CHAPTER -1

Chapter 1

INTRODUCTION

1.1 Introduction

Banking industry carries out a pivotal role in the development of the financial system of any country. Banks being the backbone of economic system act as one of the key drivers of economic development by undertaking maturity transformation and supporting the critical payment systems. Banking has become the foundation of modern economic development (Kapoor, 2004). Schumpeter (1993) considered banking system as one of the key agents in the whole process of economic development. According to Pathak (2008), the strength of any economy basically hinges on the strength and efficiency of the financial system, which, in turn, depends on a sound banking system. It is one such atypical sector which deals with plentiful risks. In the process of providing financial services, they assume various kinds of financial risks (Santomero, 1997).The specificity of banks, the volatility of financial markets, increased competition and diversification, however, expose banks to risks and challenges. Thus it can be said that Commercial banks are in the risk business. Also, banks are extremely interconnected to each other, so a spark of trouble can spurt disruption in entire economy. Hence, to maintain the momentum of growth of the economic system of a country, banking sector is to be managed efficiently so as to respond to changing times. An extremely healthy and prudent banking sector has the ability to withstand risk and shock of the financial system and ensure overall financial stability (RBI, 2011). In present financial world, the

nomenclature of Risk and Governance has gained increased thrust since the last two decades. The turmoil caused in the aftermath of global financial crisis has propelled renewed interest in the management of risk than ever before.

Banking sector in India, during post-independence and post nationalization regime has been driven by social motives and sometimes this agenda even superseded the primary motive of profit maximization. However, on the basis of the recommendation of Narsimhan Committee report, 1991, which advocated towards a more market oriented economy, Govt. of India initiated financial sector reform measures in 1992. Besides Capital market reforms, major focus was laid down on strengthening the ailing Indian Banking sector which is the reservoir of ¾ th assets of entire financial system, and aligning them with international standards.

As a result, deregulation of interest rate, introduction of stricter income recognition and asset classification norms, enhancing the capital adequacy norms, additional disclosures for greater transparency for investors to make better cash flow and risk assessment were initiated. According to Leeladhar (2007), the opening up of economy has witnessed various new windows, new banks, new instruments, new opportunities, and above all new challenges. As banks are no longer limited to financial intermediation only, they have plethora of avenues to earn from and boost their revenue, they are now more exposed to greater degree of risk. Accordingly, RBI has issued a number of guidelines convergent to international best practices to tackle such risks proactively. Following the Basel II, the CAR was set at 9% marginally higher than that of international standard. Further, guidelines on asset-liability management(ALM) and risk management systems in banks(1999), Guidance Notes on Credit Risk Management and Market Risk Management

(October 2002), Guidance Note on Operational Risk Management (2005) were introduced. Despite, Indian banks are suffering from mounting level of NPAs and loss of revenues.

At the international banking arena, there is relentless effort for making the financial supervision extremely efficient and proactive to deal with the unprecedented and sudden risks emanated from the system. As there are increased number of innovative products in the portfolio of most of the banks, which gives them competitive edge over others, at the same time they are facing increased level of uncertainty because of the volatility of the market. Basel committee has already prescribed Basel III norms, even though there is a growing concern amid worldwide banking fraternity that whether the banks those are operating in a fragile position under Basel II regime, could manage themselves to maintain the minimum Capital Adequacy Ratio (CAR, which is 2% higher than the previous one) and remain profitable. Most of the central banks across the nations are trying hard to manage their financial system in a systematic way, so as RBI in case of India. This apart, doubt still prevails regarding the efficacy of risk mitigating measures enacted in recent past in the context of their implications.

1.2 Conceptual Framework

a) RISK

Risk is inherent in every walk of life. Managing risks was for a long time considered to be beyond the power of mankind and only in the hands of the gods. According to Porthin (2004), one form of Risk Management, insurances, has been practiced for thousands of years. From mid- 17th to mid- 18th century, the concept of

probability and its primary properties, the main foundations in risk management, were developed (Bernstein, 1996). Modern risk management started evolving after the Second World War on two different fields: insurance buying as well as reliability and safety engineering. These fields grew side by side for decades with very little interaction (Williams et al., 1998). Porthin (2004) points out that today risk management in the financial field is mainly concerned with reducing undesired uncertainty. A current challenge is to study all risk factors in an organization as a whole and manage those using suitable methods from all available fields (Raikkonen, 2002; Raikkonen and Rouhiainen, 2003). This demands a holistic approach in studying risks.

The etymology of the word "Risk" can be traced to the Latin word "Rescum" meaning Risk at Sea or that which cuts (Arora & Agarwal, 2009). The common meaning of the word is uncertainty. The very word 'Risk' is associated with every walk of business life. The Chambers 20th Century Dictionary defines 'risk' as a 'hazard', 'chance of loss' or 'injury'(as cited by Rao, September, 2011).According to the Palgrave dictionary of Economics, "A situation is said to involve 'Risk' if the randomness facing an economic agent can be expressed in terms of specific numeric probabilities". Risks are generally understood to be the uncertainties related to the outcomes (in terms of revenue and profits, for example).But Mu(2007) elucidated a fine line of difference between the two terms 'Risk' and 'Uncertainty' by means of classifying unquantifiable risk as 'uncertainty' and using the term 'risk' particularly for quantifiable risk. Risks, thus, represent 'expected losses' (RBI publication, 2012).

Risk is an exposure to a transaction with loss, which occurs with some probability and which can be expected, measured and minimized (Goyal & Agarwal, 2010). Risk is the potential variation in outcomes (Williams et al., 1998). Raghavan, 2003 holds that risks are inter-dependent and events affecting one area of risk can have ramifications and penetrations for a range of other categories of risks as well. Without risk, the financial system would be vastly simplified.

Risk emanates from the situations when both macro and micro environment is exposed to sudden shifts in policies, regulations, and systems. Risk management involves identification of the risk as well as to evolve strategies to contain its intensity. The mechanisms of controlling risk differ from institution to institution and country to country.

Banking, by its nature, entails a wide array of risks (Basle Committee on banking Supervision, Sept.1997). It is a risky business. (Anand Sinha, Address, March 7, 2012). The basic business of borrowing and lending make banks and entire banking system vulnerable to risk. This has warranted the risk management system to quantify, monitor and control unexpected events affecting the banking activities.

b) RISK MANAGEMENT

Risk management has always been the means of survival in every sphere of life. According to Pyle (1997), Risk management is the process of identifying `key` risk, obtaining consistent, understandable and operational risk measures, choosing which risk to reduce and which to increase and by what means and establishing procedures to monitor the resulting risk position. Managing risk is the first step towards sustaining profitability in case of any financial institution. In present

changed scenario, organizations in the financial arena worldwide are required to follow stringent risk management framework. Goyal (2010) put forward that rising global competition, increasing deregulation, introduction of innovative products and delivery channels have pushed risk management to the forefront of today's financial landscape. Success can be achieved by measuring risks appropriately and taking appropriate action. The financial mess in abroad leading to *financial tsunami* across the globe clearly pointed out the need for understanding the nuances of risks along with their derivatives. Risk management thus emerged as one of the prime issues in every discussion encompassing financial strategies of every organization in financial arena.

The systematic process of identifying, evaluating, and reducing risks is usually referred to as risk management (Porthin, 2004). Risk management is described as the performance of activities designed to minimize the negative impact (cost) of uncertainty (risk) regarding possible losses (Schmidt and Roth, 1990). Risk management is an orderly process for the identification and assessment of pure loss exposure faced by an entity and the adoption of the most and appropriate technique to cater for such exposure (Redja 1990).

Goyal (2010) articulated that the process of risk management comprises the functions like:

- Risk identification,
- Risk measurement/quantification
- Risk control
- Risk monitoring

As it is been observed that Risk management is a step by step process, it encompasses detection of prevalent risk of any entity (bank), quantification of the depth of risk, involving measures for reducing the risks and finally screening the progress of all such measures, hence this definition of Goyal (2010) is accepted as the operational definition for this present study.

c) BANKING AND RISK MANAGEMENT

Banking is the backbone of any financial system. Schumpeter (1993) considered the banking system as one of the two key agents in the whole process of economic development. Banks play a pivotal role in the success and failure of an economy. Banking system acts as an intermediary by mobilizing savings and parking them to high return investment impinges economic growth. Banks stand ready to provide liquidity on demand to depositors through the checking account and to extend credit as well as liquidity to their borrowers through lines of credit (Kashyap, Rajan, and Stein, 1999).

According to Sinkey (2002), modern risk management in the banking industry can be highlighted by five verbs and these are; identify, measure, price, monitor and control. The Basle committee on Banking Supervision**, September 1997** grouped the major risks as- Credit risk, Market risk, Country and Transfer risk, Interest rate risk, Liquidity risk, Operational risk, Legal risk and Reputational risk, which will be dealt at length in appropriate level.

However, out of all such risks Credit risk is treated as prime and most important risk as well as threat (Luy, 2010) to financial institutions because its occurrence is very much associated with the basic banking activity of lending and borrowing. In

the words of Greuning & Bratanovic (2009), credit risk happens when "payments can either be delayed or not made at all, which can cause cash flow problems and affect a bank's liquidity". Credit risk is the risk of not receiving timely cash flow from bank granted facilities (Christophe, 2004, p. 93). Credit risk is, by far, the largest risk faced by banks. (Anand Sinha, Address, March 7, 2012). Basel Committee on banking Supervision considered credit risk in its First accord of 1988 as the principal risk while considering the elements of risk. In its subsequent accords also, Credit risk was considered along with Market and Operational risks. Hence, the management of credit risk i.e. the minimization of risk exposure and occurrence is and should be of utmost importance to all financial institutions in general and banks in particular.

The implementation of risk management is not an answer to risk, rather it implies an organizational system which involves changes in the way the banking institution organizes, assigns responsibilities, and approaches the risk management as a key competence, continuously and in due time implements the risk management. Indian financial system is deeply intertwined to the existing banks irrespective of nature and ownership, in maintaining overall financial stability (RBI, 2011). Any disruption will bring catastrophe in the entire system. In order to maintain conducive growth, ensure stability between risk and return there is the necessity of having policies of risk management. Reserve bank of India is also concerned about a more stringent risk management system in Banks responding to the changing scenario. In recent years, however, risk management has emerged as a central issue especially for financial institutions. There is increased focus on the mechanisms for the quantification and communication of risks on multiple levels –

individual risk takers within organizations, organizational units, the institution as a whole, and more recently, the entire financial system (RBI, 2012).

1.3 Statement Of The Problem

The practice of risk management is an age old phenomenon. With the passage of time almost all the economies are changing at a very fast pace, so as their regulation regarding financial institutions, thereby making them more independent in decision making. The traditional concept of doing business by staying under well guided regulations and stereotypical thinking no longer exists, which is bringing fresh air for the market but at the same time increases the extent of volatility. Thus modern financial institutions are more exposed to risk than before. Economic records exhibit instances of financial flux across the world, which in turn recognize the need for entrenched risk management system especially for the financial institutions.

The Global Financial Stability Report, GFSR (September 2011), spelt out credit risk in terms of increasing Non-Performing Loans (NPLs) ratio across most advanced economies between 2008 and 2010 except in the US. In the US, there was a moderate improvement in asset quality between 2009 and 2010, which continued in the first quarter of 2011. In contrast many of the major emerging economies showed considerable improvement in the asset quality with implementation of risk management measures.

Though, the performance of Indian Economy, especially the banking sector was quite befitting on the face of financial crisis but the banking system is vulnerable to risk if we mull over the financial performance and soundness indicators in post

crisis period. GFSR (2011) has divulged that credit risks have risen and continued to be the key potential risk to global financial stability. In India, a significant chunk of GDP happens to come from the banking sector, so for upholding the growth and vibrancy of the economy, the dominant risk should be addressed properly.

Banking sector more specifically, started facing the hurdles of increased interest rate structure and the heightened level of loss of asset quality and the associated consequences. If the bank assets become sour, then entire economy can be at snag.

The need of the hour is the concept of risk management should be viewed as 'highly- strategic unit' in lieu of cost centre (Kapoor, 2012). The foremost among the challenges faced by the banking sector today is the challenge of understanding, quantifying and managing the risk.

1.4 Profile of Indian Banking Sector

One of the finest sectors which has managed to perform well after liberalisation and contributed robustly in the growth trajectory of Indian economy is banking. It is trying to touch the lives of millions of citizens of India through its relentless functioning and operational presence. But, this sector is not built in a day rather has been through various phases of ups and down to take the present from. The name bank is derived from the Italian word "banco" which meant 'desk/bench', used during the Renaissance by Florentine bankers, who used to make their transactions above a desk covered by a green table cloth (Green, 1989, Biswas, 2012). As per Banking Companies Act, 1949,"The term 'banking' encompasses acceptance of deposit from public for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and

withdraw able by cheque, draft, order or otherwise". The Oxford Dictionary defines a bank as an establishment for the custody of money, which it pays out on a customer's order.

According to the Indian Central Banking Enquiry Committee (1931), Money lending activity in India could be traced back to the Vedic period, *i.e.*, 2000 to 1400 BC. The existence of professional banking in India could be traced to the 500 BC (as cited by RBI, n.d., p.1). History of Indian Banking affirms the presence of numerous small private players involved in the business of collecting funds and giving away loans. Mr. W.E. Preston, member, Royal Commission on Indian Currency and Finance set up in 1926, observed "It may be accepted that a system of banking that was eminently suited to India's then requirements was in force in that country many centuries before the science of banking became an accomplished fact in England." (as cited in Indian Central Banking Enquiry Committee, 1931, p.11)

During the colonial era, the need is felt for consolidation of the industry in order to have few stable and large establishments, by merging the small ones. This has given a huge impetus for better performance and growth of the sector. During this period in time, Imperial bank was formed by combining Bank of Bengal, Bank of Bombay and Bank of Madras, which subsequently came out to be the largest bank of India, State Bank of India post-independence. Prior to the establishment of Reserve Bank of India as the Central banking authority in 1935, Imperial bank initially acted as the regulator of the Indian Banking System.

After independence, when politically India adopted soft socialistic view, the need of Funding becomes more pronounced in order to build the nascent economy, so as

the need of a sound banking system. It was the time which necessitated the nationalisation of big private players having extensive reach, across various region of the country which started in the year 1969. As the demand of the economy was vigorous, so these few banks proved to be inadequate in meeting the requirement and large section of the society remain outside the purview of the sector. Also the sector was suffering from autonomy, strict control was being administered and it lacked dynamism as well as efficiency.

Second round of push came during the late70's when the Govt. has to act as the saviour of few banks by infusing capital inflow where few more were undertaken by Govt. within the category of 'Nationalised Banks'. This was done with a view to improve the performance of the sector and to make it more 'pro-poor'. Although, the basic purpose of bank nationalisation remained unmet even now. The traits experienced during this period includes poor performance, less friendly for oppressed and carrying huge amount of toxic assets in the books of banks which can be attributed to huge lending to biggies out of compulsion and few societal lending. The situation remained same for almost one more decade before the govt. Went for biggest push ever in the fraternity, in line with the newest objective of Liberalisation and Globalisation.

In 1991, Indian banking industry has been able to observe the newest forms in terms of deregulation, decontrolling of interest rates, opening the doors to more private players to perform and increased scope of competition to prevail thereby making better performance a precondition for survival and growth for the established players. It is during this period when we see better working condition, rigorous competition, relentless effort to upgrade services & systems with the help

of new and innovative technology. Thus in order to explain better, the journey of Indian Banking Sector can be classified under three chronological as well as activity oriented periods, viz,

A. Indian Banking Sector During Pre-Nationalisation Era

As mentioned in RBI, 2008:

The pre-independence period was largely characterised by the existence of private banks organised as joint stock companies. The ancient Indian banking system mostly used to function in the environment of mutual consideration and trust in lieu of securities and hence was largely different than the practices of European banking system. Also Hundi was the most primitive form of bills of exchange used during that period.

According to Bagchi (1987), "Hundis are the oldest form of credit instruments that were used as early as the 12 century AD. Deposits were accepted by some indigenous banks under the *'khataputta'* system. However, most indigenous banks like *Multanis* and *Marwaris* did not accept deposits as they relied on their own funds".

During the initial years of formal banking in India, Europeans used to claim major shares as the banks were established as Private Shareholding Companies with limited liability. As the European traders of 17th century were unable to use the indigenous banking system prevailing in the then India due to language barrier, they started establishing Agency Houses in Calcutta and Bombay, which used to conduct banking business with unlimited liability (Gajdhane, 2012). These Agency Houses which acted as bankers to the East India Company, also used to finance

movement of crops, had no capital of their own and considered deposits as their funds, established Joint Stock Banks. The earliest bank of India, Bank of Bombay, established in 1720 in Bombay(Reserve Bank of India, 2006), *was set up by English Agency House following Joint stock structure which prevailed in 18th century western world. Next banks were Bank of Hindustan by M/s. Alexander and Company of Calcutta in 1770, which closed down in 1832 following the closure of the Agency* (Indian Central Banking Enquiry Committee1931). A look into the history reveals "The General Bank of Bengal and Bihar, which came into existence in 1773, after a proposal by Governor (later Governor General) Warren Hastings, proved to be a short lived experiment"(Reserve Bank of India, n.d., p.6). Other banks which were formed during the initial years of 18th century were The General bank of India, set up in 1786 and Bank of Hindustan, established in 1790 (Gajdhane, 2012).

As trade was increasingly growing around the then Calcutta, there was increasing need of common currency to facilitate trade, modern banking transactions and remittances by the British officials and the staffs of Army, so Bank of Bengal ,the first Presidency bank, was set up in Calcutta on June 2, 1806 with initial capital of Rs.50 lakhs. This bank had 20% of the share capital subscribed by the Govt. and hence the Govt. had right to vote along with the authority of appointing directors. Along with the task of discounting the Treasury Bills, the bank was also entrusted with the right of issuing notes in 1823. In the year 1840, the second Presidency Bank the Bank of Bombay was established with Rs. 52 lakh as initial capital, followed by the Bank of Madras which was set up in the month of July, 1843 as another Presidency bank with Rs. 30 lakhs of start-up capital. These three Presidency banks, set up in three Presidencies were administered by Royal

Charters. Also they used to issue currency notes till the ratification of the Paper Currency Act, 1861, which made these banks free from this responsibility and Govt. became the sole authority for issuing currency.

Ancient Indian banking system is characterised by the prevalence of regulatory practices which was quite unique, indeed ahead of time in the context of rest of the world. The classic Kautilya's '*Arthashastra*, which dated back to 400BC, laid down norms for banks going into liquidation. If anyone became bankrupt, debts owed to the State had priority over other creditors (Leeladhar, 2007). The first formal regulation for banks was the enactment of the Companies Act in 1850 in light of a similar act of 1844 in Great Britain (RBI, n.d.). Following the prevailing worldwide practice of unlimited liability for banking and insurance companies, this particular act also incorporated the same principle for Indian banks. This principle continued till 1860, hence new players were not taking interest in the banking sector as this principle was in effect. After this principle was revoked and the principle of limited liability introduced in Great Britain, soon it was followed in India too, this ratification acted as gate opener as many new banking entities had started to commence. Also a new bank the New Bank of Bombay was established in 1868 after the fallout of the Bank of Bombay.

Further, with the enactment of Presidency banks Act 1876, all three Presidency Banks were brought under common charter with imposition of some regulation regarding their business. This act has brought in certain directives with regard to repealing handling of risk prone businesses like foreign bills and borrowing abroad for granting loan of more than six months duration. As per Act XI of 1876, the Government has introduced periodic inspection of the books of banks. This act also enforced creation of Reserve Treasuries in Calcutta, Bombay and Madras, where the sums exceeding minimum prescribed balances (to be held with

Presidency Banks) were to be deposited in the reserve and the Government can lend to Presidency Banks from such reserves.

Indian merchants in Calcutta established the Union Bank in 1839, but it failed in 1848 as a consequence of the economic crisis of 1848-49 (Gajdhane, 2012).The year 1860, which witnessed the revocation of unlimited liability of banking companies, marked the beginning of journey of many Indian owned banking companies. The first of its kind, Allahabad Bank which still prevails, was set up in 1865 as a Joint Stock bank is the oldest bank of India. Punjab National Bank was established in 1895 in Lahore, and Bank of India, the third one was set up in 1906 in Mumbai. These banks were established as privately owned entities. The Swadeshi Movement of 1906 acted as a catalyst towards the drive of Indian Owned joint stock banks and many Indian commercial banks like Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank, and Bank of Mysore were set up between1906 and 1913. Ammembal Subbarao Pai founded "Canara Bank Hindu Permanent Fund" in1906. Central Bank of India was established in 1911 by Sir Sorabji Pochkhanawala (Gajdhane,2012). As per the records of RBI (2008):

> By the end of December 1913, the total number of reporting commercial banks in the country reached 56 comprising 3 Presidency banks, 18 Class 'A' banks (with capital of greater than Rs.5 lakh), 23 Class 'B' banks (with capital of Rs.1 lakh to 5 lakh) and 12 exchange banks. Exchange banks were foreign owned banks that engaged mainly in foreign exchange business in terms of foreign bills of exchange and foreign remittances for travel and trade (p.3).

Further after the introduction of the principle of limited liability of banks, foreign banks too started to arrive, particularly in Calcutta, in the 1860s. The Comptoire d' Escompte de Paris opened a branch in Calcutta in 1860, and another in Bombay in 1862. HSBC established itself in Bengal in 1869 (Gajdhane,2012).

The amalgamation of these three presidency banks took place in the year 1921 and it led to the formation of the Imperial Bank of India. Further a number of banks belonging to native princely states like Jaipur, Mysore, Patiala and Jodhpur were also merged with the Imperial Bank of India. Before the Reserve Bank of India came into existence in 1935, the Imperial Bank of India occupied the role of central bank of the country since its inception. Thus, during this phase, the Imperial Bank of India performed three set of functions, *viz.,* commercial banking, central banking and the banker to the government.

Table 1.1: Number of Banks, Capital and Deposits in India During Pre Independence Era

(Amount in Rs. Lakh)

End Dec.	No. of Reporting Commercial Banks					Paid up Capital and Reserves				Deposits				
	Presidency/ Imperial bank#	Class A*	Exchange bank	Class B**	Total	Presidency /Imperial bank#	Class A*	Class B**	Tot al	Presidency /Imperial bank#	Class A*	Exchange bank	Class B**	Total
1870	3	2	3	-	8	362	12	-	374	1197	14	52	-	1263
1880	3	3	4	-	10	405	21	-	426	1140	63	340	-	1543
1890	3	5	5		13	448	51		499	1836	271	754		2861
1900	3	9	8	-	20	560	128	-	688	1569	808	1050	-	3427
1910	3	10	11	-	30	691	376	-	1067	3654	2500	2479	-	8699
1913	3	18	12	23	56	748	364		1112	4236	2259	3104	151	9750
1920	3	25	15	33	76	753	1093	81	1927	8629	7115	7481	233	23458
1930	1	31	18	57	107	115	1190	141	2446	8397	6326	6811	439	21973
1934	1	36	17	69	123	1128	1267	149	2544	8100	7677	7140	511	23428

#: Three presidency banks were amalgamated to form a single bank Imperial bank of India in 1921

*:Banks with capital and reserves of Rs. 5lakh and over **: Banks with capital and reserves over Rs. 1 lakh and up to Rs. 5lakh

Source- Various Statistical Tables Relating to Banks in India, RBI

History of banking during pre-independence era depicts the presence of good number of small banks having highly localised presence and a limited set of customers to deal with. In case of any difficult situation, there used to be only one option left i.e. the bank going into liquidation as both customer base as well as

control mechanism both were limited. After the setting up of Reserve Bank of India as the Central Bank, the regulations and supervisions of banking sector were enforced as per the stipulations laid down in the Reserve Bank of India Act, 1934 and the Companies Act, 1913 (RBI, September 2008). As per RBI (n.d., p.12), "At the time of independence, the banking structure was dominated by the domestic Scheduled Commercial Banks. Non-scheduled banks, though large in number, constituted a small share of the banking sector".

Although banking network prevailed connecting all the major towns/cities of commercial importance, even during that period, yet a vast area was totally secluded from mainstream banking. As a result indigenous bankers and private moneylenders could continue to squeeze common men as they had strong presence and they were beyond the purview of mainstream banking regulation.

During the period 1947-1967, i.e., the first two decades of independence, Indian economy has remained underdeveloped. It witnessed the vices like market failure in rural areas, information asymmetry leading to the lack of access of banks in those areas, among other challenges put forth to the nascent nation. Moreover, common men were hardly left with required assets to approach banking fraternity. As per RBI (n.d., p.1):

> With the transfer of undertaking of Imperial Bank of India to State Bank of India (SBI) and its subsequent massive expansion in the under-banked and unbanked centres spread institutional credit into regions which were un-banked heretofore. Proactive measures like credit guarantee and deposit insurance promoted the spread of credit and savings habits to the rural areas.

The Major Steps that the Government has initiated during the post-independence period were:

- First major step in this direction was nationalization of Reserve Bank in 1949.
- Enactment of Banking Regulation Act in 1949
- Reserve Bank of India Scheduled Banks' Regulations, 1951.
- Nationalization of Imperial Bank of India in 1955 as State Bank of India by State Bank of India Act 1955.
- Nationalization of SBI subsidiaries in 1959.
- Insurance Cover is extended to deposits in 1961.
- Finally nationalising 14 largest commercial banks from July 19, 1969.

B. Indian Banking Sector After Nationalisation

The major developments observed during the succeeding three decades of the year 1967 were- exercise of social control on banks in the year 1967, nationalisation of 14 banks in 1969 and second round of nationalisation of 6 more banks in the year1980. As Indian economy was aiming towards planned development under the aegis of five year plans, nationalisation of banks was purposefully undertaken in order to allow the scarce banking resources for meeting the said need of development. Most of the banks did not find it profitable to maintain large number of small accounts, thereby limiting their lending to rural sector. In order to contain this uneven distribution of banking resources and also to ensure credit delivery to certain priority sectors, first social control on banks and nationalisation of banks in two stages viz., 1969, 1980 were undertaken in a phased manner. For expanding

bank branches, roadmap was laid down under the Lead Bank Scheme. Thus the year 1969 marked the beginning of the process of evolution of Indian Banking Sector. During this period rapid branch expansion took place thereby taking banking services though banking networks to almost every nook and corner of the country. It helped to substantially reduce the share of credit from unorganised sector and as mentioned by RBI (2008, p.2) “the economy seemed to come out of the low level of equilibrium trap”.

These renewed provisions have tried to eradicate the constraints of the banking system so as to expand banking outreach and enhance smooth credit delivery mechanism. Nonetheless, these measures have helped to increase the spread of institutional credit and also augmented nurturing of the financial system, these measures also buckled the process. The banking sector faced the significant constraints like administered interest rate structure and the compulsion of directed lending which harnessed the growth of the sector. During this period Commercial banks of India were enjoying very limited operational flexibility, profitability was also very low. Thus the banks had been suffering from the problem of poor governance. Rangarajan (2008), former Governor of Reserve Bank of India stated “The financial sector became the ‘Achilles heel’ of the economy”. However, Indian economy has been fortunate enough that prompt action was undertaken for redressing the issues.

Box 1.1- Major Control Measures Introduced During 1967 To 1991 Period

Year	Control measures introduced
1967	Social control over banks announced in December 1967 with a view to securing a better alignment of the banking system to the needs of economic policy.
1968	National Credit Council(NCC) was established in February 1968 to assist the Reserve bank and the Government to allocate credit according to plan priorities.
1969	Fourteen banks with deposits over Rs. 50 crore were nationalised.
1969	The Lead Bank Scheme was introduced with a view to mobilise deposits on a massive scale throughout the country and also for stepping up ending to the weaker sections.
1972	Concept of priority sector was formalised. Specific targets were set out in November 1974 for public sector banks and in November 1978 for private sector banks.
1972	The Differential Rate of Interest (DRI) Scheme was instituted in 1972 to cater to the needs of the weaker sections of the society and for their up liftment.
1973	A minimum lending rate was prescribed on all loans, except for the priority sector.
1973	The District Credit Plans were initiated.
1975	Banks were requested to place all borrowers with aggregate credit limit from the banking system in excess of Rs. 10 lakh on the first method of lending, whereby 25 percent of the working capital gap, i.e., the difference between current assets and current liabilities, excluding bank finance, was required to be funded from long term sources.
1976	The maximum rate for bank loans was prescribed in addition to the minimum lending rates.
1980	The contribution from borrowers towards working capital out of their long- term sources was placed in the second method of lending, i.e., not less than 25percent of the current assets required for the estimated level of production, which would give a minimum current ratio of 1.33:1(as against 25percent of working capital gap stipulated under the norms prescribed in 1975).
1980	Six banks with demand and time liabilities greater than Rs. 200 crore as on March 14, 1980, were nationalised on April15, 1980.
1988	Service Area Approach (SAA) was introduced, modifying the lead bank scheme.
1989	The CRR was gradually raised from 5.0percent in June 1973 to15.0percent by July 1989.
1991	The SLR was raised by 12.5percentage points from 26percent in February 1970 to 30.5 percent in September 1990.

Source-RBI publications

C. Indian Banking Sector after liberalisation

The beginning of the decade of 1990 experienced a serious balance of payment problem, this led to a series of structural reform measures across the sectors like trade, industry, investment being initiated by Central Government of India. In this backdrop, financial sector reforms were also kicked off encompassing the reforms meant for Banking sector. For realisation of the full potential of reform in real economy, it was immensely necessary to have a sound and competitive financial sector, especially, a vibrant banking sector. In order to inspect all aspects related to the structure, organisation, functioning and to set procedures of the financial system, Government of India constituted a high-powered committee under the chairmanship of Mr. M Narsimham in the month of August, 1991. The committee steered a number of recommendations in connection with banks, development financial institutions and capital market, which have been implemented in the course of coming years, submitted their committee report in November 1991. The Committee, made wide-ranging recommendations, which formed the basis of financial sector reforms to banks, development financial institutions (DFIs) and the capital market in the years to come. The committee accentuated the laudable journey made by the Indian banking sector towards the path of progress by means of extension of geographical reach and banking operations which promoted large scale of financial intermediation and growth of the economy. However the committee expressed its concern regarding the poor health of the banking sector. The committee also warned regarding further erosion in the real value and return on the savings if the deterioration of the financial health of the system remained unchecked. Thus the committee suggested that in order to retain and boost the

confidence of the depositors and investors, prompt action must be taken to address the slippage of financial health of the country. In view of the above, financial sector reforms were initiated to inculcate efficiency and dynamism in the sector.

The country's approach to reform in the banking and financial sector was guided by '*Pancha Sutra'* or five principles as mentioned in RBI (n.d., p.37):

> (i) cautious and sequencing of reform measures; (ii) introduction of norms that were mainly reinforcing; (iii) introduction of complementary reforms across sectors (monetary, fiscal, external and financial sectors); (iv) development of financial institutions; and (v) development and integration of financial markets. The evolution of the banking sector in this phase could be further divided two sub-phases, *i.e*., from 1991-92 to 1997-98 and 1997-98 onwards.

C(i)First Phase of Reforms: 1991-92 to 1997-98

Financial Health and Soundness

During the early years of 1990s, the Indian banking sector encountered the key problem of brittle health, lower bottom line and weaker capital base. Another concern was to assess the true condition of the banking sector as the prevalent system of health code was developed based on subjective consideration and it lacked consistency. For addressing these issues, various measures were enforced, one such measure was internationally accepted and practiced prudential norms related to income recognition, asset classification and provisioning along with capital adequacy were initiated in April 1992 in periodical manner. Banks were also advised not to charge any interest on any non performing asset and take to their income account. Further non-performing assets were clearly defined using

objective approach and banks were instructed to classify their advances into the following four categories, viz., standard assets, substandard assets, doubtful assets and loss assets instead of eight health codes prevailing at that period.

A major change took place with regard to divulging of correct status of banks health with the inception of the revised norms. According to RBI (n.d., p.37-38),

Aggregate domestic non-performing advances of all public sector banks, which constituted 14.5 per cent of total outstanding advances at end-March 1992 based on the old health code system worked out to 23.2 per cent as on March 31, 1993 based on the revised classification. This implied that about one-fourth of banks' advances were locked in unproductive assets. In order to strengthen the capital base of banks, capital to risk-weighted assets ratio (CRAR) system was also introduced for banks (including foreign banks) in India in a phased manner. Indian banks having branches abroad were required to achieve a capital adequacy norm of 8 per cent as early as possible and in any case by March 31, 1994.

Banks were asked to remain watchful against the defaulters of other lending institutions so as to reduce the slippage of fresh assets which occurs mainly due to wrong selection of borrowers. For strengthening the same the Reserve Bank of India launched a scheme in the month of April, 1994 which facilitates sharing of credit related information. For recovering the dues already accumulated as a result of slippage of assets, commercial banks were issued directives to make the best use of *Lok Adalats* (people's court), which has remained a convenient and less cost intensive method of judiciary for settling the dispute between small borrowers and banks. Moreover, the year 1993 witnessed enactment of 'The Recovery of Debts Due to Banks and Financial Institutions Act' was put in place, which had provision for setting up of tribunals meant for swift adjudication and recovering the debts.

This provision led to establishment of 29 Debt Recovery Tribunals (DRTs) and 5 Debt Recovery Appellate Tribunals (DRATs) at a number of places in the country.

Another noteworthy development during this phase was that the banks were allowed to enjoy their liberty with regard to fixation of their own deposit as well as lending rates. Also the complex interest rate structure was rationalised in the beginning, followed by deregulation of interest rates except a few. There existed certain stipulation regarding the establishment as well as entry of any new bank in the domain of Indian banking sector since the bank nationalisation in the year 1969. Despite a large number of banks existed, the lack of threat of entry of any new player resulted complacency among banks and the entire banking sector remained less competitive and inefficient. Regulated interest rate regime coupled with the practice of financing working capital requirement adversely affected the competitive environment of the sector. Further, the banks also lacked the operational flexibility as they were restrained from opening or closing any of their branches from commercial point of view. In this milieu, certain measures were put in place to infuse competition in the Indian Banking Sector -

i) The door of Indian banking sector was opened by the Reserve Bank of India by allowing entry of new banks in the private sector. The regulations regarding the ingress of new private banks were declared in January 1993.

ii) Keeping in view the process of deregulation and the changing banking landscape of the country, banks were allowed greater flexibility in case of opening of its branches in May 1992. However, the banks were denied permission from closing down their rural branches, they were allowed to rationalise their existing branches in rural as well as semi-urban areas.

iii) The field of customer service observed a significant development in terms of enactment of Banking Ombudsment Act in June, 1995.

Since its inception, the Reserve Bank of India, being the regulator of the entire banking sector, had been reviewing, examining and evaluating customer service of banks. There was a growing concern in India and abroad that only competition does not necessarily suffice appropriate treatment of the customer or quality customer service at a reasonable price which is determined in a transparent manner. This, therefore, necessitated interventions from the regulators to institutionalise a mechanism for securing better customer service for the public at large (Leeladhar, 2007).

Thus to ensure prompt and low-cost intensive redressal of customer complaint against the paucity in banking services, Reserve Bank of India devised banking Ombudsment Scheme, 1995 under the provisions of Banking Regulation Act, 1949. As stated by RBI (2008), "The Scheme covered all scheduled commercial banks having business in India, except RRBs and scheduled primary co-operative banks. Any person whose grievance pertaining to any of the matters specified in the scheme was not resolved to his satisfaction by the bank within a period of two months could approach the Banking Ombudsman within a period of one year".

These measures which were set forth had intense impact which was exhibited in terms of notable improvement in financial performance, asset quality and capital position across the banks by the end of this Various measures initiated had a profound impact. A significant improvement was observed in the financial

performance, asset quality and capital position by the end of this sub phase i.e. 1991-92 to 1997-98.

C (ii) Second Phase of Reforms: 1998-99 and Onwards

The second part of the 1990's decade upheld and advanced the various reform measures that were kicked off in the beginning years of the decade, it is evident from fortification of Prudential Norms and NPA Management Guidelines. Further, the banking sector was reinforced with the help of the framework laid down by the Committee on Banking Sector Reforms (CBSR) which submitted its report in April 1998 under the stewardship of Mr. M Narsimham.

Other measures undertaken during this period include

- To strengthen banks capital base, there was one percent hikein the predetermined (stipulated in October 1998) minimum capital to risk-weighted assets ratio (CRAR) to 9 percent from March 31, 2000. Also, Government securities, other approved securities, investments in securities outside the SLR and State Government guaranteed securities which were issued by defaulting entities were prescribed with certain risk weights to be assigned thereon.
- Risk management guidelines were introduced to strengthen Asset Liability Management (ALM) framework.
- Income Recognition, asset classification and provisioning norms used for asset classification were also constricted.
- Decision was undertaken to replace single centralised Asset Reconstruction Companies (ARCs) with multiple ARCs. For smooth functioning and also to provide necessary legal foundation for ARCs the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest

(SARFAESI) Act, 2002 was ratified by Government of India. This act empowered the lending organisations to take possession of underlying securities for realising dues without involving courts or tribunals.

- For getting information about credit worthiness of loan applicants, a Credit Information Bureau (India) Limited was announced in Union Budget of 2000-01.
- To allow foreign investment in banking sector in tune with liberalisation, an increase in Foreign Direct Investment (FDI) limit in private sector banks in automatic route were allowed upto 74% in March 2004 from 49% in 2001. It also includes FII investment under RBI directive.
- For proper governance in private sector banks an all inclusive policy was initiated in February 2005 which tries to embark upon the following- diversifying ultimate ownership and control, to check whether important shareholders are fit and proper, also to check the fitness of directors and Chief Executive Officer along with to which extent they are following corporate governance principles, to examine whether the private sector banks maintain minimum capital for optimal operations and also for systematic stability and finally to check the transparency and fairness of policy and processes.
- In February, 2005 the blue print for presence of foreign banks in India was prepared.
- In April 2004, a risk based supervision (RBS) approach which encompass monitoring as per the risk profile of each institution was put in place on a pilot mode.

- In November 2005, banks were issued guidance to introduce a facility of 'no frills' account with nil or low minimum balance.
- Banks were allowed to utilise the services of non-governmental organisations (NGOs/ SHGs), micro finance institutions and other organisations for arranging and disseminating financial and banking services through business correspondent (BC) and business facilitator (BF) models.

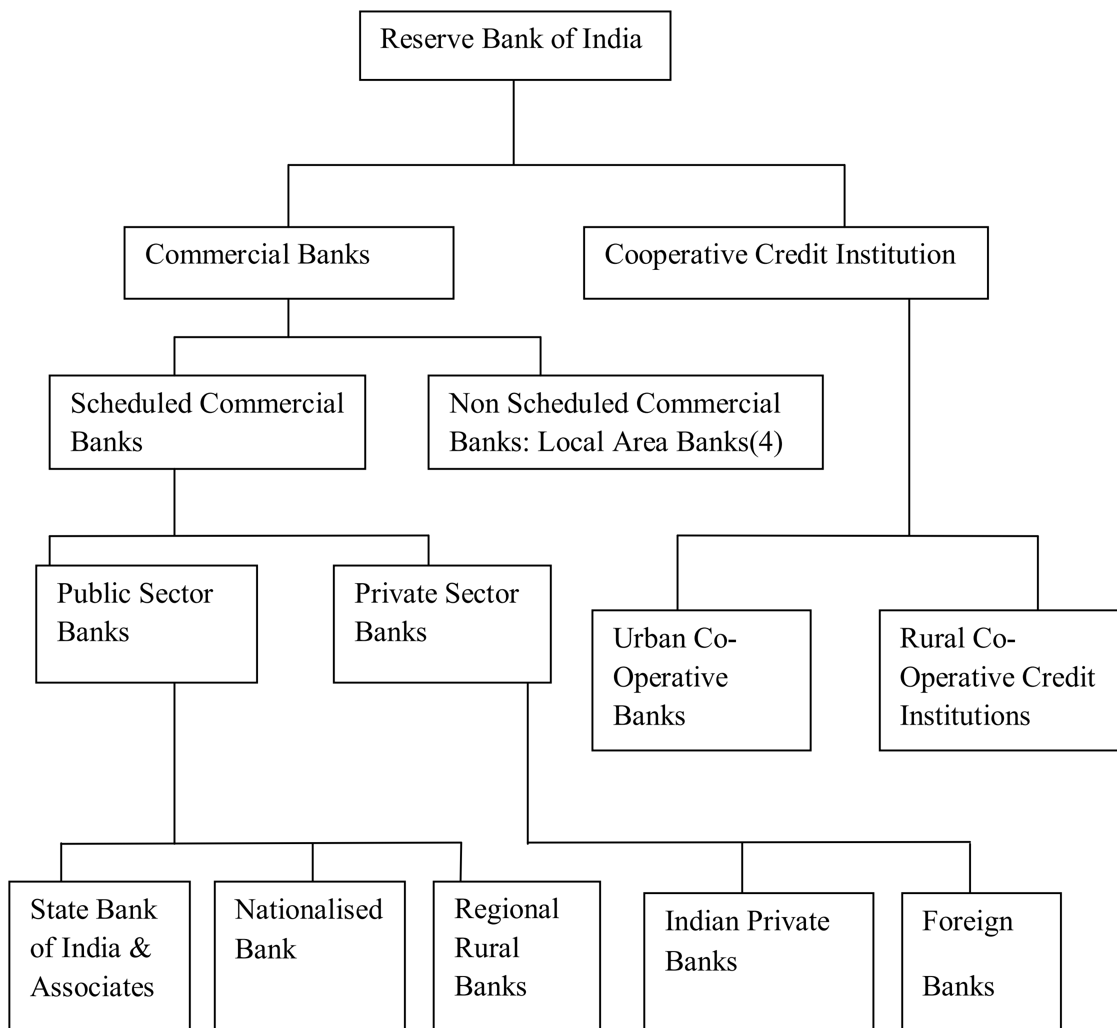
The encouraging achievement of this phase was that the banks were able to tame their non performing loans and these loans were gradually coming down thanks to the measures initiated in this phase. With the improvement of asset quality, the credit portfolio of banks started to widen along with considerable improvement in capital position of banks. Due to cut throat competition banks also witnessed narrowing down of margins. Although, increased and improved asset quality helped banks to pick up slightly in terms of profitability.

A note worthy development of this phase was observed in terms of steady increase in channelization of credit to agriculture& allied and Small Medium Enterprises (SME) sectors. With the introduction of 'no frills' account, common men also started showing their interest in banking. Thus, within a period of two years, around 13 million 'no frills' accounts were opened. The use of technology in banks also increased. This widened use of technology along with other measures helped the banks to improve their customer service. To restore the confidence and also to overcome the problem of dual control on urban cooperative banks, a mechanism of the TAFCUBs was initiated.

Thus with the passage of time Indian banking Sector is found to be evolving by embracing the changes in its surroundings.

D. Structure of Present Indian Banking Sector

The structure of Indian Banking Sector having Reserve bank of India at the helm of affair is presented below-



Source-RBI

- **Reserve Bank of India**

The Reserve Bank of India (RBI) was established by legislation in 1934 through the Reserve bank of India Act, 1934. It started functioning from April1, 1935 with its central office located in Mumbai. Though originally privately owned, it is fully

owned by the Government of India as a result of its nationalisation in 1949. Reserve Bank of India is the Central Bank of our country. The objective of the bank is stated in its preamble as: i) to secure monetary stability within the country; ii) to operate the currency and credit system to the advantage of the country.

The bank is managed by a central board of directors and four local boards of directors. Central Board of Directors consists of fourteen non-executive independent directors nominated by the Government, one Governor and four Deputy Governor. The RBI Act, along with the Banking Regulation Act, 1949, provides wide range of powers to the Reserve Bank to issue directions to the banking and financial sectors. Thus the main functions of RBI include- a) Formulating, implementing and monitoring the monetary policy, b) prescribing broad parameters of banking operations within which the country's banking and financial system functions c) issuance of currency and exchange or destroy currency and coins not fit for circulation. d) to maintain banking accounts of all scheduled banks.

- **Indian Scheduled Commercial Banks**

The commercial banking structure in India consists of scheduled commercial banks, and non-scheduled banks.

Scheduled Banks: Scheduled Banks in India constitute those banks which have been included in the second schedule of RBI act 1934. RBI in turn includes only those banks in this schedule which satisfy the criteria laid down vide section 42(6a) of the Act. "Scheduled banks in India" means the State Bank of India constituted under the State Bank of India Act, 1955 (23 of 1955), a subsidiary bank as defined

in the s State Bank of India (subsidiary banks) Act, 1959 (38 of 1959), a corresponding new bank constituted under Section 3 of the Banking companies (Acquisition and Transfer of Undertakings)Act, 1980 (40 of 1980), or any other bank being a bank included in the Second Schedule of the Reserve bank of India Act, 1934 (2 of 1934), but does not include a Co-Operative Bank". For the purpose of assessment of performance of banks, the Reserve Bank of India categories those banks as Public Sector Banks, Old Private Sector Banks, New Private Sector Banks and Foreign Banks, i.e. Private Sector, Public Sector, and Foreign Banks come under the umbrella of Scheduled Commercial Banks. The Scheduled Commercial Banks (SCBs) comprise 92.4 percent of the total assets of the entire banking system and hence are the most dominant in the banking system (Subbarao 2013).

i. Public Sector Banks- Public Sector banks are banks in which the government has a major holding (Pathak,2008).The Public Sector banks in India are regulated by statutes of Parliament and Some important provisions under Section 51 of the Banking Regulation Act, 1949. As per statutes, the central Government is mandated to hold a minimum shareholding of 51 per cent in Nationalised banks and 55 percent in State Bank of India (SBI). In turn, SBI will have to hold a minimum 51 percent of the shareholding in its subsidiaries. Another stipulation is that foreign investment in any form cannot exceed 20 percent of the total paid up capital of the public sector banks as per the provisions of Banking Companies (Acquisition and Transfer of Undertakings) Act 1970-80. The Board of public sector bank comprises of whole time directors-chairman, managing director(s), executive directors, government nominee directors, RBI's nominee directors,

workmen and non-workmen directors and other elected directors. As of 2014, total number of public sector banks is 26, which includes State Bank of India and its 5 subsidiaries, 19 nationalised banks, one other public sector bank (IDBI).

ii. Private Sector Banks- There are two distinctly observable categories among private sector banks- the new banks- aggressive, professionalized and the fastest growing, and the old private sector banks-typically smaller, with a specific regional bias and less than satisfactory performance. The broad underlying principle in permitting the private sector to own and operate banks is to ensure that ownership and control is well diversified and sound corporate governance principles are observed. As of 2014, total number of private sector banks are 20 including both old private sector banks as well as new private sector banks.

iii. Regional Rural Bank-The Government of India set up Regional Rural Banks (RRBs) on October 2,1975 under the Regional Rural Banks Ordinance, 1975. The ordinance was subsequently replaced by the Regional Rural Banks Act, 1976. RRBs were set up as institutions which combine the local feel and familiarity with rural problems, which the cooperatives possess and the degree of business organisation, ability to mobilise deposits, access to central money markets and modernised outlook which commercial banks have. The banks provide credit to the weaker sections of the rural areas, particularly the small and marginal farmers, agricultural labourers and small entrepreneurs. Initially, five RRBs were set up on October 2, 1975 which was sponsored by Syndicate Bank, State Bank of India, Punjab National Bank, United Commercial Bank and United Bank of India. The total authorized capital was fixed at Rs. 1Crore which has since been raised to Rs. 5 Crores. Of the issued capital, 50 percent is authorised by the Government of

India, 15 percent by the concerned state government and the balance 35percent by the sponsor bank, as each RRB is sponsored by a public sector bank. There are several concessions enjoyed by the RRBs by Reserve Bank of India such as lower interest rates and refinancing facilities from NABARD like lower cash ratio, lower statutory liquidity ratio, lower rate of interest on loans taken from sponsoring banks, managerial and staff assistance from the sponsoring bank and reimbursement of the expenses on staff training. The RRBs are under the control of NABARD. NABARD has the responsibility of laying down the policies for the RRBs, to oversee their operations, provide refinance facilities, to monitor their performance and to attend their problems.

iv. Foreign Banks- Foreign banks have been operating in India since decades, a few like ANZ Grindlays and Standard Chartered Bank have been functioning in India over a century. Foreign banks can operate in India in one of the following three ways: 1) through branches 2) through wholly owned subsidiaries and 3) through subsidiaries with maximum aggregate foreign investment of 74 per cent in a private sector bank. As per directive, foreign banks are required to invest an assigned capital of USD 25 million upfront at the time of opening their first branch in India. As of 2014, total number of foreign banks is 43.

- ***Non-Scheduled Banks***: **"**Unscheduled Bank in India" means a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949), which is not a scheduled bank.
- ***Co-operative Banks:*** Cooperative banks came into existence with the enactment of the Cooperative Credit Societies Act of 1904 which paved the way for formation of cooperative credit societies. These institutions play a

significant role in the financial system of the country in terms of their reach, volume of operations and the purpose they serve. A cooperative bank is member promoted and has to be registered with the state based Registrar of Cooperative Societies. It fill the gaps of banking needs of small and medium income groups not adequately met through by the public and private sector banks. Thus the cooperative banking system supplements the efforts of the commercial banks in mobilising savings and meeting credit needs of local population (Pathak, 2008). The cooperative credit sector in India comprises rural cooperative credit institutions and urban cooperative banks, whereas, rural cooperative credit institutions specialise in short-term credit and long term credit mainly for agriculture and other allied sectors; while urban cooperative banks are mostly engaged in retail banking.

1.5 Layout of the Study-

The intended study has been proffered in terms of some suitable chapters. As the Chapter 1 being Introductory in nature delves with the outline of the study. Also, Chapter 2 has portrayed the theoretical underpinning with respect to risk, risk management, credit risk management, and credit risk management in Indian context. An epigrammatic outline of the chapters is listed below:

Chapter 1: Introduction

The Chapter 1 being Introductory in nature delves with the outline of the study. With this chapter as the study is being initiated, so a brief profile of Indian banking sector during pre and post nationalization and post liberalization is highlighted.

Chapter 2: Review of Literature

This chapter portrays the theoretical underpinning with respect to risk, risk management, and credit risk management in Indian context. Review of the available literature has been presented here. Exhaustive review of literature has been undertaken in respect of risk management particularly to identify the research gap, suitable variables and direction of research.

Chapter 3: Research Methodology

This chapter includes objectives of the study, hypothesis of this study, research methodology adopted for the study, relevance in the present context and the limitation of the study.

Chapter 4: Risk Profile of Indian Banking Sector

In this chapter the typology and the extent of risks faced by the Indian banks are attempted to be presented. At the same time, a critical appraisal of the risk monitoring techniques and policies are presented here. At the end of this chapter a summated approach has been undertaken to prepare a risk profile of Indian banking sector.

Chapter 5: Asset Quality of Banks-an Assessment

An effort has been made to study the status of asset quality of the banks during the period under study. Also, it is attempted to find difference in asset quality in two time lag, that is, before and after 2008 in the light of objective 2 of the study.

Chapter 6: Determinants of Credit Risk and their Impact on Bank Performance

In this chapter, an attempt is made to identify the determinants of credit risk. Besides, the relative importance of these factors on the performance of Indian Banking Sector has been ascertained.

Chapter 7: Findings, Suggestions and Conclusion

This final chapter summarizes the entire study. This chapter contains the major findings of the study, suggestions/ recommendations and conclusion.