

CHAPTER 5
CREDIT MONITORING

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Introduction

The proposals, after being appraised and sanctioned by the right authority, the corresponding amount has to be disbursed. The lending banker's responsibility does not cease with the granting of the loans and disbursing the same to the borrowers. He has to watch the transactions on a continual basis till the last paisa is recovered from the borrowers.

The purpose of this Chapter therefore, is to study the working of commercial banks in the area of disbursement, supervision and recovery of bank credit and pinpoint the weaknesses for the purpose of corrective actions.

Section I

Pre-disbursement Stage

The pre-disbursement stage consists in fixing the terms and conditions of the loan, and the valuation of securities.

It is necessary for the banker to specify clearly the terms and conditions on the basis of which the advance is given. These terms and conditions should be mutually accepted by both the banker and the borrower. They cover the amount of the loan or the maximum limit of the advance, the nature of the advance, the period upto which it is valid, the rate of interest to be charged. They also contain the

period of repayment which depends on the purpose of the loan/advance and the size of the loan.

Industrial loans for acquiring land, building, plant and machinery or agricultural loans are granted by way of term loans repayable within a period of 10 to 25 years depending on the repayment period agreed. This repayment depends also on the cash surplus that the project or the activity undertaken by the borrower would generate and suitable instalments are fixed.

For the working capital finance, loans are sanctioned for short periods and are subject to periodical review and/or renewal. The repayment comes from the sale proceeds of the goods manufactured or produced and marketed.

For the valuation of securities, bankers consult outsiders particularly for mortgage securities (land, building, etc). Because of the legal side of securities, bankers should handle with care all the documents relating to them. They should check if all the necessary formalities are well filled in and that the borrowers are liable by their true signatures. In some cases, bankers lose their rights because of their negligence to check carefully all the clauses and legal instructions they contain. Therefore, they should always get the advice of a lawyer.

After charging a security, if required, and creating the necessary legal documents, bankers pass to the disbursement of the amount of the Permissible Bank Finance.

Section II

Methods of Disbursement of Bank Credit

Bank Credit in the past was on security basis only and as a consequence, once the security was charged, and a margin fixed and therefore the drawing power determined, the borrower could draw as much as he wanted and at any time within his drawing limit. The method of disbursing was on cash credit basis. The funds being available at the bank, the drawings depended only on the will of the borrower. This situation made the planning of cash outflow difficult at the bank level because the banker did not know at what time his borrower will withdraw how much of the money.

However, the cash credit was convenient to the borrower on whom there were no constraints to discipline his drawings and to the banker who had to create one account and to ensure that the value of the security remained adequate.

In case the value of the security goes up, the drawing power increases and along with it the capacity of the borrower to draw more. As soon as the value of the security was adequate for the loan amount, the banker was at ease and therefore ignored completely whether his borrower was using the bank credit efficiently or not.

After nationalisation of commercial banks, some improvements in the system of disbursement of bank credit have been brought about on mainly the Tandon and Chore Committee recommendations.

I - Disbursement of Credit as per the Tandon Study
Group's Recommendations

The Tandon Study Group found that the disbursement of credit based on Cash credit, enabled the borrowers to diverse the bank funds for other purposes than those for which the credit was allocated. According to the Study Group, a banker had no control under the cash credit system over the level of advances in the cash credit accounts. No notice was required for drawing within the sanctioned limits that remained partly unutilised in most of the cases.

The Study Group therefore suggested that the entire credit limit, as a Cash credit for a year, may be bifurcated into a loan and a demand cash credit which should be reviewed annually.

The Tandon Group also recommended that the financing should be placed on quarterly budgeting - reporting system for operational purposes. In short, the customer should submit a quarterly budget to the banker. When disbursing the credit, as per the Study Group suggestions, a part of the total credit requirement, within the overall eligibility, could also be provided by way of bill limit to finance receivables. These bills were thought to be on a demand basis or on a usance basis depending on the marketing practice in the industry.

The group further recommended that the seller should be paid off immediately after the sale transactions and bank credit should be extended only to the purchaser.

Because of some drawback observed in the Tandon

Group's system of credit disbursement, the Chore Committee was appointed later to go into more details about the operation of the cash credit system and to make changes/improvements if any.

II - Disbursement of Credit as per the Chore Committee

Recommendations

The Chore Committee found that the Tandon Study Group's recommendations relating to the style of credit, i. e. bifurcation of the cash credit limit into a 'core' loan and a portion as a 'variable' cash credit portion has not been put into practice to any significant extent.²⁷

The Study Group also found that one of the reasons given by the banks for not segregating the core portion was that there was no need for bifurcation of the core portion and its conversion into separate loan account because the banks were aware of the extent of the Core portion on the basis of minimum drawings in the past years.

Continuing its investigations, the group discovered that banks apprehended difficulties in documentation, registration of charges etc. The interest on the loan portion being low, as per the group analysis, banks stand to lose considerable income on such core portion and in the prevailing trend of declining profits, they could not accept such a change.

The study group recommended the enforcement of

27. Chore Committee Report, paragraph 5.1.

the system of bill finance purchase and discount of bills - which is quite popular for financing receivables. The Group, continuing its analysis, realised that the practice of financing book debts by cash credit was however, still prevalent to some extent.

Bankers were advised, wherever feasible, that they should review all such accounts and insist on the conversion of cash credit limits into bill limits. The Group recommended that to begin with it should be made compulsory for banks to extend at least 50 % of the cash credit limit against raw materials to manufacturing units whether in the public or private sector by way of drawee bill.

The R B I accepted the recommendations of the Chore Study Group pertaining to the disbursement of bank credit, while those of the Tandon Study Group have been withdrawn.²⁸

Therefore, it can be noted that three methods of disbursement of bank credit viz., cash credit, term loans and bills are actually in use in Indian Commercial banks. But it will be difficult to replace completely the cash credit system in a developing country like India inspite of the efforts of the Reserve Bank of India to popularise the Bill Market.

The lending Banker, after disbursing the credit, should keep a close watch on the end - use of

28. Based on different studies of materials available in banks pertaining to the Tandon and Chore Study Groups.

funds and ensure that the unit is working satisfactorily. In other words, he should supervise the purpose for which the bank credit is used to ensure better recovery.

Section II

Follow-up and Supervision of Bank Credit

One of the most important tasks of commercial banks today is the follow up and supervision of the credit provided. They are financing large number of borrowers from different sectors of the economy and consequently the supervision of bank credit becomes more challenging than it was before.

The main objectives of follow-up and supervision of bank credit are :

- (i) to ensure that the bank credit is used for the purpose it has been sanctioned for,
- (ii) to keep a close watch in the borrower's activity and particularly to see if the project has been started in time,
- (iii) to evaluate the performance of the unit in terms of production sales, profit etc. and also to see if the borrower is in line with the original plan,
- (iv) to appreciate the management capability,
- (v) to get information relating to external factors like economic situation, government policies etc., and
- (vi) to detect signals of sickness at their early stage in order to take corrective actions to avoid sickness.

I - Method of Follow-up and Supervision of Bank Credit as per the Tandon Committee Recommendations.

1 - Main Recommendations

Under the new credit system proposed by the Study Group, the follow-up and direction of credit have to be regulated on the basis of the genuine production needs. The Committee has suggested that borrowers should get their accounts audited and should submit their annual plans of operations for the next year. The Group also recommended bankers to analyse thoroughly the previous year's operations, so as to evaluate the performance of the borrower during the past, the quantum of finance facility that will be available to him depending on his operations. On the basis of the projected level of operations in the next year, the credit limits will be fixed.

In fact, the information system has really been introduced only in 1965 when for the first time in India, the Credit Authorisation Scheme was set up requiring the banks to apply to the Reserve Bank of India for authorisation of the credit limits over Rs. one crore.

But the originality of the Tandon Committee Report is in that it covers all borrowers who enjoy a Credit limit of Rs. 10 lakhs and above and also those enjoying credit limits of Rs. one crore or more from the banking system. Therefore, the Tandon Group divides borrowers into two categories :

One enjoying credit limits of Rs. 10 lakhs and above and another one enjoying credit limits of Rs. 1 crore or more from the banking system. This last group is qualified as big borrowers. Each group of borrowers has to submit the prescribed forms.²⁹

Through the monthly stock statement, bankers check if stocks or receivables are under the prescribed norms. This is very important particularly if goods are pledged or hypothecated. A rise in the stock figures without a corresponding increase in the turnover shows that there are some inadequacies in the borrower's production cycle or their goods are not being sold well.

The higher the stock turnover, the healthier may be the business concern.

The quarterly statement of current assets and current liabilities shows the working capital gap (i. e. total current assets minus total current current liabilities, excluding bank loan) at every quarter. In this statement, the banker can find out whether the borrower is holding inventory in excess

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29. The first group of borrowers has to submit : (a) Annual production plan, (b) past and projected balance sheets once in a year, (c) past, present and projected operating statement once in every year (Form Ia), (d) stock statement in once a month. In addition to these statements, the Second Group of borrowers has to submit, (e) statement of current assets and current liabilities on a quarterly basis but for the last quarter and projected for the current quarter (Form Ib), (f) quarterly funds flow (Form 11), (g) quarterly operating statements (Form Ia) and (h) half yearly proforma balance sheet and profit and loss account within 3 months.

of normal requirement. This statement also gives a fund of information whether there is an increase in sales, whether the borrower has earned a profit or not. The banker has to be sure that a reasonable part of the profit shown in the operating statement has been ploughed back.

The Tandon Group recommended toleration of any variation of $\pm 10\%$ in the stock or receivables. But in the case of deterioration in the operating profit, the banker should discuss the reasons with the borrower.

Alongwith the above recommendations, the group has suggested when stipulating terms and conditions, that the borrower should consult the bank sufficiently in advance to give it an opportunity to examine its own position.³⁰

The Study Group has also suggested surprise stock inspection by the banker and where a banker feels, for special reasons, that a detailed stock verification is called for, a regular stock audit may have to be arranged with the assistance of outside consultancy.

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30. This consultation is to be done in the matters of (a) making other borrowing arrangements (b) taking up new projects or large scale expansion, (c) making investments in or loans to subsidiaries, associate concerns, individuals employees under welfare scheme, (d) paying dividends other than out of current's earnings, after making due provisions (e) giving guarantee on behalf of third parties, (f) disposal of the whole or substantially the whole of the undertaking, and (g) premature repayment of loans and discharge of other liabilities.

Then, the Study Group recommendations through the Information System seems to enable the banker to follow-up and supervise the bank credit. In fact, the quarterly statements from these borrowers giving the projection of their activities for the next quarter and also the review of their performance in the relation to the projection made for the earlier quarter, give the bank an opportunity to supervise and control the credit such guidelines have not been given for smaller accounts.

Inspite of their innovative nature, the techniques of follow-up and supervision of bank credit as suggested by the Tandon Committee are subject to criticism.

2 - Tandon Group's Information System : Some Criticism

The Tandon Group has proposed an information system the objective of which is to prevent an unplanned use of cash credit facility. The recommendation is that financing should be placed on quarterly budgeting reporting system for operational purposes.

The Information System (I. S.) proposed by the group has already been recommended by the R B I to commercial banks through the CAS and this is dated since 1965. The only change is that in the group's forms, the data are on a quarterly basis.

The I. S. looks very effective on paper from the point of view of follow-up , in practice it requires constant efforts for the borrower to prepare the prescribed forms and furnish the same to the banker. Borrowers are more busy in marketing their products,

negotiating new supply of raw materials at cheaper price etc., rather than sitting in for a long time to fill in all these statements.

At the bank's level also, correct interpretation will have to be done to see whether the borrower is correctly projecting the utilisation of the Cash generation. Any diversion of working capital funds for investment in the block-assets or for making advances to the sister concerns and other non-productive purposes will be reflected in such statements and these will have to be taken up with the borrowers immediately.

The banker should also ask for supplementary information like movement of important items of inventories, of book debts, particulars of loans and advances given and also details of sundry creditors, including statutory liabilities, on a monthly basis, for the purpose of ensuring that funds provided by the bank are being properly utilised for production purpose and the borrower has taken all possible steps to bring gradual improvements to his operational efficiency.

The study group thought all these indicators will be available to the bank once the information system starts working. But the biggest problem faced by bankers was that borrowers felt that the bankers were poking their nose into their business and as a consequence many of them were really reluctant to furnish the required information.

It was because of these defects in the information system that the Chore Committee Report suggested some modification in the Tandon's Information System .

II - Method of Follow-up and Supervision as per the Chore Committee Report.

The Chore Committee Report has extended the information system to borrowers enjoying working capital credit limits of Rs. 50 lakhs and over from the banking system. The forms prescribed by the Tandon Committee have been simplified and substituted by three forms.³¹

With this reduction in the number of forms to be submitted, the Chore Committee felt that borrowers will not face any problem in submitting these statements in time. The Group also recommended that a borrower should be asked to give his quarterly requirement of funds before the commencement of the quarter on the basis of his budget for normal non-peak level as well as for peak level.

Drawings less than or in excess of the operative limit (funds required for a quarter) so fixed with a tolerance of 10 % either way but not exceeding sanctioned limit would also be subject to a penalty to be fixed by the RBI from time to time. It may be for the time fixed at 2 % . Drawings in excess of the operative limit should however be subject to a close scrutiny by the banks and allowed only where they are

31. These forms are : (a) Form I : Estimates for the ensuing quarter : projected level of current assets and current liabilities (including short term bank borrowings). It is to be submitted in the week preceding the commencement of the quarter to which the statement relates, (b) Form II : Performance during the quarter : Statement showing performance for the previous quarter with current assets and current liabilities. It is to be submitted within six weeks from the closure of the quarter to which the statement relates. (c) Form III : Half yearly operating and Fund Flow statement. It is to be submitted within two months from the close of the half year.

satisfied that such excess is warranted.

On the Group's point of view, the system of levying commitment charge on unutilised portion of the Credit as well as penalty on excess drawings may be imposed by means of directive. The commitment charge may be calculated on the basis of the unutilised portion of the credit limit which shall be the difference between the indicated limit and the average over the said quarter, actually utilised by him. It may be prescribed by the R B I .

The penalty charge may be calculated on the excess drawings in the Credit limit which shall be the difference between the amount actually utilised by the borrower and the indicated limit. It may also be prescribed by the R B I .

The Chore Group also suggested that banks should levy commitment charge only if the utilisation falls short of 90 % of the indicated limit and the penalty should be levied on a daily basis only if on any day, the utilisation goes beyond 110 % of the indicated limit. The commitment and penalty charges should not be levied on advances given by way of loans. The Chore Group also recommended that if the borrower does not submit the returns within the prescribed time, he should be penalised by charging the whole outstanding in the account at a penal rate of interest, 1 % per annum more than the contracted rate for the advance from the due date of submission of the returns till the date of its actual submission.

As a consequence of the above, the Chore Committee Report has filled the major gaps left by the

Tandon Committee's Information System.

The system based on Tandon and Chore Committee Reports is being improved from time to time and all commercial banks are required to send an annual progressive report to the R B I .

The techniques for follow-up and supervision of bank credit vary from bank to bank. Keeping in mind the Tandon and Chore Committee recommendations, the banker can use supplementary techniques according to the specific conditions of the area where he is operating.

The success or failure of follow-up and supervision of bank credit is measured by the capability of the bank to recover its dues. This introduces the problem of recovery of bank credit as discussed in the following section.

Section III

Recovery of Advances.

I - Dimension of the Problem.

Whatever the techniques of follow-up and supervision of bank credit used, the main objective for the banker is to recover all his dues in time. In this international economic crisis of today, businesses are facing more and more problems than in the past. This is particularly due to the competition among firms, protectionism policies laid down mainly by developed countries reducing the primary exports of developing countries. As a consequence, the Governments of developing countries encounter so many

problems in adjusting their economic policies to the international economic order.

Even today one of the biggest financial institution in the world i.e. the International Monetary Fund is forced to find out a solution to the outstanding Third World debt. Millions and millions of dollars of its credit to developing countries in Asia, America and Africa are not certain to be recovered.

The German Magazine Elseviers³² has analysed the debt crisis and found that inspite of the IMF's debt recovery problems, western banks have 700 billion dollars outstanding in Third World and East European countries. The most unpleasant situation was the case of the nine biggest banks of America which had lent half of their capital to Latin American Countries !

The Tuesday Daily³³ reported that the Punjab National Bank, the Central Bank of India and the Union Bank of India were having problems of recovery of the 200 millions dollars they had provided to a business enterprise in Britain.

The Financial Express³⁴ on recovery position of the banks in agriculture reported that banks recover just around 51 % of their total advances to agriculture.

32. Elseviers Weekblad, March 10, 1984.

33. Tuesday, Daily, Bombay, February 20, 1985.

34. The Financial Express, November 1982 on recovery position of the banks in agriculture shows average performance as below :

- at the end of 1981, recovery was 52.3 %
- at the end of 1980, recovery was 52.0 %
- at the end of 1979, recovery was 50.2 %
- at the end of 1978, recovery was 50.2 %.

This poor recovery of advances is explained by some responsible factors as described under.

II - Responsible Factors for Poor Recovery.

As a result of the different interviews of senior bank Officers at different levels of the commercial banking hierarchy, the factors responsible for poor recovery of bank advances have been classified into two groups, i.e. nature and human. This bad recovery is either the fault of the banker and/ or that of the borrower.

Table 5.1 gives the list of responsible factors for poor recovery of advances.

TABLE 5.1 : Responsible Factors for poor Recovery of Bank Credit*

Factors	CAUSES		RESPONSIBILITY WITH	
	Natural	Human	the Banker	the Borrower
1. Natural calamities like droughts, flood etc.	+			
2. Misutilisation of Funds		+	+	+
3. Timely help not given		+	+	
4. Over and under finance		+	+	
5. Wrong estimation of repayment capacity		+		

contd..

Table 5.1 contd..

Factors	CAUSES		RESPONSIBILITY WITH	
	Natural	Human	the Banker	the Borrower
6. Fluctuation in Prices		+		
7. Wilful default		+		+
8. Lack of supervision		+	+	
9. Political interference		+	+	+

* These factors are far to be exhaustive.

The factors responsible for poor recovery of bank credit as contained in Table 5.1 can be broadly be grouped into 3, i. e. economic and production, social and bankers' appraisal and follow-up.

A detailed study of the 3 groups as mentioned above will throw more light to the problem of recovery of advances.

1 - Economic and production factors.

Increasing cost of inputs can reduce profitability margins, making repayment difficult even for the successful borrowers. The Government Policies also can interact unfavourably with the already tight market conditions. Even if additional credit is obtained from the banker for adjustment to price rise, the problem is not yet solved unless the rate of inflation is controlled and kept down.

To these factors, it is to be added the vagaries of nature which make the conditions of borrowers, particularly those operating in priority sectors, very pitiable and the only thing they can do in this case is to postpone the loan instalments.

Another factor is the method of calculating the projected yield of the project. Bankers assume, when assessing the viability of the project, that there will be no meaningful changes in the environment.

The economic and production factors lead to reduce the borrower's income and therefore reduction of the net cash availability.

2 - Social Factors.

One of these factors is the political interference. It has been pointed out in Chapter III that, certain borrowers because of their social and political status, are able in a way or another, to press the higher bank authority for the sanction of their proposals. Once the proposals are sanctioned by this way, the recovery poses serious problems because the borrowers will use the same technique to escape from the repayment of bank credit.

There are also some borrowers who take the bank credit as a gift and therefore when they earn high income, they meet first their family expenses such as for example elaborate ceremonies and as dowry etc and the repayment of bank credit gets only a secondary place. In the agricultural sector for example, farmers keep in postponing the repayments from one harvesting season to another.

This postponment of payments leads to the accumulation of huge debts which ultimately become unpayable.

3 - Bankers appraisal and follow-up.

The banker himself is much more responsible for the delay in recovery. Many a time bank managers take an unduly long time in processing the loan case and as a result the borrower does not get timely help. In agriculture, this results in delaying the sowing the consequence of which is the poor germination of seeds, hence low yield and low income.

Here also bankers are responsible for the delayed recovery due to political interferences. It is also observed that wherever bankers have given a loan under pressures from various levels disgrading the normal appraisal process, the recovery has been poor.

It has been reported by some borrowers that sometimes bankers press them too much for the repayment of bank credit in a shorter period than the one recommended. This puts the borrowers in hardship and thus the defaults in payment. It is also observed that, wherever the bank has fixed a repayment period say, 9 years and the banker tries to recover it in say, 5 years, this has led to difficulty in recovering the money.

In many banks, it has also been noted that 'field banking' is becoming recessive while 'cabin banking' is getting dominant. The case of the company 'Progressive Construction' mentioned earlier, can serve again as an illustration for the weakness of the follow-up and supervision of bank credit leading to poor

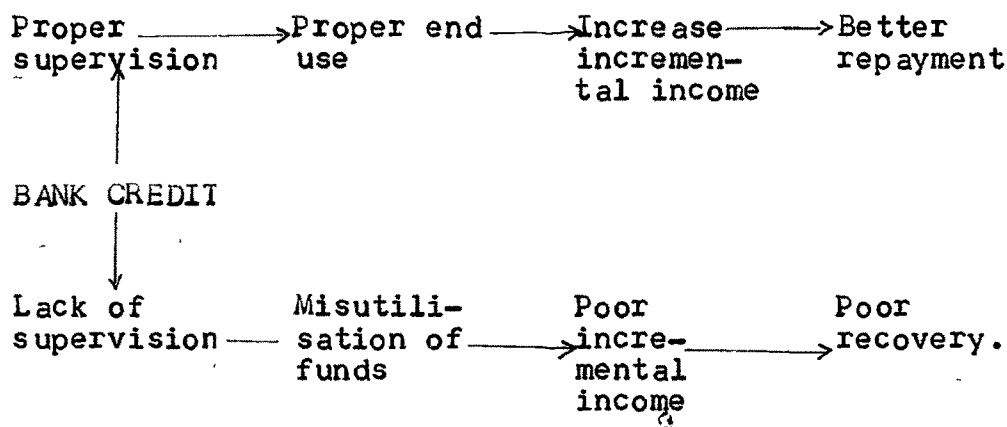
recovery of advances. Because of the political interferences and the negligence of the supervision of bank credit, the assets of the company were charged according to the need of the situation. If the Balance Sheet of the Company showed the total value of fixed assets as Rs. 2.447 crores with a minimal stock in trade of Rs. 5 lakhs, the securities offered to various banks against advance of loans was as much as Rs. 12.2 crores. That is five times the amount in the books; 'Progressive Constructions' had offered the same security as collateral to a number of banks. The same fixed assets in the form of machinery had been hypothecated to the Madhya Pradesh Government as well as to several other banks. The firm continued hypothecating the same security to different banks until the fraud was discovered. This leads naturally to the difficult recovery of the advances given by these banks. What is certain is that, unless the Company's officials got the collaboration of an M.P. and the complicity of some bank and government officers, the fraud could have not been successful.

III - Concluding Observations.

An effective strategy for the recovery of advances can be better determined through practical experience of a banker in a particular environment rather than by an academically formulated system. However bankers should reinforce their follow-up and supervision of bank credit. There should not be any political inference either in the appraisal stage or in the recovery process. Bank credit is a scarce national resource and no conscious politician should allow its misutilisation. The Central and Local Governments should take severer measures

in this regard. Whatever the case, bankers are responsible for the non-recovery of advances. Any weakness in the follow up and supervision of bank credit leads to poor recovery. This is illustrated in the following Chart.

Chart 5-1 : Supervision of Bank Credit for Better Recovery.



Such supervision should be done in an efficient manner and for that bankers should always remember the word CARE meaning C = continuous A = appraisal R = review and E = evaluation. Appraisal and evaluation of security should also be a continuous process. That is to say, bankers should be very strict with their borrowers as far as recovery is concerned.

In case the loan is repayable in instalments, a default by the borrower for the payment of any instalment makes the entire loan immediately recoverable on the option of the bank. But there are some circumstances under which the bankers recall their advances. This happens in the case of (i) the death of the borrower or guarantor, (ii) insolvency of the borrower or

the guarantor or liquidation of the borrowing company, (iii) dissolution of the partnership, (iv) failure to renew the documents sufficiently before the expiry of the period of limitation, (v) deterioration of the security, (vi) deterioration of the financial position of the party, (vii) failure to maintain adequate margin, etc.

For the recovery procedure, commercial banks generally have recourse to their lawyers for legal action. It is only after this legal action or special authorisation given at the beginning by the borrower to sell the security in case of default by him, that the banker, after sale of the security, gets fully or partially his dues depending on the value of the security. But it can be noted, among the conditions in which the advance is recalled, that there are some cases beyond the control of the borrower and a deep study should be done by the banker before selling the security.

The biggest problem of recovery arises when the borrower is insolvent. The problem here is to decide if the borrower's security is to be sold or not. Usually in the case of hypothecation, Plant and/or machinery are taken as security. In this case, selling the security means winding up (i.e. liquidating) the firm and along with it increasing the unemployment. At this stage, the unit needs a big dose of additional finance to revive. Just like a human being, who is sick and needs to be examined in order to locate the disease and prescribe a medicine accordingly. This introduces the role of a commercial bank in rehabilitating, nursing and monitoring sick units. This is dealt in the following Chapter.