Chapter III

CHAPTER III

THEORETICAL ASPECT OF RETAIL LOAN LENDING AND RECOVERY PRACTICES IN INDIA

This chapter of the study provides a theoretical discussion on loan lending practices of banks, factors determining loan offering, loan lending and recovery practices of Indian scheduled commercial banks.

3.1 Introduction

In a developing country like India, banking sector has been playing a major role in the overall development of the country. The establishment of first joint stock bank in more than two centuries in 1786 to the modern retail banking practices, significant changes occurred in the banking sector in India. A snapshot view of the major transformation that took place right from the inception of the first joint stock bank to its current status can be viewed under three different phases as given below :

1. Pre-Nationalization period (Prior to 1969)
2. The Era of nationalization and after (1969 to 1991)
3. Post reform period (After 1991)

3.1.1 Pre-Nationalization Period (Prior to 1969)

Organised Indian Banking is more than two centuries old. The banking system in India traces its root to the General Bank of India, which was recognized in 1786 as the first joint stock bank in India. In 1809, the Bank of Bengal, one of the three presidency banks established by East India Company, derived into operation. Two other presidency banks in Bombay and Madras were established in the years 1840 and 1843 respectively. In 1860, the concept of limited liability was introduced in banking. In understanding of limited liability, several joint stock banks such as Allahabad Bank Ltd, The Alliance Bank of Simla Ltd, The Oudhbank Ltd, The Punjab National Bank Ltd were established during 1860 to 1900. The swadeshi movement, which started in the early 1900s gave incitement for the growth of indigenous joint stock banks. Thus, during this period i.e.,1900 to 1910, banks like The Peoples Bank of India Ltd, The Bank of India Ltd, The Bank of Baroda Ltd and The Central bank of India Ltd were recognized. In 1921, the three presidency banks were merged to form the Imperial Bank of India.

Till 1935, majority of the banks were in private sector, set up by individuals and/or industrial houses. There were no governing mechanism for the system of banking and these private sector banks were at liberty to use the funds in the approach they wanted which caused failure of many banks between 1900 and 1925. The Central Banking Enquiry Committee (CBEC) was constituted in the year 1929, to study the reasons for the failure of banks. The committee revealed that insufficient capital, poor liquidity of assets, combining non-banking activities with banking activities, irrational credit policy, incompetent and inexperienced directors were the reasons for the failure of banks. On the basis of the approvals of CBEC, the RBI Act was passed in 1934 and it came into existence in 1935, Reserve Bank of India was established. After the independence of the nation in 1947, the Banking Regulation Act was passed in 1949 and it gave more powers to RBI to regulate, supervise and develop the banking system in the country. In 1955, as per the recommendation of All India Rural Credit Survey Committee (AIRCSC), the Imperial Bank of India was renamed as State Bank of India. Later in 1959, the State Bank of India (Subsidiary Bank) Act was passed permitting SBI to take over eight princely state associated banks as the subsidiaries (State Bank of Bikaner and State Bank of Jaipur were two separate banks earlier and merged into one bank and it was named as State Bank of Bikaner and Jaipur). Today, the legal framework of bank is based on Banking Regulation Act and RBI Act enacted in the years 1949 and 1934, respectively.

3.1.2 The Era of Nationalization and After (1969 to 1991)

The Indian banking system has undergone significant changes during the period 1969 to 1990. The Government of India, on 19th July 1969 nationalised 14 major Indian commercial banks to enable them to play more efficiently the role of a catalytic agent for the economic growth by extending banking facilities to the most eligible classes. One of the main objective for establishment of SBI and nationalization of 14 commercial banks were to satisfy the banking facilities and needs for the credit to the rural people. Though, they have made some efforts to develop their share in contributing to rural finance, it was far from satisfactory benchmark. It was in this context that Regional Rural Banks (RRBs) started in 1976, another wave of nationalization came in 1980, when six more banks were carried under the control of state. The Indian banking sector has undergone a metamorphosis changes since the nationalization of banks. Nationalisation of banks resulted in commendable progress in terms of branch expansion, mobilisation of savings, deployment of credit, lending towards priority sectors and to modern e-banking and retail banking services.

3.1.3 Post Reform Period (1991)

Earlier 1991, the public sector banks in India were facing several problems such as accumulation of losses, mounting NPAs, excessive bureaucratisation, red-tapism, poor customer services, obsolete work technology, and disruptive policies of trade unions of bank employees etc. Committee on Financial System (Narasimhan Committee) was appointed in 1991 and it submitted the report in November 1991. The recommendations of the committee included, free entry of private sector/ Foreign banks. The committee also felt that computerisation and mechanisation is a means to improvement in customer service productivity. Rigorous practice of technology started after the Rangarajan Committee (1988) endorsements concerning to the branch automation. Subsequently after the economic liberalisation of Indian economy in 1991 the banking sector underwent dramatic changes. The use of technology increases efficiency, reduces costs, saves time, improves rapport with customers and processes transactions rendered quickly.

3.2 Recent Status of Banking

The objective of economic reforms of 1991, in general was to accelerate the growth drive of the economy, defined in terms of per capita income. The broad objective of the financial sector reform was to create a viable and efficient banking system.

The major banking sector reforms comprises of modifying the policy structure; improving the financial accuracy and credibility of banks; creating a competitive environment and firming of the institutional framework. The enhancements in the policy framework are aimed at removing and reducing the external restraints bearing on the profitability and functioning of commercial banks.

The banking sector reform measures aimed to enhance efficiency and productivity through competition initiated among various categories of banks and sequenced to create an empowering environment for banks to overcome the external constraints which were related to directed structure of interest rates, high levels of anticipation in the form of reserve requirements and credit provision to certain sectors. The policy environment for public sector banks realised the fact that the lion's share of financial intermediation was accounted by the public sector during the pre-reform period and consolidation is an essential feature of the reform process. Impressive institutional and legal reforms have been executed. To illustrate, a Board for Regulation and Supervision of Payment and Settlement Systems (BPSS) has been set up under the PSS (Payment and Settlement System Act, 2007 to prescribe policies relating to the regulation and supervision of all types of payment and settlement systems. This act aimed at setting up of standards for existing and future systems, authorisation of the payment and clearance systems and determination of the criteria for membership to these systems).

The regulatory framework and supervisory practices of RBI adopted the international best practices like CAMEL for analysing the efficiency and performance of banks. Based on the CAMEL model the minimum Capital to Risk Assets Ratio (CRAR) has been kept at nine per cent and in addition to CRAR the banks are required to maintain a separate Investment Fluctuation Reserve (IFR) out of profits, towards interest rate risk, at five per cent of their investment portfolio under the categories held for trading and available for sale. RBI has recommended prudential guidelines to encourage market discipline with a focus to ensure moral governance through fit and proper owners, directors and senior managers of the banks. The RBI has notified detailed guidelines on ownership and governance of private sector banks for emphasising diversified ownership patterns.

The financial sector in India has undergone significant liberalisation in all the four segments: banking, non-banking finance, securities and insurance. Each of these sectors has grown significantly accompanied by a process of restructuring among the market intermediaries. Entry of some of the NBFCs (Non-Banking Financial Companies) into the financial segments like merchant banking, insurance, etc. have created a financial 'conglomerates' and possibility of some of the non-banking institutions in the financial sector attaining large proportions of banking services to have a total effect on the performance of scheduled commercial banks in India.

The RBI has allowed Indian banks to augment their capital funds by issuing of innovative continuous debt instruments eligible for inclusion as Tier I capital: debt capital instruments eligible for inclusion as upper Tier II capital; perpetual non-cumulative preference shares eligible for inclusion as Tier I capital and redeemable cumulative preference shares eligible for inclusion as Tier II capital. A number of banks have issued these instruments both in India and overseas to rise fund to meet their capital needs.

An efficient credit information system has been suggested to improve the quality of credit decisions and in order to improve the asset quality of banks, apart from facilitating rapid credit delivery. A scheme for disclosure of information regarding defaulting borrowers of banks and financial institutions too has been introduced (Srinivas and Shanabhogara, 2014) in the recent banking reform policies. The various options available for reducing the element of pro-cyclicality include, among others, adoption of objective methodologies for vibrant provisioning requirements, as is being done by a few economies, by estimating the requirements over a business cycle rather than a year on the basis of the riskiness of the assets, establishment of a linkage between the prudential capital requirements and through-the-cycle ratings instead of point-in-time ratings and establishment of a flexible Loan-To-Value (LTV) ratio requirements.

3.3 Performances of Banks since 1998 Reforms

Banking reforms initiated in 1991 in India, were sequenced in the following order the first priority was given to the prudential norms, supervisory inaccuracy and risk management policies. Future, deregulations of interest rates, reduction in statutory pre-emption were introduced. Later, corporate governance practices were introduced so that the banks hold themselves responsible not only for the stockholders, but for all the stakeholders in a regime can get a knowledge on sound audit, accounting and financial reporting standards (Chaudhary and Singh 2012).

Table 3.1 Performance Parameters of Commercial Banks in India

(Amount in Rs. Crores)

Year	Deposits		Advances		Investment		Total Business		Credit Deposit Ratio (%)	
	Value	Index	Value	Index	Value	Index	Value	Index	Value	Index
2001-02	1055234	100	525683	100	491905	100	2072822	100	49.82	100
2002-03	1202701	114	645742	123	588059	120	2436502	118	53.69	108
2003-04	1355624	128	739233	141	693084	141	2787941	134	54.53	109
2004-05	1575145	149	864143	164	802070	163	3241358	156	54.86	110
2005-06	1837559	174	1150836	219	869738	177	3858133	186	62.63	126
2006-07	2164680	205	1516809	289	866507	176	4547996	219	70.07	141
2007-08	2696936	256	1981236	377	950981	193	5629153	272	73.46	147
2008-09	3320061	315	2476935	471	1177329	239	6974325	336	74.61	150
2009-10	4063204	385	2997906	570	1449475	295	8510585	411	73.78	148
2010-11	4786764	454	3497054	665	1725332	351	10009150	483	73.06	147
2011-12	6453700	612	5074600	965	2230500	453	13758800	664	72.33	145
2012-13	7429500	704	5879700	1118	2613300	531	15922500	768	71.06	143
2013-14	8552841	811	6812531	1296	3061796	622	18426462	889	70.00	141
2014-15	9435101	894	7388179	1405	3169504	644	19992784	965	78.31	157

Source: Profile of Banks and Statistical Tables Relating to Banks, RBI, www.***rbi***.*org.in*

During the year 2003-04, investments of Scheduled Commercial Banks (SCBs) increased by Rs.693084 crores as compared with level of Rs.491905 crores in 2001-02. This high growth of investment has led to an increase in the investment deposit ratio from 39.7 per cent in 2002-03 to 40.7 per cent in the year 2003-04 but investment, in a rising interest rate scenario and on the back of strong economic growth and industrial recovery, slowed down significantly from Rs.869738 crores in 2005-06 to Rs.866507 crores in the year 2006-07. In the year 2011-12, investment of schedule commercial banks showed a acceleration in growth as the growth rate showed a rise from 19.03 per cent (index value

770.65) in the year 2010-11 to 29.27 per cent (index value 996.29) in 2011-12 and further to 17.16 per cent (index value 1167.28) in 2012-13 as given in Table 3.1.

Commercial banks are key source of finance to industry and commerce. In the year 1998-99, the advances constituted a share of 38.9 per cent. Bank credit rose from Rs.275635 crores in the year 1997-98 to Rs.645742 crores in 2002-03 and further in 2004-05, it reached at the level of Rs.864143 crores, registering a growth rate of 16.90 per cent. After 2004-05 there has been a dramatic jump in the credit deployment as evident from an amount of Rs.864143 crores in 2004-05 which increased to Rs.1150836 crores in the year 2005-06, showing a growth rate of 33.18 per cent. In the year 2012-13, this credit deployment rose to the level of Rs.5879700 crores. The total advances of all commercial banks have gone up significantly over last five years. Since 2003, the total advances of all commercial banks have been more than double.

It is evident from Table 3.1 that total business of commercial banks has increased from Rs.1240834 crores in the year 1998-99 to Rs.2072822 crores in 2001-02 and further to Rs.4547996 crores in 2006-07, registering a growth rate of 17.88 per cent. The overall business showed a distinct turnaround during 2011-12 when the total business exhibited a growth rate of 37.4per cent. All components of business showed noticeable improvement and thereby raising the total business from Rs.4547996 crores in the year 2006-07 to Rs.5629153 crores in 2007-08. Robust macroeconomic performance continued to underpin the business of the banks till 2011-12 and thereafter exhibited decelerating trend. Growth rate of total business decreased from 37.4 per cent to 15.72 per cent, but overall trend growth rate of 20 per cent per annum of the business indicates that commercial banks form the most vital part of the Indian financial landscape in terms of their role in focussing credit to the commercial sector and enabling the process of financial inclusion.

Table 3.2. Growth of Business per Employee and Business per Branch in Indian Banking

Year	Business Per Employee (Rs. Lakhs)		Business Per Branch Year (Rs. Crores)	
	Amount	Index	Amount	Index
2001-02	178.98	100	40.52	100
2002-03	219.26	123	47.08	116
2003-04	247.36	138	53.65	132
2004-05	286.76	160	61.36	151
2005-06	348.38	195	71.69	177
2006-07	419.80	235	82.29	203
2007-08	522.94	292	98.33	243
2008-09	643.24	359	112.45	278
2009-10	753.44	421	130.57	322
2010-11	873.32	488	144.72	357
2011-12	122.30	68	134.39	332
2012-13	139.95	78	145.00	358
2013-14(P)	160.15	89	156.45	386
2014-15(P)	183.27	102	168.80	417

Source: Profile of Banks and Statistical Tables Relating to Banks, RBI, www.rib.org.in

Note: (P) indicates Predicted Values

Table 3.2 presents the business per employee of scheduled commercial banks. It is noted from table that business per employee of commercial banks increased over six fold from Rs.152 lakhs in the year 1997-98 to Rs.873.32 lakhs in 2010-11, showing a trend growth rate of 15.39 per cent per annum over the years. Business per employee of all banks taken together increased from Rs.163 lakhs in 1998-99 to Rs.219.26 lakhs in 2002-03 and further to Rs.348.38 lakhs in the year 2005-06. After the year 2005-06, commercial banks, continued to register higher business per employee. Although business per employee has increased throughout the study period but the increase was phenomenal in year 2005-06 and for the last three years when the banks have been able to improve business per employee from Rs.419.80 lakhs in 2006-07 to Rs.873.32 lakhs in the year 2010-11. Highest growth rate in business per employee was observed in 2007-08 (24.57 per cent, index value 343.77). It appears from the data that the banks have made remarkable progress in the area of business per employee but the business per employee had a sharp decline to Rs.122.30 lakhs in 2011-12 and Rs.139.95 lakhs in 2012-13 respectively.

Business per branch of scheduled commercial banks is presented in table 3.2. It is clear in the table that growth of business accelerated since the year 2000-01. The business per branch of banks rose from Rs.21.08 crores in 1997-98 to Rs.34.25 crores in the year 2000-01 and further to Rs.47.08 crores in 2002-03. Up to the year 2003-04, the rate of growth of business per branch was slow but it picked up and accelerated after 2005-06. The banks have made remarkable improvement in the growth rate of business per branch in year 2007-08, as the growth rate of business per branch was 14.78 per cent in year 2006-07 with index value of 390.37 and it rose to 19.50 per cent in 2007-08 with index value of 466.46. It is because in year 2007-08, deposit mobilization is considered to be excellent (Rs.2696936 crores in 2007- 08 from Rs.1355624 crores in 2003-04). Then it remained slow in 2008-09 (14.35 per cent) but in the year 2009-10, it again picked up to 16.12 per cent with index value of 619.40.In 2010-11, the business per branch was a staggering amount of Rs.144.72 crores showing a growth rate of 10.84 per cent with index value of 686.53. In 2011-12, the business per branch declined to Rs.134.39 lakhs with an index value of 637.52 and in 2012-13 the business per branch was Rs. 145 lakhs with an index value of 687.86. It is further understood that overall business per branch is growing at a fluctuating rate for the entire study period and the trend growth rate turns out to be 16.04 per cent per annum for the period under study.

Table 3.3. Return on Asset and Return on Equity in Indian Banking

(Values in Per Cent)

Year	Return on Assets		Return on Equity	
	Value	Index	Value	Index
2001-02	0.54	100	9.98	100
2002-03	0.82	152	15.13	152
2003-04	1.05	194	18.42	185
2004-05	1.21	224	20.61	207
2005-06	0.97	180	15.74	158
2006-07	0.96	178	14.77	148
2007-08	1.00	185	15.51	155
2008-09	1.12	207	15.32	154
2009-10	1.13	209	15.44	155
2010-11	1.05	194	14.31	143
2011-12	1.08	200	14.60	146
2012-13	1.04	193	13.84	139
2013-14	0.81	150	10.68	107
2014-15	0.81	150	10.42	104

Source: Profile of Banks and Statistical Tables Relating to Banks, RBI, www.rib.org.in

Return on Assets (ROA) measures bank's profit per currency unit of assets. The return on asset of scheduled commercial banks is shown in Table 3.3. Immediately after the introduction of reforms; banks have registered negative returns because the practice of booking income on addition basis came to an end with the introduction of reform measures. However since the year 1997-98, the condition has changed for the better. From 1997-98, the ROA has been 0.7 per cent but in 1999-00, it fell to 0.53 per cent it was because of net loss registered by some banks. There were fluctuations in the year to year percentages but in 2002-03, it picked up to 0.82 per cent and further to 1.05 per cent in the year 2003-04. This ratio dropped marginally to 0.97 per cent in the year 2005-06. Net profits to assets ratio of scheduled commercial banks remained almost unchanged in the year 2006-07 but, it increased to 1.0 per cent in the year 2007-08, as against the decline in previous year. Overall the return on assets improved to 1.12 per cent in 2008-09. During the year 2009-10 the net profit to assets ratio of scheduled commercial banks improved moderately to 1.13 per cent as against 1.12 per cent in 2008-09. The year 2010-11 witnessed a relatively sluggish performance of the Indian banking sector. In the year 2012-13, the profitability of Indian banks captured by the return on asset was a notch lower at .081 per cent than 1.04 per cent during the previous year. This return on asset posted a fall in 2012-13, largely reflecting the significant slowdown in profits. But on the whole, return on asset has registered a trend growth rate of 4.63 per cent per annum period under consideration. In the short term, the Indian banking sector essentials to lend support to the process of economic recovery while in the medium to long term it needs to transform itself to become more efficient and vibrant so as to ensure a more sustainable pattern of economic growth.

The Return on Equity (ROE) is an indicator of banks performance from the point of interest of shareholders. The ability of the bank to attract fresh capital in the market depends upon this indicator. Data relating to return on equity for the study period is presented in table 3.3. The return on equity of scheduled commercial banks has been on positive side throughout the period. The return on equity of the banking system was high at 13.26 per cent in the year 1998-99 as against 11.09 per cent in 1997-98. Reflecting the combined impact of lower net profits and higher capital base, return on equity for scheduled commercial banks on the whole declined significantly to 9.98 per cent in 2001-02 from 12.56 per cent in previous year. After reaching a level of 20.61 per cent in 2004-05, it again declined to 14.77 per cent in the year 2006-07, reflecting mainly the impact of a higher capital base by ploughing back of profits. Then it improved to 15.51 in 2007-08 and in the year 2011-12 it declined to 14.60 per cent and further to 13.84 per cent in 2012-13. It reflects mainly the impact of increase in resources raised from the capital market during the year. Return on equity had grown at the rate of 3.09 per cent per annum in the past. The high return on equity in the banking industry may be conducive to attract capital. However, actual success of banks in tapping capital market would be contingent on the individual bank’s stability and vibrancy. Hence both return on assets and return on equity have registered a positive growth rate even when there were recessionary tendencies around the world.

3.4 Theoretical Outlook on Bank’s Lending Operation

Commercial banks undertake a wide variety of activities, which plays a vital role in the country's economy. They pool and absorb risks for depositors and provide a constant source of investment and working capital funds to various sectors of the economy as lending. The three main interrelated functions of commercial banks are holding of deposits; creating credit through lending and investment activities; and providing a mechanism for payments and transfers of funds for various productive activities. The extension of credit or lending is, therefore, the principal activity of a commercial bank.

From the early days of banking theory, the differentiated between deposits and lending and it was viewed as minimal, associated with cash balances required to satisfy uncertain cash flows and regulatory feudal i.e., landlord age extracted from the depository process by the central bank through required reserves held inflate money or central bank balances. Not only lending was the primary source of banks’ income, but it provides financing for productive activity throughout the economy. Historically, understanding the role performed by the commercial banks in the economy has its roots from macroeconomic theory of Keynes and Pesek. These economists argued that commercial banks are central to a macro economy as they act as financial intermediaries between savers and investors.

The literature available on banking provides various theories which govern the lending processes of banks. The theories have evolved over time with the evolution of commercial banks. However, most of these theories are based on the conventional difference between commercial banks as creators and other private financial enterprises as brokers of loanable funds. Commercial banks can borrow at a lower interest rate and lend at higher interest rates. They relieve the market of some primary securities and substitute others’ indirect securities or financial assets whose qualities command a higher price. The margin between yields on primary and indirect securities is the intermediaries’ compensation for the special services they supply.

The earliest theory of credit is the commercial 'Loan Theory of Credit' which was also referred to as the ‘Real Bills Doctrine’. This theory, originated in England, which goes to the eras of 18th century. Bank lending to merchants traditionally took the form of discounting of commercial bills. According to this theory, the earning assets of commercial banks must be in the form of short-term and self-liquidating loans extended to businesses for the financing of their inventory needs. It was strongly believed that banks by financing these types of loans could retain most liquid assets which will enable banks to easily meet their demand deposits requirements. The term ‘Commercial Bank’ owes its origin to the commercial loan theory as banking was related to the financing of commerce. Despite certain limitations of this theory, in practice many banks still prefer the short-term and self-liquidating loans over other types of credits extended by it.

Another major theory of bank lending was the shiftability theory. This theory states that a bank’s assets are shiftable, i.e., easily marketable and the liquidity of most of the assets is effectively maintained. For instance, the securities that can be easily converted into cash possess a high degree of liquidity. In short, the shiftability theory was based on the consideration of ‘how quickly’ the assets could be converted into cash. This theory was first set forth by H.G. Moultan in 1918. Commercial banks that hold stocks of sovereign bonds of all over the world, which in present day banking is a common practice, are knowingly or unknowingly followers of this doctrine. According to anticipated income theory, a bank can maintain its liquidity if loan repayments are scheduled on the basis of the anticipated income of the borrower rather than on the funds or the collateral securities. The basic argument of this theory was that the banks should rely on the borrower’s income earning capacity or the cash flow and the coverage of debt service requirements, rather than merely on the collateral asset values. The debt service coverage was determined on the basis of inclusive cash-flow projections which ordinarily provide a reliable indication of the quality of the loan being financed. This theory seems to be more suitable in the practice of the modern time banking than the previous two theories.

According to the liability management theory, it is not necessary for a bank to observe traditional liquidity standards if it can go into the market and bid for funds whenever it is in need of liquidity. A bank can create additional liabilities to meet its liquidity requirements**,** and banks always have a number of opportunities to meet their liquidity requirements such as issuing Certificate of Deposits (CDs), borrowing from the central bank and borrowing in the capital market etc. The liability management theory is a major breakthrough in the modern approach to commercial banking. Banks' lending operations are determined, at the micro level, based on certain considerations outlined in the theories discussed above.

To sum up, different theories have evolved from time to time to explain banks' lending behaviour. According to the commercial loan theory, which was the earliest theory on credit, the earning assets of banks were in the form of short-term and self-liquidating loans. According to the shiftability theory, the main consideration was on how quickly the assets can be converted into cash. The anticipated income theory postulates that a bank can maintain its liquidity if loan repayments are scheduled on the basis of the anticipated income of the borrower. According to the liability management theory, it is not necessary for bank to observe traditional liquidity standards if it can go into the market and attempt for funds whenever it is in need of liquidity. Banks' lending operations are determined at the micro level, based on certain considerations as suggested by the theories. However, the overall quantum and target group of lending is determined by the financial system which a country adopts, i.e., market based financial system or bank based financial system.

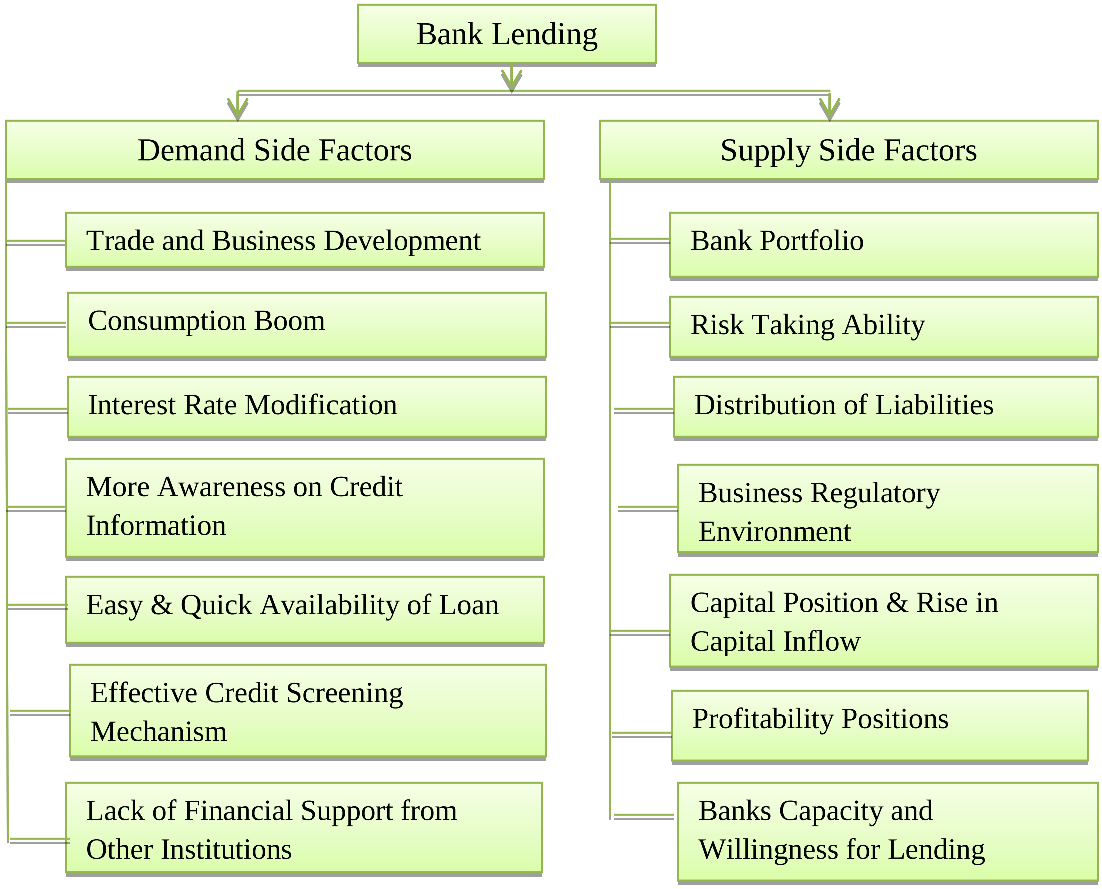
3.5 Determinants of Bank Lending

Banks' lending behaviours are determined by two principle forces that is supply and demand for loan. The principle that the demand for bank loans determines bank portfolio behaviour is sometimes referred to as the accommodation principle. Similarly the principle that commercial banks' responses to market forces determine their portfolio behaviour is referred to as profit maximisation principle. As per accommodation principle, bank lending is the key determinant of banks' portfolio behaviour. The use of the term "accommodation" implies that the demand for such loans would mainly determine bank behaviour regarding borrowing from the central bank, holdings of excess reserves, and the division of earning assets between loans and investments. Thus, the banks responses to demand for loans are influenced by economic variables such as interest rates and economic activity that would greatly determine bank behaviour regarding its lending practices. Under the accommodation principle, bank behaviour would mainly imitate the demand of customers for loans. For example, a rise in the demand for loans from banks (supply of this form of earning asset) would meet the subject to the deposit constraint, by reductions in investments and excess reserves and an increase in borrowings from the central bank and with banks being the spine of financial intermediation, the banking sector.

The profit maximisation principle implies that commercial banks' responses to market forces determine their portfolio behaviour. If the existing distribution of assets held by the commercial bank is not the distribution desired, then the bank will attempt to adjust its portfolio of assets by increasing its holdings of some assets and decreasing its holdings of other assets. The commercial banks' decision of allocating its portfolio of assets between the two earning assets, i.e., loans and investment are generally determined by the existing legal reserve requirements against commercial banks' demand and time deposits. Given the de-jure and de-facto status of the most of banks' liabilities individual bank cannot predict with certainty future deposit flows, loan demands, interest rates, and actions by the monetary authorities. Commercial banks desire to have a portion of their asset portfolio that represents a stock of liquidity have to act as a buffer against changes in the aforesaid factors. In practice, the dominance of either demand or supply side on credit fluctuations is difficult to prove as both the factors play a responsible role most of the times.

3.6 Factors Influencing Demand and Supply of Lending

Business entrepreneurs and households' demand are the primary determinant of bank credit. The credit extended by the financial institutions are in consonance with the demand conditions prevalent at that point of time. The real business cycle literature sets forth the view that the demand for bank loans is highly pro-cyclical. A positive technological changes has also supported in increase in investment and credit demand in the economy. From banking theories it has been understood that boom in consumption lead to increase in borrowers need for loans that is offered by financial institutions.



Source: Lending and Investment Operations of Banks, Report on Currency and Finance, RBI, 2009 Report.

Figure 3.1 Demand and Supply Side of Bank Lending

As discussed earlier, bank lending is determined by both supply side and demand side factors. On the supply side, banks' portfolio behaviour regulates their lending. Commercial banks hold a portfolio of assets based on risk return perceptions and distribution of the liabilities so as to yield the greatest return. Loans and investments are the two most important earning assets in the asset portfolio of banks and their composition is determined by the banks' portfolio behaviour which, in turn, is based on either accommodation principle where lending is the key determinant of banks' portfolio or profit maximisation principle. A rise in capital inflows or an easier monetary policy could also lead to increased credit supply in the economy. Banks' willingness to lend could also be affected by the regulatory command in place, and whether they hold enough capital to support all the new profitable loan proposals. Similarly, an alternate view is that fluctuations in bank lending reflect supply side developments such as changes in banks' capacity and willingness to lend.

The demand for bank loans is highly pro-cyclical. An analysis of several episodes of consumption boom in industrial and emergent economies revealed that these owed their origin to consumption boom originating in terms-of-trade improvement. A positive technological shock with the resultant increase in investment and credit demand in the economy could also be one of the factors for the growth in demand for credits.

3.7 Lending Practices of Banks in India

Banks in India have traditionally been the main source of credit for various sectors of the economy. They have also funded borrowing necessities of the Central and State Governments by investing in their securities. Lending and investment operations of banks in India have evolved in response to the changing needs of the economy. Earlier to the initiation of financial sector reforms in the early 1990s, lending by banks was tightly regulated and banks were expected to support their lending operations to plan priorities. Bank lending was the principal focus of monetary policy under the credit planning method adopted in 1967-68. However, in the wake of banking sector reforms, several restrictions on banks' balance sheet were reserved and direct credit controls largely dismantled**,** though in a phased manner. Directed investments were also reduced to a significant extent. The system of administered lending rates was also dismantled and various other restrictions on banks' lending were gradually removed in order to enable banks to operate in a flexible manner. This led to a structural transformation in the lending and investment operations of the banks. Scheduled commercial banks lending to various occupation sectors and to the private households are discussed briefly in this section of the study.

Table 3.4 Occupation-Wise Distribution of Credit Limit of Scheduled Commercial Banks in India

(Values in Rs.Million)

Year	Agriculture	Industry	Transport Operators	Professional and Other Services	Personal Loans	Trade	Finance	All Others
2001-02	787586	3716299	124506	367838	1079499	1187863	497182	793508
2002-03	1063040	4106733	129460	481624	1531105	1232215	611727	795434
2003-04	1158892	4703848	144918	553061	2458345	1335697	703820	710940
2004-05	1491433	7140054	177621	800931	3475982	1733567	914404	728670
2005-06	2068631	8528014	298262	1112332	4661495	2274714	1243101	998721
2006-07	2767919	11429963	316572	1736234	5886961	3085132	1595800	915509
2007-08	3214183	13083925	570778	2490712	6877405	2858959	2284861	1460091
2008-09	3756698	16522132	716656	3355731	7938317	4489254	2468920	1043059
2009-10	4658279	20925606	1147852	4231114	8064428	5137320	3075581	1446790
2010-11	7286841	29969567	1765858	9860317	9918588	7192004	7475726	3686411
2011-12	6825880	32455921	4572440	1750535	10860351	7858377	7064118	4172694
2012-13	8158644	36540759	1748550	6703761	12411819	9642883	6231225	1920191
2013-14	11805306	41306871	2090819	6768062	14452906	9559747	7050546	2060192
2014-15	9170886	45441344	1928095	7325692	16960773	10819861	8161256	2560462
CGR	23.12	23.31	31.43	27.28	21.31	21.17	26.85	12.71

Source: Basic Statistical Returns of RBI

It is evident from the above data analysis that the SCBs have given high priority to transport operators loans and it had registered significant growth of 31.43 per cent per annum. It has been also inferred that the credit limit of SCBs in the form of transport operators loans was accounted toRs.124506 million in 2001-02 and it had massively increased to Rs.1928095 million by the end of the year 2014-15. Followed by, it has been observed that the commercial banks have lend significant amount to priority sectors like professional and other services (27.28 per cent), finance (26.85 per cent), and for industrial development (23.31 per cent), respectively. Similarly it has been inferred that the scheduled commercial banks had distributed considerable amount to agriculture (23.12 per cent), personal loans (21.31 per cent) and for trading sector (21.17 per cent), accordingly. Further it has been observed that the credit limit of SCBs in the form of other loans accounted toRs.793508 million in 2001-02 and it had increased to Rs.2560462 million by the end of the year 2013-14 and it had registered 12.71 per cent growth rate between the years 2001-02 to 2014-15.

3.8 Classification of Retail Loans

Retail banking and retail lending are often used as synonyms, but in fact, the retail lending is just part of retail banking. In retail banking all the needs of individual customers are taken care of in a well-integrated manner. The main business of the banking company is lending of funds to the constituents, mainly to the traders, business and industrial enterprises. The major portion of a bank's fund is employed by way of loans and advances, which is the most money making employment of its funds. There are three main principles of bank lending followed by the commercial banks and they are safety, liquidity and profitability. Banks grant loans for different periods like short term, medium term, and long term and also for different purpose.

(i) Personal Loans: This is one of the major loans provided by the banks to the individuals. The borrower can use the loan for his/her personal purpose. This may be related to his / her business purpose or for their personal use. The amount of loan depends on the income of the borrower and his/her capacity to repay the loan.

(ii) Housing Loan: NHB (National Housing Board) is the wholly owned subsidiary of the RBI which controls and regulates whole industry of housing and its related lending practices as per the guidance and information. The purpose of loan is mainly for purchase, extension, renovation and land development.

(iii) Education loans: Loans are given for education in country as well as in abroad.

(iv) Vehicle Loans: Loans are given for purchase of scooter, auto – rickshaw, car, bikes etc. Low interest rates, increasing income levels of people are the two primary factors for growth in this sector. Even for second hand car finance are available these days.

(v) Professional Loans: Loans are given to Doctor, Chartered Accountant, Architect, Engineer or Management Consultant. Loan repayment is normally done in the form of Equated Monthly Installment (EMI).

(vi) Consumer Durable Loans: These loans are given for acquisition of Television, Cell phones, Air Conditioners, Washing Machines, Fridge and other items.

(vii) Loans against Shares and Securities: Finance against shares lended by banks for different uses. Now-a-days finance against shares are given mostly in demat shares. A margin of 50 percent is normally accepted by the market value in banks. For these loans the documents essential are normally accepted by the bank on market value. For these loans the documents required are normally Demand Promissory Notes (DPN), letter of continuing security, pledge form, power of attorney. This loan can be used for business or personal purpose.

(viii) Credit Cards: A credit card is an instrument, which provides instantaneous credit facilities to its holder to avail variety of goods and services at the merchant outlets. It is made of plastic and hence generally called as Plastic Money. Such cards are issued by bank to persons with minimum income ranging between Rs.50000 and Rs.100000 per annum and are accepted by a variety of business establishments which are notified by the card issuing bank. Some banks insist on the cardholder being their customer. Few banks do not charge any fee for issuing credit cards while others impose an initial enrollment fee and also for annual fee. If the amount is not paid within the specific time duration the bank charges a flat interest of 2.5 per cent. Lending Indian Banks such as: State Bank of India, Bank of Baroda, Canara Bank, ICICI, HDFC and a few foreign banks like CITI Bank, Standard Chartered etc., are the prime issuers of credit card in India.

(ix) Debit Cards: It is a popular bank product introduced in India which was introduced by Citibank a few years ago in association with Master Card. A debit card enables purchases or payments made by the cardholder. It debits money from the account of the cardholder during a transaction which implies the cardholder can spend only if they have sufficient balance in their bank account.

3.9 Retail Credit Market in India

Access to finance is one of the most fundamental requirements for the development of an economy and its people. In today's world, thanks to institutionalised credit, common man now have structured and regulated credit opportunities available for building assets, educating their children and aspiring for economic as well as social growth. For past few years India has experienced a revolution in retail credit in comparison to the last decade's growth. Banks finance are available to individuals faster and easier than ever before. The Indian Banking 2020 report of Boston Consulting Group indicates that retail banking will benefit immensely from the Indian demographic dividend. Mortgage loans will grow fast and will cross Rs.40 trillion by 2020.

Table 3.5. Contribution of Retail Credit to the Total Advances made by the Scheduled Commercial Banks in India

(Values in Rs. Million)

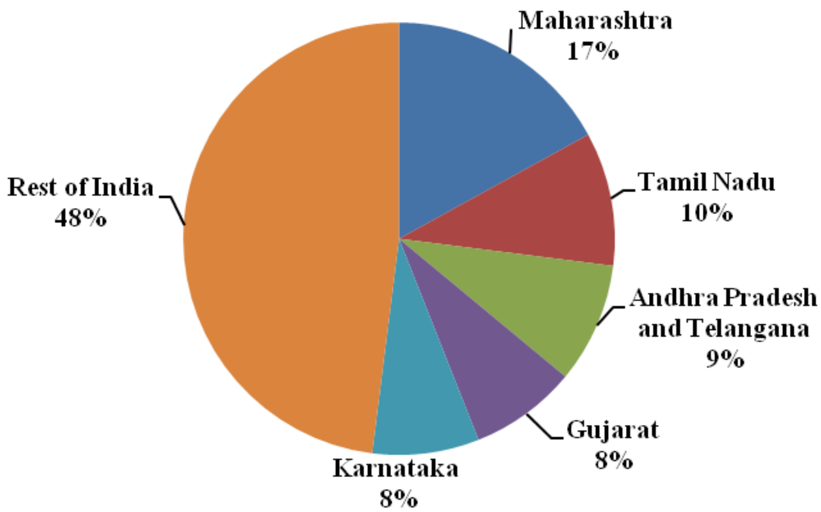
Year	Total Credit Limits	Index	Y-O-Y Growth (per cent)	Total Personal Loan	Index	Y-O-Y Growth (per cent)	Proportionate Contribution
2001-02	8554281	100	-	1079499	100	-	12.62
2002-03	9951338	116.33	16.33	1531105	141.83	41.83	15.39
2003-04	11136083	130.18	11.91	2458345	227.73	60.56	22.08
2004-05	16462662	192.45	47.83	3475982	322.00	41.40	21.11
2005-06	21185270	247.66	28.69	4661495	431.82	34.11	22.00
2006-07	27734090	324.21	30.91	5886961	545.34	26.29	21.23
2007-08	32840914	383.91	18.41	6877405	637.09	16.82	20.94
2008-09	40290767	471.00	22.68	7938317	735.37	15.43	19.70
2009-10	48686970	569.15	20.84	8064428	747.05	1.59	16.56
2010-11	77155312	901.95	58.47	9918588	918.81	22.99	12.86
2011-12	75560316	883.30	-2.07	10860351	1006.05	9.49	14.37
2012-13	83357832	974.46	10.32	12411819	1149.78	14.29	14.89
2013-14	95094449	1111.66	14.08	14452906	1338.85	16.44	15.20
2014-15	102368369	1196.69	7.65	16960773	1571.17	17.35	16.57

Source: Computed from Basic Statistical Returns of RBI, www.rib.org.in

The proportion of credit distributed to personal loans had registered maximum proportion of 22.08 per cent at the fiscal year 2003-04 to the total loan extended by SCBs and it was observed at 16.57 per cent by the end of the study period 2014-15. Subsequently it has been observed that the retail credit lending of SCBs is observed to have fluctuating growth trend during the years 2001-02 to 2014-15, the retail credit lending of SCBs had registered maximum growth of 58.47 per cent at 2010-11 which had drastically reduced to -2.07 per cent by the financial year 2011-12. Followed by it has been inferred that the total personal loans lend by SCBs had registered its maximum growth of 60.56 per cent at 2003-04 and it had decreased to 17.35 per cent by the closure of the year 2014-15. From the detailed data analysis it has been observed that the retail lending market is recovering from the global financial crisis and is expected to remain a profit driver for financial institutions into the foreseeable future (Deloitte Global Services nd), Retail lending is the next growth driver for Indian banks next to the industrial loan segments. A comparison of India's retail lending penetration levels with developed and emerging markets, when juxtaposed against demographic trends and income levels also reveal significant long-term potential. After 4-5 years of sluggish growth a turnaround in Indian retail finance market is expected in the near future (Rathi 2015).

3.10 Reason for the Growth in Retail Credit

Retail credit market has registered a positive growth in India. Credit Information Bureau (India) Limited (CIBIL) data analysis indicates that over the past five years operated by a growing demand in metros as well as Tier-II and Tier-III cities, retail credit demand has grown exponentially. This demand registered a healthy growth of 25 per cent rise in 2015 compared to the previous year rise i.e., 2014. The primary reason that could be attributed to growth of retail credit is the growing financial awareness among consumers. Today, a rising number of consumers are conscious about their individual income level and about their credit repayment ability. CIBIL report and credit score drew an understand on how significant for a consumer approval of their loan applications. For the credit sector i.e., for bankers this is a positive sign as it has resulted in significant reduction in the number of retail delinquencies. Lenders are now better placed to recognise the credit behaviour of the borrower across various parameters like: past performance, credit type, credit exposure and credit utilisation among others.



Source: http://ir.inflibnet.ac.in:8080/jspui/bitstream/10603/56374/8/08_chapterper cent201.pdf

Figure 3.2. Top Five Banks Retail Credit Market In India

Interestingly, the top five states: Maharashtra (17 per cent), Tamil Nadu (10 per cent), Andhra Pradesh and Telangana (9 per cent), Gujarat (8 per cent), and Karnataka (8 per cent) together contribute 52 per cent of the country's credit demand in India for banks. From the retail perspective, auto and personal loans have been finding favour with consumers across the country in the past few years. India is a young nation, with over 65 per cent of its workforce under the age of 35 years. Moreover, the demand for home loan is growing and this can be attributed to the young working population and their associated aspirations. In 2015, more than 40 per cent of home loan borrowers were less than 35 years of age, compared to 30 per cent five years ago. It has been observed that a majority of enquiries for home loans are originated from the metro cities and tier II cities like: Mumbai, Delhi, Chennai, Bangalore, Hyderabad, Pune, Cochin, Vijayawada, Coimbatore etc (Chandorkar 2016).

3.11 Role of Retail Loan Market in Promotion of Retail Banking in India

Retail banking is going to emerge amazingly in India. As stated earlier the rise of the Indian middle class is an important contributory factor for the growth of retail banking in India. The percentage of middle to high income Indian households is expected to continue rising. The younger population not only wields increasing purchasing power, but as far as acquiring personal debt is concerned, they are perhaps more comfortable than previous generations. Improving consumer purchasing power, coupled with more liberal attitudes towards personal debt, is contributing to India's retail banking segment. The combination of these factors promises substantial growth in the retail sector, which at present is in the nascent stage.

Retail lending is often regarded as a low risk area for money laundering because of the perception of the sums involved. The industry today is witnessing a price war, with each bank competing to have a large slice of the cake of the market, without much of a scientific study into the cost of funds involved, margins etc. (Kumar and Parashuramulu 2013). The growth of retail lending is attributable to the rapid advances in information technology, the growing macroeconomic environment, financial market reforms, and several micro level demand and supply side factors (Mittal and Pachauri 2013).

Today banking business is diversified from traditional approaches to individual approach. With the shift in customer preference from deposits in banks to investments, ever increasing competition and number of banking facilities to customers at their entrance, there is tendency that the profit margins of the banks are divided and deteriorated. Now-days almost all banks in India have started retail banking products and value added services along with their traditional banking products. It has become imperative for all the banks to retain the old customers and fascinate the new customers by providing more value added services and banking incentives under single window system as well as to find different ways to generate more income. Another significant factor led to utilize the additional deposit through loans to customers and create image about banks quality products (Matkar, 2012).

3.12 Rising NPAs in Retail Sectors

Personal loans are usually fixed rate loans and are unsecured in nature. They are not assisted by any security, collateral or guarantor. Given their unsecured nature, personal loans are not able to the same recovery efforts that are seen in other asset classes where underlying security interests improve retrieval prospects. In addition to this, personal loan financing in India is a very competitive business and this may have pushed many institutions to originate loans in riskier segments (Fitch .nd 2014-15).

Since the year 2000, the share of primacy sector in total NPAs has averaged at 45 per cent, while the share of non-priority sector averaged at 55 per cent prior to the period of 2008. Disaggregated analysis reveals that, on an average, retail loans occupy the main share in total NPAs followed by Small Scale Industries (SSIs), agriculture, personal loans, housing loans, exports, credit cards and auto loans. The growth in credit flow to retail segment has declined overtime. This is also accompanied by fall in the growth of NPAs in the retail loans sector. When compared with pre-crisis period 2008, there was a marked deceleration in the growth of retail loans and during the post-crisis period, from 7.5 per cent during 2001-2007 to 2.6 per cent during 2008-2012. This could partly be due to risk aversion that generally followed after the crisis. The deceleration in NPAs in retail loan segment has been even sharper from 9.3 per cent to 2.5 per cent during the above period. Though the share of NPAs in retail loan segment in the total NPAs has come down from 38 per cent as at end-March 2009 to 18 per cent by end-March 2012, it still continues to be high and above the levels of key priority sectors like agriculture (Lokare, 2014).

The rise in NPAs was due to some infrastructure projects, strike in global economic recovery, and continuing uncertainty in global markets leading to lower growth of credit. It was stated that public sector banks continued to be under stress on account of their past lending. Going through the information of annual financial results of public and private sector banks (including old private banks) for 2014-15, it may be noted that the Gross Non-Performing Assets (GNPA) of 26 public sector banks (including 19 nationalised banks, State Bank of India and its associates and IDBI) have risen by 22.5 per cent to Rs.2.78 crore against Rs.2.27 crore in the previous financial year. While the 19 nationalised banks have registered a rise of 39.8 per cent in gross NPA at Rs.1,92,270 crore against Rs.1,37,487 crore in the previous financial year, State Bank of India and its associates have reported eight per cent drop in their NPAs at Rs.73,508 crore against Rs.79,818 crore. The gross NPAs of eight old private sector banks (listed on stock exchanges) and Tamil Nadu Mercantile Bank put together shows a rise of 50 per cent at Rs.7,755 crore against Rs.5,170 crore in 2013-14. The details of new private sector banks - consisting of Axis Bank, DCB Bank (Development Credit Bank), HDFC Bank, ICICI Bank, Kotak Mahindra Bank and Yes Bank - present a different picture. Their gross NPA has risen by 35.3 per cent to Rs.24,534 crore in 2014-15 from Rs.18,133 crore in the previous financial year (Vardharajan, nd, 2015).

3.13 Retail Loan Recovery Practices in India

In India, retail loans have rigorous security support, which escalates with time. The level of non-performing asset in the case of the retail loans is very low. With very low post credit supervision costs, the profits from retail loan margins become attractive for banks, especially in a scenario of falling interest rates after the liberalisation of Indian economy in 1991. Retail loans are offered by the scheduled commercial banks operating in India for various purposes like: acquisition of consumer durables, for meeting travel, medical expenses and the like also offer great scope for credit absorption. As a result, all banks in the banking industry apply their own marketing strategies to attract more consumers (Vikkraman and Ganapathi, 2011), who have the potential of borrowing retail loans. Moreover, according to Credit Information Bureau (India), the country's leading credit information company, retail NPAs have dipped to their historical lows with crimes on home loans and other retail loans showing a significant fall in 2015.The better asset quality is encouraging all leading banks to grow their retail advances faster than any other segment (Manju, 2015).

In India, Credit bureaus did not exist in India till 2005, but today most banks use their services to evaluate consumer credit quality before sanctioning loans. First time loan takers, as well as already leveraged borrowers, are, in particular, scrutinised very prudently. Correspondingly, the use of data analytics and risk prediction models has increased while determining which loan applicants to accept or reject, how much to lend and at what rate. Unsecured loans i.e., personal loans are being given largely to account holders only (Nayak, 2015). Moreover, as far as small loans are concerned RBI has not prescribed any Board/Bank level position at which these loans need to be approved. The operational rules have been left to the concerned banks (Standing Committee on Finance, 2015-16.nd)

3.14 Conclusion

Growth in retail lending results in higher growth in GDP than credit to other sectors for the simple reason that, it creates demand for goods and services instantly. The credit risk exposure of commercial banks is at minimum, as the ticket size of each loan is small. As a strategic measure, commercial banks focus on different retail segments to specialise, obtain economies of scale, and leverage on experience curve for improving their efficiency in operations (Ramanadh and Naveen, 2015). This chapter, draw a detailed empirical discussion on the retail loan lending practices of the scheduled commercial banks operating in India, its outstanding status and recovery efficiency of the banks.