Munich Personal RePEc Archive

How to Prevent Non Performing Assets in Small Scale Industries

Das, Rituparna

5 January 2003

Online at https://mpra.ub.uni-muenchen.de/65191/
MPRA Paper No. 65191, posted 23 Jun 2015 06:29 UTC

CENTRE FOR STUDIES IN BANKING AND FINANCE
(Established by the Reserve Bank of India at National Law University, Jodhpur)

Paper for Workshop on Non Performing Assets
and
Prevention and Detection of Baking Frauds

How to Prevent Non Performing Assets in Small Scale Industries

Rituparna Das

January 2003

JEL Code: G 21

DOI: 10.13140/RG.2.1.1226.2563

" 'The loan which I have not yet paid', being here, having made requital of the loan to Yama, he goes freed from the debt to the world of heaven." *Yajur Veda*

Abstract

This paper tries to seek a solution to the problem of non performing assets in the small scale industries under the present circumstances of banking and insurance working together under the same roof. What is stressed in this chapter is the pressing need of the small scale entrepreneur for becoming aware and educated in modern business management holding a professional attitude toward rational decision making and banks have to facilitate that process as a part of the credit policy sold by them.

Keywords: Bancassurance, Credit Risk, Entrepreneureship

A revised version of this paper is published as Chapter 7 in *Research Methodology in Social Sciences and Management: Models on Indian Issues*, ISBN-13: 978-3639295467, pp 167-223.

1. Introduction
2. The issues
3. The methodology
4. Answers to the issues
5. Benefits of the proposal
6. Costs of the proposal
7. Conclusion

1. Introduction

Ever since the introduction of financial sector reforms in India the NPA (non performing assets) of the banking system have been getting attention. NPA cause serious strain on the profitability as, on the one hand banks cannot book income on such accounts and on the other hand they are required to charge the funding cost and provision requirements to their profits. Since the early 90s the government has had to give over Rs. 23000 crores in bailouts to various banks and financial institutions, out of the taxpayers' money. Banks feel afraid of high risk of lending to small business because of lack of accounting and reputation, uncertain property rights of the assets they are holding and noncompliance with regulations[1]. As per the international norms net NPA i.e. gross NPA less provision for loss are to be slashed down to 2-3%.

India is the only country with an extensive set of policies supporting and protecting many kinds of small enterprises by directly subsidizing them or exempting them from taxes and preferring them for government purchases[i]. Amongst the priority sector components the SSI (small-scale industries) contribute the maximum share 19.24% in total NPA of public sector banks, 18.27% in total NPA of old private sector banks and 5.74% in total NPA of new private sector banks during 2002-03 as an individual component as per the Reserve Bank of India statistics[ii]. As per the RBI report on sectoral deployment of NPA 2002-03, the SSI contributed the maximum amongst various priority sectors. This paper seeks to diagnose the problem and thereafter prescribe a solution model that can minimize the chance of NPA generation in the SSI sector.

2. The issues

This article attempts to answer to the following questions:

a). What are NPA? How does the concept evolve in the context of India?

b). What is the policy intervention of management of NPA? What has been done so far?

c). What are the shortcomings in the above?

d). How to select the right candidate for SSI loans especially under various government schemes

e). How to enable them to manage risk and survive in the phase of a number of external constraints like competition from large scale industries, dereservation, bottlenecks in infrastructure and supplies of factors of production

f). How to control willful default and moral hazard

Endnotes

[1] Morrison C., Lecomte H.B.S. and Oudin X (1994): *Microenterprises and The Institutional Framework in The Developing Countries,* OECD, Paris, Chapter 4

Answers to these are the crux of the paper.

3. The methodology

The work is a mix of doctrinaire and empirical survey. It draws heavily from related books, articles, reports, case studies and internet. The data about Indian banking downloaded from internet is cross-checked by the relevant RBI reports on the one hand and on the other hand interviews with a select number of officials from the appropriate departments of the central bank[iii]. While surveying the current literatures on Indian banking and insurance a link between the two is detected, where insurance can function as a complementary product to bank loan in order to make it viable and ensure its quality. The innovative use of insurance clubbed with bank loan turns into a powerful mechanism that minimizes the chance of NPA generation in the SSI sector.

4. Answers to the issues

a). What is NPA? How did the concept evolve?

An asset including a leased asset becomes non-performing when it ceases to generate income for the bank[iv]. A non-performing asset was defined as a credit facility in respect of which the interest and/or installment of principal has remained past due for a specified period of time. The specified period was reduced in a phased manner as under:

Year ending March 31	Specified period
1993	Four quarters
1994	Three quarters
1995	Two quarters
2004 onwards	One quarter

An amount due under any credit facility is treated as past due when it has not been paid within 30 days from the due date. Due to improvements in the payment and settlement systems, recovery climate, upgradation of technology in the banking system etc it was decided to dispense with 'past due' concept with effect from March 31, 2001. Accordingly as from that date a non-performing asset shall be an advance where

- Interest and/or installment of principal remain overdue for a period of more than 180 days in respect of a term loan.
- The account remains 'out of order' for a period of more than 180 days, in respect of an overdraft/cash credit.
- The bill remains overdue for a period of more than 180 days in the case of bills purchased and discounted.
- Interest and/or installment of principal remains overdue for two harvest seasons but for a period not exceeding two half years in the case of an advance granted for agricultural purposes and
- Any amount to be received remains overdue for a period of 180 days in respect of other accounts

With a view to moving towards international best practices and to ensure greater transparency it has been decided to adopt the '90' days overdue norm for identification of NPA, from the year ending March 31, 2004. Accordingly with effect from March, 2004 a NPA shall be a loan or an advance where

- Interest and/or installment of principle remain overdue for a period of more than 90 days in respect of term loan.
- The account remains 'out of order' for a period of more than 90 days, in respect of an overdraft or cash credit.
- The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted
- Interest and/or installment of principal remains overdue for two harvest seasons but for a period not exceeding two and half years in the case of an advance granted for agricultural purposes and
- Any amount to be received remains overdue for a period of more than 90 days in respect f other accounts.

As a facilitating measure for smooth transition to 90 days norm, banks have been advised to move over to charging of interest at monthly rests, by April 1, 2002. However, the date of classification of an advance as NPA should not be changed on account of charging of interest at monthly rests. Banks should therefore continue to classify an account as NPA only if the interest charged during any quarter is not serviced fully within 180 days from the end of the quarter with effect of April 1, 2002 and 90 days from the end of the quarter with effect from March 31, 2004.

An account should be treated out of order if the outstanding balance remains continuously in excess of the sanctioned limit/drawing power. In the cases where outstanding balances in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits continuously for six months as on the date of balance sheet or credits are not enough to cover he interest debited during the same period, these accounts should be treated as 'out of order'.

An amount due to the bank under any credit facility is overdue if it not paid on the due date fixed by the bank[v].

b). What is the policy intervention of management of NPA? What has been done so far?

It has been suggested that the central Boards of banks should periodically NPA related problems of the bank and lay down the following policies in this regard

a). With a view to get focused attention, creation of separate Division to look after very large accounts.

b). HRD intervention, to upgrade the skills of operating officials dealing with credit follow-up to arrest slippages of assets from standard Asset category.

c). Introduction of credit audit to ensure proper appraisal and compliance of terms and conditions of sanction; credit audit reports to indicate early identification of problem loans and warning signals for potential NPA, so that corrective action could be taken.

d). Banks should lay down NPA Management Policy, which should indicate early identification of problem loans and warning signals

e). NPA task force should review all loans at Apex level, Regional level and Branch Level. Suitable cut off limits can be kept for each level. Action points emanating from such reviews should be conveyed down the line and follow up action should be watched.

f). Cases referred to DRTs (Debt Recovery Tribunal) and BIFR (Board of Financial Reconstruction) should be followed up. Operating functionaries be advised to seek appropriate relieves at the internal stages, whenever warranted, to prevent asset stripping by promoters. Nodal offices be appointed to monitor cases in DRT and BIFR.

g). Establishing specialized Rehabilitation and Recovery branches for speedy follow up.

h). Credit Risk Rating System should be firmly in place.

In this context early warning signals are specified with special emphasis on conduct of accounts, danger signs appearing during unit inspection, submission of financial statements and non-financial indicators visible to banker[vi].

Following are the common strategies adopted by banks for containment/recovery of NPA accounts

a). Strengthening post sanction follow up especially by getting alerted as soon as one quarter default in interest/installment payment is noticed.

b). Exerting tremendous pressure and resorting to arm twisting measures on recalcitrant borrowers by attachment of their assets, putting these assets quickly on auction/sale and wide publicity to such firm steps taken. This may compel the borrower either to repay the dues rather quickly or settle the same through the compromise route. It also has a demonstrative/deterrent effect on other defaulters.

c). Quick responses on various adverse developments noticed in the borrowal accounts or in suit filed cases helped in retrieving the situation sooner. The endeavor has been to thwart deterioration in the position due to efflux of time.

d). Strengthening information management in NPA accounts to track down what is happening at the ground level to avoid surprise/shocks have been found to be of great help.

e). Using audiovisuals as a technique for mass education of borrowers on the importance of cultivating timely repayment habit.

f). Assigning due weight and importance to macroeconomic and industry level developments at the time of appraisal to avoid slippages within a short period of sanction[vii].

(c). How far the above policy interventions and the strategies are successful

The success of above policy interventions and the strategies can be gauged in terms of the data on trend of NPA in different sectors and with different categories of banks:

Table 1: Aggregate NPA figures with different categories of banks in Rs. Crores

Year	Nationalized Banks[viii]	State Bank Group	Old Private Sector Banks
2000-01	32,983.42	20,190.70	4,810.82
2001-02	36,762.78	19,743.57	4,850.89
2002-03	35,848.82	16,958.10	4,636.05

Source of data: *Report on Trend and Progress of Banking in India,* Reserve Bank of India for the years 2000-01, 2001-02 and 2002-03

From the above table we find that there is hardly any improvement with Nationalized Banks and Old Private Sector Banks, whereas there is marginal improvement with the State Bank Group to the extent of 16%.

Table 2: Sectorwise average NPA shares with Nationalized Banks and Old Private sector banks in terms of percentages

Year	Priority Sector			Public Sector	Non-priority Sector	Total
	Agriculture	SSI	Others			
2000-01	9.67	18.225	11.725	2.035	58.335	99.99
2001-02	9.365	19.98	12.255	0.765	57.63	99.995
2002-03	9.835	19.035	13.685	0.875	56.57	100

Source: Same as in Table 1

Here we find while there is significant improvement by more than 75% with public sector, there is hardly any improvement with SSI and little deterioration with agriculture.

Table 3: Sectorwise average NPA shares with the State Bank of India Group in terms of percentages

Year	Priority Sector			Public Sector	Non-Priority Sector	Total
	Agriculture	SSI	Others			
2001	14.95	18.84	10.43	6.01	49.77	100.00
2002	16.02	18.59	11.07	3.14	51.18	100
2003	17.53	18.07	11.88	3.1	49.41	99.99

Source: Same as Table 1

Here the picture is same as table 2. While public sector NPA have declined by 50%, agriculture NPA has worsened and the SSI NPA has shown hardly any improvement. Again public sector banks have settled about 30% of their NPA cases for which they issued notices under the SARFAESI (Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest) Act 2002. A total of 33,736 notices under the SARFAESI Act were issued by 20 nationalized banks and the subsidiaries of SBI for recovery of Rs 12,147 crore after the enactment of the Act. These banks together have settled 9,946 cases, according to data compiled by CMIE (Center of Monitoring Indian Economy). Though the percentage of dispute cases settled till June 03 amount to 29.5%, in terms of value it amounts to a paltry Rs 499 crore only, accounting for just 4.1% of the total outstanding amount for which notices were issued. The SBI and its subsidiaries together have recovered Rs 83 crore out of Rs 4,771 crore loan outstanding for which they had issued notices till June 03. Similarly, Punjab National Bank and Canara Bank, which had sent 3,015 and 1,011 notices respectively for recovery of loans amounting to Rs 711 crore and Rs 350 crore, have recovered Rs 39.3 crore and Rs 34.5 crore respectively till June 03[ix].

Now we try to find what is wrong with the policy interventions and strategies adopted by the banks?

All the policy interventions suggested are related to the banks and the enforcing authority. They do not relate to the borrowers. They aim at strengthening the administrative machinery, but are not concerned with the problems of borrowers and defaulters. Secondly, while strategy 'e' to some extent relates to the borrower, other strategies try to answer the question 'what after default', but not 'how to prevent default and expand the bank's business with the same client'. Thirdly, the data reveals that the problem exists in the borrowers, not in the banks and administration in the post-lending period, while in the pre-lending period, problem exists in the banks. As per Wignaraja 2003 lack of managerial skill in these borrowers is eating out the competitiveness of the developing countries like India vis-à-vis the developed countries[x]. In the pre-lending period, proper assessment of the competence of the applicant is required. Fourthly, banks do not see that the business runs successfully. It is necessary that banks enter into insurance business as risk carriers so that they may also sell credit policies designed to minimize the risk of default.

In short the following issues remain undressed:

1. How to select the right candidate for SSI loans especially under various government schemes
2. How to enable them to manage risk and survive in the phase of a number of external constraints like competition from large scale industries, dereservation, ceiling on further capital investment, bottlenecks in infrastructure and supplies of factors of production
3. How to control willful default and moral hazard

First we answer the third issue. In order to control willful default and moral hazard the bank should see that the loan-applicant has insured himself against all future losses which can handicap his repaying ability. This is possible in two ways – first the applicant can buy the appropriate insurance cover from a general insurance company and surrender it to the bank and second the bank itself insures him. The second possibility implies that the bank should enter general insurance business. Regarding the first possibility the current in India is that premium is not returned in case the event does not happen. Neither the bank nor the borrower gets any benefit from this. In addition if the borrower defaults the bank loses. But if the bank sells him the general insurance, then if the insured event does not take place and the borrower defaults, the paid premium can cancel out a part of the bank's loss.

It can be proved that in order to avoid default it is wise for the borrower to insure his business fully against the events causing losses and on other hand liberalization of the financial sector consequent upon competition in the banking industry would make the bank insure the borrower fully against any loss when there is fear of default. This is the economic aspect of lender's liability.

First we prove that the borrower should insure his business fully.

Let the business have an initial monetary wealth 'A'. He will lose an amount 'B' the probability of which is 'q'. This loss would prevent him to repay the loan as he can allege. Let him buy an insurance cover, which would provide him 'C' if the event occurs and he has to pay a premium 'p' for every rupee of coverage. His utility function is $U(A - B - pC + C)$ in case the event happens and $U(A - pC)$ in case the event does not happen. He will maximize his expected utility function

$EU = qU(A - B - pC + C) + (1-q)\ U(A - pC)$ by choosing the optimum amount of C. The choice variable here is C.

The first order condition is $dEU/dC = qU_C(A - B - pC + C)(1-p) + (1-q)\ U_C(A - pC)(-p) = 0$; $U_C = dU/dC$

The expected profit from the insurance business is $q(pC - C) + (1-q)pC$. Competition sets $q(pC - C) + (1-q)pC = 0 \Rightarrow q = p$. This is called pure premium. This happens when there is no transactions cost, marketing cost and any other costs in absence of any externality in the market. Putting $q = p$ in $qU_C(A - B - pC + C)(1-p) + (1-q)\ U_C(A - pC)(-p) = 0$ yields $U_C(A - B - pC + C) = U_C(A - pC)$

Assuming risk aversion i.e. $U_{WW}(W) < 0$ by the business man,

$U_C(A - B - pC + C) = U_C(A - pC) \Rightarrow A - B - pC + C = A - pC$

$\Rightarrow B = C$. So the borrower would insure his business fully against any future loss.

Second we prove that if there is any fear of default, the lending agency should fully insure the borrower or see that the borrower fully insures himself against any future loss in a liberalized competitive market. Let the anticipated loss of the consumer be 'B'. Let '1' be the situation when the loss occurs and '2' be the situation when the loss does not occur. Let q_{11} be the probability of loss when the borrower does not intend to default, q_{12} be the probability of loss when the borrower intends to default, q_{21} be the probability of not occurrence of loss when the borrower does not intend to default and q_{22} be the probability of not occurrence of loss when the borrower intends to default. Let u be the minimum utility the borrower expects from not intending to default, let D be the opportunity cost of not intending to default and I_i, i = 1,2 be the premium payment from the borrower to the insurance business. If the insurer wants the borrower not to intend to default, then the incentive problem in the principal-agent framework is

Maximize $W = q_{11}I_1 + q_{12}I_2$ subject to the participation constraints

$q_{11}U(A - I_1 - B) + q_{21}U(A - I_2) - D \geq u$

$q_{11}U(A - I_1 - B) + q_{21}U(A - I_2) - D \geq q_{12}U(A - I_1 - B) + q_{22}U(A - I_2)$

Here when the loss does not occur the borrower loses I_2 and when the loss does not occur he loses $I_1 + B$. Competitive equilibrium needs $I_2 = I_1 + B$. If $I_2 > I_1 + B$, he will not buy insurance. On the other hand if $I_2 < I_1 + B$, this means there is existence of difference between premiums in the industry. Perfect competition would reduce this difference to nil such that $I_2 = I_1 + B$. Thus the borrower would be fully insured by the bank. Following the same logic we can say that perfect competition will ensure

$q_{11}I_1 + q_{12}I_2 = 0$

and

$q_{11}U(A - I_1 - B) + q_{21}U(A - I_2) - D = q_{12}U(A - I_1 - B) + q_{22}U(A - I_2)$

These are two equations in two variables I_1 and I_2. Solving these two equations gives the equilibrium values of the variables[xi]. The interesting point is that if small entrepreneur buys business insurance from the same bank he has taken loan from, he is absolutely under the supervision and guidance under the bank. In fact banks are expected to provide entrepreneurs with financial assistance as well as inputs to support and promote their enterprise[xii]. Again if the insurance is of such type that on occurrence of the incident insured against before the expiry of the stipulated term the entrepreneur gets the assured sum and on non occurrence of the incident he gets the sum after expiry of the term provided he makes timely repayment of installment and on the other hand if he does not repay loan as per terms and conditions, the bank confiscates the assured sum whether the incident occurs or not, for which he has been paying premiums, this can check willful default. This kind of banking-cum-insurance system is more profitable than the banking system. In the first case the bank can get all premiums whereas in the second case the bank will get a part thereof.

Now we answer the second issue.

In the macroeconomic scenario the internal causes of sickness of the SSI in India include poor management of image and brand, poor marketing skills and lack of market penetration, poor sales promotion, inadequate pricing policy, absence of professionalism, absence of cost control mechanism, tardy debt collection, faulty inventory management policy and absence of knowledge of fund management. These are the variables internal to the firm, and well under the control of the entrepreneur provided he knows to control. According to the RBI Committee (1981) the two most important reasons behind sickness of SSI are management deficiency and marketing constraints[xiii].

Bhaumik *et al* 2001 argued that the process of bank restructuring has to involve an improvement in the quality of the banks' balance sheets[xiv]. The report of the Khan Committee set up by the RBI recognizes the importance of risk management in a complex financial organization, and emphasized the need of risk management capabilities. This process would have to involve a resolution of the banks' problems with respect to NPA, and the introduction of measures and institutions that allow banks to take a reasonable amount risk to augment their returns while providing options to manage and hedge against these risks adequately. Banking products include business loan also. NPA arise if the lent money does not come back. Prevention of NPA means to maximize the chance of the lent money coming back with interest. The success of the borrowing entrepreneur is a relevant issue here. In the context of India if the quality of entrepreneurship is tested before sanctioning bank loans and in addition, training regarding how to insure against various business risks is imparted to the budding entrepreneur then the probability of business failure reduces to the minimum.

Unfortunately the Indian banks have been found to be lacking on both counts and the concept of integrated approach to entrepreneur development is totally absent[xv]. While the infrastructure and supportive inputs like knowledge and training are conspicuous by their absence, the financial assistance made available by the banks is not entirely to the satisfaction of entrepreneurs. It is also true that it is not the business of banks to train entrepreneurs or conduct management program. This is not required by Banking Regulation Act or Reserve Bank guidelines. One of the major causes that may be identified for huge NPA is the negligence on the part of banks in realizing their role in the proper development of entrepreneurs. The lack of marketing knowledge, technological obsolescence and deficient managerial skill are amongst the most serious drawbacks in the non-farm rural SSI despite technical, economic, managerial and marketing consultancy and entrepreneur training provided by The Small Industries Development Organization, Small Industries Extension Training Institute, The National Board of Entrepreneurial Development and the

National Institute of Entrepreneurship and Small Business Development[xvi]. Hence, it is imperative in the present scenario that banks make some alternative arrangement for providing training and rendering the requisite knowledge to entrepreneurs for running their business successfully by assigning the task of entrepreneur development to other institution other than involving themselves on the one hand and on the other concentrating on what is the banking business proper – design and sell financial products. The results of these efforts would be improved quality of loans and increased business for the banks. In broader terms, the development of entrepreneurs would result in a flourishing business, which would not only be profitable, but also self-sustaining and making positive contribution to national economy.

A study[xvii] covering 11 branches of Allahabad bank in the Varanasi district of Uttar Pradesh conducted by the Faculty of Management, Benaras Hindu University reveals that bank officers themselves are not enough equipped to train the entrepreneurs, nor could they find time after their routine jobs to spend on the these people, who therefore prefer to visit private consultants. It was further noted that those who were aware of the various schemes had acquired the information from personal contact with other customers, borrowers, professionals, friends and their Bankers. Only about one-third of the borrowers came to know about Bank credit policies from the Bank. Another one-third obtained the information through professionals like chartered accountants and management consultants. The government agencies propaganda and media appeared to have had little impact as only 5% of the borrowers that too among those with limits less than Rs. 15 lacs, acquired information from this source. The word of mouth served the purpose in about one-fourth of the cases, which indicated that their friends, other customers and borrowers provided information to them. Analyzing activitywise, it appears that professionals played a better role than the bank. It is interesting to find that as far as the nature of assistance provided by the Bank functionaries is concerned, 87% borrowers did not approach the Bank for technical aspects. Out of the 13% borrowers who approached Bank, only 3% could get significant help. The Bank officers also mentioned that mostly they could assist the applicants in financial aspects only as they themselves were not equipped to handle technical and marketing matters[xviii]. Many bank officers themselves felt that adequate skills were not available with them. The reasons attributed to such a situation were lack of training, lack of infrastructure, and lack of time to become familiar with the lending principles and entrepreneurial development. Among the bank officials, over 50% were of the opinion that taking the help of independent management consultants would improve the financial management skills of the SSI entrepreneurs as well as the financial discipline among them. Banks are facing problem of high level of NPA and the most important reasons for it, as perceived by bank officers have been inadequate entrepreneurial skill, intentional default, lack of supervision and follow up of credit by the bank, indiscriminate financing and change in environmental conditions beyond control. It is clear that banks have not been taking the task of entrepreneurial development in all seriousness as is evident from their casual approach to creating awareness amongst potential entrepreneurs as well as providing necessary assistance to the existing borrowers. The smooth running of day-to-day operations of business enterprises as also their ultimate development into self-sustaining systems do not seem to draw sufficient interest from the bankers who have financial stake in the enterprises. With the widespread changes being introduced into the banking sector, it has become important that banks keep a constant vigil over the enterprises being financed by them. On one hand, it has to be monitored that funds are being properly utilized in business, while on the other hand it has to be ensured that the enterprise does not fail because of poor management despite the best intentions of the entrepreneur[xix].

In the appendix is the list of loans and consultancy and training services delivered by the SCBs (Schedule Commercial Banks). Proper administration of the loan money can ensure on time repayment. A survey of available 57 websites out of 100 SCBs in India during the first half of May 2002 finds that hardly six banks train and counsel the borrowers[xx]. After delivering the loans to the clients the banks should not stay aloof of the quality and manner the loans are being utilized. Banks have to confirm that the borrowers know what to do with the loan money and for that purpose borrowers are educating their personnel through some agencies or business school[xxi].

It is also true that in today's competitive market where the SSI have to fight large-scale industries on the one hand and on the other with cheap imports flooding the market as a direct fallout of removing quantitative limits on 821 items reserved for SSI out of which 643 items have been put under Open General License since 1998-99 as per WTO norms[xxii]. So it is advisable on the following grounds that the tasks of project appraisal, training and educating entrepreneurs and project monitoring and follow up should be bestowed with the professionally oriented training institutions like Entrepreneur Development Institute of Gujarat, Indian Institutes of Management, other established business schools as also Management Faculties of the universities spread across the country[xxiii].

The answer the first issue can now be given. The task of all project appraisals should be assigned to the professional bodies instead of banks.

The answers to three above issues together can be presented in terms of Figure 1:

1. Refer all loan applications submitted to the banks to the nearest one of aforementioned institutions (AIs) for project appraisal and approval. The AI should examine whether the candidate deserves loan. There is a difference between the need for loan and deserving loan. The candidate has to prove the spirit of entrepreneurship before the AI[xxiv].

2. If the project is approved by the AI send the applicant for entrepreneur training to that AI at his/her own cost before sanctioning the loan.

3. The entrepreneur development program must have separate modules on risk management, business insurance and those areas, which are found to be causes of sickness. It should be designed to shape and polish entrepreneurs and prepare them for the real world and thus is required to cover the following[xxv]:

- Personal grooming
- Social and communication skills and marketing skill[xxvi]
- Management skills development program[xxvii]
- General awareness and ability to anticipate future changes in external environment
- Improvisation or ability to adjust with changing circumstances
- Credit Management skill including ability to collect outstanding[xxviii]

- Habit of continuous SWOT analysis of the brand/product/service

4. On successful completion of the training the candidate has to get certified by the AI.

5. On production of the AI certificate the bank can sanction loan and sell various forms of insurance enumerated above required for business, where the entrepreneur has to pay the first premium with a part of the loan money. The insurance should have a design that on expiry of the stipulated period the entrepreneur gets a part of the premium refunded if the incident insured against does not occur provided he repays loan as per terms and conditions. If he defaults he does not get the premium back whether the incident occurs or not. For a select category of entrepreneurs government can contribute a part of premiums as it happens in social insurance schemes declared in recent GOI budgets.

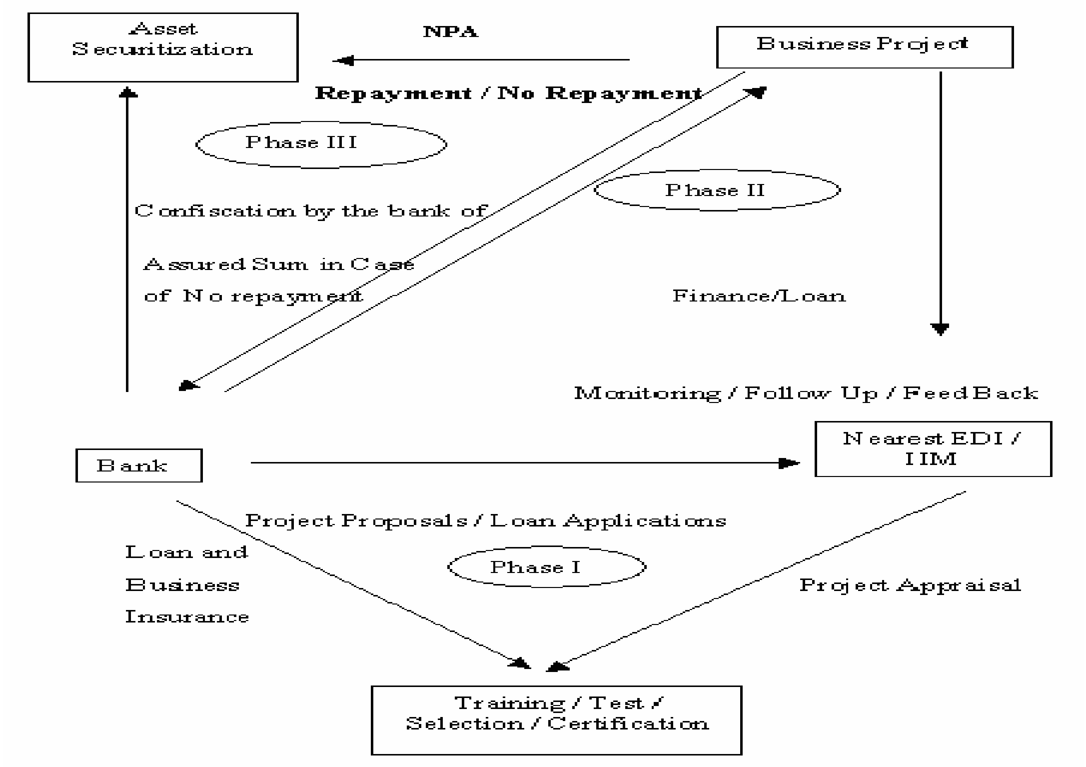

Figure 1

6. The project will be monitored and followed up by the AI during the term of the loan: -

a. If the project is successful the entrepreneur shall repay loan as per terms and conditions. If he does not do so the bank shall forfeit all insurance premiums she paid already and shall not reimburse any money on occurrence of the events insured against and further can take up the matter to an appropriate authority.

b. If the enterprise fails then the AI shall investigate the case and accordingly suggest the entrepreneur regarding the turnaround strategy and the bank regarding the treatment of the NPA if there is no hope of turnaround.

7. For continuous updating entrepreneurs with current trends and strategies AIs are required to conduct EDPs periodically. For any typical entrepreneurs it is just not

advisable in an environment full of sweeping changes that he attends EDP once for all in order to have the loan disbursed. Nor is there any management education that does not fall obsolete.

8. The question of comparative advantages in relevant here. In business training business schools/management institutions have competence and infrastructure. Banks do not have all these. The trainers are mostly bank officers and government officials, who themselves are not entrepreneurs. On the other hand many of the students of management institutions have become successful entrepreneurs. Qualitywise these people are better than mere government officeholders.

9. The AIs can get two-tier fee structure. The fee of pre-loan training can be charged on the applicants and the fee of project monitoring can be charged on banks as a proportion of the loan amount associated with the project. The first premiums of all the prescribed insurances have to be paid by a part of bank loan. For that matter banks have to increase the loan amount. In the process of continuous project monitoring and follow up by the business schools it will be clear whether the entrepreneur could be able to pay loan installments and insurance premium. Because guided by business schools and loan being granted after multiple screening the chance of business failure would come down. After all these efforts if NPA generates, the matter has to be referred to the Asset Securitization Company. Here we can think of some a mix of social and business insurance schemes, where the government may agree to contribute. A number of non-life insurance schemes are proposed in the budgets of recent years. The same may apply to small-scale business insurance scheme. Besides this, competition in insurance industry can reduce insurance premium over time. In order to improve quality of assets the banks should pay fees to the business schools. It is the price of increased asset quality and virtual expansion of universal bank. After all these institutions are reducing the risk of banking.

5. Benefits of the above proposal

1. Reduction of NPA generation: Total risk of business comprises a number of risk components. A part of these is uninsurable against and the rest insurable against. If the latter is insured against and at the same time the best quality project consultancy is available from the concerned AI we can assume that business risk is managed the best thereby minimizing the chance of failure and hence maximizing the chance of loan recovery in those cases where no moral hazard is involved.

2. EDP training can make the entrepreneur more efficient thereby leading to downward shift of the average cost and marginal cost curves. Assuming that numerous players exist in a particular commodity market, each selling a product marginally differentiated from others, the market structure is monopolistically competitive. Each firm thinks that he is monopolist in his niche, but he is not able to dictate the price because of his small size and thus he is a price taker. Figure 2 may be his condition before he takes EDP. Figure 3 and Figure 4 evaluate his states of affair after he takes EDP.

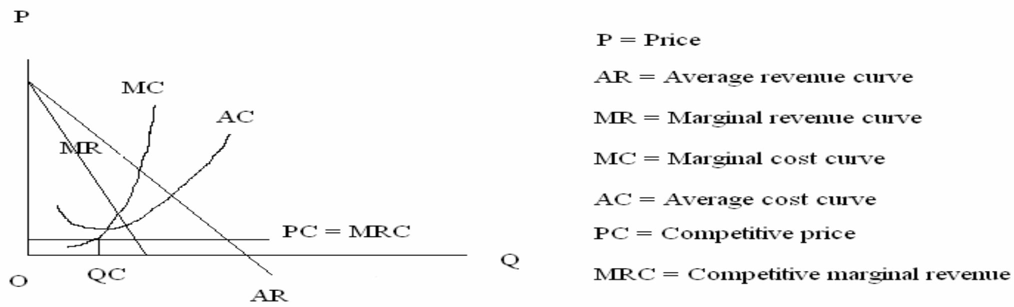

Figure 2

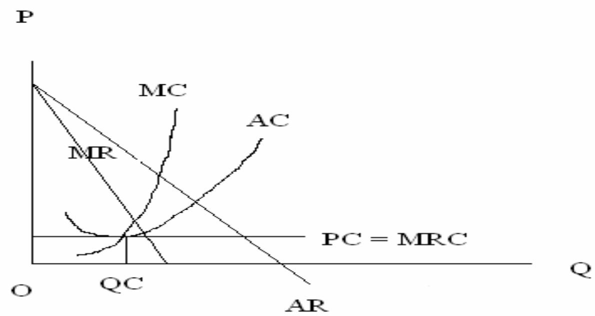

Figure 3

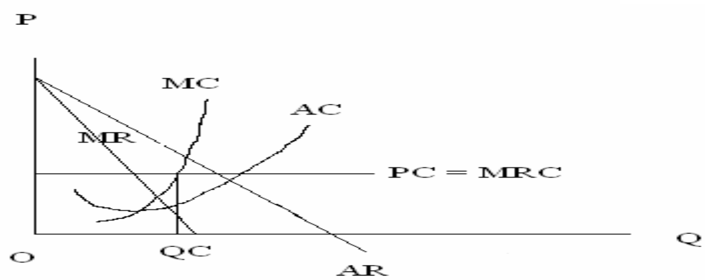

Figure 4

Improvement in variable cost can nullify his insurance premium cost which is a fixed cost.

3. Flourishing of bank owned insurance companies: Since bank loan is given to those people who come through the rigorous screening of AIs, we can assume that very few cases may turn to failure and the rest successful. The successful entrepreneur would obviously expand and diversify business as it happens during sustainable expansion of an enterprise. Through these enterprises the insurance business in which the bank has a major stake can grow. The entrepreneur can make portfolio investment with the profit accrued from his business. He may put part of the money in mutual fund or other schemes. If the bank enters these fields as well like State Bank of India, ICICI Bank, HDFC Bank and Vaisya Bank and then much of their business can come from their once upon a time borrower.

4. Generation of opportunities of employment and self-employment: An AI can open entrepreneur development wings in different areas. How should the responsibility of entrepreneur development in the entire country be divided into existing AIs? Suppose there are m banks in the country and the their number of branches are n_1, $n_{2,}$ $_{, , ,}$ n_{m-1} and n_m. So total number of branches is Σn_i where i = 1, 2, , , m-1 and m. One criterion of dividing the responsibility may be like the following: If total number of

AIs is k, then each AI should take care of entrepreneurship development of $\Sigma\ n_i/k$ branches. But the problem with this rule may be that number of loan applicants varies from branch to branch within the same bank and from bank to bank. Although each AI gets equal responsibility in terms of number of bank branches, it may happen that the number of applicants is not the same for all the AIs. Here one can divide the responsibility by dividing the total number of applicants of all branches of all banks together in to the number of AIs. But this rule is also not free of flaw in matter of project monitoring and follow-up, though it can work well in matter of pre-loan training and examination, because the amounts of loan vary from one applicant to other depending upon the nature of the project. It can happen that an AI with a lesser number of applicants has to handle big-budget projects calling for a relatively heavier load of work compared to an AI with a larger number of applicants handling small budget projects. Here what is advisable is to divide the total amount of loan given by all branches of all banks by the number of AIs and make the minimum adjustment such that the number of entrepreneurs is an integer for every AI. For this task the AIs has to increase faculty and staff. Moreover the AIs can design some entrepreneurship consultant development course whereby training would be imparted to the educated youth, who can be self-employed consultants on successful completion of training and certification by AI. A market indeed exists for these external consultants. The advantage a consultant has is that he can provide an outside view without the organizational prejudices. World Bank, ESAMI and International Labor Organization (ILO) produce the trainers, who train the small business entrepreneurs in the countries including Kenya, Nigeria, Lesotho, Burkina Faso, Senegal and Togo[xxix].

5. Employment generation – an inherent potential of business school (B-school) or management education institution: Understood that B-school training could enhance the proportion of successful amongst the entrepreneurs, there is a larger possibility of employment generation in the successful enterprises. It can help also many of the people who are employed in public and private sector often want to do something, which they consider their own.

6. Additional advantage compared to training by others than a B-school: B-School training widens a person's horizon. It imparts the trainee an all round knowledge of business and makes him sensitive to all its facets. It gives him strong conceptual skills, which coupled with experience forms a recipe for success. B-Schools can bring industry experience into the classroom. These are the people who can give a contemporary perspective in academia[xxx].

6. Additional costs of the proposal

There are two prime costs:

1. Insurance cost: This aspect is addressed in point 2 in the previous section.
2. Physical costs comprising government contribution to business insurance of SSI and fees to AIs: The first one will add to premium collection of banks, which will be invested in long run projects mostly as per investment norms for insurance sector. The second one is the price of quality of enterprise. But over time the premium as a percentage of the assured sum may come down because of competition in the deregulated and liberalized insurance industry.

3. Moral hazard: the banks have to build up strong investigation machineries for occurrence of spurious incidents insured against. It is a part of life in any insurance business.

7. Conclusion

This article tries to seek a solution to the problem of NPA in the present circumstances of banking and insurance working together under the same roof. Insurance is a supplementary tool, which can minimize the chance of business failure as well as minimize moral hazard. Implementation of this system calls for a high degree of flexibility in the rules and guidelines of the banks. In the proposed system there is a potential of flourishing banking-cum-insurance business of the banks because the percentage of successful entrepreneurs shall rise here and banks would be able to sell various life and non-life insurance products to the entrepreneurs and their families. As these entrepreneurs expand, diversify and technically upgrade business, banks can give more loans and earn interest. The AIs have to take up the tasks of selection of right people and appraisal, monitoring and follow up of projects. Banks will concentrate on what is their business. What is stressed in this article is the pressing need of the small-scale entrepreneur for becoming aware and educated in modern business management holding a professional attitude toward rational decision-making and banks have to facilitate that process as a part of the credit policy sold by them.

References

Acs Z.J. and Audretsch D.B (1991): *Innovation and Small Firms*, MIT, Massachusetts

Acs Z.J and Audretsch D. B. ed. (1990): *The Economics Of Small Firms - A European Challenge*, Kluwer, London, p 11

Barber J., Metcalf S. and Porteous M. (1989): Barriers to Growth: The Arcade Study, in Baber J., Metcalf S. and Porteous M. ed. (1989): *Barriers to Growth in Small Firms*, Routledge, New York

Bhaumik S.K. and Mukherjee P (2001): “The Indian Banking Industry – A Commentary”, *Social Science Research Network Working Paper*, Harvard

Black J (2002): *Oxford Dictionary of Economics*, Oxford University Press, Oxford, 2nd Edition, p 15

Business India (2002). Editorial, April 15-28, 2002, http://www.businessindiagroup.com/bi-editorial.aspx

Butler B., Butler D. and Issacs A. ed. (1997): *Oxford Dictionary of Finance and Banking*, Oxford University Press, Oxford, 2nd edition, p 17

Desai V. (1999): *Small Scale Enterprises*, Volume 12, Himalaya, Mumbai, Chapter14

Dignard L. and Havet J (1995): *Women in Micro and Small Scale Enterprise Development*, Westview, London, Chapter 10

Harper M. and Vyakarnam S. ed. (1988): *Rural Enterprise Case Studies from Developing Countries,* Intermediate Technology Publications, London

Little I. M. D (1987): "Small Manufacturing Enterprises in Developing Countries", *The Word Bank Economic Review*, Volume 1, Number 2

Mehta M.M and Das M. K (2003): "Non performing Assets and Prevention and Detection of Bank Frauds", *Center for Studies in Banking and Finance Workshop*, National Law University, Jodhpur, pp 87-90

Rahman A. and Khan S (1989): "Abstract of the Country and Case Studies: India" in Kaneslingam V. ed. (1989): *Appropriate Technology for Rural Industries - The case of South Asia*, Tata McGraw-Hill, New Delhi.

Reserve Bank of India (2003). Report on Trend and Progress of Banking in India 2002 – 03, https://www.rbi.org.in/Scripts/Publications.aspx?publication=Annualwww. rbi.org

Reserve Bank of India (2002) Circular DBOD No. BP. BC. 1 / 21/04.048 / 2002-03, 4 July, 2002, https://rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=7358

Reddy P. K (2002): A Comparative Study of the Non Performing Assets in India in the Global Context, *Indian Institute of Management Ahmedabad Working Paper*. https://www.scribd.com/doc/76610492/A-Comparative-Study-of-Non-Performing-Assets-in-Indian-Banking-Industry

Varian H (1992): *Microeconomic Analysis*, Norton, New York, 3rd Edition, Chapters 11 and 25

Wignaraja G. ed. (2003): *Competitive Strategies in Developing Countries*, Routledge, London, Ch 2

Endnotes

[i] This was revealed by a study on small enterprises in India and Colombia conducted by World Bank and by relevant documents from other countries - Little I. M. D (1987): "Small Manufacturing Enterprises in Developing Countries", *The Word Bank Economic Review*, Volume 1, Number 2

[ii] *Report on Trend and Progress of Banking in India 2002 – 03*, Reserve Bank of India

[iii] The names of the officials are given in the end of the paper with their respective departments.

[iv] An asset is any object tangible or intangible, which is of value to its possessor. In most cases it is either a cash or can be turned into cash; exceptions includes prepayments, which may represent

payments made for rent, rates or motor licenses in cases in which the time paid for has yet not been expired. Tangible assets include land and debtors and cash; intangible assets include goodwill, patents, copyrights and trademarks. For capital gain tax purpose an asset consists of all forms of property, whether at the home country abroad including options, debts, incorporeal property, currency (other than sterling), and any form of property either created by the person disposing of it or owned without being acquired. It must however consist of some form of property for which a value can be ascertained. Some assets are exempt from capital gain tax. Asset value is the total value of assets minus value of liabilities divided by the number of ordinary shares issued. Asset management is the management of financial assets of a company to maximize return on investment. Asset stripping is acquisition or takeover of a company whose shares are valued below their asset value - Butler B., Butler D. and Issacs A. ed. (1997): *Oxford Dictionary of Finance and Banking*, Oxford University Press, Oxford, 2nd edition, p 17

Economists classify assets into real and financial assets. Real assets include land, buildings or machinery owned. Financial assets include cash and securities and credit extended to customers. The assets side of a company's balance sheet includes both real and financial assets. Asset is also used in metaphorical and usually favorable sense to describe things that cannot actually be owned, e.g. the phrase "a company's best assets are the skill and loyalty of its employees" - Black J (2002): *Oxford Dictionary of Economics*, Oxford University Press, Oxford, 2nd Edition, p 15

[v] Reserve Bank of India circular DBOD No. BP. BC. 1 / 21/04.048 / 2002-03, 4 July, 2002

[vi] A comparative picture of measures taken in India vis-à-vis other East Asian Economies troubled by the NPA problem is available in Reddy P. K (2002): A Comparative Study of the Non Performing Assets in India in the Global Context, *Indian Institute of Management Ahmedabad Working Paper*. It is given in the end of the paper.

[vii] Mehta M.M and Das M. K (2003): "Non performing Assets and Prevention and Detection of Bank Frauds", *Center for Studies in Banking and Finance Workshop*, National Law University, Jodhpur, pp 87-90

[viii] The list of different categories of the banks is given in the appendix. New private sector banks are not considered here because of convenience in comparison. During 2000-01, data of NPA with these banks are not available. Again before 2000-01, NPA figures are not available.

[ix] http://www.banknetindia.com/banking/0448.htm, visited on 27.08.04

[x] Wignaraja G. ed. (2003): *Competitive Strategies in Developing Countries*, Routledge, London, Ch 2

[xi] Varian H (1992): *Microeconomic Analysis*, Norton, New York, 3rd Edition, Chapters 11 and 25

[xii] http://www.sbaer.uca.edu/Research/1998/ICSB/n009.htm, visited on 13 April 2002

[xiii] Desai V. (1999): *Small Scale Enterprises*, Volume 12, Himalaya, Mumbai, Chapter14

[xiv] Bhaumik S.K. and Mukherjee P (2001): "The Indian Banking Industry – A Commentary", *Social Science Research Network Working Paper*, Harvard

[xv] *Supra no 13*

[xvi] Rahman A. and Khan S (1989): "Abstract of the Country and Case Studies: India" in Kaneslingam V. ed. (1989): *Appropriate Technology for Rural Industries - The case of South Asia*, Tata McGraw-Hill, New Delhi.

[xvii] *Supra no 16*

[xviii] Marketing skill is very important for the SSI. In the phase of shift of consumers' preferences from standardized mass product goods towards stylized and personalized goods, the SSI can, through proper marketing activity carve out small niches where giant firms are not comfortable - Acs Z.J. and Audretsch D.B (1991): *Innovation and Small Firms*, MIT, Massachusetts

[xix] Empirical investigation into the Rural Planning Department (RPD) as well as the Department of Banking Operation and Development (DBOD) of the Reserve Bank of India, Headquarter, Fort, Mumbai gives the glimpse of the fact that the apex bank of the country is yet to have serious concerns in this regard of the fact that the quality of entrepreneurship affects the quality of bank loan. Naturally the circulars and guidelines sent to Scheduled Commercial Banks (SCBs) by the RBI and various credit policies are required to take into consideration this issue.

[xx] The details of the websites are given in the end of the article.

[xxi] For example, Executive Education Program, Management Development Program, Advanced Education Program or Foreign Trade Management Program or else the banks have to arrange it with some institutions. These are conducted by IIM Lucknow, Gurgaon based Management Development

Institute and IIFTM of GOI respectively or themselves are taking training from institutions like Entrepreneur Development Institute (EDI), Gujarat.

[xxii] Editorial, *Business India*, April 15-28, 2002

[xxiii] EDI is a wholly autonomous and not-for-profit institution, set up in 1983, is sponsored by apex financial institutions, the Industrial Development Bank of India (IDBI), the Industrial Finance Corporation of India (IFCI), the Industrial Credit and Investment Corporation of India (ICICI) and the State Bank of India (SBI). The Government of Gujarat pledged twenty-three acres of land on which stands the majestic and sprawling EDI campus. The EDI has been spearheading entrepreneur movement throughout the nation with a belief that entrepreneurs need not necessarily be born; they can be developed through well-conceived and well-directed activities. Over the year, EDI has designed and conducted Training Programs on skill development and attitude development of bank managers and officers engaged in project appraisal as also the entrepreneur behind-the-project. Some of its important programs, directed towards achieving this objective are Training Program on Industrial Project Preparation and Appraisal (IPPA), Training Program on Financial and Economic Analysis of Industrial and Infrastructure Projects using Computer Model for Feasibility Analysis and Reporting (COMFAR III) Expert and Training Program on Assessing the Entrepreneur using Focused Behavioral Event Interview (FBEI) technique. These programs have received encouraging response at national as well as international level. The Institute has received support from the World Bank, ILO, UNIDO, Commonwealth Secretariat, Friedrich-Naumann-Stiftung (FNSt), European Union and several other international agencies. Its international activities cover a range of entrepreneurship and investment promotion-related training programs/ workshops. Ever since its inception in 1983, the Institute has interacted with 30 developing countries thus helping them build capabilities for industrial development. So far, over 1,000 professionals from developing countries have benefited from EDI's capacity building programs including the one on Industrial Project Preparation and Appraisal co-sponsored by UNIDO. The EDI Inter-Regional Centre (IRC) is the result of UNIDO’s strategic thinking that innovative methodologies should be transferred to developing world through regional institutions with proven skills in the area of entrepreneurship and investment promotion. EDI is also a partner institution with proven skills in the area of entrepreneurship and investment promotion. EDI is also a partner institution for implementation of the European Union Economic Cross Cultural Program-ENTRIXIE Project (Entrepreneurship Training and Information Exchange for Small Businesses in India and Europe), especially set up to promote partnerships among the SMEs (small and medium enterprises) of India and Europe. EDI has an international network that has been continuously benefiting the entrepreneurs from thirty developing countries starting from Afghanistan through Vietnam to Zambia. Because the institutions like EDI are not enough to work all over the country others like institutions like Management Faculties of the universities, IIMS and other established business schools can share the task.
http://www.evishwagujarati.net/egupdate/edu/egguj.html, 13 April 2002

[xxiv] As per Knight (1921), entrepreneurs must finance themselves and bear the risk of their failure. His superior foresight must be accompanied by willingness to bear risk. Again as per McClelland (1961), who becomes an entrepreneur is determined not by personality but by entrepreneurial ability and the extent to which individuals form accurate estimates of their entrepreneurial abilities - Acs Z.J and Audretsch D. B. ed. (1990): *The Economics Of Small Firms - A European Challenge*, Kluwer, London, p 11

[xxv] These are required for survival, sustenance and growth of small as found in U.K and India - Barber J., Metcalf S. and Porteous M. (1989): Barriers to Growth: The Arcade Study, in Baber J., Metcalf S. and Porteous M. ed. (1989): *Barriers to Growth in Small Firms*, Routledge, New York

[xxvi] Materials contributed by the participants in the Cranfield course on the promotion of small enterprises in developing countries conducted by the Enterprise Development Centre, Cranfield School of Management explain the importance of market research and relative importance of sociology vis-à-vis general demography of the market area for the purpose of proper understanding of market needs - Harper M. and Vyakarnam S. ed. (1988): *Rural Enterprise Case Studies from Developing Countries,* Intermediate Technology Publications, London

[xxvii] http://www.indiainfoline.com/bisc/sibmalumni01.html, visited on 20 April 2002

[xxviii] Nowadays credit control along with outstanding collections is recognized as a separate skill - *Business India*, Mumbai, April 29 – May 12, 2002, p142.

[xxix] Dignard L. and Havet J (1995): *Women in Micro and Small Scale Enterprise Development*, Westview, London, Chapter 10
[xxx] *Supra number 28*