CHAPTER 5

Credit Monitoring and NPA Prevention

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Credit Monitoring and NPA Prevention

5.1 Hypothesis II And Its Background

Since credit monitoring is the most important part of the post sanction stage, the banks have put in place an effective post-sanction process to facilitate the efficient and effective credit management and to maintain a high level of standard asset. Most of the banks have installed multiple monitoring mechanism and inspection at different levels. For example, monitoring by branch managers or credit officer, audit by external agencies including RBI and CA firms, internal audit by head office, etc. Inspite of the multi-level monitoring system prevalent in the banks, fresh NPAs are added every year enhancing the risk of the loan portfolio. Weaknesses in credit appraisal and credit monitoring have been identified as major reasons for the accounts turning into non-performing assets (Vidwans H.P., 2001-2002). It needs hardly to be emphasized that unless slippage of standard assets to NPAs is effectively curbed, it is impossible to control and curtail NPAs to minimum possible level.

RBI has compiled from their inspections and time to time study and reported a number of lapses and deficiencies in the credit monitoring systems of banks and have suggested some measures. This study however did not attempt to relate the intensity of lapses in monitoring to the health of the accounts. Further no other systematic study covering many banks have been reported so far in this regard. This study, therefore, tries to identify the areas, in which lapses occur during the post-sanction stage of a loan account and link the intensity of lapses with the health of the borrower. For this purpose, the following hypothesis has been formulated.

Hypothesis II : Stricter credit monitoring will ensure the advances from becoming non-performing i.e., another way of saying that the lapses in credit monitoring will turn advances into NPA.

The text of this chapter is organized as- Section 5.2 describes the present credit monitoring system of banks, Section 5.3 describes the methodology used for testing the above hypothesis, Section 5.4 deals with the analysis and findings related to this hypothesis and Section 5.5 concludes.
5.2 Credit Monitoring System of Banks

Credit monitoring system of banks covers the following:

- Regular monitoring of credit accounts
- Identification of critical accounts and initiate preventive measures to protect them from becoming non-performing
- Handling of sub-standard accounts
- Compliance with audit requirement

Each bank has well-articulated policy directives for monitoring of accounts covering documentation, supervision and control over accounts, etc.

For effective credit administration, banks have different types of inspection/audit. These are:

- RBI inspection
- Regular inspection by controlling office (Head office/Regional office)
- Concurrent audit
- Stock audit
- Legal audit

5.2.1 Items covered under follow-up and monitoring of advances

The surveyed banks have the following components in their system for follow-up, monitoring and supervision of advances. These are briefed below.

a. Documentation

The various documents used by banks relate to – a) advances and its terms of sanction b) security and c) constitution and legal status of the borrower. The objective of proper documentation is to serve as primary evidence in any dispute between the bank and the borrower and for enforcing the bank’s right to recover the loan amount together with interest thereon, in the event of all other resources proving to be of no avail, through a court of law as the final resort. Hence, utmost care is taken by the branch in execution of documents to ensure that they are free from any flaw or defect and is legally perfect and enforceable.

Documentation is not confined to mere obtaining of initial security documents. It is a continuous and ongoing process covering the entire duration of an advance. It includes the following stages:
findings of such stock audit is immediately attended to ensure that the identified irregularities are removed.

g. Stock Statement Obtention and Review

The stock statement is one of the important documents by which the drawing power is ascertained against individual items of inventory. Borrowers are required to submit a stock statement every month as per the time frame stipulated in the sanction letter. The stock statement contains the description of stocks and their quantity and value. It also contains list of creditors and age-wise break up of Book Debt. The branches to arrive at correct drawing power position do a careful analysis of these statements.

h. Creation of Charge

When the borrower is a limited company or when the assets of a limited company is taken as security, a bank is required to file necessary charge with the Registrar of Companies (ROC) within 30 days from the creation of charge.

i. Search report

Once in two years a search is cast on the books of the company with the Registrar of Companies. Empanelled chartered accountants of the bank carry out this search. A copy of the Search Report is sent to the controlling office by the branch. The branch ensures that the bank’s charge has already been registered with the ROC. They also scrutinize whether the borrower has created or encumbered the same asset to some other bank/financial institution.

j. Creation of equitable mortgage

Equitable mortgage is created properly along with original title deeds, latest tax receipts and other documents as per legal opinion.

k. Hypothecation of machinery/vehicles/stocks etc.

All the securities offered by the borrower need to be properly hypothecated to the bank.

l. Monitoring of Borrowal Accounts

One of the most important aspects of post sanction monitoring is to keep a close watch on the performance of the credit limits. Branches are required to submit reports on the borrower performance monthly/quarterly (depending on the credit limit) to the controlling office. Any delay in the submission of these controlling returns by branches is viewed as a monitoring lapse. These returns contain detailed operational data of the borrowal accounts.
i) Pre-execution formalities comprising of – a. preparedness of correct opinion sheet about applicants and b. search reports.

ii) Execution of documents – It covers appropriate stamping and correct execution thereof as per terms of sanction of the advance and the internal directives of a corporate borrower such as Memorandum and Article of association, etc.

iii) Post-execution formalities

b. **Compliance of Sanction Terms**

Borrowers need to comply with the terms and conditions of sanction. Under no circumstances, the branch resort to disbursement without compliance of sanction terms.

c. **Reporting of compliance of terms of sanction**

Banks have a system of reporting compliance of terms of sanction on monthly basis by the branch to the sanctioning authority in case of regional office or head office sanctions. Such reporting is to be made within one month of sanction. If scrutiny of the report shows non-compliance in respect of any of the sanction conditions, the controlling authority initiates action.

d. **Legal Audit**

After release of limits, the branches subject the loan documents to the bank’s law officer wherever provided. If law officer is not available or not provided, the bank’s approved legal advisor peruses the documents and gives a legal audit report to be completed within 30 days from date of disbursement.

e. **Periodical Inspection of the Unit Financed**

There is a system of periodical inspection of stock, receivables, and immovable properties under charge to the bank. It is the responsibility of the branch incumbent in charge to ensure that the physical inspection of securities is distributed to the officers so that the securities charged are inspected regularly as per instructions in force or terms of sanction. The periodicity of inspection varies (quarterly, half-yearly) with respect to the rating of account, credit limit, etc. Any adverse feature noticed during inspection is required to be brought to the notice of the borrower for regularization within a time frame. If the requirement is not met, corrective measures like reduction of limit, suspension of operations in the account, recalling of advance, etc. are initiated.

f. **Stock Audit**

The banks also have a system of verification of the hypothecated stock through stock audit by a firm of auditors. Stock audits are normally restricted to larger accounts with say, limit of Rs.1 crore and above and is done at least once in every year and the
m. Regularization of ad-hoc sanctions/ excess drawings

Any excess drawings are vigorously followed up by branches for regularization at the earliest. The excess drawings that are allowed in the OD/CC accounts is promptly reported to the controlling office. Periodic balance confirmation or acknowledgement of debt is taken at least once in every year in all accounts. Any ad-hoc sanctions made is judiciously done within the delegated powers and is regularized within the stipulated time.

n. Insurance

Banks see that there is adequate insurance coverage on the Primary and Collateral securities, to cover all risks and for full market value.

o. Renewal / Review of Accounts of Accounts

As per RBI guidelines, working capital limits of Rs.10 lacs and above are reviewed / renewed every year.

p. End use of Funds

Care also is taken to detect any diversion of fund to other activities and/ or other associates / sister concern of the borrower or for acquiring long term assets or investment in shares. Such eventualities whenever detected is reported to the sanctioning authority immediately.

5.2.2 Deficiencies / Lapses in Credit Monitoring as identified by RBI

RBI has pointed out the following as common deficiencies at the monitoring stage.

i. Loans/ advances were released by the branch officials in blatant violation of the terms and conditions of the sanction laid down by the central office.

ii. No proper monitoring of the end-use of funds by the borrowers was noticed in a few cases. Cases of such diversion of funds in larger accounts was not reported to the Bank’s Board for their information and providing required direction in the matter.

iii. Monitoring of the company’s financial standing especially with reference to the financial indicators were not carried out effectively.

iv. Undue reliance on the certificates given by Chartered Accountants/ valuers without co-relating them with other relevant procedures was noticed. For example, in the case of projects under implementation, reliance was placed on the certificates without adequate monitoring of the progress of construction through
site visits. Similarly, in respect of certificates for verification of inventories, there was inadequate correlation of the figures with audited financial statements and also an inadequate follow up on the deficiencies reported.

v. There was also lack of proper monitoring even with regard to very important terms and conditions of the term loan sanction such as, tie up of funds, stipulation of promoter's contribution, etc. leading to disproportionate lending by banks.

vi. As regards working capital limits, failure to detect disappearance of stocks given as security had resulted in misappropriation of funds/sale of stock and realization of receivables without the knowledge of banks.

vii. Failure to ensure adequacy of the security offered by the borrowers, especially failure to verify whether the same asset was mortgaged to another bank was noticed.

viii. Periodical reviews of accounts were not undertaken after the funds were lent by the banks.

ix. Proper assessment of the financial standing of the projects was not carried out when the bank took over an account from another bank.

x. Excess drawings permitted by the Branch/Regional Office level functionaries in the borrowal accounts were ratified by the Head Office in a routine manner without examining the need for such permissions, at times, frequently.

xi. Limits sanctioned were allowed to be interchanged indiscriminately by the Branch officials without proper authority.

xii. In case pertaining to term loans for financing projects, important terms and conditions of the sanctions stipulated by the Board of Directors such as induction of technical directors, constitution of Audit Committees and independent project monitoring committees are not taken seriously. Many a times, non-compliance even at the stage of the release of the final instalment of the loan sanctioned is not taken seriously. This is a very serious lacuna, which cuts at the root of the principles of project management and project financing.

In addition to the above study, some of the banks have also conducted/compiled reports highlighting lapses in the monitoring of advances. We briefly state the content of the report of one bank in order to indicate the type of deficiencies unearth in the report and also quality of the works done at the bank level.

- Overdrawing in the accounts has been frequently allowed and some times overdrawing has been allowed beyond delegated powers.
• Disbursement made before receiving confirmation of sanctioned proposal.
• Head Office circulars/ guidelines regarding diversion of funds not adhered to.
• Non creation/ non-registration of charge on hypothecated stocks / fixed assets.
• LIC policy not assigned in bank’s favour.
• Execution of equitable mortgage not recorded in the title deed register.
• Insurance cover not available / comprehensive insurance has not been obtained/ policies not renewed/ under insurance.
• Sanctions/ allowing over-drawings beyond delegated power.
• First/ second pari-passu charge not created on fixed assets.
• Certificate of charge not obtained from the ROC.
• Credit report of borrower and guarantor not obtained.
• Document not filled up / signed properly/ not signed by the bank officials wherever necessary.
• Modification of charge with regard to creation of equitable mortgage not filed with ROC.
• Original title deeds not kept on record.
• Renewal/ review of limits made without removing existing defects/ irregularities, e.g. non-compliance of certain terms and conditions of sanction, diversion of funds, non-execution of joint documents etc.
• Credit reports are not reviewed at prescribed intervals.
• Delay in renewal of limits.
• Documents not renewed on time.

5.3 Measuring the Intensity of Lapses in Monitoring System
 – Methodology for Testing Hypothesis II

The intensity of lapses in the post-sanction follow-up and monitoring of advances have been examined using sixty-six loan cases. Eighteen credit monitoring parameters (listed in Appendix 3.4) have been identified from the loan documents and interview of the bank officials. Lapses in each parameter are unearthed mainly from the comments of the Inspectors/Auditors. Their comments, in respect of follow-up and monitoring of
advances by bank branches; has been noted from the head office Inspection Reports in order to note the frequency of lapses in these sixty-six cases (where comments are available). We assign value 1 when there is lapse in a particular parameter and 0 when there is no lapse in a particular parameter. We have run two regressions – 1) considering score of each of the 18 parameters as independent variables and current status as dependent variable and 2) considering total scores of each case as independent variable and current status as dependent variable. The total score reflects the intensity of the credit monitoring lapses in a particular case. Further, the study has used the $\chi^2$ test statistic to examine the relationship between the intensity of the credit monitoring lapses and current status (default or non-default).

5.4 Analysis and Findings

Analysis of the frequency of the independent variables reflecting the occurrence of lapse indicate that lapses are relatively more frequent in respect of documentation, insurance, stock inspection, renewal of accounts, etc. (Table 5.1) and lapses are relatively low in respect of charge creation, compliance of sanction terms, end use of funds, review of stock statement, ad hoc sanction recovery, credit report renewal, etc.

<table>
<thead>
<tr>
<th>Items where Lapses are recorded</th>
<th>Frequency</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Documentation</td>
<td>9</td>
</tr>
<tr>
<td>2. Equitable mortgage creation</td>
<td>4</td>
</tr>
<tr>
<td>3. Registration of charge with the ROC</td>
<td>7</td>
</tr>
<tr>
<td>4. Verification of securities</td>
<td>7</td>
</tr>
<tr>
<td>5. Search Report</td>
<td>5</td>
</tr>
<tr>
<td>6. Compliance of sanction terms</td>
<td>3</td>
</tr>
<tr>
<td>7. Collateral assignment</td>
<td>7</td>
</tr>
<tr>
<td>8. Submission of compliance certificate to controlling office by branch</td>
<td>25</td>
</tr>
<tr>
<td>9. Adequacy and timeliness of insurance</td>
<td>23</td>
</tr>
<tr>
<td>10. Proper record of stock inspection</td>
<td>23</td>
</tr>
<tr>
<td>11. Stock statement obtention</td>
<td>17</td>
</tr>
<tr>
<td>12. Renewal of account</td>
<td>24</td>
</tr>
<tr>
<td>13. End use of funds</td>
<td>5</td>
</tr>
<tr>
<td>14. Review of stock statement</td>
<td>3</td>
</tr>
<tr>
<td>15. Allowance of frequent overdrawings</td>
<td>11</td>
</tr>
<tr>
<td>16. Reporting of excess drawings</td>
<td>6</td>
</tr>
<tr>
<td>17. Recovery of ad hoc sanctions</td>
<td>3</td>
</tr>
<tr>
<td>18. Renewal of Credit Report on borrower</td>
<td>4</td>
</tr>
</tbody>
</table>
When these variables/parameters were regressed against the dependent variable i.e. current status (NPA and non-NPA), six variables have been found to be effective with explanatory power of 26.3% as shown in the Table 5.2.

<table>
<thead>
<tr>
<th>Variables</th>
<th>St. Beta</th>
<th>t</th>
<th>sig</th>
<th>Adj. R²</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>8.88</td>
<td>.000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Securities verification on record</td>
<td>-.385</td>
<td>-3.42</td>
<td>.001</td>
<td>.051</td>
</tr>
<tr>
<td>Insurance</td>
<td>-.360</td>
<td>-3.07</td>
<td>.003</td>
<td>.087</td>
</tr>
<tr>
<td>End use of funds</td>
<td>-.400</td>
<td>-3.46</td>
<td>.001</td>
<td>.145</td>
</tr>
<tr>
<td>Review of stock statement</td>
<td>.278</td>
<td>2.39</td>
<td>.020</td>
<td>.177</td>
</tr>
<tr>
<td>Ad-hoc sanction recovery</td>
<td>-.296</td>
<td>-2.56</td>
<td>.013</td>
<td>.228</td>
</tr>
<tr>
<td>Frequent overdrawings allowed</td>
<td>-.223</td>
<td>-1.95</td>
<td>.055</td>
<td>.263</td>
</tr>
</tbody>
</table>

As expected the sign of the co-efficient in case of five variables is negative indicating higher the lapses lesser the health of a borrower and higher is the probability of failure. Only in the case of the variable ‘Review of Stock Statement’, the sign was found to be positive which is unexpected. It has been observed that lapses are reported in three cases in respect of this variable and all the cases are healthy. Hence, there is a positive correlation in case of ‘Review of Stock Statement’. An interesting finding is that the variables, where lapses are frequent, have no explanatory/predictive power except Insurance, where lapses are high. On the other hand, variables which are significant are having less number of lapses.

When regression was conducted between total score and status, the regression model (Table 5.3) was not found to be effective and the score reflecting intensity of lapses has failed to explain the variation in the present status of borrowers.

<table>
<thead>
<tr>
<th>Variables</th>
<th>St. Beta</th>
<th>t</th>
<th>sig</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>-.115</td>
<td>5.0</td>
<td>.000</td>
</tr>
<tr>
<td>Total score</td>
<td>-.928</td>
<td>.357</td>
<td></td>
</tr>
</tbody>
</table>

The result has been further verified through chi-square test (refer to Appendix 5.1) which has accepted the null hypothesis of independence of the intensity of monitoring and the status/health of the borrower. The chi-square value which is 0.469 is not significant at 5% significance level (Table 5.4 in Appendix 5.1). This result must be interpreted with caution as number of lapses in a case is not very high. The highest number of lapses in a
particular case is at most 6 (out of 18). And both the npa and non-npa are on an average having same amount of lapses. In respect of lapses in monitoring both the NPA and non-NPA group appears to be homogeneous making the regression model ineffective.

5.5 Discussion and Conclusion

It can be inferred from the above analysis that lapses visible in the Inspection Reports no way signal the quality of the account and health of the borrowers. Probably the lapses which are not unearth by the inspectors could have signaled the health of the borrowers in advance. Simply, stricter monitoring of the parameters indicated in the minimum monitoring requirements of the bank may not lead to prevention of advances from becoming non-performing.

Sincere monitoring in respect of (a) verification of securities, (b) insurance cover, (c) end-use of funds, (d) review of stock statement, (e) recovery of ad-hoc sanctions and (f) frequency of overdrawings in the account (these variables are significant in the first regression model) may contribute to prevention of non-performing accounts to some extent. In view of the limited contribution of the above monitoring items, few other variables like monitoring of the company's financial standing especially with reference to the financial indicators, operations in the account and strategic standing of the firm should be included in the monitoring process. Validity of these items could not be ascertained in the study as they are not being included in the Inspection Reports from where the case-wise comments on monitoring variables has been taken.
Appendix 5.1

\( \chi^2 \) Test of Independence

We use the \( \chi^2 \) test of independence to ascertain whether there is any dependency relationship between two attributes. The \( \chi^2 \) test-statistic is defined as:

\[
\chi^2 = \sum \frac{(O_i - E_i)^2}{E_i}
\]

where \( O_i \) and \( E_i \) are the observed and expected cell frequencies.

The null and the alternate hypotheses in our case are:

\( H_0 \) : There is no dependence between intensity of credit monitoring and current status

\( H_1 \) : There is dependence between intensity of credit monitoring and current status

The intensity of monitoring (or frequency of credit monitoring lapses) has been categorized as High (low), Medium (medium) and Low (high) if number of lapses are 0-1, 2-4 or 5 and above. The current status, as mentioned earlier, has two categories i.e. default and non-default. Table 5.4 shows the observed and the expected frequencies along with the value of \( \chi^2 \). The hypothesis is tested at 5% significance level.

Table 5.4 : \( \chi^2 \) Test of Independence - Monitoring intensity & Health

<table>
<thead>
<tr>
<th></th>
<th>observed</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>High</td>
<td>Medium</td>
<td>Low</td>
<td>Total</td>
</tr>
<tr>
<td>npa</td>
<td>7</td>
<td>19</td>
<td>6</td>
<td>32</td>
</tr>
<tr>
<td>non</td>
<td>12</td>
<td>16</td>
<td>6</td>
<td>34</td>
</tr>
<tr>
<td>Total</td>
<td>19</td>
<td>35</td>
<td>12</td>
<td>66</td>
</tr>
<tr>
<td>expected</td>
<td>High</td>
<td>Medium</td>
<td>Low</td>
<td>Total</td>
</tr>
<tr>
<td>npa</td>
<td>9.21</td>
<td>16.97</td>
<td>5.82</td>
<td>32</td>
</tr>
<tr>
<td>non</td>
<td>9.79</td>
<td>18.03</td>
<td>6.18</td>
<td>34</td>
</tr>
<tr>
<td>total</td>
<td>19</td>
<td>35</td>
<td>12</td>
<td>66</td>
</tr>
</tbody>
</table>

\[
\chi^2 = 0.4697
\]

\[
\chi^2_{0.05.2,df} = 5.991
\]

The calculated value of \( \chi^2 \) is less than the critical value at 5% significance level and 2 degrees of freedom. Therefore, we accept the null hypothesis of independence between the two variables i.e. intensity of monitoring and health of the borrower.