Credit appraisal and assessment from banker’s point of view in india assignment

Art & Culture

The area of credit appraisal and assessment is very vast and each new account poses new challenges and tests our skill. Whenever a proposal is received, what does a banker looks for in it? Answer to this question is not only very detailed but also very complex. Earlier speakers might have already covered the finer aspects of the project/credit appraisal i. e. from the selection of the project to preparation of projected financials and evaluation of the project from the angle of acceptability, more importantly the following points : 1.

Commercial , financial, technical viability of the project proposed, 2. Compliance with the laws of the land, guidelines of the various regulatory authorities 3. Funding pattern. 4. Primary and Collateral security cover available, etc. 5. financial analysis and vetting of the proposal I would therefore not go in to same details of the project appraisal. However, when a project/proposal is submitted to the banker, he reevaluates the proposal/project to satisfy himself about the correctness of the various facts and calculations and acceptability of the various assumptions/projections.

The angle of a banker while evaluating a proposal /project report is to ascertain the viability of a project with a view to ensuring the repayment of the borrower’s obligation under the bank’s term assistance. Therefore it is not so much the quantum of the proposed term assistance as the prospects of its repayment that should be considered while appraising a project/proposal. This can be done by evaluating the project/proposal on the following broad parameters before undertaking detailed appraisal: . Man behind the project: A Banker enquires in to the academic background, antecedents of the promoters their background, experience as entrepreneurs, their market and social standing integrity etc. from various sources. Their conduct of the account with the existing banker and if dealing with the other banks, reasons for switching over / giving the new business to him. Details of associate concerns of the promoters and study of their financial standings, performance and market standing.

The company or its promoters/ directors/partners should not be in the defaulters list of the RBI. 2. Viability: Project status may be enquired into. What is the proposed project? Is the project technically and commercially viable. Has the promoter taken the assistance of any marketing consultants help to assess the commercial viability of the project. What is the standing and reliability of the said consultant? The technical viability study can be conducted by the bank's own technical cell or by any reputed consultant SBI Caps, GITCO, FI's and a first class bank. . While net profit is the ultimate yard stick, profit before depreciation and taxes conveys more meaningful and comparable picture as the changes in the taxes rate effect the net profit more. Non operating profit and extra ordinary items on the earning side is excluded to arrive at the correct picture of the profitability. 4. Compliance with the law of the land and the guidelines of the regulatory authority like RBI in this regard. For example, as per the RBI guidelines, banks can not finance for the take over of the controlling stake in another company.

If the proposal is for financing the take over of the controlling interest in another company the same can not be considered. 5. Whether the proposal /project complies with the policies of the bank i. e. the loan policy, industry specific loan policies and various norms like takeover norms, exposure norms, risk management policies of the bank like credit risk assessment etc. Generally every bank prescribes exposure norms prescribing separate exposure ceilings for the Individual, non corporate and the corporate borrowers and the bank can not take exposure of more than the prescribed ceiling.

The ceilings prescribed by the banks have to be within the exposure ceilings prescribed by the RBI. RBI has prescribed that a bank can not take more than exposure of more than 15% of the bank's net owned funds in case of the individual borrower and 40% in a group. Additional 10% can be taken for the group if the project is for infrastructure project. RBI have advised that ' exposure' for this purpose shall include credit and investments and that Credit exposure would comprise all types of funded and non-funded credit limits. 6.

Asset liability mismatches are also taken in to the consideration while considering any loan proposal specially the term loan proposal. Normally a bank keeps its exposure in term loans between 35 to 40% of the total advances to avoid any major maturity mismatch between assets and liabilities. Once the bank is in principle satisfied and decides to consider it further it would be taken up for the detailed assessment. Term Loan Assessment: If the proposal is for term loan, the bank at the time of assessment of the proposal looks for following: 1.

In case of higher value exposure, the proposal should have been appraised by FIs/First class banks or by institutions like /SIDBI/SBI Caps/GITCO etc. and no further technical viability study would be necessary. 2. Period of term loan shall not normally exceed 7 to 8 years (in case of infrastructure projects repayment period of 12 to 15 years also may be accepted(including moratorium) 3. DSCR: bank normally looks for a mninimum DSCR of 1. 70 but the lower than the 1. 70 2 may also be accepted in otherwise deserving cases. 4. Promoters contribution should be at least 30% in a new project.

In case of existing customer with satisfactory conduct of the account exposure up to 80% maybe considered. 5. TOL: TNW ratio shall normally not exceed 3: 1, but a higher ratio may be acceptable depending upon the merit of each case. 6. An average sized bank normally takes exposure up to Rs. 5 crore in a project on sole banking basis. Above this, normally a bank tries to form/take share in consortium. 7. Apart from the Primary Security bank may insist for collateral security of 20 to 25% of the loan amount. Personal guarantee of the non technical director is desirable. 8.

If the project is already under implementation stage, whether the implementation is as per the schedule and within the cost estimates. If there is time or cost overrun what are the arrangements to meet the cost overrun and whether the project can absorb the losses due to delay in implementation like loss of production and profit and increased interest burden. Assessment of working capital requirement: If the project /proposal is for working capital requirement also/only, the assessment of the same can be done as under by three /four methods depending upon the type of the industry .

But before the banker assess the working capital requirement; he would like to satisfy himself on following parameters: (i)Liquidity: Current Ratio (CR) of

1. 33 will generally be considered as a benchmark level of liquidity. However, the approach will be flexible. CR of 1. 33 is only indicative and may not be deemed mandatory. In cases where the CR is projected at a level lower than the benchmark or a slippage in the CR is proposed, it alone will not be a reason for rejection of the loan proposal or for sanction of the loan at a lower level.

In such cases, the reasons for low CR or slippage should have been explained thoroughly and convincingly. In deserving cases the banker would not have hesitation in accepting CR as projected. In cases where projected CR is found acceptable, working capital finance as requested may be sanctioned. In specific cases where warranted, such sanction can be with a condition that the borrower should bring in additional long term funds to a specified extent by a given future date.

Where it is felt that the projected CR is not acceptable but the borrower deserves assistance subject to certain conditions, suitable written commitment would be obtained from the borrower to the effect that he would be bringing in required amounts within a mutually agreed time frame. (ii) Net Working Capital : Although this is a corollary of current ratio, the movements in Net Working Capital is watched to ascertain whether there is a mismatch of long term sources vis-a-vis long term uses for purposes which may not be readily acceptable to the Bank so that corrective measures can be suggested. ii)Projected annual turnover should be reasonable and achievable. Projection of abnormal growth over the previous year say more than 15% would get a closer look from the banker. iv) Sales of the previous years should be as per the turnover shown in the sales tax returns and in case of existing customer should match with the summation in the account. The various methods under which working capital requirement can be assessed are as under: Projected Balance Sheet Method: It has been adopted in lieu of MPBF by some banks.

As the name suggests the assessment is on the basis of projected balance sheet and the fund flow statement for the current and coming years. Unlike MPBF it is not necessary to fix or compute the quantum of working capital finance on the basis of minimum stipulated level of current ratio. On the contrary the limit is assessed keeping in view the extent of financial support required by the borrower and acceptability of the borrower's financial position, specially the projected position. The aim of the new system is to take full care of the borrower's requirement.

This method is mainly used for the assessment of requirements of borrower engaged in the manufacturing, servicing and trading activities and requiring substantially higher fund based working capital finance. In case of SSI units requiring working capital limit of more than Rs. 25 lac and up to Rs. 200 lac they are assessed on the PBS as well as turnover method and the higher of the two limit is sanctioned. The limits under this method are assessed as under: Assessed Bank FinanceActuals (Prev. Year)Estimated (Current Year)Projected (Next Year) Year Total Current Assets(A)

Other Current Liabilities(B) WorkingCapital gap(A-B= C) Net Working Capital= D Assessed Bank Finance(ABF)= C-D ABF/TCA(%) NWC/TCA(%) OCL/TCA (%) While the above method works out the limit at more realistic level and tries to provide required liquidity support to the borrower, it is the observation of the bankers that it is being misused by the borrower by working out more than justified limit by inflating the receivable/inventory levels or by suppressing the levels of Sundry Creditors level by projecting higher cash purchase of the material which ultimately does not materialise.

Cash Budget Method: Cash Budget method is mainly used for the seasonal industry and the construction projects. In this method gap in the projected inflow and the outflow is financed by the bank. It is also used for working out the requirement of adhoc limits. Projected Turnover Method: Used for SSI units for the limits up to Rs. 100 lac or turnover up to Rs. 500 lac. Introduced in 1993 as per the instructions of the RBI for all new as well as the existing units. The minimum working capital limit is fixed on the basis of the projected turnover.

Working capital requirement is to be taken at 25% of the projected turnover and the borrower is expected to bring 5% of the projected turnover as the NWC and the remaining 20% should be financed by the bank. Some important clarifications about the assessment of the working capital limit under this method are as under: 1. The assessment should be done under the above as well as traditional method also and the higher of the two limit shall be sanctioned to the borrower. 2.

The method assumes the operating cycle of 3 months, but if the actual operating cycle is lower than the 3 month and the assessed limit works out at a lower amount then the same should be discussed with the borrower to fix a lower limit. 3. If the actual or the projected NWC/ liquid surplus is more than 5% then the actual or projected surplus/NWC should be deducted from the 25% of the turnover to workout the limit. 4. Projected turnover should be taken at gross sales i. e. inclusive of excise duty.

Maximum Permissible Bank Finance(MPBF) Method : Earlier mandatory for the bankers as per Tondon Committee recommendation. Now though not mandatory, it is still used by some banks. However, it severely restricts the need based requirement of a new unit needing more funds in the initial stages to tide over the liquidity problems. Points a banker keeps in mind while assessing the limits: 1. Receivables in the form of sales bills (inland/export) drawn under L/Cs should not be included in the Current Assets.

Correspondingly, bank borrowings in the form of L/C bills purchase limits will also not be included in the Current liabilities. It would be classified as contingent liability. 2. Only short term parking of surplus in money market instruments like CP, CD etc. may be treated as current assets. 3. Some times information under the notes on account has a major impact on the credit decision of the bankers. Banker would adjust the figures in the P or Balance Sheet to give the effect of the note on the account and rework the figures and the resultant ratio.

For example, disputed tax liability shown as contingent liability or in the notes on account will not be treated by the banker as current liability unless provided for. 4. Installments of the term loans falling due within next 12 months are treated by the bankers as current liability and it has a effect on the current ratio as well as ABF. However, if the cash accruals are likely to be comfortable or the borrower has some tie up for raising some long term source to meet the same then the lower CR may not pose many problems. 5.

Even in case of an existing borrower with satisfactory and regular conduct of the account, lower CR shall not pose much of a problem. 6. In case of an existing borrower/takeover of the accounts from other banks, following points play major role in the assessment of the working capital limits : 1. Conduct of the account 2. Frequency of irregularity in the account, return of the cheques 3. Management of current liabilities like regularity in payment of statutory dues 4. Overdues in the payment of term loan instalments 5. signs of lengthening of the working capital cycle . adverse changes in the terms of credit purchases from the suppliers 7. Higher Current Ratio with increase in the holding period of inventory and receivables indicating increase in the slow/obsolete stocks and unrealizable sundry debtors. 8. Though the inventory holding norms prescribed by the RBI are no longer mandatory for the bankers, are still used by the bankers as the guiding factor to assess the optimum level of holding. 9. Industry comparison: Performance of the borrower vis a vis other players of comparable size in the same industry and the industry average. 0. Efficiency ratios: How efficiently the borrower /proposed borrower is /will be using its resources can be assessed from the various turnover ratios of the previous years with the estimates for the current year and projected for the next year. 11. SWOT analysis CREDIT RISK ASSESSMENT (CRA) 1 All the banks have adopted CRA models to take into account all possible factors which go into appraising the risks associated with a loan. These models though in use for quite some time have been refined substantially in past 3-4 years.

The risk parameters on which generally a bank analyses a proposal at the time of first sanction or at the time of renewal are broadly categorized into financial, business, industrial and management risks and are rated separately. To arrive at the overall risk rating, the factors duly weighted are aggregated and calibrated to arrive at a single point indicator of risk associated with the credit decision. 1. Financial parameters: The assessment of financial risk involves appraisal of the financial strength of the borrower based on performance and projected financial indicators.

The overall financial risk is assessed in terms of static ratios, future prospects and risk mitigation (collateral security / financial standing). 2. Industry parameters : The following characteristics of an industry which pose varying degrees of risk are built into the CRA model : ??? Competition ??? Industry outlook ??? Regulatory risk ??? Contemporary issues like WTO etc. 3. Management parameters: The management of an enterprise / group is rated on the following parameters: ??? Integrity (corporate governance) ??? Track record ??? Managerial competence / commitment ??? Expertise ??? Structure & systems Experience in the industry ??? Credibility : ability to meet sales projections ??? Credibility : ability to meet profit (PAT) projections ??? Payment record ??? Strategic initiatives ??? Length of relationship with the Bank 4. Minimum Scores CRA models generally stipulates a minimum score under financial, business, industry and management risk parameters for a proposal to be considered acceptable in a given form. No new connections are to be considered in respect of accounts rated below the hurdle rate No enhancements in credit limits are also to be considered in existing accounts rated below the hurdle rate.

Recently banks have shifted their focus on the Small and Medium Enterprises (SME)and to consider their requirements come out with several schemes. Most banks have a separate scoring system for the SME with the credit requirements up to generally Rs. 25 lac. Score System, which is generally used for small & medium industrial and trading enterprises in the C and SIB Segments is based upon a set of most desirable characteristics and a set of least tolerable characteristics of a borrower, The characteristics are divided generally into three groups viz.

Personal, Business and Collateral Conditions. where each group carries certain parameters with scores attached. The business parameters and the financial scores carry the maximum weights. The proposals are generally evaluated on a scale of 100 and an acceptable borrower should, ??? Get a minimum score of 60 out of 100; ??? Get a minimum of 50% marks each under Personal and Business heads; ??? And a minimum of 10 marks under Collateral conditions The above points or only the illustrative or the major points at which a banker focuses whenever a proposal is received.

However, this is not an exhaustive list of checks and evaluation process that a banker carries out whenever a new project/proposal is received. Banker’s angle will change with every proposal/project received depending upon several factors like who is the promoter, industry, security cover offered, current performance of the particular type of industry and the future outlook and above all the risk perception and the risk taking capacity of the banker.