CHAPTER - II
REVIEW OF LITERATURE

The Phrase “Non-Performing Assets” (acronym NPAs), has held and continues to hold the center stage in the corridors of banks and financial institutions. Though the emphasis on management of NPAs is prevalent today, the term is not new to Indian banking. Even earlier, bankers used to handle sticky advances and make provisions against such advances. The system of asset classification, income recognition and provisioning norms introduced by the RBI in 1992 is an explicit model of assessing the credit risk that a bank or financial institution carries in its balance sheet. When implemented across the industry, it brings in uniformity, transparency, objectivity, etc in assessing the credit risk, besides receiving acceptance both in domestic and global markets. This is the prime reason for the departure of the present day policies with those existing up to 80s. The prudential norms, introduced by the RBI, have not only brought in objectivity but also placed the actual risk position in a proper perspective so that the banks can take corrective measures from time to time to keep the credit portfolio healthy and remunerative.

2.1 CAUSES FOR NON PERFORMING ASSETS

A strong banking sector is important for a flourishing economy. The failure of the banking sector may have an adverse impact on other sectors. The Indian banking system, which was operating in a closed economy, now faces the challenges of an open economy. This in turn ensured that banks needed to develop sophisticated treasury operations and Asset Liability Management skills.

A combination of directed lending and social banking relegated profitability and competitiveness to the background. The net result was unsustainable NPAs and consequently a higher effective cost of banking services.
There are various causes for NPAs in the banking sector. Some of the significant causes are as follows:

- Loans system under which commercial banks are required a prescribed percentage of their credit (40%) to priority sectors. As of today a substantial portion of Gross NPAs are locked up in 'hard-core' doubtful and loss assets, accumulated over the years.
- Sudden changes in Government’s policies.
- Poor selection of borrowers.
- Changes in external environment.
- Infrastructure bottlenecks.
- Delays in getting governmental approvals.
- Mismanagement by the borrowers. Etc

The problem India Faces is not lack of strict prudential norms but

1. The legal impediments and time consuming nature of asset disposal process.
2. Postponement of problem in order to show higher earnings.
3. Manipulation by debtors using various varieties of influences.

2.2 MARKET DISCIPLINE

In terms of Basel committee norms, the purpose of pillar three is to complement the minimum capital requirements of pillar one and the supervisory review process addressed in pillar two. The Basel committee has sought to encourage market discipline by developing a set of disclosure requirements that allow market participants to assess key information about a bank’s risk profile and level of capitalization.
Specifically, the emerging markets would need certain transition period to implement proposals in respect of consolidation of accounts and assigning capital on a consolidated basis, setting benchmarks and approving the rating methodologies of domestic rating agencies, improving the technical capabilities of supervisors and financial institutions, mapping of individual ratings of banks with the regulatory risk weight baskets, assigning of explicit capital charge for interest rate risk in the banking book and other risks e.g., operational risk, estimating economic capital and introducing more disclosures on risk-based capital ratios, etc.

1 A synoptic review of literature brings to the fore insights into the determinants of NPAs across countries. A considered view is that banks lending policy could have crucial influence on non performing loans (Reddy, 2004). He critically examined various issues pertaining to terms of credit of Indian banks. In this context, it was viewed that ‘the element of power has no bearing on the illegal activity. A default is not entirely an irrational decision. Rather a defaulter takes into account probabilistic assessment of various costs and benefits of his decision’.

2 Bercoff, Giovanniz and Grimardx (2002) using accelerated failure time (AFT) model in their study of Argentina’s banking sector’s weakness measured by the ratio of non-performing loans to total loans found that both bank specific indicators such as asset growth, the ratio of net worth to net assets, the ratio of operating cost to assets, exposure to personal loans, and institutional characteristics relating to private bank and foreign bank and macro-economic variables including credit growth, foreign interest rate, reserve adequacy and monetary expansion, besides the tequila effect were reasons behind the banking fragility. Their empirical results suggested that bank size measured by log of assets had a positive effect but asset growth had a negative effect on NPLs. The variables such as operating cost, exposure to personal loans, credit growth, and foreign interest rate had negative effect on NPLs. The macro-economic variables such

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as money multiplier, and reserve adequacy, institutional characteristics and tequila effect had positive influence on NPLs.

3Jimenez and Saurina (2003) used logit model for analyzing the determinants of the probability of default (PD) of bank loans in terms of variables such as collateral, type of lender and bank-borrower relationship while controlling for the other explanatory variables such as size of loan, size of borrower, maturity structure of loans and currency composition of loans. Their empirical results suggested that collateralized loans had a higher PD, loans granted by savings banks were riskier and a close bank-borrower relationship had a positive effect on the willingness to take more risk. At the same time, size of the bank loan had a negative effect on default while maturity terms of loans, i.e., short-term loans of less than 1-year maturity had a significant positive effect on default.

4The study examined the relationship between cyclical lending behavior of banks in Australia argued that the potential for banks to experience substantial losses on their loan portfolios increases towards the peak of the expansionary phase of the cycle. However, towards the top of the cycle, banks appear to be relatively healthy- that is non-performing loans are low and profits are high, reflecting the fact that even the riskiest of borrowers tend to benefit from buoyant economic conditions. While the risk inherent in banks’ lending portfolios peaks at the top of the cycle, the risk tends to get realized during the contractionary phase of the business cycle. At that time, banks’ non-performing loans increase, profits decline and substantial losses to capital may become apparent. Eventually, the economy reaches a trough and turns towards a new expansionary phase, as a result the risk of future losses reaches a low point, even though banks may still appear relatively unhealthy at this stage in the cycle.

3Jimenez, G and J.Saurina (2003) ‘Collateral, Type of Lender and Relationship Banking as Determinants of Credit Risk, Bank of spain’.
Lis, et.al., (2002) used a simultaneous equation model in which they explained bank loan losses in Spain using a host of indicators, which included GDP growth rate, debt-equity ratios of firms, regulation regime, loan growth, bank branch growth rates, bank size, collateralized loans, net interest margin, capital asset ratio (CAR) and market power of default companies. They found that GDP growth (contemporaneous, as well as one period lag term), bank size and CAR, had negative effect while loan growth, collateral, net-interest margin, debt-equity, market power, regulatory regime and lagged dependent variable had positive effect on problem loans. The effect of branch growth could vary with different lags.

In this study he analyses corporate bond recovery rate adducing to bond default rate, macroeconomic variables such as GDP and growth rate, amount of bonds outstanding, amount of default, return on default bonds, and stock return. It was suggested that default rate, amount of bonds, default bonds, and economic recession had negative effect, while the GDP growth rate, and stock return had a positive effect on corporate recovery rate.

Fuentes and Maquieira (1998) undertook an in-depth analysis of loan losses due to the composition of lending by type of contract, volume of lending, and cost of credit and default rates in the Chilean credit market. Their empirical analysis examined different variables which may affect loan repayment: (a) limitations on the access to credit; (b) macroeconomic stability; (c) collection technology; (d) bankruptcy code; (e) information sharing; (f) the judicial system; (g) prescreening techniques; and (h) major changes in financial market regulation. They concluded that a satisfactory performance of the Chilean credit market, in terms of loan repayments hinges on a good information

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5 Lis, S.F. de,J.M. pages, and J. Saurina (2002), 'Credit Growth, Problem Loans And Credit Risk Provisioning' In Spain, Banco de Espana – Servicio de Estudios, Documento de Trabajo no 0018.
7 Fuentes, R and Carlos Maquieira (1998) Determinants of loan repayment in Chile, School of Business and Economics, Universidad de Chile
sharing system, an advanced collection technology, macroeconomic performance and major changes in the financial market regulation.

8Chile, Fuentes and Maquieria (2003) analysed the effect of legal reforms and institutional changes on credit market development and the low level of unpaid debt in the Chilean banking sector. Using time series data on yearly basis (1960-1997), they concluded that both information sharing and deep financial market liberalization were positively related to the credit market development. They also reported less dependence of unpaid loans with respect to the business cycle compared to interest rate of the Chilean economy.

9Bloem and Gorter (2001) suggested that a more or less predictable level of non-performing loans, though it may vary slightly from year to year, is caused by an inevitable number of ‘wrong economic decisions’ by individuals and plain bad luck (inclement weather, unexpected price changes for certain products, etc) Under such circumstances, the holders of loans can make an allowance for a normal share of non-performance in the form of bad loan provisions, or they may spread the risk by taking out insurance. Enterprises may well be able to pass a large portion of these costs to customers in the form of higher prices. For instance, the interest margin applied by financial institution will include a premium for the risk of non-performance on granted loans.

10Sergio (1996) in a study of non-performing loans in Italy found evidence that, an increase in the riskiness of loan assets is rooted in a bank’s lending policy adducing to relatively unselective and inadequate assessment of sectoral prospects. Interestingly, this study refuted that business cycle could be a primary reason for banks’ NPLs. The

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8 Fuentes, R and Carlos Maquieria (2003) Institutional arrangements, credit market development and loan repayment in Chile, Schoool of Business and Economics, Universidad de Chile
study emphasized that increase in bad debts as a consequence of recession alone is not empirically demonstrated. It was viewed that the bank-firm relationship will thus; prove effective not so much because it overcomes informational asymmetry but because it recoups certain canons of appraisal.

In a study of loan losses of US banks, Mc Goventhe (1993) argued that 'character' has historically been a paramount factor of credit and a major determinant in the decision to lend money. Banks have suffered loan losses through relaxed lending standards, unguaranteed credits, the influence of the 1980s culture, and the borrowers’ perceptions. It was suggested that bankers should make a fairly accurate personality-morale profile assessment of prospective and current borrowers and guarantors. Besides considering personal interaction, banker should (i) try to draw some conclusions about staff morale and loyalty, (ii) study the person’s personal credit report, (iii) do trade-credit reference checking, (iv) check reference from present and former bankers, and (v) determine how the borrower handles stress. In addition, banks can minimize risk by securing the borrower’s guarantee, using Government guaranteed loan programs, and requiring conservative loan-to-value ratios.

This paper explores an empirical approach to the analysis of Non-Performing Assets (NPAs) of public, private, and foreign sector banks in India. The NPAs are considered as an important parameter to judge the performance and financial health of banks. The level of NPAs is one of the drivers of financial stability and growth of the banking sector. This paper aims to find the fundamental factors which impact NPAs of banks. A model consisting of two types of factors, viz., macroeconomic factors and bank-specific parameters, is developed and the behavior of NPAs of the three categories of banks is observed. This model tries to extend the methodology of widely-known Altman model. The empirical analysis assesses how macro economic factors and bank-specific parameters affect NPAs of a particular category of banks. The macroeconomic

factors of the model included are GDP growth rate and excise duty, and the bank-specific parameters are Credit Deposit Ratio (CDR), loan exposure to priority sector, Capital Adequacy Ratio (CAR), and liquidity risk. The results show that movement in NPAs over the years can be explained well by the factors considered in the model for the public and private banks. The collinearity between independent variables was measured by Durbin-Watson test and VIF characteristic and it was found to be a little for public and private banks. The factor included in the model explains 97.1% (adjusted R-square value of regression results) of variations in NPAs of public banks and 76.9% of the same of private banks. The other important results derived from the analysis included the finding that banks exposure to priority sector lending reduces NPAs.

According to Ravi Kumar Jain, in any financial Institution, NPAs are inevitable in the loan portfolio. But efforts should be made to maintain a reasonable level of NPAs. Keeping in mind the RBI plan to introduce the concept of one quarter for Identification of NPAs, it is high time to go in for recovery drive on a war-footing. While doing so prevention of NPA should not be forgotten. These are the major challenges before banks which have gone in for VRS. The newly introduced tools of credit risk ratings would eventually help a bank to assign a probability of default for the borrower according to its risk category. The probability of default is determined statistically from past data by observing the behavior of various rated clients over a number of years. The expected losses from a loan can be determined using this probability of default. This probability will then help to determine the terms and conditions for the loans in terms of the amount, interest rate to be charged, maturity etc. In the times to come credit risk rating would be one of the important inputs which will be used in making the credit decisions, besides other factors like collateral provided, period and quality of relationship with the borrower, concentration risk in the individual/group/portfolio etc. And all this would lead to better credit management and eventually lesser accumulation of NPAs, and thus the objective of better returns in the financial sector would be achieved.

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The article claims that one of the main reasons underlying the NPA phenomenon is the dilapidated and defaulter-friendly legal system. Recovery out of suit-filed accounts has been quite insignificant, and continues to be on the decline. On many occasions the contentions made by the defaulters are often flimsy. The article dwells on a variety of legal issues associated with the recovery of bank loans including through Debt Recovery Tribunals. It discusses the futility of BIFR (Board for Industrial and financial Reconstruction) in serving the purpose behind its establishment and welcomes the decision to scrap it. Finally, it touches upon the role of Lok Adalats and State Governments.

The objective of the study is to understand NPAs, needs for ARCs in Indian Banking Scenario, the operational procedure of ARCs, to offer some suggestions for smooth functioning of ARCs. Here the researcher takes into consideration only two variables. Karmarkar and Kawadia (2002) in their study have used BSE SENSEX as one of the explanatory variables. The aim of the present study is to find a direct relationship between two variables. Although stock market liquidity is affected by exchange rate, but the reverse case is also a possibility. Secondly, there are many other factors such as forex reserves movements of international stock indices etc. can affect this relationship too.

These authors predicted the issue of rural banking is an outcome of nationalization of banks. So the banks have to work in close liaison with panchayat raj institutions to make the contribution of rural economy for national development. In this research paper they concluded that due to nationalization, public sector banks have a wide network of branches in the rural areas. There has been a continuous increase in the share of rural branches in total deposits and credit until 1990. In recent years,

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14 Dr. Rajendra sing Legal Remedy for Recovery of Non-performing Assets (NPAs), vinamaya, vol XXII, No.1, 2001-02.
15 Dr. Pradeep singh: Banking sector reform: NPA management Assets Reconstruction Company (ARC) in Indian Scenario, Banking & Finance, the management accountant, October, 2007.
however, there has been a slackening of credit, investment, and capital formation. The Ninth Plan has emphasized the need for rejuvenation of the rural sectors through improvement in infrastructure, credit and other inputs.

Formal agencies have been able to meet part of the needs of production – credit relating to farm and non-farm sectors. There is a need for acceleration in this regard for food security. In this, the greater participation of banks in dry-farming and water-shed development is highly essential. Hi-tech agriculture geared for exports may have to take into account, besides credit, nuances of the market, particularly prompt delivery and packaging. The large unmet demand for micro-finance services required by the poor and weaker sections can be met through intermediation of SHGs and NGOs. Prospects of private sector participation in infrastructure development in the rural areas may have to be explored by the banks. A number of measures have been recommended by the expert groups for financial deepening of the rural areas.

Rural banking, to expand its outreach and coverage of the rural poor, reduce transactions costs and improving recovery for recycling of funds, necessarily has to adopt a participatory approach. In this context, banks have to work to close liaison with Panchayat Raj Institutions. Needless to state that all this would call for a change in the mindset of bankers, government agencies and the clientele groups. The initiative can come from the banks, if they are ensured about the accountability of the government agencies. The Regional Mangers of banks can play the pivotal role with the necessary commitment and support at the corporate level. The industry can launch an action project to evince their interest and concern towards rural economy, and learn from the process.

This international cross-section study of banking performance was conducted more in terms of standardized measures such as interest spread and bank profitability. This is the most-recent and certainly the most comprehensive ever, cross country of variations in bank performance, using two performance indicators separately regressed
on a set of explanatory variables, i.e. interest spread (used as an efficiency indicator) and bank profitability. The data set was taken at bank-level for 80 countries over the period 1988-95. The set of regressors included both bank specific characteristics (size, leverage, type of business, foreign ownership) as well as country-level variables that describe the macro-economic, legal, and institutional environment. The country-level variables were also interacted with GDP per capita to capture the difference between their effects on the performance of banks in the developed and developing countries.

The most important finding pertained to difference in the impact of foreign ownership between developed and developing countries. In developing countries foreign banks have greater interest margins and profits than domestic banks. In industrial countries, the opposite is true. The first finding brought out the reasons for the better average performance on the NPA front by foreign banks in India, but did not bear upon the pattern of NPA variation within foreign owned banks in India by country of origin. Among the macro-variables reported by DKH that effect bank profitability positively in per capita GDP and not net interest margins (the efficiency indicator). These results suggested that per capita GDP might be a lesser correlate of banking efficiency or superior banking technology, and more a correlate of banking opportunities and the general operating environment. However, this result conflicted somewhat with the (positive) significance of foreign ownership on both interest margins and profits in developing countries, where the better average performance relative to domestic banks in different host environment suggested that it is the superior banking technology rather than the operating environment there that is the correlate of higher per capita GDP. The conflict arises from ambiguity of interpretation in the directionality of the net interest margin as a variable. A lower margin indicates greater banking efficiency under competitive circumstances as, indeed, born out by the significant negative coefficient for competitiveness of the banking sector in the net interest regression.
Other findings of the DKH study which supported an inverse relationship between net interest and bank efficiency are that variations in overheads and other operating costs are reflected in variations in bank interest margins, as banks pass on their operating cost (including the corporate tax burden) to their depositors and lenders. A higher margin could indicate greater banking efficiency under segmented, or otherwise imperfectly competitive, market conditions, such as what perhaps characterizes the operating environment in developing countries, and this is borne out by the positive significances of foreign ownership on interest margins in developing countries.

DKH also included a law and order index, where better law and order lead to lower interest margins on account of reduced risk premium on bank lending. There was also a corruption index, so constructed that a high value reflects lower corruption in government. The results showed that cleaner government is associated with lower interest margin and more so in poorer countries. Both these findings showed an inverse relationship between the net interest margin and the efficiency of the operating environment. The DKH findings thus suggested that any attempt to explain across-bank NPA variations would do better to capture bank efficiency through operating profits or returns to assets, which are less ambiguous in terms of direction than the net interest margin.


Predicted the future scenario that will be prevailing in Indian banking system in various aspects and concluded that the HRD practices and bank managements are considered as indispensable tools for the effective banking system and he also expects the situation of economy will motivate Banks to join in the stream of national development. Innovative technology and computerization would help the banks in the rehabilitation or restructuring the banking sectors. The operational frame works and
service networks would be extended to pave the way for healthy customer service. The health of the banking system is critical for both macro economy and financial and political stability. If the banking system public or private is unhealthy and weak, the heat is on the whole economy.

Growing Consumer expectations by D S Narain in Industrial Economist, June 2002 stated that the customers demand better products, better-qualified salesmen, better documentation, and better grievance handling and concluded that the customers must get a chance to tell what he wants. Surely insurance companies are to keep themselves equipped to respond and be ready to ‘deliver’. Customers in India are surely entitled to the latest options, benefits available to the insured in developed countries. Adequate safeguards need to be put in place to see that customers are not lured into replacing one contract with another. This may not be the best interest of the customer. No business snatching or arm twisting is to be encouraged. The regulator must step in effectively to crush any such move. The Regulator’s role includes introducing necessary regulations to ensure that the relationship between bank and customers is not one sided. They also expect simpler policy documents for customer education.

Margin as a Credit Management Tool by Nirakar Chand, The Banker June 1996

Emphasized the implications of margin in funding and follow up and secondly, the ways to use margin as a credit management tool for quality assets and found that using margin as an effective credit management tool at all stages of advance would call for a drastic change in risk perception and credit administration. To sum up, banks should lay a conscious premium on margin by permitting healthier units a greater access to banks funds. The present working capital gap approach based on estimated minimum margin should be replaced by graduated scale of margin based on risk perception or credit rating. The cost of servicing weak units, i.e., higher cost and lower return, should be well appreciated and remedied by reducing exposure to them and increasing both interest and margin stipulations for them. By extension, rehabilitation should be a
credit decision based strictly on clear commercial viability ensured through adequate margin commitments. The leitmotif of the entire approach to lending should be the net worth or margin to ensure asset quality and profitability.

17 The pro-cyclical effects of capital regulation have overlooked the important role that the bank loan loss provisions play in the overall minimum capital regulatory framework. Inadequate assessment of expected credit losses has led to under provisioning and to the shortage of loan loss reserves at the time of crises. As a consequence capital has to offset both expected and unexpected losses aggravating the negative impact of minimum capital requirements over the economic activity during recessions. In addition, when the expected losses were properly reflected in lending rates but not in provisioning practices, banks earnings fluctuations magnify true bank profitability oscillations. The often-unsatisfactory institutional arrangements for loan loss provisioning might be seen as an effort to mitigate a problem between bank stakeholders.

The hypothesis whether the banks made provisions for bad loans in good times or not was tested over a sample of 1176 large commercial banks, 372 of which were from non G-10 Countries over the period 1988-99. In order to verify the nature of the relationship between banks earnings and to test the hypotheses about the determinants of banks provisioning decisions, they estimated the following econometric relationship:

\[ \text{LLpi}.t = a + BSVi.t + y.Cmi.t + s.CIIi + n.CBDi + v.TDt.\epsilon_i. \]

Where loan loss provisions (LLP) for the banks at time \( t \) is a function of bank specific variable (BSV) of selected number of banks, own country macro-indicators (CMI), country institutional indicators (CII) and of time specific dummies (TD). As an alternative of country institutional indicators (CII) they had used country or bank dummies (CBD) as a proxy for institution or country specific factors.

The econometric evidence showed that the protection from outsiders claim (minority shareholders in common law countries and fiscal authorities in high public debt countries) has negative effects on level of bank provisions. While these effects did not have a negative impact on the provisioning pattern over the sample period for banks located in G-10 countries, that was not so in non-G-10 countries. The latter, in fact, had on average experienced higher flows of loan loss provisions during periods of negative profitability signaling the inadequate amount of provisioning during cyclical upturns.

They also found that the protection of outsider’s claims over banks had negative effects on loan loss provisioning. Lacking adequate incentives for sound provisioning, banks may not be able to shelter profits and capital from negative, but expected, repercussions of cyclical downturns. Where cyclical oscillations are particularly wide, as it is the case of less developed economies, inadequate provisioning may vary quickly and lead to capital shortages with undesirable pro-cyclical effects on the level of economic activity. Their results suggested that sound provisioning should be considered as a component of capital regulation and only through sound provisioning practices minimum capital regulation can lose its pro-cyclical features.

This was a cross bank study for India which regressed two profitability and four efficiency measures (one of which is the net interest margin) on pooled data for two years, 1993-94 and 1994-95, for a total of 73 banks, using single-equation OLS estimation for each. The study focused exclusively on an examination of the hypothesis about the superiority of private ownership in terms of performance. Private banks were divided into traded and non-traded categories; the variables include the (log of) total bank assets, the proportion of loans made to priority sector, the proportion of semi-urban and rural branches, and the proportion of non-interest income to total income. They had found that the coefficient of foreign ownership was positive and significant (a percent significance level) for both sets of regressions. However, the coefficient of private ownership was significant only for returns on assets (ROA) and operating profit ratio (OPR). With respect to all other efficiency indicators, private domestic banks
were no better than the public banks. The coefficient of the foreign ownership on the net interest margin was positive, in conformity with the DKH results for all developing countries.


In this research paper an attempt was made the impact of the following in handling NPAs:

i) a slowdown in the branch expansion,

ii) increase in the proportion of non-performing assets,

iii) computerization at all levels – head office, zonal office and branch office,

iv) opening of subsidiaries and entry into new types of business like leasing, credit cards, merchant banking, mutual funds etc.,

v) slow down in manpower expansion and so on.

They also found the relationship between deposits and national income will change and the proportion of bank borrowings to total borrowings of the corporate sector would decline and metropolitan deposits would row faster than normal, while other deposits would grow slower.

**NPAs: All India Scheduled Commercial Banks – Trends and Factors (1985-98) by Biman Chandra De 2001 Indian Economic Association**

The objective of this research paper is to study the overall NPAs performance of all the scheduled commercial banks of India during the period 1985-98 and concluded that the significant influences of GDP and Branch expansion on time deposits during the period under consideration. The results are also in line with the present experiences
of the commercial banks in India. A rise in GDP will no doubt have a favorable effect on time deposits and hence on the profitability of the SCBs. But the branch expansion during the period instead of having a favorable impact has an unfavorable impact on the volume of time deposits. Unwise expansion of branch simply with a view to spreading the banking facilities has an unfavorable impact and hence on profitability of the SCBs of India. This is also supported by a statement made by the trade union of the United Bank of India (UBI). The Union in their representation to the M.S.Verma Committee submitted that the UBI suffered a loss due to unwise branch expansion especially in the rural areas. They also indicated that a very cautious approach is to be taken before implementing any policy of branch expansion by the SCBs.

The study examined the inter-bank differences in the efficiency within banking sector with respect to profitability, productivity, and financial management for the year 1994-95. For each of the performance criteria, area specific efficiency index had been worked out based on 15 indicators (5 for profitability, 5 for productivity and 5 for financial management), using principal component analysis. Profitability criterion was represented by ‘net’ instead of ‘gross’ profit since net profit accounts for provisions for non-performing assets. The relative profitability of a bank was expressed as the ratio of net profits to total income, deposits, and spread. Productivity per employee was taken to represent the overall productivity condition of the banks. Financial management was based on yield on assets, advances, and investments (Das, 1997).

The results showed that there was a wide variation in the efficiency among the banks according to their ownership pattern. The performance of PSBs was relatively poor compared to other bank groups. This might be attributed to their typical organizational structure, technological development, employment pattern, and managerial skills, etc. The group-wise performance indicated that, expecting few, not much variation could be found in the terms of overall efficiency indices of public sector banks, whereas there was a wide variation in performance within the foreign banks.

The study analyzed, in historical prospective, the role of banks in financial intermediation in India. The analysis of structure and progress of banks during the pre-nationalization and post-nationalization period brought out the important structural factors, which affect their performance. An examination of important parameters of banks, their cost and return on various assets, brought out the easing of external constraints on the working of banks and the gradual upward movement in spreads (net interest income) in post-financial sector reform period. The impact of financial sector reform (including prudential regulations) on performance of banks (both group-wise and bank-wise) and issues confronting the banking industry were also examined. The problem of overdues was more acute in the rural areas than in urban/metropolitan areas; overdues constituted 29.2 per cent of outstanding credit as at end March 1993. On the basis of the analysis, they concluded that the major achievement of these reforms in India was avoidance of financial instability during the reform period. This was mainly due to proper sequencing of reforms and at the same time putting in place the sound supervision system.

The study was basically confined to identifying the factors influencing NPAs, suggesting measures that would prevent the growth of NPAs and affect their speedy recovery. The major emphasis was laid on internal factors over which banks and financial institutions have direct control.

Business Planning in Banks: A New approach needed by N S Toor in the Banker 1996

In his article the author clearly presented certain action points for banks to increase their efficiency. The points are mentioned as below:

a. Higher operational efficiency and achievement of higher net profits to working funds ratio.

b. Meeting the global standards of capital adequacy for remaining globally competitive.


c. Improvement in the quality of assets and reduction of risks, cost of assets

d. Reduction in the cost of liabilities and servicing cost.

e. Optimum productivity from human assets through their development.

f. Fixation of service indices for rendering excellent customer service.

g. Improvement in house keeping for smooth operations and minimization of cost of transactions with the help of information technology.

He also concluded that in order to achieve these objectives, the banks have to orient their staffs towards marketing approach rather than mere selling of products and services. Introduction on new and innovative funds mobilization and deployment schemes focused at customer’s problems and other services and products which may increase the float funds substantially is imminent. The banks may even have to review and innovate their recruitment policies especially at officer level, by prescribing job description and by telling what is expected of them and how they will be rated.

They analyzed the repayment pattern of the borrower and came out with eleven discernable behaviours. Ideal behaviour, given as the first pattern, was where lending leads to activity that is productive and hence results into production. The Second pattern ended with repayment. It proposed a very high ethos on the part of the borrower and/or very strict recovery machinery so that whatever income was generated in the process was used for repayment. The third and the fourth pattern could be considered most prevalent once where the income generated with the help of bank credit was used for partial repayment and for improving the consumption and/or investment levels of the family. The fifth pattern may be called the diversion of the income for production purposes. In this process the economy may not suffer though the banker was initially a loser. This pattern resulted in a situation where the priorities of the borrowers differ from that of the bankers. The sixth pattern was a case of clear

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diversion and default in repayment. This might happen in a situation where the additional income generated with the help of credit-supported activities was less than the pressing consumption need. The seventh pattern might result on account of nature of activity. There were certain activities that produce directly consumable items and if their level of production was low enough to meet only the basic consumption need then the borrower directly uses the produce without going to the market and selling the same. The eighth pattern is a typical example of subsidy-oriented credit schemes where the subsidy was repaid and the loan was consumed. The ninth pattern was a clear-cut case of mis-utilisation of loan. The tenth pattern indicated an unfortunate situation of death.

These patterns had indicated many snags that were likely to emerge in the repayment behavior of the borrower. As a result of these snags, the accounts would be termed as overdue and the banks may face a NPA situation. Their analysis of the causes of NPAs indicated uncertain use of income generation as one of the most important factors, followed by lack of proper follow up and socio-political pressures as other significant reasons.

Utilization of Mobilized Resources by Commercial Banks, M S V Prasada Rao, Bank Economist Conference 1990

The author emphasized that the strategies must be employed for utilization of mobilized resources in a productive manner. He suggested that within the broad framework of economic planning, Government has introduced considerable relaxation in industrial and import-export trade regulations and those concerning technology. Thus, external trade is becoming a significant component of GDP. As a result of the growth of the modern business practices, absorption of technology etc, the flows of goods and services have become less seasonal and the distinction between what had traditionally come to be known as the ‘busy’ and ‘slack’ seasons for the ebb and flow of banking variables has got blurred. All of these changes have produced a situation where the interaction between the real sector and the financial sector has become
quicker; this has created the necessity and scope for introducing flexibility in the operations of monetary and credit policies.

The study attempted to analyse the policies pursued by the banks with focus on PSBs since their NPA level was considerably high. The policies followed by different banks vary, based on the magnitude of the problem and limitation imposed by the practices they follow. He made an attempt to relate incidence of NPAs to industry, geographical area, scheme of finance, Sector etc. The important findings of the study were:

i) The appraisal was just the justification of sanction, i.e. decision to sanction precedes appraisal.

ii) Credit monitoring and credit appraisal should be viewed complementary function and current system is ineffective.

iii) Lack of MIS system, lack of staff accountability, slow legal process, etc. were the major factors causing hurdles in the recovery of NPAs.

The study evaluated the inter-bank variability of profit among public sector banks during 1992-98. The conventional approach to inter-bank profitability comparison was mainly based on ex-post analysis of descriptive profitability statistics for different banks or for banks groups. However, such a discrete comparison might hide the underlying sequential dynamics of profit generation. The principal findings of his study were:

- Post-reform period, public sector banks recorded a reduction in the burden of raising working funds (in terms of non-interest expenses adjusted for non-interest income).
- This was attributed to a gradual shift away from traditional banking to improved provisions of financial services and enhanced earnings there from.
- Profitability had relatively high degree of variability.


The performance of the banks in terms of profitability was not merely a question of minimizing interest cost. Increasing earnings on assets was a more durable approach. Thus, profitability involved efficient management of both sides of the balance sheet.

This research highlighted the magnitude of NPAs in commercial banking sector of India taking the current position of scheduled commercial bank. They had graded all the four categories, i.e. SBI and its associates, nationalized banks, other scheduled commercial banks and foreign banks, in very good, good, bad and worst group on the basis of NPAs and capital adequacy. For the purpose of analysis, the number of banks with gross NPA percentage of 5 or below (international standards) had been categories as ‘very good’. A bank with gross NPA percentage of 16 (national average) or less but above 5 was categorized as ‘good’. Banks with gross NPA of 20 percent and above was categorized as bad / ‘worst’. For the purpose of analyzing capital adequacy ratio (CAR) under each category number of banks not meeting the stipulated requirement of 8 percent and number of banks not meeting the same had been taken separately. They concluded that banks, which got a ‘very good’ rating in terms of their NPAs, revealed that such banks were new private banks or foreign banks. One of reason given was that such banks had low network of branches, specifically in rural areas. In addition, these banks stressed upon a more stringent scrutiny of proposal and monitoring of usage for huge loans, the absence of which were the main reason for the major chunk of NPAs.

They were also of the opinion that the managerial cadre within each banking organization ought to be educated and encouraged to lend, after considering the merit of each proposal and taking up the responsibility for its recovery. In case of priority sector lending and lending under government-sponsored schemes, rather than fixing targets, the need under the service area of each branch should be assessed and purpose-based lending should be undertaken. Where borrower borrows for one purpose and utilizes for

another, repayment would be affected. A strong banking culture ought to be developed, wherein diversion of funds and default in repayment will never be tolerated even to the smallest extent. Scrutiny of proposals and monitoring of usage should be more stringent for huge loans as they contribute to the major chunk of our NPAs.

**Profitability of Public Sector Banks – Need for Risk Factoring, Dr. K. Srinivasa Rao**

- IBA Conference 1997

Stated his objectives that need for certain refinement in measuring profitability of PSBs. So that current profits are not earned at future cost. A need for risk factoring to profits will exacted so as to reflect a correct and true position of profit and loss account. The arguments would also point towards the need for measuring risk so as to find ways to hedge against the various types of asset liability risks and he also concluded that a prudent method could be to perceive the risk, measure it and provide for it from out of present profits to reflect a market position of all assets. The author also argued in favour of greater transparency in the profitability disclosures of PSBs and the need to mark the balance sheet to market using a balanced risk absorption strategy.

**S L Kapur Committee’s Recommendations on Credit to Small Scale Industries**

Recommended the following:

- Delegation of more powers to branch managers to grant adhoc limits.
- Simplification of application forms
- Freedom to banks to decide their own norms for assessment of credit requirements.
- Opening of more specialized SSI branches.
- Enhancement in the limit for composite loans to Rs. 5 lakh
- Strengthening the recovery mechanism
- Paying more attention to the backward states
• Special programmers for training branch managers for appraising small projects and
• Making customers grievance machinery more transparent and simplifying the procedures for handling complaints and their monitoring.

Human Resource Development in commercial banks in India, Neelu Rohmetra, Prajnan, Vol.XXXVIII, No.3, 1999-2000 stated in her paper that the banking industry being a service-oriented industry, its manpower is its prime asset. People at the frontline as well as back office are the catalytic agents for their banks. Their efficiency or inefficiency in delivering service to the customer has a direct bearing on the organizational success. The customer’s perception of the organization is therefore largely based on the quality of service rendered by the bank. Banks therefore have to strive to keep their human resource fully tuned to the customers’ needs through various appropriately designed and implemented HRD mechanisms and developmental processes. It is proved that the hypothesis that variations exist in the HRD climate in the two banks. There is thus a need for a much deeper and comprehensive study on HRD in India banks. Since in the process of economic liberalization and opening up of the economy and since many reforms in banking operation are already being undertaken, the HRD side is also to necessarily undergo suitable reforms.

25 Rajaraman Indira and Vasisantha (2002) in the empirical study proved that significant bivariate relationship exits between non-performing loans and Public Sector Banks and the inefficiency on the side of the borrowers. This study makes more sense for India as India suffers from inefficiency problems. Being a closed economy for so long, India still lacks the operating efficiency to push its manufacturing sector like China has done successfully. High inflation is also one of the aspects related to the Indian economy which affects its banks overall performance, especially NPAs. This is because when RBI takes some steps related to interest rates to control inflation, the defaulters, list also grows longer for banks with rising interest rates.

25 Rajaraman Indira and Vasisantha (2002), “Non-Performing Loans of Public Sector Banks – Some panel Results,” Economic and political weekly (February)
According to Muniappan (2002), there are many internal and external factors affecting NPAs. The internal factors might be: taking up new projects, promoting associate concerns, time or cost overruns during the projects implementations stage, business failure, inefficient management, stained labour relations, inappropriate technology/technical problems, product obsolescence etc, while external factors are GDP Growth (slow or fast), default in other countries, shortage of energy sources, high inflation, accidents and natural calamities.


In this book the authors clearly stated various vital aspects of challenges facing Indian banks especially after liberalization. The rationale for liberalization the authors rightly caution the country to learn from the experiences of the Latin American and Pacific core counties. In the liberalization of financial services, the components of financial deregulation are listed and the experience of Japan and the USA are explained in detail. Causes of deregulation are also discussed later and how the process of deregulation strengthened by pressure on profits, emergence of non-banking financial institutions, erosion in the traditional role of financial institutions, development of many types of financial instruments, technological changes, globalization and competition from the overseas banks have had considerable impact practically on all aspects of the working of banks, particularly on bank capital, assets shifts, liability shifts, profitability trends, organizational structures, work systems and technology. Deregulation in India is also discussed in detail and the sorry state of the Indian Banking industry is touched upon. Towards the end two different efficiency criteria are also described in brief which are to be used in assessing the impact of changes in the Indian banking system. The efficiency criteria and their application, one feels could have been dealt with a little more elaborately.

What the customer wants by Devendra Mohan-business India, 19th February 2001

Stated in his article how the customers are expecting the online banking for the smooth and easy handling of banking procedures. He concluded that the RBI position on foreign bank branches is quite rigid once and diluted now. The banks are hesitant to expand to semi-urban, urban and rural areas because much of the profits come from the metros and other big cities. It has been proved beyond doubt that non-metro banking is by and large non profitable. The gestation period is much longer and whatever small profits come in are very late to realize. The nationalized banks have to expand their reach keeping their social objectives of taking banking to the masses in mind. He also argued that the private sector and foreign banks have their limitations in terms of reach and geographical spread they have not created new customers but only taken away the customers from nationalized banks. So the customers expect quick, smooth and justified service to them.

27 Das A and Ghosh (2003) established relationship between non-performing loans of India’s public Sector Banks in terms of various indicators, such as asset size, credit growth and macroeconomic condition, and operating efficiency indicators. This study takes one step forward and tries to include more bank-related parameters and see which have affected NPAs the most. The study tries to cover the private banks and foreign banks.

28 They studied the impact of limited liberalization initiated before the deregulation of nineties on the performance of the different categories of banks, using data envelopment analysis. The study covered 70 banks during the period 1986-91. They constructed a grid for the entire period and measured technical efficiency of the banks under study.

They found PSBs had the highest efficiency among the three categories, with foreign and private banks having much lower efficiencies. However, PSBs started showing a decline in efficiency after 1987, private banks showed no change and foreign banks showed a sharp rise in efficiency. The main result according to the general perception was that, in the post nationalization era, public sector banks were successful in achieving their principal objectives of deposits and loan expansion. They also pointed out the efficiency is to be judged in relation to objective set for management and not in relation to objectives (such as profit maximization) that are believed to be desirable in them.

Credit through Co-operatives: Some thoughts, Vepa kamesam, Reserve Bank of India Bulletin August 2001

Analysed organizational, managerial, financial and operational issues in commercial banks and also suggested certain ideas of credits expansion through cooperatives. Following are the points highlighted

- Member-driven Co-operatives,
- duality of control,
- focus on development of the base tier,
- professionalization of management,
- human resource development,
- integration of short-term and long-term structures,
- revitalization of co-operative banks,
- deployment of resources,
- improved external and internal checks and balances

It was concluded that the institutionalization of savings with wide geographical and functional coverage of institutional credit as its counterpart have been central to the Reserve Bank of India’s credit planning all these years. Indeed bank has over the years put its faith in the co-operative credit agencies for bearing the major share of the task of
widening institutional agricultural credit if for no other reason than that its retail outlets are so much more widespread and far flung that it will take a long time before any other type of institutional credit agency can percolate to all corners of our country. He expressed confidence that co-operative banks will prepare themselves to grapple with the aforesaid challenges and convey them into opportunities.

They made an attempt to explain inter-bank variation in NPAs for the year 1996-97. They have also done specific tests for the impact of the region of operation on domestically owned banks, as measured by percentage branches in each of the state clusters.

Bank specific net NPAs (as a percentage of advances) for the year 1996-97 were regressed on the ownership and regional presence, controlling for the bank specific efficiency and prudential indicators relating to the same year. The findings showed that bank specific characteristics such as ownership or adherence to prudential norms do not suffice to explain inter bank variability in NPAs, while the region of operation matters. They concluded that no sustainable improvement in the performing efficiency of domestic banks is possible without prior improvement in the enforcement in difficult regions of the country. The regional exposure effect would be more transparently evident if banks report NPAs by state or regions instead of merely as a national average as at present. They are also of the view that operating environment matters particularly in Indian context where there are imposed compulsions on banks to enter into and operate in difficult regions which tend to focus on the need for greater operational flexibility for banks. Another finding of some importance is that it is not the foreign ownership in and of it so much as banking efficiency and technology co-relates of the country of origin of the foreign banks, which determine NPA performance in Indian environment.

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The presence of Non-Performing Assets has had an adverse impact on the productivity and efficiency of Indian Banks which has resulted in the erosion of profits in absolute terms made the survival of India banks very difficult. The Narasimham Committee (II) on banking sector reforms recommended the establishment of asset recovery companies and Asset Reconstruction Company (India) Limited ARCIL, the pioneer, commenced operation from August 29, 2003.


Stated that the nationalization of major commercial banks in 1969 imposed certain social obligations on banks such as opening branches in rural and semi-urban areas, target-oriented priority sector leading and increased SLR for meeting Government expenditure. The involvement of commercial banks in these avenues was so deep that their profitability came under stress. Another aspect of social lending was that the banks were regulated much more rigidly in the form of credit targets and stipulations in regard to deployment of funds. These regulations covered even commercial lending since overuse and preemption of bank credit by industry have to be checked in order to ensure adequate flow of finance to priority sector. Social lending has come in for closer scrutiny – the emphasis has shifted from quantity to quality. Apart from overall profits, the share of profits from areas such as investment, financial services and traditional intermediary function will have to be closely monitored by the banks.

Focus: The income and the profit of the bank are largely influenced by interest income and non-interest income. The focus in this is on interest income.

Objectives: An attempt has been made to study the return from the Priority sector lending and to examine critically the various segments of priority sector and the

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relevance of interest rate structure from the viewpoint of profitability and to suggest some strategies for the improvement in the profit area and the author observed that under the social lending by the nationalized banks, about 40% of total credit is extended to the preferred sections at concessional rates of interest. The viability of intermediation system form commercial point of view is affected resulting low profit. The service area approach was implemented for taking care of the credit needs of all villages. With the predominance of money lenders in rural credit system as observed by NABARD, there is no justification of keeping low interest profile at the cost of profitability of a commercial institution (Banks). The main focus is on improvement in interest income.

Productivity in Banks, Profitability of Commercial Banks, Varsha C Varde, Sampat P Singh, National Institute of Bank Management-Bombay

Explained that banking is basically a service industry. A service is identified on the criterion that it satisfies the need of the customers and for which they would be willing to pay the price or the service charge. Services rendered by a commercial bank include acceptance of deposits, credit, and remittance of funds, discount and collection of bills, safe custody and so on. The output of a bank should therefore be the summation of many services it provides. Such character of services and their diversity render measurement of output of a bank almost impossible. Assuming that a bank’s main role is financial intermediation, i.e getting funds from various sources and deploying them into various uses and these are the major services that make a bank and the rest are minor and auxiliaries services. The latter could therefore be ignored as insignificant for the purpose of measuring output.

It is reasonable to take average working funds flowing through a bank during a period as a surrogate measure of output of a bank. The volume of working funds can be defined more precisely as the balance sheet total less the contra items obtained from the average annual balance sheet. This figure is the numerator for the productivity equation. Year-end balance sheets are generally highly window-dressed. Part of this
aberration is corrected through averaging. The rest can be assumed to be a common factor over the years so as not to vitiate the trend line of the time series.

The labour input can be measured in terms of total manpower expenses incurred by the bank during the year on salary, allowances, and bonus, overtime and terminal benefits. This means choosing the more appropriate monetary measure and not the physical measure in terms of physical output per man hour i.e., use the rupee volume of working funds handled per rupee spent on manpower.

**Group Studies**

Tandon Group (1975)

The Group was appointed to suggest guidelines for commercial banks to supervise credit with the view to ensure the proper end use of funds as well as to keep a watch on the safety of advances. The group was also to suggest the operational data and other information that may be obtained by banks periodically from borrowers and by the RBI from lending banks. The major guidelines suggested by the group were with respect to-

- Norms of inventory and receivables,
- Lending norms,
- Style of credit,
- Follow up and supervision of credit, and
- Bill finance.

The group recommended proper quality-wise grading of advance portfolio by slotting of borrower accounts into four categories as (a) Excellent, (b) Good, (c) Average, and (d) Unsatisfactory/bad and doubtful. (Raj, A.S., March 1976).

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32 **Chore Group (1978)**

This group was set-up with a view to recommend guidelines for ensuring greater credit discipline as well as to enable the banks to relate credit limits to increase in output or other productive activities. The group recognized the need for close watch on the quality of the loans portfolio, and this concern was reflected in its emphasis on regular annual review of all borrower accounts with credit limits of over 10 lacs. (Hingorani, M.L. and Chawala, O.P, January-march 1982). According to the group, an information system was to be introduced, to start with, for all industrial borrowers with aggregate limits of Rs. 1 crore and above and progressively extended first to the borrowers with limits of Rs. 50 lakhs to Rs.1 Crore and next to those enjoying credit limits of Rs. 10-50 Lacs.

33 **RBI Study (July 1999)**

The Reserve Bank of India conducted a study to ascertain the contributory factors for high level of NPAs in banks (published in RBI Bulletin, July 1999). After studying about 800 top NPA accounts in 17 banks, the RBI study has found the following, in order of importance, to be the causative factors for loan accounts turning NPAs. The over-regulated environment, both in the real as well as financial sector was one of the main reasons, however, there are other important factors also as:

- Diversion of funds, mostly for expansion/diversification/new projects of business or for promoting associate concerns. This was coupled with the recessionary trends and failure to tap funds from the capital market and debt market.
- Factors internal to business like product/marketing failure, inefficient management, inappropriate technology, labour unrest, product obsolescence, etc.

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• Change in the macro-environment like recession, infrastructural bottlenecks, natural calamities, etc.
• Time/cost overruns during project implementation stage.
• Government policies like changes in excise duties, pollution control, etc.
• Willful default, fraud, and misappropriation, promoters/ directors dispute.
• Deficiencies on the part of banks like delay in release of sanctioned limits, delay in release of payments/ subsidies by government.

The report of RBI finally concluded, “Reduction of NPAs in banking sector should be treated as a national priority item to make the Indian banking system stronger, resilient and geared to meet the challenges of globalization. It is necessary that public debate be started soon on the problem of NPAs and their resolution. It is hoped that the paper will provide a base and generate a healthy public debate, which may be helpful in evolving suitable strategies for satisfactory resolution of the problem.

Reduction in Interest Rates has made Bankers and Exporters Friends,
Dr.N.K.Thingalaya, Industrial Economist 15\textsuperscript{th} October 2001

Dr.N.K.Thingalaya stated that prime lending rate (PLR) was introduced by the Reserve Bank of India in the Nineties to ensure that the interest rates were determined by individual banks based on their own risk perception and credit rating of its borrowers. One of the earliest welfare oriented lending schemes – Differential Interest Rate Scheme – under which small loans were given at four per cent or certain categories of borrowers, however continues. The interest rates have been quite high in the Indian banking system and exorbitantly high in the informal sector. Even Manu the Vedic law-giver, had prescribed many centuries ago, the rate of interest at 15 per cent per annum. From Manu to Manmohan Singh the average rate of interest has almost remained at 15 per cent. PLR stipulations are made applicable only to advance above Rs.2 lakh. Banks are not expected to lend a rate lower than the PLR to the borrowers, except to small borrowers, who borrow less than Rs.2 lakh. In the subsequent changes
the policy statement said “PLR will serve as a benchmark and banks will be able to offer loans at below PLR rates to exporters or other creditworthy borrowers, including public enterprises, on the lines of a transparent and objective policy approved by their boards” An education loan scheme has been introduced by the banks, as indicated by the finance minister in his budget speech, to finance higher studies in India and abroad. Education loans for professional studies in India would be available up to Rs.7 lakhs and upto Rs.15 lakhs for those, who study abroad, repayable over a period of 5 to 7 years.

34Country Institutional Indicators Report (1999)

CII conducted a detailed study on non-performing assets, analyzing not only the reasons for the occurrence of bad loans but also recommending solutions for the same. The study of 33 public and private sector banks revealed that the incidence of NPAs in the priority sector is much higher than in the non-priority sector. The study concluded that though the priority sector advance as a proportion to gross advance is smaller at 32 percent in 1998 than the non-priority sector advance at 46.4 percent in the same year, the proportion of priority sector NPA is higher at 16 percent as compared with that in the non-priority sector at 12.63 percent. The study held mainly the government policies responsible for the large chunk of NPAs and made the following recommendation:

- Revision of bankruptcy and recovery laws, restructuring of BIFR, change in DRT procedures, review of stamp duty and registration laws and total revamping of The Banking Regulation Act, 1949.
- RBI should mandate far better disclosures for all banks and financial institutions. These should involve all the details of assets and liabilities, structure of cost of deposits and interest on loan assets, extent of asset liability mismatch in rates as well as tenure, classification of top 50 NPAs and their share in total NPAs, NPAs out of priority sector advances, and the like. RBI should

consider the proposal for strong banks and financial institutions publishing their accounts according to US-GAAP.

- Timely identification of overdue loans by not only examining the information provided by the borrowers far more carefully, but also better coordination between banks to set-up systematic monitoring procedure.

- Proper assessment of the business realities should be done before attempting restructuring, i.e. only operationally viable but financially distressed companies should be considered. The decision of restructuring should be taken after due diligence and its feasibility, i.e only if it is less costly than liquidation.

**Chumming with bankers, Industrial economist 15 December 2001 has written that** growing NPA continues to be a problem with the banking sector in India. The consolation however, is that as result of the steps initiated by all those concerned with the health of banks, the ratio of net NPA has come down marginally from 2.7 per cent previous year to 2.5 per cent during the year. But in earning profits, the younger banks appear to be more efficient than the public sector banks. The ratio of net profit to total assets works out to be 0.81 for the new breed of banks, while for the public sector banks it remains at 0.42 per cent. State Bank of India group has a slightly better record of performance at 0.55 per cent. But it is the foreign banks which steal the show with a ratio of 0.93 per cent and he concluded that the changes in the context of globalization and liberalization are bound to affect the performance of the Indian banking sector besides the national economy. Therefore it is highly desirable that the RBI report, which contains very useful data, could be a little more analytical.

**Slowdown in NPAs and advances, Sunday Vijay Times, 28th August 2005. Finance minister P. Chidambaram pulls up PSU banks and has hinted at consolidation of public sector banks after pulling them for projecting a slowdown in NPAs and credit disbursal targets. Consolidation will become imperative to over fragmentation and slow-down in business growth and also to meet the need for higher capital requirements. He stated that fragmented banking sector is the “anthithesis” of**
profitable banking. He called upon the bankers to initiate corrective measures and work for greater growth in credit and deposits. He concluded that the Banks’ credit has to grow with the needs of the economy and deposits have also to be shored up with aggressive mobilization strategy and suggested that the banks can look for consolidation to become larger in size in order to sustain their growth and further stated that it has restricted the market share of top five banks to 41.5 per cent as against 75 per cent in China. With entry of new private banks, the banking sector has become more fragmented.

35 Narasimham Committee Report 1998

“NPAs constitute a real economic loss to the nation in that they reflect the application of scarce capital and credit funds to unproductive uses. The money locked up in NPA is not available for productive area and to the extent that bank seeks to make provisions for NPAs or to write off them it is a charge on their profit. NPA in short, are not just a problem for the bank they are bad for the economy”.

36 Basel Group (June 1999)

Over a period of time, financial innovations and the rising complexity of financial transactions necessitated a further review of the existing capital adequacy framework. In response to this urgent need, the Basel Committee on Banking Supervision, in June 1999 issued a consultative paper on “A new Capital Adequacy Framework” for comments by central bankers, market players, and other interested parties. The new framework called for better alignment of regulatory capital with underlying risks, by replacing the current “One-fit for all” approach with preferential risk weighting treatment. The new framework had important implications for emerging economies since it placed significant stress on the current regulatory/ supervisory

35 “Report of Committee on Banking Sector Reform”, (Chairman Shri.M.Narasimham, Reserve Bank of India, New Delhi 1998)
standards. In particular, the proposal for assigning capital on a consolidated basis, use of external rating agencies for assigning risk weights, the need to employ sophisticated techniques for estimating economic capital, etc. were seen to be needing modifications to reflect the institutional realities, and macro-economic factors in the emerging market economies. The committee recognized tremendous effort of the more than 350 banks of varying size and levels of complexity from more than 40 countries that participated in the quantitative exercise known as QIS 3. Its results confirmed that the framework as currently calibrated produces capital requirements broadly consistent with the committee’s objectives. The Reserve Bank’s comment on 3rd consultative document on the new capital accord on the basis of Quantitative Impact Study (QIS 3) undertaken in coordination with select banks have brought out the need for more simplicity and greater flexibility on account of different levels of preparedness of the banking systems in India. The RBI had in April 2003 itself accepted in principal to adopt the new capital accord Basel II. The RBI has announced in its annual policy statement in May 2004 that banks in India should examine in depth the options available under Basel II, draw a road map by the December 2004 for migration to Basel II, and review the progress made thereof at quarterly intervals. The RBI will be closely monitoring the progress made by different banks in this direction. To emerge successful in Basel II regulatory environment banks would need to introduce the practice of risk-based pricing of loans, which in would require a bank to implement advanced risk management systems. To implement such systems, banks would need to take the following steps:

- Develop credit risk scoring models.
- Generate Probability of Default associated with each risk grade.
- Estimate Loss Given Default for each collateral type.
- Calculate expected and unexpected Loss in a portfolio based on correlation amongst loans.
- Compute the capital that is required to be held against economic loss potential of the portfolio.
Minimum Capital Requirements:

The current accord explicitly covers only two types of risks in the definition of risk weighted assets:

a) Credit risk
b) Market risk.

It is presumed that other risks are covered implicitly, through the treatments of these two major risks. The pillar one proposals to modify the definition of risk-weighted assets in the new accord having two primary elements:

1. Substantive changes to the treatment of credit risk relative to the current accord and
2. The introduction of an explicit treatment of operational risk that will result in it being included in the denominator of a bank’s capital ratio.

The committee has been working to update the pillar-two guidance as it finalizes other aspects of the new capital adequacy framework. One update is the relation to stress testing, as it is important for banks adopting capital to protect against adverse or uncertain economic conditions. Such banks will be required to perform a meaningful conservative stress test of their own design with the aim of estimating the extent to which their internal rate-based (IRB) capital requirements could increase during a stress scenario.

Other refinements focus on banks review of concentration risks, and on the treatment of residual risks that arise from the use of collateral, guarantees, and credit derivatives. Further to the pillar one treatment of securitization, a supervisory review component has been developed, which is intended to provide banks with some insights into supervisory expectations for specific securitization exposures.
While the Indian banking sector was following the recommendations of the committee on financial system (CFS), which reported in 1991, major changes had taken place in the domestic economic and institutional scene, coinciding with the movement towards global integration of financial services. These developments reinforced the importance of building a strong and efficient financial system. Keeping in view these developments government appointed the 2nd Narasimham Committee in the year 1998. The recommendations of the committee are broadly accepted by RBI and are known by the name of Second-generation norms. This generation of reform could be conveniently looked at in terms of three broad inter-related issues:

2.3 MEASURES TO STRENGTHEN THE BANKING SYSTEM

a. Capital Adequacy

1. Over a period of three years the entire portfolio of Government Securities should be marked to market providing a 5 percent weight for market risk for Government and approved securities, which at present is subject to zero risk weight.
2. The foreign exchange open position limits should carry a 100 percent risk weight.
3. The minimum capital to risk assets ratio to increase to 10 percent from its present level of 8 percent with an intermediate minimum target of 9 percent be achieved by the year 2000 and the ratio of 10 percent by 2002.
4. Asset Quality, NPAs and Directed Credit.
5. Prudential Norms and Disclosure Requirements.

Report of the Committee on Banking Sector Reform”, (Chairman Shri M. Narasimham, Reserve Bank of India, New Delhi, 1998).
b. Systems and Method In banks

These should form the basic objective of internal control system, the major components of which are:

i. Internal inspection and audit, including concurrent audit.

ii. Control returns by branches/controlling offices to higher-level offices.

iii. Visits by controlling officials to fields level offices.

iv. Risk management systems.

v. Simplification of documentation, procedure and of inter-office communication channels.

vi. Institute an independent loan review mechanism especially for large borrowal accounts and system to identify potential NPAs.

vii. Evolve a filtering mechanism by stipulating in house prudential limits beyond which exposures on single / group borrowers are taken keeping in view their risk profile as revealed through credit rating and other relevant factors.

The committee feels that requisite success has not been achieved because of the following reasons:

- Not so strong commercially oriented inter-bank platform.
- Inadequate bank automation.
- Lack of a planned, standardized, electronic payment system backbone.
- Inadequate telecom infrastructure.
- Inadequate marketing effort, lack of clarity and certainty on legal issues.
- Lack of data warehousing network. The committee has listed out a series of implementation steps for achieving rapid induction of information technology in the banking system. Further information and control systems need to be developed in several areas like:
- Better tracking of spreads / costs and NPAs for higher profitability.
• Accurate and timely information for strategic decisions to identify and promote profitable products and customers.
• Risk and asset-liability management.
• Efficient treasury management.

38 Basel II

Banks are heavily leveraged institutions in as much as they are in control of a large amount of public money while their own stake in miniscule. Considering their high leverage as also their role in the nation’s economy and financial stability, the governments and regulators world over are concerned about the adequacy of capital of banks as a cushion against unexpected losses. Minimum regulatory capital requirements are an integral part of the mechanism for ensuring that banks have the adequate cushion. It is in this context that the Basel Accord has outlined the framework for minimum capital requirements for banks. In India, RBI has decided that all commercial banks have to be Basel II compliant, by adopting at a minimum, the Standardized Approach for credit risk and the Basic Indicator Approach for operational risk under pillar 1- Minimum Capital Requirement w.e.f March 31, 2008 for Indian Banks having overseas presence and foreign banks operating in India, and for all other scheduled commercial banks w.e.f March 31, 2009. In so far as operational risk is concerned, banks are to maintain a capital of 15% of their average gross income for the last three years as capital for operational risks form 2008/09 as the case may be. RBI has also specified that banks would have to maintain a minimum Tier I ratio of 6%, while continuing to maintain a minimum capital adequacy ratio of 9 %. Though the ultimate aim of Basel II is to ensure better risk management and promote greater capital efficiency in the system, Basel II is turning out to be more complex and challenging, involving outlay of huge funds and changes in processes, IT and human resources. However, these challenges also offer substantial opportunities.

He had tried to find the relationship among capital, Non-performing loans and productivity in Indian context using the data on PSBs for the period 1995-96 through 2002-2001. He examined the relationship between capital and credit risk and its interaction with productivity as some of the studies were already undertaken which examined the interplay between capital and portfolio risk. (Shriives and Dhal, 1992). Two sources of bank risk were considered in this study. These include credit risk and leverage. Credit risk is the risk of default of the assets of the banking firm, consisting primarily of loans and government securities. Leverage on the other hand, refers to the amount of borrowing relative to the level of capital provided by shareholders. The study found that

- The explanatory power of net NPA equation was reasonably high, ranging from 88 to 96 percent. Capital adequacy had a negative and significant effect on asset quality when PSBs were considered in totality. This implied that PSBs as a whole, relatively more capital (lower leverage) tends to be associated with less credit risk.

- The explanatory power of capital equation was significant but with high variability, with the adjusted R2 ranging from a low of 60 percent of medium sized bank to a high of 91 percent for large banks. Secondly, it was observed that NPAs played a major role in influencing capital levels for the small banks as also for the PSBs as a whole, reiterating the mutually reinforcing relation between credit risk and financial leverage. Thirdly, as regards the productivity change, it was observed that depending upon whether the objective of productivity was growth or growth with stability considerations, capital and NPAs remained crucial factors influencing productivity, i.e. higher productivity leads to drop in net NPAs and vice versa. Finally, regulatory pressures, both with regard to capital and NPAs played a significant role in influencing the capital adequacy and asset quality of PSBs.

- Annual growth rate of total loans had a negative effect on bad loans.

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The important aspect of finding was that higher productivity leads to drop in net NPAs especially for small banks.

Contrary to the widely held beliefs, loan to priority sector did not necessarily lead to high net NPAs, especially for small banks.

Bank employees will not allow closure of branches, The Hindu, 13th April 2001 stated that

There were mergers between new generation banks (the Times bank and the HDFC bank and the merger of the Global Trust bank with UTI Bank) and between old private sector and new private sector banks, reducing competition in the industry, while the avowed aim of the policy was to promote competition. The new generation banks confined themselves to urban and metropolitan centers but had hardly served the vast semi-urban and rural sectors. In the past 12 years, 17 private sector banks had gone bankrupt, and some of these including, two in Tamil Nadu, had to be absorbed by nationalized banks. Warning the banking sector employees about the Centers attempt to introduce anti-labor legislation and the need for unity of employees, the Union stated that it will not allow closure of Bank branches.

Non-Banking Finance Companies -All for a changeover, Paul Diamond, Industrial Economist 30th July 2001 found in the Research Paper

Due to higher economic growth and liberalization, the proliferation of NBFCs during the Eighties and particularly during the Nineties, has been dramatic. The number of NBFCs which stood at 7063 in 1981 increased 25,085 in 1991 and to 39,454 in 1995 – five and a half times during the period. This had its own impact. This sudden mushrooming of NBFCs brought certain problems to the fore, caused by a few companies resorting to take huge deposits from the public at high rate of interest which they could not sustain. Since regulation is a key feature of the financial services industry, this brought in its wake a strong reaction from the regulator who laid down a
number of new and stiff conditions which are now being adhered to. The new amendment to the RBI Act, in 1997, banned acceptance of deposits from the public by the UIBs. Earlier, UIBs have been indirectly regulated in some way or other by the state laws like Pawn Brokers Act, Money lenders Act, Deposits Protection Act etc. However, they were found to be inadequate. Since these UIBs have a significant role to play in the credit market and credit delivery, RBI should be careful about stifling the regulatory regime. The result: out of the total number of 37,390 applications for issue of certificate of registration, only 7,855 applications have been approved by August 1999 and only 624 NBFCs have been permitted to hold / accept public deposits. The aggregate public deposits of NBFCs also declined from Rs.13,571 crores in 1998 to Rs.9,784 crores in 1999.

Cooperative Banks: An Appraisal, Deepali Pant Joshi, Yohana December 2001

Though the cooperatives cover almost 75% of the entire countryside, the membership is still only 45% of the rural families. Agricultural laborers and rural artisans constitute only 10% of the total membership.

The weaker sections of the rural community are still not adequately represented in the membership of cooperatives. Besides the significant regional disparities in credit availability, the cooperative banks have not been able to ensure an increasing flow of production loans and investment credit in tribal, hilly and backward areas. Cooperative banks were the first institutions that were set up with a view to providing credit to agriculturists at low rate of interest to free them from the clutches of the money lenders and to ensure that “credit” reaches the farmers to enable them to meet their production needs so as to increase production and productivity in the rural areas. Their geographical spread covers over 74% of the rural sector. Cooperative banks borrow from and lend to their own members. The factors affecting the financial health of the cooperatives are poor resource base and high transaction costs and finally it is
concluded that financial institution is first as strong as the men who staff it. If they do not live up to expectations it is the institution, which falls from grace.

Re-Inventing Rural Banking, N.K.Thingalaya, Industrial Economist 15th December 1999

Thirty years after bank nationalization – its thirtieth anniversary having passed off without anybody noticing it – rural banking has taken a full circle. Decline in rural banks against 730 new branches added during the year ending June 1999, ten rural branches have been closed. New branches opened in the urban and metropolitan centers were 548 accounting form 75 per cent while in the semi-urban centers 192 branches were opened. To improve their viability, most of them have relocated their loss-incurring rural branches to the nearby semi-urban places, which partly explain the decline in the number of rural branches. It must be conceded that despite their reluctance to operate in the rural areas, with all the inconveniences – real and imaginary – the bankers have not exhibited their over-anxiety to close their rural outfits with only very few closed so far. But virtually no additions have been made either.

A couple of RRBs have shown the way accustomed to directions and regulations for 30 years, bankers in India have perhaps lost the initiative for innovation. The salvation of rural banking depends on the bankers’ ability to re-invent rural banking, not through ad hoc measures, but based on properly worked out strategy. It is not far to seek them; a couple of regional rural bank have already shown way.


The primary data have been collected from the scheduled commercial banks through the BSR-7 return. Data has been presented according to top hundred centers,
population groups, districts, states and bank groups. The top hundred centers arranged according to size of deposits accounted for 59 per cent of the total deposits. Similarly, the top hundred centers arranged according to size of bank credit constituted 74 per cent of total bank credit. Nationalized banks as a group contributed 53.8 per cent of the aggregate deposits while the State bank of India and its associates accounted for another 24.6 per cent. The shares were 11.3 per cent for other scheduled commercial banks, 6.4 per cent for foreign banks and 3.8 per cent for regional rural banks. The All-India credit deposit ratio worked out to 55.8 per cent. This ratio was relatively high for foreign banks (67.8 percent), State bank of India and its associates (65.1 per cent) and other scheduled commercial banks (58.7 percent). The CD ratios were much lower for nationalized banks are 50.5 per cent and regional rural banks at 42.9 per cent. Population group-wise, the spread of Bank branch network stood at metropolitan centers (40.5 percent) rural centers (39.8 per cent) and semi-urban centers (34.3 per cent).

CONCLUDING COMMENTS

A thorough scrutiny of above mentioned 39 studies clearly revealed that so far no study has been undertaken to find out the performance of commercial banks in terms of NPAs and credit operations in Tamilnadu and all India level. An attempt is made to identify their contribution of the performance of commercial banks in Tamilnadu and at all India level. The study microscopically verifies the NPAs and advances with respect to regions, districts, types of deposits and occupations in Tamilnadu. An elaborate study on general banking development of commercial banks based on the performance is indispensable for exact analysis. The next chapter throws a light on banking development in Tamilnadu and all India level.