Summary of Findings

In the world of globalization, the integration of domestic markets with international financial markets has been facilitated by tremendous advancement in information and communication technology. Globalization of financial markets and institutions has resulted in significant transformation of banking industry in India. Major changes have been witnessed in the financial sector: New banks, new financial institutions, new instruments, new windows, and new opportunities and, along with all this, new challenges. The Indian banks have successfully exploited the new vistas to augment revenues and have substantially improved the financial health vis-à-vis global benchmarks. The Indian banks have been performing well as per various indicators including asset quality.

It is a growing realization that the ability of a country to conduct business across national borders and the ability to cope with the possible downside risks would depend, inter-alia, on the soundness of the financial system. It is an absolute necessity to adopt a strong and transparent prudential, regulatory, supervisory, technological and institutional framework in the financial sector on par with international best practices.

Banks in the process of financial intermediation are confronted with various kinds of financial and non-financial risks that are highly interdependent and events that affect one area of risk can have ramifications for a range of other risk categories. However, before the advent of reforms in the decade of 1990s, the exercise of risk assessment and risk management was never seriously attempted, as the banks were operating in a captive economy. But in the present scenario, risk management, especially, credit risk management has emerged as a necessity.

Credit risk management should be a core competency of any bank. Inadequate credit risk management represents a bank's greatest vulnerability. Superior credit risk management represents a unique opportunity to achieve distinctive performance levels. Sophisticated and improved credit risk management is a requirement to avoid problem loans, to avoid adverse selection problems and to remain viable against leading bank and non-bank competitors.

Various micro-macro factors, internal-external factors are responsible for higher rate of defaults, leading to Non-performing Assets (Problem Loans). In the banking system, high level of NPAs can erode the profitability of banks through reduced interest income and provisioning requirements, besides restricting the recycling of funds leading to serious asset-liability mismatches. This can lead to reduction in the competitiveness and erosion of capital base. High level of problem loans can be serious drag on overall performance of economy on account of diversion of its management and financial resources towards recovery of NPAs. Greater the resources needed by banks to reserve for losses, lesser is the amount of capital they can leverage. Consequently it makes the banks risk averse in providing new loans leading to credit crunch in the financial market, amounting to economic and financial degradation. Thus, the problem of problem loans is not a matter of concern for the lenders alone. It is a matter of grave concern to the public as well, as bank credit is the catalyst to the economic growth of the country and any bottleneck in the smooth flow of credit, one cause for which could be the problem loans, is bound to create adverse repercussions in the economy.

The RBI has proactively engaged itself in the prudential supervision and has undertaken various remedial measures. These have been proved fruitful to a large extent; still, there are certain deficiencies in the system that needs to be corrected. Robust systems to effectively deal with the problem loans are absolutely essential if the Indian banks have to rise to the global standards.

The issue of problem loans (representing the default of both interest and principal) is the central issue in this research study. It is well known that the issue of problem loans or credit risk is intrinsic to banking but the banks can't stop credit expansion for the sake of risk-aversion, since the remedy to the problem doesn't lie there. Instead, it is very important to understand and analyse the circumstances and factors due to which problem loans can arise so that efforts can be made in the right direction to manage them effectively, eliminate the bank-related causes to the extent possible and reduce the impact of defaults, since complete elimination of defaults may not be possible. Understanding and paying due attention to these factors must be an integral part of lending business and credit portfolio management. If Indian banks are to compete globally, sound and robust credit risk management practices have to be instituted and problem loans have to be effectively controlled.

The information and assessment of bank-related determinants of problem loans can be directly incorporated into the process of credit portfolio management. Also, most of the Indian studies in this context have focussed on the public sector banks as these account for the maximum proportion of the assets in banking sector. Private sector banks have been largely ignored in this context. The estimation results of the techniques testing variability indicate different behavior of different Indian Private Sector Banks on key parameters and key decision variables, most of which exhibited significant F-ratios. Using data on the 24 Indian private sector banks for the period 2001-2008 and applying Arellano-Bond dynamic panel data estimation technique, the study finds the individual bank level variables such as lagged problem loans ratio, interest margins, capital adequacy, credit expansion, and branch expansion play a significant role in determining problem loans of the private sector banks. The signs on the coefficients (though not significant) of variables like size of the bank, operating expenses, proportion of liquid assets in the portfolio, proportion of priority sector advances, net profit also drop useful hints. In addition, when the old and new private sector banks are analyzed separately, then few important differences are noticed such as the lagged NPA ratio being significant only for old private sector banks; size of the bank turning out to be a significant determinant of problem loans of old private sector banks;operating efficiency turns out be an important determinant in case of new private sector banks; the proportion of liquid assets turns out to be significant in case of old private sector banks; interest margin being significant only in case of new private sector banks; capital adequacy affecting the credit policy of the two categories of banks differently and credit expansion being the major factor only in case of new private sector banks.

Based on the analysis of the trends in the problem loans, impact of Global Crisis, measures taken by the RBI, cross-country comparisons and the estimation results of the econometric models, an effort has also been made to make certain workable suggestions and recommendations in the context of Indian Economy for effectively handling and solving the NPA problem. The existing laws for handling could have been adequate but no laxity in implementation is affordable i.e. strong legal framework and legislative framework is absolutely critical. Moreover, there can never be a foolproof regulation or a flawless system, as the system is run by society at large.

It is a well-documented and well-researched fact that a robust financial system and a health banking system lie at the foundation of a strong and sound economy. A weak or crumbling foundation can have disastrous effects on the economic well-being. Just as a sound banking system constitutes the foundation of a sound economy, similarly, sound credit management lies at the foundation of the sound banking system. It has been observed and derived from the analysis that the problem of problem loans does display a declining trend. Various measures adopted by the regulatory authorities have enabled the banks to improve their asset quality. Moreover, the financial regulatory policies adopted in India have helped the Indian Banks to weather out the economic storm. As a result, India has not witnessed failures in the financial system as experienced by the developed world.

However, the problem still has its presence and is continuing. Moreover, the global economic meltdown has thrown up new challenges for the Indian Banks to maintain a healthy credit portfolio and to control the problem loans. The attempt to come up with an econometric model for bank-side determinants of problem loans has shown certain important factors that can have important bearing on the non-performing assets of Indian Private Sector Banks.

Various Indian Private Sector Banks differ on various efficiency, liquidity and profitability measures. Ensuring discipline with respect to the provisioning against problem loans is an absolute necessity as the econometric model has shown the past bad loans to be having significant effect on the present problems. Moreover, this problem seems to be more serious in case of old private sector banks. Also, the model has shown that declining margins have adverse impact on the problem loans and this tendency is more visible in case of new private sector banks, so banks need to curb their tendency of funding riskier projects in the situation of declining financial margins.

It can be seen that the solvency status doesn't have similar impact on the risk-taking behaviour of the banks. In order to increase the capital base, the new private sector banks become risk averse and old private sector banks become risk-seeker when the solvency status is threatened. The relationship between the credit growth and problem loans seem to refute the conventional wisdom that higher credit growth leads to higher problem loans. Also, in case of old private sector banks, the bigger size, possibly via the channel of diversification, seems to have favourable impact on the problem loans. But keeping in view that recently, the world saw the failure of big banks; even the bigger banks cannot afford to be negligent. In case of new private sector banks, the relationship between operating efficiency and problem loans seems to validate the postulate of 'bad management'. It has been derived that the old Indian private sector banks are not able to manage excess liquidity, which is associated with higher problem loans. Also, branch-expansion must not be carried out in a haphazard fashion so as to avoid the bad loans due to unfamiliarity with new areas. A multi-pronged approach is required for the solution to the problem of problem loans. This multi-fold approach has to address the policy issues, strategic issues, restructuring problems, disciplinary and reporting matters, supervisory issues, operational and procedural aspects, legal bottlenecks, institutional and structural reforms. Finally, the central bank should be careful and vigilant on the operations of private sector banks to control the problem loans for effective functioning of the banking sector and the economy in general.