CHAPTER – 2

CREDIT MANAGEMENT – A CONCEPTUAL FRAMEWORK

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2.1 INTRODUCTION:

Every country has to undergo from the continuous process of development. Banks play a vital role in this process. The Indian banking system has progressed as a powerful mechanism of planning for economic growth. Banks channelize savings to investments and consumption. Through that, the investment requirements of savers are reconciled with the credit needs of investors and consumers. [1]

Out of all principal roles of the banks, lending is the most important role in which banks provide working capital to commerce and industry. Importance of credit is not only because of its social obligation to cater the credit needs of different sections of the community but also because lending is the most profitable activity, as the interest rates realized on business loans have always been well above those realized on investments. Credit being the principal source of income for banks and usually represents one of the principal assets of the banks so its proper management becomes all the more necessary. The extension of credit on sound basis is therefore very essential to the growth and prosperity of a bank. With the increasing role of commercial banking in capital formation, employment generation and production facilitation, the credit operations of commercial banks are expected to be in harmony with the requirements of the economic system.

Till today, banks are the major suppliers of working capital to the trade and industry and they have privilege of having massive lending facilities produced by the banks. Hence, the management of bank credit operations is required to be more creative than the traditional approach followed by it earlier. [2]

Lending activities of banks have surround effect on the economy. For overall development of economy, all the sectors of economy should be grown and developed equally. Credit management serves the concept of credit deployment that bank should observe that overall bank credit should be deployed in such a way that each and every segment of an economy and system of nation get benefited. This is the one aspect of credit management. On the other hand, if lending activity becomes fail, it adversely affects the whole economy. In last decade, banks have realized that an increase in retail credit increased the credit risk also. Success of bank lies on profitability and liquidity and that come

majority from successful lending activity. So an examination of some of the important aspects of credit management of Indian banks would provide an insight into the credit/ lending activity of commercial bank.

2.2 CONCEPT OF CREDIT:

The word 'credit' has been derived from the Latin word 'credo' which means 'I believe' or 'I trust', which signifies a trust or confidence reposed in another person. The term credit means, reposing trust or confidence in somebody. In economics, it is interpreted to mean, in the same sense, trusting in the solvency of a person or making a payment to a person to receive it back after some time or lending of money and receiving of deposits etc.[3]

In other words, the meaning of credit can be explained as,

A contractual agreement in which, a borrower receives something of value now and agrees to repay the lender at some later date.

The borrowing capacity provided to an individual by the banking system, in the form of credit or a loan. The total bank credit the individual has is the sum of the borrowing capacity each lender bank provides to the individual.

2.3 CREDIT DEFINITIONS:

1. Prof. Kinley:

"By credit, we mean the power which one person has to induce another to put economic goods at his deposal for a time on promise or future payment. Credit is thus an attribute of power of the borrower."

2. Prof. Gide:

"It is an exchange which is complete after the expiry of a certain period of time".

3. Prof. Cole:

"Credit is purchasing power not derived from income but created by financial institutions either as on offset to idle income held by depositors in the bank or as a net addition to the total amount or purchasing power."

4. **Prof. Thomas:**

"The term credit is now applied to that belief in a man's probability and solvency which will permit of his being entrusted with something of value belonging to another whether that something consists, of money, goods, services or even credit itself as and when one may entrust the use of his good name and reputation."

On the basis of above definitions it can be said that credit is the exchange function in which, creditor gives some goods or money to the debtor with a belief that after sometime he will return it. In other words 'Trust' is the 'Credit'.[4]

5. **Vasant Desai:**

"To give or allow the use of temporarily on the condition that some or its equivalent will be returned."[5]

2.4 CHARACTERISTICS OF CREDIT:

Some characteristics of credit are of prime importance while extending credit to an individual or to a business enterprise.

1. **Confidence:**

Confidence is very important for granting or extending any credit. The person or authority must have confidence on debtor.

2. **Capacity:**

Capacity of the borrower to repay the debt is also very crucial thing to be considered. Before granting or extending any advance, creditor should evaluate the borrower's capacity.

3. **Security:**

Banks are the main source of credit. Before extending credit, bank ensures properly about the debtor's security. The availability of credit depends upon property or assets possessed by the borrower.

4. **Goodwill:**

If the borrower has good reputation of repaying outstanding in time, borrower may be able to obtain credit without any difficulty.

5. **Size of credit:**

Generally small amount of credit is easily available than the larger one. Again it also depends on above factors.

6. **Period of credit:**

Normally, long term credit cannot easily be obtained because more risk elements are involved in its security and repayments. [6]

➢ **FEATURES OF COMMERCIAL BANK CREDIT:**

1. Banks provide credit majority to trade and industries than agriculture. Because of the greater risks and inability of agriculturists to furnish good security.
2. The short term loans are given for the seasonal needs and working capital requirements.
3. Short term loans may be in the form of cash credit and overdraft, demand loans and the purchase and discount of bills. Among these, cash credit and overdraft are the most popular.
4. Indian banks sanction loans against sound security.
5. Banks take all possible protective steps to minimize their risks while granting loans to the firms.

2.5 TYPES OF CREDIT:

The credit assistance provided by a banker is mainly of two types, one is fund based credit support and the other is non-fund based. The difference between fund based and non-fund based credit assistance provided by a banker lies mainly in the cash out flow.[7] Banks generally allow fund based facilities to customers in any of the following manners.

➢ **TRADITIONAL CREDIT PRODUCTS:**

1. **Cash credit:**

Cash credit is a credit that given in cash to business firms. A cash credit account is a drawing account against a fixed credit limit granted by the bank and is operated exactly in the same manner as a current account with all overdraft facilities. It is an arrangement by which, a bank allows its customers to borrow

money up to a certain limit against tangible securities or share of approved concern etc. cash credits are generally allowed against the hypothecation of goods/ book debts or personal security. Depending upon the nature of requirement of a borrower, bank specifies a limit for the customer, up to which the customer is permitted to borrow against the security of assets after submission of prescribed terms and conditions and keeping prescribed margin against the security. It is on demand based account. The borrowing limit is allowed to continue for years if there is a good turnover in account as well as goods. In this account deposits and withdrawals may be affected frequently. In India, cash credit is the most popular mode of advance for businesses.

2. Overdraft:

A customer having current account, is allowed by the banks to draw more than his deposits in the account is called an overdraft facility. In this system, customers are permitted to withdraw the amount over and above his balance up to extent of the limit stipulated when the customer needs it and to repay it by the means of deposits in account as and when it is convenient. Customer of good standing is allowed this facility but customer has to pay interest on the extra withdrawal amount.

3. Demand loans:

A demand loan has no stated maturity period and may be asked to be paid on demand. Its silent feature is, the entire amount of the sanctioned loan is paid to the debtor at one time. Interest is charged on the debit balance.

4. Term loans:

Term loan is an advance for a fixed period to a person engaged in industry, business or trade for meeting his requirement like acquisition of fixed assets etc. the maturity period depends upon the borrower's future earnings. Next to cash credit, term loans are assumed of great importance in an advance portfolio of the banking system of country.

5. **Bill purchased:**

Bankers may sometimes purchase bills instead of discounting them. But this is generally done in the case of documentary bills and that too from approved customers only. Documentary bills are accompanied by documents of title to goods such as bills of loading or lorry and railway receipts. In some cases, banker advances money in the form of overdraft or cash credit against the security of such bills.

6. **Bill discounted:**

Banker loans the funds by receiving a promissory note or bill payable at a future date and deducting that from the interest on the amount of the instrument. The main feature of this lending is that the interest is received by the banker in advance. This form of lending is more or less a clean advance and banks rely mainly on the creditworthiness of the parties.

- **INNOVATIVE CREDIT PRODUCTS:**

Since the liberalization period there have been drastic changes in the way loans have been granted to individual customers and businessmen. The changing pattern of banks from universal to branch banking after the liberalization period also forced banks to adopt easy lending. Due to the increase in the number of mergers and acquisitions in this sector, expectation went very high. Banks have come under immense pressure to meet the targets of deposits and loans.[8]

Post globalization, Liberalization and Privatization, bankers began to focus on both corporate and retail banking activities. The international financial markets have witnessed a sea change in the last decade. Banks are likely to undergo more changes in the future. In view of these developments, banks in India are also adopting certain new practices and technology based services to cater to the needs of people. This is because it enables customers to perform banking transactions at their convenience.[9]

Technology has supported the development of financial service industry and reduced the cycle of money to the shortest possible duration. A number of financial institutions, including banks have started online services. The growth of innovative retail products offered by Indian banks is increasing sharply.

1. **Credit cards:**

Credit cards are alternative to cash. Banks allow the customers to buy goods and services on credit. The card comprises different facilities and features depending on the annual income of the card holder. Plastic money has played an important role in promoting retail banking.

2. **Debit cards:**

Debit card can be used as the credit card for purchasing products and also for drawing money from the ATMs. As soon as the debit card is swiped, money is debited from the individual's account.

3. **Housing loans:**

Various types of home loans are offered by the banks these days for purchasing or renovating house. The amount of loan given to the customer depends on the lending policies and repayment capacity of the customer. These loans are usually granted for a long period.

4. **Auto loans:**

Auto loans are granted for the purchase of car, scooter etc. it may be granted for purchasing vehicle.

5. **Personal loans:**

This is an excellent service provided by the banks. This loan is granted to the individuals to satisfy their personal requirements without any substantial security. Many banks follow simple procedure and grant the loan in a very short period with minimum documents.

6. **Educational loans:**

This loan is granted to the student to pursue higher education. It is available for the education within the country or outside the country.

7. **Loans against securities:**

These loans are provided against fixed deposits, shares in demat form, bonds, mutual funds, life insurance policy etc.

8. Consumption loans for purchase of durables:

Banks fulfill the dreams and aspirations by providing consumer durable loans. These loans can be borrowed for purchasing television, refrigerator, laptop, mobile etc.[10]

9. Hybrid loan products:

For improving the business environment and to win in the competition, banks must adopt new technologies. With fluctuating interest rates and inflation, there is a need for the banks to protect the interest of the borrowers. So banks now offer hybrid products to their customers. These products have the virtues of both fixed and floating interest rate loans. The products introduced by the different banks have their own distinctive features.

2.6 CREDIT CLASSIFICATION: [11]

(Source – Reeta Mathur: Recent Trends in Indian Economics)

2.7 CREDIT INSTRUMENTS:

Credit instruments prove very helpful in encouragement and the development of credit and help in the promotion and development of trade and commerce. Some of the credit instruments are,

1. Cheque:

Cheque is the most popular instrument. It is an order drawn by a depositor on the bank to pay a certain amount of money which is deposited with the bank.

2. Bank draft:

Bank draft is another important instrument of credit used by banks on either its branch or the head office to send money from one place to other. Money sent through a bank draft is cheaper, convenient and has less risk.

3. Bill of exchange:

It enables a seller of commodity to issue an order to a buyer to make the payment either to him or to a person whose name and address is mentioned therein either on the site of the bill or within a period of time specified therein.

4. Promissory note:

According to the Indian negotiable instrument act, 'a promissory note' is an instrument in writing containing an unconditional undertaking signed by the maker to pay a certain sum of money only to or the order of certain person or the bearer of the instrument.

5. Government bonds:

Government issues a sort of certificate to the person who subscribes to these loans. Such certificates are called government bonds. Some of them are income tax free.

6. Treasury bills:

These bills are also issued by the government. They are issued in anticipation of the public revenues.

7. **Traveler's cheque:**

This is the facility given by bank to the people. It was most useful when recent technological instrument like ATMs were not available. A customer was used to deposit money with the banks and banks give traveler's cheque in turn. It was used to avoid risk of having cash while travelling.[12]

2.8 ADVANTAGES OF CREDIT:

Credit plays an important role in the gross earnings and net profit of commercial banks and promotes the economic development of the country. The basic function of credit provided by banks is to enable an individual and business enterprise to purchase goods or services ahead of their ability. Today, people use a bank loan for personal reasons of every kind and business venture too. The great benefit of credit with a bank is probably very low interest rates. Majority people feel comfortable lending with bank because of familiarity.

1. **Exchange of ownership:**

Credit system enables a debtor to use something which does not own completely. This way, debtor is provided with control as distinct from ownership of certain goods and services.

2. **Employment encouragement:**

With the help of bank credit, people can be encouraged to do some creative business work which helps increasing the volume of employment.

3. **Increase consumption:**

Credit increases the consumption of all types of goods. By that, large scale production may stimulate which leads to decrease cost of production which in turn also lowers the price of product which in result rising standard of living.

4. **Saving encouragement:**

Credit gives encouragement to the saving habit of the people because of the attraction of interest and dividend.

5. **Capital formation:**

Credit helps in capital formation by way that it makes available huge funds from able people to unable people to use some things. Credit makes possible the balanced development of different regions.

6. **Development of entrepreneurs:**

Credit helps in developing large scale enterprises and corporate business. It has also helped the different entrepreneurs to fight with difficult periods of financial crisis. Credit also helps the ordinary consumers to meet requirements even in the inability of payment. One can borrow money and grow business at a greater return on investment than the interest rates of loan.

7. **Easy payment:**

With the help of various credit instruments people can pay without much difficulty and botheration. Even the international payments have been facilitated very much.

8. **Elasticity of monetary system:**

Credit system provides elasticity to the monetary system of a country because it can be expanded without much difficulty. More currency can be issued providing for proportionate metallic reserves.

9. **Priority sector development:**

Credit helps in developing many priority sectors including agriculture. This has greatly helped in rising agriculture productivity and income of the farmers. Banks in developing countries are providing credit for development of SSI in rural areas and other priority sectors too.

2.9 DISADVANTAGES OF CREDIT:

Credit is a mixed consent. It involves certain advantages and some dangers also at the same time. Credit is useful as well as harmful to the user even. So it should be used very cautiously otherwise it may spoil all industries and enterprises. Credit, if not properly regulated and controlled it has its inherent dangers.

1. **Encouragement of expenditure:**

Credit encourages wasteful expenses by the individuals as well as commercial institutions. As people irresponsibly think that the money is not their own. Easy availability leads to over trading over exposure that ultimately leads to bad debts.

2. **Encourage weakness:**

Credit encourages big entrepreneurs to continue to hide their weakness. Their own shortcomings are met by the borrowed capital. Even the loosing concerns continue with the help of borrowed capital in the hope to survive. In this condition, if business fails, it not only leads the borrowers in dangers but also thousands of those people who advanced credit to such people.

3. **Economic crisis:**

In several occasions credit is directly responsible for economic crisis. It leads to recession and depression in an economy as boom of credit facilities has its own evil effect on the economy. Financially weak concern having credit facility takes the economy to weaker effects.

4. **Dangers beyond limit:**

Credit in a country expanded beyond certain limits which results in over investment. Over issue credit takes beyond safe limits that result in over investment, over production and rise of prices. This danger has been emphasized by Prof. Thomas in his 'Elements of Economics', in his words: "There is no automatic limit to the expansion of a credit system as there is to an expansion of a metallic circulation through the intervention of human element. Uncertainty and variableness is the chief source of danger in a credit organization".[13]

5. **Evil of monopoly:**

Credit system has also resulted in the creation of monopolies; monopolistic exploitation is due to money placed at the disposal of individuals or companies that leads to monopolist exploitation. The different organizations have growth with the emergence of credit and have worked to the damage of both the consumers and the workers.

6. Encourage inefficient:

Credit gives encouragement to certain inefficient and worthless producers. Inefficient business concerns availing the credit and not using efficiently, accumulate money in their hands. People come into the market with the feeling that they have nothing to do but just to play only with other's money.

So, by this it can be said that it is clear that the government or the central banking authorities must keep the credit within limit so that no evil is allowed to crop up in the economy.

2.10 ROLE OF CREDIT IN ECONOMY:

Commercial banks continue to remain in the forefront of Indian financial system. Banks provide necessary finance for planned development. In developed and developing countries both, credit is the foundation upon which the economic structure is strengthening. Bank credit would play a significant role by influencing the types of commodities and quantum of their output. To achieve high rate of economic growth over a long period, agriculture and industrial credit should be increased. At the time of sanctioning the credit, the purpose should be investigated by the bank to ensure that the end use of funds confirms to overall national objectives. Banks also give credit to the priority and neglected sectors by which the sectoral development can be possible. Easy availability of credit promotes the entrepreneurial and self employment venture in the country.

Credit instruments are used as media of exchange in place of metallic or paper currency. These instruments are more effective and convenient in all business transactions. Bank credit provides assistance to production and business process. Institutional credit provides a ready flow of money to the business. Bank credit fulfills the capital requirement of an entrepreneur which increases the production at higher level by which production cost decreases and as a result price of product also decreases that affects the economy positively.

Credit provides financial ability to use advanced technology in the production. So the quality of production and product may increase. And business can survive in

an international market too. Credit makes common person to change into entrepreneur. Surplus fund utilized for credit bring return that further increase the volume of funds. Credit makes it easy and convenient for the consumers to purchase or hire durable goods. In the period of declining market, there is greater availability of cheaper source of funds through credit. Corporate borrowers paid greater attention towards banks for their financial requirements. This enables the entrepreneurs to run their business and day to day transactions very smoothly.

Bank's power to create money is of great economic significance. This gives an elastic credit system which is necessary for steady economic progress. This system geared to the seasonal demands of business. Bank lending operation acts as a governor controlling the economic activity in the country. Bank lending is very important to the economy, for it makes possible the financing of the agricultural, industrial and commercial activities of the country. According to an economist, "Credit has done more to enrich nations than all the gold mines in the world put together."[14]

2.11 CONCEPT OF CREDIT MANAGEMENT:

Banks and financial institutions mobilize deposits and utilize them for lending. Generally lending business is encouraged as it has the effect of funds being transferred from the system to productive purposes which results into economic growth. The borrower takes fund from bank in a form of loan and pays back the principal amount along with the interest. Sometimes in the non – performance of the loan assets, the fund of the banks gets blocked and the profit margin goes down. To avoid this situation, bank should manage its overall credit process. Bank should deploy its credit in such a way that every sectors of economy can develop. Credit management comprises two aspects; from one angle it is that how to distribute credit among all sectors of economy so that every sector can develop and banks also get profit and from the other angle, how to grant credit to various sectors, individuals and businesses to avoid credit risk.

Credit management is concerned mainly with using the bank's resource both productively and profitably to achieve a preferable economic growth. At the same

time, it also seeks a fair distribution among the various segments of the economy so that the economic fabric grows without any hindrance as stipulated in the national objectives, in general and the banking objectives, in particular.[15]

2.12 PRINCIPLES OF SOUND LENDING:

Lending is the most important function of the bank and profitable as well. On the contrary it is a risky business too. Loans always have the credit risk. So a banker should manage the loan business in a profitable and safe manner. All the necessary precautions should be taken by a banker to minimize credit risk. Every borrower has different nature and functions of business. While considering a loan proposal, certain general principles of lending should be kept in mind that can help establishing some credit standards.

Bank lending is an art as well as a science. These techniques, tools and methods are mostly mechanical. With a little practice, it can be learnt. Principles guide to action. According to L. C. Mathur "The ideal advance is one which is granted to a reliable customer for an approved purpose in which the customer has adequate experience, safe in the knowledge that the money will be used to advantage and repayment will be made within responsible period."[16]

1. Safety:

This is the most important guiding principle of a banker. Bank's business deals with the public deposits. Bank has to ensure the safety of the funds lent. Safety means the borrowers should be in a position to repay the loan along with interest. Otherwise, the banker will not be in a position to repay the deposits and bank may lose the public confidence. Bank follows lending policy to maximize earnings but it has always to be defensive at the same time because it cannot afford to lose the people's money. The advance should be granted to reliable borrower.

2. Security:

Security means any valuable given to support a loan or advance. A large variety of securities may be offered against loans from gold or silver to immovable property. The security accepted by a banker as a loan cover must be adequate,

easy to handle, readily marketable. A banker must realize it only as a cushion to fall back in case of need.

3. **Liquidity:**

Liquidity means a bank's ability to meet the claims of its customers. Banks should ensure that the money lent is not locked up for a long time. A bank would remain liquid with liquid advance. This is an important aspect of banking, which distinguishes it from insurance finance or industrial finance. It is the capacity of a bank to honor its obligations. A banker does the business on borrowed funds; it should ensure liquidity while lending money. At the time of need, a banker should be able to convert assets into cash to meet the demand of depositors, because depositors have faith in a bank on the basis of its liquidity.

4. **Suitability:**

Banker should concentrate lending activity on purpose desirable from the point of view of economic health of the nation. Finance to gambling is not a part of banking business. Due consideration should be given to control inflation and raising the standard of living of the people.

5. **Risk diversification:**

Every loan has its own risk. So it is better to give an advance for different purposes and segments to spread the risk. For safety of interest against contingences, the banker follows the principle of "Do not keep all the eggs in one basket." Bank should avoid concentrating the funds in a few customers or segments. The advances should be spread over a reasonably wide area, number of borrowers, number of sectors, geographical area and securities.

Another form of diversification is maturity diversification. Under this, the loan portfolio is concentrated over different maturity periods. So that, a certain amount of loans matures at regular intervals which can be utilized to meet the depositor's demand.

6. **Profitability:**

Commercial banks are profit earning concerns so bank must earn sufficient income to pay interest to the depositors, meet establishment charges, salaries to staff, earn income for the future, and distribute dividends to the share-holders etc.. The difference between the lending and borrowing rates constitutes the gross profit of the bank. A bank should possess liquidity, with surety of profit; banks should not ignore the safety or liquidity.

7. **Purpose:**

A banker should inquire the purpose of the loan. Safety and liquidity of loan depend on the purpose of loan. Loan may be required for productive purposes, trading, agriculture, transport, self-employment etc... Loan for productive purpose would increase the chances of recovery. On the other side, loan for non-productive purpose would have lots of uncertainty about recovery. After nationalization, the purpose of a loan has assumed more significant.

8. **Nature of business:**

There may be innumerable types of businesses and the repaying capacity of a borrower depends on the nature of the business. So, banker should consider this while granting the loan.

9. **Margin:**

The security offered against advance must be judged from the aspect of economic value and legal aspect. The market value of the security must be higher than the amount of advances proposed. It should give enough margins for fluctuation in prices and interest rates.

10. **National policies:**

In a developing country like India, banks are also required to fulfill some social responsibilities. Government policies and national interests impose certain social responsibilities on commercial banks. Sometimes to cater social responsibility, advances are given at concessional rate to the weaker and neglected sectors. The

lending policies of banks are to be modified from time to time to suit the needs of the economy.

2.13 FORMULATION OF LOAN POLICY:

A bank has the social obligation to meet the credit needs of different sectors of the community. But it cannot afford to incur losses. Bank has to manage lending business in safe manner by that the loan portfolio of bank remains balanced from the point of view of size, type, maturity and security that promises for reasonable and steady earnings. This is called clear cut and definite credit policy. A credit policy includes detailed guidelines for the size of the loan portfolio, the maturity periods of the loan, security against loan, the credit worthiness of the borrower, the liquidation of loans, the limits of lending authority, the loan territory etc.

Credit policy provides some directions for the use of funds, to control the size of loans and influences the credit decision of the bank. So, the loan policy is a necessity for a bank.

Formulating and implementing loan policies is the most important responsibilities of bank directors and management. In this activity, the Board of Directors take the services and co-operation of the bank's credit officers, who are well experienced and expert in the techniques of lending and are also familiar with external and internal factors that affect to the lending activities of the bank.

In formulating the loan policies, the policy formulators must be very cautious because the lending activity of the bank affects both the bank and the public at large. All the influencing factors should be considered.

- **CONTENTS OF LOAN POLICY:**

1. **Size of loan account:**

The total amount of the total advances that a bank would sanction should be clearly mentioned in loan policy. There is no iron-clad formula for fixing the size of the loan. The only rule is that bank should continue to lend till the bank has funds for lending. The basic social and business excuse for the bank is the ability to supply credit to the community. A bank should determine the optimum size of loan portfolio. In this decision, management must foresee the economic situation

of the economy and region also. The size of the loan account may be fixed at a higher limit in case of good capital position in relation to its total deposit liabilities.

2. **Credit for infrastructure:**

The operational guidelines on financing infrastructural projects have been issued to commercial banks in April, 1999. According to that, banks would be free to sanction term loans for technically feasible, financially viable and bankable projects undertaken by both public and private sector.

3. **Types of loan portfolio:**

Decision on the type of loan must also be taken. Different types of loans carry different degrees of risks which are depended upon the adequacy of its capital fund and the structure and stability of bank deposits. In the loan policy, various forms of loans and the proportion of each form should be clearly spelled out. Policy statement should also mention the maximum amount of the loan that might be granted to a particular borrower.

4. **Acceptable security:**

The Government policy and credit policy of the RBI should also be kept in view while granting any credit. Bank should observe the rules and regulation time to time for maintaining liquidity and profitability. Otherwise if security aspect is not considered, bank will have to suffer from any loss which may occur from any unsecure loan.

5. **Maturity:**

A loan may be called back in times of need to satisfy the liquidity needs of the bank. Short term loans are more liquid and less risky. The minimum period of loans and spread over various maturities subject to roll-over would now be decided by banks and banks could invest short-term / temporary surplus of borrowers in money market instruments.

6. Compensating balance:

Compensating balance is a protective device to save the bank from the risk of default. The compensating requirement may not be common for all the customers. The way in which the compensating requirement is applied seems to vary from bank to bank.

7. Lending criteria:

To minimize the risks in lending, a bank should grant loans only to deserving parties whose credit character, capacity and integrity are good. The criteria of evaluating credit character and capacity to generate income should be set forth in the policy statement.

8. Loan territory:

The loan policy statement of the bank must include the regions to be served by the banks. This will save the time and efforts of the credit department in respect to receive a loan application.

9. Limitations of lending authority:

Large-scale commercial banks consists a number of loan officers. The loan authority of different officers should determine to avoid overlapping and duplication of efforts and wastage. The management must set forth the lending limits of each officer in the policy statement.

2.14 ADMINISTRATION OF CREDIT:

1. Appraisal:

The norms for appraisal should be spelled out in the loan policy. The format, credit information, financial observation, method of lending etc., should be included.

2. Pricing:

Fixing of loan pricing should be based on the cost of funds and nature of the risks. The cost of fund should be spelled out by bank depending on credit rating of the borrower and probability of default.

3. **Expiry Terms:**

The terms of expiry of the loan should be based on maturity pattern of resources and movement in interest rates and life of collateral.

4. **Sanctioning:**

Sanctioning power of the authority should be clearly mentioned in loan policy. The sanction should be in written form and within the delegated authority. Time schedule for reporting sanctions and exceptions for confirmation of the higher authorities should also be spelled out.

5. **Documentation:**

Documentation starts with a written loan application by the borrower followed by signed loan covenants like, right of set off, right to enforce collateral / securities on default, right to debit account for charges, right to freeze operation on misuse of facilities, right to receive statements of business etc. The borrower should be given a sanction letter in standard format and borrower's written acknowledgment in terms of sanction should also be obtained.

6. **Disbursement:**

Proper authorization for disbursement of loan should be there. Adequate drawing power and security cover within stipulated margin should be taken carefully while disbursing. This should be made after proper documentation. It should be ensured also that the use of credit is for the purpose for which it was granted.

7. **Supervision:**

The main purpose of supervision is to ensure that the loan is utilized for the purpose for which it has been granted. This is achieved through the periodical statements, visits of the borrower, monitoring operations, credit reports etc.

8. **Monitoring:**

The loan portfolio is centrally monitored at the head office for returns from branches.

9. Recoveries And Rehabilitation:

In the loan policy, procedures for prompt follow up on due dates should be spelled out. To avoid such ambiguity, time schedule may also be highlighted.

10. Income Recognition and Provisioning:

Some information and norms regarding NPA should also be spelled out in loan policy.

11. Internal Controls:

The internal control system regarding policy, the procedure to be followed in this regard should be stated.

12. Loan Review:

Loan should be reviewed by an independent middle office. The job of this department is to make analysis of portfolio risk. This is an emerging concept. The basic fundamental of the overall loan policy should be to ensure safety of funds with returns.[17]

2.15 INFLUENCING FACTORS OF LOAN POLICY:

1. Variability in deposit:

A bank follows a liberal lending policy whose deposits show little or no fluctuations. Sometimes, a bank having erratic movements in deposits may follow conservative lending policy. Therefore, lending policy may be affected by variability in deposits.

2. Monetary policy:

The Central Bank influences the lending policy of bank by controlling the credit limits. By the cash reserve ratio and the net liquidity ratio, Central Bank controls the credit powers of the banks. Monetary policy of a Central Bank affects much in determining the lending policy.

3. Capital position:

Capital of bank provides the cushion to absorb the losses that may occur. A strong capital based bank can assume more credit risk than the weaker one. So that bank

can follow a liberal lending policy and provide different loan products. So, the capital position of a bank is probably the most important influencing factor.

4. **Competitive position:**

A bank management should consider the market competition. If bank management finds that as per the competition, bank cannot afford such loan policy, so that they can change the policy.

5. **Local and national economy:**

In such seasonal and cyclical fluctuated economy, bank can not adopt liberal policy. But in declining economy, bank must revise the existing policy or design a new one with such terms and conditions of lending.

6. **Ability and experience of loan officers:**

Loan officers of a bank can use their experience while formulating loan policy and granting the loans.

7. **Credit needs of the area:**

In such economy like agricultural, the bank must tailor its loan policy to meet the seasonal loan demands of the borrowers.

2.16 EVALUATION OF APPLICANT:

To make prudent credit decision, bank essentially should know the borrower well. Without these information bank cannot judge the loan application. Credit worthiness of the applicants is evaluated to ensure that the borrower conform to the standards prescribed by the bank. It can be said that a loan properly made is half-collected. So, a bank should make proper analysis before making any credit decision. With increasing credit risks, banks have to ensure that loans are sanctioned to ‘safe’ and ‘profitable’ projects. For this they need to fine tune their appraisal criteria. A mix of both formal and non-formal credit appraisal techniques will go a long way to ensure perfection in credit appraisal.

The credit evaluation process involves three steps:

1. Gathering Credit information

2. Credit Analysis (credit worthiness of applicants)
3. Credit Decision

1. Gathering credit information:

The credit department of a bank collects various important information regarding borrower from different sources to evaluate the customer. A number of sources would available for gathering information which depends upon the nature of the business, form of loan, amount of loan etc. these sources are,

- **Interview:**

  Interview with the borrower enables the banks to secure the detail information about the borrower's business which can help in credit decision process. If the applicant does not satisfy the credit norms, the lending officer may stop further procedure. In case of the success of preliminary investigation, as up to the standards, borrower may be asked to submit various financial reports.

- **Financial statements:**

  Financial statements include the balance sheet and the profit and loss account. The financial statements of the last few years should be obtained. This analysis would provide an insight into the borrower's financial position, funds management capacity, liquidity, profitability and repaying capacity of the borrower.

- **Report of credit rating agencies:**

  Credit Information Companies (Regulation) Act 2005, (CICRA) provided for the creation of credit information agencies or companies, which enable the banks to readily access the full credit history of the borrower. This is an institution that is set up by the lenders like bankers, credit card companies etc. Banks can gather information on the creditworthiness of the applicant. These companies maintain the credit histories on individuals and business entities. The CICRA became a piece of legislation with effect from June 23, 2005. Credit information in this context only includes past track record in loans availed and future repayment ability.[18]

- **Bank's own records:**

  If the applicant is the existing customer of the bank, the banker can study the previous records, which provides an insight into the past dealings with the bank. Every bank maintains a record of all depositors and borrowers. The transactions of borrower can give depth idea to banker.

- **Bazaar report:**

  Report regarding applicant can also be obtained from various markets. The strengths and weaknesses of the borrowers are monitored by the markets continuously. Market opinion can also predict the future of the business. Market intelligence can also be gathered through borrower's competitors. It should be a continuous process on existing current account holders and other prominent businessmen.

- **Report from other banks:**

  Bank credit department may ask to other banks in which the applicant has dealings.

- **Other non-formal methods:**

  There are other ways also which can give many clues and make the judgment more accurate. The most popular non-traditional method is to understand the personality, motive and the capabilities of the borrowers, based on non-verbal clues as trying to predict the results of a human mind.[19]

2. **Credit analysis (credit worthiness of applicants):**

   After gathering the credit information, banker analyses it to evaluate the creditworthiness of the borrower. This is known as Credit Analysis. It involves the credit investigation of a potential customer to determine the degree of risk in the loan. The creditworthiness of the applicant calls for a detailed investigation of the 5 'C' of credit – Character, Capacity, Capital, Collateral and Conditions.

- **Character:**

  The 'character' means the reputation of the prospective borrower. This includes certain moral and mental qualities of integrity, fairness, responsibility, trust

worthiness, industry, etc. The honesty and integrity of the borrowers is of primary importance. So, credit character should be judged on the basis of applicant's performance in bad times.

- **Capacity:**

  It is the management ability factor. It indicates the ability of the potential borrower to repay the debt. It also shows the borrower's ability to utilize the loan effectively and profitably.

- **Capital:**

  Capital refers to the general financial position of the potential borrower's firm. It indicates the ability to generate funds continuously over time. Capital means investment represents the faith in the concern, its product and nature. Bank should also determine the amount of immediate liabilities that are due. For the true estimate, market value of assets should be considered rather than book value.

- **Collateral:**

  Collateral means assets offered as a pledge against the loan. It serves as cushion at the time of insufficiency of giving a reasonable assurance of repayment of the loan.

- **Conditions:**

  It refers to the economic and business conditions of the country and position of particular business cycle, which affect the borrower's ability to earn and repay the debt. This is beyond the control of the borrower. Sometimes borrower may have a high credit character, potential ability to produce income but the condition may not be in favor. For the proper evaluation, bank should have eyesight on the economic condition too.

For this, they have to rate the borrowers in different categories like excellent, well and poor. Both the formal and non-formal tools combined would lead to perfection in credit appraisal and ward of increasing default tendency in credit. There are number of tools and techniques developed to evaluate the

creditworthiness of the borrower like, ratio analysis, cash flow projections, fund flow statement, credit scoring etc.

3. **Credit decision:**

After passing through whole this process, the banker has to take decision about sanctioning of credit facility. The creditworthiness should be matched against the credit standards of loan policy. The banker should be very conscious about this, for taking right decision to avoid the possible credit risks to arise in future.

2.17 CREDIT MONITORING:

A good lending is that the amount lent, should be repaid along with interest within the stipulated time. To ensure that safety and repayment of the funds, banker is necessary to follow-up the credit, supervise and monitor it. Credit monitoring is an important integral part of a sound credit management. The bank should always be careful for that fund properly utilized for what it has been granted. Banker keeps in touch with the borrower during the life of the loan. There are some steps from the banker's point of view, to ensure the safety of advance.

1. **Documentation:**

Once the loan is sanctioned by the bank, the borrower must provide certain documents. The properly executed and stamped documents are essential which should be dully filled and authenticated by the borrower.

2. **Disbursement of advance:**

The advance should be disbursed only after obtaining the documents. Loan account should be scrutinized to ascertain that the funds are utilized for the business purpose only.

3. **Inspection:**

The unit and the securities charged to the bank should be inspected periodically. The banker stipulates different terms and conditions at the time of granting the advance. And the banker should continue to keep a watch that all these are observed. In this, the team of financial and technical officers visits the borrower's firm to get view about customer's affairs.

4. **Submission of various statements:**

All the statements required by a banker should be regularly obtained and thoroughly scrutinized. The health of the borrower's accounts are indicated by control formats, so, should be reviewed properly. Borrower's accounts show movement of accounting and operation stage. Financial statements and balance sheets should be examined along with credit risk rating at least once in a year. The positive and the negative progress of the loan assets are indicated by these verifications.

5. **Annual review:**

Every loan account should be revised annually. A borrower makes lending decision on certain assumptions. So, it is necessary to hold those as good throughout the continuance of the advances. Annual review provides an insight view of the borrower's general and financial conditions.

6. **Market information:**

The banker should keep in touch with the market environment. Market reports are an important source to get the present information regarding trade and industry. The banker should have resource for such information.

Hence, bank must take all the precautions before sanctioning loans and after in follow-up also. The post sanctioning period is also most important to avoid the risk of NPA. It is helpful to banker to prevent the debt to be converted into bad debt.[20]

2.18 ORGANIZATION OF BANK LENDING (A FLOW CHART): [21]

(Source: R. M. Shrivastava & Divya Nigam, "Management of Indian financial Institutions)

2.19 CREDIT PROCESS (A FLOW CHART): [22]

(Source: Prefessional Banker, April, 2008)

2.20 LOAN PRICING:

Banks are required to price their deposits and loans scientifically as per the recommendations of committee. The bank's profitability depends on the loan price. Price of loans is based on the credit risk rating of the borrower. The loan pricing should be enough to recover cost of funds, credit risk premium, capital adequacy cost and overhead. However, the bank is operating in the market, in highly competitive environment. Hence, its price should be comparable to the market price. In this global and competitive market, bank has to attract the customer with such an attractive prices and returns. Growth of bank depends upon the stability of bank in this competition.

2.21 CLASSIFICATION OF SECURITIES:

Banks sanction their advances against some securities. There are various kinds of securities which banks accept against credit. They are as under,

1. **Primary security:** The security which is created with the help of finance made available by the bank like, house through the bank loan.

2. **Collateral security:** It means additional. It is a supporting security. In this finance is not made available against additional security, but the banker insists upon additional security when necessary.

3. **Personal security:** It provides legal remedy to the bank against the borrower by providing right of action against the borrower personally. Loan against this may be an unsecured.

4. **Tangible security:** Land, building, machinery are the examples of tangible securities. These are in tangible form which can be relied in times of crisis.

5. **Liquid security:** This is the most reliable form of security and easily convertible into cash. Fixed deposit, shares of blue chip Company are the examples of it.

6. **Government security:** Bonds, promissory notes, treasury bills issued by the government are called as government securities.

7. **Stock exchange security:** These are in the form of shares and debentures.

8. **Blue chip security:** Shares of highly rated, consistently dividend paying are called as blue chip securities.

2.22 CONCEPT OF CREDIT RISK MANAGEMENT:

Credit Risk Management is very important area for the banking sector and there are wide prospects of growth. Banks and other financial institutions are often faced with risks that are mostly of financial in nature. Management of risk has been very important component of business plan for the banks and an undercurrent of risk mitigation and planning has always been part of the banking business.

Risk management plays a vital role in a bank's credit management. Banking professionals have to maintain the balance between the risks and the returns. For a large customer base banks need to have a variety of loan products that are reasonable enough. If the interest rates in loan products are too low, the bank will suffer from losses.

There have been conscious efforts in minimizing the risk without affecting the business opportunities since the early days of banking. With the increasing volume of business and complexity in financial transactions, the risk management also has increased. Risk management is relatively easy in stable environments and under predictable circumstances of interest rates. However, with increasing volatility in the markets has made risk management more complex.[23]

Giving loans is risky affair for bank sometimes; Banks are constantly faced with risks. There are certain risks in the process of granting loans to certain clients. There can be more risk involved if the loan is extended to unworthy debtors. Certain risks may also come when banks offer securities and other forms of investments.

Effective Credit Risk Management is vital for success of any bank, as banks are operating with a low margin compared to other business. They should strike a

proper balance between profitability and liquidity and should always be careful about default profitability and credit value at risk.[24]

2.23 CREDIT RISK RATING:

Credit risk rating is a rating assigned to borrowers, based on an analysis of their ability and willingness to repay the loan. Under the IRB (Internal Rating Base) approach, banks will be allowed to use their internal credit risk rating system for setting capital charges. The IRB approach provides similar treatment for corporate bank and a separate frame-work for retail and project finance. [25]

IRB approach is one of the most innovative aspects to calculate credit risk under the new accord. According to Basel-II norms, credit risk is computed in two ways under IRB approach, one is the Foundation approach while the other is the Advance approach.

The foundation approach is relatively a fundamental approach. In this, the banks are allowed to develop their own model for estimating the probability of default for individual client or group of clients.

The advanced approach allows the banks to develop their own model to quantity required capital for credit risk.[26]

2.24 BASEL–II (Accord):

Basel-I was very simple as Basel-II is complex. Basel-II Accord to be adopted widely and quickly. The Basel-I Accord is considered as "One Size Fits All", which needed to be upgraded as each bank has its own way in measuring, managing and mitigating risk.

Basel-I norms deal only with credit risk. So, it did not discriminate between different levels of risk. As a result a loan to an established corporate was deemed as risky as a loan to a new business. The Basel-II accord proposes getting rid of the old risk weighted categories that treated all corporate borrowers the same replacing categories into which borrowers would be assigned on that credit system.[27]

This accord is based on three mutually reinforcing pillars, which together contribute to the safety of the financial system.

First Pillar	:	Minimum Capital Requirement
Second Pillar	:	Supervisory Review Process
Third Pillar	:	Market Discipline

The new Basel accord is a set of recommendation especially in terms of risk management. This will help in better pricing of loans in alignment with their actual risk. The customer with high credit worthiness will be benefited and will get loans at cheaper interest rates. Higher risk sensitivity of the norms provides no incentive to lend to borrower with waning credit quality. It guides and show the way of credit management to the banking system.

Its implementation will lead to more efficient loan pricing which will reflect the risks and the costs involved. So, there would be a shift towards higher quality borrowers over a period of time and the risk of the overall portfolio should decrease.

It is obvious that Indian banks have enjoyed the benefit of implementing Basel-I norms in the last period. Basel-II norms will also work for the strengthening of Indian banks in the fight with risk management in the coming years.

2.25 AN NPA CONCEPT:

The banking system has always played an important role in the growth and development of the economy and therefore countries with a sound banking system are said to be economically stronger. The failure of the banking sectors adversely affects other sectors in the economy. Non Performing Assets (NPA) is one of the major concerns for any bank. NPA is the parameter to judge bank's performance.[28]

NPAs adversely affect lending activity of banks as non-recovery of loan installments as also interest on the loan portfolio. The efficient management of loan accounts is the major concern for any bank. If proper evaluation is done at

the time of advancing loans then the NPAs can be reduced. NPAs also hurt the profitability of bank.

An asset, including a leased asset, becomes nonperforming when it ceases to generate income for the bank. A non – performing asset (NPA) is a loan or an advance where;

1. Interest and/ or installment of principal remain overdue for a period of more than 90 days in respect of a term loan,
2. The account remains 'out of order', in respect of an Overdraft/Cash Credit (OD/CC),
3. The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted,
4. The installment of principal or interest there on remains overdue for two crop seasons for short duration crops,
5. The installment of principal or interest there on remains overdue for one crop season for long duration crops,
6. The amount of liquidity facility remains outstanding for more than 90 days, in respect of a securitization transaction undertaken in terms of guidelines on securitization dated February 1, 2006.
7. In respect of derivative transactions, the overdue receivables representing positive mark-to-market value of a derivative contract, if these remain unpaid for a period of 90 days from the specified due date for payment.

Banks should, classify an account as NPA only if the interest due and charged during any quarter is not serviced fully within 90 days from the end of the quarter.[29]

2.26 THE RBI DIRECTIVES ON ADVANCES:

1. General:

The banks should charge interest on loans or advances granted by them as per the directives issued by RBI from time to time. The interest at the specified rates shall

be charged at monthly rests from April 1, 2002. Interest rates shall be rounded off to the nearest rupee.

2. **Benchmark Prime Lending Rate (BPLR) And Spreads:**

Banks are free to determine of interest subject to BPLR and Spread guidelines on the loans above Rs.2 lakhs. This is for operational flexibilities for the bank.

3. **Freedom To Fix Lending Rates:**

Banks are free to set their lending rates in some categories.

4. **Fixed Interest Rates For Loans:**

Banks are free to offer all categories of loans on fixed or floating rates, subject to conformity to Asset Liability Management (ALM) guidelines.

5. **Withdrawals Against Uncleared Effects:**

In the nature of unsecured advances, the banks should charge interest on such drawls as per the directive. This instruction will not apply to the facility afforded to depositors for immediate credit.

6. **Loans Under Consortium Arrangement:**

The banks need not charge uniform rate of interest even under a consortium arrangement.

7. **Zero Percent Interest Finance Schemes For Consumer Durables:**

These types of loan schemes lack transparency in operation and disort pricing mechanism of loan products. So, banks should refrain from offering these types of schemes. These products do not give a clear picture to the customer regarding the interest rates. Banks should also not promote such schemes by advertisement in different media.

- **GENERAL SAFEGUARDS ON LOANS AND ADVANCES SUGGESTED BY RBI**

RBI has suggested such corrective measures which may be observed while allowing advances.

- All proposals for advances, without exception, should emanate from the branches and sanctions should be made only after proper appraisal.

- Ad hoc / temporary amounts /excesses wherever sanctioned should be promptly reported higher authorities without waiting for regularization of advances, explaining the circumstances leading to the need for unforeseen urgent funds. Controlling authorities should monitor the regularization effectively.
- Sanctions within discretionary powers should also be promptly reported to the controlling authorities in the stipulated manner.
- In case of non-reporting, the controlling authorities should obtain the prescribed statements and scrutinize the same diligently and take prompt follow up action.
- Caution should be exercised against attempts by main borrowers to float fictitious companies in order to facilitate sanction of large limits ostensibly within the discretionary power of the sanctioning authority.
- In case of oral / telephonic sanction, proper record of the same should be maintained by the sanctioning as well as the disbursing authority, explaining there in the circumstances under which such sanctions had to be obtained.
- Written confirmation of the competent sanctioning authority must invariably be obtained by the disbursing authority in such cases as also in sanctions beyond discretionary powers.
- The discretionary powers of the officials, who have a tendency to exceed their powers frequently, should be reviewed by the controlling authorities.
- Controlling authorities should make frequent visits to branches and submit reports of such visits, with special focus on all loan accounts.

➢ **RBI'S GUIDELINES ON LENDING PRACTICES BY THE BANKS: (RBI, Dec. 19, 2002)**

- Application cum-acknowledgment form of banks should be comprehensive to include rate of interest, manner of charging interest, process fees and other charges, panel interest rates, pre-payment options, and any other matter which effects the interest of the borrower, so that a meaningful comparison with that of other banks can be made and informed decision can be taken by the borrower.

- Loan application form should be disposed within a reasonable period of time and state specific time period from the date of acknowledgement, within which the decision on loan request will be conveyed to the borrower.
- In case of rejection, specific reasons should be conveyed in writing.
- Credit limits which may be sanctioned may be mutually settled.
- Terms and conditions governing credit facilities such as margin, security should be based on due diligence and creditworthiness of borrower.
- Lender should ensure timely disbursement of loans sanctioned.
- Lender should give notice of any change in the terms and conditions including interest rates and service charges.[30]

2.27 VARIOUS CREDIT COMMETTES:

In early period, banks adopted security oriented system, to provide strong financial resources to borrowers irrespective of their economic function. This, in effect, aided the concentration of economic power. But, increased bank credit was not commensurate with the expansion in the levels of inventory and production. Bank funds were frequently used by a few resourceful business units. The purpose was to storage inventories of limited resources to create artificial shortages and make gains out of it. On other side, others experienced a shortage of inputs, lower capacity utilization, higher production cost etc.

1. THE DAHEJA STUDY GROUP

The National Credit Council constituted in October 1968, under the chairmanship of V.T. Daheja. The Daheja Study Group appointed in October, 1968, to examine the extent inflated credit needs of industry and trade. They found that…..

- Bank credit expanded at a higher rate during the period from 1964 to 1967.
- Ratio of short term bank credit to inventories went up from 40% in 1961-62 to 52% in the 1966-67.
- Diversion of short term bank credit for the acquisition of long term assets.
- Banks granted working capital advances by way of cash credit limits.

Conclusions of DAHEJA Study Group

- There was a tendency in the industry to avail itself of short term credit from banks for growth in inventory based production.
- Diversion was generally due to the sluggish conditions in the capital market since 1962, and limited appraisal for short term loans compared to medium and long term loans.
- Generally, banks relate their credit limits to the security offered by their clients mostly without assessment of overall financial position of the borrower through cash flow analysis.

Recommendations of DAHEJA Study Group

To control the tendency of over-financing and the diversion of the bank's funds, The Daheja study Group recommended that……

- Banks should finance on the basis of a total study of the borrower's operations rather than only security considerations.
- The present and future cash credit accounts should be remarkable between "the hard core" and the short term components.
- Company's hard core part of the working capital with a strong financial position should be separated and put on a formal term-loan basis for a repayment schedule.
- The borrowers should be asked to arrange for long-term funds to replace bank borrowing.

Despite the Daheja study group's recommendations, there was a puzzle of expansion in bank credit. Unless the lending style of bank was changed and objective norms were fixed for financing working capital requirements, a few financially sound industrial units would continue to depend on bank credit. That of a large number of new credit claimants will starve of funds. For this context, The Tandon Committee was appointed.

2. THE TANDON COMMITTEE

In July 1974, The Reserve Bank of India constituted the study group under the chairmanship of Shri P. L. Tandon to frame guidelines for follow up of the bank credit. The committee submitted its report in 1975.[31]

Objectives of TANDON Committee

- Sources of finance for minimum working capital requirements.
- To obtain periodical data from borrowers regarding their production plans and credit needs by which banks would enable to formulate their own credit plans more effective.
- To set the criteria to determine financial structure of borrower and their borrowings.
- To suggest norms for industry's inventory holding with the help of bank credit.
- Whether modifications in the existing pattern of the cash credit overdraft etc. is needed or not if so, to suggest suitable modification.

Recommendations of the TANDON Committee

The Tandon Committee's recommendations may be classified in to six broad categories like……..

- **Norms for inventory and receivables**

  To hold the inventory at the minimum level of production requirements, the committee has suggested some flexible norms for inventory and receivables in as many as 15 industries, excluding heavy engineering industry. The norms represent the maximum levels for holding inventory and receivables in each industry.

- **New approach to bank lending**

  In the context of this approach, the committee has developed three alternatives for working out the maximum permissible level of bank borrowings.

  The bank would finance a maximum of 75% of the working capital gap, and the balance is to come out of long term funds.

  The borrower has to provide for a minimum of 25% of the total current assets out of long-term funds and the bank will provide the balance. The total current liabilities, inclusive of bank borrowings, will not exceed 75% of the current assets.

  It excludes the core current assets (permanent portion of current assets) from the total current assets to be financed out of the long-term funds.

- **Style of lending**

  The present cash credit system has been expensive to operate. In spite of that, the committee has applied the principles of behavioral science and has attempted to take an advantage of cost consciousness among the borrowers.

- **Credit information system**

  The committee recommended a quarterly budgeting reporting system for operational purposes, on the basis of which the requirements of working capital finance will be calculated with reference to the borrower's future production needs.

- **Follow-up : Supervision and control**

  To verify the end-use of lending, according to the purpose for which the credit was given, the bank should follow up and supervise the use of credit. This would be necessary if the banker is to shift from security-oriented lending to production-related credit.

  For the purpose of better control, the committee has recommended a system of turnover classification in each bank within the credit rating scale. There may be a five point scale, on which the borrower may be classified as excellent, good, average, below average or unsatisfactory.

  These recommendations are applicable to all industrial units having working capital limits of Rs.10 lakhs and above from the banking system. The recommendations are applicable to only working capital unit.

Reserve Bank's Action on TANDON Committee Recommendations

The Reserve Bank introduced a reform on 21st August, 1975 to act upon the recommendations of the Tandon Committee. The reform was designed to reduce the dependence of industries for borrowings from commercial banks. The basic strategy of the reform is to convert excess borrowings into term loans. Some actions of Reserve Banks are….

The RBI has accepted the first two methods. Banks, to assess credit needs of units between Rs.10 lakhs to Rs.50 lakhs.

The Reserve Bank advised all the scheduled banks to introduce immediate action with respect to all the borrowers belonging to any of the 15 industry groups,

having credit limits in excess of Rs.10 lakhs and to ensure that they finance not more than 75% of the working capital gap.

Bank should ensure that the borrowers who are already in position two, should not slip back to position one.

As regards the style of bank credit, the Reserve Bank has advised the banks that instead of making available the entire credit limit as a cash credit, the limit may be bifurcated into a loan including the minimum level of borrowing annually.

The Reserve Bank has accepted the forms designed by the Tandon Committee for credit information purposes, which have been circulated to all commercial banks with deposits of Rs.50 crores and above.

The banks have been asked to call for the quarterly data straightaway from such borrowing companies as have already the information system.[32]

3. CHORE COMMITTEE

At the time of reviewing the monetary and credit trends in March 1979, the Governor of the RBI stressed the need for exercising continued restraint on further expansion of credit, and underscored the need for considering certain long-term issues relating to banking operation. The Governor mentioned in the letter dated the 16th March, 1979 to all scheduled commercial banks that…..

"I would like to initiate action on certain structural matters which need further examination. It is necessary to take a fresh look at another major problem faced by banks in implementing the credit regulatory measures, viz., the extensive use of the cash credit system. Its drawbacks have been pointed out by various committees in the past, including the Tandon Committee, which suggested the bifurcation of credit limits into a demand loan and a fluctuating cash credit component. Although the banks were advised to implement these recommendations, I am afraid; the progress achieved has been very slow. Clearly, this problem needs to be looked into further, and for this purpose I propose to setup immediately a small working group to report to me……. on the reforms to be introduced."[33]

In this Context in March 1979, the RBI appointed a Study Group under the chairmanship of Mr. K.B. Chore, Chief Officer, Department of Banking Operations and Development, to review the operation of the cash credit system in commercial banks in India, particularly in reference to the gap between the sanctioned credit limit and the extent of its utilization. The report of this committee is an extension of the Tandon Committee recommendations and is applicable to all borrowers, irrespective of whether he is a manufacturer or trader, enjoying total working capital limit of over Rs.50 lakhs or above from the banking system.[34]

Recommendations of the CHORE Committee

- Placing of large borrowers straight under second method of lending recommended by the Tandon Committee.

  By this, it has become difficult for business houses to obtain loans for their working capital requirements.

- Fixing of peak and non-peak limits…

  At the time of assessing the credit requirements, bank should fix separate limits, wherever feasible, for the normal non-peak level as also for the peak level credit requirements.

- Fixation of limits based on information system and regulated drawings there under in order to reduce over dependence on bank borrowings.

  The borrowers should be discouraged to approach the bank frequently for temporary limits more than sanctioned limits. Banks should consider the requests for such limits very carefully and should be given as a separate demand loan on non-operable cash credit accounts. Bank should charge an additional interest of 1% per annum above the normal rates on these limits.

- Introduction of Drawee bill system

  This recommendation was not accepted by the RBI.

- Financing of temporary requirements through loans.

  Borrower's contribution, increase up to 25% of the total current assets. The suggestion was, in case if the borrower is not able to comply this requirement immediately, and the excess borrowing should be treated separately as a working

capital term loan- which repayable in half-yearly installments within 5 years. To encourage for an early liquidation of this loan, bank may charge higher on this.

The chore committee's recommendations were accepted by the RBI. The concept of drawee bill could not take off them.

4. NAYAK COMMITTEE

The RBI constituted in December, 1991 a committee under the chairmanship of Shri P. R. Nayak, Dy. Governor, Reserve Bank of India. To go into the difficulties experienced by Small Scale Industries (SSI), on securing finance.

Recommendations of the NAYAK Committee

- Village industries and the smaller Tiny Industries with credit limits upto Rs.1 lakhs should have the first claim on the priority sector credit to the SSI.
- The working capital of the larger SSI should be fully met by the commercial banks and the Chief Executive of each bank shall ensure that.
- To the larger SSI, flexibility in the application of the inventory norms as per recommendations of the Tandon Committee, that in such units, where the norms are not presently applicable or prescribed, 25% of the output values should be allowed as working capital, of which at least four-fifths should be provided by the banking sector.
- Bank branches should give priorities to those village and small Tiny Industries which can use working capital efficiently, and which have established the facilities but enable to make further progress for lack of working capital.
- The new priority sector credit dispensation, when adopted, should fully provide for the working capital requirements of all tiny units into credit limits of Rs.10 lakhs, after first taking care of the working capital allocation made for Village Industries and the smaller Tiny Industries with credit limits upto Rs.1 lakhs.
- The reorientation of the banks will be facilitated by the following modifications in the existing instructions /guidelines issued to commercial banks by RBI.
    - The branch manager should be given discretionary power to grant 'ad-hoc' increases upto 10% over the sanctioned limits.

- Such additional margin should be permitted to be built up within a reasonable period. Banks should not insist to be brought in one installment at the time of granting 'ad-hoc' increases.
- The final decision for fresh limits should invariably be based on such review by the higher authority and should be taken within a reasonable time.

2.28 PRIORITY SECTOR LENDING:

In the pre-independent India, formal banking system was, mostly owned by the rich, aimed at servicing the rich society only. It was never felt that other masses also needed banking services, particularly credit facilities. Rural banking was traditionally a monopoly of the money lenders.

However, in post-independence era, Government of India initiated some steps for providing credit to the poor of the country with feeling of their necessity. The RBI Act vested a unique responsibility of rural credit to the central bank. As time passed, several steps have been taken by the government. The National Credit Council held in July, 1968 and social control over banks was launched to making the banking system serve social and economic objectives and prevent misdirection of resources.[35]

As millions of SSI, farmers, transport operators, small businessmen etc. could not progress for lack of availability of credit. Most of the banks had been allocating large parts of their loans and advances to giant industrial and trading institutions. Major shift in commercial bank lending policy took place with the nationalization of the major commercial banks. The task of nationalized banks was to restore vitality to the rural economy and build up the future prosperity of the common men.[36]

The concept of priority sector was evolved and formalized in 1972 on the basis of the report submitted by an informal study group on statistics relating to advances to the priority sectors constituted by the Reserve Bank in May, 1971.

On the basis of this report, the Reserve Bank prescribed for commercial bank a modified return for reporting priority sector advances and certain guidelines were issued in this connection indicating the scope of the items to be included under the

various categories of priority sectors. According to these, sectors like, agriculture, SSI, industrial estates, road and water transport operators, professionals and self employed persons, education etc. included in priority sector. These sectors have been given priority because of their significant contribution to the national income.

The meaning of the 'Priority Sector' was elaborated at the conference of custodians of nationalized banks held in New Delhi in July, 1970 by the then Finance Minister in the following words, "When we talk of priority sector the emphasis is on the needs of the common man, the man who is engaged or is willing to be engaged in a productive endeavor, which is socially useful and economically viable but is handicapped for lack of finance on reasonable terms."[37]

So, priority sectors include the areas of economic activities which are very desirable socially but have been less financed or wholly neglected by the commercial banks earlier.

The national policy makers have evolved such important measures to ensure the flow of credit which are……..

- Relaxation in the terms and conditions of credit to the specific sectors.
- To give priority to certain sectors and sub-sectors.
- Creation of supporting system to ensure the flow of credit.
- Special allocation of credit for specific sectors.

The policies pertaining to priority sector lending has been modified from time to time. The aim is to an all-inclusive development of the country, meeting the expectations of the masses and improving the economic status and well-being of the people.

- **SECTORS UNDER PRORITY :**

1. Agriculture
2. Small scale industries
3. Retail trade & small business
4. Road and water transport operators
5. Professional & self employed persons

6. Education
7. Housing

2.29 CONCLUSION:

Hence, banks are major institutions of financial transactions. People have huge trust on banks for any financial transactions than any other financial institution. On the other hand, credit delivery is also the primary function and risky as well for any commercial bank. Banks have to rely more on credit for their profit earning purpose. Though banks are playing many functions these days, they are the major player for credit requirement of the people and various sectors of economy in the market. So, banks have to perform their main function of credit delivery with huge attention and safety to maintain the trust of the people and growth of their own. The risk of NPA is increasing these days and banks are facing this risk and trying hard to reduce that but even though they are lacking in this regard. After a lot of efforts they are still not in a position to get back and relax. As a responsibility of backbone of the economy and the financial system of the country, banks always have to work hard for reducing their risk factors; mainly of credit risk and market risk. So, managing their credit is a crucial area to focus more from their side. They have to sanction loans considering the risk factors and only sanction rightly is not enough but follow up of loans and recovery are also the major areas on which banks need to focus to avoid and reduce the risk associated with the credit. In addition to this, banks also have to focus on disbursement of credit to various sectors of an economy. Moreover, banks should give attention to sanction the loans in liquid manner. Means, the maturity period of loans also should be considered while granting the loan from liquidity aspect.

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