

## CHAPTER VII

## CONCLUSION

In the foregoing chapters we have analysed various aspects of the application of management accounting techniques in lending decisions by the branches of commercial banks under study. For e.g. interbranch variations in advance to deposit ratio, profit to advance ratio, type and degree of relationship between application of various techniques segmentwise, effects of extent of application of management accounting techniques on the problem credit etc. In this chapter the main findings of the study and suggestions are presented.

1. Chapter I is an introductory Chapter.
2. Chapter II presents the evolution of management accounting system, scope of management accounting and main techniques of management accounting.
3. Chapter III discusses the basis of sample selection, the method of data collection, development of the questionnaire, and the contents and significance of the questionnaire.
4. The 'Analytical profile of commercial Banks' (Chapter IV) presents the information of branches under study from various angles. Here the ratio of each bank's advance to its deposit is found out over a period of 6 years viz. 1985

to 1991 and it has been observed that on an average it has improved after 1987.

5. 'Profit as a percentage of advance is found to be highest during 1987 which is 10.99% for the common respondent branches.

6. For the ratio of profit to volume of business it is observed that the year 1989 shows the best results out of all the years under study for the common respondent branches over a period of five years.

7. When variations in advance to deposit ratio is studied over a period of six years for the respective respondent branches the variations are noticed to be highest for the year 1987 when coefficient of variation is compared. For the ratio of profit to advance and profit to volume of business the highest variations are observed among the respondent branches during year 1985.

8. In addition to finding out profit as a proportion to advance and volume of business, an attempt is also made to estimate the dependence of profit on advance, deposit, volume of business and on credit deposit ratio, over a period of six years. It has been observed for a period of six years that for all these years the dependence of profit on advance, deposit and volume of business is significant.

The highest value of  $R^2$  for dependence of profit on advance is found for the year 1985; where  $R^2$  is 0.9389 indicating

that 93.89% of variations in profit are explained by variations in advances. When profit is regressed on deposits to examine the effects of deposits on the profit of the branch, the coefficient turned out to be statistically significant, where  $R^2$  was highest for the year 1986. On examining the dependence of profit on volume of business the highest  $R^2$  is found for the year 1986 out of the years under study, which is 0.9259.

9. After estimating the dependence of profit on various factors, an attempt is made to examine structure of advance in terms of segments to which and facilities by which advances are extended. Over a period of 5 years i.e. 1986-91 the share of priority sector advance to total advance has reduced from 52.19% for the year 1986 to 43.99% for the year 1991, for the common respondent branches. This is in line with the trend in priority sector advance, at all-India level, where it has fallen from 41% in 1986 to 37.71% in 1991.

10. So far as advance to various subsegment of priority sector is concerned, the share of agricultural advance and advances to small borrowers has reduced over a period of five years from 11.14% to 6.69% and from 43.75% to 33.38% respectively; whereas the share of SSI advance has increased over a period of five years from 45.10% to 59.93%.

11. On examining the share of various facilities of advance to total advance it is observed that over a period of five years, the share of term loan facilities has reduced from 48.92% to

37.91% whereas, the share of cash credit has remained consistent over a period of five years i.e. about 31% to 32%. Share of overdraft facilities has reduced to 9.61% from 11.98% and share of BPED facility has increased from 5.53% to 16.18%.

The above analysis provides the basis for the study of subjective factors while taking lending decision and to establish relationship of some of the aspects with application of management accounting techniques or with the proportion of the problem credit.

12. ✓ In Analysis of Data - Techniques and Segments. I, (Chapter V), we examined the relationship in relative importance given to various factors, while taking lending decisions between the segments and between the banks. The factors here are, character, capability, security, purpose, economic viability, financial feasibility, technical feasibility and national interest and suitability. The segments referred to above under study are agriculture, SSI, advances to businessman and retail trader, advances to self employed and professional, advances to transport operator, educational advances and non-priority advances.

The examination of the relative importance assigned to various factors reveals that in majority of the cases the degree of relationship is found to be quite high. However, between no two segments RCC is found to be 1; and between no two segments the RCC is found to be 0, i.e. there exists at least some relationship in ranking of factors between the segments. It is also

of interest to note that between no segments there exists negative relationship. Highest relationship in relative importance of factors is found between businessman and retail trader<sup>(BMRT)</sup> and transport operator.<sup>(TO)</sup>

13. Moreover, the examination of the relationship between the factors, within the segment shows that the RCCs are greater than 0.90 between all the factors and for all the segments.

It is also attempted to analyse whether various factors which reflect various aspects of the borrowers on the basis of which lending decisions are being taken, form a single group or not for different segments. To study this the method of linkage analysis is applied and it is observed that all the factors do not form a single group. They are divided into two to three groups for almost each and every segment. It is observed that the factors character and capability go together irrespective of the segment. The factors economic viability, financial feasibility and technical feasibility also go together irrespective of segment except advances to transport operator.

14. After examining this in order to find out whether all branches of one bank go together or not, relationship in relative importance given to factors between the bank branches is examined for each segment separately. In this evaluation for all the segments it is consistently observed that in no case all the branches of one bank are forming a single group i.e. the branches of one bank are scattered over various groups. There are

certain bank branches between which RCC is found to be 1, indicating that the relative importance assigned to factors is identical. Eventhough in majority of cases this was observed for branches of one bank only, in some cases this is found to be so between the branches of two different banks also. There are also cases where no relationship in relative importance assigned to the factors is observed. In majority of the cases, this 'no relationship' is observed between the branches of two different banks, however, there have been the cases, where it is also found between the branches of the same bank. On the basis of this, it can be said that eventhough the lending officers of one bank are trained under the same roof the relative importance given by them to various factors may not be identical.

15. In addition to analysis of factors an indepth study is carried out with reference to application of various management accounting techniques with respect to various segments while taking lending decisions. The techniques under study are business method of costing, funds flow, cash flow and analysis plan, budgeting, break-even-analysis of financial statements.

The segments for which the application of above mentioned data are studied are AGRI, SSI, BMRT, SEPR, TO EDU and <sup>C&I</sup>NPFL and <sup>C&I</sup>NPWC.

It is observed in majority of the cases that business plan is the most applied technique and the method of costing the least.

16. In order to examine the degree of relationship between various segments regarding relative applicability of various

techniques RCCs are estimated. When  $RCC=1$  it suggests that the relative applicability of various techniques for two different segments is identical. The present study reveals that out of 28 estimated RCCs, 5 RCCs turn out to be negative though statistically insignificant. Among the remaining positive RCCs, 6 RCCs are statistically significant which are estimated between AGRI and TO, SSI and NPWC, SSI and NP<sup>CAI</sup>/<sub>TL</sub>, BMRT and SEPR, BMRT and EDU and SEPR and EDU, and it is highest i.e. 0.9554 between BMRT and SEPR. It tends to conclude that the relative applicability of various management accounting techniques while taking lending decisions differ with respect to various segments.

17. In addition to the examination of relative applicability of various techniques in lending decision for various segments an attempt is also made to assess the type and degree of relationship between application of management accounting techniques for a given segment by the use of phi-coefficient. It should be pointed out here on the basis of estimated phi-coefficient that it is neither one nor zero for any of the segments ~~and for any two techniques~~ and for any two techniques. However, the high degree of relationship and statistically significant relationship is observed between (a) funds flow and cashflow and (b) funds flow and ratio analysis for the segments under study. Over and above these two techniques business plan and break-even analysis, break-even-analysis and method of costing, and budget and ratio analysis also hold significant relationship for all

segments except the advances to transport operator. Business plan and budget are found to be holding significant relationship over all the segments except term loan for non-priority segment - C & I. And break-even-analysis and fundsflow are found to be holding significant relationship for all segments except working capital advance to non-priority segment - C & I.

18. When different management accounting techniques are applied by lending officers for lending decisions for various segments, it is essential to examine which of the techniques go together for a given segment. The method of linkage analysis is adopted to examine the above aspect. Here it is observed that for agriculture segment application or otherwise of all techniques go together, whereas for SEPR, and <sup>CAI</sup>NETL these seven techniques are divided in three clusters. However, throughout for all the segments techniques fundsflow and cashflow go together, and except NP C & I TL the techniques business plan and budget go together.

19. The study is directed at a branch level also. Here for each segment extent of application of techniques is studied for each branch i.e. which branch has highest level of applicability of management accounting techniques. An attempt is also made to examine whether all the branches of one bank fall in one group or not. Here the extent of application of techniques has not remained identical over all the segments of one bank. However, the branches falling in upper or lower group with respect to



application of techniques have remained consistent for SSI, NP C & I TL and NP C & I WC on one hand and BMRT, SEPR, TO and EDU on the other.

20. The relationship is estimated between the branchwise composite index regarding extent of application of management accounting techniques and the specialisation of that branch with respect to advances for various segments. The study reveals that the application of management accounting techniques while taking lending decision for a given segment is independent of the specialisation of the branch with respect to advances.

21. Moreover, we have examined the effect of the total advances/volume of business of the branch on the application of management accounting technique. As the dependent variable is qualitative variable logit model is fitted to estimate the relationship. The positive significant relationship is observed in case of SSI advance, advance to transport operators, working capital advance to non-priority C & I segment and term loan advances to non-priority - C & I segment. It implies that with the increase in advances of the branch, the probability of application of management accounting techniques increases. For the remaining four segments viz. BMRT, SEPR, EDU and AGRI this dependence of management accounting techniques on advances of the branch is not found to be statistically significant. When the dependence of application of management accounting techniques on size of the branch is examined the same results (as above i.e. advances) are

observed. The intercept of the model represents the level of the application of management accounting techniques for different segments. Among the various segments the probability of application of management accounting techniques is as high as 0.6594, 0.6209 and 0.6411 for SSI segment, NP C & I WC and NP C & I TL respectively.

This higher level of application of management accounting techniques is assumed to be on account of the nature of the segment or type of advance. The significant relationship indicates that so far as these four segments e.g. SSI, NP<sup>CAI</sup>WC are concerned the big branch may be entertaining big proposals, in case of big branches there are also officers of senior cadre and hence the application of management accounting techniques increases with increasing advance or increasing volume of business of the branch.

The low level of application of management accounting techniques and insignificant relationship between application of management accounting techniques and advances of the branch and volume of business of branch for BMRT, SEPR, EDU and AGRI is judged to be on account of the nature of segment and the amount of advance entertained per proposal being generally very low.

22. After analysing the effects of the size of the branch on the application of management accounting techniques we have also examined, how many percentage of the respondents are applying

the techniques in detail and the correctness of decision in the hypothetical cases given in the questionnaire.

The study reveals that the business plan is the well received tool of management accounting by bankers, which is reflected from the minimum level of non-response. Also the importance of business plan to new situation and judging its correctness was represented to be important in almost all the cases.

23.✓ The study examines the application of break even analysis to various situations, e.g. use of break-even-analysis for existing borrower, new borrower, existing borrower proposing for new organisation, new borrower proposing for new organisation, considering the demand of the product to be random variable rather than a static, consideration of situation where the factors like sales price, fixed cost and variable cost may change which are generally assumed to be constant for break-even-analysis, considering multi-product situation etc. and in addition to considering the break-even-analysis from borrower's point of view, the application of the said analysis to bank branch is also examined.

a. The study on the extent of application of break-even-analysis in lending decision shows that the maximum application is being made when a new customer comes to banker with proposal for a new loan.

b. On examining the factors to be given importance and on judging the correctness of decision to hypothetical situation, it is observed that if the lending officers know that the proportion of fixed costs and variable costs is to be given emphasis, the loan decision will be taken correctly.

c. So far as the concept of margin of safety is concerned, the general awareness about the subject is found to be low as compared to earlier questions. It is found that about one-third of the responding sample has not commented about the utility or otherwise of the margin of safety. With reference to the utility of margin of safety for fixation of repayment schedule the percentage of non-response is lower than the previous one.

d. With reference to the concept of probability the response to the cases incorporating the concept of probability turns out to be very low, as compared to the overall response to the main question. The utility of sensitivity analysis for lending decisions is examined and here also, the non-response to this question and for cases developed thereon is found to be high.

e. The picture of the response to hypothetical cases shows that majority of the respondents have given correct decision for the given situation.

f. The analysis of application of break-even-analysis to multi-product situation shows that a few respondents were

conversent with this situation. The respondents were also not found much conversent with the situation of uncertainty and the changing variable situations.

g. In addition to examining the application of break-even-analysis from point of view of borrowers, the application of techniques from banker's point of view is also examined. This shows that the general feeling prevails that with increase in advances it always contributes to profit eventhough the amount is borrowed from head office for the purpose of advance. It may be noted that the point here was to emphasise the decision regarding loan mix.

24. With reference to the utility of method of costing for stock valuation, for lending decision it may be stated that, the percentage of non-response to the main question is very low, but the percentage of non-response to the cases is very high viz. 62%. Also, responses to cases make it clear that the concept requires more acquaintance with the lending officers.

25. The other tools under examination are cashflow statement and funds flow statement. The funds flow statement is funds flow statements and the cashflow statement is cash flow statement. So instead of its depth, the use and utility thereof at the time of sanction and for repayment schedule is examined and for both the tools, the use thereof is found to a higher extent for sanctioning and repayment schedule decision.

26. The utility of ratio analysis as a predictor of failure is well-known to the business and banking world and hence here to have a detailed study the loan amount is divided in four groups viz. loan amount upto Rs.25000, loan amount greater than Rs.25000 but upto Rs. 2 lakhs, loan amount greater than Rs. 2 lakhs but upto Rs.10 lakhs and loan amount greater than Rs.10 lakhs; and the ratios under study are 19 which can broadly be divided in 5 groups viz. short-term liquidity ratios long-term liquidity ratios, profitability ratios, turnover ratios and coverage ratios.

a. Over these four loan groups it is observed that for all three groups of loan amount above Rs.25000 the highest number of respondents for application of techniques were for current ratio. For loan amount upto Rs.25000 the maximum number of respondents in favour of application of ratio are for net profit ratio. For loan amount more than Rs.10 lakhs, the next to current ratio is debt equity ratio so far as application is concerned.

b. Over and above examining the percentage of respondents stating affirmation to the application of techniques, it is also attempted to examine, whether the relative affirmation to ratios over four loan groups remain same or not. Here, for no loan group the relative affirmation is found to be identical, however, it is observed that they are highly and significantly related. This indicates that when one ratio is applied by higher number of respondents as compared to other ratio for one loan group, the situation remains almost the same for another loan group also.

c. The examination of the relationship between the application of ratios within a particular loan group with an intention of examining which of the two ratios hold significant relationship, for loan group above Rs.10 lakhs shows that the highest relationship exists between Return on Common Equity and Return on Total Asset ratios. The application of the linkage analysis, with a view to find out in how many groups these 19 ratios are divided, shows that they form 5 groups.

d. The application of the above type of analysis for loan amount falling between Rs.2 lakhs and Rs.10 lakhs shows that the highest relationship is between Fixed coverage ratio and Times interest earned ratio; where phi-coefficient is found to be 0.7015 and the application of linkage analysis brings out that 19 ratios are divided in 5 groups.

Between the two loan groups it is observed that the 5 groups formed through linkage analysis are not identical.

27. After examining the techniques in detail and their extent of application by each branch, the use of these techniques for monitoring and follow-up is examined, because "problem loan situations can be detected only through follow-up procedures designed to intercept trouble signals."<sup>1</sup> Here, mainly the three techniques viz. cash flow, funds flow and ratio analysis are

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1. Dwyer Russell F. and Ensign James A, Problem Loans and Losses - Detect the Former Learn from the Latter, Journal of Commercial Bank Lending, October, 1971, p. 22.

considered for our present study and for all these three techniques it is observed that majority of the respondents are using these techniques for monitoring and follow-up. Additionally it is also noticed that in majority of the cases those who apply the said techniques for sanctioning also apply the same for monitoring and follow-up.

28. a. In the light of this it was also considered necessary to find out the effectiveness of the application of management accounting techniques on the problem credit. On account of confidential nature of data, the number of respondents for problem credit information is not high; however, it is happy to state that they were more than enough for estimation of relationship. Here, broadly the proportion of problem credit to total advance is examined as a function of probability of application of all techniques in depth, taken together for all segments. The relationship is found to be significant here and this indicates that as probability of application of techniques increases problem credit decreases.

b. Over and above the total problem credit, the problem credit for SSI, small borrowers and non-priority segment is also considered and evaluated. In this context the proportion of particular segment's problem credit to respective segment's advance is considered to be function of probability of application of technique to that segment. When the relationship is examined between the probability of application of technique for



SSI segment and proportion of SSI problem credit to SSI advance the relationship turns out to be insignificant. This insignificant relationship may be on account of the fact that problems which arise to SSI are more attributable to the internal problems of the organisations concerned rather than on account of the non-application of management accounting techniques by bankers or otherwise as discussed in Chapter VI. The relationship between application of techniques to small borrowers and problem credit of small borrower's advance as a proportion of small borrower's advance is found out and the same is found to be significant. On examining the effect of extent of application of management accounting techniques to non-priority segment on proportion of non-priority problem credit to non-priority advance it is found to be significant.

With reference to the disclosure of problem credit there prevails a very fast changing system. The first introduction was with reference to Health Codesystem. It is already stated in Chapter II that there is the emphasis on the transparency of banks' accounts with Narsimham Committee Report. The emphasis is placed on provision to be made for doubtful advances. The situation prevailing before introduction of these transparency norms is nicely summarised by Bhabatosh Datta and he states that "No one knows what the really baddebts amount to, for banks are legally permitted to show their baddebts as Nil and then to provide unstated amounts as reserves against baddebts."<sup>2</sup>

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 2. Datta Bhabatosh, Banks : 18 years after Nationalisation, The Banker, April, 1988, ③

However, with the implementation of the Narsimham Committee recommendation "with gradual implementation of the financial sector reforms based on the report of the Narsimham Committee, the banking sector in India, is expected to undergo a transformation over the next few years. .... Once the bank start revealing the true picture without any window dressing, many will have red spots in their 1992-93 balancesheets."<sup>3</sup>

When the accounts of banks becomes transparent the balance-sheet and the profit and loss account of the bank naturally talks about the health of the same, and this directly affects the public confidence which is the basis for banking business, hence the expedient available to the bankers is to improve the health of advance portfolio i.e. reduce the amount of loss assets.

During the course of discussion with various lending officers, it has been noticed that the advances upto Rs.25000/- are sanctioned without making much detailed study and this is particularly for the priority sector advances and schematized advances and also as mentioned in Chapter II the full provision is required to be made for advances amount upto Rs.25000 by March, 1994.

In Chapter II we noted that the bank performs many functions over and above the functions of lending. It is the treasury function or security portfolio of banks which has become the noticeable aspect during the period 1992-93. As the amount of

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3. Venkataraman N.V. and Nayak Gayatri, Scheduled Commercial Banker The Economic Times, Ahmedabad, 27th May, 1993.

gross problem exposure is put as high as Rs.4024.45 crores by Janakiraman Committee Report,<sup>4</sup> a reference to the situation and causes of the same would not be out of place.

#### SECURITY SCAM :

The significant features of the environment in which these irregularities took place as per Janakiraman Committee are as follows.

#### A. Environment :

There were large investible funds with the corporate sector, particularly with Public Sector Units (PSUs). The large public issues made by the PSUs did not find a ready market. These PSUs therefore, made arrangements with banks whereby the banks subscribed for a significant part of the issues and in turn, the PSUs placed the funds raised by the issues with banks who subscribed to the issues. As many of the bonds issued by PSUs were tax-free, they alongwith Units under the Unit-64 Scheme of the Unit Trust of India (UTI), which also provided tax-benefits under Section (80M) of the Income Tax Act, were mainly held by corporate entities including banks.

However, while these large investible funds were available with the corporate sector, the opportunities for short-term investment of these funds were restricted. There did not exist a significant money market in which these funds could be

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4. Janakiraman Committee Final Report : The Economic Times, Ahmedabad, 29th May, 1993.

invested and the call money market was restricted to banks and specified financial institutions. While companies in the private sector could invest in intercorporate deposits, these were perceived as a risky form of investment for large amounts. PSUs were generally prohibited by administrative guidelines from investing in inter corporate deposits. For deposits with banks there were ceilings on the rates of interest which varied according to monetary policy, the maximum rate of interest which banks were allowed to pay being 13 percent since April 1992, on deposits beyond 46 days and upto three years or more. Though the ceiling on interest rates didnot apply to Certificate of Deposit (CDS) issued by banks, each deposit had to be for a minimum value of Rs.1 crore (lowered to Rs.50 lakhs in 1990) and there was a monetary ceiling on the aggregate amount of CDs, which could be issued by a bank. On the otherhand, the stock market was booming.

Banks, particularly the foreign banks, were therefore, quick to identify 'arbitrage' opportunities whereby funds could be borrowed cheap and lent dear.

To exploit these arbitrage opportunities banks needed to circumvent existing regulations. The most significant of these regulations were as under :

a. Banks were not permitted to offer rates of interest which were in excess of the stipulated rates. On the other hand, PSUs needed to service the bonds issued and therefore, needed a

return on the funds placed with the banks at a rate higher than the coupon rate on the bonds.

b. Banks were required to maintain a significant portion of their deposits in cash or in specified securities or with the RBI. During the most relevant time only 36.5 percent of the deposits was available for commercial lending. Even out of this, almost 40 percent in respect of nationalised banks and private sector banks and a lower percentage for foreign banks was required to be lent to the priority sector, earning only a concessional rate of interest.

c. Banks were required to maintain reserve requirements (CRR and SLR) on call and notice money borrowings, which added significantly to the cost of borrowing such funds.

d. Banks were permitted to accept funds from the corporate sector under Portfolio Management Schemes (PMS) where the depositor could earn high returns but the acceptances of these funds was subject to the following restrictions.

- i. there was a minimum lock in period of one year.
- ii. the bank was to act as an agent of the depositor to make investments on his behalf and the risk of the investment was to remain with the depositor.
- iii. The bank could not share in the profits or losses made by the depositor out of the investment and could not charge the fee (fixed or as a percentage).

e. Banks could enter into ready forward transactions in securities only with other banks and only in respect of Government and other approved securities.

f. The yield on bank's investments in Government securities under the SLR prescription was much below the prevailing market rates on long-term debt instruments, and banks felt the need to improve the yield both through trading in these securities (at artificial rates) and through the mechanism of ready forward transactions.

Moreover BRS were being used on a greatly extended scale for the following reasons :

a. In respect of sale and purchase transactions in the Government securities, normally the sale would be supported by delivery of SGL transfer forms. These are orders issued on the PDO to transfer the securities from the account of the seller to the account of the purchaser. However, the incidence of dishonour of SGL transfer forms had increased due to a number of reasons. The PDO records were maintained manually and on some occasions there was delay in intimating the fact of dishonour. Therefore, for ready forward transactions, banks increasingly resorted to the issue of BRS rather than SGL transfer forms.

The SGL account facilities in the PDOs were granted regionwise. Thus, if the securities were held in the SGL account with one regional PDO and the sale was made in another region, it was not possible to issue the SGL transfer form without first

transferring the securities from one PDO to the other. Although the transfers could be effected by telegram/tekex, a BR needed to be issued even for transactions in the Government securities.

The SGL facilities were restricted to Government Securities. For purchase and sale of other securities, e.g. Units or PSU bonds, it was necessary to effect a physical delivery of the bonds, alongwith transfer forms. In many cases of PSU bonds, the actual issue of script was delayed for several years and was only an 'allotment letter'. The seller, therefore, could not make delivery of part of the bonus covered by the 'allotment letter' until the scrips were issued. Even where bonds were available, the exact delivery could not be made if the script were not available in demonimations which permitted exact delivery. Finally, for large transactions, the physical delivery could be <sup>cumbersome in respect of ready forward</sup> transactions which were intended to be reversed within a short period of time. Therefore, in all such cases, BRs were increasingly resorted to.

Thus, the stage was set for an era of irregular dealings in money disguised as securities transactions. There was a triple coincidence of wants, first, the PSUs who after the withdrawal of the Government budgetary support, had to raise funds massively in the market and had short term liquidity on their hands, wanted an avenue of investment yielding more than the coupon rate on the bonds they had issued. Secondly the stock market was booming and the 'bulls' desperately needed funds to finance their over

bought positions, never minding the high badla rates. Thirdly, bankers who had accepted high cost funds from PSUs, saw that the only avenue which yielded the anticipated high returns was financing the stock brokers in a booming market. What was needed was to devise some innovative techniques to circumvent the regulations.

To circumvent the regulations, banks needed the assistance of brokers and therefore a close nexus had developed between certain brokers and certain banks. This was aggravated by the fact that operating managers were under pressure to greatly increase the profitability of banks. While in the case of foreign banks this arose out of the growth of intense competition, in the case of nationalised banks, there was a growing awareness that their overall performance compared very unfavourably with the performance of foreign banks and steps were needed to improve the 'bottom line' of their published results.

#### B. Findings :

After examining the environment in which the irregularities arose the Janakiraman Committee mentions the irregularities which are briefly as follows :

The examination of securities transactions of the different banks has revealed a fairly consistent pattern of irregularities in most of the banks with local variants. It is also evident that these irregularities have largely arisen out of attempts to circumvent the RBI regulations. A number of irregularities



developed in the operations of the PMS schemes and a number of irregularities have also taken place in respect of schemes which were designed to circumvent the rigours of the PMS. For example :

a. RBI guidelines did not permit banks to enter into ready forward transactions with parties other than banks and also did not permit such transactions to be entered into in respect of securities other than Government and other approved securities. All banks which had such schemes obviously violated both these guidelines.

b. In most cases there is no evidence to show that securities which were presumed to have been sold and for which sale proceeds were received by the bank were in fact delivered or even separately kept in trust for the clients.

c. In some cases there are instances where at the time of alleged sale of securities even the securities were not identified in the security receipts issued.

The funds collected by banks as also their own funds could be lent to brokers only in accordance with RBI guidelines. To circumvent these guidelines, the funds were lent in the guise of ready forward transactions. As mentioned above the ready forward transactions could be entered into only with banks and only in respect of government securities. To circumvent the first stipulation, transactions were recorded as made with counter party banks but the beneficiaries of these transactions were certain brokers. To accomplish this, certain banks acted as 'routing' banks for brokers.

d. The 'routing' banks purchased securities in their own name and sold securities in their own name without indicating that they were acting for the brokers. Where securities were not readily available, they even issued their own BRs. The cost of the purchase was debited to the broker's account and the sale proceeds were credited to the broker's account.

Brokers also arranged contracts with banks where the name of a bank was given as a counter party selling bank without the knowledge of the bank concerned. The proceeds received from the purchasing bank in the form of banker's cheques in the name of the alleged counterparty bank were credited by that bank to the broker's account by virtue of an existing arrangement. Thus the purchasing bank was unaware that it was infact dealing with a broker and not with a counterparty bank. When delivery was not effected for securities for which payments had been made, liability was denied by the bank whose name was shown as the counterparty bank. A significant part of the problem exposure has arisen on this account.

A very large proportion of the transactions entered into by the banks have been ready forward and double ready forward transactions. In a ready forward transaction there is a present purchase or a present sale of a security tied with a forward sale or a forward purchase of the same security with the same counterparty. The purpose behind the transaction is not to buy or sell the security but to temporarily create finance by selling the security which finance is repaid when the sale is reversed in the second leg of the transaction. In a double ready forward

transaction, two securities are simultaneously bought and sold on a ready forward basis. The purpose behind such a transaction is not to create liquidity but rather to temporarily exchange the investment portfolios and in the process alter the holding rates of the securities.

As mentioned earlier, banks were permitted to enter into ready forward transactions only in SLR securities (i.e. investments in which SLR requirements had to be maintained) and secondly, such transactions could be entered into only with other banks. In almost all cases, banks have violated the first regulation and have entered into ready forward transactions in respect of non-SLR securities like Units and PSU bonds. Some of the banks have also violated the second regulation and have sought to camouflage this violation by ingenious means.

Normally, even in a ready forward transaction, each leg of the transaction should be accompanied by actual delivery of securities or SGL transfer forms. However, in most cases, there is no evidence to show that actual delivery of securities or SGL transfer forms was effected, but on the contrary there is evidence to suggest that BRS were issued and the same BRS were returned on reversal of the transaction. In many cases where SGL transfer forms were issued there was apparently a tacit understanding between the parties not to present the SGL transfer forms at the PDO but to return them to the seller on the reversal of the ready forward deal. In a number of cases this raises a doubt

whether underlying securities for the transaction existed at all. It will be appreciated that the ready forward transaction was in essence a financing transaction and if this transaction was not supported by underlying securities, the transaction was no more than an unsecured loan of funds.

The BR is intended to be a document which acknowledges receipt of funds for the sale of a security and which confirms that the issuer has undertaken to deliver the specified securities to the purchaser and pending such delivery is holding the securities in trust for the purchaser. Indian Banker's Association (IBA) had prescribed a standard format for the BR and also prescribed BR rules and a format for a monthly statement of BRs held and issued.

In most banks the IBA guidelines were observed only in their breach. In particular, the BRs were not issued on security paper or in the prescribed form and more significantly were not exchanged with actual scrips but were returned for cancellation on reversal of the original transactions or even against independent transactions of equivalent value. There are several instances where BRs were treated as negotiable instruments and transferred by endorsement and even instances when in support of purchases, BRs issued not by counter party banks but by 'third parties' were accepted.

There was a close nexus between certain brokers and certain banks which enabled the brokers to have unauthorised access to

funds as also undertake unauthorised transactions to their advantage.

Apart from the nexus between brokers and banks, there was a nexus between different banks whereby one bank would be used as a source of funds and the other bank was used as a disburser of the funds. Most of the funds were obtained from PSUs possibly through the intervention of brokers, who in turn were the beneficiaries of the funds disbursed.

A key element in the perpetration of the irregularities was the BR, for which the guidelines of IBA were observed in their breach.

Moreover, arising out of the close nexus between the brokers and the banks, the BRS were used to generate transactions which had no security backing. Thus, the guise of security transactions was given to what were in fact pure financing transactions. Without even the backing of an underlying security. In many cases by omission or perhaps by design no record was maintained of BRS issued. In other cases there is clear evidence to show that the BR supported by BRS was issued at the request of brokers.

These lax practices gave considerable scope to banks and brokers to indulge in a number of irregularities in the guise of securities transactions. The indiscriminate use of BRS without security backing created a kind of paper money which circulated from bank to bank like a stage army of soldiers and provided an opportunity to brokers to avail of funds of increasingly larger amounts.

A second key element in the perpetration of the irregularities was the complete breakdown of internal control in a number of banks.

In almost all banks a market practice developed whereby there was no independent confirmation of contracts between counterparty banks and in many cases, deliveries of securities, BRS and SGL transfer forms were made to and received from brokers, and even cheques for settlement of dues were given to or received from brokers. Incidentally this resulted in brokers' delaying delivery of securities, BRS and SGL transfer forms as also cheques for settlement.

A third key element in the perpetration of the irregularities was the fact that brokers were increasingly dealing on their own account and currying positions. This was one of the reasons for the differences between the rates at which the same contract was booked by two counter party banks and the large differences paid to or received from brokers.

A fourth key element was the failure to periodically reconcile the investment accounts. In the absence of this periodic reconciliation gaps in the investment portfolio remained undetected.

As a consequence of the various features mentioned earlier, 'holes' had developed in the investment portfolio of banks. These holes remained undetected because presumably the portfolio was supported by SGL transfer forms or BRS which were on hand or

which were to be delivered by brokers and it was not realised that the SGL transfer forms or BRS were not backed by securities. In effect a huge teeming and lading operation had developed, the deliveries to be effected and payments to be made under one set of transactions being met by the creation of a new set of transactions again supported by SGL transfer forms and BRS not backed by securities. Thus like a game of musical chairs, this 'hole' in the overall investment portfolio of banks was transferred from bank to bank and was detected only when the music stopped.

The event which triggered this stoppage was the enquiries into the securities transactions of banks started by RBI in January, 1992 and this in April, 1992 revealed a shortfall of Rs. 649 crores in the investment portfolio of SBI which could be traced to broker Harshad Mehta.

The discovery of the shortfall in SBI and the subsequent disclosure of the payments by NHB created a crisis in the securities market whereby other brokers also were not able to conceal the 'holes' in the investments of some banks by replacement deals.

The committee is of the opinion that if a proper internal audit and internal inspection system had been functioning, this override would have been detected. This is an activity which is considered within banks as not being intellectually stimulating or conducive to professional advancement within the bank and department is often inadequately staffed.

The RBI had detected some of the irregularities outlined in the Committee's Reports. Thus, in 1989-90, a detailed scrutiny of PMS transactions by banks revealed many irregularities. These irregularities were pointed out to the banks and revised guidelines issued by RBI through a circular dated 18th January, 1991.

It is obvious that while being aware of the violations of its directives by certain individual banks, the RBI was not aware of or did not appreciate the all pervasive nature of the malady. It treated these as technical violations for which the individual banks should be reprimanded and the banking system as a whole cautioned but it did not comprehend the total picture whereby certain brokers had in fact captured the securities operations to their own maximum benefit.

In so far as the existence and quality of investments at the balance sheet date are concerned, the auditors clearly had a duty to verify the existence and quality. This required a reconciliation of the investment account, physical inspection of securities on hand, confirmations of counterparty banks for BRS issued by such banks and on hand, confirmation of SGL balances with the PDO, and control and reconciliation of BRS issued by the bank.

In the case of an audit, within the restrictions of time and resources available, the auditor has to examine the whole area of a bank's financial operations whereas an inspection or investigation is not limited by time or coverage.



The absence of a procedure to provide detailed statements of transactions in the accounts to the holders has however hampered the regular reconciliation of investment balances and to that extent this has contributed to the failure in early detection of the irregularities.

C. Recommendations :

With a view to reduce the chances of recurrence of such irregularities in future, Jankiraman Committee has made the following main recommendations :

A key factor in perpetration of the irregularities has been the system of Bank Receipts (BRs). The issue of BRs should be an exception rather than a rule. To achieve this end, the Committee recommended that, there must be a central depository for all securities in which a bank normally deals.

At present, the PDO is a depository only for Government securities.

As the irregularities were attributable to the breach of IBA guidelines for BRs, the Committee recommended that the IBA guidelines should be strictly followed. It, further, recommended that the BR should have the validity period of only 30 days. Also, it should normally be redeemed only by actual delivery of securities and not by cancellation of the transaction or by set-off against another transaction. Moreover, the committee also emphasised the requirement for proper system in each bank for custody of unused BR forms and for control on their utilisation. It also emphasised the periodical review of existence and

operations of control by internal and it, bank supervisors and external auditors.

On account of the Committee's observation that the brokers have acted on their own account and banks have provided facilities for the purpose, it made certain recommendations. The important amongst them are, i. there must be a compulsory practice for all contracts between banks to be supported by exchange of written confirmations of the contract. This is expected to ensure that the name of the true counter party is disclosed to both contracting parties. ii. when the bank undertakes a transaction on behalf of its client, all documentation should clearly disclose the name of the party on whose behalf it has been acting. iii. The existing prohibition on banks issuing cheques drawn on their account with the RBI for third party transactions should be strictly enforced. Such payments should be made through normal instruments like banker's cheques, drafts or a transfer advice which clearly discloses the identity of the person on whose behalf the transfer is made.

On account of the perpetration of irregularities and non-detection of the same being largely attributable to inadequate control in banks regarding securities transactions and the inadequacy of the internal inspection system, the committee recommended that in each bank an immediate review be made, of the adequacy of the internal control system relating to security transactions and remedial steps be taken expeditiously.

On account of the committee's belief that the envisaged new Supervisory Board will not have the resources to adequately carry out on site inspection of the large number of banks and branches, it recommended that formal arrangements should be made for a closer coordination between the accountancy profession and the supervisory authorities whereby the former can assist the latter in the discharge of their supervisory responsibilities.

From the recommendations made by the Jankiraman Committee for security transactions for banking system it is clear that if they are adhered to strictly the chances of recurrence of such large irregularities may be reduced to a greater extent.

Thus on the one hand the Narasimham Committee has made the suggestions to make the advance portfolio sounder alongwith other suggestions, on the other hand the Jankiraman Committee recommendation will make security transactions healthier for the banking system. And recommendations of both these committees if taken together will lead to a healthier banking system towards 21st century towards which the world is marching.

#### SUGGESTIONS :

On the basis of the present study the following suggestions are to be made with reference to the advance portfolio of commercial banks. Here the comment by Holloway Douglas is worth noting, even in the Indian Scenario. He states that "Today regulatory scrutiny, increased competition and evertightening cost controls find us in an increasingly turbulent and

unpredictable environment working harder and faster, by itself, is no longer enough. loan review needs its own form of perestroika if it is to adapt to the realities of the 1990s."<sup>5</sup>

At this juncture we move to the following suggestions :

1. With increasing uncertainties and dynamic world, the variables affecting to the profitability of proposed borrower may change over a period of projections which are to be submitted by the borrower to the Bank. Hence looking to the nature of industry to which the proposed borrower belong, looking to the likely changes in government regulations and looking to the inflationary trends the projections should be examined with all probable changes and here comes the concept of probability and sensitivity analysis which needs to be taken care of while appraising the lending proposals. As informed to us, by the appraising officers at regional offices of large public sector banks, the projections are verified critically and trends there in are looked into (and necessary changes are made but the factor of uncertainty is not being taken care of and hence the suggestion.

2. The second important thing is to introduce the concept of 'break-even analysis' to branch's profitability while taking lending decision. Considering the complications involved in application of this concept it may not be applied while taking

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5. Holloway Douglas P., From Loan Review to Risk Review, Journal of Commercial Bank Lending, December, 1990, p. 33.

lending decision for loan amount less than Rs.25000, however, when one takes a decision about a loan for big amounts the impact there of on the branch's profitability and risk against it should be critically examined.

It is important to note that "its (interest rate's) impact on the income is more strong than on its expenditure with interest income accounting for more than 80 percent of the total income as against its share of around 60 percent in the total expenditure."<sup>6</sup> Also "the deposit mix and composition of advances affect individual bank's profitability."<sup>7</sup> Venkataraman and Nayak observe supportingly that "for a very long time after the nationalisation, banks have been functioning without any cost consciousness."<sup>8</sup> And here it is very important to note remark of Government of India as quoted by B. Satyamurty "Nationalisation does not absolve the banks from their obligation to maintain proper financial and monetary discipline. There is a substantial investment of public funds and a resonable return on this investment would be expected by the Government."<sup>9</sup>

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6. The Economic Times Research Buerea, Interest Rate Structure, The Economic Times, Ahmedabad, 27th May, 1993, p. 19.

7. Ibid.,

8. Venkataraman N.V. and Nayak Gayatri, Scheduled Commercial Banks, The Economic Times, Ahmedabad, 27th May, 1993, p. 17.

9. Satya Murty B., Current Accounting Practices in Commercial Banks in India, An Empirical Study Prajnan, April-June, 1992, Vol. xxi, No. 1.

3. Regarding method of costing for stock valuation the bankers are concerned with the bill value. The stock statements are being submitted monthly and physical stock inspection are carried out at random by bankers to ensure the correctness of the stock statement. The year end stock valuation is generally based on LIFO, FIFO or average method which are the accepted methods according to Accounting Standards. Here also it is pointed out by some of the lending officers that as the stock statement is to be submitted once a month, it may be submitted on 1st day of the month for one month and on 29th of the next month and still the formalities are fulfilled. Under the circumstances, the comparability of two monthly statements is distorted. Moreover, it is also pointed out by some of the lending officers that so far as the stock statement for the month in which financial year ends are concerned they are not generally submitted for stock position as on the year end date, but for some days before or after and this leaves the ground open for adjustment. The real situation comes when the balancesheet is prepared which is generally finalised after a gap of three to four months.

Hence, two important points worth suggestion here are :

a. in the month of year end the borrowers should be requested to submit their monthly stock statement as on year end date and in case the same are not so submitted, the details regarding movement of goods between the balancesheet date and the date on which stock statement is submitted should be sought for.

b. There should be a standardisation of method of stock valuation for loan monitoring portfolio for big borrowers. As discussed in Chapter III under the Accounting Standard No. 10, the declaration is to be made only in the year of change and extent thereof to be noted only if it is material. In addition to this, the bankers should standardise any of the method out of three recognised by Accounting standard No. 10 viz. FIFO, LIFO and Average stock method, and if the borrower is following any method other than the one standardised by bankers the stock valuation under the method standardised by bankers should also be requested from the borrowers. This will make the contents of advance portfolio comparable with each other. This can be considered from the first stage of advance portfolio i.e. at the time of sanctioning the advance.

4. According to Edward Jesser "there are six specific follow-up procedures which many lending officers fail to perform and which only invite trouble. First, failure to keep upto date financial figures. At the time the loan was originally granted, the company was deserving of the amount requested based on the figures presented. However, analysis of subsequent financial information may reveal the development of adverse trends."<sup>10</sup>

In the light of this it may be noted here that with the recommendation of Chore Committee. "All borrowers enjoying working capital credit limits of Rs.50 lakhs and above from

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10. Jesser Edward A., Effective loan Administration, Journal of Commercial Bank Lending, June, 1973, p. 21.

the entire banking system will now be required to submit the following statements indicating in advance at the commencement of each quarter the requirement of funds during that quarter : Estimates for the ensuing quarter and ..... performance during the previous quarter."<sup>11</sup>

Here we would like to quote the finding of B. Ramachandra Rao that 'Fifty two percent of industrial borrowers do not submit the quarterly returns at all.'<sup>12</sup> In the above background we would like to suggest that the system may be made effective for the present level and be implemented down the line looking to the demands of the day where projections have not turned out to be correct to a greater extent and this may be extended at least to Rs.10 lakhs advance from the banking system to make the disciplined borrower culture.

5. The current ratio as suggested by the Tandon Committee norms is improved over three methods from 1:1 to 1.79:1. However, still it is the second method, in operation for which also the current ratio 1.33:1 which is very low as compared to ideal standard of 2:1 for current ratio.

The cash credit facility eventhough known as "working capital advance" and for the day to day running of the business they

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11. Nabhi's How to Borrow from financial and banking Institutions, A Nabhi Publication, p. 285.

12. Ramachandrarao B., Credit Management, Some Issues in Credit Authorisation Scheme, IBA Bulletin, Vol. ix, No. 11, November, 1987, p. 239.



become the life time advance for the business. In addition to this, when the borrower expands his/her business, with growth of business the entitlement and demand for working capital advance increases and not decreases.

It is, therefore, suggested that after the establishment of business, i.e. over a period of five years or so the borrowers should achieve the current ratio of 1.79:1 as prescribed by the third method of Tandon Committee report and over a period of 10 to 15 years of establishment of the organisation they should attain the current ratio of 2:1. This may release some funds for the newly growing organisations and also when proportion of contribution of the borrowers is to be increased they will be much more cautious about the growth aspect and hence better industrial health can be attained.

6. Also the remark of Paul Ross is important to note here even in the Indian context. He states that "Lenders should probably exert more pressure on Companies to strengthen their balancesheets through more restrictive loan covenants or higher pricing on loans to the more highly leverage credit."<sup>13</sup>

Under the changing banking scenario it is important to note the following remark, "it has been reported that more than 12 of the 20 nationalised banks are likely to show losses for the year ending March 31, 1993. After making bumper profit during the year under review as they are required to make large provisions

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13. Ross Paul, Rising Indebtedness of Corporate Sector, Journal of Commercial Bank Lending, September, 1989, p. 47.

for Bad debts and non-performing assets under the new norms for provisioning introduced by Reserve Bank of India. Also the government has refused to allow tax exemption to banks on the provisions they make for bad debts."<sup>14</sup>

Thus transparency of accounts may be termed to be the first step in the direction of change.

7. It is to be pointed out that, the interest income on advances constitutes the major portion of bank's receipts and hence it can be said that the bank's profitability is dependendent on the same. The provision for doubtful advances and write-off may be considered as one time step to clean-up the books, however, it is not the permanent solution. What is important here is the development of healthy advance portfolio.

Alford Sinclair's comments eventhough are pithy linguistbale are very important in this context and they are as follows :

"Catch the bad ones as soon as you can. If you grade your loans on the front end, you can catch a lot of potential trouble and watch the low quality loans more carefully."<sup>15</sup>

"Once a loan has turned sour, act quickly and decisively. A bad loan is always worse than you think it is. Try to beat the other creditors to what is left of the borrower's assets."<sup>16</sup>

"Don't let bad loans suffer from lack of proper attention from bank personnel. Keep the original officer involved if possible,

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15. Sinclairz Alford C., Problem Loans - At the Eye ball to Eye ball level, Journal of Commercial Bank Lending, June, 1975,p.38.

16. Ibid., p. 38.

but let a sepcialist ride herd over him. Then you ride herd over both of them."<sup>17</sup>

8. In the Indian Scenario the weaving of the steps of advance portfolio is must. The bankers need not become hasty to complete the advance targets and if these targets are completed the emphasis has to be on the good health thereof. The bank lending officers should be trained up to have a grasp over the early warning signals for the problem credit.

What is required here is that so far as the big borrowers are concerned, stringent norms have to be followed-up by them. The banks should devise checklist for these big borrowers and when a particular check is not met with by the borrower, the necessary course of action by the borrower should also be decided in advance, this will eliminate much of the personal consideration. And the objective approach for monitoring and follow-up can be established. The main thrust point should be the maintenance of a complete history of the borrower. The checklist should mainly check the strength of the borrower in terms of profitability, cashflow and certain important ratios.

For the small borrowers the approach in checklist may be kept little simple.

One can be optimistic about the help which management accounting techniques can provide in restraining the sanctioning of the loan which are probable to become doubtful asset and let

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17. Ibid., p. 39.

the use of techniques become the early warning signals for bankers to protect their loan portfolio from becoming loss portfolio and let there be the introduction of the application of management accounting techniques gradually from big borrowers also to the small borrowers where the proportion of problem loan is becoming alarming.