

**RBI 105 / 2004**

DBS.FrMC.No. BC. 1 /23.04.01D/2004-05

August 7, 2004

The Chief Executives  
All Commercial Banks

Dear Sir,

**Deficiencies found in sanctioning of loans and monitoring of borrowal accounts by banks / Financial Institutions**

As you are aware, the incidence of frauds in major borrowal accounts is a cause of concern for the banks' management as also for Reserve Bank of India. Apart from acts of willful default, diversion of funds, clandestine removal of goods, fraudulent practices adopted in documentation of securities pledged with banks, submission of fake / bogus / forged bills / LCs / export documents etc., it has been observed that in many reported frauds, there were inherent weaknesses at the stages of sanction and post disbursement follow up of advances which ultimately culminated in perpetration of frauds in the accounts.

2. In this connection, the Advisory Board on Bank, Commercial and Financial Frauds (ABBCFF) has observed that in a large number of cases reported as frauds, there were administrative lapses in the processing of applications and in monitoring of accounts. The Board is also of the opinion that where such lapses had occurred, the action taken by the senior management to investigate the matter and take disciplinary action was often tardy and inadequate.

3. An illustrative list of deficiencies at the stages of sanction and monitoring of advances, observed by the ABBCFF and suggestions to improve the system, offered by it is given in the Annex for guidance of banks.

4. Please let us know the additional steps taken by you on the basis of the suggestions given in the Annex for minimizing the incidence of frauds in the advances portfolio.

5. We also advise you to apprise the Special Committee of the Board for monitoring and follow up of cases of frauds of Rs.1crore and above, of the contents of this letter.

Yours faithfully

(K V Subba Rao)  
Chief General Manager

## **ANNEX**

### **I. Deficiencies at the stage of sanction**

- (i) There were deficiencies in the appraisal of credit proposals. High projections of the borrowing company were not critically analysed by the sanctioning authorities. With the result, the borrowers' credit requirements were not properly assessed. In some cases, the credit limits were sanctioned on the basis of appraisal made by the Merchant Banking Division for the purpose of public issue. In such cases, the existence of a conflict of interest was not always appreciated, as the arranging of finance was one of the services, which the Merchant Banker was rendering to the borrower. The bank relied on such appraisal and no separate assessment for credit risk was done. There were instances where term loans were sanctioned without insisting on the project report, cost of project and means of finance.
- (ii) At the time of mid-term review of the projects, additional loans were sanctioned without proper appreciation of the market conditions and the factors which led to time and cost overruns in the projects by the sanctioning authorities.
- (iii) The sanctioning authorities had overlooked the irregularities pointed out by the lower level functionaries in the borrowal accounts or in the accounts of the group companies based on stock verification reports, audit reports, etc. and sanctioned the facilities. They had not taken into account the fact that the existing accounts of the borrower were irregular, audit objections not cleared, estimates inordinately inflated and the vital issues either not commented upon or wrongly commented in the inspection / audit report itself.
- (iv) The sanctioning authorities were not given full facts about the borrowers and the projects by the officials in controlling office / branch. This was mainly because the branch did not make proper scrutiny of the borrowing company's antecedents and verify the claims of achievements by them.
- (v) Contrary to the above, the sanctioning authorities had adequate facts about the unsatisfactory position of the borrowal accounts and yet facilities were sanctioned overlooking the deficiencies.
- (vi) There were instances where the sanction itself was not justified on the basis of projections made by the borrowers and valuation of securities offered by them.
- (vii) Sanctions were made deviating from the laid down policy on extending finance for capital expenditure / long term working capital. In one case, facilities were sanctioned by the bank's board in violation of its own internal norms.
- (viii) Sanctioning authorities overlooked the fact at the time of take over of accounts that the borrowing company had irregular accounts with the previous bank/s.

- (ix) Adhoc limits were sanctioned frequently even if the company had regular limits and its accounts were running irregularly. At times, such limits were sanctioned by branch / Zonal Office / Central Office level functionaries in excess of their delegated powers. Revival packages were also sanctioned by the Regional authorities in respect of credit limits originally sanctioned by the bank's Head Office Committee.
- (x) The terms and conditions prescribed at the time of sanction of loan facilities were subsequently relaxed by the sanctioning authorities themselves while disbursing funds without any justification for such relaxation.
- (xi) In some cases, it appears that the sanctioning authorities had acted on extraneous influences, rather than deciding on the merits of the case. The borrowal account finally turned into a non-performing asset.

## **II. Deficiencies at the monitoring stage**

- (i) Loans / advances were released by the branch officials in blatant violation of the terms and conditions of the sanction laid down by the Central Office.
- (ii) No proper monitoring of the end-use of the funds by the borrowers was noticed in a few cases. Cases of such diversion of funds in larger accounts were not reported to the bank's Board for their information and providing required direction in the matter.
- (iii) Monitoring of the company's financial standing especially with reference to the financial indicators was not carried out effectively.
- (iv) Undue reliance on the certificates given by the Chartered Accountants / Valuers without co-relating them with other relevant procedures was noticed. For example, in the case of projects under implementation, reliance was placed on the certificates without adequate monitoring of the progress of construction through site visits. Similarly, in respect of certificates for verification of inventories, there was inadequate correlation of the figures with audited financial statements and also inadequate follow-up on deficiencies reported. In one case, it came to light subsequently that the borrower company had produced forged expenditure certificates from the Chartered Accountants.
- (v) There was also lack of proper monitoring even with regard to very important terms and conditions of the term loan sanction such as, tie up of funds, stipulation of promoter's contribution, etc leading to disproportionate lending by the banks / FIs.
- (vi) As regards working capital limits, failure to detect disappearance of stocks given as security had resulted in misappropriation of funds / sale of stock and realization of receivables without the knowledge of banks/FIs.

- (vii) Failure to ensure adequacy of the security offered by the borrowers, especially failure to verify whether the same asset was mortgaged to another bank / FI was also noticed.
- (viii) Periodical reviews of accounts were not undertaken after the funds were lent by the banks / FIs.
- (ix) Proper assessment of the financial standing of the projects was not carried out when the bank / FI took over an account from another bank.
- (x) Excess drawings permitted by the branch / Regional Office level functionaries, in the borrowal accounts were ratified by the Head Office in a routine manner without examining the need for such permissions, at times, frequently.
- (xi) Limits sanctioned were allowed to be interchanged indiscriminately by the branch officials without proper authority.
- (xii) In cases pertaining to term loans for financing projects, important terms and conditions of the sanction stipulated by the Board of Directors such as induction of technical directors, constitution of Audit Committees and independent project monitoring committees are not taken seriously. Many a times, non-compliance even at the stage of the release of the final instalment of the loan sanctioned is not taken seriously. This is a very serious lacuna which cuts at the root of the principles of project management and project financing.

### **III. Suggestions to improve the system**

The following suggestions are made with a view to improving the system.

- (i) In many cases diversion of funds is facilitated by opening of accounts with other banks wherein the sale proceeds / proceeds of realized book debts are credited, without the knowledge of the lending bank. With a view to prevent such malpractices, the lending bank should obtain a certificate from the borrowers on a quarterly basis furnishing details of accounts opened with other banks.
- (ii) It is noticed that the banks rely on the certificates of valuation given by the external valuers which in some cases were subsequently found to have shown grossly inflated values. It is, therefore, suggested that the setting up of independent cells for valuation within banks themselves, which are manned by technical personnel with the right expertise is considered seriously.
- (iii) Immediate action should be taken where the malafides / gross negligence on the part of dealing officials are noticed. The Advisory Board finds that in the

large majority of cases, administrative action is either not initiated well in time or not initiated at all.

- (iv) Wherever there is a prima-facie case against the dealing officials, appropriate action in terms of CVC guidelines for their inclusion in the list of officers with doubtful integrity should be initiated by banks / FIs in consultation with the CBI.
- (v) While processing loan applications, there is no scientific application of mind by the bank officials in observance of compliance with the stipulated terms and conditions by the borrowers and as a result, certain serious defaults had occurred causing systemic failure of the financial sector. It is, therefore, suggested that banks/FIs should evolve a process of check listing which would enable them to take note of any deficiencies while releasing the funds to the borrowers or monitoring the end use of funds.
- (vi) There is a need for building up a cadre of officials with proper educational background and training to take care of at least larger projects being financed by the banks / FIs.
- (vii) Perhaps the single largest cause of financial loss to the lending institutions is the fact that in respect of project finance, disbursements are not made by the lending institution in proportion to the funds disbursed by the promoter / borrower. In several cases, the promoter / borrower is unable to bring in or raise the funds which he is required to provide in terms of the sanction and consequently, in order to protect the investment already made, the lending institution has to provide additional funds not envisaged in the original proposal. The same situation persists when there are cost over-runs, whereby the exposure of the lending institution gets increased.

This problem can be avoided if the promoter / borrower is required to bring in up-front his contribution (other than funds to be provided through internal generation) and the lending institution commences its disbursement only after the stipulated funds are brought in by the promoter / borrower.