EMERGING DYNAMICS OF EFFECTIVE CREDIT MONITORING IN INDIAN BANKS- A PROFESSIONAL PERSPECTIVE

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Abstract

The very objective of Credit monitoring is to ensure that the quality of asset remains performing, earning and must have good conduct and health. Credit sanction is an one time exercise but credit monitoring is a continuous process. Credit Monitoring system through various tools focuses on early detection of unsatisfactory symptoms, analysis of the reason of the symptoms, fast remedial measures, prevention of loan loss, improving and sustaining asset qualities and post sanction surveillances. The recently introduced framework for revitalizing distressed assets in the economy lays down guidelines for early recognition of financial distress, information sharing among lenders and co-ordinated steps for prompt resolution and fair recovery for lenders. Banks need to put in place improved credit monitoring architecture with the help of technology, upgraded skill sets, retained legal specialists, lateral hiring recovery experts supported by well entrenched policy framework to guide the asset quality follow up mechanism. The key challenge for Indian banks is to expand credit portfolio and effectively manage NPAs while maintaining asset quality and profitability. Though, management of asset quality is a balance sheet issue of individual banks, it has wider macro economic implications. Therefore, continuous improvement in asset quality on sustainable basis through well structured and effective credit monitoring has to be practiced as Mantra in a missionary zeal in order to survive global competition.

Key Words: Strategies, Gross NPA, Net NPA, credit Monitoring, Asset Quality, Early Warning System, and Distressed Assets

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Introduction

The stability and sound health of the banking system is a key pre-requisite for overall economic development and financial stability. The Non-Performing Assets (NPA) is an important prudential indicator to assess the financial health of the banking sector. Besides asset quality, NPAs epitomize the credit risk management and efficacy in the allocation of resources. The consequences of NPAs would be reduction in interest income, high level of provisioning, stress on profitability, gradual decline in ability to meet steady increase in cost, increased pressure on net interest margin (NIM) thereby reducing competitiveness, steady erosion of capital resources and increased difficulty in augmenting capital resources . Hence, Management of Asset Quality has emerged as one of the major challenges facing banks. The trend needs to be reversed or at least kept under check as the position is being watched by external world including international investors, rating agencies, correspondent banks, international development agencies etc.

The level of Gross Non-performing Advances (GNPAs) to total gross advances for the entire banking system declined to 4 percent in March, 2014 from 4.2 percent in September 2013. The Net Non-performing Advances (NNPAs) as a percentage of total net advances also declined to 2.2 percent in March 2014 from 2.3 percent in September 2013. This improvement in asset quality was due to the lower slippage of standard advances to non-performing advances and a seasonal pattern of higher recovery and write-offs that generally take place during the last quarter of the financial year. Sale of NPAs to Asset Reconstruction Companies (ARCs) in the light of the Framework on Revitalizing Stressed Assets could be another reason for this improvement. Scheduled Commercial Banks' (SCBs') stressed advances (that is, NPAs plus restructured standard assets) also declined to 9.8 percent of the total advances from 10.2 percent between September 2013 and March 2014.Public Sector Banks (PSBs) continued to register the highest stressed advances at 11.7 percent of the total advances, followed by old private banks at 5.9 per cent. There are five sub-sectors- infrastructure, iron and steel, textiles, mining and aviation sectors which contribute significantly to the level of stressed advances. The share of these five stressed sub-sectors to the total advances of SCBs is around 24 per cent, with infrastructure accounting for 14.7 per cent. In this backdrop, a need for arresting the slippage in loan assets through effective credit monitoring, clearly exists.

Credit monitoring system

In the wake of financial sector reforms, enough attention is paid to the management of NPAs in banks but credit monitoring calls for more serious attention. This is evident from initiatives taken by the banking system during the recent years. For instance, Reserve bank of India (RBI) has been issuing new guidelines from time to time in regard to income recognition, asset classification & provisioning and recovery from NPAs. Similarly, banks have also taken up a series of measures to bring down the level of gross NPAs by cash recovery & write offs, debt restructuring and actions taken under Securitization Act. While these efforts will continue, the major challenge is how to arrest further slippage in loan assets.

The very objective of Credit monitoring is to ensure that the quality of asset remains performing, earning and must have good conduct and health. While Credit growth is needed for survival, it is imperative to ensure that the credit growth does not result in NPAs later. Therefore, Banks have to resort to effective credit monitoring on continuous basis. When an advance is granted to a customer, banker is required to ensure that it remains a standard asset. The question as to when does Credit Monitoring start can be viewed in two ways. In a limited perspective, it can be stated that monitoring commences only after the advance is disbursed and in many cases, only when the account shows signals of sickness. But on a broader plane, the monitoring of advance should begin even at the time of sourcing of the account i.e., at the time of conducting credit investigation of the proposed borrower and continue in all other stages of credit cycle viz., putting up the proposal with right terms and conditions, pre-disbursement care, observations on the conduct of the account from the records available and On-site visits.

Credit Monitoring system through various tools focuses on early detection of unsatisfactory symptoms, analysis of the reason of the symptoms, fast remedial measures, prevention of loan loss, improving and sustaining asset qualities and post sanction surveillances. But the effectiveness of various tools needs to be strengthened. Against the backdrop of a slowing economy and several factors, NPAs of several banks have risen sharply, though there are few that have managed to bring loan losses under control.RBI has also expressed concerns on the rising delinquencies.

In this backdrop, credit monitoring system in banks needs a re-look. Towards this end, an attempt is made in this present paper to discuss (A) Early Warning System (B) Deficiencies in

the Present System (C) Sources of Information to obtain Signals (D) Suggested Strategies for Preventive Action (E) Latest Developments

Credit Monitoring in Banks

(A) Early Warning System:

Credit sanction is an one time exercise but credit monitoring is a continuous process. Effective Credit Management encompasses four pillars-Credits Policy, Credit Risk Management, Credit Appraisal and Credit Monitoring & Follow-up. As stated above, the objective of effective credit monitoring is that the asset quality must be performing and stable. The major components or processes of EWS followed by banks in India as brought out by a study conducted by the RBI in September 2002 at the instance of the Board of Financial Supervision are: Designing Relationship Manager/Credit Officer for monitoring accounts, Preparation of your 'Know your client' profile, Credit rating system, Identification of watch-list/special mention category accounts and Monitoring of early warning systems. The recently introduced framework for revitalizing distressed *assets* in the economy has been discussed in detail towards the end.

(B) Deficiencies in the Present System of Credit Monitoring:

There are several deficiencies observed in the present practices relating to credit monitoring. This may not be observed in all cases. But there are instances when loans and advances are released by the branch officials in violation of the terms and conditions of the sanction and there is lack of proper monitoring of the end-use of the funds by the borrower. Similarly, monitoring of the company's financial standing especially with reference to the financial indicators is not carried out effectively. Undue reliance on the certificates given by the Chartered Accountants/Valuers without correlating them with relevant procedures is noticed. There is also lapse in monitoring even with regard to very important terms and conditions of the term loan sanction such as tie up of funds, stipulation of promoter's contribution leading to disproportionate lending by the Banks/FIs.

As regards working capital limits, failure to detect disappearance of stocks given as security has resulted in misappropriation of funds/sale of stocks and realization of receivables without the knowledge of banks/FIs. Failure to ensure adequately the security offered by the borrowers, especially failure to verify whether the same asset is mortgaged to another bank/FI, is also

noticed. Periodical reviews of the accounts are not undertaken after the funds were lent by banks/FIs. Proper assessment of the financial standing of the projects is not carried out when the banks/FIs take over an account from another bank. Excess drawings permitted by the branch/regional office level functionaries in the borrowal accounts are ratified by the Head Office in a routine manner without examining the need for such permissions at times, frequently. Limits sanctioned are allowed to be interchanged indiscriminately by the branch officials without proper authority. In cases pertaining to loans for financing projects, important terms and conditions of the sanction stipulated by the Board of Directors such as induction of technical directors, constitution of Audit committees and independent projects monitoring committees are not taken seriously. Many a times, non-compliance even at the stage of the release of final installment of the loan sanctioned is not taken seriously. This is very serious lacuna which cuts at the root of the principles of the project management and project financing. In view of these and many other deficiencies, a careful look at sources of information and their linkage to obtain signals of incipient sickness/loan default is needed.

(C) Sources of Information to obtain Signals:

The major sources of information to obtain signals include : conduct of credit facilities such as cash credit, term loan, bills, DPG etc, operations in account; stock inspection report; factory visit report; receivables management – ageing of receivables; review of an account – review proposal note; minutes of meetings with the borrower and with other banks ; market reports; compliance of terms of the last sanctions; irregularities of the last Inspection report / RBI Inspection report; annual report of the unit etc.

(D) Suggested Strategies for Preventive Action:

(1) Preventive action at pre-disbursement:

Prevention is better than cure, so goes the age-old maxim. Preventive steps can be taken at two different stages: Pre-disbursement and Post-disbursement. During the pre-disbursement stage, a little care and prudence at the time of pre-sanction can help us in filtering out possible problems later. Pre-sanction appraisal must focus on the cash generation ability of the prospective client and asset. A conscious effort has to be made to move away from a defensive frame of mind where

security is the major concern to one where long term sustainability of the asset is of paramount importance. ***While risk taking is the essence of banking, it must also be realized that we deal with other peoples' money i.e. depositors' money and we have actually no right to take unknown risks.*** Risk and Return are often stated to be directly proportional. 'Know Your Customer' (KYC) is the heart and essence of a healthy asset portfolio. Knowing your customer can even insulate us against non-controllable risks. It is essential that the banker revisits the entire rationale/set of assumptions that have been the basis of credit sanction to ensure that there are no intervening developments that adversely affect the risk profile of the client/business activity. There could be instances like, business activity being discouraged or banned by regulators, the entire economics of the credit going awry because of input costs (say oil prices shooting up), Country risks (like the wars and change of regime etc.), Acts of nature (Tsunami or an earthquake affecting either the supplier or the buyer though not the client himself), Firm specific risks, like management disputes, exit of key man, issues of succession etc.Further, the banker has to take care of the documentation which accords a legal sanctity and enforceability to the borrower's acceptance of the terms and conditions on the basis of which the credit facilities are sanctioned and as such is to be treated with due respect.

2. Preventive action at post-disbursement stage:

The responsibility for maintenance of the health of portfolio falls squarely on the shoulders of Bankers. Monitoring of end use hinges on the principle that money should be actually spent for the purpose for which credit facility is sanctioned and the money will be repaid in time. The second dimension is that of integrity of the borrower in the sense that he is using the money for the purpose sought. Timely identification/detection of weakness/potential default/incipient sickness in advance accounts and initiation of appropriate corrective actions for preventing impairment in credit quality, slippages in asset classification / relegation in credit ratings are called for. Banks should also identify deserving cases for restructuring. Banks need to chalk out exit strategies including recovery action in appropriate cases and try to endeavour for upward migration of credit ratings.

3) Study of periodical statements/ market reports:

Banks should carry out regular scrutiny of borrower's fund in-flows /out flows in the accounts with the bank and study of operations in all the borrowing accounts of the customer. It is to be ensured that periodical verification of interest application and other applicable charges (LC/CLG

commission etc)/system of plugging leakage of income gets strengthened. Scrutiny of periodical stock/book debts statements vis-à-vis Drawing Power, Study of Quarterly information Systems(QIS) and Monthly Select Operational Data(MSOD),Study of Credit Audit Reports, Stock Audit Reports, Concurrent Audit Reports, Statutory Auditor's Reports, adequate/appropriate insurance of securities, Updating market reports on the borrower/guarantor periodically, registration of charges with appropriate authorities, valuation of immovable securities from approved valuer, Periodical on-site inspection of the securities offered in the accounts including collaterals,Structured review/renewal of credit facilities at least once a year including; review of the business performance/audited financials, (including ratios analysis) review of credit risk factors, utilization of credit limits, earnings in the account, adequacy of credit turnover, adequacy or other wise of the credit limits, security documentation, etc. are some of the system and procedures- both off-site and on-site that need to be strengthened. Banks should also to ensure that all immoveable properties offered as security are accessible and have direct/independent access and all applicable taxes/charges are current, compliance with all terms and conditions of sanction, non -withdrawal of capital and or subordinated debts. Any changes in the owner-ship pattern of the businessman availing of facilities from other banks/FIs, consortium borrowing discipline, if applicable, are to be looked into. Banks should hold discussion with the customer for reviewing the exposure/credit rating/relationship etc. Reasons for any raids conducted by any regulatory authorities i.e IT/ST etc. are to be ascertained. In addition to the above statements received during the year, the Banker should also obtain and analyze Annual Report of every company which contains Directors' Report, Management Discussion Analysis, Auditors' Report and Financial Statements with Notes. These data are very useful to a banker to take a call whether the unit is running well. One important point to be noted is that the Banker has to compare the actual financials with the one projected during the beginning of the year as all limits are assessed on the basis of projections.

4) Monitoring of Term Loan:

In case of term loan, banks need to ensure that disbursement is made as per the schedule approved by the bank and as per the progress made. For any delay, bankers need to seek borrower's views on steps taken for rectification. Banks should also monitor costs being incurred, borrower's contribution and reasons for cost overruns. In case of sanction of term loan along with cash credit, banks need to focus on the verification of adequacy of stocks, physical

verification of stocks on a test check basis and valuation of stocks. The quality of stocks charged should not be old, obsolete, rejected goods etc.Bankers need to ensure their saleability.Stocks not hypothecated to the bank must be kept separately.

(5) Annual review of the account:

For carrying out this exercise, banks should scrutinize balance sheet, profit and loss account and tax returns of the borrower. Undesirable features should be discussed with the borrower to initiate corrective action early. Annual Review should be considered as a logical decision taken by the competent authority to continue the facilities based on determinable factors & data.

6) MIS for monitoring:

Information systems form the bedrock of credit risk management. Hence, Banks need to strengthen the following areas:

- Efforts should be made to capture more exhaustive and granular data.
- The information system must enable timely detection of problem accounts, flag early signs of delinquencies; facilitate timely information to management on these aspects, etc.
- An appropriate coordinating mechanism across departments within a bank.
- And, most importantly, the information system of banks should be integrated into decision making, capital planning, business strategies, etc.

7) Coordination among credit institutions:

Coordination between commercial banks and financial institutions should be strengthened in order to arrest slippages and maintain the asset quality.

8) Special Task Force for Prevention of Slippage:

Many Banks have constituted Special Task Force for prevention of slippage of quality in advance accounts. However, in view of the present scenario where stressed assets constitute alarming proportion, the functioning of such special task forces should be reinvigorated and made more effective.

9) Organizational aspects of credit monitoring:

Credit monitoring Officers (CMOs) should focus on monitoring of stressed accounts and attend the exhaustive list of signals of stress exclusively. Credit Monitoring Officers should also be adequately exposed to training for updating their knowledge and skills in carrying out this exercise on continuous basis.

(10)Need for quicker decision- making:

Timely decision making is crucial to the success of any project. The appraisal, sanction and disbursement decisions should be timely and fast. Similarly, additional limits/ concessions, if needed, should be sanctioned quickly in order to enable the business unit to smoothly tide over the problem.

(11) Credit Information Companies (CICs):

There is a need to leverage CICs not only for sanctioning purposes but also for monitoring and recovery. At the monitoring stage, CICs can furnish a 360 degree view of customers, thereby enabling portfolio risk assessment and early warning triggers to identify and address delinquency. At the recovery stage, CICs can help entities in reaching their not so easily contactable base, thereby improving recoveries.

(E)Latest Developments:

There is need to focus more closely on the restructuring of standard loans. In response, RBI made debt restructuring norms more stringent and loans recast after April 1, 2015 will need to be classified as NPAs. The provisioning requirement for fresh standard restructured advances has been increased to 5 per cent from 2.75 per cent from June 2013 and also to increase provisioning in a phased manner for the stock of restructured standard accounts as on May 31, 2013 during the interim period.

Framework for Revitalizing Distressed Assets in the Economy:

As the growing volume of non - performing assets along with restructured assets was becoming a major cause for concern for the financial as well as the real sector, a framework for revitalizing distressed assets in the economy has been implemented with effect from April 1, 2014. The Framework lays down guidelines for early recognition of financial distress, information sharing among lenders and co-ordinated steps for prompt resolution and fair recovery for lenders. It envisages centralised reporting and dissemination of information on large credits, early formation of lenders' forums and incentives for lenders and borrowers to agree on resolution and disincentives for both in the event of failure to act in a timely way. Improvements in the current restructuring process such as an independent evaluation of large value restructuring with a focus on viability and fair sharing of gains and losses between promoters and creditors have been mandated. Finally, a more liberal regulatory treatment of distressed asset sales,

particularly to asset reconstruction companies, has been provided. It proposes to bring non-bank lenders also under its ambit for enhanced effectiveness.

Before a loan account turns into a NPA, banks are required to identify incipient stress in the account by creating three sub-categories under the Special Mention Account (SMA) category .SMA Sub-categories are as given in the table below:

Table 1: Table showing Basis for Classification

SMA Sub-categories	Basis for classification
SMA-0	Principal or interest payment not overdue for more than 30 days but account showing signs of incipient stress
SMA-1	Principal or interest payment overdue between 31-60 days
SMA-2	Principal or interest payment overdue between 61-90 days

Source: Master Circular –Prudential Norms on IRAC, RBI, July, 2014

RBI will set up a Central Repository of Information on Large Credits (CRILC) to collect, store, and disseminate credit data to lenders. Banks will be required to report credit information, including classification of an account as SMA to CRILC on all their borrowers having aggregate fund-based and non-fund based exposure of Rs.50 million and above with them. Banks are advised that as soon as an account is reported by any of the lenders to CRILC as SMA-2, they should mandatorily form a committee to be called Joint Lenders' Forum (JLF) if the aggregate exposure (AE) [fund based and non-fund based taken together] of lenders in that account is Rs 1000 million and above. Lenders also have the option of forming a JLF even when the AE in an account is less than Rs.1000 million and/or when the account is reported as SMA-0 or SMA-1. The JLF may explore various options to resolve the stress in the account. The intention is not to encourage a particular resolution option, e.g. restructuring or recovery, but to arrive at an early and feasible solution to preserve the economic value of the underlying assets as well as the lenders' loans. The options under **Corrective Action Plan (CAP)** by the JLF would generally include:

(a) Rectification- Obtaining a specific commitment from the borrower to regularise the account so that the account comes out of SMA status or does not slip into the NPA category or the possibility of getting some other equity/strategic investors to the company may be explored by the JLF in consultation with the borrower or the JLF may also consider providing need based additional finance to the borrower, if considered necessary, as part of the rectification process.

(b)Restructuring - Consider the possibility of restructuring the account if it is prima facie viable and the borrower is not a willful defaulter, i.e., there is no diversion of funds, fraud or malfeasance, etc. At this stage, commitment from promoters for extending their personal guarantees along with their net worth statement supported by copies of legal titles to assets may be obtained along with a declaration that they would not undertake any transaction that would alienate assets without the permission of the JLF.

(c)Recovery - Once the first two options at (a) and (b) above are seen as not feasible, due recovery process may be resorted to. The JLF may decide the best recovery process to be followed, among the various legal and other recovery options available, with a view to optimising the efforts and results.

While the JLF formation and subsequent corrective actions would be mandatory in accounts having aggregate exposure (AE) of Rs1000 million and above, in other cases also the lenders who have to monitor the asset quality closely and take corrective action for effective resolution as deemed appropriate.

Accelerated Provisioning

In cases where banks fail to report SMA status of the accounts to CRILC or resort to methods with the intent to conceal the actual status of the accounts or evergreen the account, banks will be subjected to accelerated provisioning for these accounts and/or other supervisory actions as deemed appropriate by RBI. The current provisioning requirement and the revised accelerated provisioning in respect of such non performing accounts are as under:

Table 2: Table showing current provisioning requirement and the revised accelerated provisioning

Asset Classification	Period as NPA	Current Provisioning	Revised

		(%)	Provisioning (%)
Sub-standard (secured)	Up to 6 months	15	No change
	6 months to 1 year	15	25
Sub-standard unsecured ab-initio)	Up to 6 months	25 (other than infrastructure loans)	25
		20 (infrastructure loans)	
	6 months to 1 year	25 (other than infrastructure loans)	40
		20 (infrastructure loans)	
Doubtful I	2nd Year	25 (secured portion)	40(secured portion)
		100 (unsecured portion)	100(unsecured portion)
Doubtful II	3rd & 4th Year	40(secured portion)	100 for both secured and unsecured portions
		100(unsecured portion)	
Doubtful III	5th Year	100	100

Source: Master Circular –Prudential Norms on IRAC, RBI, July, 2014

If any of the lenders who have agreed to the restructuring decision under the CAP by JLF and is a signatory to the ICA and DCA, but changes their stance later on, or delays/refuses to implement the package, will also be subjected to accelerated provisioning requirement.

Willful Defaulters and Non-Cooperative Borrowers

The provisioning in respect of existing loans/exposures of banks to companies having director/s (other than nominee directors of government/financial institutions brought on board at the time of distress), whose name/s appear more than once in the list of willful defaulters, will be 5% in cases of standard accounts; if such account is classified as NPA, it will attract accelerated provisioning. With a view to discouraging borrowers/defaulters from being unreasonable and non-cooperative with lenders in their bonafide resolution/recovery efforts, banks may classify such borrowers as non-cooperative borrowers' after giving them due notice if satisfactory clarifications are not furnished. Banks will be required to report classification of such borrowers

to CRILC.

Sale of Financial Assets to securitization Company (SC) Reconstruction Company (RC): a financial asset may be sold to the SC/RC by any bank/FI where the asset is reported as SMA-2 by the Bank /FI to CRILC.

Issues and Suggestions- The Way Ahead

1. In order to have proper system in place for recognition of SMA 0 accounts, banks could look at multiple factors which could be important signal so far as stress and early warning signal is concerned.

2. Once an account is reported as SMA 2 in the CRILC, the system automatically search the other banks' exposure in that account and generates an automated email other banks as well. Hence, accuracy and integrity of data is of utmost importance for the overall stability of the system and to implement the RBI guidelines in true spirit.

3. Banks need to include in their Core Banking System (CBS), a few qualitative parameters, like projected sale, non-compliance of terms and condition etc.

4. Due to adoption of different stand-alone system, in many cases the credit summations derived from CBS does not reveal true status of the outstanding balance. And hence, Credit summations need to be worked upon.

5. Issues like instances of cheque returns, non-submission of stock statement or delayed submission etc. are not actually integrated and more importantly not tracked in case of multiple banking.

6. The banks need to be careful and should not extend any lending facility in case of any borrower under RBI caution list. Further, the banks should not allow opening current account of the non-borrowers.

7. Level of participation in JLF has to be at sufficiently senior level officer instead of the present system of representation of mid-level officers. This will ensure faster decision making.

8. When an account is identified as SMA 1, the banks need to start working on the future course of action including restructuring, recovery etc. It will facilitate faster decision making once it is reported as SMA 2.

9. For faster and effective decision making, the bank with the highest exposure and the next to highest exposure should discuss together and come out with the strategy even before the

discussion under JLF. This can be done through the creation of JLF sub-committee in line with the CDR mechanism

10. In tackling the issue of willful defaulters, there is a need for the united effort by the bankers to put ban on any further sanctions to such borrowers.

Conclusion:

When the business volume are on the rise and complexities of credit structure is changing, the strategies and approaches of maintaining asset quality in banks need to be in sync with the dynamics of the time. The system driven management of NPAs makes available a host of data which could be analyzed to intervene at the right time. The Government and RBI have in different forums stressed the need for improvement of the asset quality of banks. The challenges of rising volumes also indicate that banks must revisit their credit monitoring systems and procedures to make them more aligned to handle larger and divergent portfolio. Asset quality is fundamental to nurture a strong, sound and robust financial system in the country so critical for sustained economic growth. Banks need to put in place improved credit monitoring architecture with the help of technology, upgraded skill sets, retained legal specialists, lateral hiring recovery experts supported by well entrenched policy framework to guide the asset quality follow up mechanism. The key challenge going forward for Indian banks is to expand credit portfolio and effectively manage NPAs while maintaining asset quality and profitability. Though, management of asset quality is a balance sheet issue of individual banks, it has wider macro economic implications. In order to overcome the associated risks including externalities, there is an imminent need for the banks to strengthen their credit monitoring system. Therefore, continuous improvement in asset quality on sustainable basis through well structured and effective credit monitoring has to be practiced as Mantra in a missionary zeal in order to survive global competition.

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