BANKING

Standardization of Loan Documentation and Its Role in Minimizing Credit Risk in Indian Banks

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Abstract

Credit is a key area of concern for Indian banks. Despite enhancements to banks' asset base and regulation, as well as debt recovery processes, the extent to which loan documentation is used to control credit risk has not been widely analysed. This research investigates methods of standardising loan documentation and explores its contribution to credit risk management within Indian banks. A combination of primary and secondary research was undertaken to analyse pertinent laws, RBI guidelines, regulatory reports and previous research. Legislation analysed within this paper comprises the Indian Contract Act, 1872; Transfer of Property Act, 1882; Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002; Recovery of Debts and Bankruptcy Act, 1993 and the Insolvency and Bankruptcy Code, 2016. Standardised documentation can assist credit risk management in three main ways – it can increase legal enforceability, promote an effective debt recovery process and enable enhanced credit oversight by ensuring uniformity in data provision. Challenges relating to standardised documentation are also discussed, including those arising from more complex credit facilities, lack of resources and potential for 'paper only' compliance. Overall, this paper concludes that standardised documentation is a key factor in controlling credit risk, and that this can be further enhanced by conducting routine legal reviews, utilising technology, providing appropriate employee training and carrying out robust credit assessment.

Keywords: loan documentation; standardisation; credit risk; non-performing assets; Indian banking sector; legal enforceability; debt recovery; bank regulation

1 Introduction

Credit risk arises where a borrower fails to comply with a contract and the lender then incurs a loss. It is a major area of concern for commercial banks and has an impact on profitability, liquidity and stability (Basel Committee on Banking Supervision [BCBS], 2000).

Over the last decade there has been much change within the Indian banking industry regarding asset quality. The gross non-performing assets (GNPA) ratio of scheduled commercial banks fell to 2.7% by the end of March 2024, down from 11.2% in March 2018 (RBI, 2024a). This has been driven by asset quality improvements and also by regulation, rehabilitation schemes, provisioning and credit risk management enhancement.

Whilst prior analysis of credit risk typically centres on evaluating a borrower and their ability to repay a loan, together with security, pricing and loan oversight, there is also significance attached to how well banks document loans. Poorly drafted loan documentation, incorrectly provided guarantees and/or inadequate or unregistered security can all compromise a bank's ability to successfully claim for debt in the case of borrower non-payment.

Documentation is therefore a key area which links both operation and credit risk. Although poor documentation is not necessarily the reason for a borrower defaulting, it can exacerbate the impact of a borrower's default by complicating banks' ability to realise security, confirm the terms of a contract and initiate claims for repayment (BCBS, 2006).

This paper investigates the extent to which standardised loan documentation helps to reduce credit risk within Indian banks.

Standardisation of documentation facilitates loan contract enforceability. It also expedites the documentation recovery process and reinforces oversight. Furthermore, it promotes uniformity. However, whilst advantageous, these positive outcomes are contingent upon good standardisation practice and should never be used as a substitute for accurate credit evaluation and appropriate internal controls.

Secondary sources were utilised within this investigation including RBI material, legislation, court rulings, bank reports and academic articles. Primary data was not gathered.

2 Conceptual background

2.1 Loan documentation

Loan documentation is used to both define and control a bank's lending activity. It defines what is expected from a borrower and also details how repayments should be made. Further, it defines a bank's recourse in the event that a borrower defaults.

Typically, for secured lending, documentation will include:

- Loan applications and sanction;
- Loan and repayment arrangements;
- Mortgage, hypothecation and pledge documentation;
- Personal and corporate guarantors' documentation;
- KYC and financial data;
- Board resolutions and approvals;
- Appraisals and title checks;
- Charge registrations and post-lending oversight information.

Well-prepared documentation is key to proving a bank's lending and underpins the bank's contractual and legal recourse.

2.2 Credit and documentation risk

Credit risk occurs where a borrower does not meet their repayment commitments. Documentation risk is about poor-quality documentation relating to a bank's lending.

Credit and documentation risk can therefore be linked. Even if a borrower is unable to repay due to financial issues, poor documentation may increase the complexity and cost of a bank's collection efforts.

Good credit governance, oversight and control are highlighted by the BCBS (2000) as key areas. Documentation plays a key role within these areas as it defines the information and contractual position which is needed to effectively manage credit risk.

2.3 Standardisation

Standardisation is concerned with employing common, legally reviewed documentation and processes for creating, signing, checking and storing loan documentation.

There are four main aspects to standardisation:

1. Document standardisation – utilising appropriate standard documentation for loans, guarantees and security.
2. Information standardisation – displaying in a clear and comparable way the interest rate, repayment terms, charges and other relevant loan provisions.
3. Process standardisation – applying standard documentation checklists, plus legal and 'maker-checker' processes.
4. Information storage standardisation – storing loan information in a structured manner so that it can be easily analysed, audited and reported upon.

Whilst standardisation does not always entail identical documentation for all borrowers, there should be common core legal and process requirements. Appropriate adaptation should, however, be permitted for varying types of lending.

3 Review of literature

Whilst there is academic literature relating to credit risk and banks' contractual, collaterals and recovery processes, there is not extensive research which analyses standardised loan documentation as a separate method of mitigating credit risk within Indian banks.

Stiglitz and Weiss (1981), discussed how asymmetric information can affect lending processes and may even lead to credit rationing. Good information is therefore important to alleviate information issues.

Diamond (1984) assessed the function of financial intermediaries as agents and identified how banks gather and analyse information on borrowers. This facilitates banks to effectively monitor their borrowers and, in turn, manage their lending processes.

Berger and Udell (1990) analysed the links between collaterals, lending quality and bank risk. Whilst it has been shown that collaterals can be significant within banks' lending processes, secured lending does not wholly remove credit risk.

Rajan (1994) analysed the effects of imperfect contracts and the alignment of management remuneration. This underpins our understanding of the significance of well-specified contracts and monitoring within banking processes.

Berlin and Mester (1992) analysed debt covenants and the incentive for institutional lenders to monitor. They identify that good contract design can in fact stimulate a bank's monitoring behaviour so as to safeguard its interests.

Berger and DeYoung (1997) analysed links between a bank's non-performing loans and its efficiency levels. It was shown that poor bank and asset quality can be linked, thus further emphasising the significance of strong internal controls.

Boot (2000) analysed relationship banking and explained how banks utilise both information and borrower relationships to inform lending decisions. Again, this serves to reinforce the significance of good, standardised borrower information.

Visaria (2009) analysed the micro-economic effects of Debt Recovery Tribunals within India. Introduction of these tribunals was shown to lower a bank's non-performing loans and improve the recovery environment. Thus, good recovery processes are again identified as important.

Cerqueiro et al. (2016) analysed the links between collaterals, lending rates and monitoring. It appears that collaterals can therefore both affect lending rates and also a bank's monitoring behaviour.

Freudenberg et al. (2017) analysed breach of covenants and evolving contract design. Previous covenant breaches can in fact affect future contract design, according to this research.

Brahmaiah (2022) analysed credit risk management within Indian commercial banks. Risk identification, analysis, monitoring and control are highlighted as important aspects of good credit risk management.

Kokane and Pandit (2023) analysed various Indian banks' recovery processes such as Lok Adalats, Debt Recovery Tribunals, SARFAESI and the Insolvency and Bankruptcy Code. Continued significance is attached to good recovery processes for the management of non-performing assets.

Antony and Gopal (2023) analysed the determinants of credit risk, using bank level data. Both bank- and macro-economic factors were shown to affect credit risk.

Kandpal et al. (2024) analysed the reasons for non-performing assets within Indian financial institutions. Good borrower credit quality, good collateral and sufficient monitoring were identified as key determinants of asset quality.

Nayak and Nomani (2025) analysed credit risk management and non-performing assets within Indian commercial banks. Once more, the significance of good risk identification and credit risk management is emphasised.

Whilst current academic research recognises the importance of contracts, collaterals, monitoring and recovery processes, generally these works analyse wider credit risk management and do not specifically analyse the separate significance of standardised loan documentation. Thus, there exists an area for further research, as explored within this study.

4 Research objectives

1. To explore the significance of documentation in the credit risk management process of Indian banks.
2. To analyse the benefits that standardisation provides in making loan and collateral documentation legally binding.
3. To recognise the link between high quality documentation and effective loan recovery.
4. To assess the part played by RBI rules and technology in encouraging standardisation of loan documentation.
5. To recognise the difficulties and constraints in applying standardised loan documentation in Indian banks.

5 Research methodology

The research method employed in this study is qualitative, descriptive and doctrinal. Information has been sourced from RBI, banking policy, law, court judgements and websites along with journals.

This research investigates the Indian law and policy relating to banking documentation. It considers the inter-connection between standardised documentation, legal enforceability and effectiveness of asset recovery and credit risk control.

No primary research (surveys and/or interviews) was undertaken. Therefore, this is not statistical research, and no attempt is made to determine a statistical link between documentation standardisation and decreased NPA levels.

6 Legal and regulatory environment

6.1 Contract and property law

Under the Indian Contract Act, 1872, bank – borrower contractual relationships are governed. This includes loan and guarantee contracts.

Mortgages and conveyancing are regulated under the Transfer of Property Act, 1882. Correct execution and registration of relevant documentation is key in ensuring that security can be legally enforced.

Stamp duty is regulated by the Indian Stamp Act, 1899 and state stamp legislations. Documents may be challenged if they are incorrectly stamped and further compliance may be necessary.

Furthermore, the Information Technology Act, 2000 acknowledges and regulates electronic data and electronic signing. This assists in the use of digital documentation.

6.2 Recovery legislation

The Recovery of Debts and Bankruptcy Act, 1993, provides for the operation of Debt Recovery Tribunals (DRTs) which aid in the judicial assessment and recovery of debt from banks and financial institutions.

The SARFAESI Act, 2002 permits secured lenders to directly enforce security (without first turning to the civil courts) where relevant legislation is complied with. The constitutionality of the Act was affirmed by the Supreme Court in Mardia Chemicals Ltd. v. Union of India (2004). The Court acknowledged the need for appropriate procedural controls.

The Insolvency and Bankruptcy Code, 2016, offers a mechanism for dealing with company insolvency. To launch a Section 7 insolvency process, financial creditors must demonstrate both the existence of financial debt and that this has defaulted. The significance of demonstrating debt and default was emphasised by the Supreme Court in Innoventive Industries Ltd. v. ICICI Bank (2018).

6.3 Digital registration bodies

The Central Registry of Securitisation Asset Reconstruction and Security Interest of India (CERSAI) registers security and so promotes transparency in secured lending.

National e-Governance Services Limited (NeSL), an information utility operating within the IBC environment, is responsible for providing digital technology to register and confirm financial information.

Such facilities enhance the benefits that can be gained from documentation standardisation as they facilitate uniform data input, confirmation and access.

6.4 Directions issued by the Reserve Bank of India

The RBI has issued various directives aimed at promoting both transparency and standardisation in banking documentation.

Alongside the Fair Practices Code for Lenders (RBI, 2003) and Master Direction on Know Your Customer (RBI, 2016), further guidance includes the Guidelines on Digital Lending (RBI, 2022) and Key Facts Statement provisions for loans and advances (RBI, 2024b).

In addition, the RBI's 2023 directions stipulate that regulated bodies should provide original movable and immovable property documentation and discharge relevant registrations of charges after repayment or discharge has occurred within the required timeframe (RBI, 2023).

Collectively these illustrate the growing significance of standardised information provision, documentation and borrower protection.

7 Credit risk arising from document issues

A range of issues can be associated with documentation and in turn heighten the credit risk faced by banks.

- **Unclear contract provisions:** Indistinct definitions of the repayment process, default criteria and enforcement procedures can lead to contention between banks and borrowers.
- Poorly executed or unregistered security documentation may hinder a bank's ability to enforce its security and to assert a superior claim over a borrower's secured assets.
- Incorrectly signed, insufficiently stamped or unauthorised guarantees can also compromise their legal enforceability.
- In addition, incomplete loan documentation, irregular bank statements and absent evidence of default can slow a bank's progress through the recovery tribunal and/or judicial processes.Inconsistent branch practices: Different documentation procedures across branches can result in uneven compliance and difficulties in maintaining centralised records.
- **Inadequate borrower disclosures:** Failure to communicate important loan conditions clearly can create disputes, customer complaints and regulatory complications.

Whilst these factors are unlikely to cause a borrower to default, they can then exacerbate the losses and costs incurred by a bank in respect of such a default.

8 Standardisation and credit risk mitigation

Standardised and checked documentation assists in ensuring that appropriate elements (for example, debt repayment, default, security and guarantee arrangements and enforcement) are set out in loan agreements.

8.1 Streamlined administration

Standardised documentation facilitates effective administration of loan agreements, account details, security and default documentation.

It can therefore speed up a bank's efforts to recover a defaulted loan via DRTs, SARFAESI and insolvency processes.

8.2 Enhanced borrower information

Standardised information dissemination improves a borrower's understanding of interest rates, repayments and fees as well as further relevant aspects of a loan.

The RBI has produced 'Key Facts Statement' standardisation initiatives which increase information clarity and thus help to alleviate information asymmetry.

8.3 Enhanced oversight and information analysis

By standardising data relating to a borrower's repayment, security, guarantees and financial covenants, banks are enabled to more effectively recognise anomalies and analyse a borrower's position.

Data can also be utilised within early warning and credit risk analysis tools at a bank-wide level.

8.4 Control and auditing

Standardised documentation, a maker-checker system and legal checking all serve to promote control.

They also allow internal audit teams to recognise control issues and lessen a bank's reliance on individual staff.

8.5 Technology

Loan information systems can include standardised documentation together with electronic signing functionality. Further, they can check documents and electronically register them.

Connection to CERSAI and information agencies can also enhance the quality and standardisation of a bank's loan data.

9 Challenges and issues to address

9.1 Documentation is not a substitute for credit assessment

Despite the use of standardised documentation, there remains a risk that loans will be issued to unsound borrowers. Appropriate credit assessment, including examination of a borrower's cash flow together with credit oversight is therefore still crucial.

9.2 Need for adaptation

Specialist areas such as corporate, project and syndicated lending can sometimes necessitate bespoke documentation. Over-standardisation may therefore compromise adaptability.

9.3 Resource restrictions

Smaller and co-operative banks may lack both financial and technological resources to fully implement suitable documentation controls.

9.4 Lack of genuine adherence to controls

Staff may tick boxes on documentation control forms, but fail to adequately confirm the correctness and genuineness of related information.

9.5 Fraud and conspiracy

Standardisation does not in itself deter falsification of documentation, overvaluation of security or conspiratorial behaviour between borrowers and bank staff.

9.6 Alterations to regulation, RBI policy and judgement

Standardised documentation must continually be assessed and updated in response to new regulation, RBI policy and judicial judgement.

10 Recommendations

- **Document format:** Banks should create approved document formats for both consumer, micro and small to medium enterprises (MSMEs), agricultural and corporate loans. These should allow suitable adaptability.
- **Document review:** Loan and security documentation should be periodically reviewed to assess how it is prepared, recorded and managed.
- **Technology:** Banks should further connect technology used for managing loans, CERSAI and information utilities along with other recording bodies.
- **Legal review:** Approved document formats should be routinely assessed by suitably qualified lawyers.
- **Assisting smaller bodies:** Industry and regulatory bodies should help small bodies to obtain access to suitable document formats, together with training and cost-effective technology solutions.
- **Staff development:** Staff should appreciate the legal and business relevance of documents rather than simply adhere to tick-box lists.
- **Information management:** Banks should systematically digitally record the details of loans, security and repayments.

11 Conclusion

Whilst credit risk assessment does involve determining suitable and creditworthy customers and analysing their ability to repay, it also necessitates appropriate legal and business underpinning to safeguard a bank's position.

This paper has analysed how the standardisation of loan documentation may aid documentation risk mitigation within India's banking sector. Uniform legal formats, correct security recording, uniform information provision and systematic information management can all enhance enforceability, enable debt recovery and improve oversight.

India's legal and regulatory environment including the SARFAESI Act, Recovery of Debts and Bankruptcy Act, Insolvency and Bankruptcy Code and RBI guidelines accentuates the value of precise and demonstrable documentation.

Yet, although document standardisation can be valuable, it should not substitute for good credit assessment, customer oversight and company governance. Successful document standardisation will depend on suitable adaptability, alongside routine reviews, staff development and technology.

There appears to be potential for further research to investigate whether banks that have more robust documentation processes achieve superior debt recovery results. This may also highlight if they are involved in fewer legal matters and/or whether they can recover debts more swiftly. Additional evidence could therefore be obtained as to how beneficial document standardisation may be for credit risk mitigation within Indian banks.

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