NON-PERFORMING ASSETS: STATUS & IMPACT
A COMPARATIVE STUDY OF PUBLIC & PRIVATE SECTOR BANKS
[WITH SPECIAL REFERENCE TO SBI, CANARA, HDFC and KARUR VYSYA BANKS]

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By

NAMMI LALITHA, M.Com., M.B.A., M.Phil.
Facility, Samata College
Visakhapatnam

Under the guidance of

Dr. B. RAJA KUMAR, Ph.D.
Faculty of Commerce and Management Studies
School of Distance Education
Andhra University, Visakhapatnam

DEPARTMENT OF COMMERCE AND MANAGEMENT STUDIES
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INTRODUCTION

A country’s development can be better perceived through economic growth which is influenced by the prevailing financial system. The ‘Financial System’ plays a crucial role and it intermediates between the flow of funds belonging to those who save a part of their income and those who invest in productive assets. A strong financial system is crucial to fulfill the objective of strengthening the real economy and for its healthy and orderly growth.

Financial Institutions are intermediaries that mobilize savings and facilitate the allocation of funds from surplus units to deficit unit in an efficient manner. Good financial institutions are vital to the functioning of an economy. If finance were to be described as the articulatory systems of the economy, financial institutions are its brain. They make decisions that tell scarce capital where to go and ensure that it is used most efficiently. The process of financial intermediaries support increasing the capital accumulation though the institutionalization of savings and investment and as such, fosters economic growth. The gains to the real sector of the economy therefore depend on how effectively the financial sector performs this basic function of financial intermediation.

The financial systems of most developing countries are characterized by co-existence and co-operation between the formal and informal financial sectors. The Indian financial system can also be broadly classified into formal (organized) financial system and informal (unorganized) financial system. Banking institutions are creators and purveyors of credit. While the liabilities of banks are part of the money supply, this many not be true of non-banking financial institutions. There is no hard and fast rule to distinguish between banking and non-banking institutions.

Banks play a very useful and dynamic role in the economic life of every modern state: They are important constituents of the money market and their demand deposits serve as money in the modern community. Banks can work as catalytic agents of growth by following the right kind of policies in their working, depending upon the socio-economic conditions prevailing in a country. It is realized that since banks have the required investment potentiality, they can make a significant contribution in eradicating poverty, unemployment, and they can bring about progressive reduction in inter-regional, inter-state, and inter sectoral disparities through rapid expansion of banking services.
Commercial banks have come to play a significant role in the development of countries. The two basic functions of commercial banks are: mobilization of the savings of the people and disbursement of credit according to socio-economic priorities, thus accelerating the pace of economic development in the desired direction. The world over, banking system is the focal point in the financial set-up of any developing country. In India too economic development has evolved around the banking system.

NEED FOR THE BANKS

Before the establishment of banks, the financial activities were handled by money lenders and individuals. At that time the interest rates were very high. The interest rate charged by them is higher than the interest charged by other banking institutions. Again there was no security of public savings and no uniformity regarding loans. So as to overcome such problems the organized banking sector was established, which was fully regulated by the government. The organized banking sector works within the financial system to provide loans, accept deposits and provide other services to their customers.

BANKING SYSTEM IN INDIA

Indian banking industry has been divided into two parts, organized and unorganized sectors. The organized sector consists of Reserve Bank of India, Commercial Banks and Co-operative Banks, and Specialized Financial Institutions (IDBI, ICICI, IFC etc). The unorganized sector, which is not homogeneous, is largely made up of money lenders and indigenous bankers.

The Indian banking system has the Reserve Bank of India at the apex. It is the nerve centre of the Indian monetary system. The RBI is governed by a central board (headed by a Governor) appointed by the central government of India. RBI has 22 regional offices across India. The reserve bank of India was nationalized in the year 1949. The bank was constituted to regulate the issues of banknotes, maintain reserves with a view to securing monetary stability and to operate the credit and currency system of the country to its advantage.

With economic growth assuming a new urgency since independence, the range of the Reserve Bank’s functions has steadily widened. The bank now performs a variety of developmental and promotional functions, which, at one time, were regarded as outside the normal scope of central banking.
SCHEDULED COMMERCIAL BANKS

The commercial banking structure in India consists of scheduled commercial banks and unscheduled banks. Scheduled Banks in India constitute those banks which have been included in the second schedule of RBI act 1934. 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. “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”.

NON PERFORMING ASSETS (NPAs)

Authentic history of banking tells that it deals with lending and collection of money. However, it followed the basic law of demand and supply where persons having excess money lent to persons who needed it for more productive purposes and were willing to pay a price for this. The operations were limited to the money lender knowing every person he lent money to.

Proper regulation and organization of these activities was necessitated, over a period of time, as the operations began to grow because of increase in the number of clients. Gradually, simple banking transformed itself into commercial banking and the commercial banking itself has undergone numerous changes all over the world, during the last five decades. In the regard, India is not an exception and in fact, the changes that have taken place in India have been far more significant and much more radical in some regards, than elsewhere in the world.

The concept of Non-Performing Assets (NPAs) was introduced for the first time in the Narasimham Committee on “Financial System Reforms” that was tabled in Parliament on December 17th 1991. The Committee studied the prevailing financial system, identified its short comings and weaknesses and made with ranging suggestions and recommendations in line with internationally accepted norms. Based on the recommendations of the Committee on “Financial System Reforms”, the RBI evolved prudential norms on Income recognition, Asset classification and Provisioning and issued revised instructions to banks in April 1992. While conveying non-performing category and their anxiety to present rosy picture of their affairs the above instructions to banks also
advised them that as per practice followed internationally, income on NPAs is not to be recognized on accrual basis but is to be looked only when it is actually realized because an asset becomes non-performing when it ceases to generate income. The above instructions of RBI have since been implemented by banks from the financial year ended March 1998.

The problem of NPAs is linked to the function of lending money. The lending of money collected from the public, for interest, instead of one’s own money, was the beginning of banking. Though the present day banking does not restrict itself to traditional deposit collection and money lending, encompassing a wide sphere of financial activity, lending still remains the prime activity connected with banking. Most credit needs of the society, for carrying, commercial activities are fulfilled by the banks. The conventional credit from the banking system to the Commercial sector comprises bank loans and advances in the form of term loans, demand loans, cash credit, overdrafts, inland and foreign bills purchased and discounted as well as investments in instruments issued by non-government sector.

Non-performing assets (NPAs) constitute integral part of banks’ operations. A bank gives out money upfront and earns income over a time on the promise of a borrower to repay. When loans are not repaid, the bank loses both its income stream, as well as its capital. Lending is always accompanied by the credit risk arising out of the borrower’s default in repaying the money. The level of non-performing loans is recognized as a critical indicator for assessing banks’ credit risk, asset quality and efficiency in allocation of resources to productive sectors. The most calamitous problem facing commercial banks all over the world in recent times is spiraling non-performing assets which are affecting their viability and solvency and thus posing challenge to their ultimate survival. So the problem of NPAs should be nipped in the bud. It is possible only if the check is placed on NPAs from the very beginning.

The lack of preparedness and structural weakness of our banking system led to the emerging scenario and trying to switch over to globalization were only aggravating the crisis. The major reason for this situation was that the threat of NPAs was being surveyed and summarized by Reserve Bank of India (RBI) and Government of India with a bird’s eye-view of the banking industry, independent from the rest of the economy.
SIGNIFICANCE OF THE PRESENT STUDY

There are diversities among banks based on ownership, as among the 28 Public Sector Banks (including IDBI Bank Limited), themselves, between different geographical regions and between different customers using banks credit. Similarly, NPAs concerns of individual banks summarized as a whole and expressed as a mathematical average for the entire bank cannot convey a dependable picture.

NPAs adversely affect lending activity of banks as non-recovery of loan installments as also interest on the loan portfolio negates the effectiveness of credit-dispensation process. Non-recovery of loans also hurts the profitability of banks. Besides, banks with high level of NPAs have to carry more owned funds by way of capital and create reserves and provisions and to provide cushion for the loan losses. NPAs, thus, make two-pronged attack on the bottom-lines of commercial banks; one, interest applied on such assets is not taken into account because such interest is to be taken, into account only on its realization unlike interest on performing assets which is taken into account on accrual basis; two, banks have to make provisions on NPAs from out of the income earned by them on performing assets.

Persistently high level of NPAs in loan portfolio of banks makes them fragile, leading ultimately to their failure. This will shake the confidence both of domestic and global investors in the banking system which will have multiplier effect, bringing disaster in the economy. Thus, the most critical condition for bringing about an improvement in the profitability of banks is reduction in the level of NPAs. In fact, it is a pre-condition for the stability of the financial system. The NPA concept presently in vogue was introduced by RBI for implementing in the banks, in the year 1993 based on the recommendations of the committee on the financial system in line with internationally accepted norms.

With the implementation of the revised norms on Asset classification, income recognition and provisioning on NPAs in the 1993 while are well defined with little scope for different interpretations, many banks went into the red in the first year. Further, the remaining few which had shown marginal profits were also not quite sure as to whether they could be able to sustain the profits in the years to come. Naturally, such a situation shocked not only the banks but also those connected with the banking industry.

In India, the magnitude of the problem of bad debts was first realized only in early 90s, subsequently, following the recommendations of Narsimham Committee (1991,
and Verma Committee (1999), some steps have been taken to solve the problem of old NPAs. Though concern regarding the reduction of NPAs in the balance sheets of the banks, particularly Public Sector Banks (PSBs), continues to be expressed from every corner, there has hardly been any systematic evaluation of the best way of tackling the problem. There seems to be no unanimity in the proper policies to be followed in resolving this problem. There is also no consistency in the application of NPA norms, ever since these have been recognized.

Today the Indian banking system has undergone significant transformation following financial sector reforms, adopting international best practices. Several prudential, payment, integrating and provisioning norms have been introduced, and these are pressurizing banks to improve efficiency and trim down NPAs to improve the financial health of the banking system. It is among the best in the world because Indian banks are favorable on growth, asset quality and profitability; RBI and Government have made some notable changes in policies and regulations to strengthen the sector. NPA involves the necessity of provisions, any increase in which brings down the overall profitability of banks and is the indicator of banking health in a country.

It is always important to have periodical assessment in order to have an idea of the impact of different measures designed and implemented for improving the situation. Such evaluation helps in better planning or in improvising the existing mechanisms. Since the nature and magnitude of the problem of NPAs is likely to differ in different types of banks, uniform measures or interventions may not yield expected results. Hence, it sometimes necessitates case specific remedies in different situations. This can be done only through periodical study of the problem in different types of banks.

Many such studies have been taken up so far on the management of NPAs. However, the main focus was laid only on identifying causes of NPAs and extending suggestions in the form of some measures to be taken at micro level, that too specific to some individual banks. Therefore, there is every need to conduct a study on management of NPA’s of Schedule Commercial Banks in both Public and Private Sectors.

In this background, the present study has been proposed to make a comparative study of public sector and private sector commercial banks with regard to their NPA situation and management in terms of the operational performance of four banks, two each selected from Public and Private Sectors.
OBJECTIVES OF THE STUDY

The present study has been taken up with the following objectives:

1. To understand the performance of the public and private sector banks during the last decade.
2. To make a comparative study of the magnitude and dimensions of NPAs in the Public and private sector banks.
3. To examine the causes for incidence and trends of NPAs in the public and private sector banks.
4. To examine the recovery measures and strategies followed for reducing the burden of NPAs by the public and private sector banks.
5. To make suitable suggestions for the public and private sector banks to effectively handle the challenge posed by the NPAs.

HYPOTHESES

1. The financial health and credibility of Banks is not similar in public and private sectors.
2. There has been a steady improvement in the management of NPA’s in Banks with considerable variation between the public and private sector banks.
3. The recovery measures are better followed in private sector banks compared when to the public sector banks.

STUDY DESIGN

The present study is designed to be a narrative study with appropriate analytical discussions presented in tune with the proposed objectives. For the present purpose, two banks from public sector and two from the private sector have been selected purely considering the bank’s profitability based on the recent performance figures of the banks. In each sector, one bank from the high performing group and the other from the low performing group has been picked up on random basis. Accordingly, State Bank of India and Canara Bank from the public sector, while HDFC Bank and Karur Vysya Bank from the private sector have been selected and performance figures of these four banks have been used for the comparative analysis.
DATA BASE
The data used in the present analysis is confined to the past one decade (11 years to be exact) from 2001-2002 to 2011-2012. For the study of comparable financial performance of the selected public and private sector banks, data pertaining to the 11 year reference period (2001-2002 to 2011-2012) were obtained from secondary sources such as Annual Reports and accounts of Public Sector Banks and Private Sector Banks.

METHODOLOGY
Information needed for the present study is to be obtained from primary as well as secondary sources. Data from the secondary sources have been obtained for a period of eleven years from 2001-02 to 2011-12. The data were collected from Annual Reports and accounts of Public Sector Banks and Private Sector Banks, Newsletters of Banks, Proceedings of Bank Economists, conferences, published and unpublished Doctoral Dissertations on Banking and Bank management, RBI bulletins, RBI Reports on Trend and Progress of Banking in India, RBI Annual Reports, RBI Reports on statistical Tables Relating to Banks in India, RBI Reports on Currency and Finance, RBI Reports on Hand book of statistics on Indian Economy, RBI Report on Hand book of Indian economy, RBI Report on hand book of monitory statistics of India, RBI Reports on Bank statistical returns of scheduled commercial Banks in India. RBI Report on Quarterly statistics on Deposits and credit of Scheduled commercial Banks, RBI Report on Banking statistics; Basic statistical returns, RBI report on Branch Banking statistics; RBI Press Release, RBI speeches RBI notifications.

The secondary data were also collected from IBA publications – IBA Bulletin (Monthly) IBA Indian Banking year books, Special Annual Issues and IBA publications on Performance highlights of Public Sector Banks and Private Sector Banks.

Secondary data were also collected from different journals on banking, economics and Finance; Database of Indian Economy Financial Express, Publications and Websites of Industry Associations (IBA, CII and ASSOCHAM); Publications of Bank Management Institutes (NIBM, IIBF) Annual Reports of Ministry of Finance (Government of India), Publications of World Bank (IBRD); Asian Development Bank (ADB) and Board for International Settlement (BIS).

Data from the primary source comprises of the information elicited through formal and informal interviews with the managers and officials on random cum convenience
sample basis from Visakhapatnam city in Andhra Pradesh. The respondents are from the four selected banks of public and private sectors.

Data thus obtained has been analysed in tune with the set objectives of the study bringing out comparison between the public and private sector banks on different parameters. The observations were neatly tabulated to facilitate easy understanding and were supplemented with appropriate graphical presentations. Banks group wise (all public sector and all private sector) and Bank – wise comparison (between SBI, Canara bank, HDFC bank and Karur Vysya banks) has been made to examine the difference existing between them using percentages and other relevant statistics.

**ANALYSIS OF DATA**

The data obtained has been analyzed using appropriate statistical measures/techniques like percentages, averages and financial ratios. While analyzing the incidence and trends of NPA’s, usual statistical techniques like percentages and ratios are used. ‘t – test’ and ‘F – test’ were used to determine the significance of difference in averages between public sector and private sector banks and among the four banks studied in the present study. Impact of the Gross NPAs (GNPA) and Net NPAs (NNPA) has been assessed basing on the Correlation Coefficient Values (r). The reference period is from 2001 to 2012 and we have data for these 11 years. Hence, no attempt is made to use regression analysis because of the small number of observations (N=11).

**LIMITATIONS OF THE STUDY**

1. Study of the causes and analysis of NPA’s is confined to Public and Private sector banks and the foreign banks are not taken into consideration.
2. Since the analysis has been restricted to four banks, the inferences may not hold good hundred percent for other banks and also when looked at individual branch level.
3. The percentage and averages as tools of analysis lack absolute accuracy as they are adjusted to the nearest decimal points.
4. Preventive measures which are initiated by the select banks to reduce the NPAs are not available to the researcher, though the statistical figures relating to the same are published by RBI from time to time. At macro level the data is available but at micro level the data is not available.
5. The study considered the impact of NPAs on the exclusive parameter of financial performance of select banks.

ORGANIZATION OF THE THESIS

The present thesis has been organized in to Five Chapters as detailed below:

Chapter – 1: Presents a brief introduction about banking, need for banks, history of Indian banking, banking system in India, role of banks in Indian economy, NPAs, significance of the present study, objectives of the study, study design and methodology etc.

Chapter – 2: Comprises of a review of past studies in the area of research i.e. management of NPAs.

Chapter – 3: Profile of the Selected Banks

Chapter – 4: Presents a detailed account of the concept of NPAs, its impact on banking, remedial measures such as different reforms, different strategies and measures for recovery followed etc.

Chapter – 5: Comprises the Analysis of Data and Presentation of the Observations. This chapter is divided into four sections.

Section-1: Financial Performance of Banks during 2001-02 to 2011-12.

Section-2: Status of NPAs during 2001-02 to 2011-12.

Section-3: Management of NPAs.

Section-4: Opinion of the bank officials on NPAs and reaction of the staff in handling Non-performing assets.

Chapter – 6: Presents a Summary of Findings, Conclusions and Suggestions for better management of NPAs.

SALIENT OBSERVATIONS OF THE STUDY

- Performance in terms of Gross Returns on Total Assets appears good in the case of the two private sector banks compared to the two public sector banks during the reference period and this holds good for all the private sector banks for the reference period (2001-2002 to 2011-2012).

- The Net Return on Total Assets appears good in the case of the two private sector banks compared to the two public sector banks during the reference period and this holds good for all the private sector banks for the reference period.
- The Interest Income on Total Assets appears good in the case of Karur Vysya bank among the two private sector banks and in Canara bank among the two public sector banks during the period from 2001-2002 to 2011-2012. This average was more in the case of all public sector banks than in the private sector banks.

- The average of ‘other income’ for the HDFC bank was more than the average computed for all private sector banks. In case of the public sector banks, SBI recorded average that was better than the one computed for all public sector banks. The average operating expenses was better in the case of private sector banks than in the public sector banks.

- The rate of increase in NPA’s sub standard assets, doubtful assets and loss assets stand minimal, while the proportion of standard assets in NPAs and the rate of increase in standard assets and total advances are encouraging.

- There was a decline in gross NPAs in all the four banks covered in the study over the 11 years. The average gross NPAs to gross advances for the SBI was more than the average computed for all public sector banks and in case of the private sector banks, Karur Vysya bank recorded average that was better than the one computed for all private sector banks. The average gross NPAs were better in the case of private sector banks than in the public sector banks.

- There was a decline in net NPAs in all the four banks covered in the study over the 11 years. The average net NPAs to net advances for the SBI was more than the average computed for all public sector banks and in case of the private sector banks, both Karur Vysya bank and HDFC bank recorded average that was better (Lower) than the one computed for all private sector banks. The average net NPAs were better in the case of private sector banks than in the public sector banks.

- The gross NPAs to total assets have come down significantly from 2001-02 to 2011-12. The average for the SBI was more than the average computed for all public sector banks and in case of the private sector banks, both Karur Vysya bank and HDFC bank recorded average that was lower than the one computed for all private sector banks. The average was better in the case of private sector banks than in the public sector banks.
• There was a marked decline in the average net NPAs to total assets from 2001-02 to 2011-12, with the focus and attention put by the banks. The average net NPAs to total assets for SBI was slightly more than the average computed for all public sector banks and in case of the private sector banks, both HDFC and Karur Vysya banks recorded average that was less than the one computed for all private sector banks. The average net NPAs (% of total assets) were better in the case of private sector banks than in the public sector banks during the reference period.

• The average proportion of NPAs in priority sector in the case of public sector banks was more than double compared to that of private sector banks during the period 2001-02 to 2010-11. The average was slightly more in Canara bank than in SBI among the public sector banks and was more in the case of Karur Vysya bank than in the HDFC bank among the private sector banks.

• The average proportion of NPAs in non-priority sector in the case of public sector banks during 2001-02 to 2010-11 was less than the average for private sector banks. This average was more or less similar in SBI and Canara banks among the public sector and was more in the case of HDFC bank than in the Karur Vysya bank among the private sector banks.

• The number of cases disposed off by the DRTs is quite significant during 2002-03. As high as 23,393 cases were disposed off during this year. Since then, there was a lag up to 2008-09. From 2009-10, there was an increasing trend in the number of cases disposed off. Thereafter, during 2010-11, 12,872 cases were referred with `.14,092 crores amount involved and `.3,930 crores had been recovered.

• The percentage of amount recovered against the amount involved was highest at 81.1 percent during 2008-09 followed by 75.5 percent during 2005-06 and it is 51.9 percent during 2007-08. In all the remaining years, the percentage recovery is less than 50.

• Of the different means, the SARFAESI Act stood first which accounted for an NPA recovery of ` 34,900 crores out of the total NPA’s recovered during 2003-04 to 2010-11. It was followed by DRT’s accounting for ` 26,434 crores, ARCs accounting for ` 14,506 crores, one-time settlement accounting for ` 2,105 crores and Lok Adalats accounting for ` 1,168 crores, during the reference period.
The percent recovery of NPA amount (percentage of amount recovered to amount involved) was high during 2004-05 (69.3 percent) followed by 50.7 percent during 2005-06, 50.1 percent during 2007-08. This percentage was less than 40 during 2006-07, 2008-09 and 2010-11 while it is less than 25 during 2003-04 and 2009-10. Lowest percentage recovery was recorded during 2003-04 during the 8 year reference period considered here.

A major share of the NPA amount recovered from 2003-04 to 2005-06 was through DRTs while during the years 2006-07 to 2010-11 the contribution of recovery through SARFAESI Act was more.

Regarding the amount involved in NPA’s recovery during 2003-04 to 2010-11, major share was from SARFAESI Act that accounted for 44.1 percent (`.34,900 crores) followed by DRTs 33.4 percent (.26,434 crores). In this regard the share of Lok Adalats and One–time settlement were minimal with 1.5 per cent and 2.7 per cent respectively. The share of Arcs is 18.3 percent (.14,506 crores).

Most of the respondents (34 percent) were of the opinion that there was a lack of support from representative chambers like FICCI, CCI, CII and FIEO etc in recovering the bank dues from their members. About 18 percent were of the opinion that banks have no system of exchange of information about borrower customers and nearly 18 percent reported that there was inadequacy of staff to manage loan portfolio. 10 percent opined that the interest rates were not fixed according to the borrower’s repaying capacity, and 6 percent reported that, in general, banks do not pay adequate attention to borrower customers.

Opinion of most of the respondents (28 percent) on implication of NPAs indicated that there was a marked preference for banks to investment in Government securities because of growing NPAs. About 18 percent expressed that the banks raise subordinates Debt at high cost supplement Tier-II capital and to meet capital Adequacy Norms because of the NPAs and 14 percent indicated that NPAs affect only banks and other Stake holder, other than defaulting borrowers. About 13 percent felt that banks have a general aversion to lending because of NPAs. Other indications reported by relatively less proportion of the respondents include – ‘Banks are unable to bring down Interest Rate on account of NPAs’ (11 percent),
‘Present Capital Adequacy reduces / minimizes the risk of NPAs’ (8 percent), ‘Interest charged to borrowers far exceed the declared PLR’ (5 percent) and ‘Overall cost to borrowers is very high resulting in NPAs’ (5 percent).

- Twenty percent of the respondents reported that the implication of NPAs on bank books was in the form of ‘Increasing Provisions’. Impact of NPAs was reported on increasing intermediation costs by 20 percent and 19 percent were of the opinion that the NPAs impact was high on declining reserve and surpluses. 19 percent reported that the impact of NPAs on bank books by way of ‘erosion of profit’. Other implications reported are - ‘increasing spread’ by 13 percent and ‘increasing market borrowings’ by 10 percent.

- These observations indicate that both the public and private sector banks have diversified their activities and focusing more on other than the core-banking activities - loans and advances- for generating income.

- Basing on the observations made from the survey and information obtained during the course of non-formal interviews or discussions, it can be concluded that NPAs were caused because of willful default, diversion of funds, deficiency in the credit appraisal standards and lack of supervision and follow-up. Opinions indicate that banks were becoming averse to lending and prefer to have safe investment in Government securities. Lack of market intelligence system, need of adequate trained staff to supervise the credit portfolio, absence of exchange of credit information among banks was the major obstacles in containing NPAs.