Chapter-I

INTRODUCTION

A Prologue

India lives in villages but with two endemic problems of underdevelopment and inequality - spatial, sectoral and sectional.\(^1\) The main factors retarding the economic growth and equitable distribution are:

i) high growth rate of population which stood at 2.0 per cent per annum;\(^2\)

ii) agriculture continued to be the mainstay of the millions of people;\(^3\)

iii) the stagnation of work force in the occupational distribution with 70 per cent engaged in primary sector, 10 per cent in the secondary sector and 20 per cent in the tertiary sector throughout the planning period.\(^4\)

iv) about 39.3 per cent of the population of the country living below the poverty line as estimated by the Expert Group of Planning Commission as per 1992-93 estimation;\(^5\) and

v) ever increasing disparity between the affluent and poor on one hand and the urban and rural population on the other.\(^6\)

A cryptic view of the vulnerable economic scenario of the Indian populace goes further ahead as many facts of too much magnitude seek an elbow room to be elaborated. A host of facts trace out an inexplicable notion that many grey areas have to be identified such as need for improvement in agricultural productivity, increased income levels to

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3 Paroda, R.S. "Lab to Land : Research and Development", Yojana, December 1997, p.4.
decrease diehard poverty, manifold increase in employment opportunities to remove everlasting unemployment and amelioration of the helpless and the destitutes. The above few lines indicate a dictum that the plight of the rural masses needs to be ameliorated.

To bring about an impeccable turnaround situation in majority of the hitherto identified grey areas, among other things, the timely and sufficient pumping of the major input of credit which is inevitable. As it is aptly described that the provision of finance is, however, only one of the factors -- though of critical value in determining the face and quality of growth of agriculture. The credit is just one necessary input in the process of development, which is not sufficient in itself. Dantwala rightly stated that "it is truism that supply of adequate and timely credit is a crucial constituent of any rural programme of agricultural development".⁷

COMMERCIAL BANKING

The transformation of the rural economy depends to a large extent on the financial intermediaries, mainly commercial banks. A journey through the history of economic thought shows that the process of economic development falls on banks as described and understood in various ways over different periods.⁸ The following roles standout for the banks for economic emancipation.

1. banks as financial intermediaries;
2. the direct correlation between economic growth on one hand and financial growth driven by the financial sector in general and banks in particular on the other;


3. the important role of banks in creation of money which creates the demand for goods and services;

4. the role of banks as a catalyst of social development as emerged India in the late sixties since the nationalisation of banks; and

5. finally, the role played by the banks in facilitating promotion/branch basing of entrepreneurial activity, an essential condition for all round rapid economic growth.9

Commercial banks play a crucial role in accelerating the tempo of economic growth in a developing economy like India. In fact, banks are the mart of the world, the nerve centres of the economics and finance of a nation and the barometer of its economic prosperity.10 Since the nationalisation of the 14 major commercial banks in 1969, banks have been asked to make deliberate attempt for accelerating rural development through their instrumentality of credit to the various sectors in the rural areas.11 Of the measures taken by the Reserve Bank of India during the post-nationalisation period, the channelisation of the major chunk of the resources of the banking sector to the hitherto neglected priority sector is a hallmark in the annals of the banking history. The Reserve Bank of India has initiated certain concrete steps to divert credit to the priority sector wayback in 1967, following the radical step of clamping social control over the commercial banks12 with an avowed objective of removing structural deficiencies and weaknesses that crippled our agricultural growth for decades together.13 But the actual

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9 Ibid., p. 175.
13 Sharma, B.P., op. cit., p.364.
CHART - I.1
SCHEDULED BANKING STRUCTURE IN INDIA (AS ON MARCH 31, 2007)

Reserve Bank of India
[Central Bank and Supreme monetary authority of the country]

Scheduled Banks

Scheduled Commercial Banks

Scheduled Co-operative Banks

- Public Sector Banks (28)
- Private Sector Banks (25)
- Foreign Banks in India (29)
- Regional Rural Banks (196)
- Nationalised Banks (19)
- State Bank of India & its Associates (8)
- Old Private Banks (17)
- New Private Banks (8)
- Scheduled State Cooperative Banks (16)
- Scheduled Urban Cooperative Banks (51)

Source: Indian Banks Association (IBA) Bulletin.
commencement of opening up of the gates for funding the agriculture and small scale industry has made a humble beginning only after the nationalisation of fourteen major commercial banks in 1969.

Commercial banking system in India comprises of the scheduled and non-scheduled commercial banks. The scheduled commercial banks are further classified as public sector and private sector banks. The public sector banks consist of the State Bank of India and its Seven Associate Banks, 14 major commercial banks nationalised on July 19, 1969 and 6 commercial banks nationalised on April 15, 1980 (under this category New Bank of India was merged in 1993 with Punjab National Bank) and Regional Rural Banks. Apart from the other Indian Scheduled Commercial Banks there are foreign banks and private sector banks.\textsuperscript{14}

\textbf{Post-Nationalisation and Pre-Reform saga of Indian Banking}

Commercial banks in India, most of which are in the public sector since the nationalisation of banks, gained a significant place in the financial intermediation process. The achievements of these banks in terms of expanding geographical coverage, mobilisation of savings and providing funds for investment with special emphasis on the weaker sections was remarkable until 1991.

It can be observed from Table I.1 that all the major development indicators of the banking sector were between 1969 and 1991. During this period, there was almost a four fold expansion in the number of banks and a seven fold in the number of branches. The spread of banking to the masses is evident from an increase in the share of rural branches

\textsuperscript{14} Chipa, M.L. “\textit{Commercial Banking Development in India}”, Printwell Publishers, Jaipur, p.4.
Table I.1

SCHEDULED COMMERCIAL BANKS – QUANTITATIVE EXPANSION IN THE PRE-REFORMS PERIOD

<table>
<thead>
<tr>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Scheduled Commercial banks (including RRBs)</td>
<td>73</td>
<td>264</td>
<td>272</td>
</tr>
<tr>
<td>Total branches in India</td>
<td>8,262</td>
<td>51,385</td>
<td>60,220</td>
</tr>
<tr>
<td>Share of Rural branches in total branches</td>
<td>22.2</td>
<td>38.7</td>
<td>58.5</td>
</tr>
<tr>
<td>Population per office (‘000)</td>
<td>64</td>
<td>15</td>
<td>14</td>
</tr>
<tr>
<td>Total deposits (Rs. crore)</td>
<td>4,646</td>
<td>77,075</td>
<td>2,01,190</td>
</tr>
<tr>
<td>Total Credit (Rs. crore)</td>
<td>3,599</td>
<td>30,921</td>
<td>1,21,865</td>
</tr>
<tr>
<td>Advances to priority sector (Rs. Crore)</td>
<td>504</td>
<td>19,829</td>
<td>14,572</td>
</tr>
<tr>
<td>Share of priority sector advances to total non-food credit</td>
<td>15</td>
<td>46.2</td>
<td>39.2</td>
</tr>
<tr>
<td>Share of priority sector advances to total advances</td>
<td>14</td>
<td>39.9</td>
<td>37.7</td>
</tr>
<tr>
<td>Deposits per office (Rs. lakh)</td>
<td>56</td>
<td>150</td>
<td>334</td>
</tr>
<tr>
<td>Credit per office (Rs. Lakh)</td>
<td>44</td>
<td>99</td>
<td>202</td>
</tr>
<tr>
<td>Per capita deposits (Rs.)</td>
<td>88</td>
<td>1,026</td>
<td>2,368</td>
</tr>
<tr>
<td>Per capita credit (Rs.)</td>
<td>68</td>
<td>678</td>
<td>1,434</td>
</tr>
<tr>
<td>Deposits as percentage of national income</td>
<td>15.5</td>
<td>39.4</td>
<td>49.4</td>
</tr>
<tr>
<td>Credit deposit ratio (%)</td>
<td>77.5</td>
<td>66.1</td>
<td>60.6</td>
</tr>
<tr>
<td>Investment deposit ratio (%)</td>
<td>29.3</td>
<td>35.4</td>
<td>37.7</td>
</tr>
<tr>
<td>Cash deposit ratio (%)</td>
<td>8.2</td>
<td>16.0</td>
<td>17.6</td>
</tr>
</tbody>
</table>

**Source:** Banking Statistics, Basic Statistical Returns, RBI, and several issues.
from 22.2 per cent in June 1969 to 58.5 per cent\(^\text{\textsuperscript{15}}\) in March, 1991, a drastic reduction in population served per bank branch and increase in deposits and credit per office. In the spheres of the community financial savings, the commercial banks have emerged as major financial intermediaries in the country.

The credit deployment of commercial banks has increased enormously and it followed a discernible change in the direction of flow of credit. The share of rural areas credit have increased diverting an increased share to the priority sector like agriculture, small scale industries, etc. However, credit-deposit ratio which is an important indicator of banking activities, declined to 60.6 per cent in March, 1991 from 77.5 per cent in June, 1969. This indicates bank’s insignificant improvement in lending activities to pick up the credit demand.

By and large, the major objectives of nationalisation of banks have been fulfilled. The banks played a positive role in institutionalising savings and becoming a source of credit to small borrowers with an excessive focus on quantitative achievements and social obligation at the expense of achieving profitability and efficiency. Such a progress has been achieved within a highly regulated environment with interest rates, credit allocation and entry being controlled by the Central Bank.

But by 1991, the macro economic crisis faced by the country paved the way to extensive financial sector reforms. Despite impressive widening of banking sector, there was a general consensus that it had not actually become sound and vibrant as it needed. As a result, 90’s experienced a volatile banking business. A large number of commercial

banks were caught in the problems of low profitability, productivity, efficiency and high intermediation cost. The quality of customer service was unsatisfactory and public sector banks lagged behind international standards in terms of technology.

Besides, lack of competition, undercapitalisation, proper risk management system was not followed, prudential norms were weak and burdened with unsustainable level of Non-Performing Assets (NPAs) on their books and all these resulted in poor asset quality.

The banks were running either at a loss or on very low profits, and consequently were unable to provide adequately for loan defaults and build their capital. There has been organisational inadequacies, the weakening of management and control functions, the growth of restrictive practices, the erosion of work culture, and flaws in credit management. The strain on the performance of the banks had emanated partly from the imposition of high Cash Reserve Ratio [CRR], Statutory Liquidity Ratio [SLR], and directed credit programmes for the priority sector – all at below market or concessional or subsidised interest rates. This, apart from affecting bank profitability adversely.

**Profitability**

Commercial banking in India, though more than a century old, has witnessed significant development and rapid strides of progress only during the last three decades. Against the spectacular achievement in business and branch expansion, the financial performance of the industry in general and of the public sector banks in particular has not been good. This is reflected in rising costs, deterioration of quality of loan assets, the

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mounting non-performing assets of banks and the consequent erosion in the profitability except for marginal improvement in certain years.

The banking scenario has tremendously changed in the last two decades. The edifice built over two decades is crumbling and emphasis is more on the viability of the system, instead of feeling proud solely in meeting social obligations. Actually long back itself, the Banking Commission recognised the profit objective for banks. Commenting on the profit objective, the Banking Commission observed that it was now an accepted principle that the banks are not run solely or even mainly with the objective of making maximum profits. However, this does not mean that they are not to make any profits at all. In particular, there is substantial investment of public funds in banks and a reasonable return on this investment would be expected by the Government. Thus for incessant growth, it is a must for banks to generate adequate surplus not only to meet current obligations but also to strengthen their reserves for enabling them to assume greater responsibility. At present, most of the public sector banks are working on waferthin profits and if this trend persists, the financial viability of the banks may even be undermined in future. In view of this, profitability of banks has gained considerable significance in public debate in India. The bankers who are concerned primarily with profitability, seldom discuss this aspect in their annual reports. They do refer to pressure on profitability, raising wage cost, establishment expenses etc. But nowhere is an integrated picture of profitability available. However, ‘banks’ organised forum viz. Indian Banks Association, does attempt to express its concern through its Chairman’s statements on falling profitability, factors affecting it, including broad suggestions. The
Chairman of the Indian Banks Association (I.B.A.) in his annual speech delivered on 26th June 1980 said, “Although many of the banks continue to show an increase in published profits in absolute terms, the decline in profitability has become a matter of major concern”. A significant indicator of this situation is decline in actual profit as a ratio of total working funds which has become a major concern even to the common man.17

The official committees, set up for the enquiry, have recognised the dwindling profitability of banks. The James Raj Committee observed that the rise in the profitability of the banks had not been commensurate with the increase in their working funds since nationalisation, this ratio is substantially lower than in the preceding decade. This ratio is unduly low compared to that of banks in the developed countries. The PEP committee set up by the R.B.I.18 is also reported to have expressed anxiety over profitability and has made several suggestions for improvement. The Government too has shown its awareness of the pernicious problem. The economic survey for 1979-80 presented to the Parliament in June 198019 says banks also seem to face a difficult situation since a substantial part of their funds gets pre-empted under statutory liquidity regulations into securities, which earn a low rate of return, raising cost of operations, high rates on deposits and regulation of their lending into different segments, not all of which yield adequate return. Under these circumstances, the commercial banks find it a difficult task to fulfil the twin objectives of profitability and responsibility. Thus, banks profitability became a serious concern both to the Government and the public.

The profitability of Indian banks was extremely low in spite of rapid growth of deposits. The average return on assets in the second half of 1980 was about 0.15\%.$^{20}$ The profit on the working capital of the nationalised banks in 1975 was 0.2 per cent and it declined to 0.17 in 1987 and 0.14 per cent in 1991. On the other hand, in 1991, the rate of profit of the private sector banks and 22 foreign banks was 0.35 per cent and 1.41 per cent, respectively.$^{21}$ The rate of net profit to total working fund of the commercial banks was 0.4 per cent in 1969 and it declined to 0.14 per cent in 1985.$^{22}$

**Profit scenario – A Bank Group-wise analysis**

The bank group-wise net profit of Scheduled Commercial Banks in the pre-reform period during 1980 to 1991 is presented in Table I.2. As evident from the table, the net profit of SBI and its associates which was Rs.13.15 crores in 1980 went up to Rs.149.92 crores by 1991 with a growth rate of 24.8 per cent. It the case of Nationalised Banks, the net profit Rs.28.49 crores shot upto Rs.220.80 crores with a growth rate of 20.5 per cent during the period under reference. In the corresponding period, with respect to the total public sector banks, the net profit increased to Rs.370.72 crores in 1991 from only Rs.41.99 crores in 1980 at a growth rate of 21.9 per cent.

In the case of private sector banks and foreign banks which respectively stood with 2.89 crores and Rs.9.13 crores of net profit in 1980, the growth rate in profit stood


Table I.2
BANK GROUP-WISE NET PROFIT OF SCHEDULED COMMERCIAL BANKS DURING 1980-91
(At the end of December)       (Amount in crores)

<table>
<thead>
<tr>
<th>Year</th>
<th>S.B.I. and its Associates</th>
<th>Annual Growth Rate</th>
<th>Nationalised Banks Group</th>
<th>Annual Growth Rate</th>
<th>Public Sector Banks (2+4)</th>
<th>Annual Growth Rate</th>
<th>Private Sector Banks Group</th>
<th>Annual Growth Rate</th>
<th>Foreign Banks Group</th>
<th>Annual Growth Rate</th>
<th>Total SCBs (6+8+10)</th>
<th>Annual Growth Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>13.15</td>
<td>28.49</td>
<td>41.64</td>
<td>2.89</td>
<td>9.13</td>
<td>53.66</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1981</td>
<td>16.32</td>
<td>24.11</td>
<td>30.38</td>
<td>6.63</td>
<td>12.15</td>
<td>3.94</td>
<td>36.33</td>
<td>15.15</td>
<td>39.73</td>
<td>65.79</td>
<td>22.60</td>
<td></td>
</tr>
<tr>
<td>1982</td>
<td>20.18</td>
<td>23.65</td>
<td>34.01</td>
<td>11.95</td>
<td>54.19</td>
<td>16.04</td>
<td>3.27</td>
<td>-17.00</td>
<td>16.81</td>
<td>10.95</td>
<td>74.27</td>
<td>12.89</td>
</tr>
<tr>
<td>1984</td>
<td>25.34</td>
<td>0.83</td>
<td>33.41</td>
<td>-7.96</td>
<td>58.75</td>
<td>-4.36</td>
<td>-1.91</td>
<td>58.65</td>
<td>23.68</td>
<td>20.93</td>
<td>80.52</td>
<td>-5.97</td>
</tr>
<tr>
<td>1985</td>
<td>34.14</td>
<td>34.72</td>
<td>43.65</td>
<td>30.65</td>
<td>77.79</td>
<td>32.41</td>
<td>6.62</td>
<td>-246.5</td>
<td>36.26</td>
<td>53.12</td>
<td>120.67</td>
<td>49.86</td>
</tr>
<tr>
<td>1986</td>
<td>41.25</td>
<td>20.82</td>
<td>94.98</td>
<td>117.59</td>
<td>136.23</td>
<td>75.13</td>
<td>9.77</td>
<td>47.58</td>
<td>70.17</td>
<td>93.51</td>
<td>216.17</td>
<td>79.14</td>
</tr>
<tr>
<td>1987</td>
<td>73.54</td>
<td>78.28</td>
<td>163.48</td>
<td>72.12</td>
<td>237.02</td>
<td>73.98</td>
<td>12.41</td>
<td>27.02</td>
<td>65.67</td>
<td>-6.41</td>
<td>315.10</td>
<td>45.76</td>
</tr>
<tr>
<td>1988-89</td>
<td>110.74</td>
<td>50.58</td>
<td>254.16</td>
<td>55.47</td>
<td>364.90</td>
<td>53.95</td>
<td>9.68</td>
<td>-22.00</td>
<td>116.25</td>
<td>77.02</td>
<td>490.83</td>
<td>55.77</td>
</tr>
<tr>
<td>1989-90</td>
<td>117.28</td>
<td>6.35</td>
<td>185.12</td>
<td>-27.16</td>
<td>302.40</td>
<td>-17.13</td>
<td>20.05</td>
<td>107.12</td>
<td>182.97</td>
<td>57.39</td>
<td>505.42</td>
<td>2.97</td>
</tr>
<tr>
<td>1990-91</td>
<td>149.92</td>
<td>27.83</td>
<td>220.80</td>
<td>19.27</td>
<td>370.72</td>
<td>22.59</td>
<td>37.16</td>
<td>85.33</td>
<td>231.50</td>
<td>26.52</td>
<td>639.38</td>
<td>26.50</td>
</tr>
</tbody>
</table>

CARG    | 24.8 | 20.5 | 21.9 | 26.1 | 34.2 | 25.2

Source: Financial Analysis of Banks Volume-I and Statistical tables relating to Banks in India, of various years, published by Indian Banks Association and Reserve Bank of India respectively.
comparatively higher at 26.1 per cent (private sector banks) 34.2 per cent (Foreign Banks) by the year 1991 where the net profits of private sector banks stood at Rs.37.16 crores as against Rs.231.50 crores in the case of foreign banks. On the whole, in the case of the total scheduled commercial banks, the net profit of Rs.53.92 crores in 1980 increased to Rs.639.38 crores in 1991 with a growth rate of 25.2 per cent. Thus comparatively the private sector and foreign banks registered a growth rate in net profits above that of the total scheduled commercial banks whereas the SBI and its associates and the nationalised banks stood below the average of 25.2 per cent. On the whole, it can be surmised that all the groups of scheduled commercial banks experienced a marked growth in the net profits during 1980 to 1991, but the public sector banks and the constitutes i.e., SBI and its associates and the nationalised banks lagged behind. This scenario highlights the need for reforms to tone up the profit performance of the public sector banks in India.

BANKING SECTOR REFORMS – A SCAN

In view of the extreme volatility and as part of the financial sector reforms, the Government of India appointed a nine member committee under the chairmanship of M. Narasimham, former Governor of Reserve Bank of India, in August 1991, to address the problems and suggest remedial measures.23

Banking sector reforms are a part of economic reforms. The main objectives of the reforms were at improving the efficiency, productivity and profitability of the

banking industry through operational flexibility and functional autonomy, particularly public sector banks.\textsuperscript{24}

After thorough examination of the above areas, in November 1991, the Narasimham Committee submitted its report and recommended for immediate implementation. The Government of India accepted the report in full and initiated implementation of the recommendations.

**The Key Recommendations of the Narasimham Committee**

a) **Liberal Branch Licensing:** Banks, which have adopted prudential accounting norms and achieved capital adequacy are permitted to open branches. During 1995, the Reserve Bank of India revised the branch licensing policy as given below:

   (i) Banks should have a three-year profitability record.

   (ii) It should have non-performing assets below 15 per cent.

   (iii) Its capital adequacy ratio should not be less than 8 per cent with a minimum owned funds requirements of Rs.100 crores.

   During March 1997, RBI has again given directions to banks to approach them for license whether the banks meet the above conditions or not.

b) **Entry of private sector banks to increase competition:** The Narasimham Committee which pleaded for competition in the banking industry urged the Government to allow private and foreign banks to enter the industry.

c) **Capital Adequacy:** RBI introduced capital adequacy norms in April 1992. Indian banks, which have branches abroad, should meet the norms of 8 per cent of capital to the risk weighted assets by 31st March by 1996. The budget for the year 1992-93 provided an amount of Rs.700 crores, which has been inducted into 14 medium and small nationalised banks.

d) **Prudential Accounting Norms:** Banks classified the assets into four categories based on records of recovery. During the year 1st April 1993 to 31st March 1997, many banks reported huge losses due to their norms and now emerged as strong banks.

e) **Deregulated Interest Rates:** The Committee felt that the existing interest rate structure on loans and advances is very complex and they should be market oriented. The position was reviewed and now banks are coming out with market driven interest rates. Banks are free to come out with their prime lending rates.

f) **Reduction in SLR and CRR:** The Committee recommended that SLR should be reduced to 25 per cent and CRR to 10 per cent over a time. The SLR, which was 38.25 per cent on January 9, 1993, came down to 25 per cent with effect from 22 October 1997. The CRR has been gradually reduced to 4.25 per cent from 15 per cent and now using it as part of open market operations.

g) **Phasing Out the Directed Credit Programmes:** The committee recommended that the priority should be redefined. The target for the redefined sector should be fixed at 10 per cent of the aggregate subject to taking review after three years. The priority
sector definition has been enlarged to include certain types of advances, which were hitherto not to include in the priority sector. The government has decided not to reduce the level of priority sector lending from 40 per cent.

h) **Transparency in Balance Sheet:** The committee felt that Balance Sheet should disclose more information. RBI and the Government have modified the format w.e.f. March 1992. From 1997 onwards break up of the capital adequacy ratios and from 1998 onwards banks were asked to disclose seven critical ratios relating to productivity and profitability.

i) **Establishment of Debt Recovery Tribunals:** The Committee felt that the steps should be taken for speedy recovery of dues. Accordingly, the Government passed an Act in August 1993 providing for the creation of recovery tribunals for loan accounts with outstanding balance of Rs.10 lakhs and more.

j) **Tackling Doubtful Debts:** The bad and doubtful debts are taken at discount by creating assets reconstruction fund components. Now institutions of that nature are coming up.

k) **Restructuring of Banks:** Instead of having mushroom growth of banks, the Committee felt that three or four large banks to have international status, eight or ten national banks with network the remaining local banks in specific regions. This has not taken concrete shape.\(^\text{25}\)

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THE SECOND PHASE OF REFORMS

The Government of India constituted another high level committee under the chairmanship of M. Narasimham to suggest further reforms as close to international standards. It was popularly known as Narasimham Committee II. Its mandate was to review the record of financial sector reforms since 1991. Accordingly, the committee submitted its report on the banking sector reforms in March 1998. Its major recommendations are:

a) Capital Adequacy: The minimum capital adequacy should be increased to 10 per cent from 8 per cent in phased manner.

b) Asset Quality: An advance should be classified as doubtful if it is in the substandard quality for 18 months. Net NPAs of the banks should be reduced to below 5 per cent by 2000 and 3 per cent by 2002.

c) Prudential Norms and Disclosure: The period should be reduced from six months to 90 days for the purpose of income recognition. It is under active consideration to implement the same with effect from 31st March 2004.

d) Introduction of a general provision of one per cent on standard assets: Banks have been directed to make a general provision of minimum 25 per cent each year from March 2002.

e) Application of provisioning norms to Government guaranteed account w.e.f. 31st March, 2001: They have bought fewer than 100 per cent.
f) Giving attention to asset-liability management and risk management techniques:

Banks have been advised to put in place Asset Liability Management w.e.f. 1st April 1994.  

Most of the recommendations of the committee were accepted by the Government and are implemented too, though they are revolutionary in many respects and are opposed by some of the trade unions and the Finance Ministry of the Central Government itself. A series of prudential norms and structural reforms have been implemented in the banking sector to make the banks more conscious, cost effective and efficient and to enable them meet the challenges to be confronted in a globalised economy. In India, progressive strengthening of the regular and supervisory framework has been a key element of financial sector reforms since their introduction.

NON-PERFORMING ASSETS

The performance of a commercial bank depends upon various factors such as growth in deposits, advances, profitability, better customer service and decline in non-performing assets etc. The major function of commercial banks is the acceptance of deposits for the purpose of lending which results in profit. In the Indian banking scenario, all the banks have to maintain Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) with the RBI from the deposits mobilised. The balance is deployed in the form of loans and advances and investments. Advances constitute a

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major portion of assets of a commercial bank. However, due to various factors all the advances do not yield income. While the advances which yield income fall under the category of performing advances, those advances which do not yield income to the bank are non-performing assets.\(^{28}\)

**Concept of a Non-Performing Asset (NPA) – A Further Focus:**

It is a new name given to the old disease called Bad and Doubtful debts. The success of a banker lies in keeping these bad debts to the bare minimum as they cannot be avoided at all. According to Narasimham Committee it has been decided that an NPA should be defined as “a credit facility or an advance as on the date of the balance sheet, in respect of which interest has remained unpaid for a period of four quarters during the year ending 31\(^{st}\) March, 1993, for three quarters during the year ending 31\(^{st}\) March, 1994 and for two quarters during the year ending 31\(^{st}\) March, 1995 and onwards”.

Bhaskara Rao\(^ {29}\) attempted to define a non-performing asset as an asset which did not directly contribute to a bank’s profitability. He further stated that non-performing assets were essentially loans and advances, interest on which was doubtful to realise. According to him, excess holding of cash balances, mounting overdues and sticky loans, bad and doubtful debts and deteriorating productivity of employees are some of the examples of non-performing assets.

\(^{28}\) Toor, N.S. “*Non-Performing Advances in Banks*”, Skylark Publications, New Delhi, p.5.

NPAs are “those loans given by a bank or financial institution where the borrower defaults or delays repayment of interest or principal. An asset which ceases to generate income for the bank is called as non-performing asset.\(^{30}\)

**PRUDENTIAL NORMS**

Indian banks entered a very exciting and challenging phase under the impact of Narasimham Committee recommendations on the Indian Financial System. The year 1992-93 was marked by another historical phase in the development of banking in the country. Due to the introduction of financial sector reforms in that year a number of developments had taken place in the banking sector. Introduction of prudential accounting norms were one among them. The implementation of prudential norms and guidelines had constituted a significant step towards greater transparency in accounting practices and in bringing the norms to internationally accepted standards.

The prudential norms, primarily, include three canons viz., a) Income Recognition, b) Asset Classification, and c) Provisioning. These norms were introduced in a phased manner, beginning with the accounting year 1992-93 in the Indian banking industry. The introduction of these norms have drastically changed the complexion of the Indian banks. Several banks faced practical difficulties in implementing the norms and suffered heavy losses.\(^{31}\)

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(a) INCOME RECOGNITION

Income Recognition norms are primarily based on the principle of ‘Record of Recovery’ rather than on any subjective consideration. It was observed that internationally, income from non-performing assets is not recognised on accrual basis but is booked as income only when it is actually received. The Narasimham Committee, therefore, recommended that a similar practice should be followed by banks in India.

An asset / amount becomes non-performing when it ceases to generate income for a bank. A non-performing asset is defined as a credit facility in respect of which interest remained ‘past due’ for a period of four quarters during the year ending 31st March, 1993 for three and two quarters during the years ending 31st March, 1994 and 1995 respectively and onwards. With a view to moving towards international best practices and to ensure greater transparency, it has been decided to adopt the new income recognition norm of one quarter i.e., 90 days instead of existing two quarters from the year ending 31st March, 2004. For the purpose of application of income recognition norms, the various assets of a bank are broadly classified into four groups, viz., i) Term loans ii) Cash credits / over drafts iii) Bills purchased / discounted iv) Other Assets.

Concept of Past due

An amount should be considered as past due when it remains outstanding for 30 days beyond the due date. For example, if interest becomes due on, say 31st March, it becomes past due on 30 April, if not paid.

The modalities for identifying NPAs

i. Term Loans

From the year 1994-1995, a term loan was to be treated as NPA if interest or instalment of principal remains past due for two quarters or more. In other words, a term loan becomes NPA when the interest or instalment is not paid for a period of 7 months from the due date.

ii. Cash credits / overdrafts

A cash credit or overdraft account will be treated as NPA if an account remains out of order for a period of two quarters or 6 months from the year 1994-95. An account should be treated as ‘out of order’ if, (i) the outstanding balance remains continuously in excess of the sanctioned limit / drawing power, (ii) in cases where the outstanding balance in the principle operating account is less than the sanctioned limit / drawing power, and there are no credits continuously for six months on the date of Balance Sheet or credits are not enough to cover the interest debited during the same period. [The past due (30 days) is not applicable for this facility].

iii. Bills purchased and discounted

The bills purchased / discounted account should be treated as NPA if the bill remains overdue and unpaid for a period of two quarters during the year ended 31st March 1995 and onwards. However, overdue interest should not be charged and taken to income account in respect of overdue bills unless it is realised.
iv. Other accounts

Any other credit facility should be treated as NPA if any amount to be received in respect of that facility remains past due for a period of 4, 3 and 2 quarters during the years ending 31\textsuperscript{st} March, 1993, 1994 and 1995 and onwards respectively.\textsuperscript{33}

(b) ASSET CLASSIFICATION

In the light of the Narasimham Committee recommendations, the RBI has redefined the non-performing assets and advised the banks to classify their advances into four broad groups viz., i) Standard assets ii) Sub-standard assets iii) Doubtful assets, and iv) Loss assets by compressing the then existing eight health codes.\textsuperscript{34}

i. Standard Assets

Standard asset is one which does not disclose any problems and which does not carry more than normal risk attached to the business. Such an asset is not a non-performing asset. However, Government guaranteed advances, although categorised as NPA for the purpose of income recognition, are to be treated as standard assets. Further, the advances against term deposits, NSCs (National Saving Certificates), eligible for surrender, Indira Vikas Patras, Kisan Vikas Patras and LIC Policies are to be classified as standard assets (where adequate margins are maintained) as no provision is required in such accounts.

\textsuperscript{33} “Circular Letter” (BOD) (RET) 12, SBI Circle Office, Hyderabad, dt. 18-3-1998, p. 23.
ii. Sub-Standard Assets

An asset which has some credit weaknesses, which, if not rectified may jeopardise the recovery of the debt in the long term.

a. An NPA account can continue to be classified as sub-standard for a period not exceeding 18 months.

b. A sub-standard asset wherein the terms of the loan agreement regarding payment of interest and principal have been renegotiated or rescheduled after commencement of production will remain as sub-standard asset till one year of satisfactory performance.

iii. Doubtful Assets

An asset which has all the weaknesses inherent in substandard assets with an added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, condition and values improbable.

a. which has remained sub-standard for a period exceeding 18 months.

b. A doubtful asset where the terms of the loan agreement regarding payment of interest and principal have been renegotiated or rescheduled after commencement of production will remain doubtful asset for at least for a period of one year of satisfactory performance. It may be noted, that rescheduling does not mean upgradation of the quality of an advance automatically.

c. Accounts where there are potential threats for recovery on account of erosion in the value of security or non-availability of security and existence of other factors such as frauds committed by borrowers are to be classified as doubtful assets straight away without waiting for the completion of 18 months as NPA under sub-standard category.
iv. Loss Assets

A loss asset is one which is considered irrecoverable fully and of such little value that its continuance as a bankable asset is not warranted. In other words, a loss asset where loss has been identified by the bank or Internal Auditor, the External Auditor and the RBI Inspector.\textsuperscript{35} But the amount has not been written off.

(c) PROVISIONING

Taking into account the time lag between an account becoming doubtful of recovery, its recognition as such, the realisation of security and erosion over time in the value of security charged to the Bank, it has been decided that provision should be made against standard, sub-standard, doubtful and loss assets.

The branches should make a general provision @ 0.25 per cent on their standard advances and 10 per cent provision has to be made on sub-standard assets. 100 per cent provision has to be made on the unsecured portion and 20 to 50 per cent on the secured portion of doubtful assets depending on the period for which the account has remained in doubtful category and 100 per cent provision is to be made in the case of loss assets.

Systems and Methods:

- The internal control, loan review mechanism, computers are to be improved.

Banks have geared up Voluntary Retirement Scheme with incentives. They have already implemented Voluntary Retirement Scheme and around one lakh of employees have retired.

\textsuperscript{35} “Hand Book on NPAs and Its Management”, Andhra Bank, August 2000, pp. 6-7.
• **Banks are given autonomy in fixing remuneration:** This is the aspect that has not received active consideration.

• **Rapid introduction of information technology:** A majority of the banks have come out with networking, online banking, branch mechanisation, partial mechanisation, ATMs etc.

**Structural Changes:**

• The Development Financial Institutions should convert themselves to banks over a period of time. IDBI, ICICI, HDFC etc., have come out as banking entities.

• Mergers between strong banks and Financial Institutions. This aspect is gaining momentum. Merger of Punjab National Bank with New Bank of India is an example.

• **Functional Autonomy to Banks:** RBI controls and Government regulations have been reduced.

**Regulation and Supervision:** Banks have been directed to publish half yearly disclosures in two arts, one is general disclosure on performance and the other is depositor / investor information. Accordingly, Board for financial supervision came into existence. CSMELS rating is being implemented, off site surveillance in place of annual inspections.

**Legal and Legislative Framework**

Banks and Financial Institutions may be given power of sale of property without intervention of the court. The recent ‘securitisation of financial aspects’ is a stop in that direction.
The Challenges are not over. Indian banking system has been built with strong foundation and its brick is further strengthened by the financial sector reforms. The movement of bank share prices in the stock market and the built up of foreign exchange resources over $100 billion is a prima facie evidence to show that the Banking sector in India is on the path to progress.

The areas for further research / scope for study are:

a) Management of knowledge assets
b) Cross selling of products
c) Value addition in business development

R.B.I. GUIDELINES FOR PROVISIONING NORMS

General

The primary responsibility for making adequate provisions for any diminution in the value of loan assets, investment or other assets is that of the bank managements and the statutory auditors. The assessment made by the inspecting officer of the RBI is furnished to the bank to assist the bank management and the statutory auditors in taking a decision in regard to making adequate and necessary provisions in terms of prudential guidelines.

In conformity with the prudential norms, provisions should be made on the non-performing assets on the basis of classification of assets into prescribe categories as detailed herein. Taking into account the time lag between an account becoming doubtful of recovery, its recognition as such, the realisation of the security and the erosion over time in the value of security charged to the bank, the banks should make provision against sub-standard assets, doubtful assets and loss assets as below:
**Loss Assets**

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

**Doubtful assets**

100 per cent of the unsecured portion, i.e., 100 per cent of the extent to which advance is not covered by the realisable value of the security to which the bank has a valid recourse and the realisable value is estimated on a realistic basis. Net worth of borrower / guarantor should not be taken for arriving at secured portion.

In regard to secured portion, provision should be made on the following basis, at the rates ranging from 20 per cent to 100 per cent of the secured portion depending upon the period for which the asset has remained doubtful.

**Sub-standard assets**

A general provision of 10 per cent on total outstanding should be made without making any allowance for DICGC/ECGC guarantee cover and securities available. The ‘unsecured exposures’ which are identified as ‘substandard’ would attract additional provision of 10 per cent i.e., a total of 20 per cent on the outstanding balance.

**Standard Assets**

From the year ending 31st March, 2000, the banks should make a general provision of a minimum of 0.25 per cent on standard assets on global loan portfolio basis. (This is being done at Corporate level).
**Guidelines for Provisions under Special Circumstances**

**State Government guaranteed advances**

a) For the year ending March 31, 2005, State Government guaranteed advance and investment in State Government guaranteed securities which would attract asset classification and provisioning norms, if interest and/or principal or any other amount due to the Bank remains overdue for more than 180 days.

b) With effect from the year ending March 31, 2006, State Government guaranteed advance and investment in State Government guaranteed securities would attract asset classification and provisioning norms, if interest and/or instalment of principal or any other amount due to the Bank remains overdue for more than 90 days.

**Advances granted under rehabilitation packages approved by BIFR / term lending institutions**

(i) In respect of advances under rehabilitation package approved by BIFR/term lending institutions, the provision should continue to be made in respect of dues to the bank on the existing credit facilities as per their classification as sub-standard or doubtful asset.

(ii) As regards the additional facilities sanctioned as per package finalised by BIFR and/or term lending institutions, provision on additional facilities sanctioned need not be made for a period of one year from the date of disbursement.

(iii) In respect of additional credit facilities granted to SSI units, which are identified sick and where rehabilitation packages/nursing programmes have been drawn by the banks themselves or under consortium arrangements, no provision need be made for a period of one year.
Provisioning norms for agricultural advances rescheduled / rephased under farmers in distress scheme

Though these accounts will become current dues after restructuring, the provisions made earlier for the NPA account may not be reversed on restructuring as these accounts have basic credit weaknesses.

However, advances against gold ornaments, government securities and all other kinds of securities are not exempted from provisioning requirements.

Take-out finance

The lending institution should make provisions against a ‘take-out finance’ turning into NPA, pending its take-over by the taking-over institution. As and when the asset is taken-over by the taking-over institution, the corresponding provisions could be reversed.

Provisioning norms for sale of financial assets to Securitisation Company (SC) / Reconstruction Company (RC) -

(i) If the sale of financial assets to SCIRC, is at a price below the net book value (NBV) (i.e., book value less provisions held), the shortfall should be debited to the profit and loss account of that year,

(ii) If the sale is for a value higher than the NBV, the excess provision will not be reversed but will be utilised to meet the shortfall / loss on account of sale of other financial assets to SC/RC.

(iii) With a view to enabling banks to meet the shortfall, if any, banks are advised to build up provisions significantly above the minimum regulatory requirements for their NPAs, particularly for those assets, which they propose to sell to securitisation / reconstruction companies.
Guidelines on Treatment of Projects under Implementation involving time over-run

Income Recognition: Income should be recognised only on realisation basis though classified as ‘Standard Asset’ but has otherwise become ‘Non. Performing’ as per the revised delinquency norm of 90 days.

Provisioning: Branches which are holding provisions against some of the accounts, which may now be classified as ‘Standard’ shall continue to hold the provisions and shall not reverse the same.\(^{36}\)

Magnitude of NPA’s of Public Sector Banks

Ever since the introduction of financial sector reforms in India, the non-performing assets of the banking system have started getting highly focussed attention. The question of NPA in banks is a cause of worry to all the concerned, may it be the management of banks, government, industry federations and the public at large.\(^ {37}\)

India has acquired an alarming number of Non-Performing Assets (NPAs) over the last two decades. Non-Performing Assets have surfaced in the Indian Banking Scenario around the eighties. As on March 2003, the banks and financial institutions in India hold Non-Performing Assets worth Rs.1,10,000 crore\(^ {38}\) approximately. High level of Non-Performing Assets reflect adversely on the financial strength of banks which in the present era of globalisation, are required to conform to stringent international

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standards and in order to enable public sector banks to meet the prescribed standards, the Government is faced to recapitalise weak banks from time to time.

The problem of NPA is multi-dimensional and unless the same is checked and the NPA level is brought down to the international standards of 2 to 3 per cent of total loan assets, it is bound to weaken the banking system. A major stumbling block for the banks to reduce their Non-Performing Assets has been the prevailing legal system in the country.\textsuperscript{39}

In order to do away with the menace of the NPAs, the Government banks have put maximum effort to ensure substantial reduction on one hand and also to tight-fence fresh slippage on the other.\textsuperscript{40} After the implementation of prudential norms, the gross NPAs of public sector banks increased from about Rs.18,000 crores in 1991-92 to Rs.39,253 crores at the end of March 1993 and to Rs.53,033 crores at the end of March 2000. Whereas in terms of percentage it declined from 23.2 per cent in 1993 to 2.7 per cent by the end of March, 2007. In the case of net non-performing assets, in absolute terms, they increased from Rs.17,567 crores in 1995 to Rs.27,969 crores by the end of March, 2001. However, it has come down to Rs.15,145 crores by the end of March, 2007. The net NPAs as a percentage to net advances came down from 10.7 per cent to 1.1 per cent during the period.

\textsuperscript{39} Bhattacharya, K.M., \textit{op. cit.}, p. 12.
Trends in NPAs of Public Sector Banks in the Post Reforms Era

The gross and Net NPAs of Public Sector Banks in the post reform period during 1993 to 2007 is presented in Table I.3. As evident from the table, the gross NPAs of Public Sector Banks which were Rs.39,253 crores went up to Rs. 56,473 crores in 2002 but gradually came down to Rs.38,968 crores by 2007. Thus, during the period under review, the gross NPAs of Public Sector Banks declined at a compound rate of –0.5 per cent. The rate of decline is comparatively sharper in the case of net NPAs which declined from Rs.17,567 crores in 1995 to Rs.15,145 crores in 2007 registering a rate of decline of 1.13 per cent.

Moreover, the gross NPAs as a ratio of gross advances and total assets which were 23.2 per cent and 11.8 per cent respectively in 1999 remarkably dropped down to 2.7 per cent and 1.6 per cent respectively in the year 2007. The scenario is similar in the case of net NPAs as a percentage of net advances and also to total assets. These two ratios which stood at 10.7 per cent and 4 per cent respectively in 1995 experienced a marked decline to 1.1 per cent and 0.6 per cent respectively in the year 2007. The analysis thus shows that the incidence and intensity of the gross and net NPAs of public sector banks in the post reform period ending with 2007 has diluted over the years as can be observed from the rolling down ratios of gross NPAs and Net NPAs to advances and total assets. Gratitude to the measures initiated and the sensitisation of the public sector banks about the menace and intensity of NPAs.
<table>
<thead>
<tr>
<th>Year End of March</th>
<th>Gross NPAs</th>
<th>Net NPAs</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Gross NPA Amount</td>
<td>Per cent to Gross Advances</td>
</tr>
<tr>
<td>1993</td>
<td>39,253</td>
<td>23.2</td>
</tr>
<tr>
<td>1994</td>
<td>41,041</td>
<td>24.8</td>
</tr>
<tr>
<td>1995</td>
<td>38,385</td>
<td>19.5</td>
</tr>
<tr>
<td>1996</td>
<td>41,661</td>
<td>18.0</td>
</tr>
<tr>
<td>1997</td>
<td>43,577</td>
<td>71.8</td>
</tr>
<tr>
<td>1998</td>
<td>45,653</td>
<td>16.0</td>
</tr>
<tr>
<td>1999</td>
<td>51,710</td>
<td>15.9</td>
</tr>
<tr>
<td>2000</td>
<td>53,033</td>
<td>14.0</td>
</tr>
<tr>
<td>2001</td>
<td>54,773</td>
<td>12.4</td>
</tr>
<tr>
<td>2002</td>
<td>56,473</td>
<td>11.1</td>
</tr>
<tr>
<td>2003</td>
<td>54,090</td>
<td>9.4</td>
</tr>
<tr>
<td>2004</td>
<td>51,538</td>
<td>7.8</td>
</tr>
<tr>
<td>2005</td>
<td>48,541</td>
<td>5.5</td>
</tr>
<tr>
<td>2006</td>
<td>41,358</td>
<td>3.6</td>
</tr>
<tr>
<td>2007</td>
<td>38,968</td>
<td>2.7</td>
</tr>
</tbody>
</table>

*CARG* = -0.5

NPAs in PSBs in India – A Cross country comparison

The economic activities are no longer confined to nations and the banking services are to be on par with international standards. Moreover, the competition is global, concerns relating to banking are global and India has joined the executive club of members of Bank for International Settlements (BIS). Hence, we cannot shy away from the guidelines and accords emanating from the BIS. On the other hand, WTO is driving towards liberalisation. Indian banking is not an exception to the changes world around.\(^{41}\)

To get an idea of the scale of India’s bad loans problem in comparison with the rest of the world, is not out of context. Table 1.4 provides a comparison of incidence of NPAs in India with that in some selected countries across geographical regions. The ratio is lower in India compared to other countries except for Japan and Korea. However, in terms of the average rate of reduction per year, India’s performance ranks after Japan, China and Korea.

It can be observed that the incidence of NPAs have come down over the past few years for almost all countries as it is evident from the table. Moreover, incidence of NPAs in India appears to be quite low as compared to some other Asian economies such as China, Indonesia and Malaysia. However, some emerging economies such as Brazil and Korea have lower incidence of NPAs than India. Developed countries such as USA,

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Table I.4
CROSS-COUNTRY COMPARISON OF GROSS NON-PERFORMING LOANS TO TOTAL LOANS (PER CENT)

<table>
<thead>
<tr>
<th>Country</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>5.6</td>
<td>4.8</td>
<td>4.8</td>
<td>3.8</td>
<td>4.1</td>
</tr>
<tr>
<td>Russia</td>
<td>6.2</td>
<td>5.6</td>
<td>5.0</td>
<td>3.8</td>
<td>3.4</td>
</tr>
<tr>
<td>China</td>
<td>29.8</td>
<td>25.6</td>
<td>20.1</td>
<td>15.6</td>
<td>10.5</td>
</tr>
<tr>
<td>India</td>
<td>11.4</td>
<td>10.4</td>
<td>8.8</td>
<td>7.2</td>
<td>5.2</td>
</tr>
<tr>
<td>Indonesia</td>
<td>31.9</td>
<td>24.0</td>
<td>19.4</td>
<td>14.2</td>
<td>15.8</td>
</tr>
<tr>
<td>Korea</td>
<td>3.4</td>
<td>2.4</td>
<td>2.6</td>
<td>1.9</td>
<td>1.2</td>
</tr>
<tr>
<td>Malaysia</td>
<td>17.8</td>
<td>15.9</td>
<td>13.9</td>
<td>11.7</td>
<td>9.8</td>
</tr>
<tr>
<td>Thailand</td>
<td>11.5</td>
<td>16.5</td>
<td>13.5</td>
<td>11.8</td>
<td>11.1</td>
</tr>
<tr>
<td>Egypt</td>
<td>16.9</td>
<td>20.2</td>
<td>24.2</td>
<td>26.9</td>
<td>26.0</td>
</tr>
<tr>
<td>South Africa</td>
<td>3.1</td>
<td>2.8</td>
<td>2.4</td>
<td>1.8</td>
<td>1.6</td>
</tr>
<tr>
<td>Australia</td>
<td>0.7</td>
<td>0.6</td>
<td>0.4</td>
<td>0.3</td>
<td>0.2</td>
</tr>
<tr>
<td>Canada</td>
<td>1.5</td>
<td>1.6</td>
<td>1.2</td>
<td>0.7</td>
<td>0.5</td>
</tr>
<tr>
<td>Japan</td>
<td>8.4</td>
<td>7.2</td>
<td>5.2</td>
<td>2.9</td>
<td>2.4</td>
</tr>
<tr>
<td>United States</td>
<td>1.3</td>
<td>1.4</td>
<td>1.1</td>
<td>0.8</td>
<td>0.7</td>
</tr>
</tbody>
</table>

**Source:** Global Financial Stability Report, IMF, April 2006.
Australia and Canada, exceptionally have the lowest levels of NPAs. Clearly, while India’s bad loans problem is not as severe as in several other comparable economies.\textsuperscript{42}

**NPAs - A PEEP INTO IMPACT AND RECOVERY MECHANISM**

The concept of non-performing assets, in the Indian context has been developed over the years. To elaborate in the seventies, NPAs were termed as hard-core and out of order accounts, sticky accounts, overdue accounts etc.\textsuperscript{43} But during that period, practices of banks in identifying such NPAs were not uniform. Hence in 1985, banks were advised by the Reserve Bank of India to classify their advances under a uniform grading system (Health code system) in accordance with financial health of the borrower units. The accounts were accordingly classified into eight categories. But here again, the practices followed in India were different from those in other nations regarding classification of accounts and definitions of NPAs. So in 1991, the RBI accepted the recommendations of the ‘Narasimham Committee’, which also dealt with the definition of NPAs and other related matters such as income recognition, asset classification, etc.\textsuperscript{44}

**Impact of Non-Performing Assets (NPAs)**

The worry some factor with regard to NPA is it’s impact on economy on various fronts. A bank with high level of NPA would be forced to incur carrying costs on a non-income yielding assets. Other consequences would be reduction in interest income, high level of provisioning, stress on profitability and capital adequacy, gradual decline in


ability to meet steady increase in cost, increased pressure on net interest margin (NIM) thereby reducing competitiveness, steady erosion of capital resources and increased difficulty in augmenting capital resources. The lesser-appreciated implications are reputational risks arising out of greater disclosures on quantum and movement of NPA, provisions etc. The non-quantifiable implications can be psychological like ‘play safe’ attitude and risk aversion, lower morale and disinclination to take decisions at all levels of staff in the bank.\textsuperscript{45} It affects mainly the profitability of the banks by creating a great burden on the exchequer. Further, the banker is psychologically affected because of NPA making him to focus more and more on security aspects.\textsuperscript{46} The impact of NPA on banks is as follows.

**Impact on Profitability**

The earning capacity and profitability of many banks have been adversely affected by the high level of NPA. Thus, the increase of NPA is posing the biggest challenge to banks, both in public and private sectors. It is more acute in the public sector. Provision should be made from profits against NPA as per RBI guidelines. In PSBs, nearly 65 per cent of profits on an average went towards provisions against bad and doubtful loans every year. The write off of unrealised advances against profits amounts to allowing the willful defaulters at the cost of national wealth.


Burden on Exchequer

The profitability of the PSBs as a group turned negative as many nationalised banks reporting net losses in 1992-93. By March 1996, the outer time limit prescribed for attaining capital adequacy of 8 per cent, eight public sector banks were still short of the prescribed limit. The public sector banks which suffered losses of Rs.3,293 crore in 1992-93 and Rs.4,349 crore in 1993-94, i.e., in the initial years of introduction of prudential norms, have ended the year 1997-98 with a net profit of Rs.5,027 crore. PSBs recorded an aggregate net profit of Rs.8,101.24 crore in 2001-02. All this is the expense of exchequer, as the profits get blocked in provisions without reaching the government and other shareholders.

Between 1st April, 1993 and 31st March, 2001, commercial banks incurred a total amount of Rs.31,251 crore towards provisioning NPA. This has brought Net NPA to Rs.32,632 crore or 6.2 per cent of net advances. The enormous provisioning of NPA together with the holding cost of such non-productive assets over the years has acted as a severe drain on the profitability of the PSBs. Equity issues of nationalised banks that have already tapped the market are now quoted at a discount in the secondary market. This has alternatively forced PSBs to borrow heavily from the debt market to build capital to meet capital adequacy norms putting severe pressure on their profit margins.

Impact on Psychology of Banker

The psychology of the banks today is to insulate them with zero per cent risk turn lukewarm to fresh credit. This has affected adversely credit growth compared to growth
of deposits, resulting a low Credit Deposit Ratio around 50 per cent to 54 per cent for the industry.

**Excessive focus on Security**

It is evident that the existence of collateral security at best may convert the credit extended to productive sectors into an investment against real estate, but will not prevent the account turning into NPA. Further blocked assets and real estate represent the most insecure and NPA in such advances has the tendency to persist for a long duration. Nationalised banks have reached a dead-end of the tunnel and their future prosperity depends on an urgent solution of this threat.

**Excessive focus on Credit Risk Management**

The most important business implication of the NPA is that it leads to the credit risk management assuming priority over other aspects of bank’s functioning. The bank’s whole machinery would thus be pre-occupied with recovery procedures rather than concentrating on expanding business.

**Impact on Asset Quality**

In India, Asset quality is weaker and hence loan loss provisions continue to be higher. This suggests that, there is a greater scope for enhancing the asset quality of banks, in general, public sector banks, in particular, need to reduce the operating costs further. The tenure of funds provided by banks either as loans or investments depends critically on the overall asset-liability position. An inherent difficulty in this regard is that since deposit liabilities of banks often tend to be of relatively shorter maturity, long-term lending could induce the problem of asset-liability mismatches.
The maturity profile of commercial bank deposits shows that less than one fifth is of a tenor of more than three years. On the asset side, nearly 40 per cent has already been invested in assets of over three years maturity. Banks also have some capacity to invest in long term assets, but this capacity will remain highly limited until the fiscal deficit remains as high as it is and the government demand for investment in long dated bonds remains high. Some enhancement of their capacity to invest in infrastructure, industry and agriculture in longer gestation projects can be achieved by allowing a limited recourse to long term bond issues.

**High cost of funds to genuine Borrower**

Quite often genuine borrowers face the difficulties in raising funds from banks due to mounting NPA. Either the bank is reluctant in providing requisite funds to the genuine borrowers or if the funds are provided, it is provided at a very high cost to compensate the lenders losses caused due to high level of NPA.

**Recovery from NPAs**

An attempt is made to discuss various recovery measures adopted by banks and Financial Institutions (FIs) for reducing the level of NPAs. Over the years, many initiatives have been taken by the Reserve Bank of India and the Government of India in introducing new measures in the light of the problems experienced by banks and FIs and in keeping with the universal practices. In addition, these banks and FIs have also tried to come out with new measures for NPA reduction. Each of these measures are unique in terms of the arrangements for the recovery. Hence, it is worth to review such recovery measures as under.
LEGAL MEASURES

1. Debt Recovery Tribunals (DRTs)

In the context of recovery from NPAs, DRTs are assuming great importance since efforts are on to set up 7 more DRTs during this year and also to strengthen them. Though the recovery through DRTs is at present less than 2 per cent of the claim amount, banks and FIs have to depend heavily on them. Efforts are on to amend the Recovery Act to assign more powers to DRTs. More importantly, the borrowers’ tendency to challenge the verdict of the Appellate Tribunals in the High Court to seek natural-justice needs to be checked. Otherwise, early recovery efforts through DRTs would be futile. Secondly, training of presiding officers of Tribunals about the intricacies of banking practices is very essential. Further, the number of Recovery officers have to be enhanced in every DRT for effective recovery. Finally, banks and FIs have to come forward to provide liberal help to DRTs to equip them in terms of infrastructure, manpower, etc.

2. National Company Law Tribunal (NCLT)

As per the announcement made in the Budget 2001-02, Sick Industrial Companies Act (SICA) will be repealed and Board for Industrial Finance and Reconstruction (BIFR) will be wound-up. As an alternative arrangement, it is proposed to set-up NCLT by amending the Companies Act, 1956. In August 2001, the Bill was introduced in the Parliament. Accordingly, NCLT is expected to consolidate the powers of BIFR, High Court and Company Law Boards to avoid multiplicity of forums. In matters of rehabilitation of sick units, all the concerned parties are supposed to abide by the orders of NCLT. There shall be 10 benches, which will deal with rehabilitation, reconstruction
and winding-up of companies. The entire process is estimated to be completed during a period of 2-3 years as against 20-27 years presently taken. The Tribunal will have, in addition, powers of contempt of court.

A rehabilitation and revival fund will be constituted to make interim payment of dues to workers of a company declared sick or is under liquidation, protection of assets of sick company and rehabilitate sick companies. While NCLT will be acting on the lines of BIFR in matters of rehabilitation, viability of the projects will be assessed on ‘cash test’ and not in the present test of ‘net-worth’. Another important change will be in respect of time limit for completing each formality relating to rehabilitation and winding-up. Though the Bill is well drafted to ensure NCLT to become timewise, and more effective than BIFR in respect of rehabilitation and winding-up, doubts are raised about the implementation of the Bill taking into account the present political economy. In any case, it is too early to comment.

3. Asset Reconstruction Corporation (ARC)

It is proposed to set up ARCs in the private sector to take over NPAs of the public sector banks. The RBI will be the regulator of these ARCs. The ARC will buy NPAs of the banks and financial institutions at the pre-determined discounted value and issue NPA Redemption Bonds which carry a fixed return. ARCs are expected to be managed by professionals to effect maximum recovery of NPAs which will help in redemption of bonds after some time. The Finance Ministry has finalised the draft Bill to set up ARCs. Though the proposed scheme seems to be attractive, its success will depend upon the
efficiency of DRTs and courts. Further, if ARC is going to depend on the staff deputed by weak banks, its recovery chances are doubtful.

4. Company Mergers

Under the Companies Act, 1956, mergers are permitted. In 1977, Section 72-A was inserted in the Income Tax Act to offer tax incentives to healthy companies which take over the sick companies and prepare revival plans. Response to this scheme has been limited because of delays in completing formalities as per the instructions of the High Court and Income Tax Department. Tax incentives are found to be inadequate to motivate healthy companies to come forward and take advantage of the scheme. Recovery of bank dues on company-mergers is not assured since hardly 7.8 per cent of sick companies are successfully revived. Encouraged by the success achieved in company mergers in developed countries, a review of the scheme under Section 72-A of IT Act is called for.

5. Financial Reconstruction

The essence of a rehabilitation programme for a sick unit involves rescheduling its maturing obligations and matching them with the liquidity expected to be generated in future and maintenance of the resultant capital structure through the period of reconstruction. The steps involved in the reconstruction programme have been discussed in the following paragraphs.

The assets and liabilities, after reconstruction, should properly match and the post-reconstruction equity and debt should be capable of being adequately serviced in future by internal generation of the unit. This may call for reduction of the existing
preference capital, rescheduling of existing loans, conversion into equity, reduction, write-off or combination of such measures, consistent with the continued operation of the unit on a viable basis.

6. Civil Courts

Recovery through courts is possible provided decrees are awarded early. In this regard, it is essential to introduce fast-track settlement of cases. In addition, certain courts may be identified to deal exclusively with bank cases.


The Act covers the following three areas, viz.,

(a) Registration and regulation of Securitisation Company (SCo) and Asset Reconstruction Company (ARC).

(b) Enforcement of security interest by banks and financial institutions without court intervention, and

(c) Establishment of central registry of securitisation and reconstruction of financial assets and creation of security interest under the ordinance.

The Act provides for setting up of Securitisation Company (SCo) and Asset Reconstruction Company (ARC). Such company before commencement of business should obtain a certificate of registration from RBI. The networth of the company should not be less than Rs.2 crores or an amount exceeding 15 per cent of the total financial assets acquired or to be acquired. The SCo or ARC can acquire financial assets of any bank or FI by issuing a bond or any other security on mutually accepted terms between
the SCo/ARC and the bank/FI. On acquisition of financial asset by SCo/ARC from bank/FI, the SCo/ARC shall become the deemed lender and all rights of such bank/FI shall vest in the SCo/ARC in relation to the financial assets. Any suit, appeal or other proceedings pending at the time of acquisition of assets shall be continued by SCo/ARC. The SCo/ARC can issue security receipt of institutional buyers for subscription. The SCo/ARC can provide for proper management of the business of the borrower, sale or lease of a part or whole of the business of the borrower, rescheduling of payment of debts by the borrower and settlement of dues payable by the borrower.

8. The Enforcement of Security Interest and Recovery of Debts Laws (Amendment) Act, 2004

The securitisation and Reconstruction of Financial Asset and enforcement of Security Interest Act, 2002 was enacted to regulate securitisation and reconstruction of financial assets and enforcement of security interest and for matters connected thereto. The Act enables the banks and financial institutions to realise long-term assets, manage problems of liquidity, asset liability mis-match and improve recovery by exercising powers to take possession of securities, sell them and reduce non-performing assets by adopting measures for recovery or reconstruction. The Act further provides for setting up of asset reconstruction companies which are empowered to take possession of secured assets of the borrower including the right to transfer by way of lease, assignment or sale and realise the secured assets and take over the management of the business of the borrower.
9. Other Legal Measures

Other legal measures mainly include the recovery under State Finance Corporation Act, 1951 and Cooperative Societies Act, 1950.

Section 29 of the State Finance Corporation Act, 1951 empowers State Finance Corporations (SFCs) to take-over the management or property or both of the industrial concern which has defaulted loan instalments covering interest and principal. This right applies to the property mortgaged, pledged, hypothecated or assigned to the Financial Corporation. On take-over of the property, the corporation gets all the rights of the owner. This also refers to goods manufactured or produced wholly or partly from goods forming part of the security held by it. On receipt of sale proceeds of the property, the corporation is entitled to reimburse first all costs/expenses incurred in holding the property and arranging subsequent sale and recovery of dues. If any surplus left over, the same shall be paid to the person entitled thereto. Where Financial Corporation has taken any action against an industrial concern under provisions of sub-section (I), the Financial Corporation shall be deemed by the owner of such limited company for the purpose of suits by or against the concern, and shall then be sued.

Despite the above wide ranging powers, the Financial Corporations have not been able to recover much effectively because of non-cooperation from the management of the industries concerned. In some cases, the workers also agitate and prevent any take-over of the property. Thus, what is important is to create a conducive recovery environment and not just vesting the additional powers to the Financial Corporation as discussed above.
Recovery under the Maharashtra Cooperative Societies Act, 1960 is also possible. Credit institutions in cooperative sector have to apply to the Registrar to seek his assistance in the recovery of dues from the members. The Registrar, after receiving necessary particulars, will make such inquiries, as he deems fit, and then grant a certificate for the recovery of the amount due as arrears. The certificate granted by the Registrar shall be final and a conclusive proof and the same shall be enforceable according to the law like land revenue law. Credit institutions in cooperative sector are taking full advantage of the facility provided under the Act. As discussed above, the recovery process is also slow in this context, because of recovery climate which is not conducive besides lack of cooperation from defaulting members.47

CONCLUSION

In the present scenario, NPAs are inevitable in the loan portfolio of any financial institutions. Here efforts should be made to maintain a reasonably low level of NPAs. It is high time to go for periodical recovery reviews in monitoring NPA levels. While doing so, prevention of NPAs is always a better option. No doubt in this regard challenges in the vanguard of commercial banks are varied. But a committed professional approach and orientation for the survival, success and viability of banking on the part of the management as well as employees, work positively for achieving this objective. But, in view of the global challenges in the banking sector, intensity of competition and the syndrome of sickness, the problem of non-performing assets need to be effectively addressed for which an in-depth analytical study of the problem and its ground realities are very much needed.

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