CHAPTER 2
AN OVERVIEW OF INDIAN BANKING
STRUCTURE AND LENDING PRINCIPLES

2.1 Structure and Overview of Banking Institutions in India
Banking is an ancient business in India with some of oldest references in the writings of Manu. Bankers played an important role during the Mogul period. During the early part of the East India Company era, agency houses were involved in banking. Modern banking (i.e. in the form of joint-stock companies) may be said to have had its beginnings in India as far back as in 1786, with the establishment of the General Bank of India. Three Presidency Banks were established in Bengal, Bombay and Madras in the early 19th century. These banks functioned independently for about a century before they were merged into the newly formed Imperial Bank of India in 1921. The Imperial Bank was the forerunner of the present State Bank of India. The latter was established under the State Bank of India Act of 1955 and took over the Imperial Bank. The Swadeshi movement witnessed the birth of several indigenous banks including the Punjab National Bank, Bank of Baroda and Canara Bank. In 1935, the Reserve Bank of India was established under the Reserve Bank of India Act as the central bank of India.\textsuperscript{32}

2.2 Development of Banking System in India
The first bank in India, called The General Bank of India was established in the year 1786. The East India Company established The Bank of Bengal/Calcutta (1809), Bank of Bombay (1840) and Bank of Madras (1843). The next bank was Bank of Hindustan which was established in 1870. These three individual units (Bank of Calcutta, Bank of Bombay, and Bank of Madras) were called as Presidency Banks. Allahabad Bank which was established in 1865 was for the first time completely run by Indians. Punjab National Bank Ltd. was set up in

\textsuperscript{32} Purnendu Paul, \textit{Efficiency Measurement Of Indian Public Sector Banks: Non-Performing Assets As Negative Output} Asia Pacific Journal Of Finance And Banking Research Vol. 5. No. 5. 2011
1894 with headquarters at Lahore. Between 1906 and 1913, Bank of India, Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank, and Bank of Mysore were set up. In 1921, all presidency banks were amalgamated to 22 from the Imperial Bank of India which was run by European Shareholders. After that the Reserve Bank of India was established in April 1935.

After independence, Government has taken most important steps in regard of Indian Banking Sector reforms. In 1955, the Imperial Bank of India was nationalized and was given the name State Bank of India. This bank was given the mandate to handle banking operations across India.

Seven banks forming subsidiary of State Bank of India was nationalized in 1960. On 19th July, 1969, major process of nationalization was carried out. At the same time 14 major Indian commercial banks of the country were nationalized. In 1980, another six banks were nationalized, and thus raising the number of nationalized banks to 20. Seven more banks were nationalized with deposits over 200 Crores.

Since 1992, the banking sector reforms were introduced which faced new challenges in the ever changing scenario. The challenges were many amongst them vital challenges were “4 Cs” i.e. Credit, Customer, Computer, and Capital Restructuring. In the changing scenario, the banks are under tremendous pressure to redefine their priorities, in order to manage these challenges effectively for their survival and growth. 33 On the suggestions of Narsimhan Committee, the Banking Regulation Act was amended in 1993 and thus the gates for the new private sector banks were opened 34

2.3 Phases in growth of banking system in India

In over six decades since dependence, banking system in India has passed through five distinct phase, viz.

(a) Evolutionary Phase (prior to 1950)

(b) Foundation phase (1950-1968)

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34 Sukhvinver Mishra Banking Law and Practice First Edition 2012 S Chand and Company p 142
(c) Expansion phase (1968-1984)
(d) Consolidation phase (1984-1990)
(e) Reformatory phase (since 1990)

2.3.1 Evolutionary Phase (prior to 1950)

English Agency House is one of the important medium to understand the modern banking in India. These agencies functions as trading firms and carry the banking business also as part of their business. But inspite of this, they cannot succeed much mainly due to lack of their own capital and holding of double functions that is trading as well as banking. Ultimately they vanished from the phase by 18th century.

Then by the first half of the 19th century, East Indian Company laid the foundation of modern banking in India. This lead to establishment of three banks in India which are as follow:-

(i) Bank of Bengal in 1809
(ii) Bank of Bombay in 1840
(iii) Bank of Madras in 1843

These banks since are established in Presidency towns so they were also known as Presidency banks. They function as independent units. With the passage of time a number of banks were established with the Indian management that is during the last part of 19th century and early phase of the 20th century. Some of them are like Punjab National Bank Ltd. in 1895, The Bank of India Ltd. in 1906, The Canara Bank Ltd. in 1906, The Indian Bank Ltd. in 1907, and The Bank of Baroda Ltd. in 1908, The Central Bank of India Ltd. in 1911.

Then by 1921, Imperial Bank of India was established which is formed by amalgamation of three Presidency Banks. However to regulate the flow of currency, issue of notes and other economy parameters, Reserve bank of India Act was passed in 1934 by the recommendations of Banking Enquiry Committee which established Reserve Bank of India in 1935.That time it was constituted as private shareholders' bank with a fully paid up capital of Rs. 5 crores.
But after independence, things started changing. Government started nationalization and thus 'Reserve Bank of India' (Transferred to public ownership) Act was passed in 1948. As a consequent of this the entire Share Capital of the bank was acquired by the Central Government from the private shareholders against compensation and it ultimately nationalized on January 1, 1949.

2.3.2 Foundation Phase 1948-1968

Under this phase, the existing banking sector is consolidated and reorganized. Various steps have been taken under this. The first step is the enactment of Banking Companies Act, 1949 followed by rapid industrial finance. The role of banks was to provide impetus to the industrialization particularly the Small scale and heavy industries. Later Bank also started facility of credit support to the farmers and small borrowers.

Then in 1959 establishment of Public Sector Bank is extended by passing of 'State Bank of India’ Act. In 1963, the first two banks were amalgamated under the name of The State Bank of Bikaner and Jaipur. Further in 1980 six more banks were nationalized. These banks constitute the public Sector banks. Apart from these, the other banks whether they are schedule or nonscheduled banks are in the private sector.

In order to further extend the credit facility to all segment of the economy and to mitigate regional imbalances, fourteen more Banks were nationalized on July, 1969. The government defended its decision to nationalise fourteen banks by officially taking the stand that “public ownership of the larger banks will help most effectively the mobilisation and development of national resources and its utilization for productive purposes, in accordance with planning and priorities.

Thus it can be said that in the period from 1948-1968 a strong foundation of sound banking system in the country was established. Banking Regulation Act which was enacted in 1949 also helps in establishment of banking system in the country. It thus conducts and control operations of the commercial banks in India. Another step which was taken under this phase was the transformation of Imperial Bank of India into State bank of India. Thus it can be said that during

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35 Preamble to The Banking Companies (Acquisition and Transfer of Undertakings Act), No. 5 of 1970
the pre-independence India Banking sector cater the needs of the Government, rich individuals, traders however with the beginning of this phase it opened its door for the entire productive sector of the economy. The Banking scenario prevalent in the country till 1968 emphasized on class banking based on security rather than on purpose.  

2.3.3 Expansion Phase (1968-1984)

Under this phase the bank which was already established lead to expansion of the banks. One of the main objects of nationalization of bank which took place in previous phase was to make banking services within the reach of the masses which can be termed as first banking revolution. Commercial banks help in reaching masses by way of rapid branch expansion, deposits mobilization and credit creation. Even in the rural areas, commercial banks open their branches thus it leads to expansion where everyone can access the facility of bank.

Further widening of public sector bank took place on April 15, 1980 where six more commercial banks were nationalized. With this government sponsored programmes also to implement and also to bringing out the reform where one favour the social banking. Socialization of bank was to be taken as highest priority under this phase.

With the advent of commercial banks, it is viewed as agents of change and social control on banks. However the mechanism of social control on all banks is inadequate except he SBI and its seven associate banks which were in the private hands and there motive was more of profit mechanism rather than to serve social interest. In order for the serve social interest banks were nationalized.

Thus this phase mark the birth and growth of direct lending by the banks. During this phase not only with great pace commercial banks were established to far areas in the country but also during this period a number of poverty alleviation and employment generating schemes were sought to be implemented through commercial banks. Another remarkable step during this phase is the establishment of Regional Rural Banks (RRBs) in 1975 and NABARD in

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36 Hazray, M., Bank Nationalisation: Some Misconceptions (1969) 14(11) Yojana 15-16
1982. With the emergence of Regional Rural Banks there was decline in the numbers of commercial banks from 281 in 1968 to 268 in 1984. Thus, it can be seen that in this phase there was rapid expansion of commercial banks. As many as 50,000 bank branches were set up, three fourth of these branches were opened in rural and semi urban areas. However with every pros there is cons. Though the expansion of banks has taken place but there are cons like inefficiency and loss of control over widely spread offices. In fact lending rate in the risk prone area has increased; quality of assets of banks has been deterioted and thus resulted into the loss. Not only were this other deteriorations lack of competitive efficiency, lack of customer service.

2.3.4 Consolidation phase (1985-1990)

The mark of this phase began in 1985 with the objectives of consolidating the gains of branch expansion undertaken by the banks. Banks in this phase started looking at the minute things like improving housekeeping, customer service, credit management, staff productivity and profitability of the banks for its growth and development. The concrete steps were taken during this period to rationalize the rates of bank deposits and lending. Structural constrain was there which was inhibiting the development of money market. Measures were initiated in this phase in order to reduce the structural constraints.

During this phase 90% of the commercial banks were in the public sector and closely regulated in all its facets. Reserve Bank of India hold the responsibility of fixing the prices of asset liability, prices of services were fixed by the Indian Banking Association (IBA), composition of assets were also fixed as much of 63.5% of the bank funds were mopped up by CRR and SLR and the remaining was directed towards priority sector lending and small loans.

Reasons of consolidation were the lack of autonomy in vital decisions, lack of commercial approach in operations and lack of efficiency. There was liquidation of many smaller banks by amalgamating with bigger stronger Banks. The growth of this phase represents the program made by the commercial banks since 1951 and the main reason for the expansion of banks goes to nationalization of banks.
But this growth at a point decline also. The reason for decline of income earning is listed by Narasimhan Committee -I which are as follow:-

i. directed investment in terms of minimum Statutory Liquidity Ratios which together with viable Cash Reserve Ratio, Pre-empting well over half of the total resources mobilized by banks.

ii. Directed credit programme of deploying 40% of the bank credit to the priority sectors at low interest rates.

These factors show that there was loss in the interest income earned by the bank and also there was deterioration in the quality of loan portfolio in priority sector and traditional sectors. Thus this leads to the accumulation of Non-Performing Assets. Mounting of Non-Performing Assets leads to erosion of earning and profitability of banks. The operational efficiency of banking system was detoriated in terms of low profitability, growing incidence of NPAs and low capital base. There was overall fall of banking industry whether it was in terms of customer service or use of technology. With the advent of private sector banks, public sector banks were not able to meet up the standard of private sector banks. A tough competitive environment was created and thus in order to meet them reform agenda was formed for banking sector.

2.3.5 Reformatory phase

In the early 1990, steps were taken for the financial sector reform which aim was to create an efficient, competitive and stable financial sector that could contribute to stimulate growth. There was shift in the monetary policy framework from direct instruments of monetary management to an increasing reliance on indirect instruments. Since 1991 there were various sector reforms under the various heads.

2.3.5.1 Financial Markets

In the last decade, Private Sector Institutions played a significant role. They rapidly grew in commercial banking and asset management business. With the openings in the insurance sector for these institutions, they started making debt in the market. Also there is high competition among financial intermediaries which plays an important role in the decline of interest rates. By this real rate of interest was maintained. This adds to the win-win situation for both borrowers
and depositors where a borrower does not need to pay high price and depositors got incentive to save. It was something between the nominal rate of interest and the expected rate of inflation.

2.3.5.2 Regulators

The Finance Ministry continuously formulated major policies in the field of financial sector of the country. The Government accepted the important role of regulators. The Reserve Bank of India (RBI) has become more independent. Securities and Exchange Board of India (SEBI) and the Insurance Regulatory and Development Authority (IRDA) became important institutions. Opinions are also there that there should be a super-regulator for the financial services sector instead of multiplicity of regulators.37

2.3.5.3 The Banking System

In spite of the private sector bank is prevalent bank in the market, public sector bank still dominate the commercial banking system. Shares of the leading PSBs are already listed on the stock exchanges. At the same time private sector banks also got chance to emerge, so the RBI has given licenses to new private sector banks. Along with private sector banks, RBI also provide license to industrial houses. Many banks are also running the function of retail and consumer segments but are not yet able to achieve success in industrial finance, retail trade, small business and agricultural finance.

The PSBs have maximum number branches in the country which is the upper hand for it where as foreign banks have limited number of branches. Thus PSBs faces very limited competition from Foreign Banks in terms of expansion. It’s just that the onus is on the Government to encourage the PSBs to be run on professional lines.

2.3.5.4 Development of Financial Institutions

Now, there comes to the development of Financial Institution. Financial Institutions access to Statutory Liquidity Ratio funds reduced so in order to have debt and equity funds they have to approach capital market. However for putting certain restriction capital adequacy norms also fixed. Convertibility

clause no longer obligation for assistance to corporate sanctioned by term-lending institutions. Other financial institutions such as IDBI and ICICI have expanded to other financial services such as services such as commercial banking, asset management and insurance through separate ventures. Thus this leads a step towards Universal Banking.

2.3.5.5 Non-Banking Finance Companies

After the financial institutions has set up, there comes the emergence of Non-Banking Financial Companies which need to registered with the RBI and the minimum requirement of net owned funds of Rs. two Crore has to be fulfilled.

RBI also performs the function of sales of dated securities and treasury bills through its open market operations (OMO) window. Primary dealers then bid for these securities and also trade in them.

Then the secondary market also develops where DFHI is the principal agency for money market instruments and Government of Indian treasury bills. The RBI has introduced a liquidity adjustment facility (LAF) in which liquidity is injected through reverse repo auctions and liquidity is sucked out through repo auctions.

Since the banks also started issuing securities, this also leads to the establishment of The Securities Trading Corporation of India (STCI) which started its operations in June 1994 which also has a mandate to develop the secondary market in government securities. In order to regulate the equity market, SEBI comes with the idea of development of debt market. In order to promote it and encourage paperless trading, stamp duty is withdrawn at the time of dematerialization of debt instruments.

2.3.5.6 Overall approach to reforms

We have seen that in the last decade governments has taken many efforts for the assisted in the introduction of international practices and systems. Use of technology proper working of financial market. The participants of the financial market is properly regulated. The government and the regulatory authorities have followed a step-by-step approach, not a big bang one. Along with the development of Indian financial institutions, foreign institutions are also allowed and thus they also is also enhanced which helps in the improvement of
customer service. Thus the overall effect of the developments since 1991 has been quite encouraging and this is evident when the crisis has took place in Southern Asian but India was not affected by the same.

2.3.5.7 Deregulation of Banking system

In order for the regulation of banking sector, prudential norms were introduced for income recognition, asset classification, provisioning for delinquent loans and for capital adequacy. The Government also comes to the recourse of PSBs by providing substantial capital to the banks.

But RBI in order to encourage public sector banks comes with deregulated policies like Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR) brought down in steps. Interest rates on the deposits and lending sides almost entirely were deregulated.

Competitions were developed among private sectors. Also Public Sector Banks were encouraged to approach the public for raising resources. For the recovery of loan arrears Recovery of debts due to banks and the Financial Institutions Act, 1993 was passed, and special recovery tribunals set up.

There is also risk associated while giving credit. Thus a credit information bureau is being established to identify bad risks. Derivative products such as forward rate agreements (FRAs) and interest rate swaps (IRSs) introduced.

2.4 Banking Sector Reforms

It is a settled law that every time situation is not the same, so does the economy of any country. A serious economy crisis was faced by the India in 1991. There was a steep fall in the country's foreign exchange reserves to about $1billion, which is equal to the value of only two weeks' imports. Not only was the loss of foreign reserve but there large fiscal deficit close to ten per cent of GDP and an unsustainable external balance with current account deficit at three per cent of GDP.

In order to overcome the crisis, India adopted reforms which involves macroeconomic stabilization and structural adjustment programmes. The motive of the reformation was to improve the economic performance and also to accelerate the economic growth. This can be done through a transition from an
inward-looking strategy to an outward-looking one and from a regime of licenses and controls to a system of incentives and price mechanism. There was a phased deregulation of the financial sector along with reforms of trade and industrial policies.

Narsimhan Committee

The financial crisis of 1991 has affected the economy of the country, so in order to revive financial health of commercial banks and to make their functioning efficient and profitable; there was appointment off committee to review the situation and recommendations. The main recommendations of the Committee were in regard of Statutory Liquidity Ratio (SLR) which were to reduce twenty five percent over a period of five years. Then there should be Progressive reduction in Cash Reserve Ratio (CRR). In priority sector direct credit programme to be phased out. Interest rates to be regulated so as to reflect emerging market conditions. Also Stipulation of minimum capital adequacy ratio of percent to risk weighted assets by March 1993, eight percent by March 1996, and eight percent by those banks having international operations by March 1994. The accounting practice which has to be used for income recognition, asset classification is to be uniform and there should be provision against bad and doubtful debts. The bank balance sheets should be transparent and disclosures to be made. Special Tribunals should be set up for the process of recovery of loans. Asset Reconstruction Funds (ARFs) is also set up to take over from banks a portion of their bad and doubtful advances at a discount. The banking system to be restructure to have three or four large banks, which could become international in character, eight to ten national banks and local banks confined to specific regions. Rural banks, including Regional Rural Banks (R.RBs), confined to rural areas. The license which the banks require before it’s starting should be abolished so that more banks comes up. Policy with regard to foreign banks should be liberalized. To have a check supervisory authorities to be there for the inspection based on the internal audit and inspection reports. A separate authority for supervision of banks and financial institutions which would be a semi-autonomous body under Reserve Bank of
India. Regional Rural Bank subsidies to be set up by Public Sector Banks. It should be permitted to engage in all types of banking business.  

While the report in second committee recommended the following:—

a) In PSBs the equity should be divested by the Government.

b) Net NPA to be pegged down to the level of 5 percent by 2000 and 3 percent soon thereafter

c) The problem of high interest to be catered.

d) The mechanism of recovery of debt should be found.

e) Recovery of NPAs - Creation of Asset Recovery Fund (ARF)

f) The credit system of rural area is in shambles, so the steps should be taken for its growth.

g) Proper Regular Authorities should be there.

h) Universal Banking should be adopted.

i) Challenges Posed by Global Financial Integration should be met

j) Lending to Corporate Customers and Financing Local Trade, Small Industry and Agriculture for overall development and growth.

k) Functional Autonomy to ensure greater Operational Flexibility.

The Committee in its report (April 1998) made wide-ranging recommendations covering entire gamut of issues ranging from capital adequacy, asset quality, NPAs, prudential norms, asset-liability management, earnings and profits, mergers and acquisitions, reduction in government shareholdings to thirty per cent in public sector banks, the creation of global-sized banks, recasting banks boards to revamping banking legislation. The major recommendations were:

- Capital adequacy requirements should take into account market risks also
- In the next three years, entire portfolio of Govt. securities should be marked to market
- Risk weight for a Govt. guaranteed account must be 100%

• CAR to be raised to 10% from the present 8%; 9% by 2000 and 10% by 2002
• An asset should be classified as doubtful if it is in the sub-standard category for eighteen months instead of the present twenty months
• Banks should avoid ever greening of their advances.
• There should be no further re-capitalization by the Govt.
• NPA level should be brought down to 5% by 2000 and 3% by 2002
• Banks having high NPA should transfer their doubtful and loss categories to Asset Reconstruction Company (ARC) which would issue Govt. bonds representing the realizable value of the assets.
• We should move towards international practice of income recognition by introduction of the ninety day norm instead of the present eighty days.
• A provision of 1% on standard assets is required.
• Govt. guaranteed accounts must also be categorized as NPAs under the usual norms
• Banks should update their operational manuals which should form the basic document of internal control systems.
• There is need to institute an independent loan review mechanism especially for large borrower accounts to identify potential NPAs
• Recruitment of skilled manpower directly from the market be given urgent consideration.
• To rationalize staff strengths, an appropriate VRS must be introduced.
• A weak bank should be one whose accumulated losses and net NPAs exceed its net worth or one whose operating profits less its income on recap bonds is negative for three consecutive years.

2.5 An Overview of the Process of Loans and advances by the banks

An overview of the loans and advances

Credit system originated from credit culture. With the change sin social and economic development in the society there came various changing in this regard. In earlier time the dependence on credit was on mutual trust between

39 Su Ning: Fostering modern credit culture. https://www.bis.org/review/r041022h.pdf
individuals through contacts. Such credit culture only meets the needs when the scope for economic activities was very limited. But, with the introduction of reforms and opening up of economy, it adopted a unique, social, institutional, professional and commercial feature. In India, various financial institutions provide credit to borrowers and banks are one among them. Banks whether public sector, private sector or foreign banks which play an important role in mobilizing credit.  

2.5.1 Principles of Lending

The lending is one of the main activities carried out by the banks. This activity carry an inherent risk as a result the banking institutions cannot afford to bear the risk more than the calculated. to avoid such situation with regard to the risks in lending the lending institutions need to adhere certain principles by which the lending can be termed as safe. With the passage of time there have been various modifications in the lending principles which were being followed by the banks traditionally. Let’s have an overview of principles of lending in details:

2.5.1.1 Safety: As the banks lend the funds entrusted to it by the depositors, the first and foremost principle of lending is to ensure the safety of the funds lent. Safety implies that the borrower is in a position to repay the loan, along with interest, according to the terms of the loan contract. The repayment of the loan depends upon the borrower’s capacity to pay and willingness to pay. The borrower's capacity to depends upon his tangible assets and the success of his business; if he succeeds in his efforts, he earns profit and can repay the loan promptly. Otherwise, the loan is recovered out of the sale proceeds of his tangible assets. The willingness to pay depends upon the honesty and character of the borrower. The banker should, therefore, taken utmost care in ensuring that the enterprise or business for which a loan is sought is a sound one and the borrower is capable of carrying it out successfully. He should be a person of integrity, good character and reputation. In addition to the above, the banker

generally relies on the security of tangible assets owned by the borrower to ensure the safety of his funds. 41

2.5.1.2 Nature of assets

The loan disbursed by the banks is payable on demand. These are generally a need for working capital. While sanctioning the loan the bank should ensure the ability of the borrower to repay it. the nature of assets which is owned by the borrower should be of nature of conversion into liquidity.

2.5.1.3 Profitability

Now a day’s all organizations are commercial in nature aiming for the profits. When the organization is profitable there will be serving the interest of all the stakeholders. Lending is the main business of the banks and the interest along with the principal amount is the main sources of income to them. the banks while sanctioning the amount should properly verify the credibility of borrowers so that the principle amount along with the interest should be repaid on time.

2.5.1.4 End use of the Loan

Banks/FIs should closely monitor the end-use of funds and obtain certificates from borrowers certifying that the funds are utilised for the purpose for which they were obtained. In case of wrong certification by the borrowers, banks/FIs may consider appropriate legal proceedings, including criminal action wherever necessary, against the borrowers.

2.5.1.5 Diversifying Risks

Diversification of the risks is one the cardinal principles in the mitigating risk which is also equally applicable to the lending principles. The banks and financial institutions should sanction the loans to various sectors of the economy. In economy there are fluctuations in different in various sectors of the economy. Some of the sectors may perform well while various sectors are not performing well. Various internal and external factors are important factors for the profitability of the organizations. the banker should aim at spreading the advances as widely as possible over different industries and different localities.

41 PN Varshney Banking Law and Practice Sultan Chand and sons.
this would enable him to compensate any losses which might arise as result of unanticipated factors adversely affecting particular industries. So banking and financial institutions should lend in all sectors of the economy.

2.6. Credit worthiness of borrowers

The sanctioning of unsecured advances is more risky and needs special care and attention on the part of the banker. In the absence of a charge over any specific asset, the safety of advance depends upon the honesty and integrity of the borrower as much as upon the worth of his tangible assets. The banker has, therefore, to make proper enquiries about not only about the borrower’s capacity to pay but also about his willingness to pay the amount. The credit worthiness of a borrower means that he deserves a certain amount of credit, which may safely granted to him. Such creditworthiness can be judged by the banker on the basis of his Character, Capacity and Capital.

(a) Character: the assessment of the credit worthiness of the borrowers is an essential requisite to the sound lending. the character of the borrower depends upon the various factors.

(b) Capacity: Capacity of a borrower requires two aspects to be assessed. First, the borrower must have legal capacity to borrow. For example, banks will not lend to minors. In the case of partnerships unless specifically prohibited in the partnership agreement, partners have the legal capacity to borrow money on behalf of the partnership. Limited companies will have the capacity to borrow if the articles of association of a company empower its board of directors to do so. Lending banks will always inspect the articles to ensure that the directors can borrow and also mortgage a company’s assets for the purpose of giving security. It will also check whether the Directors’ powers to borrow are restrictive or not. An assessment of the ‘financial capacity’ of a borrower is relevant in ascertaining the repayment ability of a borrower. Individual borrowers would be asked to submit a statement of income and expenditure, and of their assets and liabilities. In the case of corporate borrowers, lenders would insist on inspecting the profit and loss accounts and the balance sheets of the

42 Gower, L., Gower’s Principles of Modern Company Law, 5th Ed, Sweet and Maxwell,
business and other financial information such as cash flow statements, management accounts and final projections.\textsuperscript{43}

\textbf{(c) Capital:} The capital base of a corporate borrower is also an indication to a lender of the borrower’s financial stability. The equity of a company is an important factor to consider if the potential borrower is small and also new to the bank, or where the business is relatively new. In the first few years of a small business it will usually have little or no retained earnings, and very little external financial help. It would, therefore, have to rely on its own capital in the event of externally imposed challenges such as interest rate fluctuations, inflation and changes in market conditions.

‘Collateral’ is not mandatory in the securing of a loan. Lenders, however, will favour the availability of security; if, in the bank’s view, there is an element of doubt as to the repayment capacity of a borrower. The amount of collateral that is taken must reflect that element of doubt. As Weerasooria writes:

\textit{“Many customers believe that the primary requirement for obtaining a loan from a bank is the availability of satisfactory security, but this is a misconception. No doubt banks are concerned with the security that a customer can offer for a loan but this ought not to be the first or only consideration”\textsuperscript{44}}

Security improves the position of lenders in two circumstances. First, if a debtor becomes insolvent, a lender as a holder of valid real estate security will be in a position of pre- eminent advantage. As a holder of such security, a lender is entitled to enforce its rights of realisation of that security independently, and thereby stand outside the insolvency process.

‘Market conditions’ as well as social and economic conditions; affect a potential borrower’s business activities. It is quite possible that a borrower may satisfy all the other elements of credit assessment but if the potential borrower were engaged in a business that has an uncertain market, lenders would be reluctant to advance the money. For example, banks may be reluctant to lend for property development during a recession or where the property prices are reducing. A

\textsuperscript{43} Berry A. Faulkner, S., Hughes, M., and Jarvis, R., Bank Lending: Beyond the Theory, Chapman and Hall, London, 1993
\textsuperscript{44} Weerasooria W., Banking Law and the Financial Systems in Australia, 3rd Ed Butterworths, 2003
prudent lender will always closely study the prevailing conditions in a country before granting a loan.\textsuperscript{45}

2.6.1 Collection of Credit Information

With the availability of credit information of borrowers, the lenders are enabling to differentiate between those who have honoured their obligations responsibly and those who have defaulted. In India due to the absence of the specialized credit agency for the collection of information relating to the borrower, the task of a banker becomes difficult. Every bank maintains a Credit Investigation Department to collect information regarding the financial position of the borrower.

Assessing the credit rating of a potential borrower is a specialised function of a lender. Whilst there are lending guidelines, each loan application must be treated on its merits. Lenders must gather all the available information and then attempt to reach an objective decision. Experienced bankers no doubt have developed considerable expertise in this field. Nevertheless, for assessing fairly accurately the credit rating of both big and small customers, adequate and reliable information is essential. Most of the information is provided by the customer himself, whilst some information can be obtained from external sources such as specialised agencies or other banks.\textsuperscript{46}

The credit information is collected through the following sources:

(i) Credit Information Bureau

The Indian Banking Commission felt there was a need for outside agencies to furnish banks with information but it recognised the difficulties of establishing such agencies under prevailing Indian conditions and suggested that these agencies should be set up by legislation as separate statutory bodies. The Saraiya Commission also recommended the establishment by Legislation of specialised credit agencies, but these recommendations by both Commissions remain unimplemented.\textsuperscript{47}

\textsuperscript{45} Mather, L., The Lending Banker, 3rd Ed., Waterlow & Sons Ltd, London, 1966, 12
\textsuperscript{46} Guide to Credit Scoring, Office of Fair Trading, London, 1993
\textsuperscript{47} Report of the Banking Commission, Government of India, Delhi, 1972, 248-249, 538-539
(ii) **Borrower:** The Reserve Bank of India has advised the Banks and Financial Institutions to submit the information in the prescribed format by end of financial year consisting the details of the information regarding the details of borrowal accounts which have been classified as doubtful and loss accounts by them with outstanding Rs. One crore and above.48

(iii) **Market Reports:** one off the other mode for determining the creditworthiness of the customer is through market report. there are various mutual arrangement with regard to such publications which are helpful is assessment off the financial conditions.

**Information Provided by Banks**

Credit inquiries between banks may be formal or informal. Where one bank requests a credit reference from another bank, two problems arise. On the one hand, banks are inhibited in providing information because of their obligation to the customer to maintain secrecy about his financial affairs. On the other hand, banks are concerned with the possibility of being held responsible to the other party who may act upon the information provided by them.

According to the common law on bank confidentiality, (bank secrecy) the disclosure of information about customers to other banks or specialised credit agencies may be unlawful. That a bank is under an obligation to keep its customers affairs confidential, but the obligation imposed on banks were not absolute.49

Bankes LJ stated:

At the present day I think it may be asserted with confidence that the duty is a legal one arising out of contract, and that the duty is not absolute but qualified. It is not possible to frame any exhaustive definition of the duty.

The most that can be done is to classify the qualification, and to indicate its limits on principle I think the qualifications can be classified under following heads:

- where disclosure is under compulsion by law

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48 Circular DBOD No BC/CIS/47/20
• where the interests of the bank require disclosure
• where discharge of obligation is for the public at large

Lending Agreements

Loan agreement must be just and equitable to lenders as well as borrowers. Bankers must feel confident that the provisions in the loan agreement will afford them adequate credit protection and give them power to exert influence over borrowers, or control over a loan if necessary. For example, if the bank were in an unsecured position it would insist on including restrictive covenants into the loan agreement to protect itself. If a bank were aware that a corporate borrower has had a doubtful past record or there are material doubts related to the loan, it may want the right to control the loan tightly. On the other hand, a borrower company may consider this an unwanted intrusion into the management’s freedom to run the company. Nevertheless, it is the price to pay to obtain a loan.  

In India, loan agreements are governed by English legal principles. Judges will not enforce loan agreements that are harsh and unconscionable.  

Contract of Guarantee and surety’s liability

Meaning of guarantee

In the common parlance the word guarantee means a promise or assurance. While in the context of financial transactions, guarantee means a legal promise to repay a loan if the original borrower makes default.

As per the Oxford dictionary of accounting guarantee means “a promise made by a third party (guarantor), who is not party to a contract between two others, that the guarantor will be liable if failing in the contractual obligations.

As per the oxford dictionary of Law, guarantee means a secondary agreement in which a person (the guarantor) is liable for the debt or default of another (the principal debtor), who is the party primarily liable for the debt.

A contract of guarantee is a contract under which a person is known as surety (or guarantor) gives a promise to discharge the liability of a third person called

51 Pollock and Mulla on Indian Contract and Specific Relief Act 11th Ed., Vol. 1
principal debtor. The person whom the guarantee is given is called creditor. Guarantee is a collateral security. Guarantee is in addition to the security of mortgage or hypothecation of some property.

As per section 126 of Indian Contract Act "contract of guarantee" is a contract to perform the promise, or discharge the liability, of a third person in case of his default. The person who gives the guarantee is called the "surety"; the person in respect of whose default the guarantee is given is termed as "principal debtor", and the individual to whom the guarantee is given is termed as the "creditor". A guarantee may be either oral or written.\footnote{Chitty on Contracts, 27th Ed, Vol. 1, Sweet and Maxwell, London,1994,443}

The essence of guarantee is that a guarantor agrees to discharge his liability only when the principal debtor fails in his duty. “Let him have the loan, I will see you paid” or “if he does not pay I will” are the phrases ordinarily used when a guarantee is given. In other words, a guarantee presupposes the existence of a principal debtor, and if in any contract there never was at any time another person who can properly be described as a “principal debtor” in respect of whose default a guarantee can be given, there cannot be said to have been any “guarantee” either in its technical meaning or in its ordinary meaning. A promissory note executed jointly by a company and its managing agent does not come.”

Surety’s liability to pay is not deferred until the creditor has exhausted his remedies against the principal debtor. In the absence of special equity the surety has no right to restrain an action against him by the creditor on the ground that the principal debtor is solvent or that the creditor may have relief against the principal debtor in some other proceedings. Likewise, where the creditor has obtained a decree against the surety and against the principal debtor the surety has no right to restrain execution against him until the creditor has exhausted his remedies against the principal debtor. Thus, the surety’s liability is not deferred until remedies against principal debtor are exhausted. Liability of surety is not deferred until the creditor exhausts his remedies against the principle debtor.
Usury and Money Lending Legislation in India

In India the Usurious Loans Act, 1918 gives power to a Court to prevent enforcing a contract that is unconscionable and usurious. If a Court has reason to believe that the amount payable on a loan transaction is high or unfair due to a high interest rate that is being charged, the Act empowers the court to re-open the transaction and relieve the debtor of all liability in respect of any excessive interest.  

In 1984, the Banking Regulation Act, 1949 was amended by inserting section 21A which provided that, notwithstanding the provisions of the Usurious Loans Act and comparable state legislation, a court was prohibited from re-opening transactions between a bank and its debtor on the ground that the interest charged was excessive. This amendment has caused much controversy in the High Courts, and its scope and application has been interpreted differently, giving borrowers a useful defence in such cases. Money lending Legislation enacted at state level provides for the registration of moneylenders, maintenance of accounts in a particular form, exemption to specific lenders or types of transactions etc. In practice, moneylenders’ Legislation is not a problem to banks because most of the laws are confined to transactions involving small amounts and does not apply to banks.

Terms of a Loan

When a loan agreement is being drafted, the covenants must be designed to achieve at least three objectives for the lenders. First, in addition to repaying the loan, a bank must commit the borrower to obligations such as providing financial information regularly to the bank, undertake not to dispose of its assets, or change its business activities. Second, the covenants must put the lender in a strong position when there is inability to pay. The bank must have the right to terminate the agreement, and where relevant, be released from providing further loans that were agreed. Third, they must enable lenders to recover the money when default occurs without difficulty, preferably without recourse to court. From a borrower’s stand point, agreeing to these covenants may be regarded as the price he has to pay to secure a loan at a reasonable interest.

53 Section 3(1) the Usurious Loans Act 1918
54 Banking Law (Amendment) Act of 1983
interest rate. The borrower’s concern, however, will be to minimize the intrusiveness of a bank into the freedom of how it conducts its affairs.

**Documentation**

It is fundamentally important that loan agreements are carefully drafted and documentation for security properly prepared. Loan documentation becomes most important at the time when steps are being taken to recover overdue debts, particularly if legal action has to be initiated. In such an event, the loan documents must be capable of being admitted as evidence in a court of law. When a borrower defaults and disputes arise, the defects at the outset of a loan are often used by borrowers to defend legal actions filed against them by the banks. Loopholes and defects in documentation offer strong defences to borrowers and consideration of these at trials are often very time consuming, resulting in long delays in litigation. If the documents were defective, the very purpose of obtaining documents at the stage of granting the loan would be defeated. It is therefore essential that due care is taken when loan documents are prepared, and the required procedure is followed.

Another aspect that must be looked at is the various disincentives in the law that prevents proper documentation. The problem revolves around minimising high stamp duty and registration fees when loan agreements are signed and security is taken. In India, an English mortgage is subject to heavy stamp duty. The advantage to a bank of taking this type of mortgage is that in the event of default, the security can be enforced by way of extra-judicial sale but banks tend to ignore this advantage because of the high cost involved in stamp duty. Banks prefer to take mortgages by way of a deposit of title deeds simply because they are not subject to stamp duty, even though to realise the security a court order is required. It is doubtful whether high stamp duty needs to deter banks from taking proper security. Inevitably, these charges will be passed on to the borrower and if it can be spread over the loan period the burden will not be prohibitive. The Supreme Court of India has also ruled that such costs and charges are allowable deductions for the purpose of income tax. If the tax
deduction is taken into account, the argument that taking legal mortgages are expensive is considerably weakened.\textsuperscript{55}

In India, a genuine attempt has been made to evolve an effective credit monitoring system throughout banks. The first step in this direction was taken in 1965 when the Credit Authorisation Scheme was introduced. Thereafter, several credit monitoring schemes were implemented following the recommendations of various study groups and working committees. The Tandon Committee, Chore Committee, Marathe Committee and Pendharkar Working Group have all made various recommendations. The greater part of these recommendations were on new lending norms, effective follow up systems and management information services (MIS) for monitoring of loans and the parameters for financing sick units.\textsuperscript{56}

\subsection*{2.6.2 Types of credit facilities}

The lending activity is carried out by various banking and financial institutions. These institutions are providing various kinds of credit facilities to borrowers which are

Cash Credit, Overdrafts, Bills Finance, Term loans, Bridge loans, Composite Loans, Consumption Loans. In addition to the above there are various other non-based facilities like bank guarantee including financial guarantee, performance guarantee and deferred payment guarantee.

In India banks favor the granting of advances in the form of cash credit. In share of the entire bank credit the cash credit amount to fifty percent of the total credit. Under this method the bankers allow the customer to borrow up to a certain amount known as cash credit limit. Usually the borrower is required to provide security in the form of pledge or hypothecation of tangible securities.

The method of granting advances under overdraft resembles the cash credit system. However to avail of an overdraft facility the borrower has to open a current account. This account is allowed to be overdrawn up to a certain limit.

\textsuperscript{55} Tannan's Banking Law and Practice in India, 19th Ed, India Law House, New Delhi, 1998,
2.7 Securities for Bank Loans

2.7.1 General Principles of Secured Advances

While granting advances on the basis of securities offered by customers, a banker should observe the following basic principles:

During the sanctioning of the amount on the basis of the collateral offered by the borrower the lending institutions should adhere to the basic principles.

(a) Adequacy of Margin: adequacy of the margin is very significant factor in the lending process. The lending institutors keep a safe margin during the sanctioning of the amount.

(b) Marketability of Securities: the loans are sanctioned for a period by the banking and financial institutions which are repayable on the demand. In case of the default of the payment by the borrower the collateral can be converted into liquidity. There it is very necessary that the collateral should be of such quality having quality of marketability.

(c) Documentation: loan agreements must be drafted, preferably by lawyers, to incorporate the individual terms and conditions of the loan. Properly drafted loan agreements could provide lenders with credit protection or give them influence over borrowers, or control over a loan. Detailed covenants, clearly setting out reporting and monitoring obligations by borrowers, also enhance credit protection to lenders. It is also an effective method of monitoring a borrower's performance after a loan have been granted. Covenants that require a borrower to provide information regarding its financial status would provide lenders with early warning signals of any financial difficulties a borrower may be experiencing.

Forms of securities for secure advances

Traditionally the land and building has been used as a security very well but with the passage of time there has been the change in the nature of security. There are series of the items which can be used as a security. The major categories are land, stocks & shares, debentures, goods, life policies, fixed deposits.
2.8 Charges over Securities

In banking terms, creation of charge is a mode of creation of security for lending. In banking terms, creation of charge is a mode of creation of security for lending. Such a can be created by way of mortgage, hypothecation or pledge. In case of hypothecation the hypothecator can be in possession of the goods hypothecated and enjoy the same without causing any damage to the rights of the hypothecatee whereas in the case of pledge the possession of goods will be transferred to the pawnee and he will be in possession and the pawnor will not be able to enjoy the same as the possession has already been parted with.\textsuperscript{57}

Under Section 2(n) SARFAESI Act charge induced during hypothecation includes floating charge and crystallization of such charge into fixed charge on movable property. So the charge created in or upon any movable property, existing or future, created by a borrower in favor of a secured creditor without delivery of possession of the movable property to such creditor, as a security for financial assistance and includes floating charge and crystallization of such charge into fixed charge on movable property.

Floating charge holders cannot be said to be holding a security interest in the asset until the charge crystallized.

The governing idea of a floating security is to allow a going concern to carry on its business in the ordinary course, the effect of which would be to make the assets liable to constant fluctuation, and some event must happen or some act must be done by the mortgagee to crystallize the same.\textsuperscript{58}

In Evans v. Rival Granite Quarries Ltd. Buckley LJ observed:

"A floating security is not a future security; It is a present security, which possibly affects all the assets of the company expressed to be included in it On the other hand, it is not a specific security; the holder cannot affirm that the assets are specifically mortgaged to him. The assets are mortgaged in such a way that the mortgagor can deal with them without the concurrence of the

\textsuperscript{57} State Bank Of India vs S.B. Shah Ali (Died) And Others AIR 1995 AP 134
\textsuperscript{58} H V Low And Co Ltd Vs. Pulimbiharilal Singha AIR 1933 Cal 154
mortgagee. A floating security is not a specific mortgage of the assets, plus a license to the mortgagor to dispose of them in the course of the business, but is a floating mortgage applying to every item comprised in the security, but not specifically affecting any item until some event occurs or some act on the part of the mortgagee is done which causes it to crystallize into a fixed security." 59

Such a security can be created by way of mortgage, hypothecation or pledge.

**Pledge of Security**

Pledge of security is a contract whereby an article is deposited with a lender as a promise or security for the repayment of a loan or performance of a promise. For the completion of the contract of pledge, delivery of the goods to the banker is necessary. Delivery of title documents relating to the goods, or the key of the godown where the goods are stored, may be the sufficient to create a valid pledge. In the case of pledge an important precautions that a banker should take is to ensure that the pledged goods to the bank are free from prior encumbrance.

**Hypothecation over Securities**

Where a mortgage of movables is created by delivery of possession of goods, it is known as pledge, and where no possession is given it is termed as hypothecation. Hypothecation is used for creation of charge against the security of movable assets, but in this case the possession of the security remains with the borrower himself.

**Lien**

A lien may be defined a right to retain property belonging to a debtor until he has discharged the debt due to retainer of the property. Banker’s lien is a general lien bankers have a general lien on all securities deposited with them as bakers by a customer, unless there be an express contract, or circumstances that show an implied contract, inconsistent with lien. in case of lien banker’s right of sale extends only to fully negotiable securities.as far as such securities are concerned, the banker may exercise his right of sale after serving reasonable notice to the customer.

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59 Evans V Rival Granite Quarries Ltd: Ca [1910] 2 Kb 979
Assignment

This is also one of the modes of creating the charge on securities offered to the lender. It is transfer of ownership from one person to another person.

Mortgage

When the banker is securing advances with collaterals, the question whether particular collateral is a movable or an immovable property assumes significance. A mortgage may be created only by a transfer of interest in an immovable property. The mortgage may be created either by deposit of titled deeds, delivery of possession or by a registered document. It is relevant for determining the period of limitation for suit for declaration of the title to the property or for recovery of possession of the property. If the property is movable, then such suit is required to be filed within three years.

Summary of the chapter

This chapter has dealt with the overview and framework of the Indian banking sector. It focused on the credit system in India's banking industry during liberalization era. It also provides a brief overview of historical perspective of Indian banking industry with special emphasis on the reforms during liberalization phase since 1991.

In the phase of post-independence and before nationalization, Banking sector remained in the private hands of large industrialists who had their control in the management of the banks and were utilizing the major portion of financial resources of the banking system and as a result low priority was accorded to priority sectors. Like as other sectors of Indian Economy the baking sector also had suffered various structural problems by the end of 1980s. By the 1990 the Indian Banking sector was characterized as unprofitable, inefficient and financially unsound. India faced a serious economic crisis in 1991. There was a steep fall in the country's foreign exchange reserves to about $1billion, equal to the value of only two weeks' imports. There was a large fiscal deficit close to 10 per cent of GDP and an unsustainable external balance with current account deficit at 3 per cent of GDP. Faced with such a crisis, India adopted reforms involving macroeconomic stabilisation and structural adjustment programmes. They aimed at improving economic performance and accelerating the rate of
economic growth through a transition from an inward-looking strategy to an outward-looking one and from a regime of licenses and controls to a system of incentives and price mechanism. At the core of the programme was a phased deregulation of the financial sector, along with reforms of trade and industrial policies. Until the late 1950s, the financial system in India was fairly liberal with no ceilings on interest rates and low reserve requirements.

In the early 1960s, the government tightened its control over the financial system by introducing lending rate controls, higher liquidity requirements and by establishing state development banks for industry and agriculture. This process culminated in the nationalisation of the fourteen largest commercial banks in July 1969. Again in April 1980, six more commercial banks were nationalised.

Various policies were used for the banking sector to gain influences such as interest rate controls, directed credit programme and statutory preemptions. In early 1980 the interest rate regulation almost steadily increased but in the late 1980s the degree of interest’s rate controls was lowered. Since the beginning of the 1990s, the degree of interest rate controls has steadily declined which reflects that today most interest rates are determined by the market. The Indian economy initiated economic reforms, the Indian banking industry also made great advancement in terms of quality, quantity, expansion and diversification in keeping with the updated technology.

The statutory ration of CRR and SLR has been gradually lowered since 1991. This statutory reduction resulted a greater flexibility for banks in determining both the volume and terms of lending. In the following years, reforms covered the areas of interest rate deregulation, directed credit rules, statutory pre-emption's and liberalization of the financial sector.

Removal of regressionist policies leads to an increased availability of capital. Introducing the globally accepted best practicing norms on Capital to Risk Asset Ratio (CRAR) requirement, accounting, income recognition, provisioning and exposure. Steps to strengthen risk management though recognition of different component of risk, assignment of risk weights to various asset classes, norms of connected lending, risk concentration, application of market to market
principle for investment portfolio limits on deployment of fund in sensitive activities. Introducing capital charge for market risk, higher graded provisioning for NP As, guidelines for ownership and governance, securitization and debt restructuring mechanism norms, etc.

The liberalisation processes with a set of objectives especially the financial market has witnessed a strong revival of the Economy since 1991 especially the banking, insurance and capital market. The Banking sector in India consists of scheduled Commercial banks, Development Banks, Cooperative Banks, Regional Rural Banks, and even Non-Banking Financial Companies. The reforms in this sector introduced a new creative and competitive environment for the affluence of banking sector as a whole. In India laws facilitating free market economic policies are being actively promoted, by the introduction of new laws as well as the amendment of existing legislation.

India has completed more than two decades of its economic reforms. The economic reforms can be successful if the country keeps pace with the global trends and maintains parity with important economic and finance sector legislations in other countries. The biggest challenge is hence to create efficient, well integrated and transparent machinery.

The introduction of financial sector reforms in 1993 brought to fore the extent of NPAs in a structured fashion, and the stock of NPAs is being tackled through various measures. Detailed steps have been introduced by the Government of India on lines of the recommendations of two reports of Narasimhan Committee on arresting and containing the growth of NPAs. In the year 1993, RBI introduced prudential norms as conveyed by the Basel Accords of 1988 applicable to Indian Banks.60

**Institutional and Legislative Reforms**

- Establishment of Debt Recovery Tribunals, Asset Reconstruction Companies, Corporate Debt Reconstructing Mechanism and Lok-Adalats (people's court), etc. for quick recovery of debts.

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• Introducing the asset reconstruction and by the Legislative framework and its subsequent amendment for ensuring the rights of the creditors.

• Setting up of Credit Information Bureau of India Limited for sharing of information of the borrowers and defaulters.

• Establishment of Board of Financial Supervision as the watchdog for the banking, financial and non-banking financial companies.

• Introduction of the consolidated supervision, strengthening of off-site surveillance through control returns.

Till 1990s, Indian Banking Sector was mostly used by the government as one of its departments to finance its fiscal deficits at low costs, channelize money towards the weaker sections of the society. Reserve Bank of India (RBI) controlled all Banks with iron fist and banks had very little discretion in fixing the interest rates for advances and deposits, recruitment policies, decision on branch expansion, etc. Consequently, banking industry was flooded with loans or assets, which failed to perform, or turned out bad.

Loan transactions may be secured or unsecured. Lenders will be prepared to grant unsecured loans if the creditworthiness of borrowers sufficiently assures that the loan will be repaid. Most lenders in developing countries however, do not lend without security. Lending institutions demand security as a precondition to the granting of credit irrespective of the extent of the risk involved. If bankers were to grant unsecured loans, their credit appraisal must be carried out to an extremely high standard, where the risk element is assessed as accurately as possible.

Security improves the position of lenders in two circumstances. First, if a debtor becomes insolvent, a lender as a holder of valid real estate security will be in a position of pre-eminent advantage. As a holder of such security, a lender is entitled to enforce its rights of realisation of that security independently, and thereby stand outside the insolvency process. If security had not been taken, a lender would be regarded as an unsecured creditor, and would have to prove a claim in the insolvency proceedings, for a pro rata settlement of its debt. Second, if a borrower defaults payment, a lender who has taken security would be able to recoup his losses by enforcing the security. Under SICA Act ,1985 regime there it effectively blocks secured creditors from enforcing their security.
in the event the debtor becomes “sick” or “potentially sick. According to section 22 of the Act, notwithstanding any law, if an inquiry were pending or a rehabilitation scheme were under consideration, and various other actions only with the consent of the Board. Clearly, as a matter of law, section 22 blocks the exercise by creditors’ of their rights of security. The suspension imposed on secured creditors is not time bound. Consequently, creditors will be unable to exercise their rights until a rehabilitation scheme either succeeds or fails which in practice may take several years.

Credit is no longer solely based on the assessment of individuals of the borrowers who they know personally but also on assessment of others that the borrower has no direct contact at all. It is no longer solely based on information obtained from face-to face contacts but also on the analysis and judgment of a specialized third party, and limited to the use of borrower and lender, but also acquires the nature of public goods. These features of modern credit culture develop it into a huge industry and hence have a far reaching impact on the social and economic life.

‘Collateral’ is not mandatory in the securing of a loan. Lenders, however, will favour the availability of security, if, in the bank’s view, there is an element of doubt as to the repayment capacity of a borrower. The amount of collateral that is taken must reflect that element of doubt. As Weerasooria writes:

“Many customers believe that the primary requirement for obtaining a loan from a bank is the availability of satisfactory security, but this is a misconception. No doubt banks are concerned with the security that a customer can offer for a loan but this ought not to be the first or only consideration”. Market conditions’ as well as social and economic conditions affect a potential borrower’s business activities. It is quite possible that a borrower may satisfy all the other elements of credit assessment but if the potential borrower were engaged in a business that has an uncertain market, lenders would be reluctant to advance the money.

Assessing the credit rating of a potential borrower is a specialised function of a lender. Whilst there are lending guidelines, each loan application must be

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treated on its merits. Lenders must gather all the available information and then attempt to reach an objective decision. A country aiming to achieve economic growth by promoting private investment must secure creditors’ rights. Unless creditors' rights are recognised and protected, lenders would be compelled to adopt restrictive lending policies. This may lead to high interest rates, and low volumes of lending that directly affect the economic growth of a country. It is to be concluded that none of the principles mentioned above should be read in isolation while considering the proposal for an advance. What is required is a judicious blending of all these principles when evaluating a loan proposal. In individual cases, it may be necessary to give prominence to one or more of the principles as compared to others. Also technical competence of the borrower, operational flexibility and economic viability of the project have their own importance and relevance.