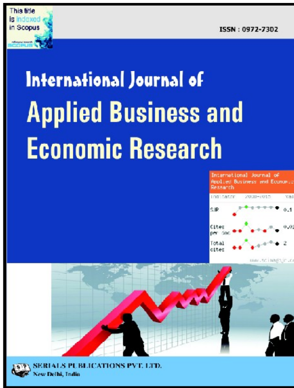

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Critical Analysis of Credit Policy Parameters adopted by Banks - Working Capital Loans and Borrowers' Perceptions

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Abstract: Bank Credit is the leading source of institutional finance. While giving loans, every bank follows a credit policy. This policy is a framework of the guidelines, rules and regulations the bank must observe in sanctioning or declining a loan request. Working capital loans provided to organizations working in agriculture sector, small and medium enterprises as well as large corporates form a major chunk of loans approved by banks. These loans are the resources invested in the current assets of the organization and are required for meeting day to day running expenses by the business. As such, all types of loans are given to the borrowers on the basis of the bank's credit policies.

Credit Policies are the backbone of the entire lending process of a bank. The quality of the loan portfolio depends on the type of credit policy adopted by the bank. These policies can be lax or stringent. In case the policy adopted by the lender is too lenient, number of borrowers and hence volume of portfolio does increase but there is always a chance of greater delinquencies and rising non-performing assets. On the other hand, if the policy adopted is too rigorous, size of portfolio and spread earned by the lender can come under pressure, though the portfolio built would be healthier. Hence every lender tries to frame and implement policies which strike a balance between perceived risks and expected returns while keeping in mind the expectations of the borrowers.

However, looking at the intangible nature of banking services, making an evaluation of borrower perception about credit policy parameters and service quality becomes difficult. Yet, all banks recognize the importance of these intangible factors and try to incorporate them into their policies despite pressures placed on margins. This paper is an attempt to study the policies adopted by banks for working capital loans and the perception of these policies by the borrowers. Data has been collected from 395 respondents with the help of a structured questionnaire. The study infers that the policies should neither be too stringent nor too lenient but should be so designed that the quality of the portfolio is optimized.

Keywords: Credit Policy parameters, working capital loans, asset quality.

INTRODUCTION

Finance is the lifeline of every business. It is required for starting of a business, day to day running of the business as well as for growth and expansion of the business. Loans availed from banks are the leading source of institutional finance. These are required for various purposes and include retail loans, agricultural loans, small and medium enterprises (SME) loans and corporate loans.

Retail Loans include unsecured loans (personal/business loans) and secured loans (education, vehicle and housing loans). Secured loans are those in which a security has been provided while in unsecured loan no security exist and loans are given on the basis of past credit history, bank statement and income analysis of the borrower by the bank.

Agricultural, SME and Corporate loans include fund based limits (term loans, working capital loans) and non-fund based limits (letter of credit, bank guarantee). Fund based limits are those in which there is immediate outflow of funds from the financers side but in non-fund based limits, release of funds is postponed, depends on occurrence or non-occurrence of an event and is therefore a contingent liability on the financer.

Term loans are taken for purchase of equipment or machinery and are given for a tenor of more than a year while working capital loans are given for running of a business and are generally renewed on a yearly basis. In addition to the above, agriculture loans also include commodity based finance. Commodity finance is a type of funding based on a receipt issued by a warehouse where the commodity is stored. The warehouse receipt contains the price, quality, quantity of commodity stored amongst other information and becomes the basis of finance. Unsecured business loans are also provided for any other requirement of borrowers.

While giving these loans, every bank follows a credit policy. This policy is a framework of the guidelines, rules and regulations the bank must observe in sanctioning or declining a loan request. These policies include overall credit guidelines, credit appraisal techniques, credit terms and recovery and collection policies of the bank. Credit guidelines relate to the type of desirable loan portfolio to be built by the bank. Credit appraisal entails checking the credit worthiness of the consumer by the lender. Infact, the entire lending process commences from the time a consumer walks into a bank for availing a loan and culminates with the closure of the loan availed by repayment from the borrowers' side and regular monitoring for credit and financial risk from lenders side.

All the public and private sector banks provide loans to consumers on competitive terms. Consumers also visit/interact with a number of lenders and study the various parameters on which the loan is being provided. The main credit parameters and areas of interest include fees being charged, rate of interest being offered, instalment/ interest to be paid, tenor of the loan, security to be provided, documentation requirement. They also ascertain how much loan they can get and how soon the facility can be sanctioned

The financers also assess the credit worthiness of the customers by using varied techniques to understand the capacity of the client to avail and repay the loan, his credibility and genuineness from market sources. Some of the parameters scrutinized by the lenders are nature of business activity, duration for which the entity has been in the line of business, financial position and net-worth availability, track records of loans availed as well as banking history, security which can be provided for availing the loan, industry in which the client operates and the risk attached with that industry.

Despite the similar set of conditions for availing a loan and due diligences undertaken from financer's side, the customer settles on a single financer. Yet, willingly or unwillingly, loans are not paid on a regular basis and level of Non-Performing Assets (NPAs) in banks has been rising. The incidences of switching banks, first payment default, bouncing of instalments, wilful default, one time settlements, enforcement of security and the like have been on the upswing.

While increased competition between banks and hence offering better credit terms and services to a customer and recessionary impact on economy could be reasons for switching banks and occasional irregularity in payment, there could also be a link between the borrowers' experience with the bank while the banks were building the portfolio and the ultimate portfolio built by the bank. Many times, just to attract borrowers, promises and false commitments are made by lenders which are later not fulfilled. This leads to disgruntled borrowers. While there could be genuine reasons for default like loss in business, recessionary pressures on the economy, personal problems of the promoters, it might also be possible that dissatisfied borrowers show their resentment by not repaying their dues to the bank.

This research will endeavour to find the linkage between the credit policies adopted by select private sector bank for borrowers availing working capital loans, borrowers' perceptions about these credit policies and the impact on the asset portfolio quality of the banks. This can help in better service and retention of clients by banks thereby reduce cost, NPAs and the provisioning which goes with it; increase profit, Capital Adequacy Ratios and goodwill of the bank and finally assist in better Asset Liability Management by the Bank.

LITERATURE REVIEW

As per D. Subbarao (2013), banks are the dominant players in Indian financial system, constituting 63% of market share of financial assets. They are the major source of working capital required by both individuals and firms and working capital is that part of current assets which exceed current liabilities and is known as net working capital.

As per Bhunia, (2010) working capital is a critical point of concern while taking financial decisions as it is that component of investment in assets which requires appropriate financing. Gitman, (2000) also observed that working capital is financed by a combination of long term and short term funds. Long-term sources of funds comprise of capital and long-term debt, which provide for a relatively small portion of the working capital requirement and the rest of it is met from the short term sources.

For providing these working capital funds, all banks undertake credit appraisal of the borrowers. Credit Appraisal is a process to ascertain the risks associated with the extension of the credit facility and is carried out by the financial institutions which are involved in providing financial assistance.

Sathya Varathan & others, (2012) opined that credit appraisal is an important activity carried out by the credit department of the bank to determine whether to accept or reject the proposal for finance. Banking includes working capital, working capital cycle, methods of assessment, compilation of credit reports and working capital management. Agri, SME and corporate loans are mainly in the form of working capital loans. Methods that are used by the banks in order to calculate these loan limits are Turnover method, Maximum Permissible Bank Finance (MPBF) system and Cash budget system. For this, the financial

statements are taken, profit and loss account and balance sheet are analysed and the firm's financial performance is assessed through ratio analyses.

According to Jass Ram Yadav, (2013) credit appraisal is a process of collecting related information of customers and projects to undertake risk assessment exercise by the bank prior to providing any loans & also check the technical, economical & financial viability of the project proposed. It also includes verification of primary & collateral security available for recovery of such funds being lent to the customer. Credit Appraisal thus ascertains the risks associated with lending functions in banks. It is generally carried out by the banks which are engaged in providing finance to its customers.

This credit appraisal undertaken by the bank therefore tries to ensure that the portfolio built by the bank is healthy, has negligible non performing assets and hence profitable. These bank level factors of credit appraisal and their impact on asset quality were studied by some researchers. Berger and Deyoung (1997) conducted a study of US commercial banks during the period 1985 to 1994 and found evidence in support of the fact that poor credit appraisal skills and credit monitoring practices of a bank, were expected to lead to higher non performing assets in future. This was called the 'bad management hypothesis'.

Williams (2004) applied Berger and Young's hypothesis to European banks between 1990 and 1998 and also found support for 'bad management hypothesis'. His study concluded that compromise in rigorous credit appraisal though led to decrease in cost, resulted in diminishing loan quality and hence profit efficiency as well.

Podpiera and Weill (2008) tested similar hypothesis on Czech banks from 1994 to 2005, a duration marked by a number of bank failures. These failures were related to increases in non-performing loans and deteriorating cost efficiency of banks, thereby supporting 'bad management hypothesis'. They therefore concluded that deterioration in cost efficiency preceded increases in non-performing loans.

Louzis, Vouldis, and Metaxas (2012) studies the determinants of non performing loans in Greek banking sector during 2003 to 2009. They examined three different loan categories - consumer, mortgages and business loans separately. They found that macro-economic variables like lending rate, GDP growth rate, unemployment rate, and sovereign debt as well as bank specific variables like cost inefficiency and performance had a strong effect on level of non performing loans thereby supporting 'bad management' hypothesis of Berger and Deyoung.

Nancy Arora & others, (2013) during their study also felt that it is necessary to appraise the credibility of the customer in order to mitigate the credit risk emitting from non-repayment of the credit obtained by the customer of a bank. Therefore, proper evaluation of the customer needs to be performed by measuring the financial condition and the ability of the customer to repay the loan in future.

Arpita Ghosh (2014) was of the view that lax credit appraisals and monitoring in banks due to poor management quality leads to higher NPAs.

In addition to the above, many studies were of the view that economic condition also impact credit policies and thereby the health of the portfolio built. Borio & Lowe, (2002) found during the course of their study that poor quality assets created during the boom period of economy become visible in the form of non performing assets during the recessionary phase of the economy.

Jimenez and Saurina (2005) found evidence of credit terms becoming lenient during economic boom both in terms of loan appraisal as well as collateral requirements, which translates into soft credit policies. Their study revealed that during boom time, banks accepted loss making projects as credit errors were judged leniently. Further, increasing bank competition in such times results in lenient credit terms. Another reason for lax policies is also the fact that during boom times, bank employees go for excessive credit growth as managerial rewards which improve their social standing and position, are growth driven. Also, the learning experiences from a bad loan are forgotten with the passage of time. Therefore bank managers expand their loan portfolios forgetting to avoid risky borrowers.

They also found evidence of a positive relationship, though lagged, between rapid credit growth and future NPAs. Higher NPAs create an adverse effect on bank profitability and capital adequacy, thereby negatively affecting the lending abilities of the bank. This tightens bank credit which further accelerates the unfavorable impact of business cycle on the economy. When the economy sees such a downturn, value of collaterals and strength of balance sheets fall and since banks rely on these for granting credit, bank credit also shrinks. Shrinking of bank credit slows down the economy even further. This turns into a vicious cycle impairing the ability of the borrowers to repay/borrow and the ability of the banks to grant credit.

Quagliariello M. (2006) examined around 200 Italian banks from 1985 to 2002 and confirmed that it is interaction between banks specific characteristics like cost efficiency, risk taking ability, and credit growth as well as macro-economic factors like interest rates and GDP growth which drives non performing assets and provisioning.

Espinoza and Prasad (2010) examined 80 banks in GCC banking system over 1995 to 2008 and found non performing loans to increase with interest rates and risk aversion on account of tightening global financial conditions. They also found firm specific factors like cost efficiency, credit growth and size of capital to affect non performing loans and the feedback effect of such loans on growth to be strong, but short-lived.

Some researches also showed that quality of service provided to the borrower also impacted the portfolio quality. Suresh Chandar, (2002) found that the relationship between service quality and customer satisfaction in Indian banking sector were independent but closely related. Hence better the service, lesser would be the likelihood of default leading to better asset portfolios. K. Ravichandran, (2010) also concluded in his study that increase in service quality of the banks can satisfy and develop customer satisfaction which ultimately retains valued customers and hence builds healthy portfolios.

Shashidhar M. Lokare, (2015) was of the view that in a bank-based economy, sound health of the banking system is imperative for efficient financial intermediation in the context of overall financial viability and growth. In the post- global crisis period, the Indian banking system, has witnessed growing weakness in asset quality. Sectoral analysis has shown rising incidence of loan defaults in majority of the sectors across bank groups. Considering the weakening economic backdrop and global trends, going forward the asset quality could come under greater strains, impacting the soundness of banks as also the macro financial stability. Therefore, in order to remain profitable and financially viable, banks would have to focus on their asset portfolio quality.

OBJECTIVES

The main objectives of this research paper are:

1. To study the credit policy parameters adopted by select banks while approving working capital loans.
2. To evaluate the perception of borrowers regarding these credit policy parameters adopted by banks.
3. To suggest changes in policy parameters implemented by banks with a view to improve asset quality of the portfolio.

RESEARCH METHODOLOGY

Data for the research has been collected through both primary and secondary sources.

For the primary data, a survey was undertaken of 395 borrowers who had availed working capital loans from select private sector banks under study. These include ICICI Bank, HDFC Bank, Axis Bank, Yes Bank and Kotak Mahindra Bank. Descriptive and Conclusive Research Design has been used for this research. Data has been collected by using Stratified Random and Judgemental sampling techniques with the help of an undisguised structured Questionnaire. Suitable parametric and nonparametric techniques have been used to study the impact of credit policies on asset portfolio quality built by banks.

Secondary data has also been analyzed to study the working capital norms and processes used by banks under study. Publications of various researchers in similar field have also been studied.

OUTCOME & ANALYSIS

As seen in the literature review and based on our study of the select banks, we have considered the following credit policy parameters that are considered by prospective borrowers.

1. Main product schemes offered under working capital finance: These include Bank Overdraft, Cash Credit, Term Loan, Bill Discounting, Letter of Credit, Bank Guarantee, Export Packing Credit, etc.
2. Borrower Categories: The working capital loans are given to borrowers working in any of the following patterns: sole proprietorship, partnerships and private or public limited company. Most of these categories are offered loans till their main promoter/director attains the age of 65 years.
3. Maximum Loan Amount: Depends on the product availed. It is bank specific.
4. Tenure of the loan: It depends on the scheme opted for. The duration for Overdraft facility and Cash Credit is 12 months and the facility is renewable at the end of this term. Renewal of the account depends on maintenance of good track record and submission of fresh financial documents. Term loans are for 5 or 7 years depending on the purpose it has been availed for. Non fund based facilities like Letter of Credit/ Bank Guarantee are for a span of 12 months.
5. Security: In overdraft facility, residential /commercial /industrial property is taken as security while in case of cash credit facility, charge on current assets i.e. stocks and debtors supported

with commercial / residential / industrial property is considered. For term loans, asset financed is the primary security. Additional securities, where the primary security is not sufficient or for additional comfort is also taken by banks.

6. Repayment: For overdrafts and cash credit facilities, the interest on the outstanding loan amount is payable monthly while for term loan, repayment is done through fixed equated monthly installments called EMIs.
7. Fees Charged: Depends on loan amount or non fund based services being availed by a client and is bank specific.

From the bankers perspective, they also study the safety and liquidity of the money lent, spread being earned by them, security offered by the borrower and margin available to them, purpose of loan as it should be income generating and not speculative in nature. They are also governed by government directives and policies issued from time to time while giving these loans. In addition, the following parameters are also considered as they affect the asset quality of the banks and have been studied.

1. Vintage of the business
2. Nature of the business and the industry in which it operated
3. Financial performance of the borrower
4. Track Records of any loans availed in the past
5. Banking history to check financial strength and repayment behavior
6. Security being offered by the borrower should have a clear title and be marketable.

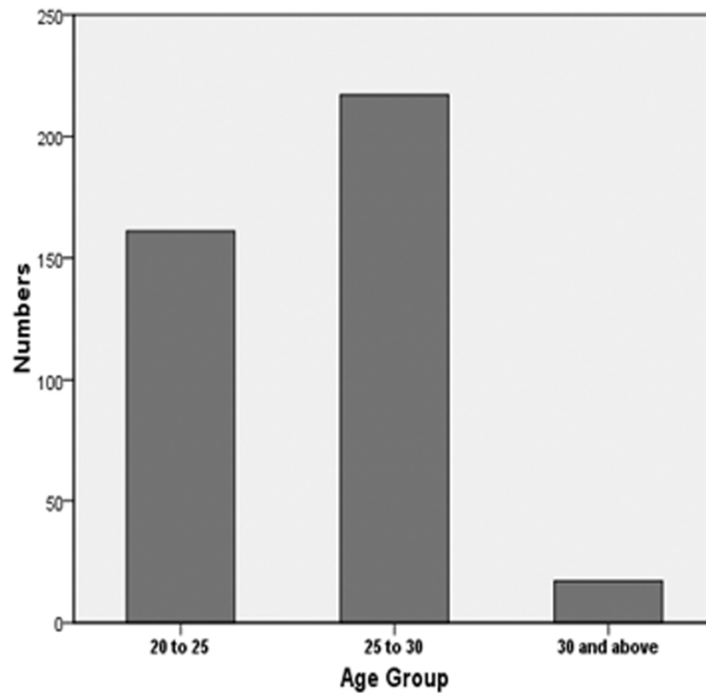

Chart 1: Age Profile

Responses from 395 borrowers were collected and studied. 161 respondents (40.8%) were from the age group of 20–25 years, 217 (54.9%) from 25–30 years and remaining 17 (4.3%) were in the age group of 30 and above. On the basis of gender, 300 of the respondents were males and 95 were females. As regards marital status, 331 of the respondents (83.8%) were unmarried and only 64 (16.2%) were married and from educational qualification perspective, 269 or 68.1% were graduates and 126 or 31.9% were post graduates.

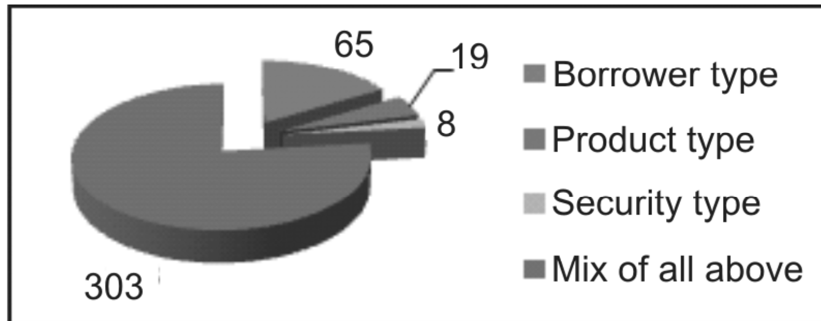

Chart 2: Loan Scheme basis

When the respondents were asked whether the loan scheme should be based on type of borrower, product, security or a mixture of all the three criteria, 76.7% felt it should be a mixture of all the criteria depending on borrowers' choice as against 16.5% opting for borrower type and 4.8% for product type (prevalent parameters). As regards the question whether a maximum loan limit should be prescribed 79% of the respondents (312 in number) felt that a maximum limit should be there while only 21% (83 in number) felt that it should not be there. The borrowers felt that if there was a maximum limit, more number of borrowers could be accommodated by banks which have limited amount to lend.

On the issue of margin or borrowers contribution in the loan and whether it should be based on risk attached with type of borrower, income of borrower, product being offered to borrower or security being

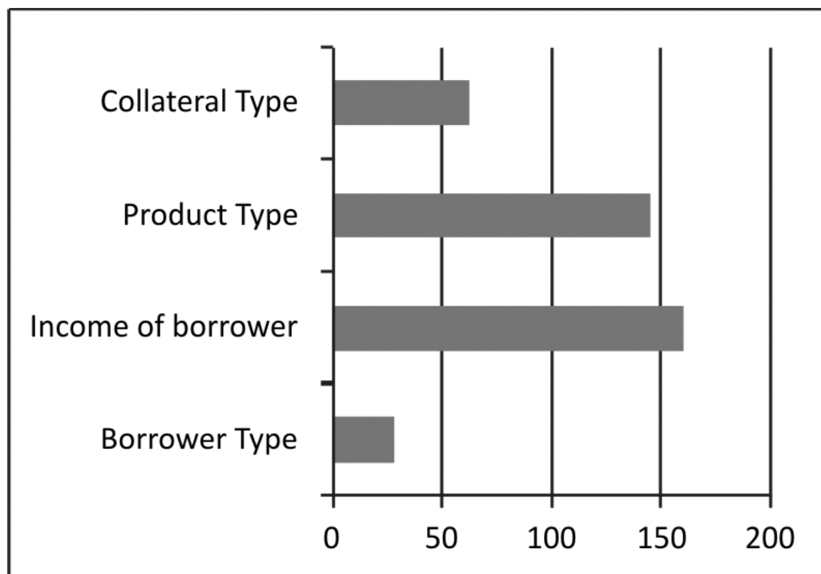

Chart 3: Margin – Risk Association

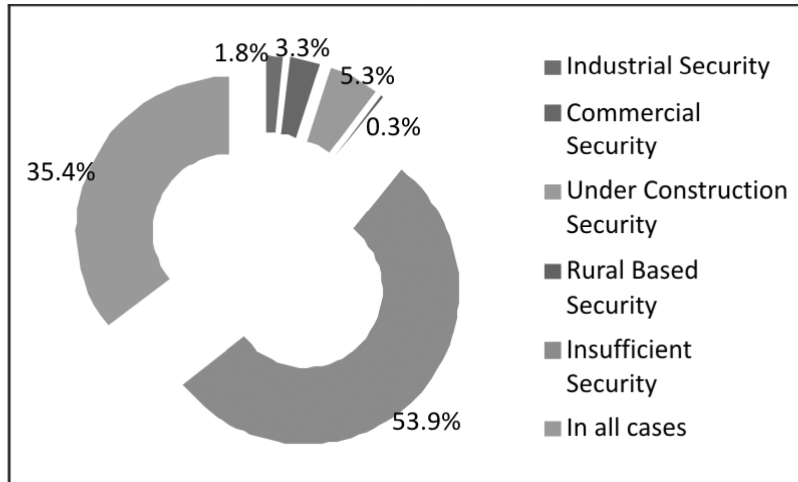

Chart 4: Primary security nomenclature & Additional security

provided, 40.5% or 160 respondents felt it should be borrowers income based and 36.7% or 145 respondents were of the view that it should be linked to the product offered. In other words, risk should be associated with income of the borrower as ability to repay and NPAs are related to financial health rather than any other criteria. Carrying on in the same vein, 91% or 359 respondents felt that additional collateral security and guarantors can be insisted upon by bankers and only 9% or 36 respondents felt, such conditions should not be stipulated by banks. However, 213 or 54% of the respondents felt that this should be resorted to only in case the primary security was insufficient to cover the loan. 35.4% of the respondents were comfortable in providing additional security in all cases. 88% of the respondents also held the opinion that if the primary security for whatsoever reason is not marketable or its value is very volatile/ fluctuating as in agricultural commodities, then also additional security can be insisted upon. This analysis shows that borrowers do not mind giving additional security for getting working capital loans, as long as they could get the loans and also do not want to be being classified as NPA account holders as this will adversely impact their future credibility.

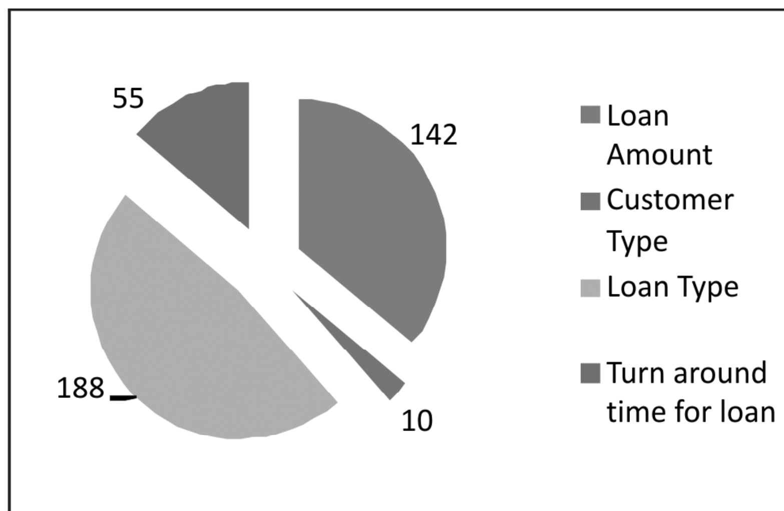

Chart 5: Basis of charging Processing Fees

As regards basis of charging processing fee on loans, 47.65% felt that it should be based on loan type while 35.9% felt it should be on loan amount sanctioned and only 13.9% felt that it should be linked to the turnaround time taken to sanction a loan. The remaining 2.5% felt it should be customer specific in nature.

The bankers also study seven parameters regarding viability of a proposal viz. safety, spread, security, liquidity, purpose, income generation & government guidelines. The rank of these in order of importance on a scale of 1 to 7, 1 being highest & 7 lowest, follows the following pattern: Safety being the highest followed by Liquidity, then Income Generation, Purpose, Spread, Security and Government Guidelines.

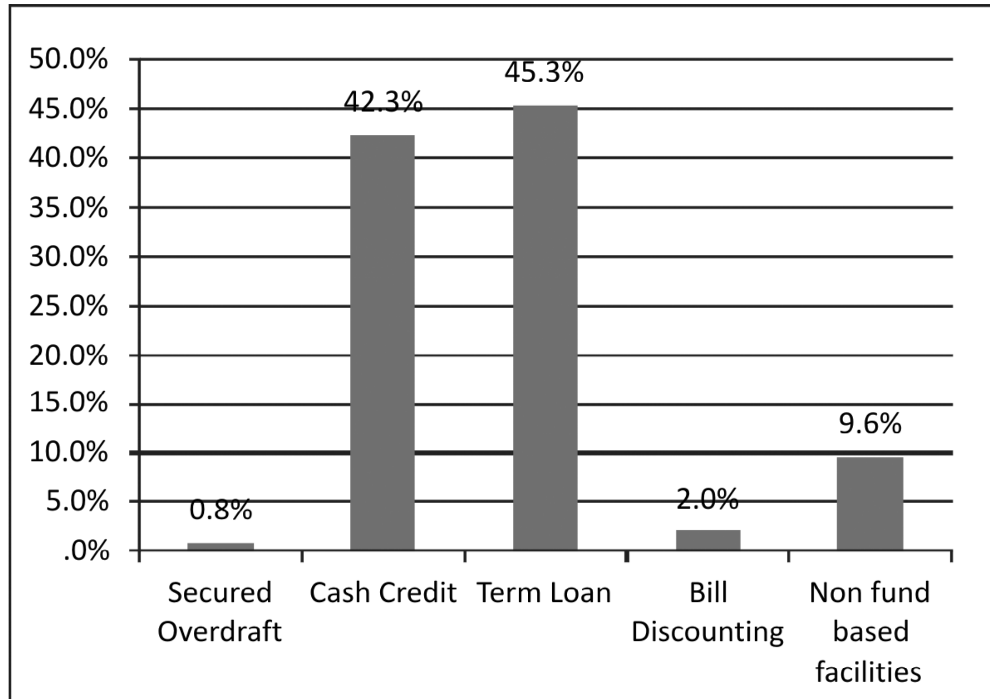

Chart 6: Contribution to NPA

Further, as regards the working capital facility that should be given to borrowers initially, the study shows that Secured Overdraft (54.2%), followed by Term Loans (34.4%) and finally Cash Credit (8.1%) should be given. In order of popularity, 1 being most popular and 5 being least popular, Term Loan was the most popular, followed by Cash Credit, Secured Overdraft, Bills Discounting and Non Fund based facilities like LC & BG in this order. As regards contribution to NPAs in a portfolio, Term Loans were ranked the highest (45.3%) followed by Cash Credit (42.3%), Non Fund based facilities (9.6%), Bills Discounting (2%) and Secured Overdraft (0.8%). On the basis of the above, Secured Overdraft facilities should be given to borrowers in the initial stages as their contribution to NPAs is negligible and it is also backed by a security. In the current day scenario, post demonetization, where the position of current assets (debtors & stock) which back Cash Credit facility is questionable, Secured overdraft facility appear a logical choice.

The parameters that affect the asset quality of banks were also analyzed and it was found that the ranking from the highest to lowest was as follows: first, financial performance of the borrower at 70.1%; second, track records of any loans availed in the past at 63.5%; third, banking history to check financial

strength and repayment behavior at 47.8%; fourth, security being offered by the borrower should have a clear and marketable title at 47.3%; vintage of the business at 36.5% and nature of the business and the industry in which it operates at 23.8%.

During this study, we have also looked at all the credit parameters studied by the borrowers and the bankers in context of the following four hypotheses:

1. Age of the borrower effects the parameters under study
2. Gender of the borrower impacts the parameters under study
3. Marital Status of the borrower impacts the parameters under study
4. Education Level of the borrower impacts the parameters under study

However, on applying non-parametric test (Chi Square Test) between the above four criteria and credit parameters studied, no significant relationship was found except between gender of the borrower and whether minimum loan should be prescribed so as to manage loan portfolio and NPAs. Hence age, gender, marital status and level of education do not impact the borrowers' perception about credit parameters, nor does it impact bankers' assessment of their asset portfolios.

SUGGESTIONS & CONCLUSIONS

Credit policies parameters selected by banks while approving working capital facilities of borrowers definitely impacts their perception about the banks. This in turn affects the quality of the loan portfolio being built by the respective banks. To build healthy and profitable portfolios some of the points that can be considered by banks are given hereunder.

Currently the loan schemes being offered are product specific and derive all their salient features and unique selling propositions therefrom. However, the loan scheme being offered should be tailor-made for a client's requirement so as to include a judicious blend of borrower-product-security combination.

The margin or own contribution to be brought into the loan depends on the loan to value ratio of the security or as specified in the loan scheme being offered. However, borrowers' contribution in the loan should be linked to his financial standing as the risk of default is also associated with income of the borrower and his ability to repay the loan.

Additional collateral security and guarantors are presently insisted upon by bankers only in case the primary security is insufficient to cover the loan being approved, the primary security is not marketable or its value is very volatile/ fluctuating as in agricultural commodities. However, borrowers do not mind giving an additional security or providing guarantees which are jointly and severally liable as borrowers for getting working capital facilities.

As regards processing fee, it is currently charged on the loan amount sanctioned. However, it should be linked to loan type as amount of due diligence required and risk is attached with the nature of loan being provided.

Secured Overdraft facilities should be given to borrowers in the initial stages as their contribution to NPAs is negligible and this facility is also backed by a security. Further, post demonetization, debtors are

stagnant and stock is slow moving, and as these current assets back Cash Credit facilities. Therefore, secured overdraft facility becomes a logical choice.

Many banks follow scorecard system for appraisal of loans. These scorecards can be built taking into consideration hierarchy of scores of the following parameters:

i) financial performance of the borrower
ii) track records of loans availed
iii) banking history and repayment behavior
iv) security being offered
v) vintage of the business
vi) nature of the business and the industry in which it operates

Finally, an incentive based scheme should be designed by RBI for banks to recover NPAs and maintain healthy portfolio.

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