

S S Mundra: Banker-borrower interplay – synergies & challenges

Inaugural address by Mr S S Mundra, Deputy Governor of the Reserve Bank of India, at the “Bankers-Borrowers-Business Meet”, organized by the Associated Chambers of Commerce and Industry of India (ASSOCHAM), New Delhi, 23 March 2015.

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1. Shri A.C. Mahajan, Chairman, BCSBI; Shri M. Narendra, Chairman, Assocham National Council for Banking & Finance; Shri Ashvin Parekh, MD APAS LLP; other dignitaries on the dais; colleagues from the banking fraternity; members of Assocham; representatives of the print and electronic media; ladies and gentlemen! Let me begin by complimenting ASSOCHAM for flagging an issue that is so relevant and contemporaneous for the banking industry. Banks face immense challenges in the area of management of loans and advances in view of the mounting non-performing assets. These challenges exist in spite of the normal rigors that are specified by the regulator and banks’ own Head and controlling offices. An increasing number of enabling statutes and enactments coupled with fair practice lending codes make the job of a lender extremely challenging and open to scrutiny. It is against this backdrop that the bankers- borrowers “love-hate” relationships need to be analysed. It seems to be an imaginative idea on part of ASSOCHAM to invite the banking supervisor to inaugurate the session in a bid to arbitrate between the banker and borrower and invite the wrath of both! On a more serious note, a determining aspect of the banker-borrower relationship is built on trust and understanding. It is also important that these relationships neither get too cosy nor do they get too strained as either would have deleterious consequences for the sector and the larger economy. The banking regulations in a way set the ground rules for bank-borrowers relationship, while the supervisory process ensures that this relationship remains healthy. Based on my own practical experience in the field- first as a commercial banker and now as the banking supervisor, I intend to highlight some of the behavioral practices that RBI expects from the bankers and the borrowers. I would also emphasize some regulatory/supervisory concerns that currently exist and could arise from unhealthy relationships between the two.

Banker-borrower relationship: Built on foundation of trust and understanding

2. Relationships demand honest discharge of certain responsibilities by the parties concerned and that alone leads to development of mutual trust and respect. This is equally applicable to a banker-borrower relationship as well. A non-receptive banker or a truant borrower is a malady that the credit system can ill-afford. The banker-borrower relationship is essentially symbiotic as both need each other. Both have certain expectations from the other and when these don’t get fulfilled on account of a malafide or fraudulent intent on the part of either of them, the relationship gets strained.

Recent spurt in instances of forensic audit being conducted by bankers on their borrowers signifies a breakdown in the implicit trust. There has also been an increase in incidence of suits filed against defaulters and cases of wilful default – an unwillingness to pay, despite an ability to pay. These problems could have their genesis in a failure to exercise the right amount of prudence and due diligence on part of the banker or an *ab initio* intent of the borrower to defraud the bank. This, however, is not a one-way street. The bankers have also been known to be indifferent and negligent of the genuine needs or problems of the borrowers in many cases. More often than not, it is due to a lack of basic understanding of the borrowers’ business. At times it is due to factors which are beyond the borrowers’ control. In fact, both extremes- excessive or too little trust and due diligence can prove detrimental to banking business. A middle course perhaps would be the most ideal mix with the bankers

following the right regulatory rigor and the borrowers following a model code of conduct in their dealings.

3. Having set out the broader realm of the banker-borrower relationship; let me now turn to some specifics insofar as the expectations from bankers and the borrowers are concerned and non-observance of which can vitiate the relationship between the two.

4. **Expectations from bankers**

i). **Timely sanctioning and disbursal of the loans** – Borrowers approach the banks because they need finance. The business needs varying quantum of money at different stages. I do not need to go into the details but what is of essence is observing timeliness by the banks in sanctioning the loans and disbursing as per the needs of the borrower. The borrower would have his commitments to its creditors, suppliers etc. and if these are not met his projections can go haywire. This issue is of far greater significance in case of small borrowers like MSMEs. Unlike large corporate they do not have multiple sources of finance and they could quickly go out of business. The banks also need to provide handholding support to the borrowers, especially in times of stress.

ii) **Adequacy of finance** – A related issue is to ascertain how much finance should the bank give when the borrower approaches. It is at this stage that the efficacy of the credit appraisal process of the bank comes under scrutiny. The bankers should be able to appreciate the business prospects of the borrower and be able and willing to logically reason with the borrower about the projections and assumptions. Excessive financing might result in funds being siphoned off for other purposes and inadequate finance could mean stalled projects and idling of resources. The lending decisions cannot, however, be made alone on an idiosyncratic analysis of the riskiness of the project/business that the borrowers seeks funds for. A very important dimension to contend for the banks is risk of concentration in a particular segment. There is a need to eschew the urge to lend to a sunrise sector following the herd mentality. Concentration risk can hurt the banks badly as has been the case in past in lending to steel, mining, gems and jewellery and infrastructure sector. Exposure concentration in one sector in a geographical area (eg. Exposure to sugar mills in UP) also suffers from political risk.

iii) **Pricing of loan** – An aspect related to adequacy of finance is the pricing of loan. Not only does the finance need to be adequate but also the price charged to the borrower. Bestowing finer pricing of loans on an inferiorly rated or an unrated borrower does raise red flags from the banking supervisor. Loan pricing needs to be risk-based, fair and transparent. If the interest rate being charged is too coercive, the borrower would be squeezed, the business would suffer with banks being forced to take the ultimate hit.

5. **Expectations from the borrowers:**

i) **Refrain from Q to Q existence** – The pressure from shareholders tends to drive many imprudent business managers and owners to look for short-term wins. This is reflected in their approach whereby they look to report better financial results than the preceding quarter. In the process, they end up diluting their own internal norms such as extending larger credits than normal and also extending credit for longer periods etc. It must be understood that while the business managers may be temporary, the businesses themselves are going concerns and they cannot be expected to perform miracles even under unfavourable business environment. The efforts to appease the shareholders by all means “Fair or foul” must end.

ii) **Focus on core competencies** – Rather than looking to make quick bucks by diversifying into so-called “hot” but unrelated activities, the businesses must focus

on their core competencies. Diversification, if at all, must be a well-considered and long-term measure rather than “quick-fix” decision. Another trend that has caught the attention of the borrowers is taking a view on the movement of exchange rates and keep unhedged positions. The disturbing part is that even businesses with no earnings/expenses in foreign currency are taking such bets and are likely to burn their fingers. Taking a view on currency is a job of the domain experts and the businesses having no core competency in the area & hence should resist the temptation as wrong -way bets can potentially obliterate a firm overnight.

- iii) **Over leverage** – Excessive leverage run up by the Indian corporate is a matter of great concern. Over-leveraging is like having blood pressure- too low or too high, both are detrimental to the health. While banks need to do proper due diligence taking into account a consolidated balance sheet of the group; on their part the borrowers and the large business houses must end over-reliance on borrowed funds for achieving extraordinary growth rates. Operating with too little equity in the enterprise is like treading on thin ice. Too much leverage dilutes promoter’s responsibility and has implications for banks’ ability to recover loans. Double leveraging, where promoters pledge their own shares for funding their other companies needs to be viewed with caution. This, then denigrates to a possibility where the promoter is responsible only to the extent of such shares pledged with banks while funds solicited on the strength of such securities finds its way to the books of SPVs floated or the company’s subsidiaries. I am sure that responsible corporate borrower behavior and banks’ mechanisms to counter the same will be given due thought in this seminar.
- iv) **Diversion of funds** – There are several instances of borrowers diverting money to real estate or capital market for short term gains without deploying them for purposes borrowed. Rather than de-risking the balance sheet, such short-term misadventures often prove very costly.

6. Let me now briefly touch upon some other issues which we as regulators/supervisors of the banking sector feel uncomfortable about.

The regulatory / supervisory view

7. As members of global standard setting bodies, we are committed to implementation of the global best practices in regulation and supervision. While, we continue to apply discretionary judgments in contentious issues in the best national interest, it must be understood that our actions are liable for scrutiny. We have been subjected to a peer review by a BCBS committee for regulatory consistency on Basel III capital standards already and a FSB peer review is scheduled later in the year. These developments signify the importance of being consistent in rule making and supervisory assessments. The scope for extending regulatory forbearances is getting limited by the day. With this backdrop, let me highlight some issues which should help shape the behavior of banks and borrowers alike.

- While on one hand, there are issues around delaying of sanctions to borrowers resulting in escalation of project costs, very often as banking supervisors we also observe instances where bankers appear to be too liberal in sanctioning loans or bringing in restructuring or CDR dispensation for the benefit of the borrower.
- The level of stressed assets in the system underscores the need to improve the monitoring of performance of banks as lenders as also the need for the borrowers to adhere to the loan covenants. A key point in this context for the banks is that they cannot afford to outsource their responsibility of credit appraisal which is a basic function to a third party. Lending is the most critical of banks’ functions and that cannot be outsourced.

- Pricing of loans does not always follow the corresponding rating. Similarly, the computation of Base Rate by the banks has not been found to be very scientific and transparent.
- Often the smaller borrowers allege bias by banks in favour of corporate entities in matters of lending. An oft heard grievance from SME borrowers is the insistence on collaterals where it is neither mandated nor necessary. Perhaps there is also a need for significant percolation of regulatory intent across the wide network of branches and offices of banks.
- The transparency in disclosures of fees/charges payable by borrowers for processing of loan etc. needs improvement
- The regulatory intent of resolving stressed assets through the means of a Joint Lender forum framework, sometimes gets undermined due to differences amongst the bankers. There are instances of banks complaining about non-cooperation by other lenders, taking unilateral action in reaching compromises or restructuring outside the JLF, declaring wilful defaults to stall the concerted operation of JLF
- Innovation is important but let us not innovate to the extent of securitising the receivables of a project which is yet to fully come into existence

Early recognition of stress in loan accounts

8. A very common occurrence that strains the banker-borrower relationship is recognition of stress in loan accounts. An account can turn non-performing on account of genuine difficulties – an unfavorable business environment, certain unforeseen political, legal or judicial development. Projects do suffer from delays due to delay in getting permissions and witness cost and time – overruns. It may be difficult for even the most precise of business projections or the most efficient of credit appraisals to foresee these problems. It would be irrational on part of either the supervisor or the banker to cast aspersions on the intent of the borrowers in such cases. However, it is important in such cases that the bankers as well the borrowers do admit the problem at the earliest and initiate measures to revive the account including infusion of new equity, sanction of new debt, induction of new promoters etc. Restructuring of problem accounts is a perfectly genuine banking tool and must be used if in the bankers' assessment the business is worthy of revival and holds economic value. Any delay in reviving a project showing signs of incipient sickness would only lead to loss of further value which the banking system /economy can ill afford.

Dealing with errant behavior

9. It is a presumption in banking that all borrowers will be scrupulous and adhere to a general code of conduct. The issue is how to deal with imprudent and non-co-operative borrowers, wilful defaulters or for that matter, fraudsters? It is important that the errant borrowers are quickly brought to book and recovery proceedings be completed as early as possible. A non-performing account of whatever origin and pedigree, is a drag on the banking system and increases the cost of intermediation, which pinches an honest borrower the most. It is important for the system to weed out the unethical elements at the earliest opportunity to ensure the credibility and the efficiency of the credit system in the country. Several attempts are already underway, one of which is the establishment of a central fraud registry, which will enable quick sharing of information on entities found to be defrauding banks. RBI and IBA together have also taken upon themselves the circulation of "caution advices" relating to all types of frauds, including those pertaining to loans and advances. Efforts also need to be made to alienate the wilful defaulters and fraudsters and debar them from accessing the banking system for further finance. Similarly, there would also be a need to the deviant behavior within the banking community through effective vigilance practices, quick staff accountability measures and timely institution of criminal cases in fraud cases. A

message needs to go down loud and clear that intentional wrong-doings will not go unpunished and lax credit monitoring or reckless sanctions will be appropriately dealt with.

Conclusion

10. I am sure that not just RBI, but an industry body like the ASSOCHAM, the large assembly of bankers and borrowers gathered here are all seized of the real problems that beset the financial sector today. The need is for taking strong and timely measures. I hope the seminar would deliberate on some of the issues that I have raised today and do some soul-searching. With giant strides that have been made in IT, the banks should not find it difficult to exercise a stricter oversight regime to identify early sign of impending default. I would also exhort the borrowers (individual or corporate) to understand their basic responsibilities, co-operate with lenders and adhere to a general code of conduct and discipline. The minimum one can do is to adhere to the loan agreements. Use of judicial channels should not be too prolific and frequent; instead, these should be used to foster better borrower protection rather than to undermine the credit discipline in banks. Any lender-borrower relationship can only survive on mutual trust and co-operation; breach of trust can ultimately become either an offence (under criminal law) or a civil wrong thereby defeating the credit system in India.

11. I thank you all for inviting me here to share my thoughts. I wish the conference all success.

Thank you.