

Credit appraisal process

[Science](#), [Physics](#)



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The securities in stock exchange have fallen down drastically which has become the root cause of bankruptcy of many financial institutions and individuals. The root cause of the economic and financial crisis is credit default of big companies and individuals which has badly impacted the world economy. So in the present scenario analysing one's credit worthiness has become very important for any financial institution before providing any form of credit facility so that such situation doesn't arise in near future again.

Analysis of the credit worthiness of the borrowers is known as Credit Appraisal.

In order to understand the credit appraisal system followed by the banks this project has been conducted. The project has analysed the credit appraisal procedure with special reference to Punjab National Bank which includes knowing about the different credit facilities provided by the banks to its customers, how a loan proposal is being made, what are the formalities that is to be satisfied and most importantly knowing about the various credit appraisal techniques which are different for each type of credit facility. Before going further it is necessary to understand the need and basic framework of the project.

Therefore this chapter provides an introduction to the topic, objective of the project, reasons for selecting the project and the basic structure and framework how the project proceeds. In order to understand the importance of the topic selected an introduction to the overview of the commercial bank , its functions, and present trends and growth in bank credit are required and it is covered in this chapter. Reasons for selecting the project Whenever an individual or a company uses a credit that means they are borrowing money that they promise to repay with in a pre-decided period.

In order to assess the repaying capability i. e. to evaluate their credit worthiness banks use various techniques that differ with the different types of credit facilities provided by the bank. In the current scenario where it is seen that big companies and financial institutions have been bankrupted just because of credit default so Credit Appraisal has become an important aspect in the banking sector and is gaining prime importance. It is the

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incident of credit defaults that has given rise to the financial crisis of 2008-09.

But in India the credit default is comparatively less than other countries such as US. One of the reasons leading to this may be good appraisal techniques used by banks and financial institutions in India. Eventually the importance of this project is mainly to understand the credit appraisal techniques used by the banks with special reference to Punjab National Bank. Scheme of the project It covers the objective and structure of the project which is discussed as follows:- Objective of the project The overall objective of this project is to understand the current credit appraisal system used in banks.

The Credit Appraisal system has been analysed as per the different credit facilities provided by the bank. The detailed explanation about the techniques and process has been discussed in detail in the further chapters. Structure or Plan of the project The project first of all makes a study about the commercial banks- its important functions. Then it highlights on the concept of Bank Credit & its recent trends. The project then proceeds towards the lending procedure of banks and here it highlights about credit appraisal being the first step in building up of a loan proposal.

Then it discusses the bank credit policy with respect to Punjab National bank where the project was undertaken. The project then proceeds with the review of literature i. e. review of some past work regarding credit appraisal by various researchers. The project then moves towards research methodology where it covers the information regarding the type of data collected and the theoretical concepts used in the project are discussed in detail. Then the project proceeds with the next chapter consisting of the

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analysis part which covers the analysis of various techniques used by the banks for the purpose of credit appraisal.

Then the project moves to its next chapter i. e. findings where some results found out are interpreted and then moving on to the last and the final chapter i. e. the suggestions and conclusions where some steps are suggested to be implemented to increase the work efficiency and to reduce to work pressure Commercial banks and its objectives A commercial bank is a type of financial intermediary that provides checking accounts, savings accounts, and money market accounts and that accepts time deposits.

Some use the term " commercial bank" to refer to a bank or a division of a bank primarily dealing with deposits and loans from corporations or large businesses. This is what people normally call a " bank". The term " commercial" was used to distinguish it from an investment bank. Commercial banks are the oldest, biggest and fastest growing financial intermediaries in India. They are also the most important depositories of public savings and the most important disbursers offinance. Commercial banking in India is a unique banking system, the like of which exists nowhere in the world.

The truth of this statement becomes clear as one studies the philosophy and approaches that have contributed to the evolution of banking policy, programmes and operations in India. The banking system in India works under constraints that go with social control and public ownership. The public ownership of banks has been achieved in three stages: 1995, July 1969 and April, 1980. Not only the public sector banks but also the private sector and foreign banks are required to meet the targets in respect of sectoral

deployment of credit, regional distribution of branches, and regional credit deposit ratios.

The operations of banks have been determined by lead bank scheme, Differential Rate of interest scheme, Credit authorization scheme, inventory norms and lending systems prescribed by the authorities, the formulation of credit plans, and service area approach. Commercial Banks in India have a special role in India. The privileged role of the banks is the result of their unique features. The liabilities of Bank are money and therefore they are important part of the payment mechanism of any country.

For a financial system to mobilise and allocate savings of the country successfully and productively and to facilitate day-to-day transactions there must be a class of financial institutions that the public views are as safe and convenient outlets for its savings. The structure and working of the banking system are integral to a country's financial stability and economic growth. It has been rightly claimed that the diversification and development of Indian Economy are in no small measure due to the active role banks have played financing economic activities of different sectors.

Major objectives of commercial banks Bank Credit The borrowing capacity provided to an individual by the banking system, in the form of credit or a loan is known as a bank credit. The total bank credit the individual has is the sum of the borrowing capacity each lender bank provides to the individual. The operating paradigms of the banking industry in general and credit dispensation in particular have gone through a major upheaval. * Lending rates have fallen sharply. * Traditional growth and earning such as corporate credit has been either slow or not profitable as before. Banks moving into

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retail finance, interest rate on the once attractive retail loans also started coming down. * Credit risks has went up and new types risks are surfaced

Types of credit- Bank in India provide mainly short term credit for financing working capital needs although, as will be seen subsequently, their term loans have increased over the years. The various types of advances provide by them are: (a) Term Loans, (b) cash credit, (c) overdrafts, (d) demand Loans , (e) purchase and discounting of commercial bills, and, (f) instalment or hire purchase credit. Volume of Credit-

Commercial banks are a major source of finance to industry and commerce. Outstanding bank credit has gone on increasing from Rs 727 crore in 1951 to Rs 19, 124 crore in 1978, to Rs 69, 713 crore in 1986, Rs 1, 01, 453 crore in 1989-90 , Rs 2, 82, 702 crore in 1997 and to Rs 6, 09, 053 crore in 2002. Banks have introduced many innovative schemes for the disbursement of credit. Among such schemes are village adoption, agriculture development branches and equity fund for small units. Recently, most of the banks have introduced attractive education loan schemes for pursuing studies at home or abroad.

They have introduced attractive educational loan schemes for pursuing studies at home or abroad. They have moved in the direction of bridging certain defects or gaps in their policies, such as giving too much credit to large scale industrial units and commerce and giving too little credit to agriculture, small industries and so on. The Public Sector Banks are still the leading lenders though growth has declined compared to previous quarter. The credit growth rate has dipped sharply in foreign and private banks compared to previous quarter. In all, the credit growth has slipped in this

quarter. Credit (YOY Growth) March 28 2008 March 27 2009| Public Sector Banks| 22. 5| 20. 4| The rates have gone down compared to previous quarter when it was seen that there was no changes in loan rates in private and foreign banks. But then compared to rate cuts done by RBI, they still need to go lower. Table 16: Reduction in Deposit and Lending Rates | (October 2008 - April 2009*)| (Basis points)| Bank Group| Deposit Rates| Lending Rates (BPLR)| Public Sector Banks| 125-250| 125-225| Private Sector Banks| 75-200| 100-125| Five Major Foreign Banks| 100-200| 0-100| | |

BPLR| Oct - 08| Mar - 09| Apr - 09| Change (from Oct to Apr)| Public Sector Banks| 13. 75-14. 75| 11. 50-14. 00| 11. 50-13. 50| 125-225| Private Sector Banks| 13. 75-17. 75| 12. 75-16. 75| 12. 50-16. 75| 100-125| Five Major Foreign Banks | 14. 25-16. 75| 14. 25-15. 75| 14. 25-15. 75| 0-100| Sector-wise credit points credit has increased to agriculture, industry and real estate whereas has declined to NBFCs and Housing. A bank group wise sectoral allocation is also given which suggests private banks have increases exposure to agriculture and real estate but has declined to industry.

Public sector banks have increased allocation to industry and real estate. There is a more detailed analysis in the macroeconomic report released before the monetary policy. Sector| As on February 15, 2008| | As on February 27, 2009| | | % share| Variations| % share | Variations| | in total| (per cent)| in total| (per cent)| Agriculture| 9. 2| 16. 4| 13| 21. 5| Industry| 45. 2| 25. 9| 52. 5| 25. 8| Real Estate| 3. 1| 26. 7| 8. 5| 61. 4| Housing| 7. 3| 12| 4. 7| 7. 5| NBFCs| 5. 7| 48. 6| 6. 6| 41. 7| Overall Credit| 100| 22| 100| 19. 5| To sum up, the credit conditions seems to have worsened after January 2009.

The rates have declined but lending has not really picked up. However, the question still remains - whether credit decline is because banks are not lending (supply) or because people/corporates are not borrowing (lack of demand). It is usually seen that all financial variables as lead indicators say if credit growth (along with other fin indicators) is picking, actual growth will also rise. However, it is actually seen the relation is far from clear. In fact, the financial indicators hardly help predict any change in business cycle. Most rise in good times and fall in bad times.

Most financial indicators failed to predict this global financial crisis and kept rising making everyone all the more complacent. Recent policy developments Regarding Bank Credit Bank lending was done for a long time by assessing the working capital needs based on the concept of MPBF (maximum permissible bank finance). This practice has been withdrawn with the effect from April 15th 1997 in the sense that the date, banks have been left free to choose their own method (from the method such as turnover , cash budget, present MPBF , or any other theory) of assessing working Capital requirement of the borrowers.

The cash credit system has been the bane, yet it has exhibited a remarkable strength of survival all these years. In spite of many efforts which were direct in nature, only a slow progress has been made to reduce its importance and increase bill financing. Therefore a concrete and direct policy step was taken on April 21, 1995 which made it mandatory for banks, consortia, syndicates to restrict cash credit components to the prescribed limit , the balance being given in the form of a short term loan, which would be a demand loan for a

maximum period of one year, or in case of seasonal industries , for six months.

The interest rates on the cash credit and loan components are to be fixed in accordance with the prime lending rates fixed by the banks. This “ loan system” was first made applicable to the borrowers with an MPBF of Rs 20 crore and above; and in their case , the ratio of cash credit (loan) to MPBF was progressively reduced(increased) from 75 (25) per cent in April 1995 , to 60 (40) percent in September 1995, 40 (60) per cent in April 1996 , and 20 (80) percent in April 1997.

With the withdrawal of instructions about the MPBF in April 1997 , the prescribed cash credit and loan components came to be related to the working capital limit arrived in banks as per the method of their choice. With effect from September 3, 1997, the RBI has permitted banks to raise their existing exposure limit to a business group from 50% to 60%; the additional 10% limit being exclusively meant for investment in infrastructure projects. The term lending by banks also has subject to the limits fixed by RBI. In 1993, this limit was raised from Rs 10 crore to Rs 50 crore in case of a loan for a single project by a single bank, and from Rs 150 crore to Rs 200 crore for a single project by all the banks. The latter limit was subsequently raised to Rs 500 crore in the case of general projects and Rs 1000 crore for power projects. From September 3, 1997 these caps on term lending by banks were removed subject to their compliance with the prudential exposure norms. The banks can invest in and underwrite shares and debentures of corporate bodies. At present, they can invest five percent of their incremental deposits in equities of companies including other banks.

Their investment in shares/ Bonds of DFHI, Securities trading Corporation of India (STCI), all Indian financial institutions and bonds (debentures) and preference shares of the companies are excluded from this ceiling of five per cent with effect from April 1997 . From the same date banks could extend loans within this ceiling to the corporate against shares held by them. They could also offer overdraft facilities to stock brokers registered with help of SEBI against shares and debentures held by them for nine months without change of ownership. CHANGING PHASE OF BANK CREDIT-

A study group headed by Shri Prakash Tandon, the then Chairman of Punjab National Bank, was constituted by the RBI in July 1974 with eminent personalities drawn from leading banks, financial institutions and a wide cross-section of the industry with a view to study the entire gamut of Bank's finance for working capital and suggest ways for optimum utilization of Bank credit. This was the first elaborate attempt by the central bank to organize the Bank credit. Most banks in India even today continue to look at the needs of the corporate in the light of methodology recommended by the Group.

The report of this group is widely known as Tandon Committee report. The weaknesses in the Cash Credit system have persisted with the non-implementation of one of the crucial recommendations of the Committee. In the background of credit expansion seen in 1977-79 and its ill effects on the economy, RBI appointed a working group to study and suggest- i) Modifications in the Cash Credit system to make it amenable to better management of funds by the Bankers and ii) Alternate type of credit facilities to ensure better credit discipline and co relation between credit and production. The Group was headed by Sh. K. B. Chore of RBI and was named

Chore Committee. Another group headed by Sh. P. R. Nayak (Nayak Committee) was entrusted the job of looking into the difficulties faced by Small Scale Industries due to the sophisticated nature of Tandon ; Chore Committee recommendations. His report is applicable to units with credit requirements of less than Rs. 50 lacs.

The recommendations made by Tandon Committee and reinforced by Chore Committee were implemented in all Banks and Bank Credit became much more organized. However, the recommendations were perceived as too strict by the industry and there has been a continuous clamor from the Industry for movement from mandatory control to a voluntary market related restraint. With recent liberalization of economy and reforms in the financial sector, RBI has given the freedom to the Banks to work out their own norms for inventory and the earlier norms are now to be taken as guidelines and not a mandate.

In fact, beginning with the slack season credit policy of 1997-98, RBI has also given full freedom to all the Banks to devise their own method of assessing the short term credit requirements of their clients and grant lines of credit accordingly. Most banks, however, continue to be guided by the principles enunciated in Tandon Committee report. Trends of Bank Credit in India The face of Indian banking has changed radically in the last decade. A perusal of the Basic Statistical Returns submitted by banks to the Reserve Bank of India shows that between 1996 and 2005, personal loans have been the fastest growing asset, increasing from 9. per cent of the total bank credit in 1996 to 22. 2 per cent in 2005. Of course, this is partly due to the huge rise in housing loans, which rose from 2. 8 per cent of the bank credit to 11 per cent

over the period, but 'other personal loans' — comprising loans against fixed deposits, gold loans and unsecured personal loans — also rose from 6.1 per cent to 10.7 per cent. Other categories whose share increased were loans to professionals and loans to finance companies. In contrast, there has been a sharp decline in the share of lendings to industry. Credit to small scale industries fell from 10. per cent of the total in 1996 to 4.1 per cent in 2005.

Reasons for declining trend of bank credit * A major share of the economic growth has been led by the expansion of the service sector * Capital intensity and investment intensity required for growth in the current economic context may not be as high as it used to be in the past. * In manufacturing sector more efficient utilization of existing capacities contributed to the sectoral growth rather than any large addition of fresh capacities. The consequential increase in the demand for credit was also subdued. Greater and cheaper avenues for credit resulted in a bigger share of disintermediation being resorted to by large borrowers. The other trend has been the substantial drop in the share of rural credit, while the share of metropolitan centres has increased. While bankers say that up gradation of rural centres into semi-urban could be one reason (the share of semi-urban centres has gone up), it is also true that the reforms have been urban-centric and have tended to benefit the metros more. The number of rural bank offices fell from 32,981 in March 1996 to 31,967 by March 2005.

The states have been the main beneficiaries of bank credit are the northern region as it has increased its share from 18.7 per cent of the total credit in 1996 to 22.2 per cent in 2005. As it was seen that Delhi's share went up from 9.5 per cent to 12.1 per cent over the period. This is not due

to food credit, the account of which is maintained in Delhi. Clearly, the national capital has gained a lot from liberalisation. Trends for the year 2008-09 The aggregate deposits of scheduled commercial banks have expanded during 2008-09 at a somewhat slower rate (19. %) than in 2007-08 (22. 4%). Within aggregate deposits demand deposits have shown an absolute fall (-Rs 4, 179 crore) in contrast to the sizeable increase (Rs 94, 579 crore or by 22%) in 2007-08,. On the other hand, time deposits have shown an accelerated increase of 22. 6% (or Rs 647, 806 crore) as against 21. 8% (Rs 512, 844 crore) in the previous year. In the investment portfolio of banks, the expansion during 2008- 09 at Rs 194, 031 crore has been much lower than the expansion of Rs 340, 250 crore as increase in net bank credit to government under monetary data for the same period. This has happened because the latter has a sizeable amount of RBI credit to government following the increased open market operations. Finally, there has occurred considerable slowdown in bank credit expansion. Because of relatively higher procurement of foodgrains, food credit has expanded by Rs 1, 812 crore during 2008-09 as against an absolute fall of Rs 2, 121 crore in 2007-08. Non-food credit growth at Rs 406, 287 (17. 5%) has been slower than in the previous year at Rs 432, 846 (23. 0%).

Procedure for providing Bank Credit- Banks offers different types of credit facilities to the eligible borrowers. For this, there are several procedures, controls and guidelines laid out. Credit Appraisal, Sanctions, Monitoring and Asset Recovery Management comprise the entire gamut of activities in the lending process of a bank which are clearly shown as below: Source- Self constructed From the above chart we can see that Credit Appraisal is the

core and the basic function of a bank before providing loan to any person/company, etc.

It is the most important aspect of the lending procedure and therefore it is discussed in detail as below. Credit Appraisal Meaning - The process by which a lender appraises the creditworthiness of the prospective borrower is known as Credit Appraisal. This normally involves appraising the borrower's payment history and establishing the quality and sustainability of his income. The lender satisfies himself of the good intentions of the borrower, usually through an interview. * The credit requirement must be assessed by all Indian Financial Institutions or specialised institution set up for this purpose. Wherever financing of infrastructure project is taken up under a consortium / syndication arrangement - bank's exposure shall not exceed 25% * Bank may also take up financing infrastructure project independently / exclusively in respect of borrowers /promoters of repute with excellent past record in project implementation. * In such cases due diligence on the inability of the projects are well defined and assessed. State government guarantee may not be taken as a substitute for satisfactory credit appraisal.

The important thing to remember is not to be overwhelmed by marketing or profit centre reasons to book a loan but to take a balanced view when booking a loan, taking into account the risk reward aspects. Generally everyone becomes optimistic during the upswing of the business cycle, but tend to forget to see how the borrower will be during the downturn, which is a short-sighted approach. Furthermore greater emphasis is given on financials, which are usually outdated; this is further exacerbated by the fact

that a descriptive approach is usually taken, rather than an analytical approach, to the credit.

Thus a forward looking approach should also be adopted, since the loan will be repaid primarily from future cash flows, not historic performance; however both can be used as good repayment indicators. Indian Banking Sector ; Its Major Challenges It is well recognised by the world that India is one of the fastest growing economies in the world. Evidence from across the world suggests that a sound and evolved banking system is required for sustained economic development. The last decade has seen many positive developments in the Indian banking sector.

The policy makers, which comprise the Reserve Bank of India (RBI), Ministry of Finance and related government and financial sector regulatory entities, have made several notable efforts to improve regulation in the sector. The sector now compares favourably with banking sectors in the region on metrics like growth, profitability and non-performing assets (NPAs). A few banks have established an outstanding track record of innovation, growth and value creation. This is reflected in their market valuation. However, improved regulations, innovation, growth and value creation in the sector remain limited to a small part of it.

The cost of banking intermediation in India is higher and bank penetration is far lower than in other markets. India's banking industry must strengthen itself significantly if it has to support the modern and vibrant economy which India aspires to be. While the onus for this change lies mainly with bank managements, an enabling policy and regulatory framework will also be critical to their success. The failure to respond to changing market realities

has stunted the development of the financial sector in many developing countries.

A weak banking structure has been unable to fuel continued growth, which has harmed the long-term health of their economies. In this “white paper”, we emphasise the need to act both decisively and quickly to build an enabling, rather than a limiting, banking sector in India. Indian banks have compared favourably on growth, asset quality and profitability with other regional banks over the last few years. The banking index has grown at a compounded annual rate of over 51 per cent since April 2001 as compared to a 27 per cent growth in the market index for the same period.

Policy makers have made some notable changes in policy and regulation to help strengthen the sector. These changes include strengthening prudential norms, enhancing the payments system and integrating regulations between commercial and co-operative banks. However, the cost of intermediation remains high and bank penetration is limited to only a few customer segments and geographies. While bank lending has been a significant driver of GDP growth and employment, periodic instances of the “failure” of some weak banks have often threatened the stability of the system.

Structural weaknesses such as a fragmented industry structure, restrictions on capital availability and deployment, lack of institutional support infrastructure, restrictive labour laws, weak corporate governance and ineffective regulations beyond Scheduled Commercial Banks (SCBs), unless addressed, could seriously weaken the health of the sector. Further, the inability of bank managements (with some notable exceptions) to improve capital allocation, increase the productivity of their service platforms and

improve the performance ethic in their organisations could seriously affect future performance.

India has a better banking system in place Vis a Vis other developing countries, but there are several issues that need to be ironed out. Major challenges of Indian banking sector are mentioned below. Interest rate risk Interest rate risk can be defined as exposure of bank's net interest income to adverse movements in interest rates. A bank's balance sheet consists mainly of rupee assets and liabilities. Any movement in domestic interest rate is the main source of interest rate risk. Over the last few years the treasury departments of banks have been responsible for a substantial part of profits made by banks. Between July 1997 and Oct 2003, as interest rates fell, the yield on 10-year government bonds (a barometer for domestic interest rates) fell, from 13 per cent to 4.9 per cent. With yields falling the banks made huge profits on their bond portfolios. Now as yields go up (with the rise in inflation, bond yields go up and bond prices fall as the debt market starts factoring a possible interest rate hike), the banks will have to set aside funds to mark to market their investment. This will make it difficult to show huge profits from treasury operations.

This concern becomes much stronger because a substantial percentage of bank deposits remain invested in government bonds. Banking in the recent years had been reduced to a trading operation in government securities. Recent months have shown a rise in the bond yields has led to the profit from treasury operations falling. The latest quarterly reports of banks clearly show several banks making losses on their treasury operations. If the rise in

yields continues the banks might end up posting huge losses on their trading books.

Given these facts, banks will have to look at alternative sources of investment. Interest rates and non-performing assets The best indicator of the health of the banking industry in a country is its level of NPAs. Given this fact, Indian banks seem to be better placed than they were in the past. A few banks have even managed to reduce their net NPAs to less than one percent (before the merger of Global Trust Bank into Oriental Bank of Commerce OBC was a zero NPA bank). But as the bond yields start to rise the chances are the net NPAs will also start to go up.

This will happen because the banks have been making huge provisions against the money they made on their bond portfolios in a scenario where bond yields were falling. Reduced NPAs generally gives the impression that banks have strengthened their credit appraisal processes over the years. This does not seem to be the case. With increasing bond yields, treasury income will come down and if the banks wish to make large provisions, the money will have to come from their interest income, and this in turn, shall bring down the profitability of banks. Competition in retail banking

The entry of new generation private sector banks has changed the entire scenario. Earlier the household savings went into banks and the banks then lent out money to corporate. Now they need to sell banking. The retail segment, which was earlier ignored, is now the most important of the lot, with the banks jumping over one another to give out loans. The consumer has never been so lucky with so many banks offering so many products to

choose from. With supply far exceeding demand it has been a race to the bottom, with the banks undercutting one another.

A lot of foreign banks have already burnt their fingers in the retail game and have now decided to get out of a few retail segments completely. The nimble footed new generation private sector banks have taken a lead on this front and the public sector banks are trying to play catch up. The PSBs have been losing business to the private sector banks in this segment. PSBs need to figure out the means to generate profitable business from this segment in the days to come. The urge to merge In the recent past there has been a lot of talk about Indian Banks lacking in scale and size.

The State Bank of India is the only bank from India to make it to the list of Top 100 banks, globally. Most of the PSBs are either looking to pick up a smaller bank or waiting to be picked up by a larger bank. The central government also seems to be game about the issue and is seen to be encouraging PSBs to merge or acquire other banks. Global evidence seems to suggest that even though there is great enthusiasm when companies merge or get acquired, majority of the mergers/acquisitions do not really work. So in the zeal to merge with or acquire another bank the PSBs should not let their common sense take a back seat.

Before a merger is carried out cultural issues should be looked into. A bank based primarily out of North India might want to acquire a bank based primarily out of South India to increase its geographical presence but their cultures might be very different. So the integration process might become very difficult. Technological compatibility is another issue that needs to be looked into in details before any merger or acquisition is carried out. Impact

of BASEL-II norms Banking is a commodity business. The margins on the products that banks offer to its customers are extremely thin vis a vis other businesses.

As a result, for banks to earn an adequate return of equity and compete for capital along with other industries, they need to be highly leveraged. The primary function of the bank's capital is to absorb any losses a bank suffers (which can be written off against bank's capital). Norms set in the Swiss town of Basel determine the ground rules for the way banks around the world account for loans they give out. These rules were formulated by the Bank for International Settlements in 1988. Essentially, these rules tell the banks how much capital the banks should have to cover up for the risk that their loans might go bad.

The rules set in 1988 led the banks to differentiate among the customers it lent out money to. Different weightage was given to various forms of assets, with zero percentage weightings being given to cash, deposits with the central bank/govt. etc, and 100 per cent weighting to claims on private sector, fixed assets, real estate etc. The summation of these assets gave us the risk-weighted assets. Against these risk weighted assets the banks had to maintain a (Tier I + Tier II) capital of 9 per cent i. e. every Rs100 of risk assets had to be backed by Rs 9 of Tier I + Tier II capital.

To put it simply the banks had to maintain a capital adequacy ratio of 9 percent. The problem with these rules is that they do not distinguish within a category i. e. all lending to private sector is assigned a 100 per cent risk weighting, be it a company with the best credit rating or company which is in the doldrums and has a very low credit rating. This is not an efficient use of

capital. The company with the best credit rating is more likely to repay the loan vis a vis the company with a low credit rating.

So the bank should be setting aside a far lesser amount of capital against the risk of a company with the best credit rating defaulting vis a vis the company with a low credit rating. With the BASEL-II norms the bank can decide on the amount of capital to set aside depending on the credit rating of the company. Credit risk is not the only type of risk that banks face. These days the operational risks that banks face are huge. The various risks that come under operational risk are competition risk, technology risk, casualty risk, crime risk etc. The original BASEL rules did not take into account the operational risks.

As per the BASEL-II norms, banks will have to set aside 15 per cent of net income to protect themselves against operational risks. Over the last few years, the falling interest rates, gave banks very little incentive to lend to projects, as the return did not compensate them for the risk involved. This led to the banks getting into the retail segment big time. It also led to a lot of banks playing it safe and putting in most of the deposits they collected into government bonds. Now with the bond party over and the bond yields starting to go up, the banks will have to concentrate on their core function of lending.

The banking sector in India needs to tackle these challenges successfully to keep growing and strengthen the Indian financial system. Furthermore, the interference of the central government with the functioning of PSBs should stop. A fresh autonomy package for public sector banks is in offing. The package seeks to provide a high degree of freedom to PSBs on operational

matters. This seems to be the right way to go for PSBs. The growth of the banking sector will be one of the most important inputs that shall go into making sure that India progresses and becomes a global economic super power. Products and Services Corporate banking * Personal banking * Industrial finance * Agriculture finance * Financing of trade * International banking * Home loan * Auto loan * ATM/Debit card * Deposit interest rate * Credit interest rate * Other services: lockersfacility, internet banking, EFT ; Clearing services etc Review of Literature Literature review provides available research with respect to the selected topic of the project or the research findings by an author which has been done with respect to the research topic. This chapter provides the overall view of the available literature with respect to the topic of the project.

The review of the related research works are described as under:- 1. A research work on the topic " On the appraisal on consumer credit banking products with the asset quality frame: A multiple criteria application. " done by Panagiotis Xidonas, Alexandros Flamos, Sortirios Koussouris, Dimitrious Askouins ; Ioannis Psarras from National Technical University of Athens in 2007 says that Asset quality refers to the likelihood that the bank's earning assets will continue to perform and requires both a qualitative and quantitative assessment.

Decision problems like the " internal appraisal of banking products", are problems with strong multiple-criteria character and it seems that the methodological framework of Multiple Criteria Decision Making could provide a reliable solution. In this paper, the Asset Quality banking indicators are the, so called, " criteria", the value of these indicators are the, so called, " scores"

in each criterion and the P. R. O. METH. E. E. [Preference Ranking Organization Method of Enrichment Evaluations, Brans & Vincke (1985)] Multiple Criteria method is applied, towards modelling banking products appraisal problems.

A Multiple Criteria process, strictly mathematically defined, integrates the behaviour of each indicator-criterion and utilizes each score in order to rank the so called " alternatives", i. e. categories of banking products. 2. The research Paper on " Evaluation of decision support systems for credit management decisions" by S. Kanungo, S. Sharma, P. K. Jain from Department of studies, IIT Delhi have conducted a study to evaluate the efficiency of decision support system (DSS) for credit management. This study formed a larger initiative to access the effectiveness of the I.

T based credit management process at SBI. Such a study was necessitated since credit appraisal has become an integral sub-function of the Indian banks in view of growing incidence of non-performing assets. The DSS they have assessed was a credit appraisal system developed by Quattro pro at SBI. This system helps in analysis of balance sheets, Calculation of financial ratios, cash flow analysis, future projections, sensitivity analysis and risk evaluation as per SBI norms. They have also used a strong Quassi experimental design called Solomon's four group design for the assessment.

In the experiment the managers of SBI who attended the training programme were the subjects the experiment consisted of the measurements that were taken as pre and post tests. An experimental intervention was applied between the pre-tests and the pro-tests. The intervention or stimulus consisted of DSS training and use. There were four

groups in the experiment. The stimulus remained constant as they took care to ensure that the course content as well as the instructors remained the same during the course of the experiment. Two were experimental groups and two were control groups.

All four groups underwent training in credit management between the pre and the post tests. Results from research shows that while the DSS is effective, improvement needs to be done in the methodology to assess such improvements. Moreover such assessment frameworks while being adequate from a DSS-centric viewpoint do not respond to the assessment of DSS in an organizational setting . In the concluding section they have discussed how this evaluative framework can be strengthened to initiate an activity that will allow the long term and possibly the only meaningful evaluation framework for such a system. . The research paper on the topic “ Towards an appraisal of the FMHA farm credit program: A case study of the efficiency of borrower by S. Mehdian, Wm. McD. Herr, Phil Eberle, and Richard Grabowski” have studied that the a production frontier methodology is used to measure the overall efficiency of a sample of farmers home administration(FMHA) compared to non participants. The study did not find evidence that the efficiency FMHA farms improved between a time period Results indicated that overall efficiency of FMHA borrowers is associated with selected financial characteristics of the farms.

A review of the literature shows that agricultural finance specialists have not been successful in evaluating whether FMHA programs improve the efficiency and income of probability of success. Liberal loan policies Eligible borrowers. Inadequate evaluation of the FMHA program occurs partly

because of because the difficulty of adequately determining the impacts of changes in the economy-borrowers in a more normal period of the loan.

This study addressed these difficulties by utilizing a nonparametric production frontier technique to measure overall efficiency and a matched pair statistical procedure to measure how efficiency of farms receiving FMHA credit changed relative to a Non-FMHA farmers. 4. The book named "Financial Analysis for Bank Lending in Liberalised Economy" by Sampat. P. Singh and Dr. S. Singh have discussed the subject financial analysis for bank lending has assumed considerable importance, particularly since early 1990's when, like most of the countries, India opted for the policy of liberalisation and globalisation after 1991.

The present volume is meant to be a standard reference as well as text book on the varied facets of financial analysis with reference to credit management by Banks and Financial Institutions. The book consists of three parts. Part I discusses the concepts and tools of Financial Analysis; Part II explains various concepts of working capital in its historical context; while Part III demonstrates the application of these tools in the changing context of liberalised economy by focusing on new concepts like 'Credit Worthiness', Risk-Analysis, Credit Rating, Products-Differentiation, Pricing-Differentiation, Asset-Liability Management, etc.

The book contains- Bank Lending and Industrial Finance in India , Basic Economics for Bankers and Business Managers , Introduction to Fundamentals Accounting Principles , Profit and Loss Account (Operating Statement) , Analysis of Profit and Loss Account (Operating Statement) , Structure and Analysis of Balance Sheet , Ratios as Tools of Financial

Statements Analysis , Accounting Flows : Income, Cash and Funds , Break-even Analysis and Margin of Safety , Appraisal of Capital Projects , New Conceptual Framework for Analysis, Liberalised Era and New Focus of Bank Lending , Managing Working Capital by Strategic Choice , Financing Working Capital : Conceptual and Historical Exposition, Creditworthiness and Credit Rating : At Centre stage Nucleus of Credit Appraisal , Working Capital Management-I : MPBF System of Appraisal and Bifurcation of Fund-Based Limit in Two Components Working Capital Management-II : Alternative Methods of Appraisal , Working Capital Management-III : Follow-up and Supervision , Appraisal of a New Project Involving Term Loan , Management of Problem Accounts , Management of Non-Performing Assets (NPAs), Rehabilitation of Sick Industrial Units, Working Capital Management : Concepts and Techniques , 1st Committee on Financial Sector Reform and the 2nd Committee on Banking System Reform (Known as Narasimham Committee Report, 1998). 5. The research paper on the topic “ Competitive analysis in banking: Appraisal of the methodologies” by Nicola Cetorelli has discussed about the U. S. banking industry has experienced significant structural changes as the result of an intense process of consolidation. From 1975 to 1997, the number of commercial banks decreased by about 35 percent, from 14, 318 to 9, 215.

Since the early 1980s, there have been an average of more than 400 mergers per year (see Avery et al. , 1997, and Simmons and Stavins, 1998). The relaxation of intrastate branching restrictions, effective to differing degrees in all states by 1992, and the passage in 1994 of the Riegle. Neal Interstate Banking and Branching Efficiency Act, which allows bank holding

companies to acquire banks in any state and, since June 1, 1997, to open interstate branches, is certainly accelerating the process of consolidation. These significant changes raise important policy concerns. On the one hand, one could argue that banks are merging to fully exploit potential economies of scale and/or scope.

The possible improvements in efficiency may translate into welfare gains for the economy, to the extent that customers pay lower prices for banks. services or are able to obtain higher quality services or services that could not have been offered before. 1 On the other hand, from the point of view of public policy it is equally important to focus on the effect of this restructuring process on the competitive conditions of the banking industry. Do banks gain market power from merging? If so, they will be able to charge higher than competitive prices for their products, thus inflicting welfare costs that could more than offset any presumed benefit associated with mergers.

In this article, analysis of competition in the banking industry is done highlighting a very fundamental issue: How market power is measured and how do regulators rely on accurate and effective procedures to evaluate the competitive effects of a merger. Credit Philosophy ; Policy with regards to Punjab National Bank An ideal advance is the one given to a reliable customer for an approval purpose with adequate experience, safe in knowledge that the money will be used to advantage and repayment will be made within a reasonable period from trade receipts or known maturities due on or about given dates. Credit philosophy - " To achieve credit expansion required for sustaining the profitability of the bank and emphasis on quality assets, profitable relationships and prudent growth. " CREDIT

POLICY Bank follows following broad policy imperatives:- Reduction in dependence upon short term corporate loans, especially unsecured exposures. * Aiming to achieve more sanctions at levels closer to the customer. * Changing the mix of the portfolio in favour of better diffused and higher yielding credit. * Building competencies in credit management through training ; promotion of self directed learning. Objectives of credit policy

1. A balanced growth of credit portfolio, which does not compromise safety.
2. Adoption of a forward looking and market responsive approach for moving into profitable new areas on lending which emerge, within the pre determined exposure ceilings.
3. Sound risk management practices to identify measure, monitor and control risks.
- 4.

Maximize interest yields from credit portfolio through a judicious management of varying spreads of loan assets based upon their size, credit rating and tenure.

5. Leverage on strong relationships with existing long-standing clients to source a bulk of new business by addressing their requirements comprehensively.
6. Ensure due compliance of various regulatory norms including CAR, income recognition and asset classification
7. Accomplish balanced development of credit to various sectors and geographical regions.
8. Achieve growth of credit to priority sectors / subsectors and continue to surpass the targets stipulated by reserve bank of India.
- 9.

Using of pricing as a tool of competitive advantage ensuring however that earnings are protected.

10. Develop and maintain enhanced competencies in credit management at all levels through a combination of training initiatives, promotion of self directed learning and dissemination of best practices.

Objectives in Credit To maintain healthy balance between- * Credit volumes * Earnings * Asset quality within the framework of regulatory prescriptions, corporate goals and bank's social responsibilities. Introduction to loans Loans are advances for fixed amounts repayable on demand or in instalment. They are normally made in lump sums and interest is paid on the entire amount.

The borrower cannot draw funds beyond the amount sanctioned. A key function of the Bank is deploying funds for income-yielding assets. A major part of Bank's assets are the loans and advances portfolio and investments in approved securities. Loans ; Advances refer to long-term and short-term credit facilities to various types of borrowers and non-fund facilities like Bank Guarantees, Letters of Credit, Letters of Solvency etc. Bill facilities represent structured commitments which are negotiable claims having a market by way of negotiable instruments. Thus, Banks extend credit facilities by way of fund-based long-term and short-term loans and advances as also by way of non-fund facilities.

Loans/Advances Classification of Loans Loans/Advances Pre-shipment Finance Post shipment Finance Letter of Credit Bank Guarantee Term Loan Export Finance Bill Discounting Cash Credit Retail Loan Non-Fund Based Fund Based Fund Based Bank provides credit in various forms. These are broadly classified into two categories- Fund based and Non -Fund Based. Fund based refers to the type of credit where cash is directly involved i. e. where bank provides money to the seeker in anticipation of getting it back. Where as in a Non-fund Based, Bank doesn't pay cash directly but gives assurance or takes guarantee on behalf of its customer to pay if they fail to do so.

In case on Fund Based there are different categories of loans which are discussed as follows I. RETAIL LOANS- Retail banking in India is not a new phenomenon. It has always been prevalent in India in various forms. For the last few years it has become synonymous with mainstream banking for many banks. The typical products offered in the Indian retail banking segment are:-

- * Housing loans
- * Consumer loans for purchase of durables
- * Auto loans
- * Educational loans
- * Credit Cost.
- * Personal loans

Retail loan is the practice of loaning money to individuals rather than institutions. Retail lending is done by banks, credit unions, and savings and loan associations.

These institutions make loans for automobile purchases, home purchases, medical care, home repair, vacations, and other consumer uses. Retail lending has taken a prominent role in the lending activities of banks, as the availability of credit and the number of products offered for retail lending have grown. The amounts loaned through retail lending are usually smaller than those loaned to businesses. Retail lending may take the form of instalment loans, which must be paid off little by little over the course of years, or non-instalment loans, which are paid off in one lump sum. These loans are marketed under attractive brand names to differentiate the products offered by different banks.

As the Report on Trend and Progress of India, 2007-08 has shown that the loan values of these retail lending typically range between Rs. 20, 000 to Rs. 100 lakh. The loans are generally for duration of five to seven years with housing loans granted for a longer duration of 15 years. Credit card is another rapidly growing sub-segment of this product group. In recent past retail lending has turned out to be a key profit driver for banks with retail

portfolio. The overall impairment of the retail loan portfolio worked out much less than the Gross NPA ratio for the entire loan portfolio. Within the retail segment, the housing loans had the least gross asset impairment.

In fact, retailing makes ample business sense in the banking sector. Basic reasons that have contributed to the retail growth in India are- * First, economic prosperity and the consequent increase in purchasing power has given a fillip to a consumer boom. Note that during the 10 years after 1992, India's economy grew at an average rate of 6.8 percent and continues to grow at almost the same rate - not many countries in the world match this performance. * Second, changing consumer demographics indicate vast potential for growth in consumption both qualitatively and quantitatively. India is one of the countries having the highest proportion (70%) of the population below 35 years of age (young population).

The BRIC report of the Goldman-Sachs, which predicted a bright future for Brazil, Russia, India and China, mentioned Indian demographic advantage as an important positive factor for India. * Third, technological factors played a major role. Convenience banking in the form of debit cards, internet and phone-banking, anywhere and anytime banking has attracted many new customers into the banking field. Technological innovations relating to increasing use of credit / debit cards, ATMs, direct debits and phone banking has contributed to the growth of retail banking in India. * Fourth, the Treasury income of the banks, which had strengthened the bottom lines of banks for the past few years, has been on the decline during the last two years. In such a scenario, retail business provides a good vehicle of profit maximisation.

Considering the fact that retail's share in impaired assets is far lower than the overall bank loans and advances, retail loans have put comparatively less provisioning burden on banks apart from diversifying their income streams. * Fifth, decline in interest rates have also contributed to the growth of retail credit by generating the demand for such credit. According to K V Kamath, the changing demographic profile and a downward trend of the interest rates will propel retail credit in India. " There is a huge retail credit opportunity that is surfacing. Banks have low penetration in this segment currently. But it is the one area that is providing the momentum in the banking business now," India has among the lowest penetration of retail loans in Asia.

Though the sector has been growing at around 15 per cent, there is still a huge opportunity to tap into. Middle and -high-income homes in India has increased to 2. 57 crore (25. 7 million). Interest rates on retail loans have been dropping rapidly too. For instance residential mortgages slumped by 7 per cent over the last four years. " The entry of a number of banks in India in the last few years has helped provide increased coverage and a number of new products in the market," says Kamath. II. WORKING CAPITAL / CASH CREDIT Cash credit is a short-term cash loan to a company. A bank provides this type of funding, but only after the required security is given to secure the loan.

Once a security for repayment has been given, the business that receives the loan can continuously draw from the bank up to a certain specified amount. The bank provides certain amount to the company for its day to day working keeping certain margin in hand. III. TERM LOANS A bank loan to a

company, with a fixed maturity and often featuring amortization of principal. If this loan is in the form of a line of credit, the funds are drawn down shortly after the agreement is signed. Otherwise, the borrower usually uses the funds from the loan soon after they become available. Bank term loans are very a common kind of lending. Term loans are the basic vanilla commercial loan. They typically carry fixed interest rates, and monthly or quarterly repayment schedules and include a set maturity date.

Bankers tend to classify term loans into two categories: * Intermediate-term loans: Usually running less than three years, these loans are generally repaid in monthly instalments (sometimes with balloon payments) from a business's cash flow. According to the American Bankers Association, repayment is often tied directly to the useful life of the asset being financed. * Long-term loans: These loans are commonly set for more than three years. Most are between three and 10 years, and some run for as long as 20 years. Long-term loans are collateralized by a business's assets and typically require quarterly or monthly payments derived from profits or cash flow. These loans usually carry wording that limits the amount of additional financial commitments the business may take on (including other debts but also dividends or principals' salaries), and they sometimes require that a certain amount of profit be set-aside to repay the loan. Appropriate For: Established small businesses that can leverage sound financial statements and substantial down payments to minimize monthly payments and total loan costs. Repayment is typically linked in some way to the item financed. Term loans require collateral and a relatively rigorous approval process but can help reduce risk by minimizing costs. Before deciding to finance equipment,

borrowers should be sure they can they make full use of ownership-related benefits, such as depreciation, and should compare the cost with that leasing. Supply: Abundant but highly differentiated.

The degree of financial strength required to receive loan approval can vary tremendously from bank to bank, depending on the level of risk the bank is willing to take on. IV. BILL DISCOUNTING While discounting a bill, the Bank buys the bill (i. e. Bill of Exchange or Promissory Note) before it is due and credits the value of the bill after a discount charge to the customer's account. The transaction is practically an advance against the security of the bill and the discount represents the interest on the advance from the date of purchase of the bill until it is due for payment. Bills of exchange- A bill of exchange or " draft" is a written order by the drawer to the drawee to pay money to the payee.

A common type of bill of exchange is the cheque (check in American English), defined as a bill of exchange drawn on a banker and payable on demand. Bills of exchange are used primarily in international trade, and are written orders by one person to his bank to pay the bearer a specific sum on a specific date. Prior to the advent of paper currency, bills of exchange were a common means of exchange. They are not used as often today. A bill of exchange is an unconditional order in writing addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at fixed or determinable future time a sum certain in money to order or to bearer.

It is essentially an order made by one person to another to pay money to a third person. A bill of exchange requires in its inception three parties--the <https://assignbuster.com/credit-appraisal-process/>

drawer, the drawee, and the payee. The person who draws the bill is called the drawer. He gives the order to pay money to third party. The party upon whom the bill is drawn is called the drawee. He is the person to whom the bill is addressed and who is ordered to pay. He becomes an acceptor when he indicates his willingness to pay the bill. The party in whose favor the bill is drawn or is payable is called the payee. Promissory Note- A promissory note is a written promise by the maker to pay money to the payee.

Bank note is frequently transferred as a promissory note, a promissory note made by a bank and payable to bearer on demand. A maker of a promissory note promises to unconditionally pay the payee (beneficiary) a specific amount on a specified date. A promissory note is an unconditional promise to pay a specific amount to bearer or to the order of a named person, on demand or on a specified date. A negotiable promissory note is unconditional promise in writing made by one person to another, signed by the maker, engaging to pay on demand, or at fixed or determinable future time, sum certain in money to order or to bearer V. EXPORT FINANCE- This type of a credit facility is provided to exporters who export their goods to different places.

It is divided into two parts- pre-shipment finance and post-shipment finance. * Pre Shipment Finance is issued by a financial institution when the seller want the payment of the goods before shipment. * Post Shipment Finance is a kind of loan provided by a financial institution to an exporter or seller against a shipment that has already been made. This type of export finance is granted from the date of extending the credit after shipment of the goods to the realization date of the exporter proceeds. Exporters don't wait for the

importer to deposit the funds. Non Fund Based loans generate income for the bank without committing the funds of the bank. Bank generates substantial income under this head.

There are two types of credit under this category which are discussed as follows:- I. BANK GUARANTEE- A bank guarantee is a written contract given by a bank on the behalf of a customer. By issuing this guarantee, a bank takes responsi