CHAPTER - I
INTRODUCTION

Banking system remains focal point in the financial set up of any developing country. Banks are regarded as special in view of their specialised functions in the financial intermediation and payment system. Banking plays an increasingly important role in nation’s economy. Occupying a pivotal position in the organized money market, it has acquired a special place with its large network of branches, with its huge deposits and advances. With the gradual change in the very concept of banking and with the entry of state in its administration, Banking has assumed enormous importance as a subject of analysis and research.

Meaning of Banking

Banking Regulation Act, 1949 was the first state act enacted to control and regulate the activities of the banking companies. It defines the term Banking as:

“Accepting, for the purpose of lending or investment of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft and order or otherwise”.

The essential function of a bank is therefore two folds-

1. Acceptance of deposits
2. Investment of funds

Section 8 of the same Act prohibits a Banking company from engaging in trading activities.

Functions of a Bank

Functioning of a bank is among the more complicated of corporate operations. Since Banking involves dealing directly with money, governments in most countries regulate this sector rather stringently. In India, the regulation traditionally has been very strict and in the opinion of certain quarters, responsible for the present condition of banks, where NPAs are of a very high order. The process of financial reforms, which started in 1991 has cleared the cobwebs somewhat but a lot remains to be
done. The multiplicity of policy and regulations that a Bank has to work with makes its operations even more complicated, sometimes bordering on illogical.

**Indian Banking System**

The Banking system is an integral sub – system of the financial system. The financial system functions as an intermediary and facilitates the flow of funds from the area of surplus to areas of deficits. A financial system is a composition of various institutions, markets regulations and laws, practices, money managers, analysts, transactions and claims and liabilities. It represents an important channel of collecting small savings from the households and lending it to the corporate sector. The Reserve Bank of India (RBI) is the apex body of the Indian banking system and for all matters relating to the banking system. It is the ‘Central Bank of India’. It is the banker to all other banks.

**Functions of RBI**

1. Currency issuing authority
2. Banker to the Government
3. Banker to other banks
4. Framing of Monetary Policy
5. Exchange control
6. Custodian to Foreign Exchange and Gold Reserves
7. Developmental activities
8. Research and Development in the banking sector

**Classification of Banks**

Following is the classification of banks:

**A. Scheduled Banks**

Scheduled Banks are banks which are included in the Second Schedule of the Banking Regulation Act, 1965. According to this schedule, a scheduled Bank:

(1) Must have paid-up capital and reserve of not less than Rs.5, 00,000.

(2) Must also satisfy the RBI that its affairs are not conducted in a manner detrimental to the interests of its depositors.
B. Non Scheduled Banks

These are banks which are not included in the Second Schedule of the Banking Regulation Act, 1965. It means they do not satisfy the conditions laid down by that schedule.

Scheduled banks are sub-divided as:

1. State Co-operative Banks:
   
   These are co-operatives owned and managed by the State.

2. Commercial Banks:
   
   These are business entities whose main business is accepting deposits and extending loans. Their main objective is profit maximization and adding shareholder value. These are further sub-divided as:

   (i) Indian Banks:
   
   These banks are companies registered in India under the Companies Act, 1956. Their place of origin is in India.

   (ii) Foreign Banks:
   
   These are banks that were registered outside India and had originated in a foreign country.

Indian banks are also sub-divided as:

a. State Bank of India and its Subsidiaries:

   SBI’s 7 Associate Banks:
   
   1. State Bank of Hyderabad
   2. State Bank of Mysore
   3. State Bank of Bikaner and Jaipur
   4. State Bank of Patiala
   5. State Bank of Saurashtra
   6. State Bank of Indore
   7. State Bank of Travancore.

   SBI has 7 international subsidiaries /Joint ventures (As at Mar’99). These are:

   Subsidiaries:
   
   1. SBI European Bank PLC
2. SBI (Canada), Toronto
3. SBI (California), Los Angeles

**Joint Ventures:**
1. Indo-Nigerian Merchant Bank Ltd (Lagos), Nigeria
2. Bank of Bhutan, Bhutan
3. Nepal SBI Bank Ltd, Nepal
4. SB International Ltd (Mauritius) (Very recently, it has become the Bank’s subsidiary; earlier it was a joint venture company).

The Indian non-banking subsidiaries of SBI:
1. SBI Capital Markets Ltd. (SBICAP)
2. SBI Funds Management Ltd. (SBIFML)
3. SBI Home Finance Ltd. (Affiliate)
4. SBI Factors and Commercial Services Ltd. (SBI Factors)
5. SBI Gilts Ltd. (Broking Business)
6. SBI Securities Ltd.
7. SBI Cards and Payment Services Pvt. Ltd.

**b. Other Nationalised Banks:**

This group consists of private sector banks that were nationalized. The Government of India nationalized 14 private banks in 1969 and another six in the year 1980.

**c. Regional Rural Banks:**

These were established by the RBI in the year 1975 of Banking Commission. It was established to operate exclusively in rural areas to provide credit and other facilities to small and marginal farmer, agricultural labourers, artisans and small entrepreneurs.

**d. Old Private Sector Banks:**

This group consists of banks that were established by the privy states, community organizations or by a group of professionals for the cause of economic betterment in their area of operations. Initially their operations were concentrated in a
few regional areas. However, their branches slowly spread throughout the nation as they grew.

e. New Private Sector Banks:

These banks were started as profit oriented companies after the RBI opened the banking sector to the private sector. These banks are mostly technology driven and better managed than other banks.

Today the commercial banking system in India may be distinguished into:

C. PUBLIC SECTOR BANKS
   a. State Bank of India and its associate banks are called the State Bank group
   b. 19 Nationalised banks and one new public sector bank namely IDBI Ltd.
   c. Regional Rural Banks mainly sponsored by Public Sector Banks

D. PRIVATE SECTOR BANKS
   a. Old private banks
   b. New generation private banks
   c. Foreign banks in India
   d. Scheduled Co-operative banks
   e. Non-scheduled banks

E. CO-OPERATIVE SECTOR BANKS
   a. State Co-operative banks
   b. Central Co-operative banks
   c. Primary Agriculture Credit Societies
   d. Land Development banks
   e. Urban Co-operative banks
   f. Primary Agricultural Development banks
   g. Primary Land Development banks
   h. State Land Development banks

F. DEVELOPMENT BANKS
   a. Industrial Finance Corporation of India(IFCI)
   b. Industrial Investment Bank of India(IIBI)
   c. Small Industries Development Bank of India(SIDBI)
d. SCICI Ltd.
e. National Bank for Agriculture and Rural Development (NABARD)
f. Export Import Bank of India
g. National Housing Bank

CHART NO: 1
CLASSIFICATION OF BANKS

Reserve Bank of India

Scheduled Banks

State co-op Banks

Commercial Banks

Indian

Public Sector Banks

SBI & its Associates

Foreign

Private Sector Banks

Nationalized Banks

Private Sector Banks

Regional Rural Banks
Among the banking institutions in the organised sector, the commercial banks are the oldest institutions having a wide network of branches, commanding utmost public confidence and having the loin’s share in the total banking operations. Initially they were established as corporate bodies with share – holdings by private individuals but subsequently there has been a drift towards state ownership and control. Today 27 banks constitute the strong Public Sector Banks in Indian Commercial Banking. Up to late sixties, they were mainly engaged in financing organized trade, commerce and industry but since then they are actively participating in financing agriculture, small business and small borrowers also. The commercial banks operating in India fall under a number of sub – categories on the basis of ownership and control of management. Foreign commercial banks are the branches in India of the joint stock banks incorporated abroad. These banks besides financing the foreign trade of the country, undertake banking business within the country as well. The RBI Act has divided the banks into two categories:

A. Scheduled Commercial Banks:

According to RBI Act 1934, a scheduled bank is that bank which has been included in the second schedule of the Reserve Bank of India. To be eligible for this concession a bank must satisfy the following three conditions:

- It must have a paid up capital and reserves of an aggregate value of at least Rs.5 lakhs.
- It must satisfy the RBI that its affairs are not conducted in a manner detrimental to the interests of its depositors.
- It must be a corporation and not a partnership or a single owner firm.

RBI gives them credit and many other facilities. These banks can also get their hundies rediscounted from the RBI. Commercial banks have to keep fixed proportions of their demand deposits and time deposits with the RBI. They have to submit deposits of their business to RBI.

B. Non – scheduled Commercial Banks:

These are those banks of which the total capital is less than Rs.5 lakhs. These banks are not included in the second schedule of the RBI. RBI has no specific control
upon these banks. But they have to send details of their business to the RBI every month.

**Public Sector Banks:**

Public sector in Indian banking reached its present position in three stages:

- Conversion of the existing Imperial Bank of India into the SBI in 1955 followed by the establishment of its seven associate banks.
- Nationalization of 6 more commercial banks on April 15, 1980.

One of the new banks of India was later on merged with PNB. Thus 27 banks constitute public sector in Indian commercial banking. Public Sector Banks include SBI, Associates of SBI, and 14 banks nationalized in 1969 and 6 banks nationalized in 1980.

**Differences between State Bank and Nationalized Banks**

Though all the 27 PSBs are corporate bodies, but the statutes under which they were established are different. The SBI was established under the SBI Act, 1955, the subsidiary banks under the SBI Act, 1959 and the nationalized banks under the Banks Companies (Acquisition and Transfer of Undertaking) Acts of 1970 and 1980.

Initially, cent percent ownership of the 20 nationalized banks vested in the Government of India whereas the SBI was owned, to a large extent, by the RBI, there was small private ownership in the share capital of the State Bank. The subsidiary banks are owned by the SBI during recent years SBI and some of the nationalized banks-OBC (Oriental Bank of Commerce), Dena Bank, Bank of India has enlarged their capital by issuing shares to the public.

The SBI acts as an agent of the RBI. According to section 45 of the RBI Act 1934, “The RBI shall appoint the State Bank as its sole agent at all places in India where it does not have an office or branch of its Banking Department and there is a branch of the State Bank or branch of a subsidiary bank”. But the nationalized banks have not been conferred with this privilege of acting as agent of the RBI. Since the enforcement of the banking laws (amendment) Act, 1983, the RBI has been
empowered to appoint any nationalized to act as its agent at all places in India where it has branch for the following purposes:

- Paying, receiving, collecting and remitting money, bullion and securities on behalf of any Government in India.
- Undertaking and transacting and other business entrusted by the RBI from time to time.

Private Sector Banks are those Banks which are owned by the private sector. The private sector played a strategic role in the growth of joint sector banks in India. In 1951, there were in all 566 private sector banks, of which 474 were non-scheduled and 92 were scheduled. But there was not a single private sector bank at that time. Since then, the number of Public Sector Banks is increasing while those of Private Sector Banks are decreasing.

Private Sector Banks include:
- Foreign banks
- Scheduled commercial banks
- Non – scheduled commercial banks

**New Private Sector Banks**

In accordance with the financial sector reforms adopted in 1991 New Private Sector Banks have been permitted to be set up. According to Narasimham Committee New Private Sector Banks should be allowed to be established in India. These New Private Sector Banks will complement the overall Financial Sector Reforms. They will provide a financially viable technologically up to date, customer friendly and efficiently competitive financial intermediation.

**Policies followed in India**

A bank that has a large amount of NPAs on its balance sheet, has two options: To continue with the NPAs in its books while making loan loss provisions and initiating recovery of bad debt itself; or to write off such accounts and shift the bad assets to asset reconstruction companies (ARCs), to make its balance sheet clean. However, these decisions affect the financial health of the bank and hence are important to consider, in formulating proper policies to arrest NPAs. Carrying NPAs
on its balance sheet, has a deleterious impact on the functioning of banks in more
than one ways. If the bank continues to make provisions for NPAs year after year,
large parts of its profitability go under this head. Consequently, Capital Risk
Adjusted Ratio (CRAR) is affected severely with the contraction of its capital base
through decline in Tier I capital. This erosion of profitability may create several
problems on the bank’s functioning overtime and may even force the bank to close its
operations. Hence, banks adopt the other option to remove such assets from their
balance sheets through sale of their bad assets to ARCs. This leads to a lower
requirement for provisioning and the resultant increase in profits can be used to
enhance capital base, as the value of risk – weighted assets would go down with
removal of non-performing loans. Thus, selling bad debts to ARCs has a positive
impact on CRAR.

The problem of NPAs was first brought into focus by the Narasimham
Committee on financial system (1991), set-up at the advent of the liberalisation
process. The Committee stated that the genesis of the problem was in the laxity of the
prudential norms relating to income recognition, asset classification and provisioning.
The Committee placed emphasis on identifying problem loans of banks and making
provisions for such loans and so instituted a proper definition of NPAs. Apart from
identification of bad assets, the committee also suggested some ways to deal with
them. In order to speed up the process of recovery of problem loans, it recommended
the setting up of Debt Recovery Tribunals to adjudicate on bad debts of and an asset
reconstruction fund to take such loans off the bank’s balance sheets. At the same
time, the RBI took several other measures relating to freeing of interest rates on
deposits and advances, reduction of Cash Reserve Ratio (CRR) and Statutory
Liquidity Ratio (SLR) and deregulation of entry of new private sector banks.

The Narasimham Committee on Banking Sector Reforms (1998) suggested
the second-generation reforms for improving the financial health of banks. The
Committee mainly stressed upon improved capital adequacy ratio along with tighter
asset classification, income recognition, and provisioning norms. Subsequently, the
Verma Committee (1999), formed in order to formulate appropriate policies to deal
with weak PSBs, emphasized, “NPAs have been the single most vexing problem
faced by the public sector banks. Banks that have been identified as weak are mainly
so because of the loss of their income, high carrying costs of NPAs both in terms of their funding as well as provisioning and the general stagnation of operations caused by the NPAs in their books” (RBI, Report of the Working Group on Restructuring Weak Public Sector Banks, 1999, p. 39).

The Committee recommended substantial diminution of existing NPAs through the setting up of ARCs. The Committee also chalked out a detailed structure of ownership and functioning as such ARCs. The Confederation of Indian Industries (CII) Report (National Task Force Report on non – performing assets in the Indian financial system: an agenda for change, 1999), representing the view of the Indian corporate on this issue, also pleaded for NPAs removal from bank balance sheets with the help of ARCs.

In line with the recommendations of the Narashimam Committee and Verma Committee, a number of measures have been initiated to resolve the problem of NPAs.

A few of them are, settling up of Debt Recovery Tribunals (DRT’s) and Lok Adalats, formation of ARCs, setting up of Credit Information Bureaus and formulation of policies regarding one – time settlement and corporate debt restructuring. DRTs were set-up in 1993 to speed up the recovery proceedings initiated by banks. However, the performance of these DRTs has been far from satisfactory. As on June 30th, 2003, out of 57, 915 cases (involving Rs.82,266 crore) filed by banks to DRTs, 22,163 cases (involving Rs.19,633 crore) have been adjudicated and the amount recovered so far stood at Rs.5,787 crore. (Reserve Bank of India, Report on Trends and Progress of Banking in India, 2002-03, p.26).

The legal recovery process is further prolonged in cases under the Sick Industrial Companies Act (SICA) and with the Board for Industrial and Financial Reconstruction (BIFR): As pointed out by RBI Bulletin (1999), a large part of the NPAs of the PSBs is chronic and locked in legal proceeding or with the BIFR, and some part is nearly irrecoverable because of defaults by the public sector units despite the loans being guaranteed by the Government. The poor record of recovery makes it evident that lack of well – functioning legal procedures and undue delay
involved in the judicial system were mainly responsible for the failure of the recovery process. In an attempt to remove the constraints faced in the recovery process, the Government has recently made a number of significant moves.

Proposals have been made for the abolition of the SICA and BIFR and the formation of National Company Law Tribunal (NCLT), which is expected to consolidate the powers of BIFR, High Court and Company Law Board to avoid multiplicity of forums. In matters of rehabilitation of sick units, all concerned parties are supposed to abide by the orders of NCLT. In addition, the periodic publication of a list of willful defaulters and the suit-filed cases not only revealed some interesting features of the NPA profiles but also made recovery easy for banks. However, the most drastic step, taken so far, which has far-reaching implications for the recovery process, is the enactment of “The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002” (SARFAESI Act, 2002) by the Government. This act aims at changing the legal system for securitisation, empowering banks, and financial institutions to take possession of the securities and sell them without going through the protracted judicial process.

The legislation not only permits the setting up of asset securitisation or reconstruction companies that can acquire the financial assets of any bank or financial institution by issuing a debenture or bond, but also identifies measures of asset reconstruction and enforcement of security interest, after allowing the borrower a 60-day time limit to settle the dues, without the intervention of court or tribunal. Banks can even take over the management of the defaulting units. Apart from bringing about reforms in order to make the recovery process smooth and quick, Government has also taken steps towards removing NPAs from banks’ balance sheets through ARCs. Since the enforcement of the SARFAESI Act till end June 2003, PSBs have issued 33,736 notices for an outstanding amount of Rs.12,147 crore and have recovered Rs.499.20 crore from 9,946 cases (Reserve Bank of India, Report on Trends and Progress of Banking in India, 2002-03, p.28).

Following the unequivocal suggestion of several committees, The Asset Reconstruction Company (India) Ltd. (ARCIL), India’s first ARC, has commenced operation with an initial equity of Rs.100 crore. ICICI Bank, IDBI and SBI (State
Bank of India) have picked up 24.5 percent stake each in ARCIL, with the remaining equity has been contributed by IDBI Bank, HDFC Bank and UTI Bank. A trust formed by ARCIL will issue units in exchange for NPAs purchased from banks and financial institutions (Business Standard, 26th June 2003, p.45).

Moves are afoot for preventing new NPA creation as well. Apart from significant strengthening of prudential norms, the RBI has instructed banks to improve screening and monitoring of loans and disclose more information in order to enhance the transparency of the system. RBI is emphasizing the establishment and enforcement of internal procedures for the management of risk, credit assessment, and approval, and monitoring of borrowers’ performance to ensure timely payment of interest as well as principal.

The setting up of Credit Information Bureau of India Limited (CIBIL) in 2001 is also an important step, since it provides an institutional mechanism for sharing of credit information on borrowers among banks and financial institutions. These mechanisms have led to perceptible increase in the recoveries by the SCBs from Rs.9, 716 crore during 1998-99 to Rs.23, 302 crore during 2002-03.

**Importance of the study**

Non-performing assets are the index of banking health. One of the major hurdles in Indian Banking today is its ever-growing size of non-performing assets. “Non-performing assets” are affecting the profit of the bank and it could not allow the bank to meet its capital adequacy ratio. So, bankers are paying much attention towards non-performing assets.

In this critical situation, it is felt necessary by the researcher to conduct a study about the NPAs in commercial banks. The present study highlights the level of NPAs in public sector banks, private sector banks and foreign banks for a period of 10 years. The researcher has given some suggestions to minimize the NPAs in commercial banks, which would be quite useful to the planners, and policy makers in the banking industry.
OBJECTIVES OF THE STUDY

The study has been undertaken with the following objectives:

1. To study the prudential norms in the Banking Industry.
2. To study the concept and significance of non-performing assets in Indian Banking Industry.
3. To know the causes of NPAs.
4. To find out the level of NPAs in Public Sector Banks, Old and New Private Sector Banks and Foreign banks operating in India.
5. To know the existing systems/procedures for NPAs identification.
6. To study about the "Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act" (SARFAESI); and
7. To offer suggestions to minimise the level of NPAs.

METHODOLOGY

The study is based on secondary data. The researcher experienced much difficulty in collecting data relating to NPAs of Commercial Banks. But with the concerted efforts of the researcher and able guidance of the guide, it was possible to collect the required information pertaining to the study. In this regard, IBA Bulletin, RBI Bulletin, Trend and Progress of Banking in India, The Economic Times, The Chartered Accountant, Annual Reports of Banks, Financial dailies, other magazines and journals were referred to.

The Public Sector Bank consists of 19 Nationalised banks, One New Public Sector Bank namely IDBI Ltd., State Bank of India and its 7 Associates. But now there are only 6 Associates of State Bank of India because State Bank of Saurashtra was merged with State Bank of India itself.

There were 25 Old Private Sector Banks in India. But now there are only 14 Old Private Sector Banks because the Bank of Madura Ltd. was merged with the ICICI Banking Corporation Ltd., Bharat Overseas Bank Ltd. was merged with Indian Overseas Bank, The Sangli Bank Ltd. was merged with ICICI Banking Corporation Ltd. and Development Credit Bank Ltd. has become New Generation Private Sector Bank, Lord Krishna Bank Ltd. is now a part of HDFC Bank Ltd., Nainital Bank Ltd. is associated with Bank of Baroda, The Nedungadi Bank Ltd. was merged with
Punjab National Bank, Ganesh Bank of Kurundwad Ltd. was amalgamated with The Federal Bank Ltd., The Benares State Bank Ltd. was amalgamated with Bank of Baroda, The United Western Bank Ltd. was merged with IDBI Bank Ltd. and Bareilly Corporation Bank Ltd. was merged with Bank of Baroda.

There were 11 New Generation Private Sector Banks in India. But now there are only 7 New Generation Private sector banks because the Times Bank Ltd. was merged with HDFC Bank Ltd., Global Trust Bank Ltd. was merged with Oriental Bank of Commerce and IDBI Bank Ltd. has become a Public Sector Bank, Bank of Punjab Ltd. was merged with Centurion Bank Ltd. and Centurion Bank Ltd. was merged with HDFC Bank Ltd., Development Credit Bank Ltd. has become New Generation Private Sector Bank.

There were 50 Foreign Banks in India. NPAs of all the above banks have been analysed in this study.

**Period of study**

This study has been conducted for a period of 10 years i.e. from 1996-97 to 2005-06.

**Tools of Analysis**

Arithmetic average and Standard Deviation are the tools used in this study.

Analysis of variance and POST.HOC tests are used. The collected data have been processed both manually and with the help of computers also. SPSS package is used to analyse the data.

**Hypothesis**

Private Sector Banks, Public Sector Banks and Foreign Banks have the same level of NPAs.
Chapter Arrangement

This study consists of seven chapters.

Chapter I deals with Indian banking system, policies followed in India, importance and objectives of the study.

Chapter II deals with review of 59 different studies conducted at individual and group levels in India and abroad over the last two decades.

Chapter III explains the concept of NPA in banking industry, factors affecting NPAs and its significance. Also explains Prudential Accounting Norms.

Chapter IV deals with existing systems/procedures for NPA Identification at Commercial banks. In this regard various risks namely Credit risk, Market risk, Liquidity risk, Interest rate risk, Foreign exchange risk, Country risk, Operational risk are explained and different approaches are also explained.


Chapter VI deals with the Analysis of NPAs in Indian Banking Industry among Public Sector Banks, Private Sector Banks and Foreign Banks operating in India.

Chapter VII deals with the Findings and Suggestions.