CREDIT MANAGEMENT

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UNIT - I

Definition of Credit - Forms of credit: Consumer credit, Commercial credit,
Export credit, Banking credit, Agriculture credit.

I. 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.

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.

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.

II. 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.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.

III. CREDIT DEFINITIONS:

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."

Prof. Gide:

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

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."

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".

Vasant Desai:

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

IV. 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.

V. 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.

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.

VI. NPA:

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.

1. 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.
2. 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;

3. Interest and/ or installment of principal remain overdue for a period of more than 90 days in respect of a term loan,
4. The account remains „out of order‟, in respect of an Overdraft/Cash Credit (OD/CC),
5. The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted,
6. The installment of principal or interest there on remains overdue for two crop seasons for short duration crops,
7. The installment of principal or interest there on remains overdue for one crop season for long duration crops,
8. 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.
9. 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.

VII. 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.

VIII. CREDIT INSTRUMENTS:

Credit instruments prove very helpful in encouragement and the development of credit and help I 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.

IX. Credit Manager:

A credit manager is a person employed by an organization to manage the credit department and make decisions concerning credit limits, acceptable levels of risk, terms of payment and enforcement actions with their customers. This function is often combined with Accounts Receivable and Collections into one department of a company. The role of credit manager is variable in its scope and Credit managers are responsible for:

Roles and Responsibilities of a Credit Manager:

- ✓ Controlling bad debt exposure and expenses, through the direct management of credit terms on the company's ledgers.
- ✓ Maintaining strong cash flows through efficient collections. The efficiency of cash flow is measured using various methods, most common of which is Days Sales Outstanding (DSO).
- ✓ Ensuring an adequate Allowance for Doubtful Accounts is kept by the company.
- ✓ Monitoring the Accounts Receivable portfolio for trends and warning signs.
- ✓ Hiring and firing of credit analysts, accounts receivable and collections personnel.
- ✓ Enforcing the "stop list" of supply of goods and services to customers.
- ✓ Removing bad debts from the ledger (Bad Debt Write-Offs).
- ✓ Setting credit limits.
- ✓ Setting credit terms beyond those within credit analysts' authority.
- ✓ Setting credit rating criteria.
- ✓ Setting and ensuring compliance with a corporate credit policy.
- ✓ Pursuing legal remedies for non-payers.
- ✓ Obtaining security interests where necessary. Common examples of this could be PPSA's, letters of credit or personal guarantees.
- ✓ Initiating legal or other recovery actions against customers who are delinquent.
- ✓ Credit managers tend to fall into one of three groups due to the differing specialty legal and jurisdictional knowledge required:

1. Commercial Credit Manager
2. Consumer Credit Managers
3. Construction Credit Managers

X. TYPES OF CREDIT FACILITIES:

The business of lending is carried on by banks offering various credit facilities to its customers. Basically various credit facilities offered by banks are generally repayable on demand. A bank should ensure proper recovery of funds lent by him and acquaint itself with the nature of legal remedies available to it and also law affecting the credit facilities provided by it.

Credit facilities broadly may be classified as under:

(a) Fund Based Credit Facilities

Fund based credit facilities involve outflow of funds meaning thereby the money of the banker is lent to the customer. They can be generally of following types:

(i) Cash credits/overdrafts
(ii) Demand Loans/Term loans
(iii) Bill finance.

(b) Non-Fund Based Credit Facilities

In this type of credit facility the banks funds are not lent to the customer and they include:

I. Bank Guarantees
II. Letter of Credit.

CASH CREDIT:

Cash credit is the main method of lending by banks in India and accounts for about 70 per cent of total bank credit. Under the system, the banker specifies a limit, called the cash credit limit, for each customer, up to which the customer is permitted to borrow against the security of tangible assets or guarantees. Cash credit is a flexible system of lending under which the borrower has the option to withdraw the funds as and when required and to the extent of his needs. Under this arrangement the banker specifies a limit of loan for the customer (known as cash credit limit) up to which the customer is allowed to draw.

The cash credit limit is based on the borrower's need and as agreed with the bank. Against the limit of cash credit, the borrower is permitted to withdraw as and when he needs money subject to the limit sanctioned. It is normally sanctioned for a period of one year and secured by the security of some tangible assets or personal guarantee. If the account is running satisfactorily, the limit of cash credit may be renewed by the bank at the end of year. The interest is calculated and charged to the customer's account. Cash credit, is one of the types of bank lending against security by way of pledge or /hypothecation of goods. 'Pledge' means bailment of goods as security for payment of debt. Its primary purpose is to put the goods pledged in the possession of the lender. It ensures recovery of loan in case of failure of the borrower to repay the borrowed amount. In 'Hypothecation', goods remain in the possession of the borrower, who binds himself under the agreement to give possession of goods to the banker whenever the banker requires him to do so. So hypothecation is a device to create a charge over the asset under circumstances in which transfer of possession is either inconvenient or impracticable.

Other features of cash credit arrangements are as follows:

(1) The banker fixes the cash credit limit after taking into account several features of working of the borrowing concern such as production, sales, inventory levels, past utilization of such limits; etc. The banks are thus inclined to relate the limits to the security offered by their customers.
(2) The advances sanctioned under the cash credit arrangement are technically repayable on demand and there is no specific date of repayment, but in practice they 'roll over' a period of time. Cash accruals arising from the sales are adjusted in a cash credit account from time to time but it is found that on a larger number of accounts no credit balance emerges or debit balance fully wiped out over a period of years as the withdrawals are in excess of receipts.
(3) Under the cash credit arrangement, a banker keeps adequate cash balances so as to meet the demand of his customers as and when it arises. But the customer is charged interest only on the actual amount utilized by him. To neutralize the loss of interest on the idle funds kept by the banks within the credit limits sanctioned, a commitment charge on the unutilized limits may be charged by the banks.
(4) The Reserve Bank has advised the banks to evolve their own guidelines to ensure credit discipline and levy a commitment charge. Thus the commitment charge depends upon the discretion of individual banks.

ADVANTAGES OF CASH CREDIT SYSTEM

1. **Flexibility:** The borrowers need not keep their surplus funds idle with themselves, they can recycle the funds quite efficiently and can minimize interest charges by depositing all cash accruals in the bank account and thus ensures lesser cost of funds to the borrowers and better turnover of funds for the banks.
2. **Operative convenience:** Banks have to maintain one account for all the transactions of a customer. The repetitive documentation can be avoided.

Weakness of the System

1. **Fixation of Credit Limits:** The cash limits are prescribed once in a year. Hence it gives rise to the practice of fixing large limits than is required for most part of the year. The borrowers misutilise the unutilized gap in times of credit restraint.
2. **Bank's inability to verify the end-use of funds:** Under this system the stress is on security aspect. Hence there is no conscious effort on the part of banks to verify the end-use of funds. Funds are diverted, without banker's knowledge, to unapproved purposes.
3. **Lack of proper management of funds:** Under this system the level of advances in a bank is determined not by how much the banker can lend at a particular time but by the borrower's decision

to borrow at the time. The system, therefore, does not encourage proper management of funds by banks.

These weaknesses of the cash credit system were highlighted by a number of committees appointed for this purpose in India. Guidelines have been issued by the Reserve Bank for reforming the cash credit system on the basis of recommendations of the Tandon Committee and the Chore Committee.

OVERDRAFTS:

When a customer is maintaining a current account, a facility is allowed by the bank to draw more than the credit balance in the account; such facility is called an **'overdraft'** facility. At the request and requirement of customers temporary overdrafts are also allowed. However, against certain securities, regular overdraft limits are sanctioned.

Salient features of this type of account are as under

(i) All rules applicable to current account are applicable to overdraft accounts mutatis mutandis.

(ii) Overdraft is a running account and hence debits and credits are freely allowed.

(iii) Interest is applied on daily product basis and debited to the account on monthly basis. In case of temporary overdraft, interest should be applied as and when temporary overdraft is adjusted or at the end of the month, whichever is earlier.

(iv) Overdrafts are generally granted against the security of government securities, shares & debentures, National Savings Certificates, LIC policies and bank's own deposits etc. and also on unsecured basis.

(v) When a current account holder is permitted by the banker to draw more than what stands to his credit, such an advance is called an overdraft. The banker may take some collateral security or may grant such advance on the personal security of the borrower. The customer is permitted to withdraw the amount as and when he needs it and to repay it by means of deposit in his account as and when it is feasible for him. Interest is charged on the exact amount overdrawn by the customer and for the period of its actual utilization.

(vi) Generally an overdraft facility is given by a bank on the basis of a written application and a promissory note signed by the customer. In such cases an express contract comes into existence. In some cases, in the absence of an express contract to grant overdraft, such an agreement can be inferred from the course of business. For example, if an account-holder, even without any express grant of an overdraft facility, overdraws on his account and his cheque is duly honoured by the bank, the transaction amounts to a loan. In Bank of Maharashtra vs. M/s. United Construction Co. and Others (AIR 1985 Bombay 432), the High Court concluded that there was an implied agreement for grant of overdraft or loan facility.

(vii) Banks should, therefore, obtain a letter and a promissory note incorporating the terms and conditions of the facility including the rate of interest chargeable in respect of the overdraft facility. This is to be complied with even when the overdraft facility might be temporary in nature.

Overdraft facility is more or less similar to 'cash credit' facility. Overdraft facility is the result of an agreement with the bank by which a current account holder is allowed to draw over and above the credit balance in his/her account. It is a short-period facility. This facility is made available to current account holders who operate their account through cheques. The customer is permitted to withdraw the amount of overdraft allowed as and when he/she needs it and to repay it through deposits in the account as and when it is convenient to him/her.

Overdraft facility is generally granted by a bank on the basis of a written request by the customer. Sometimes the bank also insists on either a promissory note from the borrower or personal security of the borrower to ensure safety of amount withdrawn by the customer. The interest rate on overdraft is higher than is charged on loan.

BILLS FINANCE:

In order to ease the pressures on cash flow and facilitate smooth running of business, Bank provides Bill finance facility to its corporate / non corporate clients. Bill finance facility plugs in the mismatches in the cash flow and relieves the corporates from worries on commitments. Besides the fund based bill finance, we also provide agency services for collection of documentary bills/cheques. Under bills finance mechanism a seller of goods draws a bill of exchange (draft) on buyer (drawee), as per payment terms for the goods supplied. Such bills can be routed through the banker of the seller to the banker of the buyer for effective control.

TERM LOANS:

The loan is disbursed by way of single debit/stage-wise debits (wherever sanction so accorded) to the account. The amount may be allowed to be repaid in lump sum or in suitable installments, as per terms of sanction. Loan is categorized Demand Loan if the repayment period of the loan is less than three years, in case the repayment of the loan is three years and above the loan be considered as Term Loan.

Under the loan system, credit is given for a definite purpose and for a predetermined period. Normally, these loans are repayable in installments. Funds are required for single non-repetitive transactions and are withdrawn only once. If the borrower needs funds again or wants renewal of an existing loan, a fresh request is made to the bank. Thus, a borrower is required to negotiate every time he is taking a new loan or renewing an existing loan. Banker is at liberty to grant or refuse such a request depending upon his own cash resources and the credit policy of the central bank.

Advantages of Term Loan System

1. **Financial Discipline on the borrower:** As the time of repayment of the loan or its installments is fixed in advance, this system ensures a greater degree of self-discipline on the borrower as compared to the cash credit system.
2. **Periodic Review of Loan Account:** Whenever any loan is granted or its renewal is sanctioned, the banker gets as opportunity of automatically reviewing the loan account. Unsatisfactory loan accounts may be discontinued at the discretion of the banker.
3. **Profitably:** The system is comparatively simple. Interest accrues to the bank on the entire amount lent to a customer.

Drawbacks

1. **Inflexibility:** Every time a loan is required, it is to be negotiated with the banker. To avoid it, borrowers may borrow in excess of their exact requirements to provide for any contingency.
2. Banks have no control over the use of funds borrowed by the customer. However, banks insist on hypothecation of the asset/ vehicle purchased with loan amount.
3. Though the loans are for fixed periods, but in practice the roll over, i.e., they are renewed frequently.
4. Loan documentation is more comprehensive as compared to cash credit system.

Types of Term Loans:

Term loans are granted by banks to borrowers for purchase of fixed assets like land and building, factory premises, embedded machinery etc., to enable their manufacturing activities, and their business expansion, if the amounts are repayable after a specific period of time, they are all called as term finance. On the basis of the period for which the funds are required by the borrowers, these loans are classified as short, medium and long term loans.

Banks have been given freedom to fix their own interest rate for loans and advances. As per bank's lending and interest rate policies applicable interest and other charges would be applicable to CC, OD, Term loan accounts. Each bank should decide "base rate" of interest on advances as per RBI directives.

Loans which are repayable within 1 – 3 years are classified as Short term, 3-5 years are classified as Medium Term and above 5 years are classified as long term.

Term Loans - Important aspects:

1. Term loans are given to the manufacturing, trading and service sector units which require funds for purchasing various items of fixed assets, such as, land and building, plant and machinery, electrical installation and other preliminary and pre-operative expenses.
2. Repayment of term loans would depend upon the firm's capacity to produce goods or services by using the fixed assets as financed by banks.
3. Like any other loan, a term loan is sanctioned by the bank, after evaluation of credit proposal (application). The bank before granting terms loans needs to carry out a clear due diligence as to the borrower's requirement, capacity and other aspects.
4. While considering a term loan proposal, the bank need to verify the financial status, economic viability and the firm's production capacity.
5. After proper verification and satisfaction of various requirements, banks can grant a term loan, on certain terms and conditions, covenants, including repayment terms.
6. Term loans like any other credit facility needs to cover Six C concepts and the banks should follow bank's lending policy, exposure norms and the RBI's guidelines and directives
7. All required valid collateral security, duly executed should be one of the pre conditions for the loan amount to be disbursed.

8. The assets created out of the bank loan, are charged depending upon the nature of security (hypothecation, mortgage, etc.,
9. At the time of fixing the limit and quantum of finance, a banker is required to make assessment of actual cost of assets to be acquired, margin to be contributed, sources of repayment, etc.

Bridge Loans

Bridge loans are essentially short term loans which are granted to industrial undertakings to meet their urgent and essential needs during the period when formalities for availing of the term loans sanctioned by financial institutions are being fulfilled or necessary steps are being taken to raise the funds from the capital market. These loans are granted by banks or by financial institutions themselves and are automatically repaid out of amount of the term loan or the funds raised in the capital market.

In April, 1995, Reserve Bank of India banned bridge loans granted by banks and financial institutions to all companies. But in October, 1995, Reserve Bank of permitted the banks to sanction bridge loans/interim finance against commitment made by a financial institutions or another bank where the lending institution faces temporary liquidity constraint subject to the following conditions:

(i) The prior consent of the other bank/financial institution which has sanctioned a term loan must be obtained.
(ii) The term lending bank/financial institution must give a commitment to remit the amount of the term loan to the bank concerned.
(iii) The period of such bridge loan should not exceed four months.
(iv) No extension of time for repayment of bridge loan will be allowed.
(v) To ensure that bridge loan sanctioned is utilized for the purpose for which the term loan has been sanctioned.

In November, 1997, Reserve Bank permitted the banks to grant bridge loans to companies (other than non- banking finance companies) against public issue of equity in India or abroad. The guidelines for sanction of such loans are to be laid down by each bank and should include the following aspects:

(i) Security to be obtained for the loan.
(ii) The quantum of outstanding bridge loan (or the limit sanctioned, whichever is higher) during the year.
(iii) Compliance with individual/group exposure norms.
(iv) Ensuring end use of bridge loan.
(v) The maximum period of the bridge loan to be one year.

COMPOSITE LOANS

When a loan is granted both for buying capital assets and for working capital purposes, it is called a composite loan. Such loans are usually granted to small borrowers, such as artisans, farmers, small industries, etc.

CONSUMPTION LOANS

Though normally banks provide loans for productive purposes only but as an exception loans are also granted on a limited scale to meet the medical needs or the educational expenses or expenses relating to marriages and other social ceremonies etc. of the needy persons. Such loans are called consumption loans.

NON – FUND BASED FACILITIES:

In the business of lending, a banker also extends non-fund based facilities. Non-fund based facilities do not involve immediate outflow of funds. The banker undertakes a risk to pay the amounts on happening of a contingency. Non-based facilities can be of following types among other:

(a) Bank Guarantees
(b) Letter of Credit
(c) Underwriting and credit guarantee

BANK GUARANTEE:

As part of Non-fund based facilities, banks issue guarantees on behalf of their clients. A Bank Guarantee is a commitment given by a banker to a third party, assuring her/ him to honour the claim against the guarantee in the event of the non- performance by the bank's customer. A Bank Guarantee is a legal contract which can be imposed by law. The banker as guarantor assures the third party (beneficiary) to pay him a certain sum of money on behalf of his customer, in case the customer fails to fulfill his commitment to the beneficiary.

Types of Guarantee:

Banks issue different types of guarantees, on behalf of their customers, as illustrated below:

(1) Financial Guarantee:

The banker issues guarantee in favour of a government department against caution deposit or earnest money to be deposited by bank's client. At the request of his customer, in lieu of a caution deposit/ earnest money, the banker issues a guarantee in favour of the government department. This is an example of a Financial Guarantee. This type of guarantee helps the bank's customer to bid for the contract without depositing actual money. In case, the contractor does not take up the awarded contract, then the government department would invoke the guarantee and claim the money from the bank.

(2) Performance Guarantee:

Performance Guarantees are issued by banks on behalf of their clients.

For example:

XYZ Ltd, the Indian engineering company undertakes an overseas project. The project is to construct highways in one of the African nations. XYZ Ltd, required to furnish a bank guarantee. Since the company has undertaken an overseas project, the company is called as project exporter. XYZ Ltd approaches his banker to issue a bank guarantee in favour of the African nation to whom the company is going to construct the highways. XYS's bank issues a bank guarantee and it will be a performance guarantee. Bank as guarantor guarantees the beneficiary that in case the project exporter (XYZ company) does not perform to the satisfaction of the beneficiary, then within the validity period (including the claim period if any) of the guarantee, the beneficiary can invoke the guarantee an7d the banker has to honour his commitment and pay the amount mentioned in the guarantee. There are three parties in a guarantee:

(a) (Applicant)
(b) (Beneficiary) and
(c) the Banker (guarantor)

(3) Deferred Payment Guarantee:

Under this guarantee, the banker guarantees payments of installments spread over a period of time.

For example:

A purchases a machinery on a long-term credit basis and agrees to pay in installments on specified dates over a period of time. In terms of the contract of sale, B (the seller) draws Bills of Exchange on the customer for different maturities. These bills are accepted by A. The banker (guarantor) guarantees payment of these bills of exchange on the due date. In the event of default by A, the banker need to honour the claim to the seller (beneficiary).

Bank Guarantee – Some Important Features:

– Bank's obligation to pay is primary
– Banker's commitment to honour the claim is primary, even if there is any dispute between the beneficiary and the debtor
– Banker needs to honour the claim, irrespective of the customer's balance in the bank account
– Except in case of frauds, in other cases, the banker cannot refuse payments, when a claim is received within a stipulated time. Courts also have refused to grant injunctions against banks from making payment under the guarantee, except in cases of frauds

Bank Guarantee: Precautions:

The liability of the bank under a guarantee depends on:

(i) the amount of the guarantee and (ii) the period of the guarantee

These two are important factors to be clearly mentioned in the guarantee issued by the banker, otherwise the bank's liability could be unlimited. The bank should obtain a counter guarantee from the customer on whose behalf guarantee is issued. At the time of issuing the guarantee, the amount to be paid under the guarantee should clearly state whether the amount is inclusive of all interest charges, taxes and other levies to avoid disputes regarding the liability of the bank.

On invocation (claim made by the beneficiary), the bank is liable to pay the entire amount of the guarantee unless in case of a fraud. The bank should specifically indicate the period for which the guarantee is valid. The guarantee should also indicate the claim period, usually beyond the validity period.

Further in case of invocation, the banker is required to ensure that: (a) invocation is made within the validity period (b) the amount is not more than the guaranteed amount (c) the person invoking has powers to invoke the guarantee

LETTER OF CREDIT:

A Letter of Credit is issued by a bank at the request of its customer (importer) in favour of the beneficiary (exporter). It is an undertaking/ commitment by the bank, advising/informing the beneficiary that the documents under a LC would be honoured, if the beneficiary (exporter) submits all the required documents as per the terms and conditions of the LC.

Importance of Letter of Credit in trade activities:

The trade can be classified into Inland and International. Due to the geographical proximities of the importers and the exporters, banks are involved in LC transactions to avoid default in payment (credit risks). To facilitate trade and also to enable the exporter and importer to receive and pay for the goods sold and bought, letter of credit is used as a tool. Letter of credit mechanism that the payment and receipts (across the globe) are carried out in an effective manner.

Letter of Credit – Parties:

1. Applicant (importer) requests the bank to issue the LC
2. Issuing bank (importer's bank which issues the LC [also known as Opening banker of LC])
3. Beneficiary (exporter) Different types of banks:
   - Opening bank (a bank which issues the LC at the request of its customer [importer])
   - Advising bank (the issuing banker's correspondent who advices the LC to beneficiary's banker and/ or beneficiary)
   - Negotiating bank (the exporter's bank, which handles the documents submitted by the exporter. The bank also finances the exporter against the documents submitted under a LC)
   - Confirming bank (the bank that confirms the credit)
   - Reimbursing bank (reimburses the LC amount to the negotiating/ confirming bank)

Types of LC's:

(a) Sight Credit – Under this LC, documents are payable at sight/ upon presentation

(b) Acceptance Credit/ Time Credit – The Bills of Exchange which are drawn, payable after a period, are called usance bills. Under acceptance credit usance bills are accepted upon presentation and eventually honoured on due dates.

(c) Revocable and Irrevocable Credit – A revocable LC is a credit, the terms and conditions of the credit can be amended/ cancelled by the Issuing bank, without prior notice to the beneficiaries. An irrevocable credit is a credit, the terms and conditions of which can neither be amended nor cancelled without the consent of the beneficiary. Hence, the opening bank is bound by the commitments given in the LC.

(d) Confirmed Credit – Only Irrevocable LC can be confirmed. A confirmed LC is one when a banker other than the Issuing bank, adds its own confirmation to the credit. In case of confirmed LCs, the beneficiary's bank would submit the documents to the confirming banker.

(e) Back-to-Back credit – In a back to back credit, the exporter (the beneficiary) requests his banker to issue a LC in favour of his supplier to procure raw materials, goods on the basis of the export LC received by him. This type of LC is known as Back-to-Back credit.
Example: An Indian exporter receives an export LC from his overseas client in Netherlands. The Indian exporter approaches his banker with a request to issue a LC in favour of his local supplier of raw materials. The bank issues a LC backed by the export LC.

(f) Transferable Credit – While a LC is not a negotiable instrument, the Bills of Exchange drawn under it are negotiable. A Transferable Credit is one in which a beneficiary can transfer his rights to third parties. Such LC should clearly indicate that it is a 'Transferable' LC.

(g) "Red Clause" Credit & "Green Clause" Credit – In a LC a special clause allows the beneficiary (exporter) to avail of a pre-shipment advance (a type of export finance granted to an exporter, prior to the export of goods). This special clause used to be printed (highlighted in red colour, hence it is called "Red Clause" Credit. The issuing bank undertakes to repay such advances, even if shipment does not take place.
In case of a 'Green clause' credit, the exporter is entitled for an advance for storage (warehouse) facilities of goods. The advance would be granted only when the goods to be shipped have been warehoused, and against an undertaking by the exporter that the transportation documents would be delivered by an agreement date.

(h) Standby LC: In certain countries there are restrictions to issue guarantees, as a substitute these countries use standby credit. In case the guaranteed service is not provided, the beneficiary can claim under the terms of the standby credit. In case of Standby LCs, the documents required are proof of non- performance or a simple claim form.

Documents handled under Letter of Credit:

Documents play a crucial role in trade transactions. Documents are integral part of LCs. The banks involved in LC transactions deal only with documents and on the evidence of the correct and proper documents only the paying banks (opening bank/confirming bank) need to make payment. In view of these factors, banks have to be careful while handling documents/ LCs.

At various stages, different banks (Negotiating bank {beneficiary's bank}, confirming bank, opening bank) have to verify whether all the required documents are submitted strictly as per the terms and conditions of credit. The important documents handled under LCs are broadly classified as

(a) Bill of Exchange:

Bill of exchange, is drawn by the beneficiary (exporter) on the LC issuing bank. When the bill of exchange is not drawn under a LC, the drawer of the bill of exchange (exporter), draws the bill of exchange on the drawee (importer). In such a case, the exporter takes credit risk on the importer, whereas, when the Bill of Exchange is drawn under LC, the credit risk for the exporter is not on the importer but on the LC issuing bank. Banks should be careful in ensuring that the Bill of Exchange is drawn strictly as per the terms and conditions of the credit. Some others important aspects are:

(i) It should be drawn by the beneficiary on the opening bank (ii) It should clearly indicate the amount and other details (iii) Depending upon the LC terms a Bill of Exchange may be drawn as a sight bill or an usance bill (iv) It should clearly indicate the LC number.

(b) Commercial Invoice:

This is another important document. Commercial invoice is prepared by the beneficiary, which contains (i) relevant details about goods in terms of value, quantity, weights (gross/net), importer's name and address, LC number (ii) Commercial invoice should exactly reflect the description of the goods as mentioned in LC. (iii) Another important requirement is that the commercial invoice should indicate the terms of sale contract (Inco terms) like FOB, C&F, CIF, etc (iv) Other required details like shipping marks, and any specific detail as per the LC terms should also be covered.

(c) Transport Documents:

When goods are shipped from one port to another port the transport document issued is called the bill of lading. Goods can be transported by means of airways, roadways and railways depending upon the situations. In case goods are transported by means of water ways, the document is called bill of lading, by airways it is known as airway bills and by roadways called as lorry receipt and by railways it is known as railway receipt. In case of a single transaction, when different modes are used to transport the goods from the beneficiary's country to the importer's destination, a single transport document can be used viz., Multi model transport document.

For ease of reference the most commonly used document i.e., Bill of Lading is discussed here.

(d) Bill of Lading (B/ L):

The B/ L is the shipment document, evidencing the movement of goods from the port of acceptance (in exporter's country) to the port of destination (in importer's country). It is a receipt, signed and issued by the shipping company or authorized agent. It should be issued in sets (as per the terms of credit).

Other important features:

As per the terms and conditions of the credit, a bill of lading should clearly indicate:

(i) the description of goods shipped, as indicated in the invoice
(ii) conditions of goods "Clean" or otherwise (not in good condition/ shortage/damaged)
(iii) drawn to the order of the shipper, blank endorsed or in favour of the opening bank
(iv) the gross and net weight
(v) Freight payable or prepaid
(vi) Port of acceptance and port of destination

PRIORITY SECTOR LOANS AND ADVANCES:

National Credit Council meeting held in July 1968 emphasized that commercial banks should increase their involvement in the financing of priority sectors, viz., agriculture and small scale industries. Nationalization of banks ushered in new concept in bank's lending and added a dimension of social banking to business of lending by banks. Initially there was no specific target fixed in respect of priority sector lending. In the recommendations of the Working Group on the Modalities of Implementation of Priority Sector Lending and the Twenty Point Economic Programme by Banks (Chairman: Dr. K. S. Krishnaswamy), all commercial banks were advised to achieve the target of priority sector lending at 40 percent of aggregate bank advances by 1985. Sub-targets were also specified for lending to agriculture and the weaker sections within the priority sector.

Since then, there have been several changes in the scope of priority sector lending and the targets and sub-targets applicable to various bank groups. The guidelines were revised by RBI in the year 2007 based on the recommendations made in September 2005 by the Internal Working Group of the RBI (Chairman: Shri C. S. Murthy). The Sub-Committee of the Central Board of the Reserve Bank (Chairman: Shri Y. H. Malegam) constituted to study issues and concerns in the Micro Finance institutions (MFI) sector, inter alia, had recommended review of the guidelines on priority sector lending.

Accordingly, Reserve Bank of India in August 2011 set up a Committee to re-examine the existing classification and suggest revised guidelines with regard to Priority Sector lending classification and related issues (Chairman: M V Nair).

The recommendations of the committee were examined by RBI and revised guidelines have been issued w.e.f. 1st July,2012. Some modifications have been made in the Agricultural and MSME category of advances w.e.f. 1st April 2013.

CATEGORIES UNDER PRIORITY SECTOR:

(i) Agriculture
(ii) Commercial - Micro and Small Enterprises.
(iii) Education
(iv) Housing
(v) Export Credit
(vi) Others

1. AGRICULTURE:

(a) Direct Agriculture

Loans to individual farmers [including Self Help Groups (SHGs) or Joint Liability Groups (JLGs), i.e. groups of individual farmers, provided banks maintain disaggregated data on such loans], directly engaged in Agriculture and Allied Activities, viz., dairy, fishery, animal husbandry, poultry, bee-keeping and sericulture (up to cocoon stage).

(i) Short-term loans to farmers for raising crops, i.e. for crop loans.
This will include traditional/non-traditional plantations, horticulture and allied activities.
(ii) Medium & long-term loans to farmers for agriculture and allied activities (e.g. purchase of agricultural implements and machinery, loans for irrigation and other developmental activities undertaken in the farm, and development loans for allied activities).
(iii) Loans to farmers for pre and post-harvest activities, viz., spraying, weeding, harvesting, sorting, grading and transporting of their own farm produce.
(iv) Loans to farmers up to `50 lakh against pledge/hypothecation of agricultural produce (including warehouse receipts) for a period not exceeding 12 months, irrespective of whether the farmers were given crop loans for raising the produce or not.
(v) Loans to small and marginal farmers for purchase of land for agricultural purposes.
(vi) Loans to distressed farmers indebted to non-institutional lenders.
(vii) Bank loans to Primary Agricultural Credit Societies (PACS), Farmers' Service Societies (FSS) and Large- sized Adivasi Multi Purpose Societies (LAMPS) ceded to or managed/ controlled by such banks for on lending to farmers for agricultural and allied activities.
(viii) Loans to farmers under Kisan Credit Card Scheme.
(ix) Export credit to farmers for exporting their own farm produce.
Loans to corporates including farmers' producer companies of individual farmers, partnership firms and co- operatives of farmers directly engaged in Agriculture and Allied Activities, viz., dairy, fishery, animal husbandry,
poultry, bee-keeping and sericulture (up to cocoon stage) up to an aggregate limit of `2 crore per borrower for the following activities:

(i) Short-term loans to farmers for raising crops, i.e. for crop loans.
This will include traditional/non-traditional plantations, horticulture and allied activities.
(ii) Medium & long-term loans to farmers for agriculture and allied activities (e.g. purchase of agricultural implements and machinery, loans for irrigation and other developmental activities undertaken in the farm, and development loans for allied activities).
(iii) Loans to farmers for pre and post-harvest activities, viz., spraying, weeding, harvesting, grading and sorting.
(iv) Export credit for exporting their own farm produce.

(b) Indirect agriculture

1. Loans to corporates including farmers' producer companies of individual farmers, partnership firms and co-operatives of farmers directly engaged in Agriculture and Allied Activities, viz., dairy, fishery, animal husbandry, poultry, bee-keeping and sericulture (up to cocoon stage)
   (i) If the aggregate loan limit per borrower is more than `2 crore, the entire loan should be treated as indirect finance to agriculture.
   (ii) Loans up to ` 50 lakh against pledge/hypothecation of agricultural produce (including warehouse receipts) for a period not exceeding 12 months, irrespective of whether the farmers were given crop loans for raising the produce or not.
2. Bank loans to Primary Agricultural Credit Societies (PACS), Farmers' Service Societies (FSS) and Large- sized Adivasi Multi- Purpose Societies (LAMPS)
3. Other indirect agriculture loans
   (i) Loans up to ` 5 crore per borrower to dealers /sellers of fertilizers, pesticides, seeds, cattle feed, poultry feed, agricultural implements and other inputs.
   (ii) Loans for setting up of Agriclinics and Agribusiness Centres.
   (iii) Loans up to ` 5 crore to cooperative societies of farmers for disposing of the produce of members.
   (iv) Loans to Custom Service Units managed by individuals, institutions or organizations who maintain a fleet of tractors, bulldozers, well-boring equipment, threshers, combines, etc., and undertake farm work for farmers on contract basis.
   (v) Loans for construction and running of storage facilities (warehouse, market yards, godowns and silos), including cold storage units designed to store agriculture produce/products, irrespective of their location.
   If the storage unit is a micro or small enterprise, such loans will be classified under loans to Micro and Small Enterprises sector.
   (vi) Loans to MFIs for on-lending to farmers for agricultural and allied activities as per the conditions specified.
   (vii) Loans sanctioned to NGOs, which are SHG Promoting Institutions, for on-lending to members of SHGs under SHG-Bank Linkage Programme for agricultural and allied activities. The all-inclusive interest charged by the NGO/SHG promoting entity should not exceed the Base Rate of the lending bank plus eight percent per annum.Loans sanctioned to RRBs for on-lending to agriculture and allied activities.

2. COMMERCIAL - MICRO AND SMALL ENTERPRISES:

The limits for investment in plant and machinery/equipment for manufacturing / service enterprise, as notified by Ministry of Micro Small and Medium Enterprises, vide, S.O.1642(E) dated September 9, 2006 are as under:-

Bank loans to micro and small enterprises both manufacturing and service are eligible to be classified under priority sector as per the following:

(a) Direct Finance

***1.* Manufacturing Enterprises**

The Micro and Small enterprises engaged in the manufacture or production of goods to any industry specified in the first schedule to the Industries (Development and regulation) Act, 1951 and as notified by the Government from time to time. The manufacturing enterprises are defined in terms of investment in plant and machinery.

Loans for food and agro processing

Loans for food and agro processing will be classified under Micro and Small Enterprises, provided the units satisfy investments criteria prescribed for Micro and Small Enterprises, as provided in MSMED Act, 2006.

***2.* Service Enterprises**

Bank loans up to `5 crore per unit to Micro and Small Enterprises engaged in providing or rendering of services and defined in terms of investment in equipment under MSMED Act, 2006.

3. **Export credit to MSE** units (both manufacturing and services) for exporting of goods/services produced/rendered by them.

***4.* Khadi and Village Industries Sector (KVI)**

All loans sanctioned to units in the KVI sector, irrespective of their size of operations, location and amount of original investment in plant and machinery. Such loans will be eligible for classification under the sub-target of 60 percent prescribed for micro enterprises within the micro

and small enterprises segment under priority sector.

(b) Indirect Finance:

(i) Loans to persons involved in assisting the decentralized sector in the supply of inputs to and marketing of outputs of artisans, village and cottage industries.
(ii) Loans to cooperatives of producers in the decentralized sector viz. artisans village and cottage industries.
(iii) Loans sanctioned by banks to MFIs for on-lending to MSE.

3. EDUCATION:

Loans to individuals for educational purposes including vocational courses up to `10 lakh for studies in India and `20 lakh for studies abroad.

4. HOUSING:

(i) Loans to individuals up to ` 25 lakh in metropolitan centres with population above ten lakh and ‘ 15 lakh in other centres for purchase/construction of a dwelling unit per family excluding loans sanctioned to bank’s own employees.
(ii) Loans for repairs to the damaged dwelling units of families up to `2 lakh in rural and semi- urban areas and up to `5 lakh in urban and metropolitan areas.
(iii) Bank loans to any governmental agency for construction of dwelling units or for slum clearance and rehabilitation of slum dwellers subject to a ceiling of `10 lakh per dwelling unit.
(iv) The loans sanctioned by banks for housing projects exclusively for the purpose of construction of houses only to economically weaker sections and low income groups, the total cost of which do not exceed `10 lakh per dwelling unit. For the purpose of identifying the economically weaker sections and low income groups, the family income limit of ` 1,20,000 per annum, irrespective of the location, is prescribed.
(v) Bank loans to Housing Finance Companies (HFCs), approved by NHB for their refinance, for on-lending for the purpose of purchase/construction/reconstruction of individual dwelling units or for slum clearance and rehabilitation of slum dwellers, subject to an aggregate loan limit of `10 lakh per borrower, provided the all- inclusive interest rate charged to the ultimate borrower is not exceeding lowest lending rate of the lending bank for housing loans plus two percent per annum.
The eligibility under priority sector loans to HFCs is restricted to five percent of the individual bank’s total priority sector lending, on an ongoing basis. The maturity of bank loans should be co-terminus with average maturity of loans extended by HFCs. Banks should maintain necessary borrower-wise details of the underlying portfolio.

5. EXPORT CREDIT:

Export Credit extended by foreign banks with less than 20 branches will be reckoned for priority sector target achievement.

As regards the domestic banks and foreign banks with 20 and above branches, export credit is not a separate category under priority sector. Export credit will count towards the respective categories of priority sector, i.e. Agriculture and MSE sector.

6. OTHERS:

1. Loans, not exceeding `50,000 per borrower provided directly by banks to individuals and their SHG/ JLG, provided the borrower’s household annual income in rural areas does not exceed ` 60,000/- and for non-rural areas it should not exceed ` 1,20,000/-.
2. Loans to distressed persons not exceeding `50,000 per borrower to prepay their debt to non-institutional lenders.
3. Loans outstanding under loans for general purposes under General Credit Cards (GCC). If the loans under GCC are sanctioned to Micro and Small Enterprises, such loans should be classified under respective categories of Micro and Small Enterprises.
4. Overdrafts, up to `50,000 (per account), granted against basic banking / savings accounts provided the borrowers household annual income in rural areas does not exceed ` 60,000/- and for non-rural areas it should not exceed `1,20,000/-.

WEAKER SECTIONS:

Priority sector loans to the following borrowers will be considered under Weaker Sections category:-

(a) Small and marginal farmers;
(b) Artisans, village and cottage industries where individual credit limits do not exceed ` 50,000;
(c) Beneficiaries of Swarnjayanti Gram Swarozgar Yojana (SGSY), now National Rural Livelihood Mission (NRLM);

(d) Scheduled Castes and Scheduled Tribes;
(e) Beneficiaries of Differential Rate of Interest (DRI) scheme;
(f) Beneficiaries under Swarna Jayanti Shahari Rozgar Yojana (SJSRY);
(g) Beneficiaries under the Scheme for Rehabilitation of Manual Scavengers (SRMS);
(h) Loans to Self Help Groups;
(i) Loans to distressed farmers indebted to non-institutional lenders;
(j) Loans to distressed persons other than farmers not exceeding `50,000 per borrower to prepay their debt to non-institutional lenders;

RETAIL FINANCE:

Loans to individual women beneficiaries up to `50,000 per borrower; Banks assist their clients to tide over their financial needs by extending retail loans. Personal loans, consumer loans comes under the category of retail finance.

PERSONAL LOANS:

Banks under the category retail finance, are extending two important loans viz., Personal Loans and Consumer Loans. Usually banks give personal loans without any tangible security. Invariably such loans are given to salaried persons based on their regular source of income i.e., salary.

Purpose:

To cover travel, marriage or educational and medical expenses. Some banks extend loans to celebrate functions/ festivals as well.

Eligibility:

Different banks follow different systems, however depending upon the bank's policy the terms and conditions may vary. Regular and permanent employees of Central, State Governments, employees of reputed corporate companies, industrial establishment both in Private and Public Sector, with a specific minimum number of years of service.

Loan amount:

The loan amount is calculated based on how many times of the gross/net salary.(Banks generally verify the proof of employment and salary certificate, to work out the eligible loan amount) The net take home pay would also be considered while arriving at the loan amount. Some banks insist that a minimum of 35 to 40 percent of the gross salary should be the minimum take home pay after the proposed EMI for the loan.

Security:

While no tangible security like fixed assets is required, some banks require a personal guarantee.

Loan Documents:

(i) Bank's loan sanction letter (ii) Demand Promissory Note (iii) Loan agreement (as per bank's standard format) (iv) Proof of employment and salary certificate, some banks obtain bank pass book to verify the salary credits (v) Guarantee agreement, if the loan is guaranteed.

Other terms:

As per bank's policy the other terms and conditions are decided like, interest rate, tenor of the loan, repayment amount, EMI, pre- payment, processing charges etc.,

CONSUMER CREDIT:

Consumer loans are either granted by banks by way of term loans and/or finance companies by way of hire purchase. These loans are given to customers to assist them to obtain consumer durables of their choice and requirement, with easy terms. If the goods are purchased through the hire purchase, then the title of the goods passes to the buyer at the end of the term after the last installment is paid.

Purpose:

Consumer loans, another category of retail finance are granted to enable the customers to buy consumer durables and white goods like refrigerators, TV, PCs. Laptops washing machines, music system, kitchen appliances ,etc.

Eligibility:

Generally persons who have regular source of income like, salaried persons, professionals, pensioners, self employed small businessmen farmers and village artisans and other individuals.

Loan Amount:

(i) The loan amount would be decided based on the cost of the goods to be purchased and the margin (which needs to be provided by the borrower) (ii) The minimum take home pay of 30 to 35 percent (after the application of the EMI of the proposed loan) is also considered. (iii) 10 to 20 percent margin is obtained.

Security:

The consumer goods to be purchased out of the loan amount, are to be hypothecated to the bank

Loan Documents: (i) Bank's loan sanction letter (ii) Demand Promissory Note (iii) Hypothecation agreement (as per bank's standard format) (iv) Proof of employment and salary certificate, some banks obtain bank pass book to verify the salary credits (v) Salaried persons: Proof of employment and salary certificate for three to six months for the individual and his spouse (spouse's income is also taken to work out higher loan eligibility) (vi) Professionals, Self employed, businessmen, IT Returns, Form 16/ 16A (vii) Quotations of the goods/ articles from reputed dealer

Other conditions:

As per bank's policy the other terms and conditions are decided like, interest rate, tenor of the loan, repayment amount, EMI, pre payment, processing charges etc.,

CONSORTIUM CREDIT:

Generally banks finance their clients based on their lending policy. Sometimes a single banker may not be able to finance a customer. In such situations, more than one bank joinly grant loans and advances and other credit facilities to a borrower, such type of financing is called as consortium finance.

Banks lend under consortium finance on account of:

- Regulatory requirements
- Restrictions on single and group borrower's limits
- As part of risk management and diversification policy of banks
- At the request of a borrower

When two or more banks join together to finance a borrower it is called Consortium Financing. In case of consortium finance, based on a formal agreement between member banks of the consortium and the group would have identified a banker as ' Lead Bank'.

The functions of lead bank as leader of the group, would include:

(a) arranging meetings between the member banks
(b) active involvement in credit appraisal, to obtain legal documents, to ensure proper charges are created on assets and also to monitor the account

TRADE CREDIT:

Banks play a vital role in providing financial assistance and also comfort levels to the traders through their financing called as "Trade Finance". Trade finance is granted in the form of fund based finance and non- fund based finance to enable the traders in their trading activities. The borrower may be a manufacturer/ trader or trader a who require working capital and term finance for his production and managing his cash flows. Apart from these type of loans, wherein the banker allows the borrower to draw down actual funds, banks also extend credit facility in the form of non -fund based facilities, called non fund based limits like letters of credit, bank guarantees.

Trade finance is granted to the domestic traders as well as traders who are handling EXIM trade (export and import). If the bank extends finance mainly in rupee funds to assist his borrower to sell or buy goods and services within India, it is classified as inland trade finance. On the other hand if a banker assists his borrower to handle international trade activities of export and import the banker is extending credit called overseas trade finance.Banks also extend trade finance in the form of bills finance for their clients.

EXPORT – IMPORT CREDIT:

An Indian exporter is extended credit facilities (fund based/non fund based) by his banker in the form of;Both are categorized under fund based limits. Both put together can be equated to "working capital finance" granted to an exporter.

Pre-shipment Credit and Post – Shipment Credit:

Pre-shipment credit, also called as packing credit is extended to the exporter to assist him (if he is a manufacturer and exporter) in his procurement of raw material and converting the raw materials to finished and exportable goods. With the assistance of bank finance an exporter is able to produce the goods and keep it ready for export. In other words, bank is financing against the inventory of the exporter in the form of inventory financing. It is called as "pre-shipment credit" because the production activities take place before shipment of exportable goods.

Pre-shipment Credit – features and precautions:

1. The status of the borrower as an exporter should be established by the banker. Every exporter is given an exporter's code by the Govt. authorities.
2. Export finance is granted at concessional rate of interest, to encourage exports. Hence banks should be guided by the Bank's policy, exposure norms and the Regulator's guidelines and directives in

extending export credit.

3. Banks should also be guided by the provisions of 'FEMA,1999' since export receivables would result in inflow of foreign currency. Export and import of goods and services are treated as current account transactions, as such banks should be careful in reporting requirements of export and import financial transactions in the prescribed formats and frequencies
4. As far as foreign banks operating in India export credit is also eligible to be included in the target/sub targets of Priority Sector lending.
5. Pre-shipment credit is extended to an exporter invariably against export letter of credit issued in favour of the exporter. Banks should ensure all the required credentials, export caution lists, etc. before extending export credit. Banks should be satisfied with the terms and conditions of letter of credit and if need be satisfied with the applicable provisions of UCPDC 600 as well.
6. Banks should extend pre shipment credit based on the type of letter credit, and only for fob value and not for any other value like c & f or c i f value of the lc. Sufficient margin needs to be kept on the fob value and allow the exporter export credit accordingly.
7. Once goods are exported the pre-shipment credit exposure should be squared off against post shipment credit - discounting of export bills.

Post – Shipment Credit:

Similarly, once goods are exported, the status changes to "post-shipment credit' since the banker is financing against receivables by either purchasing or discounting the export bills. Invariably, the exporter is granted, both pre-shipment and post-shipment facilities. This is due to the following reasons:

A banker would grant an export credit as under:

Pre-shipment credit	-	` 1,000,000
Post-shipment credit	-	` 1,000,000
Overall export credit	-	` 1,000,000

Why should a banker grant an export credit in the above mentioned manner?

(i) The pre-shipment credit and post-shipment credit are linked and granted for the same goods

(ii) By fixing the over all limit equivalent to both pre-shipment credit and post-shipment credit, the bank indicates to the exporter that at any given point in time, the exporter can have a maximum exposure of ` 1,000,000 as export credit and (i) the o/s of ` 1,000,000 in pre-shipment and nil o/s in post-shipment or

(iii) nil o/s in pre-shipment and o/s ` 1,000,000 in post-shipment or (iii) the total o/s in both pre-shipment and post-shipment should not exceed ` 1,000,000**.**

IMPORT CREDIT:

Banks extend credit and other facilities to an import customer in his import activities as part of trade finance. Banks generally grant non fund based limits like letters of credit for an import customer. On the due date bank as per their commitment as opening banker of letter of credit would pay against documents received from exporter's banker, and recover the amount from the importer. In case the importer does not have sufficient balance in his account then the banker would grant an import loan, as part of fund based import finance

While dealing with importer and granting import finance, banks should take necessary precautions.

1. Bank should follow the bank's loan policy, exposure norms, the RBI's guidelines and FEMA,1999 provisions
2. In most of the cases only letter of credit limits are granted, though it is a non- funded limit, banks should carry out all the required due diligence, careful credit evaluation, ensuring all the required procedures are followed to avoid any NPA situation once the non funded limit is converted into fund based import finance
3. Like in the case of an exporter, the importer's status needs to be verified and his credentials also to be ensured to safe guard bank's position
4. Close monitoring of funding status in importer's account is a must to enable the banker to pay on the due date against letter of credit. Banks can also obtain sufficient margin, lien on bank's fixed deposits to ensure the funds are available on the due dates
5. Banks should follow the reporting requirements
6. All other precautions are to be taken to cover the risks as well.

UNIT – II

Principles of lending – The 7C's of Credit – Fair practice code – Various types of Borrowers

I. INTRODUCTION:

Lending (also known as "financing") in its most general sense is the temporary giving of money or property to another person with the expectation that it will be repaid. In a business and financial context, lending includes many different types of commercial loans.

II. 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."

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.

III. 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 :

7C's of credit – Character, Capacity, Capital, Collateral, Conditions.

1. Character:

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

2. **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.

3. **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.

4. **Commitment:**

Making a commitment involves dedicating yourself to something, like a person or a cause. Before you make a commitment, think carefully. A commitment obligates you to do something.

Some commitments are large, like marriage. When you take a job, you're making a commitment to show up and do the job well, and your employer makes a commitment to pay you. There are smaller commitments too. If you said you'd meet a friend at six, that's a commitment — show up or your friend will be mad. You also can speak of commitment as a quality. Staying after school for a study group shows your commitment to good grades.

5. **Cash flow:**

Cash flow is the net amount of cash and cash-equivalents being transferred into and out of a business. At the most fundamental level, a company's ability to create value for shareholders is determined by its ability to generate positive cash flows, or more specifically, maximize long-term free cash flow (FCF).

6. **Collateral:**

Collateral is an asset that a lender accepts as security for extending a loan. If the borrower defaults on her loan payments, the lender may seize the collateral and sell it to recoup some or all of his losses. Collateral can take the form of real estate or other kinds of assets, depending on what the loan is used for.

***7.* 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.

IV. RBI GUIDELINES ON FAIR PRACTICES CODE FOR LENDERS:

On the basis of the recommendations of the Working Group on Lenders' Liability Laws constituted by the Government of India, we have examined, in consultation with Government, select banks and financial institutions, the feasibility of introducing the Fair Practices Code for Lenders. The guidelines have since been finalized and banks/ all India Financial Institutions are advised to adopt the following broad guidelines and frame the Fair Practices Code duly approved by their Board of Directors.

(i) Applications for loans and their processing

(a) Loan application forms in respect of priority sector advances up to Rs.2.00 lakhs should be comprehensive. It should include information about the fees/charges, if any, payable for processing, the amount of such fees refundable in the case of non acceptance of application, pre-payment options and any other matter which affects 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.

(b) Banks and financial institutions should devise a system of giving acknowledgement for receipt of all loan applications. Time frame within which loan applications up to Rs.2 lakhs will be disposed of should also be indicated in acknowledgement of such applications.

(c) Banks / financial institutions should verify the loan applications within a reasonable period of time. If additional details / documents are required, they should intimate the borrowers immediately.

(d) In the case of small borrowers seeking loans up to Rs. 2 lakhs the lenders should convey in writing, the main reason/reasons which, in the opinion of the bank after due consideration, have led to rejection of the loan applications within stipulated time.

(ii) Loan appraisal and terms/conditions

a. Lenders should ensure that there is proper assessment of credit application by borrowers. They should not use margin and security stipulation as a substitute for due diligence on credit worthiness of the borrower.
b. The lender should convey to the borrower the credit limit along with the terms and conditions thereof and keep the borrower's acceptance of these terms and conditions given with his full knowledge on record.
c. Terms and conditions and other caveats governing credit facilities given by banks/ financial institutions arrived at after negotiation by lending institution and the borrower should be reduced in writing and duly certified by the authorised official. A copy of the loan agreement along with a copy each of all enclosures quoted in the loan agreement should be furnished to the borrower.
d. As far as possible, the loan agreement should clearly stipulate credit facilities that are solely at the discretion of lenders. These may include approval or disallowance of facilities, such as, drawings beyond the sanctioned limits, honouring cheques issued for the purpose other than specifically agreed to in the credit sanction, and disallowing drawing on a borrowal account on its classification as a non-performing asset or on account of non-compliance with the terms of sanction. It may also be specifically stated that the lender does not have an obligation to meet further requirements of the borrowers on account of growth in business etc. without proper review of credit limits.
e. In the case of lending under consortium arrangement, the participating lenders should evolve procedures to complete appraisal of proposals in the time bound manner to the extent feasible, and communicate their decisions on financing or otherwise within a reasonable time.

(iii) Disbursement of loans including changes in terms and conditions

Lenders should ensure timely disbursement of loans sanctioned in conformity with the terms and conditions governing such sanction. Lenders should give notice of any change in the terms and

conditions including interest rates, service charges etc. Lenders should also ensure that changes in interest rates and charges are effected only prospectively.

(iv) Post disbursement supervision

a. Post disbursement supervision by lenders, particularly in respect of loans upto Rs.2 lakhs, should be constructive with a view to taking care of any" lender-related" genuine difficulty that the borrower may face.
b. Before taking a decision to recall / accelerate payment or performance under the agreement or seeking additional securities, lenders should give notice to borrowers, as specified in the loan agreement or a reasonable period, if no such condition exits in the loan agreement.
c. Lenders should release all securities on receiving payment of loan or realisation of loan subject to any legitimate right or lien for any other claim lenders may have against borrowers. If such right of set off is to be exercised, borrowers shall be given notice about the same with full particulars about the remaining claims and the documents under which lenders are entitled to retain the securities till the relevant claim is settled/paid.

(v) General

a. Lenders should restrain from interference in the affairs of the borrowers except for what is provided in the terms and conditions of the loan sanction documents (unless new information, not earlier disclosed by the borrower, has come to the notice of the lender).
b. Lenders must not discriminate on grounds of sex, caste and religion in the matter of lending. However, this does not preclude lenders from participating in credit-linked schemes framed for weaker sections of the society.
c. In the matter of recovery of loans, the lenders should not resort to undue harassment viz. persistently bothering the borrowers at odd hours, use of muscle power for recovery of loans, etc.
d. In case of receipt of request for transfer of borrowal account, either from the borrower or from a bank/financial institution, which proposes to take- over the account, the consent or otherwise i.e, objection of the lender, if any, should be conveyed within 21 days from the date of receipt of request.

3. Fair Practices Code based on the guidelines outlined in the paragraph 2 above should be put in place in respect of all lending prospectively, but not later than 01 August 2003. Banks and financial institutions will have the freedom of drafting the Fair Practices Code, enhancing the scope of the guidelines but in no way sacrificing the spirit underlying the above guidelines. For this purpose, the Boards of banks and financial institutions should lay down a clear policy.

4. The Board of Directors should also lay down the appropriate grievance redressal mechanism within the organization to resolve disputes arising in this regard. Such a mechanism should ensure that all disputes arising out of the decisions of lending institutions' functionaries are heard and disposed of at least at the next higher level. The Board of Directors should also provide for periodical review of the compliance of the Fair Practices Code and the functioning of the grievances redressal mechanism at various levels of controlling offices. A consolidated report of such reviews may be submitted to the Board at regular intervals, as may be prescribed by it.

5. The adoption of the Code, printing of necessary loan application forms and circulation thereof among the branches and controlling offices should also be completed latest by end of June 2003. The Fair Practices Code, which may be adopted by banks and financial institutions, should also be put on their website and given wide publicity. A copy may also be forwarded to the Reserve Bank of India.

V. VARIOUS TYPES OF BORROWERS:

Individuals Accounts of individuals form a major chunk of the deposit accounts in the personal segment of most banks. Individuals who are major and of sound mind can open a bank account.

(a) Minors:

In case of minor, a banker would open a joint account with the natural guardian. However to encourage the habit of savings, banks open minor accounts in the name of a minor and allows single operations by the minor himself/ herself. Such accounts are opened subject to certain conditions like

(i) the minor should be of some minimum age say 12 or 13 years or above
(ii) should be literate
(iii) No overdraft is allowed in such accounts
(iv) Two minors cannot open a joint account.
(v) The father is the natural guardian for opening a minor account, but RBI has authorized mother also to sign as a guardian (except in case of Muslim minors)

(b) Joint Account Holders:

A joint account is an account by two or more persons. At the time of opening the account all the persons should sign the account opening documents. Operating instructions may vary, depending upon the total number of account holders. In case of two persons it may be

(i) jointly by both account holders

(ii) either or survivor

(iii) former or survivor In case no specific instructions is given, then the operations will be by all the account holders jointly, The instructions for operations in the account would come to an end in cases of insanity, insolvency, death of any of the joint holders and operations in the account will be stopped.

(c) Illiterate Persons:

Illiterate persons who cannot sign are allowed to open only a savings account (without cheque facility) or fixed deposit account. They are generally not permitted to open a current account. The following additional requirements need to be met while opening accounts for such persons:

– The depositor's thumb impression (in lieu of signature) is obtained on the account opening form in the presence of preferably two persons who are known to the bank and who have to certify that they know the depositor.

– The depositor's photograph is affixed to the ledger account and also to the savings passbook for identification.

Withdrawals can be made from the account when the passbook is furnished, the thumb impression is verified and a proper identification of the account holder is obtained.

(d) Hindu Undivided Family (HUF):

HUF is a unique entity recognized under the Hindu customary law as comprising of a 'Karta' (senior-most male member of the joint family), his sons and grandsons or even great grandsons in a lineal descending order, who are 'coparceners' (who have an undivided share in the estate of the HUF). The right to manage the HUF and its business vests only in the Karta and he acts on behalf of all the coparceners such that his actions are binding on each of them to the extent of their shares in the HUF property. The Karta and other coparceners may possess self-acquired properties other than the HUF property but these cannot be clubbed together for the HUF dues. HUF business is quite distinct from partnership business which is governed by Indian Partnership Act, 1932. In partnership, all partners are individually and collectively liable to outsiders for the dues of the partnership and all their individual assets, apart from the assets of the partnership, would be liable for attachment for partnership dues. Contrarily, in HUF business, the individual properties of the coparceners are spared from attachment for HUF dues.

The following special requirements are to be fulfilled by the banks for opening and conducting HUF accounts:

– The account is opened in the name of the Karta or in the name of the HUF business.

– A declaration signed by Karta and all coparceners, affirms the composition of the HUF, its Karta and names and relationship of all the coparceners, including minor sons and their date of birth.

– The account is operated only by the Karta or the authorized coparceners.

– In determining the security of the family property for purposes of borrowing, the self-acquired properties of the coparceners are excluded.

– On the death of a coparcener, his share may be handed over to his wife, daughters and other female relatives as per the Hindu Succession Act, 1956.

The Hindu Succession Act, 1956 has been amended in 2005. The Amendment Act confers equal rights to daughters in the Mitakshara Coparcenary property . With this amendment the female coparcener can also act as Karta of the HUF. When any HUF property is to be mortgaged to the Bank as a security of loan, all the major coparceners (including female coparceners) will have to execute the documents.

(e) Firms

The concept of 'Firm' indicates either a sole proprietary firm or a partner- ship firm.Asole proprietary firm is wholly owned by a single person, whereas a partnership firm has two or more partners. The sole-proprietary firm's account can be opened in the owner's name or in the firm's name. A partnership is defined under section 4 of the Indian Partnership Act, 1932, as the relationship between persons who have agreed to share the profits of business carried on by all or any of them acting for all. It can be created by an oral as well as written agreement among the partners. The

Partner- ship Act does not provide for the compulsory registration of a firm. While an unregistered firm cannot sue others for any cause relating to the firm's business, it can be sued by the outsiders irrespective of its registration. In view of the features of a partnership firm, bankers have to ensure that the following requirements are complied with while opening its account:

– The account is opened in the name of the firm and the account opening form is signed by all the partners of the firm.

– Partnership deed executed by all the partners (whether registered or not) is recorded in the bank's books, with suitable notes on ledger heading, along with relevant clauses that affect the operation of the account.

– Partnership letter signed by all the partners is obtained to ensure their several and joint liabilities.

The letter governs the operation of the account and is to be adhered to accordingly. The following precautions should be taken in the conduct of a partnership account:

– The account has to be signed 'for and on behalf of the firm' by all the authorized partners and not in an individual name.

– A cheque payable to the firm cannot be endorsed by a partner in his name and credited to his personal account.

– In case the firm is to furnish a guarantee to the bank, all the partners have to sign the document.

– If a partner (who has furnished his individual property as a security for the loan granted to the firm) dies, no further borrowings would be permitted in the account until an alternative for the deceased partner is arranged for, as the rule in Clayton's case operates.

(f) Companies:

A company is a legal entity, distinct from its shareholders or managers, as it can sue and be sued in its own name. It is a perpetual entity until dissolved. Its operations are governed by the provisions of the Companies Act, 1956.

A company can be of three types:

– Private Limited company: Having 2 to 51 shareholders.

– Public company: Having 7 or more shareholders.

– Government company: Having at least 51per cent shareholdings of Government (Central or State).

The following requirements are to be met while opening an account in the name of a company:

– The account opening form meant for company accounts should be filled and specimen signatures of the authorized directors of the company should be obtained.

– Certified up-to-date copies of the Memorandum and Articles of Association should be obtained. The powers of the directors need to be perused and recorded to guard against 'ultra vires' acts of the company and of the directors in future.

– Certificate of Incorporation (in original) should be perused and its copy retained on record.

– In the case of Public company, certificate of commencement of business should be obtained and a copy of the same should be recorded. A list of directors duly signed by the Chairman should also be obtained.

– Certified copy of the resolution of the Board of Directors of the company regarding the opening, execution of the documents and conduct of the account should be obtained and recorded.

(f)Trusts

A trust is a relationship where a person (trustee) holds property for the benefit of another person (beneficiary) or some object in such a way that the real benefit of the property accrues to the beneficiary or serves the object of the trust. A trust is generally created by a trust deed and all concerned matters are governed by the Indian Trusts Act, 1882. The trust deed is carefully examined and its relevant provisions, noted. A banker should exercise extreme care while conducting the trust accounts, to avoid committing breach of trust:

– A trustee cannot delegate his powers to other trustees, nor can all trustees by common consent delegate their powers to outsiders.

– The funds in the name of the trust cannot be used for crediting in the trustee's account, nor for liquidating the debts standing in the name of the trustee.

– The trustee cannot raise loan without the permission of the court, unless permitted by the trust deed.

(g) Clubs

Account of a proprietary club can be opened like an individual account. However, clubs that are collectively owned by several members and are not registered under Societies RegistrationAct, 1860, or under any other Act, are treated like an unregistered firm. While opening and conducting the account of such clubs, the following requirements are to be met:

– Certified copy of the rules of the club is to be submitted.

– Resolution of the managing committee or general body, appointing the bank as their banker and specifying the mode of operation of the account has to be submitted,

– The person operating the club account should not credit the cheques drawn favouring the club, to his personal account.

(h)Local Authorities

Municipal Corporation, Panchayat Boards are local authorities created by specific Acts of the state legislature. Their constitution, functions, powers, etc. are governed by those Acts. Bankers should ensure that accounts of such bodies are opened and conducted strictly as per the provisions of the relevant Act and regulations framed there under. The precautions applicable for company or trust accounts are also applicable in the case of these accounts, in order to guard against ultra virus acts by the officers of the local authority operating the account.

(i) Co-operative societies

Co-operative societies are required to open accounts only with these banks which are recognized for this purpose (under the Co-operative Society Act).

The following documents should be obtained while opening their account:

– Certificate of registration of the society under the Co-operative Society Act.

– Certified copy of the bye-laws of the society.

– Resolution of the managing committee of the society prescribing the conditions for the conduct of the account.

– List of the members of the managing committee with the copy of the resolution electing them as the committee members.

UNIT – III

Benefits and dangers in using credit, understanding consumer rights and obligations

I. INTRODUCTION:

Having the ability to borrow money when you need it gives you flexibility. But borrowing too much money and being unable to pay it back is a serious problem in our country. In fact, the fastest growing group declaring bankruptcy is age twenty to twenty-four. It's important to use credit responsibly and avoid having too much debt. If you understand how credit works and use it wisely, it can help you to reach your goals.

II. BENEFITS OF USING 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.

10. Credit benefit zone

The benefits of having credit are:

- ✓ The option of buying something today and paying the money back over time, rather than having to wait
- ✓ The flexibility to act on major purchases and life opportunities that may require more money than you have on hand right now, like buying a computer, or borrowing for college
- ✓ Easier to rent an apartment and to get service from local utility companies
- ✓ Easier to buy what you want, when you want it

III. DANGERS OF USING 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.

7. Credit risk zone

The risks of having credit are:

- ✓ Overdoing it; borrowing more than you can afford to repay
- ✓ If you don't make your payments on time, you'll damage your credit record
- ✓ Losing money on late fees
- ✓ Having to pay additional interest
- ✓ Difficulty getting loans or credit in the future

IV. ROLE OF CREDIT IN ECONOMIC DEVELOPMENT:

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.”

V. CONSUMER RIGHTS AND OBLIGATIONS:

The RBI released a Charter of Customer Rights specifying five basic rights that bank customers enjoy. Though there is already a framework outlining service standards, industrywatchers feel a direct intervention from the RBI in the form of the charter will make the process more robust.

“This will simplify matters for a layperson. Customers can now cite this charter to get their rights,” says certified financial planner Harshvardhan Roongta, CEO, Roongta Securities.

The central bank has also advised the Indian Banks’ Association (IBA) and the Banking Codes and Standards Board of India (BCSBI) to formulate a ‘Model Customer Rights Policy’ based on the charter’s principles. These measures would ultimately strengthen the customer service framework.

In case a bank violates any right as laid down by the RBI, customers can approach the customer services division of the apex bank. “With this charter, the RBI will have legislative powers to act against the errant banks,” says a retired head of a large public sector bank. Here are the rights of customers as notified by the RBI that you should be aware of.

1. **Right to fair treatment:**

This right prohibits banks from discriminating against customers on grounds of gender, age, religion, caste and physical ability while offering products and services. Banks can, however, continue to offer differential rates of interest or products to customers. “The financial services provider may, however, have certain special products which are specifically designed for members of a target market group or may use defensible, commercially acceptable economic rationale for discriminating between its customers.”

2. **Right to transparency, fair and honest dealing:**

You can expect language in bank documents to be simplified and transparent. The charter requires banks to ensure that all contracts are transparent and easily understood by the common person. The onus of sending out effective communication will rest with banks. Information on the product’s price, customer’s responsibilities and key risks will have to be clearly disclosed. “Any features that may disadvantage the customer should be made known to him. Important terms and conditions should be clearly brought to the notice of the customer,” the charter says.

3. **Right to suitability:**

Despite several regulations, complaints related to mis-selling continue to plague the distribution space, particularly in case of life insurance policies. Lured by higher commissions, sales officials tend to push products without ascertaining their suitability for the customer. With this charter coming into force, such officials might find it difficult to palm off say market-linked insurance products to senior citizens who are looking for stable returns. The charter has now made it mandatory for banks to sell products after keeping in mind customers’ needs, financial circumstances and understanding.

4. **Right to privacy:**

Banks are duty-bound to keep customers’ personal information confidential, unless the

disclosure is required by law or customers have given their consent. “Customers have the right to protection from all kinds of communications, which infringe upon their privacy,” the charter states. Banks cannot pass on your details to telemarketing companies or for cross-selling. “There have been instances where bank officials, on the basis of transaction details, have asked customers to route their investments through them (since banks also act as distributors for mutual funds and insurance companies). This is unethical,” says Roongta.

5. **Right to grievance redressal and compensation:**

The right to grievance redressal is at your aid if your bank fails to adhere to basic norms. The charter makes banks accountable for their own products as well as those of third parties like insurance companies and fund houses. They will no longer be able to wash their hands of the responsibility once the product is sold. Banks will have to communicate the policy for compensating for mistakes on their part, lapses in conduct and non-performance or delays. The redressal and compensation policy will have to state the rights of customers when such events occur.

CONSUMER OBLIGATIONS:

a) Prompt payment of Bills:

Consumers have an obligation to pay all their bills and clear these when they are due.

b) Environmental Protection:

Each consumer has a responsibility of ensuring that his/her utilization or consumption of communication services is not in a manner hazardous to the environment.

The environment is the responsibility of every individual on the planet. As an example of this responsibility, a consumer should ensure that wraps and scratch cards are disposed off safely or in the appropriate way.

c) Awareness:

It is the responsibility of the consumer to be alert and to question issues such as terms and conditions of service. Consumers should know their rights and obligation as well as finding out the other information available to them.

d) Action:

A consumer has an obligation to be assertive so as to ensure that he/she and other users of the service(s) receive a Fair deal. t is wrong for a consumer to notice a weakness in a service received or in the sector and remain silent about it.

e) Protection of Communication Facilities:

A consumer has a responsibility to protect all communication equipment and Facilities within his/her vicinity.

UNIT – IV

Credit Policy: Definition – Role and use of the policy – Basic contents of the policy

I. INTRODUCTION

The term credit policy is now popularly known as RBI's monetary policy or money management policy. It is the central bank's view on what should be the money supply in the economy and also in what direction the interest rates should move in the banking system.

Credit policy / financial policy is the use of the financial system to influence aggregate demand (AD). Monetary policy affects AD through the Central bank controlling interest rates and the money supply. Fiscal policy affects AD through the use of government spending and taxation.

Credit policy looks at factors such as:

- Bank lending rates to firms and households in the economy.
- The supply of credit and availability of loans from banks to firms and households.

In normal economic circumstances, it was felt the Central Bank could adequately control the economy through changing base rates.

II. FORMULATION OF CREDIT 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.

III. FACTORS INFLUENCING CREDIT POLICY:

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.

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.

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.

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.

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.

Ability and experience of loan officers:

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

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.

IV. ROLE AND USE OF THE CREDIT POLICY:

MONETARY POLICY

The central bank uses alternate instruments and interest rate to impact the supply of money to achieve a country's macroeconomic targets. This method used by RBI is known as the monetary policy.

Credit policy forms a sub part of the monetary policy. It is used to decide the quantum and the rate of interest at which credit is given by the banks. The monetary policy is either contractionary or expansionary and the same is decided depending upon the amount of money supply required in the economy. An expansionary policy raises the total money supply in the economy and a policy which contractionary reduces the total amount of money supply in the economy by compressing credit conditions. An expansionary policy is generally used to fight unemployment during recession by reducing interest rate. However, the objective of a contractionary policy is to raise interest rates to rein in inflation.

MONETARY POLICY OBJECTIVES:

Some of the key objectives of the monetary policy are:

- Employment generation
- Stabilize the Exchange Rate
- Provide stability in prices
- Put the economy of fast track growth
- To maintain a balance between investments and savings

Traditionally, monetary policy was released two times in a year i.e. once in a lean season policy (From April to September) and once in a peak season policy (From October to March). This was in line with the agriculture cycle.

There are various methods available with RBI in order to meet the monetary policy objectives. Some of these are mentioned below:

- Forex Market Interventions
- Bank rate Fluctuations
- Open market operation
- Moral suasion

READY FORWARD CONTRACTS (REPOS)

Ready Forward Contract refers to a transaction where two parties mutually agree to purchase and sell the same asset or security. In this agreement, the person sells a pre-defined amount of securities with the understanding to buy back the same at a common agreed price and date. On similar terms, the buyer buys the assets or securities with a contract to resell the asset or security to the seller on a common agreed price and future date.

REPO is when the RBI lends to the banks for a short-term period basis government bonds as security. The banks take the responsibility at a future date / overnight / few day to repurchase the security. In short, repo rate refers to the rate of interest charged by the RBI for lending money.

The RBI also borrows funds from the banks to suck in excess liquidity by selling of securities and repurchasing them over a short period of time. This is called Reverse Repo. As the name suggest, it is called as reverse repo rate since it functions in the opposite way of the repo operations. The Repo Rate exceeds the reverse repo rate by 1 percent.

The reverse repo or repo transactions can be done only in Mumbai. Additionally, there is a restriction that the deals must be only in securities as formally accepted by RBI (i.e. State and Central Government Securities, Treasury Bills).

The RBI uses reverse repo and repo as a means to adjust the liquidity in the system. The Repo rate is additionally also referred to as the policy rate and acts as an indicator for the entire financial ecosystem to correct their borrowing and lending operations.

The current Repo Rate is 6.25% and Reverse Repo Rate is 6%.

Bank Rate:

Bank Rate refers to the rate of interest at which RBI lends long term loans to commercial and scheduled banks. It is an instrument which the RBI has adopted in order to maintain adequate money supply in the system.

Any change in bank rate by the Reserve Bank is an indication for the banks to change the deposit rates and also to change the prime lending rate (PLR refers to the rate of interest which the banks their customers for extending loans)

The Bank Rate is now aligned with MSF (Marginal standing facility) rate and the Repo rate. This was done as a one-time method of technical adjustment and did not indicate a modification in the monetary policy. The bank rate is also considered as a penal rate which is applied on banks for any defaults in adhering to the requirements of Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR). The current bank rate is 6.5%

Marginal Standing Facility (MSF)

In the year 2011, the Reserve Bank introduced the MSF or Marginal Standing Facility. It is a special window through which scheduled banks could borrow funds from the RBI /Central Bank on an overnight basis at a rate which is higher than the repo rate. Originally it was supposed to be 1% above Repo Rate. This borrowing is in addition to what is available to the Banks through the Liquidity Adjustment Facility (LAF) window and is offered against specified and approved government securities. This facility is a way to ease the liquidity scenario in the market in acute situations when inter-bank liquidity completely dries up. Hence, it is used by banks only as a measure of last resort. The repo route can be used by banks for the securities which is in addition to the mandatory SLR Holdings i.e. 20.5% of bank deposits.

MSF window has also gained importance due to the fact that the repo operations are permitted only for a specific time during a day. It currently stands at 6.5%.

Liquidity Adjustment Facility

In the year 2000, RBI launched the concept of Liquidity Adjustment Facility (LAF). Funds under this window are used by the banks to manage their daily liquidity mismatches. It covers credit at the repo rate as well as the reverse repo rate. Upon the introduction of LAF, RBI has stopped the practice of discounting and rediscounting of bills of exchange. Due to that, now the Bank Rate has is no longer an active tool for monetary management.

Reserve Requirements

Reserve banking is a common universal practice followed by banks as per the directions of the Central Bank in the financial system. Under this, banks keep a portion of the complete deposits that are managed by the bank as balance or reserves, which cannot be used for lending purposes. These ratios are periodically altered by the Reserve Bank depending upon the state of the economy. The requirement of this reserve is a regulation given by the bank that fixes the least amount of reserves that each bank must keep with itself. The reserves are used to fulfil multiple needs like giving advances (loans) to the government from the funds kept with their own selves (SLR) or in the form of cash, held by the RBI (CRR).

Statutory Liquidity Ratio (SLR)

It refers to the part of demand liabilities (current accounts and savings bank) and time (fixed deposits) deposits of banks which they need to keep in the method of pre-defined assets that are liquid like approved securities of RBI e.g. public sector bonds, balances in current account kept with other banks and gold along with government securities. The aim of the SLR is to ensure that the requirement needs for the funds of the government is partly, but without fail met by the banks.

The Banking Regulation Act of 1949 and the RBI Act of 1934 had set the lower limit at 25% and the upper limit is at 40%. However, certain changes were made in 2007 which eliminated the lower limits but retained the upper limit at 40%. Due to this reason, the RBI has the flexibility to change the SLR at any given point of time depending on the prevailing macro-economic conditions. As of April 2017, the SLR stands at 20.5 percent

Cash Reserve Ratio

RBI has a monitoring tool called as Cash Reserve Ratio (CRR) to regulate the supply of money in the system. CRR is a part of the bank deposits that a bank needs to keep with the RBI in the form of cash. The deposits made via CRR earn no interest. The Banking Regulation Act of 1949 and the RBI Act of 1934 had set the lower limit at 3% and the upper limit at 20%. However, changes were introduced in 2007 which eliminated the lower and upper limits. Currently, the CRR is 4 percent.

Open Market Operations of RBI

Open Market Operations can be defined as a full sale or purchased government securities in an open market by the RBI so that it can direct and control the amount of credit and money in the economy. Open market refers to financial institutions and banks. The buying back of government securities by RBI helps to add money into the market and thus, leads to an increase in credit.

Selective Credit Controls

RBI has ordered that more credit can be extended to selective entities or businesses as a discretionary measure while a few others may be given lesser credit by banks. Hence, these selective credit controls facilitate in the accomplishment of many social objectives like preventing black marketing and hoarding of few important commodities by sellers by giving reduced credit.

Moral Suasion

Moral Suasion is a persuasive way used by the Reserve Bank of India to impact and pressure. However, it is not a mean to force the banks into sticking to the policy. Some of the measures used are the enhanced strictness of inspections, meetings with directors of banks within closed doors, appeals to the community, etc.

Monetary Policy and Its Growing Importance

Most governments elected by the majority of the people's vote refrain from employing fiscal policy in order to target inflation, since it forces the elected government to consider actions that may not be to not go down well with the general public e.g. taking decisions to increase taxes or reduce the spends. The realities of the modern-day politics call for a stronger role for monetary policy especially during inflationary times. Certain elements like mitigation of unemployment can be achieved more effectively through the use of fiscal policy. The government, in order to achieve this objective can look at increasing the spending to public departments and in the process, creating more jobs. However, for every aspect that the monetary policy can help in achieving, there is always a threshold for the effectiveness of the monetary policy, which can revive the economy from a phase of deep crisis.

Market Stabilization Bonds

In the year 2004, the Reserve Bank started to float treasury bills and government securities. This was a part of a scheme to stabilize market conditions. The objective of this scheme was to suck in the additional liquidity from the economy.

Monetary Policy in Developing Countries

Some of the developing countries find it very difficult to effectively implement the monetary policy. The most difficult part is that the government's priorities are set through the fiscal policy and the apex bank of the country is not always actively involved in decisions that are connected to money supply through the means of borrowings.

The Significance of Interest Rates

The rates that are given for the money placed in banks, offered for investing in bonds, rates at which the money is taken or borrowed from the financial institutions and banks along with the rate that is charged from borrowers is called as Interest rates.

Some of the factors that help in determining the interest rates are:

- Promote the idea of savings
- Global factors, e.g. in case there is a need to keep hold of more foreign fund
- Inflation - More the inflation, greater will be the interest rates. The reason being that the same money which is invested in things like commodities and various assets would not be able to fetch higher returns due to inflation
- The need for the Governments to borrow - the amount of program defined for government borrowing also helps in deciding interest rates. The higher the borrowing, more will be the interest rates.

V. CONTENTS OF CREDIT 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.

ADMINISTRATION OF CREDIT:

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.

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.

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.

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.

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.

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.

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.

Monitoring:

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

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.

Income Recognition and Provisioning:

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

Internal Controls:

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

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.

UNIT –V

Consumer Assessments: Credit Bureau, Credit Applications, References, Credit evaluation of borrowers, Collection procedure, Debit Recovery Tribunal, Writing off Bad Debts.

I. INTRODUCTION:

An accurate customer risk assessment will help you acquire the most profitable consumers while minimizing risk. For business-to-consumer companies, Experian offers consumer credit information, advanced scoring software, prescreening systems and application decisioning tools. For companies looking to acquire business customers, our business reports and public records, portfolio data and risk modeling tools allow clients to create comprehensive profiles of business prospects. Determine which businesses are well-capitalized and financially suited for customer acquisition.

Generally if the loan account is an overdue account, that is, when the borrower has committed default in repayment of loan amount with interest as per the dates specified in the loan agreement, then the banks have power to take the necessary steps against the borrower, which will result in the recovery of NPAs amount.

II. CONSUMER RISK ASSESSMENT TECHNIQUES:

The vast credit portfolio can be segregated into smaller groups such that priority attention can be focused on these, leading to initiation of result oriented steps. A credit manager while scanning the extent of risk attached to an asset looks at the period of time for which the asset is NPA.

1. Willful Defaulters:

Commercial Banks are required to report instances of willful default to RBI periodically RBI shall publish the same in their website. As per RBI guidelines, willful default is defined as follows: - "A willful default would be deemed to have occurred if any of the following events is noted."The unit has defaulted in meeting its payment repayment obligations to the lender even when it has the capacity to honor the said obligations.

2. Compromise Settlements:

A compromise is a settlement of disputes reached by mutual consent. It is a negotiated settlement with sacrifice components on all the parties to the dispute. It is a non-legal remedy for reduction of NPAs of the Bank. Negotiated compromise settlement is made to maximize the compromise amounts. Each Bank has to devise their own Recovery policy facilitating compromise settlement of dues in NPA account.

3. Write Off:

Write off is resorted to in the borrower accounts when the Bank has exhausted all possible avenues of recovery and there are no more chances for affecting the recovery. Write off is of two kinds. Prudential write off and regular write off.

Legal Measures:

4. Debt Recovery Tribunal:

One of the problems faced by banks is the low rate of loan recoveries. This has a bearing on the accounting standards as well as on current operations of banks. It is in this context the „Recovery of Debts‟ due to Banks and Financial Institutions Bill, 1993‟ was passed in August 17, 1993 that facilities establishments of Debt Recovery Tribunals for expeditions adjudications and recovery of debt due to any bank or financial institutions.

5. Corporate Debt Restructuring:

Corporate Debt Restructuring mechanism has been institutionalized in 2001 to provide a timely and transparent system for restructuring of the corporate debts of Rs.20 core and above with the bank and financial institutions. RBI has issued revised guidelines in February 2003 with respect to the CDR mechanism. Corporate borrowers with borrowing from the banking system of Rs. 20 crores and above under multiple banking arrangement are eligible under the CDR mechanism. As of March 31, 2003, 60 cases worth Rs.44, 369 corers had been referred to the CDR, of which 29 cases worth Rs. 29,167 corers have been approved for restructuring.

6. Credit Information Bureau:

Institutionalization of information sharing arrangement through the newly formed Credit Information Bureau of India Ltd., (CIBIL) is under way; RBI is considering the recommendations of the SRI year group to operationalise the scheme of information dissemination on defaults to the financial system.

7. Lok Adalat:

For simpler, quicker and cost effective disposal of cases, banks are approaching the system Lok Adalats are organized under Legal Services Authority Act, 1987 by the state and or district and

taluka Legal Services Committee. Branches should consult Local Legal Services Committee and IBA chapter, if necessary for organizing Lok Adalats.

Lok Adalat is a process of administering justice without resorting to courts. The award of Lok Adalat has the effect of a decree of a civil court and binding on the parties to the dispute. No appeal can be either of the parties. The maximum claim amount that can be dealt by Lok Adalat is Rs. 20lakh. SARFAESI Act 2002: Securitization and Reconstruction of financial Asset and Enforcement of Security tool in the hands of the dues there by reducing NPAs.

The Act has three segments –a) Securitization and Asset Reconstruction Companies b) Central Registry c) Enforcement of Security Interest.

III. CREDIT BUREAU:

A credit bureau is a data collection agency that gathers account information from various creditors and provides that information to a consumer reporting agency in the United States, a credit reference agency in the United Kingdom, a credit reporting body in Australia, a credit information company (CIC) in India, Special Accessing Entity in the Philippines, and also to private lenders. It is not the same as a credit rating agency.

Credit Information Bureau (India) Limited (CIBIL), India's first Credit Information Bureau was established by the Reserve Bank of India to improve the functionality and stability of the Indian financial system by containing non-performing assets (NPAs) while improving credit grantors' portfolio quality.
CIBIL is now promoted by Trans Union International Inc. (Trans Union) to provide comprehensive credit information by collecting, collating and disseminating credit information, pertaining to both commercial and consumer borrowers, to a closed user group of members.

RBI approved three other credit bureaus in 2010 – CRIF High Mark (earlier High Mark), Equifax and Experian[6][7]. The consumer credit scores in India range from 300 to 900.
High Mark launched India's first micro finance bureau in early 2011 & today operates the world's largest micro finance bureau besides offering traditional bureau services for the Retail lending industry. CRIF High Mark is India’s first full-service credit bureau serving all borrower segments – Retail, Agri & Rural, MSME, commercial and Microfinance.

CIBIL stands for Credit Information Bureau (India) Limited. It is India’s first Credit Information Company, which was founded in August 2000. After establishment, CIBIL played vital role in Indian Financial System. It helps in collection and maintaining records of Individual payment affecting loans and Credit Card. The member bank and all the credit institution submit their records to CIBIL on monthly basis. The information received from banks and credit institutions would be used to create Credit Information Report and Credit Score that are provided to credit institution to help in evaluation and approving loan applications.

Objectives of CIBIL

- ✓ It takes pride in having the topmost credit information sharing in India that makes enable the credit grantor in accepting payment and information backed decisions.
- ✓ CIBIL has gained knowledge, experience and expertise to offer data and technology backed solutions.
- ✓ Wide gamut solutions were developed diligently for helping our customers in making intelligent decision in entire stage of customer life cycle.

Functions of CIBIL

- ✓ The Consumer Bureau of CIBIL keep its dynamic information repository of India for providing its member comprehensive risk management tools
- ✓ Consumer Credit Information is important tool used by credit grantor at the time of new customer acquisition.
- ✓ Portfolio Review provides the credit grantor with a comprehensive view of their borrower’s credit relationships across multiple lenders.

IV. CREDIT APPLICATION:

Credit application processes are increasingly becoming faster and more automated as new financial technology systems emerge in the credit market. Technology allows lenders to offer borrowers varying types of credit applications that can be done either in person or individually. Regulation Z governs the disclosures provided in credit applications for borrowers and provides for consistency across all types of loans.

Technology also allows borrowers to complete a credit application completely on their own through an online application. Credit card applications are typically processed through an online credit application often providing the borrower with an immediate approval. Banks and

emerging fintech companies have also increased the online lending options available for borrowers. LendingClub and Prosper, are two of the largest online peer-to-peer lenders in the U.S. offering loans to borrowers through a fully automated credit application that requires no in person interaction. Banks have also followed this trend adding many new online lending services for both consumers and businesses.

Credit Application Processes:

Consumers and businesses have a growing number of providers to choose from when seeking credit. Beyond just traditional lenders and credit cards, borrowers also have the option to choose from many emerging fintech companies offering varying types of loans.

For borrowers who seek more personal interaction, traditional bank lenders offer branches across the nation with customer service representatives available to help borrowers in the lending process. Some banks even offer telecommuting services for discussing loans and completing a loan application over the phone. This type of service is part of the traditional bank model that includes more personal interaction in banking services. Typical loans that borrowers may seek to apply for in person can include bank lines of credit, mortgage loans, and home equity loans.

Credit Application Information

In all types of credit applications, the information requested is typically the same. A lending decision will be based on a hard credit inquiry which provides details on a borrower's credit score and credit history. In addition to credit scoring, lenders also base loan decisions on a borrower's debt to income. Mainstream lenders will typically look for a credit score of 650 or higher with a debt to income ratio of 35% or less. Each individual lender, however, will have their own standards for credit underwriting and credit approval.

Regulation Z

Regulation Z is legislation that governs the reporting of credit details to borrowers. This legislation was established as part of the Truth in Lending Act of 1968. It is enforced by the U.S. Federal Reserve Board and the Consumer Financial Protection Bureau. Regulation Z helps to provide consistency across credit disclosures. This consistency is expected to protect borrowers from being misled by creditors, while also helping borrowers to better understand credit terms and more easily compare products across lenders.

V. CREDIT EVALUATION OF THE BORROWERS:

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:

- ✓ Gathering Credit information
- ✓ Credit Analysis (credit worthiness of applicants)
- ✓ Credit Decision

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.

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.

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.

VI. 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.

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.

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.

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.

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.

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.

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.

VII. THE RBI DIRECTIVES ON ADVANCES:

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.

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.

Freedom To Fix Lending Rates:

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

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.

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.

Loans Under Consortium Arrangement:

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

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.

VIII. CREDIT COLLECTION PROCEDURE:

The picture that many people have in mind when they think about the stereotypical debt collector is a hard-hearted scoundrel of melodrama infamy, threatening to throw widows and orphans into the street because the rent is overdue.

1. Establish process. Your accounts receivable are your company assets. You need to choose the best process for managing your company's accounts receivable, but whatever method you choose, be sure that you: create a record of all sales and receipts, have a system in place for generating invoices on an ongoing basis, and keep close track of account balances, both current and overdue.

2. Create policies. Before you sign on your first customer, you need to have established your credit policy. This policy should cover your credit policies, accepted methods of payment, interest charges, etc. You should also establish clear billing policies, including billing terms and billing frequency.

3. Clear invoicing. This might sound basic, but you'd be surprised at how many startups neglect to have clear, itemized invoices for their clients. Invoices should include your business name, where to direct the payment, and contact information for billing questions. If you don't tell your customers how much to pay, and when, how can you expect them to pay?

4. Timely invoices. You should have a set invoicing schedule and send out your invoices, in the form of monthly statements, as soon as money is due. If you don't receive payment by the payment deadline, don't wait until the next billing cycle to send out an invoice reminder. Stay on top of your invoicing and send out an immediate reminder. If you're working on a big project for a client, you may want to set up a billing cycle rather than wait until the end for full payment. Statements also provide you with good documentation in the case that you need to ever send an account to a collection agency.

5. Proactively manage your accounts. Your accounts receivable process should include a regular review of accounts. This will help you to identify and manage aging accounts, those that are past due. Have a system in place to deal with those accounts that are 30, 60, 90, or more days past due.
Contact Early Growth Financial Services for help managing your accounts receivable and for other accounting and finance support.
6. Call. As with most business communications, a simple phone call can be the most effective means of communication. It's harder for your client to avoid payment when you have them on the phone.
7. Call again. Nobody wants to be a nudge, but sometimes one call is not enough. If you want to be paid, you need to be persistent. You've provided your product/services; now it's time for your clients to keep up their end of the bargain. Repeated calls are not a nuisance; they're the price of doing business.
8. Discounts for fast payment. Some companies will choose to offer customers a discount for fast payment as an incentive. If you decide to go this route, a token discount is plenty, say between 1-3% for payments received within 1-2 weeks of invoicing.
9. Use a collection agency. Some people believe in going to debt collection after 90 days. There are pros and cons to this (check out this article on 10 Tips for Entrepreneurs Thinking about Using a Debt Collection Agency). I believe that before using a debt collection agency, you want to make sure you understand the associated costs—both the financial costs and costs to your customer relations. That said, the longer a bill goes without paying, the less chance you have of it ever being paid.

VIII. DEBT RECOVERY TRIBUNAL

Debt Recovery Tribunals were created to facilitate the speedy recovery of debt payable to banks and other financial institutions by their customers. DRTs was set up after the passing of Recovery of Debts due to Banks and Financial Institutions Act (RDBBFI), 1993. A person or entity aggrieved by orders of the DRT can appeal against its orders to Debt Recovery Appellate Tribunal (DRAT). The DRAT will not entertain the appeal until such person deposits the 75% of the amount of debt so due determined by the DRT. In this article, we look at the Debt Recovery Tribunal Act, in detail.

IMPORTANCE OF DRT:

The main objective and role of DRT is the recovery of funds from borrowers which is payable to banks and financial institutions. The Tribunals power is limited to settle cases regarding the restoration of the unpaid amount from NPAs as declared by the banks under the RBI guidelines. The Tribunal has all the powers vested with the District Court. The Tribunal also has a Recovery officer who guides in executing the recovery Certificates as passed by the Presiding Officers. DRT follows the legal procedure by emphasising on speedy disposal of the cases and fast implementation of the final order.

DRT PROCESS

There are following procedure involved in making application to Debt Recovery Tribunal are as follows:

1. Procedure for filing of application

- ✓ The applicant should apply with the Registrar within whose jurisdiction the applicant is functioning as a bank or financial institution in the present.
- ✓ An application should be presented in the prescribed format.
- ✓ The application can be presented by the applicant or by his agent or by an authorised legal practitioner.
- ✓ The application to be presented to the registrar of the tribunal within whose jurisdiction his case falls or can be sent through registered post addressed to the Registrar.

2. Submission of application

- ✓ If the application sent by post to be deemed to have been presented to the Registrar on the same day of receiving the request by the registrar.
- ✓ The application should be presented in two sets. An empty file size envelops bearing full address of the respondent. The applicant should furnish full bearing address of each of the respondents.

3. Presentation and verification of application

The registrar or any other concerned officer authorised by him will approve every application on the date in which it is presented or deemed to have been filed under that rule and should sign the endorsement.
If on verification the application is found to be in order, it should be duly registered and give a serial number.

4. Issuance of original application number

- ✓ The Registrar of DRT is responsible for the Overall Administration of the tribunal.
- ✓ The Registrar will issue the Original Application (OA) number and summon after verifying the application. Also serves a copy of the application and paper book on each of the respondents. The respondent may file four complete sets indicating the reply to the application along with documents within one month (or extended time allowed by the tribunal) of its receipt.

Procedure Before Filing a Case in DRT

The following procedures are to be followed before filing the case in debt recovery tribunal.

- Sell pledged goods after addressing particular notice to the lender.
- In the case of hypothecated goods, get possession of the assets, and sell them after addressing the due in the form of notice.
- In the case of LIC policies, handover such policies and designate the surrender value towards the loan account.
- Set off the credit balance in any current or savings, account and TDRs in the names of the Borrowers or Guarantors, before filing a suit.
- Proof of ownership or debt such as shares, debentures, NSC, Mutual Fund Securities should be realised and be adjusted against the outstanding.
- Secure the documents or securities are enforceable against borrowers/guarantors while handling files to advocates for requesting Recovery Application before the tribunal.
- Brief the advocate accurately by providing a detailed narrative or write-up and by examining in detail the conduct of the account, documents received up to the date, securities created and other relevant information relating to the account.
- Analysis of the draft application to verify the correctness of every fact and relevant details stated in the draft application
- After verifying the accuracy of the draft application, the branch has to forward the draft application to the concerned authority for approval along with the copy of the memorandum for legal action in the account and the copy of the narrative or write-up provided earlier to the advocate along with the list of documents.
- After obtaining permission from the Authority, the Branch should discuss with the advocate about the changes or observations made by the appropriate authority while according approval and finalise the Application for recovery of updated dues of the Bank.

Procedure at Filing the Case in DRT

The following procedures are to be followed at the time filing the case in debt recovery tribunal.

- The Recovery Application, in the prescribed format, should be submitted with the DRT within the specified time from the day of the appropriate authority mentioned for approval against the legal action.
- Recovery Application should contain the description of all relevant documents and securities charged to the Bank.
- While filing Recovery Application, Xerox copies of records are to be produced to the Advocates.
- Original Documents should be maintained with the Branch till DRT requires the same.
- Interim reliefs such as the injunction against properties, attachment before judgement, the appointment of Receiver, Recovery Certificate for admitted dues should be appealed as a rule.
- Account Extracts to be provided and certified as per the provisions of Bankers Books Evidence Act and be annexed to the Recovery Application.
- Penal Interest should not be compounded.
- Costs for preserving the securities before filing suit and during the pendency of the lawsuit claimed.

Procedure After Filing the Case in DRT

The following procedures are to be followed after filing the case in debt recovery tribunal.

- If the Recovery Application filed is satisfied in all respects, ORT will issue a serial number and summons to borrowers or guarantors called defendants.
- Serving of warrant for quick disposal of the case and the Branch/Advocate should get to see that summons are served within one month.

- If the summons is served on the defendants, proceedings commence with evidence by way of affidavits filed by the bank followed by cross-examination of Bank's witnesses and vice versa followed by arguments ending up in Recovery Certificates in respect of the Bank.
- Evidence by way of affidavits as preceding, clarifications or reports excepted by the DRT should be filed in time, and no adjournment to be asked on this score. Reply to counter-claims made by the borrowers should be submitted without any delay.
- Defendants attempt to get an adjournment on various grounds including that their compromise proposal is pending consideration before the Bank's Advocate should oppose the Bank.
- The DRT has the controls to order arrest and detention in civil prison of those defendants who do not follow the specified orders of the DRT. Wherever the defendant disobeys the laws of the DRT, the Branch should notify the Bank's Advocate to appeal for arrest and detention of such defendant.

Execution of Recovery Certificate

The Presiding Officer finally grants Recovery Certificate and sends it to Recovery Officer (R.O.) for execution. On receipt of the Recovery certificate, the recovery officer can issue the notice to Certificate Debtors, giving 15 days for payment of the amount stated in the Recovery Certificate.

If the defendant neglects to pay the amount, Recovery Officer will proceed to recover the amount by any one or more of the methods, which are listed below:

- Attachment and sale of Movable or Immovable Property of the defendant.
- Arrest and Detention of the defaulter.
- Appointment of Receiver.
- The closing of DRT Application after full recovery of bank dues, the application is closed by Recovery officer.

IX. WRITING OFF BADDEBTS:

When money owed to you becomes a bad debt, you need to write it off. Writing it off means adjusting your books to represent the real amounts of your current accounts. To write off bad debt, you need to remove it from the amount in your accounts receivable. Your business balance sheet will be affected by bad debt

Banks prefer to never have to write off bad debt since their loan portfolios are their primary assets and source of future revenue. However, toxic loans—loans that cannot be collected or are unreasonably difficult to collect—reflect very poorly on a bank's financial statements and can divert resources from more productive activity. Banks use write-offs, which are sometimes called "charge-offs," to remove loans from their balance sheets and reduce their overall tax liability.

X. 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.

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.

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.

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.

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."

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.

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.