

PART I
CREDIT MANAGEMENT FUNCTION

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In this part, an attempt has been made to deal with the first two objectives of the study, viz. (i) to examine the existing organisation and the system of execution of credit management function in commercial banks in India, and (ii) to identify the problems faced by them in these areas and make suggestions accordingly.

Credit management function includes mainly the following activities at the bank level:

- Credit planning
- Delegation of lending powers
- Credit appraisal, and
- Credit monitoring.

In the First Chapter of this part, the methods of credit planning have been examined and the problems faced by banks in performance budgeting have been identified and solutions proposed at the end of the Chapter.

Having determined the lending resources through credit planning and policy, the next point consists in studying the lending powers delegated to various bank officials. This has been dealt in chapter two of this part. The practical problems faced by commercial banks in this area have been identified and suggestions offered at the end of the chapter.

In chapter three of the same part, an attempt has been made to study the techniques of credit appraisal both for working capital and term loan. But, due to the legal restrictions on commercial banks in providing term loans, the main attention has been focussed on the appraisal of working capital with reference to the Tandon, Chore and Marathe working groups.

Chapter four of the part deals with credit monitoring especially with the disbursement, supervision and recovery of bank credit. Here, the main focus has been on the area of follow-up and supervision of bank credit. Some problems have been identified and suggestions offered accordingly.

CHAPTER 2
CREDIT PLANNING

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Introduction

Credit planning is the first step of credit management function and therefore it is very important for us to begin with it. It involves the determination of long term as well as short term goals for the bank as a whole and designs for achieving them. It aims at maximising the future opportunities and minimizing the future risks by evaluating all the related variables and choosing the best out of the various alternative courses of action for taking better decision. Planning is therefore, a tool for an individual bank to measure its future performance and to take corrective actions in case of change of economic environment or in the Government policies. The system of credit planning is more needed in public sector banks which have, inspite of the Corporate objectives, to be in lines with the government policies. In fact, they have to allocate the lendable resources according to the following objectives.⁷

- (i) ensuring credit flows to the identified sectors for increasing output targets,
- (ii) allocation of credit among different sectors according to the undernoted national priorities,
 - (a) achieving a Credit-deposit ratio of 59.9 and 50.0 respectively in rural and semi-rural population group,

7. Based on the study of various issues of 'Credit Information Reviews' by the Reserve Bank of India.

- (b) stepping up of priority sectors credit to 40 % of the total additional credit in a year and 40 % of the net outstanding,
 - (c) bank advances to agriculture should constitute 16 % of the total credit and 50% of the loan earmarked for agriculture and allied sectors should go to small and marginal farmers,
 - (d) of the total advance to the small sectors under priority sector lending 12.5 % should go to rural artisans, village craftsmen, and cottage industries,
 - (e) lending should be under the Differential Rate of Interest (DRI) Scheme to the tune of 1 % of the total credit,
 - (f) of the assistance under the DRI Scheme, 2/3 has to be in rural and semi-urban areas and 40 % should flow to the scheduled castes and scheduled tribes, and
 - (g) every branch must provide employment-oriented credit facilities to at least two additional borrowers per month to help in tackling the unemployment problem. After making provision for advances to the aforementioned priorities and for assistance with respect to food grains and fertilizers, the remaining funds are allocated to industry, trade and other sectors,
- (iii) the allocation system should result in a proper distribution of credit between the rural and urban areas, and

- (iv) the equitable distribution of credit among different geographical areas must be ensured.

In order to make the credit plan exercise successful in achieving the aforestated public objectives, each divisional/regional manager formulates a detailed credit plan for his region. This plan is made on a quarterly basis and consolidated into an annual plan so as to recognise seasonal demands and to facilitate the periodic monitoring of the actual performance. Apart from the public objectives there are certain corporate objectives for any individual bank which should be embodied in its credit plan. The primary amongst such objectives is to maintain and increase the profitability of operations since banks whether they are in the public or private sector have to make profits in order to survive. Therefore, the profitability of commercial banks very much depends on the manner in which they deploy their available funds among various sectors. Since different categories of borrowers are charged different rates of interest, the mix of advances has a considerable influence on the profits of commercial banks and that is why commercial banks should also plan systematically their profits particularly in these days when their profitability is declining.

The RBI estimates the total money supply and along with it the total demand and time deposits of commercial banks and consequently the total credit required for all the commercial banking system. The Reserve Bank, taking into consideration the size, the geographical spread, the functional coverage, the organisational set-up etc of each individual commercial bank, fixes some targets in terms of deposit mobilisa-

tion, credit deployment etc., for each individual bank. The Head Office keeping in mind the targeted objectives of the RBI, has to assess its regional as well as its zonal and branch potentialities in order to comply with the targeted objectives. In other words, the Head Office has also to determine some targets for its zonal and regional offices in order to be in line with the RBI's requirements.

The regional/zonal offices consult their branches in order to make them assess the business environment of their respective command areas, and fix consequently their performance in achieving the identified business potentialities in terms of deposits, credit, etc. After this preliminary exercise, they pass the information to the zonal/regional office which checks if the branch credit plans comply with its zonal/regional credit plan. This method of credit planning which flows right from the grass-root to the apex level is known as Performance Budgeting System. In spite of the performance budgeting, commercial banks are involved in the District Credit plans and the Lead Bank Scheme. But since commercial banks operate mainly on short term and due to the fact that the RBI, when estimating its credit plan assumes that credit given by commercial banks is mainly for short term, only the performance budgeting which is meant for short term credit planning will be discussed in the following section.

Section I

Performance Budgeting System in Commercial Banks : Budget Formulation and Settlement.

I - Background

The performance Budgeting System (PBS) had its origin in the Hoover Commission Report (1949) which recommended that the whole budgeting concept of the Federal Government should be refashioned by the adoption of a budget based on functions, programmes and activities.⁸ The importance of programme and performance budgeting for developing countries was given special priority by the United Nations Organisation in 1955 and 1957.⁹ The Twentieth Report of the Estimates Committee (1957-58) of the Government of India emphasised the need for the adoption of performance-cum-programme budgeting¹⁰ stated that "Performance-cum-programme system of budgeting would be ideal for a proper appreciation of the schemes and outlays in the budget especially in the case of large - scale developmental activities. Performance budgeting should be the goal which should be reached gradually and by progressive stages without any serious budgeting dislocation."

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8. Report on Budgeting and Accounting, Commission on Executive Branch of the Government (Chairman Herbert Hoover), Washington D.C. U S Government Printing Office, 1949.
 9. Government Budgeting and Economic Planning in Developing Countries, U. N. O., New York, 1966, p. 14.
 10. Estimates Committee, Twentieth Report (1957-58) on Budgetary Reforms, New Delhi, Second Lok Sabha Secretariat, Government of India, p. 12.

The Seventy-Third Report of the Estimates Committee on the Preparation of Budget Estimates reiterated the need for adopting performance-cum-programme estimates by the public industrial undertaking.¹¹ In 1968, the Administrative Reforms Commission had stated that the departments and organisations which are in direct charge of development programmes should introduce performance budgeting. This should be done at the Centre and States.¹²

Further, in 1972, the Ministry of Finance (Banking Department) of the Government of India had directed the public sector banks to prepare annual business plans and take measures to introduce performance budgeting. Later on, at the top management seminars by the NIB M in May, 1972, and April 1973, it was decided to introduce performance budgeting in commercial banks in India.¹³

The Report of the Productivity, Efficiency and Profitability (PEP) Committee adopting planning and performance budgeting in banks stated 'The Performance budget helps the management to proceed along the project goals and the performance evaluation at monthly or quarterly intervals indicates the deviation and corrective action that should be initiated.'¹⁴ In

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11. Estimates Committee, Seventy - Third Report (1959-60) on Preparation of Budget Estimates of Public Undertakings and presentation of the Annual Reports and Accountant to Parliament, New Delhi, Second Lok Sabha, Government of India, 1960,p.7.
 12. Administrative Reforms Commission,Report of Finance, Accounts and Audit,Government of India,New Delhi,
 13. Based on the Study of various documents pertaining to the interoduction of performance budgeting system in commercial banks in India.
 14. Report of the Committee on Productivity,Efficiency and Profitability of Commercial banks in India, RBI, 1977, p.11-2.

fact, the Performance Budgeting System was initially introduced in 1972 by the State Bank of India for accelerating the tempo of efforts to channelise credit to the priority sectors. From 1974, most of the nationalised banks and some of the private sector banks have adopted the system.¹⁵

II - Objectives of Performance Budget System

The major objectives for which the Performance Budgeting System was initiated in commercial banks in India are stated as under.¹⁶

- (i) to enable a bank to prepare a realistic business plan from the grass-root level upwards and work out its financial and manpower implications thereby ensuring a satisfactory business growth,
- (ii) to enable the branch managers to gain competence in planning and monitoring of the performance of the operations of the branch,
- (iii) to enable the divisional/regional management to exercise effective control on the performance of branches for indentifying the strengths and weaknesses, and initiating corrective action, and,
- (iv) to improve the involvement of different levels of the management of the bank in the setting up of targets and evaluating the performance and to improve the communication between different levels.

15. Based on the study of Circulars and manuals of various banks, following the performance budgeting system.

16. Mohinder N. Kaura, Management Planning and Control System in Commercial banks, Vikas House Pvt.Ltd. , 1984, p.56.

Thus, performance budgeting is a scientific approach towards ascertaining where a bank/branch is vis-a-vis other banks/branches at a particular point of time in respect of various banking functions such as deposits, credit deployment, etc., at the end of the year or of the planned period. In other words, a performance budget amounts to fixation of targets by the bank/branch manager for his own performance.

Depending on the size of his branch, its location (metropolitan urban, semi-urban or rural) , environmental factors etc., a Branch manager has to estimate the potential for deposits and credit needs of the area in which he operates. The branch credit budget is influenced by the guidelines issued by its Head Office which again is influenced by the credit policy of the R B I and national objectives. In practice, there are cases where the resources of some banks may not be adequate to meet their credit needs. In case of other branches, there may be adequate lending opportunities. These imbalances are set right by transfer of resources between branches through the head office.

In case of branches having a credit deposit ratio below the prescribed limit (i.e. 69), the problem is one of identifying borrowers. At no point of time can all the branches of the bank have the same credit-deposit ratio nor is it necessary. What is important is that for the bank as a whole, the credit-deposit ratio must be within the limit. Every effort has to be made to correct the imbalances between rural, urban and metropolitan areas. Not all branches can

lend to all categories of borrowers. That will depend upon the opportunities available in the area. For instance, export credit is limited to a few branches, direct agricultural advances are possible only in rural areas. There may not be scope for financing small scale industries in rural branches.

On the basis of the assessment of the area where the branch manager operates, it should be possible for him to estimate how much more business he can bring at the bank both in regard to quantum and numbers. Performance budgeting is done at three level in big banks and at two levels in small banks. The important budget levels are the Head Office, the Regional/Zonal Office and the branch offices. In small banks, it is done at the Head Office and at the branch office.

III - Policy Framework

To begin with, at least two background papers are prepared at the Head Office. The first one outlines the economic outlook for the coming year. A closer analysis is given for the sectors as agriculture, industry, exports and the general liquidity position. Based on this study, the outlook for the banking industry is visualised. The second paper aims at analysing the likely economic and banking trends from the angle of business of a bank. It gives clear ideas in respect of the growth of deposits, credit expansion and diversification, capital expenditure as well as the likely increase in the staff and training facilities required of the existing staff. On the basis of these two background papers, a policy statement is issued by the Chairman and Managing Director.

The branch manager, keeping in view the bank's objectives, prepares the budget of his branch based on its past performance analysis of environmental data, extent of competition, etc. The branch budget so prepared is submitted to the next higher authority who may be the area, divisional, regional or zonal manager, who is responsible for the performance of the area, division, region or zone under his control. They are given certain guidelines by the Central Office in respect of the expected growth rate in deposits, advances, etc. Keeping these guidelines in mind, the area, divisional regional or zonal manager examines the branch budgets submitted to him to see how the total of the branch budgets submitted to him tally with the performance goals set for the area, division, region or zone.

In practice, the consolidation of branch budgets will indicate that the performance goals of the area, division, region or zone fall short of the expected rate of growth. In order that the branch budgets are aligned to the performance goals of the area, division, region or zone, a meeting between the branch managers and the higher authority is arranged to settle the budget, to mutual satisfaction. This stage is known as 'budget settlement'.

IV - Budget Settlement in Principle and in Practice.

In principle, budget settlement is the process by which the budget estimates of the branches are sought to be reconciled with the goals set for the area/division/region/zone under which they operate. It is a process by which the branch budgets are critically and objectively examined to ensure that they reasonably

reflect the business potential of their respective command areas and what they can achieve in terms of deposits, advances etc. The branch budgets are discussed with the higher authority and the performance goals of the branches are settled on a mutually agreed basis. In other words it is a two-way communication. The objective is that the goals finally settled for a branch/region/zone as well as the bank as a whole reach its desired and agreed goals.

Several discussion had with branch/regional/zonal bank managers as well as planning officers have enabled us to assess how the budgets are settled in practice.

In actual practice, the process of budget settlement is different from its principles. Many branch managers complain that there are considerable mistrusts and lack of proper understanding during the settlement. The supervisory authority - area, divisional, regional or zonal - expects an element of challenge in the branch budgets which they find absent in many cases. There is also presumption that branch managers, in general deliberately underestimate the business potential of their respective command areas and have not carried a thorough and systematic analysis of their environment.

The reasons for deliberate underestimation of performance goals is born out of a branch manager's experience in the matter of budget settlement. The supervisory authority finds mostly that the total of branch budgets do not tally with the performance goals set for his area, division, region or zone and

he takes opportunity of budget settlement to prune the branch budgets presumably after discussion with the respective branch managers.

The outcome is that the estimates arising after budget settlement are invariably higher than what the branch managers had given originally. The revised estimates do pose a challenge to many branch managers. Anticipating upwards revision of estimates, many branch managers deliberately plan for low performance goals which, after revision of the budget settlement meeting, becomes what they regard as realistic.

However, there are enthusiastic and young branch managers who, in order to impress their supervisory authority, estimate optimistically and eventually find it difficult to reach the goals. But experienced branch managers for moderate conservative or even pessimistic goals, knowing fully well that whatever figures are given by them are likely to be revised upwards during the budget settlements, under-estimate their budgets.

From the above, it is clear that performance budgeting in commercial banks is a complex and dynamic exercise and therefore subject to many problems. Some of these problems originate from within the bank/branch and some other outside of it. It is therefore important for us to study these problems in order to suggest corrective actions.

Section II

Problems of Performance Budgeting in Commercial Banks

There are many problems bank managers are facing

in performance budgeting.

Firstly, while framing the credit budget, bank managers have to make the major assumption that there will be no major changes in credit policy though certain minor changes have to be anticipated as and when certain economic situation warrants, and that there will be no major changes in the environmental factors.

In reality, both the assumptions are subject to question. The RBI's credit policy is changing quite frequently. A glance at the RBI's Annual Report 1983-84 shows that the C R R was raised from 7 to 8 % in April 1983 and again from 8 to 8.5 % in August 1983. Five months later, it was raised again from 8.5 to 9 % with effect from January, 1984. These changes upset the budget calculations of the commercial banks either in the matter of deposits or advances.

Similarly, environmental changes may be favourable or adverse for budget realisation, natural disasters, labour unrest, sickness of industrial units, etc will have their impact on the deposit growth and the advance portfolio of banks. As and when changes take place, the budget also has to be revised. A periodical, if not a frequent revision in the budget thus seems to be inevitable.

Secondly, due to their various preoccupation in the day to day operations of their branches, branch managers have some constraints in making budget estimates on a scientific or systematic basis. Apart from time factor, the non-availability of adequate and upto date environmental data may place a branch manager at a handicap, making him rely on past performance and approximate guesses about future growth in business.

Thirdly the area, divisional, regional or zonal manager has a number of branches spread over a large geographical area under his control and it will be physically difficult for him to meet all the branch managers individually and discuss their budgets in details. So, only a few minutes are devoted to the budget settlement for each branch. Therefore, the budget estimates of branches are revised upwards by the high authority to meet the performance goal of his area, division, region or zone.

Fourthly, the branch managers are not, as a consequence of the above point, given adequate time to explain the basis on which they had arrived at their estimates and some of them do not feel at ease to discuss their budget in the presence of other branch managers.

Fifthly, in the process, the budget settlement gets vitiated with the area, divisional, regional or zonal manager deciding the performance goal for the branches.

Finally, when the higher authority communicates the budget goals for the branches, it evokes generally poor response from the branch managers. They feel that it is a budget from the top, unrelated to environmental reality and they have compulsorily to reach the given performance goals. It is useful, in order to illustrate this point, to quote here the views of a branch manager on the budget settlement in practice : "The actual settlement, however, is a difficult job because the regional manager has not only to settle the business budget but also the resource budget. There again his hands are mostly tight. So, what he has to do is to plan his budget within the given resources and ask the branches to execute the plan."¹⁷

17. Pathak, K.B., The Settlement Process : Paper presented at the National Seminar on Banking, M.S. University of Baroda, 1979.

In connection with the above, some suggestions can be made by way of actions to be taken to remove the short comings and to make the process of budget formulation and settlement fully serve the purpose for which the system of performance budgeting was originally introduced in commercial banks. These suggestions are given below :

Firstly, the practice of the controlling authority deciding in advance as to how each region/zone or branch should contribute should be discontinued. This should be done only through free and frank discussions with regional/zonal or branch managers. For this, at the budget settlement meetings, the branch manager should be asked to give reasons for or justify item - wise the draft budget prepared by him. For this purpose, few branch managers should attend the budget settlement Conference. This implies that the number of branches under the region/zone be divided into sub-groups, say, of 5 to 6 branches. When all the branch managers of a particular region/zone are contacted and their budgets discussed, then the final budget of the region zone could be settled.

Secondly, instead of keeping many economists at the head office, it appears more realistic to appoint some of them, at least on temporary basis, in region/branch offices in order to assess the environmental business potentialities in terms of deposits mobilisation, credit allocation, settlement of new industries etc. This will help to release a little bit the branch managers who will concentrate more on the day-to-day operations of his branch and therefore increases the branch management efficiency. The alternative to this suggestion is to train a clerk of the branch in the

field of Economics or related subjects so as to enable him to be in charge of credit planning. The clerk given this major role be designated as Economist Credit Planner (E C P). He will be reporting directly to the branch manager and the higher authority. Before the final budget settlement, few E C Ps should meet the high authority in order to discuss and prepare the next final budget settlement. This practice will help the higher authority to have in advance rough figures for each branch at the final budget settlement conference. Therefore the ECP will help in two ways : Firstly, he will be the main agent responsible for the assessment of the business potentiality of the area where his branch is operating. This will help in getting more scientific and systematic credit plans. And secondly, the E C P will be a member of the District Consultative Committee where he will be representing his branch/bank and therefore will be in a better position to discuss the share of his branch/bank in the District Credit Plans - The E C P will be a dynamic agent of the Lead Bank.

Thirdly, in framing the draft budget, an effort should be made to focus not only on quantitative targets such as deposits, advances etc., but also on qualitative targets such as reduction of the number of sick accounts, better recovery of advances, fulfilment of the target to the priority sectors, improvement of the customer service etc. This will help to increase the efficiency in Credit management.

As a result of the above, it can be noted that,

performance budgeting has got a great acceptance among commercial banks in India inspite of the problems branch/regional/zonal managers are facing in formulating and settling credit budgets. However, the system has been only operating since 1974 and to be effective its working should be regularly reviewed.

Once the credit is planned and the bank resources cut down through the instruments of credit control and therefore the lendable resources determined, the next stage in credit management function consists in delegating sanctioning/renewal powers to various bank officials. This is dealt with in the following Chapter.