Credit Monitoring in Banks: Effective Strategies

Deepak Narang & V S Kaveri

As per the Financial Stability Report of the Reserve Bank of India (RBI) of June 2015, gross non-performing advances (GNPAs) of scheduled commercial banks (SCBs) as percentage of gross advances rose to 4.6 per cent between September 2014 and March 2015. The restructured standard advances during the period also increased, pushing up stressed advances of these banks to 11-12 per cent of the total advances from 10.7 per cent.

Public sector banks (PSBs) recorded the highest level of stressed advances at 13.5 per cent of the total advances as at end of March 2015, compared to 4.6 per cent of private sector banks (PVBs). Thus, slippage in loan asset quality is on the rise, calling for strengthening the credit monitoring function in banks by observing due diligence in credit, and also by evolving best practices.

Thus far, bank branches are expected to undertake this function for all types of advances. However, realising their genuine difficulties in performing this function effectively due to shortage of staff, lack of skills at branches, etc., controlling offices are also involved in credit monitoring of high-value advances. In addition, the RBI has come out with a framework for management of stressed advances in banks in February 2014. The framework ensures effective handling of 'potential NPAs', also called as 'Special Mention Accounts (SMAs)'. This framework will supplement the present system of credit monitoring.

The present article discusses credit monitoring function based on the RBI guidelines, due diligence in credit, and best practices related to credit monitoring in banks.

Credit monitoring aims at ensuring compliance of terms of pre-disbursement conditions, keeping documents legally enforceable, end use of funds as per the loan agreement to prevent diversion of bank funds, security offered to the bank

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Sources of Information for Credit Monitoring

In order to ensure effective credit monitoring, it is essential to examine credit monitoring tools. At the ground level, we should periodically receive a certified statement of actual cost of the project from the borrower. The actual cost as per the certified statement submitted by the borrower should be compared with the projected statement of project cost to be incurred at each stage of the project. For cost overrun, if noticed, close monitoring is called for to prevent the account from turning into a NPA. In addition, site inspection of securities report is a very useful source to get early warning signals. Any erosion in the value of securities / negligence noticed on the part of the borrower to keep securities in order would be a matter of concern.

The project loans should be disbursed as per the periodical progress reports submitted by the borrower and subsequent site inspection done by the branch. In terms of mega projects, we should obtain a report from the auditor on capital expenditure incurred at each stage of the project to ensure the end use of funds. Besides site inspection, credit monitoring should be done by obtaining periodical returns and statements from the borrowers, including stock statement and book debt statement, monthly select operational data (MSOD) / quarterly information system (QIS), half-yearly operating statement, credit audit report in eligible cases and concurrent audit report/transaction audit report. In addition, there are other sources of information for credit monitoring.

These are internally available to the bank, which include ledger account/ statement of account of the borrower, monthly control return indicating the account-wise loan sanction and amount outstanding, branch inspection report/ risk-based internal audit report of the branch, stock audit report in respect of high-value advances, long form audit report (LFAR) of the statutory auditor, annual RBI inspection report / RBI risk-based supervision report, periodic search report from ROC, annual review report prepared on a borrowal account at the time of renewal of cash credit limit, SMAs report, list of potential NPAs/stressed advances, etc. In addition, banks should obtain a list of debtors of the borrower to ascertain timely realisation of book debts. Here, we can compare sales realisation with the turnover in the account and enquire reasons for poor turnover.

One such reason for poor turnover may be that the borrower has opened a current account with another bank wherein the sales proceeds are deposited. Similarly, the bank should receive a list of major suppliers of raw-materials to ensure the end use of bank funds. We should detect those cheques which are drawn in
favour of parties not related to the borrower’s business under the RTGS environment to prevent diversion of funds. Further, from the statement of debtors, we can confirm whether bills discounted are deducted from the list of debtors.

Similarly, while calculating drawing power (DP) based on stock statement and stock inspection, we should ensure whether advances received against orders for goods are deducted to arrive at DP. Letters of Credit (LCs) should be deducted from the total inventory. More importantly, month-wise purchases and sales should reasonably be reflected in the borrower’s ledger account/statement of account to prevent diversion of funds. In this regard, banks should insist on the auditor of the borrower firm to certify, among other items, sources of funds, funds brought in and end use of funds.

**Early Warning Signals**

The aim of this section is to provide a list of major early warning signals (EWS) noticed from the scrutiny of banking operations, which are reflected in the borrower’s ledger account/statement of account, stock statement, MSOD, QIS, half-yearly/annual financial statements, site inspection reports, minutes of loan consortium meeting, etc.

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<tr>
<th>Check Point</th>
<th>Likely Reason(s)</th>
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<tr>
<td>1. Unusual debit entries</td>
<td>Diversion of funds</td>
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<td>2. Unusual credit entries</td>
<td>Borrowing from outside</td>
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<td>3. Frequent return of cheques</td>
<td>DP shortfall</td>
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<td>Shortage of working capital</td>
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<td>4. Frequent return of bills</td>
<td>Low quality of products</td>
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<td>Slackness in market demand</td>
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<td>Accommodation bills</td>
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<td>5. Frequent overdrawing</td>
<td>Shortage of liquid funds</td>
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<td>Decline in sales</td>
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<td>Low realisation from debtors</td>
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<td>Payment to creditors</td>
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<td>Withdrawal of funds for own use</td>
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<td></td>
<td>Incurring cash losses</td>
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<td>Building inventory for speculation</td>
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<td>6. Low turnover in the account</td>
<td>Sales proceeds through another account in other bank</td>
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<tr>
<td>7. Frequent transfer to an account</td>
<td>To project higher DP so as to match with credit outstanding</td>
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<td>not connected with business</td>
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<tr>
<td>8. Non-submission, delayed submission</td>
<td>Not achieving projected level of business, poor MIS</td>
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<td>of stock statement/MSOD</td>
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It is difficult to develop an exhaustive list of EWS. However, in the appendix, an attempt has been made to provide a list of major EWS as per sources of information available at the branch level.

**Due Diligence in Credit and Preventive Action**

Branches have to observe due diligence in credit both at pre-sanction and post-sanction stages. By doing so, it is possible to notice early warning signals and undertake preventive action. In this respect, a checklist of items of due diligence in credit based on loan policy, RBI and bank-specific guidelines and best practices followed in banks is prepared for the benefit of branches.

**Pre-Sanction Stage**

- **Compliance of KYC norms:** It should be ensured that all borrower accounts are 100 per cent KYC-compliant.

- **Scrutiny of loan application, credit reports, IT return and other documents submitted by the borrower:** The scrutiny of these documents helps to verify genuineness, authenticity and accuracy of financial data relating to business activity of the borrower and details given in the asset-liability statement of the firm and promoters/guarantors. This exercise would also help in tracing the assets of borrowers/guarantors, even if not charged, in case the account becomes a NPA. To ensure good quality and full scrutiny of the documents as part of credit appraisal, every bank should develop a checklist of items to be seen especially for project loans, infrastructure projects, CRE, NBFCs, manufacturing units, etc.

- **Market report:** This assists to ascertain sources of the borrower to bring in margin money and market reputation. In particular, an in-depth analysis of the market report is needed to assess managerial/technical/commercial/economic viability status of government approvals/clearances, pollution control/environmental clearances, other business players in the market, global/industry/market scenario, status of securities offered vis-a-vis credit limits applied, confidential report from existing bankers, etc.

- **Pre-sanction visit report, search for CIBIL report, willful defaulter list of the RBI, search report from ROC, and pre-sanction visit to the business premise/residence of the borrower is a must to know occupancy status, ownership status, valuation and credit worthiness of the borrower. A search for CIBIL report/willful defaulter list of the RBI confirms whether the borrower is not a defaulter of any other bank or financial institution. It also talks about the status of existing charges, if any, on securities offered to the bank before sanction/disbursement.**

- **Legal opinion/index inspection/non-encumbrance certificate (before and after sanction):** Enough care has to be taken while considering immovable
properties as security to avoid any chance of receiving forged/fake title deeds.

- **Valuation report of the property/assets offered as security – frequency and periodicity of valuation:** From the valuation report, it should be ensured that inflated values are not considered while accepting property as security and realistic approach with regard to realisable market value is assessed in case a need arises. Branch managers (BMs) should ensure that the value of assets charged to the bank is fairly stated to recover the amount due to the bank. There should be two independent valuation reports for all properties of high value, say Rs 5 crore and above.

- **Assessment and bank ability of the proposal:** BMs should ensure compliance with appraisal standard/parameters relating to assessment of funded and non-funded limits, RBI/bank-specific guidelines, credit rating of the borrower, etc.

- **Disposal of loan applications within the time framework:** All loan applications are to be dealt on individual merit and disposed of within the prescribed time-frame by the bank. BMs must ensure uniformity and transparency while dealing with credit proposals. The role of middlemen and arrangers should be discouraged to ensure quality of lending.

- **Pre-disbursement audit:** This is done to ensure compliance of sanctioned terms and conditions, including documentation and creation/filing of mortgage. Disbursement should be made only after compliance of the said guidelines.

### Post-Sanction Stage

- **Acceptance of terms and conditions of sanction:** Borrower’s written acknowledgement of having accepted terms and conditions of sanction is of vital importance at the time of initiation of recovery proceedings. This must be obtained and kept on record.

- **Documentation and legal compliance certificate:** The security documents are primary evidence of the grant / release of credit facility to the borrower. BMs must ensure that all required documents are executed by the authorized person and accurately filled. BMs must ensure that all charges are filed / registered with the appropriate authority. Branches are required to submit legal compliance certificate with regard to compliance of terms and conditions of the sanction, creation/filing of bank’s charge with ROC, etc. Incomplete documents become an obstacle in the recovery of bank dues. It must be ensured that documents don’t get time-barred and are kept in a safe place, preferably in the strong room.

- **Vetting of security documents:** Security documents duly executed must be vetted from the bank’s legal counsel and zonal/regional inspectorate as per the bank’s guidelines. In addition, in respect of high-value advances, second
stage vetting should be done by an independent advocate on the bank's panel, other than the advocate who had done the first vetting.

- **End use of funds**: BMs should ensure that funds are released for the purpose for which the loan has been sanctioned. Else, the borrower may siphon off the bank's funds for other purposes/activities not related to the main business, leading to persisting irregularity in the account and migration of the account to NPA category. Therefore, monitoring of the end use of funds is a must for term loan, working capital finance, etc. Term loan must be disbursed as per schedule approved by the bank and actual progress/implementation of the project. Borrower's contribution must be received first before disbursement. In case of cash credit limits, if sanctioned along with the term loan, it must be disbursed only when the unit starts commercial production. The bank's name must be prominently displayed at the business place of the borrower. Lender's engineer report has to be obtained for project loan where the amount is substantially large, say Rs 10 crore or more or the total cost of project is Rs 25 crore or above, with term loan component not being less than Rs 10 crore. This ensures the end use of funds. Also, a chartered accountant other than that of the borrower company is expected to certify at quarterly intervals that there is no diversion of funds and the borrower has brought in his contribution as per the schedule approved.

- **Insurance of securities/assets charged to the bank**: The assets charged to the bank need to be adequately insured against all applicable risks to protect the bank's securities and the bank's lien should be duly registered with an insurance company. Renewal of the insurance policy is equally important. Cover should be obtained for the full value of the security. Maintenance of quality of assets charged must be ensured.

- **Registration of equitable mortgages**: BMs should ensure timely registration with the concerned authorities.

- **Stock audit**: This is mandatory for high-value advances of say Rs 10 crore and above and should be conducted on a quarterly basis by a CA's firm or approved technical consultants. From the stock audit report it is possible to know deficiencies, if any, in quantity, quality and value of stock hypothecated to the bank.

- **Regular monitoring of operations in the borrower's account**: All high-value debit operations in the account must be verified to see payments related to business activity of the borrower. Similarly, credit operations should be seen to ensure that sale proceeds are routed through the account. It must also be ensured that interest, payment of bills, LC/BG for supply of raw materials, and term loan installments are paid in time.
Information system – offsite monitoring: An information system for the purpose of offsite follow-up of advances comprises stock statements, MSOD, QIS, statement of debtors/creditors, cash flow statement, quarterly/half-yearly/yearly financial statements, etc. to monitor the level of production and sales achieved vis-a-vis projections submitted at the time of sanction of credit facility. Segregation between paid and unpaid stock/age-wise break-up of debtors and creditors and also quality of stock in terms of obsolete and new stock must be done to arrive at the exact drawing power.

Periodical inspection/unit visit report: Onsite inspection assists to verify level of activity, capacity utilisation, present condition of assets charged to the bank, availability of raw material and spares, and power supply or any other issues that may affect the business activity/running of the unit. It must be ensured that goods are properly stored and the warehouse is well-maintained. Periodicity of visits should be as per the bank’s guidelines. In general, monthly visits are suggested for accounts of trade/industry showing warning signals and classified as sub-standard assets. Quarterly visits may be carried out for standard assets of trade/industry accounts.

Others: Branches should submit periodical statements related to loans and advances to the controlling office. Rectification of irregularities as pointed out in the report of branch inspection, concurrent audit, statutory audit, regional manager’s visit, etc. should be done in time and the controlling offices should be reported accordingly. Branches should ensure timely renewal of cash credit limits and revival of securities.

Credit Audit

In the context of early warning signals, credit audit report is a very important tool. In terms of the RBI’s guidelines, banks are expected to conduct credit audit in respect of high-value advances, say of Rs 5 crore and above. This is done internally by those executives such as inspectors who are not involved in credit sanction to the party concerned. It is performed immediately after loan disbursement to ensure due diligence in respect of documentation, disbursement, etc. However, a credit auditor is not to question credit decisions. Credit audit helps in identifying deficiencies, if any, in documentation, disbursement, etc. From the study of credit audit report, early warning signals, if any, in the account shall be noticed. Such signals include deterioration in the quality of credit portfolio of the bank, deficiencies in observing due diligence in credit and regulatory compliances, decline in the quality of credit portfolio, diversion of bank funds, etc.

A bank shall takeover any borrowal account from another bank by observing norms as stipulated by the RBI. In this regard, credit audit report is expected to comment on deficiencies, if any, observed in the fulfillment of takeover norms such as conduct of pre-inspection, presence of report of regional office and branch on the account to be taken over, rating of the account being satisfactory, change in
the lenders by the borrower during the last three years, in-principle approval by
the Board before takeover, no enhancement to take place in credit limit within six
months from takeover, etc.

Credit audit becomes very essential in respect of Letter of Credit (LC) whose
report is helpful for the purpose of credit monitoring to find out any deficiencies
observed in opening a LC. While going through the borrower’s LC file, a credit
auditor should look into the issue of LC as per approved purpose, presence of
relevant documents such as original invoice/order copies, bill of exchange,
certificate of origin for import LCs, market report, cash flow statement, etc.,
monitoring of the actual performance vis-a-vis the given cash flow, earmarking of
limit in case of LC, stock statement submitted along with a separate declaration of
goods procured under LC along with creditors, incidences of development of LC
in the past 12 months, proper hedging arrangement and LC issued pending
regularisation of devolved LC.

Management of SMAs: RBI’s New Framework for Credit Monitoring

There are several warning signals that shall be noticed by a lender. These may
include delay in submission of stock statements/MSOD/QIS or financial
statements, delay/ non-review of credit facilities based on audited financials, actual
sales/operating profits falling short of projections by 40 per cent or more, reduction
of drawing power (DP) by 20 per cent or more after stock audit, evidence of
diversion of funds for unapproved purposes, drop in internal risk rating, etc.
Wherever such one or more warning signals are noticed in advance, it is called as
Special Mention Account (SMA), which is a new sub-category in the standard
assets’ category. SMAs should be classified further into three categories: SMA-0,
SMA-1 and SMA-2. In respect of these SMAs, principal or interest payment is not
overdue for more than 30 days, between 31-60 days and between 61-90 days
respectively.

It is mandatory for banks to report SMA status in the above categories to the
Credit Repository of Information on Large Credit (CRILC), RBI on a quarterly
basis for loan amount of more than Rs 5 crore (loan amount outstanding) and
more than Rs 1 crore (debit/ credit balance) in the current account. However, in
respect of SMA-2, reporting to CRILC should be done immediately, within a week
starting with the 61st day. There are certain advances which are exempted from
reporting, which include crop loan, inter-bank lending, and offshore branch
providing credit. The largest lender/ the second-largest lender or bank with escrow
accounting arrangement will be responsible to report SMA-2 to the CRILC
immediately. It is also mandatory to form a Joint Lenders Forum (JLF) for SMA-2
accounts with outstanding credit of more than Rs 100 crore within 45 days. Lastly,
it is equally compulsory for JLF to prepare a corrective action plan (CAP) within
45 days of JLF formation.
For preparing CAP for the identified SMA-2 accounts, members of JLF have to examine one of the three options. These include:

(i) **Rectification**: Here, the borrower promises to regularize the account by bringing in additional funds and this action does not call for any change in the original loan agreement. However, the borrower should furnish an undertaking in this regard and JLF is expected to monitor it.

(ii) **Restructuring**: This option applies to eligible corporate debt restructuring (CDR) and non-CDR cases. In respect of CDR cases, it is expected that the sanctioned debt restructuring package should be implemented within 120 days and 150 days for less than Rs 500 crore and more than Rs 500 crore respectively. Regarding non-CDR cases, the process of implementation of the sanctioned restructuring package should be completed within 105 days for less than Rs 500 crore and 135 days for more than Rs 500 crore respectively. For CDR cases of more than Rs 500 crore (loan amount outstanding), techno-economic viability (TEV) should be recommended by an independent evaluation committee (IEC) and approved by JLF within 45 days.

(iii) **Recovery**: If the above two options i.e. (i) and (ii) are not possible, recovery process should be recommended. In the larger scheme of things, loan compromise shall be thought first. If not possible, legal action shall be taken which includes filing suit with the Debt Recovery Tribunal (DRT) and serving notice under Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002. For any default in compliance of the mandatory requirements i.e., reporting of SMA status to CRILC, formation of JLF and preparation and implementation of CAP within the prescribed time limit, the RBI imposes penalty on the concerned bank, which is in the form of accelerated provisioning for loan assets. By now, the RBI SMA framework has been in existence for more than one year and it is found to be very useful for banks to monitor SMAs and to arrest slippage in loan asset quality.

**Conclusion**

In this article, an attempt has been made to discuss credit monitoring of borrowers' accounts, which aims at obtaining signals of incipient sickness or loan default as early as possible and arrest slippage in the quality of loan asset. There is a need to strengthen credit monitoring taking into account the steep rise in the number of NPA accounts. But there are numerous issues associated with credit monitoring. To elaborate, with shortage of staff at branches, it is becoming difficult to meet small borrowers more frequently for cash recovery. This also applies to mega projects wherein implementation does not take place in time due to unforeseen events, including court cases. Therefore, they become non-performing right at the stage of implementation of the project.
The present shortage of staff at branches is now under the consideration of banks, which are in the process of increasing staff strength. Banks have to send reminders to borrowers before loan installment is due through SMS, telephonic alerts, etc. Another issue relates to verification of end use of bank funds when the cheques are cleared for payment at a central place under CBS environment and not at branches. To overcome this problem, a senior officer may be placed at the central server who can contact the branch in case of any doubt about the end use of funds, and clear cheques accordingly. Along with these arrangements, it is necessary to create awareness on importance of credit monitoring and fill up knowledge and skill gaps. Towards this end, banks have to pay sufficient attention to training and education in related areas.

References


Appendix

Sources of Information and Early Warning Signals

Stock Vérfication

- By comparing a stock statement of the borrower with a stock register, it is possible to ensure whether stock position as declared by the unit is in accordance with the books of accounts. If there is a major variation, a signal is thrown. In case of large borrowers, verification of stock includes stock kept at the factory premise, finished stock at the sales depots of the company, raw materials sent to outsiders for conversion or processing and stock in transit. Besides the physical verification of stock, it is necessary to examine the purchase price of raw material as indicated in the invoices, position of stock in process and finished stock as on the given date duly certified by the production manager, and pricing policy of the company and methods of valuation of stock adopted. Any major variation in stock value as per the stock statement on one hand and books of accounts on the other gives an indication of misappropriation of stock. The physical verification of stock ensures the end use of loans. If the stock is found to be inadequate, it indicates that the funds are not fully utilised for the agreed purpose.

- If the stock statements are deliberately not submitted for a long time, it shows that a major portion of the stock may not exist.
If the company has taken dual finance from two different bankers on the same stock, it indicates the dishonesty of the borrowers.

It is difficult to ensure the quality of the stock. However, if there is no movement of a major part of finished goods, it shows that the stock is outdated and not saleable.

Removal of the bank’s board stating that the stock has been hypothecated indicates that the unit does not want to disclose its dealings with the bank.

Study of Ledger Data

Poor turnover in an account indicates that either sale proceeds are being routed through the other bank or have, in fact, been dropped.

Each time cheques are drawn for a large and round amount, post-dated cheques and frequently issued in favour of those parties not related to business need to be examined carefully. A dialogue with the borrower could be initiated to find out the cause and to take remedial steps.

Devolvement of Deferred Payment Guarantee (DPG) installments and Letter of Credit and non-payment within a reasonable period.

Frequent invocation of bank guarantees (BGs) and non-payment within a reasonable period. The bills account reveals bills’ transactions of the business. Frequent return of bills may mean that the borrowers’ goods are being rejected by the purchasers. When the bills are received back, the borrower is promptly advised that the same have been returned by the collecting branch for the reasons "payment not forthcoming" and that he should replenish his account forthwith. Often, banks are more worried about the conduct of the bills’ account and not the reasons for non-payment.

If there has been irregularity in the account for a long period, it indicates that outflows are in excess of inflows of cash.

If there are no operations in the account during a part of the year, it indicates that the company has stopped working during that period. This is a signal for ascertaining reasons for inactive operations in the account.

The behaviour of the account during the year would help us in getting the signal. The actual drawings should be related to the business requirements. It is expected that the company normally requires more funds during the busy season. It is also expected that the company has to maintain minimum level of stock and, therefore, it requires less funds all through the period. Any variation in these expectations would throw a signal.

If there is a heavy withdrawal of cash, banks may consider the same as a signal of sickness.
Scrutiny of Periodical Statements

- Poor financial performance in terms of declining sales and profits, cash losses, net losses, erosion in net worth, etc.
- Book debts remaining in the books for a long time.
- Shortage of working funds.
- Unsatisfactory position of equity.
- Diversion of short-term funds for long-term use.
- Building up of unproductive assets.
- Unhealthy accounting practices, discussion with the borrower.
- Major breakdown in plant and machinery.
- Labour strike.
- Change in management.
- Sudden death/illness of partner/director.
- Disputes among partners/directors.
- Frequent reconstitution of the firm/board.
- Frequent requests for enhancement of limits, market reports.
- Recession in industry.
- Unfavourable position of the inputs.
- Unsatisfactory reports about the party.
- Sharp fall in prices.
- Unfavourable changes in government policy as regards imports, exports, price fixation, etc.
- Routing transactions to other banks.

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