default willfully or fraudulent intention – misappropriation
• Disputes between the promoters or management and strained labour relations,

c) Internal factors

• Poor credit appraisal systems including improper selection of borrower
• Delay in disbursement
• Under financing as well as over financing
• Lack of professional approach, and lack of proper follow up and post sanction supervision
• Lack of transparency.\textsuperscript{11}

RECOVERY OF BAD LOANS

Banks being commercial organizations have to necessarily earn profits. Even under the present era of social banking, profitability cannot be lost sight of. Profitability depends upon how banks are able to roll over the advances portfolio that is possible only if there is fast recovery of the money lent. Of late it was experienced that persuasion, follow up with borrowers have their own limitations. Number of willful defaulters was increasing by leaps and bounds with all most all public sector banks. Legal course of action is the only remedy left for the banks to book the willful defaulters.

In those days the banks were treated as ordinary litigants in the court of law and no special treatments were given like government though for some purpose they were treated as State under Article 12 of Constitution of India. Further, it is established fact that when a suit is filed at each stage much time is consumed. On an average seven to

\textsuperscript{11} MUNIAPPAN, G.P, "The NPA Overhang - Magnitude, Solutions, Legal Reforms", address at CII Banking Summit - 2002 at Mumbai on April 1, 2002, taken from RBI web site.
eight years is spent for deciding a suit. There are number of factors contributing to the said delay and these factors are interlinked and interdependent. The broad factors which contribute to the delay are as under:

- Government- Lack of priority, No realistic assessment, facilities not provided to courts
- Courts- Lack of proper management, wide appellate and review powers, Lack of effective control by the courts over lawyers
- Advocates- Inadequate distribution of professional work, un-preparedness of the cases, and seeking adjournments, manipulation of interim orders, resorting to strike or boycott
- Litigants- Taking advantage of the loopholes in the ad judicatory system. manipulating things to get ex-party orders, to make counter claims though not maintainable, to drag on the matter for one reason or other in both legitimate or illegitimate means.
- Others- Statutes themselves creating hurdle to dispose of the cases viz. like statutory notice to be issued for suits against Government, in suits against the company in liquidation leave of the High Court is necessary etc.\textsuperscript{12}

In the causes of legal, action the delay is caused at every stage of the suit, starting with servicing of summons and appearance of defendants. Moreover, from filing of written statement and subsequent adjournments sought by the defendants to keep on the matter lingering for years together are also responsible for delay in the legal action against the defendants. Even at the stage of framing of issues 3 to 24 months is consumed due to heavy workload in the courts. In addition, during the final arguments the cases have been adjourned for many days. The courts do not pronounce the judgment within one month from the date of conclusion of arguments, due to over burden of matters the same is not adhered invariably in most of the cases.

Expenses in connection with suit filed and decreed cases are also an important subject to be discussed with. There were direct cost and indirect and incidental cost to be incurred for filing a suit for the recovery of NPA. Invariably banks by filing

normal suits in the civil courts have not achieved the desired results. To eliminate all these difficulties faced by the banks the Government appointed various committees to study the inherent deficiencies in the legal system and suggest remedial measures inter-alia including the faster recovery of the outstanding dues to the banks.

As on 30-9-1990 there were more than 15 lakh of cases filed by the public sector banks of which 304 cases filed by the financial institutions were pending in various courts and the debts involved therein was more than Rs.5622 Crores in Public Sector Banks and about Rs.391 Crores with regard to financial institutions. The locking up of such a huge amount of public money in litigation prevents proper utilization and recycling of funds for the redevelopment of the country. Banks had thus stepped up their recovery efforts with a view to complying with the prudential norms for capital adequacy and provisioning for bad and doubtful debts.

CONTROL OF NPAs

Various committees were set up by Govt. of India to study the problems faced by banking industry and to suggest solutions for the same. One of the earliest committee that was appointed by Reserve Bank of India by its memorandum dated May 14th 1981 was Tiwari Committee\(^{13}\). This committee examined thoroughly the legal and other difficulties faced by banks and financial institutions in rehabilitation of sick industrial undertaking and suggested remedial measures: As the civil courts do not give priority for the recovery of dues of the banks special legislation have to be enacted to set up exclusive forum which will take care of the recovery of dues by banks, and the modes to recover the dues of the banks is to be through special process

\(^{13}\) TIWARI COMMITTEE, Reserve Bank of India, 1981.
viz. to treat the dues of the banks and financial institutions as arrears of land revenue and to entrust the recovery of the same to State, with special powers in favour of banks similar to those conferred on State Financial Corporation under their respective statutes, and to set up special legislation creating quasi-judicial authorities exclusively devoted to adjudicate recoveries.

Subsequently, Narasimham Committee\(^{14}\) was constituted vide memorandum dated 14/08/1991, issued by Government of India, Ministry of Finance. The terms of reference and inter-alia included to examine the existing structure of financial system and its various components and to make recommendations for improving the efficiencies and effectiveness of the system with particular reference to the economy of operations, accountability and profitability of the commercial banks and financial institutions. Further the committee was asked to review the existing legislative framework and to suggest necessary amendments for implementing the recommendations that may require legislative change.

In order to pursue further phases of bank reforms Government had appointed Narasimham Committee II\(^{15}\) in the year 1997. This committee had submitted its report in the month of April 1998. The committee’s recommendations have been accepted by Reserve Bank of India in its review of Monetary and credit policy 1998-99. On the basis of the recommendation of various committees the Recovery of debts due to Banks and Financial Institutions Acts 1993 was enacted. Under the said act Special Debt Recovery Tribunals (DRT) has been set up to deal exclusively to recover debts of banks and financial institutions. 29 debt recovery tribunals have already been set up under the said Act. Further Five appellate tribunals have been set up under the

\(^{14}\) NARASIMHAM COMMITTEE, op.cit.
\(^{15}\) Narasimham Committee II, op.cit.
Act at Allahabad, Mumbai, Delhi, Kolkatta and Chennai. As on 30-09-2001 the DRT's had disposed off 18,703 cases involving Rs14, 026 Crore and Rs.3527 Crore have been recovered by the said tribunals.

In addition, in consultation with the Government of India, a Working Group under the Chairmanship of M.S. Verma was appointed by the RBI to suggest measures for revival of weak public sector banks. The Committee articulates that "the restructuring programme will have to encompass operational, organisational, financial and systemic restructuring and must be implemented in a time bound manner. Any delay will add to the cost of the restructuring. The different measures suggested by the Group for financial, operational and systemic restructuring are a unified package and for results to be really achieved have to be implemented as such. A stage has reached when gradualism will not succeed and if resorted to may cause more harm than good. By adopting a pick and choose approach, not only a total effect expected from the package will be lost, but even the individual measures picked up for implementation would lose much of their efficacy."

After putting in hectic efforts to reduce the NPA over a period of seven years, the progress of DRTs has not been up to the level of the expectations. According to the information available, as on March 1999, out of the total number of 21,781 cases filed and transferred to DRTs involving Rs.17, 921 crore, only 3,774 cases had been solved so far. If the DRTs and DRATs functions in the same way, it will quiet difficult to bring down the NPAs at the accepted level.

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17MUNIAPPAN, G.P. op.cit.
For recovery of smaller loans the Lok Adalat have been proved a very good agency for quick justice and settlement dues. The Gujarat State Legal Service Authority and the DRT Ahmedabad have nominated and appointed Conciliators to deal with the cases before the Lok Adalat comprising of retired High Court Judge and two members from senior Advocates, Industrialists, and Executives of the banks. These adalats in the state of Gujarat have been found useful as a supplement to the efforts of recovery by the DRTs. It is important to note that such agencies should also established in all the states.

As a consequence of the unabated efforts made by the Government by pursuing various reforms, public sector banks were able to recover Rs.12, 860 Crore in 2000-2001 as compared to Rs9, 883 Crore in the previous year and net NPAs as percent of net advances came down to 6.7 percent as on March 31st 2001 as compared 7.4 percent in previous year.

To formulate specific proposals and to give effect to the suggestions made by the Narasimham committee, Government of India appointed a committee in February 1999, under the Chairmanship of T.R. AndhyaruJina. The said committee submitted its report on legal reforms in banking sector in May 2000. The important recommendations are banks should have power for taking possession and sale of securities without the intervention of courts, securitization as a beneficiary measure has been suggested, amendment to DRT Act to make it more effective, and

amendment in contract Act to give more time to banks to enforce their rights under guarantee.

Apart from these committees which have been constituted, RBI as a regulatory authority is also taking various policy decisions to control the problem of NPAs. RBI has introduced a onetime settlement scheme for settlement of NPAs for small borrowers was introduced in 1999. Under this scheme public sector banks have recovered a total sum of Rs. 2,192 Crore in respect of 5.23 Lakh accounts as on 30-06-2001. Policy norms for NPAs have been made strict and revised prudential norms on Asset classification were prescribed vide RBI master circular dated 04-7-2002. Moreover, the latest Monetary and credit policy for 2002-03 announced by Dr. Bimal Jalan, Governor, RBI on 29-04-2002, is “Consistent with the recommendations of Narasimham committee II and with a view to moving closer to international best practices, it is proposed that with effect from March 31, 2005, an asset would be classified as doubtful if it remained in the sub standard category for 12 months. Banks are permitted to phase the consequent additional provisioning over a four-year period with a minimum of 20 percent each year”.

PRUDENTIAL NORMS

Introduction of prudential norms on income recognition, assets classification and provisioning during 1992-1993 and other steps initiated apart from bringing the transparency in the loan portfolio of banking industry have significantly contributed towards improvement in the pre-sanction appraisal and post sanction supervision which is reflected in lowering of the levels of fresh accretion of non-performing advances of banks after 1992.

DEFINITION OF NON-PERFORMING ASSETS

Non-Performing Assets can be defined as the share of credits which the borrowers had stopped servicing. According to Income recognition rules of Reserve Bank of India: An asset including a leased asset becomes Non-performing when it ceases to generate income for the bank. A “Non-performing Asset (NPA)” was defined as credit facility in respect of which the interest and or installment of principal has remained “past due “for a specified period of time. “The total asset balance i.e. aggregate, borrower–wise fund based outstanding and period is classified as performing asset or Non-performing asset. The non-fund based limits are included only if and when they result in fund based outstanding.”

According to latest income recognition rules of RBI, an account will be NPA account if interest and installment of principal remains overdue for a period of more than 180 days. According to general notes on income recognition rules, treatment of a borrowal account is borrower wise and facility wise, i.e. even if one of the many facilities in a borrowal account becomes NPA, the entire account and total outstanding is classified as NPA i.e. a deemed NPA. With a view to moving towards international best practices and to ensure greater transparency, it has been decided to adapt “the 90 days overdue” norm for identification of NPA from the year ending March 2004.

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ASSET CLASSIFICATION

Asset classification is also done borrower wise. Therefore, the total borrower wise fund-based on outstanding is classified as, any one of the following i.e. Standard Asset or Sub-Standard Asset or Doubtful Asset or Loss Asset.

DEFINITIONS

Standard Asset: A standard asset has to be a performing asset so far the share of credits the borrowers is servicing. As per RBI guidelines banks should make a general provision of minimum of 0.25 percent on global loan portfolio basis and not on domestic advance alone

Sub-Standard Asset: Once the asset has been classified as NPA and whose age is up-to 18 months it is Sub-standard asset. As per RBI guidelines banks should make a provision of 10 percent on total balance outstanding.

Doubtful Asset: Once the asset has been classified as NPA and whose age is exceeding 18 months it is doubtful asset. As per RBI guidelines banks should make provisioning as under

- 20% of the balance out-standing covered by realizable value of security in case of NPAs up to 3 years OR
- 30% of the balance out-standing covered by realizable value of security in case of NPAs over 3 years but up to 5 years OR
- 50% of the balance out-standing covered by realizable value of security in case of NPAs is over 5 years

Loss Asset: NPA that is considered irrecoverable and which has been identified by the Bank or by internal or statutory auditors or by the RBI Inspector, but the amount has not been written off wholly or partially is considered as Loss Asset. Provisioning for loss assets have to be made for 100 percent or the amount outstanding should be written off.
REASONS FOR NPAs

There can be a plethora of reasons for why the NPAs are burgeoning in the financial system in general and banking system in particular, in the Indian Economy. Out of these, some widely acknowledged major reasons are discussed hereunder.

- **Credit Appraisal** – A robust credit appraisal system is the primary requisite for any lending institution. Primarily, lending is for carrying out a new venture or continuing some economic activity. At the appraisal stage, ample opportunities are available to the lending officer to test the viability of the activity being funded under various scenarios, including the ‘Stress Scenario’. However, lack of such rigorous appraisal system or not adhering to such system, even if it exists, may induce the “Adverse Selection” by the unscrupulous borrowers and sow the seeds for the future NPA.

- **Credit Monitoring** – The Financial Institution is an intermediary. It raises scarce financial resources, rations and deploys the same to the needy entities, thereby contributing to the economic development of the country and while doing so earns a spread for itself. Obtaining periodical information from the borrowers about their business activity and the profitability and testing the same against the assumptions / projections made while appraising the loan facility are some of the functions of Credit Monitoring. Such periodical review helps in diagnosing the inherent or potential problem cases much early for remedial actions. Such remedial actions can be cutting further exposures as a preventive measure or recalling the existing loans as a corrective measure. In the absence of such an efficient monitoring system, the bank is likely to be saddled with the pile up of NPAs.

- **Changing Economic and Business Scenario**: The economic liberalization and the opening up to the global players changed the way business is carried out in the country. There are no longer the ‘safe businesses’ or ‘safe houses’. Each segment of business and every individual borrower have to be passed through the rigorous appraisal system. It is to be remembered that the amounts being lent can be recovered from the future cash flows from the
venture being funded and not from the experience of how a business house handled the past or how they were known to be successful in the past. The lack of appreciation of this or the delayed realization had led to the increased NPAs

- **Professionalism in Operations:** In case of private Sector Banks monitoring and follow-up is more personalized. The foreign Banks are not only selective in granting credit facilities but are consistent and focused in appraisal system and faster in delivering the credit. The collateral taken by private and foreign Banks would not be as much as in the case of public sector banks, but follow-up and monitoring is better in private and foreign banks, since these factors are not in the PSU banks, hence the occurrence of NPAs is unavoidable in PSU banks.

- **Directed Lending:** Banks are required and mandated to finance for various sectors such as agriculture, SSI and many entrepreneurial developments PMRY, SEPUP, SUME, and IRDP etc. These are the primary aims of the governments to uplift the downtrodden and socially weaker section groups; hence the banks are directed to provide credit to this sector and to these schemes. Normally, the NPAs occur in these programs since under these schemes borrowers are not required to furnish any guarantee and security. Irrespective of legal actions taken by the banks these loans became uncontrolled NPAs.

- **External Fissures:** Due to the influences of internal and external factors usually political and bureaucratic, NPAs of some Public Sector Banks are higher than their capital reserves. Even percentage of NPAs to owned funds of some of the PSU banks is quite high. Over a period of a decade various measures at all levels have been taken but these efforts were not fruitful and foolproof to control or cut down the NPAs at the accepted level at international levels. Even after 10 yrs of continuous efforts the authorities are unable to bring down the NPA levels to acceptable limit of 1 to 2 % and still in Indian scenario the NPAs levels are much higher than this level.
• **Legal Hindrances:** The other major reasons for the NPA phenomenon are the dilapidated and defaulter friendly legal system. Recovery from the cases of suit filed accounts has been quite insignificant and continues to be on the decline. On many occasions the defenses laid down by the defaulters are often flimsy. Due to the above said legal system only marginal amount of NPAs only recovered so far out of the very large amount identified as NPA, which is hindering the profitability of the banks and weakening their Balance Sheets and also depriving them the opportunity of recycling the money locked up in the NPAs, for more productive purposes.21

**IMPACT OF NPA**

Banks have been considered as instruments of socio economic development of a nation. Ultimately the performance of the banking sector of a nation certainly will have tremendous impact on the economic growth of that nation. The Banking sector performance has been measured not only in terms of profitability and efficiency of its services but in terms of the quantum of credit issued particularly to the priority sector and the number of branches opened. But for over the last two decades many banks are experiencing erosion of wealth in view of the ever increasing NPAs thereby hindering the optimum utilisation of the resources and consequent contribution to the economy.

**EFFECTS OF NPS's**

The ill effects of NPA are its effect on profitability, effect on return on assets, effect on credit rating, effect on capital restructuring, effect on capital restructuring, effect on interest rate, effect on productivity, effect on net-worth, effect on capital

21BANAMBAR SAHO, op.cit. pp 20-46, and Reserve Bank of India, Master Circular- Prudential norms on income recognition, asset Classification and provisioning pertaining to the advances portfolio, Circular dated 4 July 2002.
adequacy ratio, effect on business mobilization, and effect on recycling of funds. These effects negatively affect the present and future growth of banks.

**NEED FOR THE STUDY**

NPAs constitute real economic cost to the India, in that they reflect the application of scarce capital and credit funds to unproductive uses. The money locked up in NPAs are not available for productive use and to that extent the banks seek to make provision for NPAs or write them off, and it is a charge on the profits of the banks. Banks have to charge on their productive and diligent customers a higher rate of interest. It is the customer who uses credit efficiently those subsidies the inefficiency represented by NPAs. This also raises the transition cost in the system by denying the diligent credit customers the benefit of lower rates, which would help them to be more efficient and competitive. NPAs in short are not only the problem for banks, but they are bad for the economy as well.

World Bank studies have indicated that a capital adequacy ratio of 8 percent, if the net NPAs of a bank reach 15 percent it will wipe out its capital. Therefore, as a rule of thumb, when the net NPAs of the banking system is over 15 percent the system is likely to be in distress and unsound. NPAs affect bank’s ability to lower interest rates. It compels to maintain higher spreads to protect their profit position. When the inflation level goes down, banks are not in position to lower their lending rates.

Banks being a derivative institution, their well being is inextricably linked to the other sectors of the economy. Bank losses have to be ultimately born somewhere in the economy and such loss allocation has politico-economic connotations. The
pernicious impact of NPAs extends far beyond the balance sheets. Banks incur several costs on them—a-holding cost, a provision for capital adequacy and opportunities foregone while harboring the NPAs. The reform era has been the time when serious weaknesses of the financial system such as burgeoning NPAs were first detected. Since the problem of bad loans cannot be wished away by executive fiat, it might be useful to correct the inhibitions that hamper debt recoveries in govt. controlled banks.

The high level of NPAs of India's public sector banks threatens solvency if they remain unchecked, or allowed to grow. NPAs are considered as an albatross, which clearly influence the inability to lower interest rates. They have ballooned to such an extent that even securely employed bank officials fight shy of on lending deposits to genuine constituents.

Public sector banks are still dominant in the overall financial system in India. Since the adoption of prudential standards in 1993-94 there has been a reduction in non-performing assets in relation to the total assets, especially over the last five years. However, the level of NPAs still remains unduly high, partly because of the carry over of NPAs in certain sunset industries and continued existence of weak internal control systems in banks, and partly because of relatively weak legal support to the recovery mechanisms.

The large quantum of NPAs however, poses a major problem for a few banks identified as weak banks i.e. United Bank of India, United Commercial bank and Indian Bank, where the possibility of a return to profitability, without substantial restructuring, is doubtful. At this crucial juncture, this study aims to find out in detail
about the major reasons for the ever-growing nature of the NPAs and find the ways and means to control over the NPAs.

AREA OF STUDY

The NPAs are prevalent in Indian banking sector, which results in inefficient performance of PSU banks – exists in all over the country more particularly in Mumbai as it is the commercial capital of India, where larger sum of loans are being sanctioned.

PERIOD OF STUDY

In the Indian economy the classification of NPA started appearing from 1991. The review of RBI data reveals that during the period 1991-2001 the NPAs have exponential growth. Hence this study examined the NPAs from 1991 to 2001.

SCOPE AND LIMITATIONS OF THE STUDY

Non-performing assets are the curse on the welfare of a society. Many of the committees appointed by RBI have identified poor credit appraisal or decision by the Management of banks, cyclic changes in the economic environment; directed credit and unscientific approach to lending etc. as some of the factors responsible for the poor asset quality. The present study of non-performing asset with more emphasis on recovery will also help to identify the root cause and also to canalize the process of recovery so as to enhance the recovery rate to the International levels.

As per the RBI study 14, 36,739 suit filed cases were pending for disposal as on 31st March 1998, involving an amount of Rs.21, 824.92 Crore. The long drawn procedure for recovery of debts due to banks and financial institutions has resulted in
blocking of a significant portion of their funds in unproductive assets, the value of which deteriorates with the passage of time.

Recourse to legal procedure is not only time consuming but also expensive. It is just like throwing good money after bad money. Money has an opportunity cost. If money is recovered in time, it can be deployed for a higher rate of return. Hence, the time factor in recovery of dues is much of importance. Study in the area of recovery of non-performing assets is needed for more systematic knowledge about the recovery process, which can be brought to the borrowers notice at the first instance viz. at the time of availing the loan itself which will create the impression that after borrowing the money from the bank there is no other way except to repay the same.

Traditionally loans are advanced in India after analyzing the company’s future cash flow and over and above taking collateral security of movable or immovable assets to equal sum of the loan. Hence, theoretically speaking there should be no difficulty in recovering the loan full and final. In these circumstances, an attempt is made in this Thesis to undertake A Study on Non-Performing Assets of Indian Public Sector Banks.

The study aims to assess the opinion of the bank officials in Mumbai. The present study will have a limited scope of assessing the views of bank officials and not the opinion of other experts in the field. Further, the primary objective of the study is to assess the causes for NPA from the opinion of sample respondents. Moreover, the impact of NPA is not discussed at length in the Thesis. Though the secondary data on NPA have been collected in terms of sector-wise and bank-wise but
the details are analysed to elicit the reasons and efficacy of operative mechanisms of NPA from the firsthand information gathered from the bank officials.

OBJECTIVES

The major objectives of the study are to examine the problem of the fast growth of NPAs of PSU Banks and suggest remedial measures through a better legal framework. The specific objectives are:

1. To study the growth of NPAs of all public sector banks (State bank of India & its associates and all nationalized banks) in the context of credit appraisal.
2. To study the growth of NPAs of all Public sector banks in the context of credit monitoring and follow up
3. To study the growth of NPAs sector wise and analyze the trend in priority sectors and in non-priority sectors.
4. To examine the NPAs in weaker bank among PSU banks and compare with the comparatively stronger bank in term of NPAs.
5. To study the recovery mechanism, the legal ways and means available for recovering NPAs
6. To study the ways and means to enhance the recovery of NPAs and to control the growth of NPAs.

HYPOTHESES

The following hypotheses have been formulated for this study.

1. The credit appraisal methods in the banking system have affected the performance of PSU banks.
2. The credit monitoring in follow up of the credit in the banking system has affected the performance of PSU banks
3. The defaulter friendly legal system provides scope for the rise of NPAs.
4. NPA among priority sector is lower than the non-priority sector.
5. The credit appraisal and credit monitoring are the major factors for the higher growth of NPAs in the weaker bank than the stronger one.

**METHODOLOGY**

The data base for the present study consists of both primary and secondary sources. The primary data was collected from bank officials who were instrumental in sanctioning loans i.e. credit appraisal, credit monitoring, asset recovery management and persons from legal department who are closely monitoring the recovery aspects. The sample bank officers were chosen from the list provided by the Regional/ Head Offices of different public sector banks in Mumbai. From the list, 300 bank officers were selected at random and the questionnaires were mailed to them. Out of 300 questionnaires sent only 205 questionnaires were received. Of which 200 questionnaires were duly filled in by the bank officers and complete in all aspects. The remaining five questionnaires were incomplete and hence they could not be included in the study. Therefore, the actual sample population for the present study is 200.

Secondary data collections have been made from various published books, journals and reports of RBI and World Bank and from the web sites of various public sector Banks. Additional data has been collected from Handbook of Indian Economy, statistical figures published by central Statistical Organization.

For the analysis of data various statistical tools like frequency table, cluster analysis, multi dimensional scaling technique, ANOVA, and Chi-Square technique were applied and the results are presented in Chapter IV and V of the thesis.
CHAPTERISATION

The research study is presented in six chapters. The first chapter deals with introduction, statement of the problem, period of the study, objectives, hypotheses, methodology and chapterisation.

In the second chapter, a review of available literature on the research topic is presented along with financial sector reforms, public sector banks, NPA and PSBs.

The third chapter dwells upon development of Banking in India, origin and growth of NPA, and various policy measures initiated by the Government and RBI on NPA and the general profile of the study area that deals with general information about Mumbai.

Fourth chapter, analyses the NPA based on secondary data. The various analyses presented are on progress of commercial banks in India, dimensions of NPA and NPA and profitability of banks.

Fifth chapter, deals with the analysis of NPA based on primary data covering general information, reasons for NPA in the banking industry, NPA and credit appraisal, NPA and credit monitoring, NPA and legal issues, effects of NPA’S, recovery of NPA’S, and controlling NPA’S. Finally test of hypotheses is also presented in the Chapter.

The sixth chapter deals with summary of the thesis and suggestions.
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