CHAPTER-I

INTRODUCTION
One of the major areas of macro-economy which has been the subject of focused attention is the efficiency and soundness of the financial sector. How well a bank employs its resources and simultaneously minimizes its costs and maximize revenue. Within the broad scope of the financial sector, a stable and properly performing banking system has heightened due to universalisation of banking operations with continuing deregulation, more competition and technological development leading to the transformation of a bank from an intermediary between the income saver and the borrower to a more customer-centric entity. Since, majority of the Indian financial sector assets come from the banking system, it is all the more important to study the efficiency of the Indian commercial banks, understand the potential risks involved and develop policy measures towards a more stable and vibrant banking system.

Indian financial network under the governance of Reserve Bank of India occupies an important and strategic place in the financial discipline leading to acceleration of economy facing the challenges in the scenario of global competition. The commercial banking sector needs to work flexibly to overcome the confronting economic problems as well as policy measures in order to gain an effective and a purposeful role in making to march the economy of a nation. It is the commercial banking system on which depends the process of acceleration of economy as mobilize of savings and deployer of credit.

A successful operation of the banking sector in accelerating the economy of country entirely depends upon taking sound decisions for healthy operations and thereon an effective implementation of those decisions in ever-changing competitive
An effective policy coupled with a healthy organization is half-baked; the other half is the prudent management. Both these factors are equally responsible for effectively implementing the right things for attaining the expected results of an organization.

Non-performing asset may spill over the banking system and contract money stock, which may lead to the economic contraction. This spill over effect can canalize through liquidity or bank insolvency (a) when many borrowers fail to pay interest which affects liquidity shortage and jams payment across the country, (b) illiquidity causes a constraint to the bank in honoring the demand of depositors, and (c) undercapitalized bank exceeds its capital base.

**CAMEL AS A MANAGEABILITY TOOL**

For success of a planned economy and undertaking proper credit planning, it is essential that the control of banks do not remain with a few private players. In response to this, nationalization has taken place to (a) break nonoposony control of large business houses over banking system, (b) spared banking services to the rural areas and (c) mobilize funds for priority sectors like agriculture, small enterprise, export sector, etc. With focus on social obligations, branch network expansion undertake the priority sector lending activities, and the objective of spreading banking activities to the masses was achieved. But, it took a heavy toll on profitability and efficiency of Indian commercial banks. Reserve Bank of India has initiated gradual deregulation of banking sector so that scarce investable resources are put to more productive use with acceptance of the Narasimham Committee report in 1992. The nationalized banks had a setback in terms of profitability in the initial period of
reforms mostly because of stringent norms adopted for classification and income recognition. Indian banking is at a critical juncture.

The soundness of commercial banks has deteriorated due to low profitability; fall in quality of customers service and customers relationship management, corruption even by the staff of banks, slackness in supervision and monitoring controls, etc., apart from the natural calamities being effected on the working of banking sector. India banking system which is stricken by loans write-off, political appointments and life sapping diseases of a similar nature, needs to be reviewed and revamped in its totality.\(^1\) The Narasimham Committee said that the approach to the issues of financial sector reforms is to ensure the services of financial industry so as to operate on the basis of operational flexibility and functional autonomy with a view to enhancing efficiency, productivity and profitability\(^2\). It is high time for the commercial banks to look inside themselves and see whether they are equipped to meet the challenges of the Indian economy which being integrated with the globe for gaining opportunities. An indepth analysis of their working in terms of strength and weakness internally and opportunities and threats externally is necessary. The steps to be taken are to eliminate or at least reduce those weaknesses and create conducive climate avoiding threats while consolidating the strong points.\(^3\)

Tremendous increase of service in qualitative dimensions caused an enormous strain on banks in terms of manpower, infrastructure facilities, systems and procedures, and management capabilities which leads in customers’ service falling beyond their expectation. It is appropriate to quote that the quasi-monopolistic intermediation of the public sector commercial banks over the last twenty years will not last very long.\(^4\) Under this situation, the public sector commercial banks is facing a stiff competition
from the foreign commercial banks and Indian private sector commercial banks; and resultantly finding difficult in attracting deposits from surplus income people with a view to maximize profit as the cost of deposits is low. Hence, banking is a service-oriented industry which must be of high quality with standards to safeguard tomorrow’s banking.

Faith is a key credential aspect but a bank cannot run on faith alone neglecting the aspect of business in charging even a little profit. Innovative thinking on the issue of banking policy did commence towards quality of services to be offered by the banking sector; patronize such services managerially and financially. Inter-and-intra banking competition has been on the move nationally as well as globally due to the changing environment across the globe. To find the means of mechanism for effective transactions to attain the anticipated results even facing competition nationally and globally is the need of the hour and the order of the day.

To know the feasibility of financial operations of commercial banks, one needs to resort to study not only manageability but also the position and pattern of funds. Hence, the study of (i) Capital adequacy, (ii) Asset quality, (iii) Management, (iv) Earnings and (v) Liquidity System and Control, a five point scale is appropriate measure to know diligently the operations carried by the commercial banks. This measure is abbreviated as CAMEL and assumes a significant importance for knowing how safely and soundly Indian commercial banks are footing, to what extend their operations are healthy and what they contribute towards the good progress of the society.
STATEMENT OF PROBLEM

Non-performing assets (or bad debts) was first realized in early 1990s. Today, they assumed great importance accounting over ₹ 150000 crore in banking institutions. Gross non-performing assets reflect the quality of loans made by banks whereas net non-performing assets show the actual burden of banks. Now, it is increasingly evident that they need to take the strategic initiatives to reduce the magnitude of non-performing assets in time bound.

Commercial banks particularly the public sector commercial banks figure prominently in the debate not only because they dominate the banking industries, but also since they have much larger non-performing assets compared with that of the private sector commercial banks. This raises a concern in the banking industry and academia, because the non-performing assets, generally felt, not only reduce the profitability but also weaken the financial health and erode the solvency of commercial banks.

To acclaim the defined purpose and pace progress in an orderly approach, a bank has to undertake the quality business operations with prudential norms and professional management in ever-changing competitive environment. It is imperative. Though the performance of Indian banking sector is significant in terms of quantitatively but coupled with mounting overdues which push its operations into no viability. If this melody continues, it becomes a sinking ship in the whirlful nature of current competitive sea. For making the banking operations more effective yielding better working results and achieving high managerial efficiency, a bunch of norms were recommended by the Narasimham Committee under the nomenclature of reform. The implementation of these norms has also completed about a period of two decades, yet the banking sector has been facing the alarming threat from non-performing
assets. It is a right time to diagnose the achieved results of commercial banks under the reforms which disclose the causes of and reasons for such state of affairs. Hence, the present investigation on non-performing assets in commercial banking sector under reforms.

REVIEW OF LITERATURE

To know the working results of any business concern, research on such concern is so essential on which a policy prescription can be made. Institution without right policy is like "building a house on sand." It means an effective management of bank always needs a thorough and critical examination into the nature of and the reasons for consequences. By doing this, the researcher gets comprehensiveness on literature which ensures thorough knowledge and identify gap, if any. In line of this, review of literature is made on the subject to have an indepth insight into the nature of problem. Attempt is made to review and found the specific remarks of earlier studies on the subject which is presented below.

Describing Chilean crisis, Lorraine Mauricio identified the causes to the macro-economic problems such as unsound financial practices and permeation of entire financial system affected about 60 percent of total loan portfolio. Some banks were liquidated while others rehabilitated. Rehabilitated banks aimed at improving borrowers' capacity to repay loans and rebuilding capital base of the banks.¹

Narasimham Committee on Indian Financial System described the public sector commercial banks achievement of social aims in terms of extending the geographical reach and functional spread of banking services which are impressive. This achievement is at the cost of decline in productivity and efficiency; the consequence of this is serious erosion of profitability. Responsible factors are the macro
environment externally; and micro-environment (organization, staffing and branch spread) internally. Growth of overdues is a consequence of the measure of laxity and departure from the principles of sound lending. The Committee has recommended for implementation of international standards in the matters of capital adequacy and income recognition and asset classification norms in phases, and called for reforms in legal aspects to speed up the recovery process of delinquent loans.  

Kallu Rao and Shaji Thomas in their study found that “the deposits are growing at compound rate along with advances to agriculture and rural industries, and observed an increasing trend in recovery rate with an average of 50 percent.” “The recovery position of commercial banks and regional rural banks are affected to a large extent by the loan-wavier promises made by some political parties” is the opinion of Gayathri.  

McGoven John in a study of loan losses of US banks argued that character has historically been a paramount factor of credit and major determinant in the decision to lend money. Banks have suffered loan losses through relaxed lending standards, unguaranteed credits, the influence of 1980s culture and the perception of borrowers. He suggested that bankers should make fairly accurate personality, morale, profile assessment of the prospective and current borrowers and guarantors. Apart from personal interaction, the banker should know the morale and loyalty of staff, personal credit worthiness, check trade-credit reference from both the present and the former bankers and determine how the borrower handles stress. Further borrower’s guarantee is being provided through the Government guaranteed loan programs and adopts a conservative loan-to-value ratio.
Toor, N.S., studied the recovery of non-performing assets through the process of compromise by direct talks rather than by the lengthy and costly procedure of litigation. By constant monitoring, he suggested, it is possible to detect the sick accounts and the incipient sickness of a unit in the early stages itself and review it and put it back on the road to recovery.10 De Juan reviewed a multitude of cases in many countries to infer a simple reason for bank failure is poor management.11

On examining the problem relating to the non-performing assets in the banking industry, Mallaya, K.G., draws attention to an urgent need to create conducive recovery climate and to make borrowers understand that the funds borrowed from banks are to be repaid in time and in full to honor the depositors’ demand. He suggested that the banks should take steps for educating them. If the non-performing assets are not fully eradicated, they become as dangerous as cancer and ruin the very existence banks.12

At the inaugural address of the 18th Bank Economist Conference, Narasimham M, stated that “though the overall progress made by the financial system in terms of geographic and functional coverage, but its operational efficiency has been unsatisfactorily characterized by low profitability, high level of non-performing assets and relatively low capital base.”13

On identifying macro-economic volatility (domestic and external), Morris Goldstein and Philip Turner stated that the asset price collapse and surges in capital inflow, increasing bank liabilities with large maturity/currency mismatches, inadequate preparation for financial liberalization, heavy Government involvement and loose controls on lending, weaknesses in accounting procedure, disclosure and legal
framework and distorted incentives for bank owners, managers and creditors, as well as bank supervisors are the factors that result in banking crisis.14

On eighty-six episodes of bank insolvency covering the macro and micro-economic factors, Caprio Gerard Jr. and Daniel Klingebiel have stated that in bank crisis, few Governments have responded well to these episodes. Deregulation proceeded faster than improvement in financial infrastructure and poor incentives led to the crisis. For better managing insolvencies, the policy makers must develop a regulatory framework allowing banks to respond more robustly to the shocks and provide an incentive to the bankers.15

Non-performing loans in China, India and Indonesia have been particularly heavy in the State sector. The nations with the highest share of State owned banks are, on average, also the ones with the higher operating costs and the higher incidence of non-performing loans.16

The biggest ever challenge that the banking industry now faces is the phenomenon of non-performing assets. “Inadequate management competence of bank is a major cause of non-viability of rural branches of many public sector banks.”17

In the study of non-performing assets in Italy, Sergio found that an increase in riskiness of loan assets is rooted in a bank’s lending policy adducing inadequate assessment of sectoral prospects. Further, an increase in bad debts as a consequence of recession alone is not empirically demonstrated. The bank-firm relationship proves effective not so much because it overcomes information asymmetry but because it recoups certain canons of appraisal.18

On four hypotheses namely bad luck, bad management, skimping and moral hazard, Allen N. Berger and Robert De Young found that the hypothesis of bad luck is due to
exogenous events can cause non-performing loans, the bad management is due to poor run banks which can cause both cost and loan underwriting, the skimming hypothesis is due to low cost by under-spending on loan underwriting and monitoring in the short run; and the moral hazard is due to cause capital negatively, which in turn cumulatively cause non-performing loans. Increase in non-performing loans tends to be followed by decrease in cost efficiency. Decrease in cost efficiency is generally followed by increase in non-performing loans; it is of bad management practices, which are manifested not only in excess expenditures, but also in monitoring practices that eventually lead to non-performing loans.¹⁹

Patrick Honahan observes that poor management, micro-economic deficiencies and Government pervaded banking system are major causes for banking failures. Poor lending decisions based on over-optimistic assessment of creditworthiness, willingness to repay or recoverability of the delinquent loans; undue concentration of lending or overly rapid expansion exceeding the capacity of bank lending function or even exceeding the economy's potential to generate bankable projects are the reasons for the failure of individual bank.²⁰

In spite of care taken by the bank management in assessing the lending risk, it may not always be possible to keep the level of non-performing assets under check. Krishna Murthy stated that: “It is a fact that public sector banks are usually saddled with a higher level of non-performing assets than the private sector ones.”²¹

For an indepth analysis of loan losses due to different variables affecting loan repayment such as (a) limitations on the access to credit (b) macro-economic stability (c) collection technology (d) bankruptcy code (e) information sharing (f) judicial system (g) pre-screening techniques and (h) major changes in financial market
regulation, Fuentes and Maquieira found that a satisfactory performance of credit market in terms of loan repayments which hinge on a good information sharing system, advanced collection technology, macro-economic performance and major changes in the financial market regulation.\textsuperscript{22}

The Narasimham Committee Report had pointed on classifying Indian banking sector into (i) phase of the curative measures-ensuring the banking sector more oriented to the market and impart competition to the environment and (ii) phase of the preventive measures - enhancing smooth functioning of the banking sector in long-run. The latter is recommended primarily on privatization and reduction of Government stake, more stringent capital adequacy, asset classification and provisioning norms, and establishment of asset reconstruction companies. Banks were asked to avoid the practice of ever-greening and any effort at financial restructuring must go hand-in-hand with operational restructuring. Also asked to ensure along with the cleaning up of the balance sheet, simultaneously steps are taken to prevent/limit re-emerging of new non-performing assets.\textsuperscript{23}

In the past, the public sector commercial banks have impressive progress in terms of deposits mobilization, credit dispensation, lending to deprived social segments, geographical expansion, functional reach and diversification. According to Rajendra Kumar Jain, "the Government must get down to the planning of a phased programme to remove the burden of non-performing assets from the banking sector. This would not only increases the liquidity of banks but also result in a more effective, albeit, slightly, costlier credit delivery system to the priority sector."\textsuperscript{24}

On the alarming level of non-performing assets in Indian banking sector, the Narasimham Committee said that "the directed credit has a proportionately higher
share in non-performing assets portfolio of banks and has been one of the factors in erosion in the quality of bank assets.”

In the opinion of Rashid Jilani, “non-performing assets are not just a problem for banks. They are bad for the economy.” Taori said: “The quality of loan assets is the most important factor for the basic viability of the banking system. Spiraling of non-performing assets is hurting the commercial banks profitability by way of both non-recognition of interest income and loan loss provisioning.”

A bank with most viewing problem of non-performing assets is termed as weak bank. In other words, it suffered from loss of income, high carrying costs of non-performing assets, both in terms of funding as well as provisioning and the general stagnation of operations caused by the non-performing assets in its books. Verma Committee stated that a sizeable portion of non-performing assets with the public sector banks is chronic. Further, a significant portion of non-performing assets is locked in legal proceedings. There are also loans given to State or Central public sector units which failed to repay. The Committee opined that the quickest and possibly the most effective way of removing the non-performing assets from the books of the weak banks would be to move out these to a separate agency called Asset Reconstruction Company which will buy these loans from the banks and make its own efforts for their recovery apart from internal organizational restructuring of the weak public sector banks.

Siddiqi, Rao and Thakkar, Department of Banking Supervision, Reserve Bank of India have analyzed the causes and composition of non-performing assets and observed this. Besides, the internal factors like weak credit appraisal, non-compliance and willful default, the external factors such as preponderance of certain traditional
industries which are suffering from serious inherent operational problems, natural calamities, policy and technological changes causing increase of the incidence of sickness, labour problems and non-availability of raw materials. The study concludes that the reduction of non-performing assets in banking sector should be treated as a national priority item to make the Indian banking system stronger, resilient and geared to meet the challenges of globalization.29

Naik noted that the percentage of non-performing assets to total assets of private sector banks and foreign banks, on an average, is far lower than the public sector banks. Influence to grant credit, erosion in decision making capacity to finance when badly needed to bring the borrowers out of difficulty; ineffective legal machinery and transition of Indian economy are the contributing factors to non-performing assets.30

Confederation of Indian Industry’s task force on non-performing assets in the Indian financial system recommends that several public sector banks and financial institutions either be closed down or privatized; and legal reforms be introduced to enable quicker liquidation of defaulting companies in order to enable the recovery of dues by the banks.31

Brian Peters recognizes and discloses bank losses in a timely manner. Many banks throughout the world have been slow to recognize losses and begin the process of working out bad debts. This has left banks and, in some cases, entire banking system saddled with a mountain of bad debts, which freezes their growth. He viewed, in the United States, the accrual of interest on impaired loans and capitalization of interest is practices that are frowned upon and usually avoided at all costs.32

In meeting the challenges of globalization, Taori is of the opinion that “there is a need to treat reduction of non-performing assets in banking sector as national priority item
to make the Indian banking system more strong, resilient and geared to meet the challenges of globalization." The recovery of big loans continued to be a problem despite the ‘fairly liberal’ settlement scheme announced by the Central Bank.\textsuperscript{34}

The Great Saint poet Tiruvalluvar said this: Thou can conquer even the whole world if thou choose the proper time and the proper objectives. “The banking industry should act in concert with the unity of motive and chalk out strategy. If this is done, the banking industry could add one more feather to its cap for having successfully tackled the perilous phenomenon of non-performing assets.”\textsuperscript{35}

It is not a particular sector or purpose or class of borrowers, for which overdue or bad loan confine, but it is the big borrowers who contribute much to the product of bad loans. Commerce and industry account for around 70 percent of the total non-performing assets of the banking sector. Analysis of non-performing assets over ₹ 50 crore shows that it is the big corporate who are closely associated with the major chambers of commerce are to be blamed the most.\textsuperscript{36}

“The high share of non-performing assets in the credit portfolio of a bank, particularly the public sector commercial banks, has become a matter of great concern for the mandarins of the financial system.”\textsuperscript{37} Taori has explained as: “Non-performing asset is a double edged weapon which affects bank’s profitability due to interest income not being recognized on non-performing assets account, and the loan loss provisions to be created from profits earned.”\textsuperscript{38}

Niran Bhiraban stated that the main factors contributing to the inability to repay the loan were found to be the national economic downturn which lead to depression for business in general; reduce buying ability of consumers; misuse of loan and the combination internal and external debts of debtors. Non-performance assets are
mainly due to the bank’s negligence in monitoring and follow-up measures while the debtors concealed some true data in their applications.  

Utaiwan Kanjananirint used probit model to find factors affecting non-performing loans’ reduction in Government Housing Bank, Lamphun Branch, Thailand. It was found that there were four influencing factors of non-performing loans reduction namely the client’s cooperation, the client’s residential area or hometown, the length of loan payment and the ratio between loan amount and the value of collateral assets. 

Pradeep Raje critically appraised the reform agenda thus: Failure to tackle the complex problems in supporting the real sector as well as institutional restructuring issues within the banking sector lacked in the Indian reform agenda. This can be traced due to lack of political will to tackle many dimensions of the problem at the same time.  

Ding Lu, Shandre M. Thangavelu, Qing Hu have observed a link between non-performing loans and lending behavior in China’s State owned banks. The Chinese Government took over huge amount of bad loans from the major State owned banks through its four State-sponsored asset management companies overwhelmed the efforts to improve banking management, resulting in more lending bias, slacker credit rationing to the worse-than-average-risk firms and continuous credit liquidity to keep afloat the firms in deep financial distress.  

In the study on gross and net non-performing assets of all public sector banks from 1998 to 2000, Nambirajan could find marginal increase of non-performing assets. That corporation bank has got lowest non-performing assets (16.81 per cent).
interest margin applied by the financial institutions should include the premium for the risk of non-performance on granted loans" is the opinion of Bolem and Gorter.\textsuperscript{44}

Khan and Bishnoi categorically stated that Indian banking is a case of banking distress during the period of 1991-99; profitability, non-performing assets and capital adequacy are the indicators of banking distress in India.\textsuperscript{45}

With the economic liberalization and imminent globalization, the problem of non-performing assets will assure complex dimension. Describing India as one of the least globalized and lower recipient of capital, Jalan, the then Governor of Reserve Bank of India said this: "More reforms were needed internally for integration with world economy".\textsuperscript{46}

Bidani said "banks should try to list out the specific cause which is responsible for increasing non-performing assets and evolve strategic plan for their removal. Such an approach would not only help banks in bringing down the existing non-performing assets but also check slippage of performing accounts into this category."\textsuperscript{47} Interest rate deregulation, non-performing assets, direct lending, ownership structure, legal frame work, etc., are weaknesses in banks after second generation of reform.\textsuperscript{48} Indira Rajaraman and Garima Vashishta's identified the relation between the non-performing assets and the operating efficiency.\textsuperscript{49}

Muniappan observed that the problem of non-performing assets is not just limited to bankers but also to the financial system as a whole. Hence, both lenders and borrowers should realize their roles, responsibilities and appreciate the difficulties of each other to work towards a healthy financial system.\textsuperscript{50}
Bhide, Prasad and Saibal Ghosh have identified various weaknesses in banks after second generation of reforms namely interest rate deregulation, non-performing assets, direct lending, ownership structure, legal framework, etc.\(^5\)

Michael Debabrata Patra and Sunando Roy opined that the complementarity between macro-economic and financial policies has provided a sound infrastructure for an overhaul of the financial system in the pursuit of international standards. The empirical results indicate that those banks which have secured the greatest reduction in non-performing assets have reaped the maximum gains in terms of profitability or at least in terms of unshackling financial performance from policy intervention. For the Indian banking system, the adjustment to macro and micro prudential regulations has been relatively rapid although the speed of adjustment has varied across the industry.\(^5\)

Eswar K said that “as our markets and customer requirements change, and hence the positioning strategy needs to be modified. Positioning is not a one-time effort. It is a constant pursuit.”\(^5\)

Suresh Krishna Murthy said this: “Public sector banks, hitherto seen as the Government’s white elephants, have entered into a golden era. Reduced non-performing assets and better operating practices have turned these enterprises into a force to reckon with.”\(^5\)

Chandra Shekhar opined that “the most important dimension of Indian banking sector reforms is reducing the non-performing assets. In fact, the whole effort to reform the banking sector would collapse if the banks are not able to reduce their non-performing assets. It would be impossible for a bank with high non-performing assets to be either vibrant or competitive. What are these non-performing assets? These are the assets that do not yield any return.”\(^5\)
On default of bank loans, Jimenez and Saurina made observation that collateralized loans had a higher probability default, loans granted by savings banks were riskier and a close bank-borrower relationship had a positive effect on the willingness to take more risk.\(^5^6\)

On comparing the efficiency and productivity of public sector banks relation to the private sector banks (both domestic and foreign) over a nine year period (1992-00), Ram Mohan and Subhash C. Ray concluded that there is no significant difference in productivity, growth and efficiency between the public sector banks and the private sector banks.\(^5^7\)

Profitability of the public sector banks did improve on relative basis compared to the private and foreign banks, but they have lost ground in their ability to attract deposits at favorable interest rates, technological up-gradation, their staffing and employment practices which have implications in their longer-term profitability is the observation of Errol D’ Souza.\(^5^8\)

Saibal Ghosh and Subhra Bhattacharjee studied the relationship between the net interest margins and the gross non-performing assets, size of bank, off-balance sheet exposure, leverage ratio and index of risk of public sector banks in India and concluded that the gross non-performing assets have a negative impact on the net interest margin (NIM) and the coefficient is (-) 0.41.\(^5^9\)

Paramita Mukherjee empirically studied that the reduction of non-performing assets is not the unique but only solution to the problem of weak banks. The banks must also take into account the capital base and the cost aspect in order to maintain good performance in terms of profitability and solvency.\(^6^0\) While critically analyzing on bank’s investment portfolio and lending policy, Rakesh Mohan viewed that banks
have resorted to huge investment in Government securities drastically cutting down their advances to the real sector showing their reluctance to take risk.\textsuperscript{61}

Vaswani, T.A., conducted a study and concluded that "banking institutions today form the heart of financial structure of a country, whether it is developed or developing, rich or poor, advanced or backward in science and technology."\textsuperscript{62}

Banks, in the opinion of Banking Commission, have the important task of inducing savers to hold their savings in the form of socially useful assets, of which bank deposits are the most important.\textsuperscript{63} Howard Crosse and George Hempel examined commercial bank’s functions, structure and risks; and described how they should attract deposits.\textsuperscript{64}

On spread of banking geographically and functionally with wider area and much larger segment of population than it did in the pre-nationalization, the then Finance Minister said this: “The progress has been some what uneven and while regional disparities in banking development have been narrowed to some extent, a lot remains to be done.”\textsuperscript{65}

While saying the performance of banking sector was better and the development imperatives of the country call for much more than what has been achieved, Ragupathy said this: “If the objectives are not yet fully achieved, the fault does not lie entirely with bankers. The fault lies in our not being able to integrate all powerful instruments of development into an effective system.”\textsuperscript{66}

Agarwal. H.N, precisely described the social obligation of nationalized banks, their management, branch expansion, deposits mobilization, credit delivery and the role of commercial banks in the developing Indian economy.\textsuperscript{67} On the significant changes that have occurred in the Indian banking system since nationalization, particularly in
deposits mobilization and credit deployment, Rangarajan expressed that the impact of interest rate change on the deposits, advances and operational efficiency of Indian public sector banks.68

Report on Trend and Progress of Banking in India, it is pointed out that banks would need to do proper risk identification, classify risks and develop necessary technical and managerial expertise to shade away risks. Banks facing major categories of risks are market risk, credit risk, legal risk and operational risk.69

On comparing the performance of public sector banks, Das found that while there is an increase on non-interest income, banks have tended to show risk-averse behavior by opting for risk-free investments over risky loans.70 Thingalaya observed that the process of de-regulation of the interest rate structure is certainly a welcome measure to improve the competitive efficiency of banks.71

In the words of Kulakarni, “Nationalization of banks in 1969, no doubt, produced the desired results, but at the same time created a number of weaknesses and problems for them and within the system as a whole. They are (a) deterioration in customers’ service (b) development of a culture to please people who mattered for one’s career (c) publishing of ‘no fair view’ balance sheets to avoid the stigma of showing losses and (d) lack of transparency in overall operations.”72 Tapora, S.S., with great foresight on the banking sector said that “nationalization is not the best means of achieving a national institution”73

“Transparency of banking operation ensures effective marketing discipline and serves as a potentially crucial mechanism for keeping banks prudent”.74 Reserve Bank of India in its Report on Trend and Progress of Banking in India pointed out that bank mergers are a possible avenue for improving the structure and efficiency of the
banking industry. It is possible to categorize the motivations for bank mergers into four viz., cost benefits (economic of scale, organizational efficiency, funding costs and risk diversification) revenue benefits (economies of scope, enhancing monopoly rents) economic conditions (mergers after crises or after the upswing of the business cycle) and other motives (private managerial benefits, defense against takeovers etc.)

Recently, the Government has been looking at consolidating the banking industry. The idea of encouraging mergers among banks to create ‘global sized’ institutions sounds attractive but may not be the right way to boost capital adequacy. The merged entity’s capital will be just sufficient to support the aggregate business. A merger does not necessarily free capital from either of the merging banks. Any of the existing public sector banks is unlikely to have ‘spare’ capital. Moreover, there are fundamental objections to the merger route. The Finance Minister has advocated gradualism, preferring individual banks to decide. The Reserve Bank of India feels financial inclusion is a more important objective than bank consolidation.

Karamala Padmashree conducted a study on reforms of commercial banks and examined the performance of banking sector in terms of branch network, mobilization of deposits, deployment of credit, priority sector services, non-performing assets, profitability and productivity.

Muniappan, G.P., focused on two areas. First, challenges faced by bank management and second, management of challenges by banks. Every aspect of functioning of the banking industry, be it profitability, non-performing assets management, customer service, risk management, human resource development etc., has to undergo the process of transformation to align with the international best practices. He concluded
that the future of Indian banking system needs a long-term strategy which would broadly cover areas of structural aspects, business strategies, prudential control system and integration of markets, technology issues, credit delivery mechanism, and information sharing.\textsuperscript{78}

The Hindu in its Economic Survey states that the liberalization and growing integration of the Indian financial sector with the international market, the supervisory and regulatory role of the Reserve Bank of India has become critical for the maintenance of financial stability. The Reserve Bank of India has been continuously fine tuning its regulatory and supervisory mechanism in recent years to match international standards.\textsuperscript{79}

Reddy Y.V opined that banks' lending policy could have crucial influence on non-performing loans. The issue of credit culture is of paramount importance in addition to institutional, legal change and policy initiatives. Banks should work towards evolving conducive credit culture and perhaps the critical factor on which it's anchor is fairness. Honest repayment by a borrower must be honored and recognized in the form of soft credit terms.\textsuperscript{80}

Rajiv Ranjan and Sarat Chandra Dhal have observed in their study that the terms of credit variables have significant effect on the banks' non-performing loans in the presence of bank size and macro-economic shocks. Factors like horizon of maturity of credit, better credit culture, and favorable macroeconomic and business conditions lead to lowering of non-performing assets.\textsuperscript{81}

Sujata Visaria adopted the micro data set on project loans to examine the effect of reform in India aimed at speeding up the formal legal system (i.e. Debt Recovery Tribunal) of dispute settlement between the banks and the defaulting borrowers.
Results show that borrowers between 2 to 14 percent are less likely to become delinquent on loans as a result of this reform.\textsuperscript{82}

The Union Finance Minister, Chidambaram said that “Our banks are today among the strongest pillars of Indian financial sector.” He further said that, “the public sector banks in the country are among the strongest pillars of the world banking industry.” This conclusion is based on the factor that our banks are strong because of strong traditions built in the Indian institutions.\textsuperscript{83}

“Wide indiscriminate grant of credit must be avoided; credit policy should definitely not deny finance to productive purposes. There is a need to speed up the development and infrastructure prospects in the country and improve that bank credit is available to all sectors, sections and units across the scale.”\textsuperscript{84}

Bank never considered the possibility of a large decline in house prices despite wide spread warnings that were in midst of a monstrous housing bobble. “The financial crisis was not an act of Government. It is resulted from acts of men and women.”\textsuperscript{85}

Indian banking sector, according to McKinsey & Co’s\textsuperscript{86} white paper will require as much as ₹ 60000 crore in capital over the next few years to fund growth in advances, non-performing loans write-off and investments in Information and Technology and human capital up-gradation to reach a high performance scenario.

The academic research on the performance of the financial institutions has been increasingly focused on their efficiency in the wake of financial deregulation and liberalization.\textsuperscript{87} A few studies reported an adverse or insignificant effect deregulation and liberalization policies on the performance of banks which include Bhattacharya et.al,\textsuperscript{88} Ram Mohan and Ray,\textsuperscript{89} Reddy\textsuperscript{90} and Jafffy et.al.\textsuperscript{91}
The efficiency of bank is not always reflected only by the size of its balance sheet, but by the level of return on its assets. Upendra Sastry et al viewed that "non-performing assets do not generate interest income for the banks, but at the same time banks are required to make provisions for such non-performing assets from their current profit. Non-performing assets have a deleterious effect on the return on assets."\textsuperscript{92} The Chairman and Managing Director of Andhra Bank, R.S. Reddy stated that "the asset quality has to be monitored as there is a risk of restructured accounts turning into non-performing assets. This is a big challenge."\textsuperscript{93}

"Lending of money involves a credit risk. When the loans and advances made by banks or financial institutions turnout as non-productive, non-rewarding and non-remunerative, then they will become Non-performing assets.\textsuperscript{94} Bhatacharya rightly pointed that "in an increasing rate regime, quality borrowers would switch over to other avenues such as capital market and internal accruals for their requirements of funds. Under such circumstances, banks would have no option but to dilute the quality of borrowers thereby increasing the probability of generation of non-performing assets."\textsuperscript{95}

Prashanth K. Reddy, in his research paper, "A Comparative Study of Non-performing Assets in India in Global Context - Similarities and Dissimilarities, Remedial Measures had stressed this: Changes required tackling the non-performing assets problem would have to span the entire gamut of judiciary, polity and the bureaucracy to be truly effective. It also dealt the experiences of other Asian countries in handling of non-performing assets.\textsuperscript{96}"

24
From lenders’ perspective, Das and Ghosh empirically examined the non-performing loans of India’s public sector banks in terms of various indicators such as asset size, credit growth and macro-economic condition, and operating efficiency indicators.97

Arunkumar, Rekha and Kotreswar, G., examined and compared the trends in non-performing assets level, CRM practices of commercial banks, the response to reforms under Basel Accord II and Risk Based Supervision between the public sector banks and the private sector banks. The study found a strong relationship between non-performing assets level and credit portfolio diversification.98

The empirical analysis of Misra and Sart Dhal study demonstrate that banks’ non-performing assets are influenced by three major sets of factors, i.e., (i) terms of credit, (ii) bank specific indicators relating to asset size, credit orientation, financial innovations (non-interest income), and regulatory capital requirement and (iii) business cycle shocks. Using panel regression model, the study found that the terms of credit variables such as interest rate, maturity and collateral and bank specific variables had significant effect on the banks’ non-performing loans in the presence of macro-economic shocks. The empirical findings support the policy approach to the banking in the Indian context.99

On resolving non-performing assets of the Indian banking system, Dong reviewed the nature of non-performing assets in the Indian banking system and discussed the key features that would be important for the Asset Reconstruction Companies to play an effective role in resolving non-performing assets. The analysis drew upon recent regional and cross-country experiences in dealing with impaired assets during periods of financial crises.100 R.K.Uppal clearly indicated the non-performing assets were
more in public sector bank group because advances by it to the priority sector were high.\textsuperscript{101}

According to Ernst & Young, the actual level of non-performing assets of banks in India is around $40 billion, much higher than the Government own estimates of $16.7 billion. This difference is largely due to the discrepancy in the accounting of non-performing assets followed by India and rest of the world.\textsuperscript{102}

Though found in the above studies a few good measures for achieving better performance of banking sector, but may not find the pragmatic solutions to the vision of reforms. Hence, the need arises for present investigation entitled "Non-performing Assets in Commercial Banks: An Empirical Study."

**OBJECTIVES OF STUDY**

To know the reforms contribution on sound working of commercial banks is the main motto of the present study. The specific objectives of the present study are as follows.

1. To analyze the factors leading to reforms of banking sector
2. To study the progress of commercial banks during post reforms – first phase reforms and second phase reforms
3. To examine the non-performing assets
4. To diagnose the managerial performance of commercial banks

**METHODOLOGY**

The present study is an empirical in nature. It covers the commercial banking sector in Indian Union and the analysis of it is based on the compiled data. The aspects examined in order to explain the objectives of study are branch network, sources and deployment of funds, non-performing assets and managerial performance. The study is covered period of 19 years which is broadly divided into (i) 1991-92 to 1997-98 –
first phase period (7 years) and (ii) 1998-99 to 2009-10 – second phase period (12 years) for the purpose of analysis.

SOURCE AND COLLECTION OF DATA

The analysis of the present study entirely depends on the secondary source and the required data was compiled from the (i) Report on Trend and Progress of Banking in India, (ii) Currency and Finance, (iii) Bulletins of Reserve Bank of India, (iv) International Business Management Reports and (v) Statistical Tables Relating to Banks in India. The other relevant data was also compiled from other published works and websites.

ANALYSIS OF DATA

The compiled data was classified and arranged in the form of tables. Data analysis refers to presenting the data in such manner for drawing inferences. In other words, the underlying objective of drawing inferences lies on the application of scientific statistical techniques. To identify the progress of banking sector including regional imbalances with reference to branch expansion, financial deposits, credit and credit-deposit ratio and non-performing assets, an attempt has been made by the author. The statistical techniques which studied are presented hereunder.

**Location Quotient**: Location Quotient is studied to estimate the location imbalances. The national average is calculated by dividing the number of ranches in the country to the population. Similarly, the regional average is obtained by dividing the number of branches in the region to the total population of that region. Then, dividing the latter by the former, gives Location Quotient. It will be either proportional or less or more than one, which would mean that the region average is in balance with or below or
above the national average. The study of this technique is in line with the study of Raj Committee. Algebraically, it is written as:

\[
\text{(i) Branches: } LQ_b = \frac{\text{NBr}}{\text{Pr}} \div \frac{\text{NB}}{P}
\]

Where,

- \( \text{NB} \) = Number of ranches
- \( P \) = Population
- \( r \) = Region

**Elasticity Co-efficient:** The location quotient does not explain the rate of change in relative position of a region to that of nation. The elasticity coefficient technique explains the relative change in the volume of deposits or credit as a result of proportionate change in the number of branches. It is denoted by ‘\( e \)’ and is explained as:

\[
\text{(i) Deposit: } De = \frac{\Delta d}{D} \div \frac{\Delta b}{B}
\]

\[
\text{(ii) Credits: } Ce = \frac{\Delta c}{C} \div \frac{\Delta b}{B}
\]

Where,

- \( \Delta d \) = Change in deposits
- \( \Delta c \) = Change in credit
- \( \Delta b \) = Change in branches
- \( D \) = Total deposits
- \( C \) = Total credit
- \( B \) = Total branches

The elasticity co-efficient will be either proportional or less or more than one. If it is more or less than one, it would mean, the average deposits/credit is increasing more or
less than the marginal increase in the number of branches. Hence, the marginal increase in deposit/credit would be more or less than the average increase of branches. If it is equal to one, it would mean that the change in deposits/credit is equal to the change in the number of branches. Reddy C.R. has studied elasticity co-efficient to know inflow and outflow of funds relation.104

**Growth Rate:** The growth rate is studied to measure the progress of banking sector on year-to-year basis. For given time series, data is increasing or decreasing over a period of time can be fitted to the semi-log trend, \( Y = ab^x \). The long-linear function of Least Squares technique can be written as:

\[
\log Y = \log a + x \log b
\]

Where,

- \( \log Y \) = value of variable (deposit/credit)
- \( \log a \) = Intercept
- \( \log b \) = Regression co-efficient
- \( x \) = Time (in years)

The growth rate is calculated by solving the equation, \( (1 + r) = \log b \) or \( r = \text{Antilog} \left( \frac{\log b - 1}{x} \right) \times 100 \)

The above stated techniques are studied to the various variables during the pre-reforms period and the post-reforms period so that can be known how effective the reforms on banking system. Varde and Singh105 and Bandi Kamaiah106 have studied the growth rate to estimate variable of deposits using time series.

**CHAPTER PLAN**

The report of the study is presented in six chapters. All the methodological issues relating to the present study are discussed in the first chapter. Reforms of banking sector with the causes of and the reasons for reforms including trends in banking are
studied in the second chapter. Funds-mix and credit-mix including network during 1991-92 to 1997-98 (first phase period) and 1998-99 to 2009-10 (second phase period) is examined in the third chapter. Analysis of non-performing assets is diagnosed in the fourth chapter. Managerial performance is examined in fifth chapter. Conclusions and suggestions are dealt in the last chapter.

CONTRIBUTION

The study of effectiveness of banking sector pertaining to funds mobilization, their deployment, recovery and overdues is examined as per the prudential norms. The non-performing assets with causes and cures coupled with trends in the present competitive environment will certainly add literature to the subject. The study would also become a base for policy prescription with which banking can be put on sound footing and healthy operations.
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