CHAPTER – I
INTRODUCTION

Commercial banks undertake a wide variety of activities, which play a critical role in the economy of a country. They pool and absorb risks for depositors and provide a stable source of investment and working capital funds to various sectors of the economy. In addition, they provide a smooth functioning of payment system that allows financial and real resources to flow relatively freely to their highest return uses. They are also a back up source of liquidity for any sector in the economy in temporary difficulty. Banks are a particularly important source of funds for small borrowers who often have limited access to other source of funds for small borrowers who often have limited access to other sources of external finance. The three main interrelated functions of commercial banks are holding of deposits; create credit through lending and investment activities; and providing a mechanism for payments and transfer of funds for various productive activities. The extension of credit or lending is, thus, the principal activity of a commercial bank.

Portfolio Behaviour of Banks

Commercial banks hold a portfolio of assets and, given the characteristics and distribution of the liabilities, they attempt to structure their portfolio of assets in such a manner so as to yield the greatest return, subject to the constraints. Banks have four categories of assets, viz.,

- Cash in hand and balances with the central banks;
- Assets with the banking system;
- Investments in Government and other approved securities; and
- Loans and advances.

Quantitatively, lending and investments are the most important earning assets of banks. The quantum and also the composition of loans and investments is determined by the banks’ portfolio behavior which, in turn, is generally determined by the present and expected levels of market interest rates, loan demand and cash demand and actions of the central banks.
In India, prior to initiation of financial sector reforms in the early 1990s, the lending operations of the banking sector were highly regulated. These related to an administered structure of interest rates, high levels of pre-emption in the form of reserve requirements, and credit allocation to certain sectors. There existed different credit limits and margin requirements in respect of sensitive commodities and sectors. There were requirements of prior approval from the Reserve Bank for sanction of credit beyond a threshold. Commercial banks were also required to meet mainly the short-term/working capital funds requirements. As such, banks did not have much choice in terms of allocation of resources among different asset classes.

The initiation of financial sector reforms facilitated a gradual move away from a financially repressed regime to a liberalized one. Banks were given the freedom to innovate and expand their businesses. Lending rates were free to enable banks to price their products freely. Interest rate deregulation imparted greater efficiency to the resource allocation process. The objective of the banking sector reforms was to promote a diversified, efficient and competitive financial system with the ultimate objective of improving the allocative efficiency of resources through operational flexibility, improved financial viability and institutional strengthening. With the phasing out of the regulated regime, banks started exploring new avenues for expanding businesses.

**Lending Operations of Banks: Major Policy Initiatives**

Since the early 1990s, several policy measures have been initiated to provide flexibility to banks in their lending and investment operations.

**Lending Interest Rates**

Lending interest rate of commercial banks were deregulated in October 1994 and banks were required to announce their prime lending rates (PLRs). The concept of benchmark prime lending rate (BPLR) was introduced by the Reserve Bank on April 29, 2003 to advise the need for transparency in banks’ lending rates as also to reduce the complexity involved in pricing of loans. Banks are now free to prescribe respective BPLRs. Banks are also permitted to offer floating rate loan products linked to a market benchmark in a transparent manner.
Term-lending by Banks

Various restrictions on term loans by banks were gradually phased out by 1997. In terms of the guidelines prevailing before the initiation of economic reforms in 1991, banks were expected to extend term loans for small projects in participation with the State level institutions, though it was not mandatory. For large projects, however, they were allowed to participate compulsorily along with all-India financial institutions (FIs), subject to the condition that one share of the banking system would be restricted to 25 per cent of term loan assistance from banks and FIs and the aggregate term finance from the banking system could not exceed Rs.75 crore.

Exposure Limits

Regulatory limits on banks’ exposure to individual and group borrowers in India were prescribed to avoid concentration of credit. The applicable limit is 15 per cent of capital funds in the case of a single borrower and 40 per cent in the case of a group borrower. Credit exposure to borrowers belonging to a group may exceed the exposure norm of 40 per cent of bank’s capital funds by an additional 10 per cent (i.e., up to 50 per cent) provided the additional credit exposure is on account of extension of credit to infrastructure projects. Credit exposure to a single borrower may exceed the exposure norm of 15 per cent of bank’s capital funds by an additional 5 per cent (i.e., up to 20 per cent). In addition, banks may, in exceptional circumstances, with the approval of their boards, consider enhancement of the exposure to a borrower up to a further 5 per cent of capital funds.

Priority Sector Lending

Over the years the stipulation for lending to the priority sector has been retained, though its scope and definition was fine-tuned by including new items. Based on the recommendations of the Working Group, set up by the Reserve Bank, the priority sector norms were revised in April 2007. As per the revised norms, the sectors of the society/economy that impact large segments of the population, the weaker sections and the sectors which are employment-intensive such as agriculture and micro and small enterprises, have been retained as priority sector, which came into effect from April 30, 2007. Agriculture, small enterprises, micro credit, retail trade, education loans and housing loans up to Rs.20 lakh are the broad categories included in the priority sector.
NPA Management

The high level of non-performing loans (NPLs) of banks, apart from limiting the ability of credit institutions to recycle their funds, also weakened them by adversely affecting their profitability. The Reserve Bank and Central Government, therefore, initiated several institutional measures to recover the past dues to banks and FIs and reduce the NPAs. These were Debt Recovery Tribunals (DRTs), Lok Adalats (people’s courts), Asset Reconstruction Companies (ARCs) and the Corporate Debt Restructuring (CDR) mechanism, Settlement Advisory Committees have also been formed at regional and head office levels of commercial banks. Furthermore, banks can also issue notices under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 for enforcement of security interest without intervention of courts. Further, banks, (excluding securitization companies/ reconstruction companies) have been permitted to undertake sale/purchase of NPAs. Thus, banks and other credit institutions have been given a menu of options to resolve their NPA problems.

Development of Securitisation Market

With a view to ensuring healthy development of the securitization market, the Reserve Bank issued guidelines on securitization of standard assets on February 1, 2006 to banks, financial institutions and non-banking financial companies.

Credit Information Bureau

Comprehensive credit information, which provides details pertaining to credit facilities already availed of by a borrower as well as his repayment track record, is critical for the smooth operations of the credit market. Lack of credit history is an important factor affecting the credit flow to relatively less creditworthy borrowers. In the absence of credit history, pricing of credit can be arbitrary, the perceived credit risk can be higher and there can be adverse selection and moral hazard. Accordingly, a scheme for disclosure of information regarding defaulting borrowers of banks and financial institutions was introduced in 1994. In order to facilitate sharing of information relating to credit matters, a Credit Information Bureau (India) Limited (CIBIL) was set up in 2000, which took over the functions of dissemination of information relating to defaulting borrowers form the Reserve Bank. The Credit
Information Companies (Regulation) Act was enacted in 2005 to facilitate the setting up of credit information companies.

**Statutory Liquidity Ratio Provisions**

At present, all scheduled commercial banks are required to maintain a uniform Statutory Liquidity Ratio (SLR) of 25 per cent of net demand and time liability as on the last Friday of the second preceding fortnight under Section 24 of the Banking Regulation Act. The assets eligible for meeting the Statutory Liquidity Ratio requirements can be held in the form of cash, gold or in unencumbered approved securities, consequent upon the amendment to Section 24 of Banking Regulation Act, 1949, the floor rate of 25 per cent for the SLR has been removed and the Reserve Bank has also been empowered to determine the SLR eligible assets. However, no change has been made in the SLR so far in view of the prevailing macroeconomic and monetary condition.

**Trends in the Lending Operations of SCBs**

In India, like many other emerging market economies, commercial banks remain the most important source of credit supply. The total credit extended by scheduled commercial banks grew at 17.2 per cent during the 1980s and 16.0 per cent during the 1990s as given in Table 1.1.

Table 1.1

<table>
<thead>
<tr>
<th>Period</th>
<th>Agriculture</th>
<th>Industry</th>
<th>Transport Operators</th>
<th>Professional Services</th>
<th>Personal Loans</th>
<th>Trade</th>
<th>Finance</th>
<th>SMEs</th>
<th>Total Bank Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980-81 to 1989-90</td>
<td>18.1</td>
<td>17.4</td>
<td>13.6</td>
<td>20.7</td>
<td>25.3</td>
<td>11.8</td>
<td>29.2</td>
<td>29.7</td>
<td>17.2</td>
</tr>
<tr>
<td>1990-91 to 1999-00</td>
<td>10.6</td>
<td>15.4</td>
<td>9.4</td>
<td>16.8</td>
<td>22.7</td>
<td>17.3</td>
<td>25.6</td>
<td>8.1</td>
<td>16.0</td>
</tr>
<tr>
<td>2000-01 to 2005-07</td>
<td>26.0</td>
<td>19.0</td>
<td>18.2</td>
<td>35.3</td>
<td>30.0</td>
<td>16.2</td>
<td>28.1</td>
<td>19.7</td>
<td>22.9</td>
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Memo:
April-March

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<tr>
<th>Period</th>
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<th>Transport Operators</th>
<th>Professional Services</th>
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<th>Trade</th>
<th>Finance</th>
<th>SMEs</th>
<th>Total Bank Credit</th>
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<td>13.3</td>
<td>10.5</td>
<td>7.7</td>
<td>31.3</td>
<td>27.7</td>
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<td>44.0</td>
<td>25.1</td>
<td>17.7</td>
<td>42.2</td>
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<td>21.6</td>
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<td>2008-03</td>
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<td>14.9</td>
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</tr>
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<td>2009-04</td>
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<td>9.4</td>
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<td>2010-05</td>
<td>29.2</td>
<td>33.5</td>
<td>22.0</td>
<td>25.0</td>
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<td>27.8</td>
<td>24.3</td>
<td>22.8</td>
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</tr>
<tr>
<td>2011-06</td>
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<td>39.0</td>
<td>15.9</td>
<td>29.8</td>
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</tr>
<tr>
<td>2012-07</td>
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<td>22.7</td>
<td>36.4</td>
<td>30.3</td>
<td>23.0</td>
<td>28.6</td>
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</table>

Source: Basic Statistical Returns of Scheduled Commercial Banks, various issues, Reserve Bank of India.
Credit by scheduled commercial banks from the early 1990s witnessed three distinct phases. In the first phase (from 1990-'91 to 1995-'96), bank credit growth showed erratic behavior with the growth rate varying between 8 per cent and 29 per cent. In the second phase (from 1996-'97 to 2001-'02), bank credit growth decelerated sharply and ranged between 10 and 18 per cent. In the third phase (from 2002-'03 to 2006-'07) credit growth generally remain high. *(Plate.1.1).*

**Plate 1.1**

*Non-food Credit and Bank Credit*

The deceleration in credit during the second phase was on account of several factors, both on the demand and the supply sides. On the supply side, introduction of prudential norms relating to income recognition, asset classification and provisioning in the early 1990s made banks cautious. Application of norms revealed large gross non-performing assets (NPAs) with scheduled commercial banks (15.7 per cent of their gross advances at-end March 1997). Banks, therefore, became wary of enlarging their loan portfolio. Regression analysis suggests that asset quality is one of the main

*Source: Basic Statistical Returns of SCBs, various issues, RBI*
determining factors of credit, besides time deposits and lending rate. The relatively high level of NPAs, in particular, had a severe impact on weak banks. Banks’ capacity to extend credit was also impaired due to little headroom available in the capital adequacy ratio (8.7 per cent at end-March 1996). Banks found risk adjusted returns on Government Securities and attractive. Hence, despite lowering of statutory pre-emption in the form of SLR, banks continued to invest in Government Securities, far in excess of the stipulated requirements, banks’ investments in SLR securities at end-March 1996 were 36.9 per cent of net demand and time liabilities (NDTL) as against the prescribed requirement of 31.5 per cent. Banks’ investments in SLR securities remained more or less at that level (36.7 per cent) by end March, 2002, even as the SLR was brought down significantly to 25 per cent (RBI, 2007).

On the demand side also, several factors contributed to the decline in demand for credit by the corporate sector. The industrial sector witnessed massive expansion in capacity in certain sectors, especially cement and steel, in the initial phase of reforms. However, as the quantitative restrictions were removed and import tariffs reduced, the corporate sector faced intense competition during the latter part of the 1990s. The focus of the corporate sector, thus, shifted from expanding capacity to restructuring and industrial sector slowed down significantly. The average annual growth rate of industrial production was 5.2 per cent during 1996-'97 to 2001-'02 as compared with 9.4 per cent in the preceding three years. This effected the demand for credit by the corporate sector. Increased competition also forced corporate to restructure their balance sheets, whereby they increased their reliance on retained earnings and reduced their borrowings. This was evident from the debt-equity ratio, which declined from an average of 85.5 per cent during 1990-1991 to 1994-1995 and 65.2 per cent during 1995-1996 to 1999-2000.

This affected the demand for credit by the corporate sector. Increased competition also forced corporate to restructure their balance sheets, whereby they increased their reliance on retained earnings and reduced their borrowing. This was evident from the debt-

Although the Reserve Bank pursued accommodative monetary policy during this period (1996-'97 to 2001-'02) by reducing the Cash Reserve Ratio (CRR) and policy rates viz., the Bank Rate and the Reverse Repo Rate (the then Repo Rate), credit off take did not pick up. Downward stickiness of nominal interest rates on the
one hand, and the falling inflation rate on the other, led to a significant rise in real interest rates. The average real lending rates of banks increased to 12.5 per cent during 1996-’97 to 2001-’02 as against 6.5 per cent during 1990-’91 to 1995-’96 (Mohan, 2003). This also appeared to have contributed to sickness in the credit expansion.

In the third phase (2002-’03 to 2006-’07), credit growth generally remained high. The nature of rapid credit growth from May, 2002 has been structurally at variance from the historical trends. Credit, in particular, expanded at a robust pace of around 30 per cent for three consecutive years from 2004-’05 to 2006-’07. The credit expansion was also pro-cyclical in nature, which indicates that the strong income growth recorded in recent years also significantly contributed to credit growth. One of the major contributory factors was an improvement in asset quality. As banks’ gross / net NPAs declined to more reasonable levels, credit growth accelerated.

Other major factors that contributed to the acceleration in credit growth were a pickup in economic growth, moderation in inflation and inflation expectations, decline in real interest rates, rising income of households and increased competition with the entry of new private sector banks. Besides, the sharp growth in bank credit in recent years could also be attributed to factors such as financial deepening from a low base, structural shifts in supply elasticities, rise in efficiency of credit markets and policy initiatives to improve the flow of credit to sectors such as agriculture and small and medium enterprises. During this phase, retail credit, especially housing loans, emerged as the major source of credit demand. Housing loans combined with infrastructure financing led to a sharp increase in the share of medium and long-term loans in total credit as given in Plate-1.2.

The share of long-term loans in the outstanding credit of scheduled commercial banks increased from 21.9 per cent at end-March, 2000 to 34.4 per cent at end-March, 2003 and further to 48.2 per cent at end-March, 2007.
The share of medium-term loans also showed an increase from 8.4 per cent in 2000 to 12.6 per cent in 2007.

Bank group-wise analysis indicates that credit growth of private sector banks was consistently above the overall credit growth. At time, it also showed wide variations Plate 1.3.

Source: Basic Statistical Returns of SCBs, various issues, RBI
Bank credit (outstanding), which constituted 20.4 per cent of GDP at end-March, 1991, increased to 22.3 per cent at end-March, 2000 and 46.8 per cent at end-March, 2007. Plate 1.4

Plate 1.4
Credit – GDP Ratio of SCBs in India

Notwithstanding the increase, the credit to GDP ratio in India was lower than that of developed and several emerging market economies.

Credit – Deposit Ratio (CDR)

The credit-deposit ratio refers to the proportion of loan assets funded by banks from deposits mobilized. The credit-deposit ratio of scheduled commercial banks tended to move upwards from 2000-’01. The ratio, which was 48.4 per cent at end-March, 1994, increased to 53.2 per cent at end-March, 2002 and further to 73.0 per cent at end-March, 2007. The financing of a higher proportion of credit in recent years in a way was facilitated by excess SLR securities portfolio built-up by banks in the mid-1990s. An analysis of bank group-wise credit-deposit ratio during the 1991-2007 reveals that the credit-deposit ratio of all bank groups tended to move up in line with the increase in overall credit from 2001-’02. The ratio of various bank groups almost converged at around 73 per cent at end-March, 2007, barring foreign bank group, which maintained significantly higher credit-deposit ratio from 1995-’96 than other
bank groups. The ratio in respect of foreign banks was at around 84 per cent at end-March, 2007. *Plate 1.5.*

**Plate 1.5**

Bank Group-wise Credit-Deposit Ratio

(End-March)

![Graph showing credit-deposit ratio for different bank groups from 1981 to 2007.](image)

*Source: Basic Statistical Returns of SCBs, various issues, RBI*

**Statement of the Problem**

Preceding pages highlighted that banks in India have traditionally been the main source of credit for various sectors of the economy. They have also funded borrowing requirements of the Central and State Governments by investing their securities. Lending and investment operations of banks in India have evolved in response to the changing needs of the economy. Prior to the initiation of financial sector reforms in the early 1990s, lending by banks was tightly regulated and banks were expected to align their lending operations to plan priorities. Bank lending was the principal focus of monetary policy under the credit planning approach adopted in 1967-’68. However, in the wake of banking sector reforms, various restrictions on banks’ balance sheet were withdrawn and direct credit controls largely dismantled, though in a phased manner. Directed investments were also reduced to a significant
extent. The system of administered lending rates was also dismantled and various other restrictions on banks’ lending were gradually removed in order to enable banks to operate in a flexible manner. This lead to a structural transformation in the lending and investment operations of the banks. In this backdrop, the researcher has undertaken the research work on “A Study on Advances by Scheduled Commercial Banks”.

**Objectives of the Study**

The study is undertaken with the following objectives:

1. To study the lending operations of SCBs in India.
2. To learn about the theoretical framework of commercial bank credit in India.
3. To make an analysis of the advances portfolio of Public Sector Banks (PSBs).
4. To make an analysis of the advances portfolio of Private Sector Banks (Pvt.SBs).
5. To make bank-group wise analysis of Non-Performing Assets (NPA) of SCBs.
6. To find out the measures to minimize the NPAs, and
7. To suggest measures for improving prospects of bank credit.

**Methodology**

The study has been carried out All Scheduled Commercial Banks in India except foreign banks operating in India and Regional Rural Banks (RRBs). Thus the study includes the following groups of commercial banks.

a) State Bank of India and its subsidiaries (SBI & its group),
b) Nationalised Banks (NBs),
c) Old Private Sector Banks (OPSBs), and
d) New Generation Private Sector Banks (NGPSBs).

A study of this nature requires secondary data. Data relating to the Advances of the bank constitutes secondary data for the study.
For the purpose of analysis detailed informations are collected from the various special issues of RBI websites like Trend and Progress of Banking in India and Statistical Tables Relating to Banks in India.

**Review**

In view of advances, a number of researchers have been conducted in India and abroad. Similarly, number of research papers has been published by academicians and practitioners in India and abroad highlighting the commercial banks and agricultural credit, bank lending etc. in the banking sector. Besides, a number of papers have been presented relating to that topic under study by the eminent academicians and practicing bankers in the conferences and National and international seminars. An attempt has been made to review a few of the above studies and papers as a starting point for the present study.

**Processing of Data**

All the data have been classified, tabulated for better comprehension and analysis. The secondary data have been analysed with the help of computer. Simple mathematical tools like averages, statistical tools like standard deviation, co-efficient of variation, one-way analysis of variance F-test, students t-test and percentage analysis have been applied for analysis of data. All analysis has been done by using Microsoft Excel Sheet 2007.

**Framework of Analysis**

In the present study some mathematical and statistical tools have been applied in order to realize the objectives of the study. The tools applied and the relevance of its application is described below.

The study of arithmetic average, standard deviation and co-efficient of variation has been used to study the magnitude and trend of advances of banks during the study period. F-test and students’ t-test has been used to evaluate the relationship between advances and non-performing assets.

Compound Growth Rate (CGR) for Gross non-performing assets and Net non-performing assets of different bank groups has been computed on the basis of the semi-log or exponential function.

\[
CGR = \left( \text{Antilog } \beta - 1 \right) \times 100
\]
**Period of study**

Since secondary data on Advances of the Scheduled Commercial Banks from 1997-'98, i.e., from the introduction of banking sector reforms, a period of 12 years from 1997-'98 to 2008-'09 has been taken for the present study.

**Limitations of the Study**

1. This study is based on the secondary data only.
2. In this study researcher has to consider only the SCHEDULE – 9 of the Banks Balance sheet. The other avenues does not taken into account.
3. All Scheduled Commercial Banks for the study does not include Foreign Banks in India, RRBs and Scheduled Co-operative Banks due to non-availability of comprehensive data in the required format and quantity.

**Significance of the Study**

The researcher has a fervent hope that the analysis, findings and suggestions that will be thrown up a result of this study will certainly be useful to the Government of India, State Governments and Managements of RBI and the Commercial Banks in India and various other officials and non-officials dealing in credit. It will be of much used to commercial banks in India so as to evolve improved techniques of credit management and lay down more feasible guidelines and the norms in the feasible guidelines and the norms in the nature of their credit policies and practices.

**Hypothesis**

1. There is a significant difference in Mean GNPA among various bank groups.
2. There is a significant difference in Mean NNPA among various bank groups.
3. There is no significant difference among various bank groups in respect of GNPAs to Total Advances Ratio.
4. There is no significant difference among various bank groups in respect of NNAPAs to Total Advances Ratio.
5. There is no significant difference among various bank groups with regard to GNPAs to Total Assets Ratio.
6. There is no significant difference among various bank groups with regard to NNAPAs to Total Assets Ratio.
Research Design

The Researcher has to classify the chapters in the following manner.

Chapter I
- Portfolio Behaviour of Banks,
- Lending operations of Banks; Major Policy Initiatives,
- Trends in the Lending Operations of SCBs in India,
- Statement of the problem,
- Objectives of the study,
- Methodology,
- Significance of the study,
- Limitations of the study,
- Scope of the study,
- Hypothesis, and
- Research Design.

Chapter II
- Review of Relevant Literature.

Chapter III
- Commercial Bank Credit in India – Theoretical Framework.

Chapter IV
- Analysis of the advances portfolio of Public Sector Banks (PSBs).

Chapter V
- Analysis of the advances portfolio of Private Sector Banks (Pvt.SBs).

Chapter VI
- Bank-group wise analysis of Non-performing Assets (NPAs) of Scheduled Commercial Banks.

Chapter VII
- Measures to minimize NPAs.

Chapter VIII
- Suggestive measures for improving prospects of bank credit.