Banking Baatein: T.R. Radhakrishnan

The author is an ex-bank manager and now a Banking & Management consultant with three decades of experience in the banking sector. He is also a facilitator for DRT and SARFAESI Acts and also a HR Trainer for corporates, colleges and schools undertaking various workshops on various subjects. He is based in Indore. His contact details are: Mobile: +91-9229248048, Email: trrk1941@gmail.com; radhakrishnan1941@gmail.com

IS COLLATERAL SECURITY NECESSARY FOR BANK LOANS?

The quick answer to the headlined question is NO. In this article I will try to explain why although it is true that many bankers still ask MSMEs for collateral security when they approach banks seeking loans for their businesses. Perhaps, the discussion here will help you to deal with bankers better.

The concept of "Social control" in the banking sector was introduced by the Government of India for the first time in 1967 and with that in view, the Banking Regulation Act, 1949 was amended. The steps taken by amending the Banking Regulation Act were, however, not found to be sufficient by the government. The study group of the National Credit Council headed by Dr. D.R. Gdgil favoured nationalization of banks. The then Deputy Prime Minister and Finance Minister declared in the Parliament on December 14, 1967 that the government has decided to have effective social control over banks.

Consequently, through a Presidential Ordinance in 1969, 14 major commercial banks having deposits of not less than Rs 50 crore as on June 30, 1969 were nationalized and subsequently The Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 replaced the ordinance. The purpose of nationalization of banks, as set forth in the Preamble of the Act was to control the heights of the economy in conformity with the national policy and objectives and for matters connected with or incidental thereto.

The banks are regulated and controlled by the Reserve Bank of India and the Central Government. Section 7, Reserve Bank of India Act, 1934 empowers the Central Government to issue such directions to Reserve Bank, as it may, after consultation with the Governor of the Bank, consider necessary in the public interest. Thus the Central Government may exercise control over the banks by issuing directions to Reserve Bank of India. Hence Reserve Bank directives and instructions are mandatory.

1990 saw the banking reforms initiated by the then finance Minister Dr. Manmohan Singh and the first Narasimhan committee report were placed. The reforms continued and the second report also came into existence. With the banking reforms, the perception of lending also changed. The advent of nationalization and social reforms saw the constitution of such committees as the Tandon committee, the Chore Committee, the Nayak Committee etc which changed the perception of bank lending. The reforms introduced the concept of purpose-oriented lending from security-oriented lending and introduced

prudential norms, credit monitoring norms, credit assessment norms, off the Balance Sheet norms, on the Balance Sheet norms, future derivatives etc. In consonance with the objectives of Nationalization and National interest particularly national economy and socio economic development, the banks are expected to take a proactive role to encourage developmental activity and social welfare schemes by way of innovative and creative lending. They are to gear up their resources to meet not only national challenges but also to tap the global opportunity to keep up their competitiveness and quality.

The introduction of purpose-oriented financing reduced the importance of collateral security because under this the repayment of debt and servicing of interest etc are to be met out of the earnings of the units. Hence the assessment of financial requirements also changed along with the reforms. Besides meeting social needs, the need to develop the economy was also being felt. Originally, before the reforms, the lending was purely based on security aspect of lending which meant that only the affluent section of society alone was able to avail of bank finance. Hence, the whole economy was controlled by that section leading to concentration of wealth among the affluent few. The reforms changed the entire concept and made finance available to entrepreneurs belonging to the small and medium scales also and also for those who do not have any security to offer.

Any project finance consists of two vetting two aspects, namely, the project's economic viability and its technical feasibility. Whereas the technical feasibility

depends upon the infrastructure available which includes logistics and marketing, the economic viability is based on the earning capacity and the repayment capacity of the enterprise. The achievement of result depends upon how the factors of production are utilized effectively and efficiently to realize the objectives of the enterprise. The bank while assessing the technical feasibility and economic viability takes into consideration the various factors including the risk factor to arrive at the quantum of finance. After satisfying all aspects only do they sanction the eligible limits.

There are primarily two types of facilities in project finance. The first is the term loan for acquiring the assets connected with the implementation of the project which comes under the category of fixed assets or block assets. The other is the working capital finance to run the unit on a day to day basis. Since the bank is not expected to finance 100% of the cost of the project, a margin is stipulated depending on the project which is to be brought by the promoters by way of capital investment and working capital margin. This is promoters' stake in the business.

The most important aspects of term financing are as follows:

(a) Debt Service Coverage Ratio (DSCR) which is an indication whether the unit will be able to repay the loan with interest over the stipulated period of repayment,

(b) Break-Even Point which will show whether the unit will start creating surplus cash generation to meet their financial commitment of repayment of term loan and servicing of interest in terms of capacity utilization and sales.

(c) Sensitivity Analysis which will show whether the unit can absorb price fluctuations and if so, to what extent.

(d) Debt-equity ratio will give the investment ratio of the promoters and the financial institution.

(e) Total outside liability to Tangible Net Worth will show the ratio of total indebtness.

(f) Cash Flow Analysis will give the sources and uses of finance indicating cash surplus or deficit

The bank after satisfying all the aforesaid aspects and making sure that the enterprise can pay back the term loan without any difficulty, then sanctions the term loan. Thus the repayment is out of the earnings of the enterprise. When the bank is sure of the adequate cash generation, the Bank need not take any collateral security to secure the loan.

The working capital is governed by the daily needs of the unit and any short fall in working finance will affect the performance of the unit. The bank also should

ensure the continuous flow of adequate and appropriate working capital on a regular basis to run the unit without any impediments. The working capital is primarily assessed based on any of the following methods or combination of methods.

(a) The Inventory Method.

(b) The lending Method.

(c) The Turnover Method.

(d) The Cash Flow Method.

Thus the bank sanctions the various facilities for the implementation and smooth running of the unit only after satisfying themselves that the objectives will be achieved without any impediments. The question of security to secure the loan does not come at all. What is to be ensured is the performance of the unit. Banks' responsibility does not end with the sanction of loans. Another important responsibility and duty of the bank is to monitor the conduct of the account for which various methods have been devised by introducing controlling statements and systems and procedures which if followed diligently and effectively can quickly detect any signs of deterioration and steps should then be taken immediately to arrest the trend and rectify it. This comes under credit monitoring. Besides, quarterly review of the accounts is also undertaken. The

performance of the unit is assessed on a quarterly basis and any short comings found will be rectified by timely action in consultation with the borrower. Further bank has the responsibility also to educate their customers.

If the unit does become sick due to any unforeseen circumstances, steps can be taken by the banks to nurse the unit back to health by adopting rehabilitation schemes. Repeated rehabilitation schemes are also available.

The Reserve Bank of India has formulated various schemes to suit the different needs of the banks to monitor the credit and rehabilitate the sick units. In this connection, various circulars are being issued by RBI and updating the circulars every year. The purpose of issuing such circulars is to inform the banks the importance of helping the borrowers who are the backbone of the economy and of the nation and creators of employment potential and contributors to GDP. It also means that the bank has to take all possible steps to help the borrowers in the time of their distress and recovery of debts through legal means shall be the last resort after exhausting all means as directed by the Reserve bank of India through their various circulars. But taking into account how the bank approaches their debt recovery, there need to be a thorough reorientation of their approach and mindset so that their attitude becomes more lending and borrower friendly.

Considering what is stated above, the bank cannot justify their condition of taking collateral securities and taking drastic action under the Securitization Act without understanding the problems and predicaments faced by the borrowers especially

at the time of crisis which are beyond their control like the recent global meltdown and finding solutions to solve them.

Links to Bondia's articles in previous issues:

http://www.fisme.org.in/newsletters/July_1_2012/docs/Banking_baatein.pdf