Credit Evaluation
Credit Evaluation

• Assessment of borrower capacity to repay the loan.

• Assessment of borrower’s ability to bring in profits from operations.

• Assessment of project viability.

• Assessment of managerial strength.

• Assessment of capital adequacy.
Borrower Evaluation

• Appraisal before Loan Sanction
  ✓ Project worthiness
  ✓ Cash earning capacity
  ✓ Ability to pay back loan

• Appraisal during Loan Servicing
  ✓ Loan documentation
  ✓ Supervision of loan performance
  ✓ Follow up of cash flows
Risk Evaluation of a Loan

• Credit Report
  ✓ Internal rating through banker’s policy measures
  ✓ External rating from credit rating agencies

• Loan proposal risk evaluation
  ✓ Historical financial data
  ✓ Project performance
  ✓ Working capital position
Risk Evaluation of a Loan

• Loan proposal risk evaluation
  ✓ Loan collateral value
  ✓ Market report
  ✓ Reports from firm’s auditors
  ✓ Tax assessment report
  ✓ Confidential report from other bankers or industry

• Risk evaluation through rating methods
Tasks for Loan Evaluation

• Before sanction of loan
  ✓ Industry report
  ✓ Firm analysis
  ✓ Bank policy

• After sanction of loan
  ✓ Documentation of loan policy
  ✓ Follow up of financial performance
  ✓ Loan transaction value utilization follow up
  ✓ Physical field level inspection of collaterals pledged by the borrower
  ✓ Review of periodical statements submitted by the borrower
Internal Credit Report of Banks

- Borrower information from
  - Previous interactions with the bank
  - Suppliers to the firm
  - Related players in the business
  - Other banks

- Sensitive information of business
  - Market strategies
  - Customer specific information
  - Customer contract estimates
  - Takeover strategies of firms in respect of competitors
  - Account details of borrower other than loan account
Banking Regulation Act

• Distinction of secured and unsecured loans and advances.

  ✓ Secured loans and advances are approved by banks based on the security of assets held by the business.

  ✓ Market value of the assets so secured are monitored such that the value of loans and advances are lesser than the value of assets.

  ✓ Unsecured loans and advances do not have an asset or group of asset as security for the loan.

• Secured loans can use the value of assets pledged as security by disposal if the loan obligations of the borrower are not met.

• Unsecured loans carry greater risk while secured loans have to be monitored regularly to evaluate the risk status.
Secured Loans and Advances

• Primary security
  ✓ Adequate for projects with good credit standing and low competition
  ✓ Professionally managed firms
  ✓ Large conglomerates
Secured Loans and Advances

✓ Business firm with subsidiaries

- Personal security
  - Promissory note
  - Acceptance and endorsement of bill of exchange
  - Documentation giving the right to the banker to legally exercise the security in case of default

- Impersonal security
  - Pledge
  - Hypothecation
  - Mortgage
Secured Loans and Advances

- Collateral Security

  Guarantee by the borrower to hand over the assets that have been given as collateral to the bank

- Collaterals are additional assets such as raw materials or finished goods that are secured for the loans and advances

- Collaterals may take the form of secured or unsecured guarantee

- Collaterals may take the form of deposits to title documents held by the borrower

- Collaterals supply additional risk cover above that of primary security

- Agricultural advances that take harvested crop as collateral would be considered as unsecured collateral till the crop is harvested
Additional Prerequisites of Loan Sanction

- Willingness to repay by the borrower
- Intention to repay as per agreement conditions
- Voluntary supply of requisite documents
- Ability of the borrower to meet the banker at times of critical need
- Maintain a track record of consistent debt servicing
- Borrower’s ability to manage contingent events such as market downturn
- Ability of borrower to document usage of approvals and apply the loans for the purpose for which loan sanction has been made
- Ability of the borrower to make use of market opportunities
Revision of Risk Status of Loans

• Market position turning negative.

• New entrants in the market.

• Change in the manufacturing technique.

• Revision in the terms of banks and other borrowers due to changes in market interest rates.

• Change in borrower repayment capacity due to increased costs or reduced sales level.
Loan Evaluation Method

• Financial Analysis through ratios
  ✓ Profitability ratios
  ✓ Turnover ratios
  ✓ Liquidity ratios
  ✓ Leverage ratio
  ✓ Market performance ratios

• Cash flows
  ✓ Operational cash flows
  ✓ Investment cash flows
  ✓ Financial cash flows
Loan Evaluation Method

• Projections of future
  ✓ Projects
  ✓ Business reports
  ✓ Analyst reports

• Surveillance
  ✓ Physical verification of securities
  ✓ Audit of loan performance
Qualitative Evaluation

• Integrity
• Honesty
• Resourcefulness
• Reliability
• Management competency
• Managerial and staff expertise
• Experience of managers holding top positions
• Performance of related enterprises or sister concerns
• Qualitative evaluation of securities provided as guarantor
• Due diligence report on credit proposal
• Governance reports
Know Your Customer (KYC) Norms

- Information on Borrowers
- Fair Practice Code
- Business Practices
- Lender’s Liability
Sample KYC Form

• Name of applicant company
• Date of incorporation and registration
• Nature of the company
• Country of registration
• Documents required
  ✓ Permanent account number card
  ✓ Certificate of incorporation
  ✓ Board resolution
  ✓ Photo identify proof of authorized person
• Turnover of the company
Hindrances in Credit Evaluation

- Several stages of credit sanction.
- Credit sanction through a hierarchy level in banks.
- Several personnel simultaneously reviewing a proposal.
- Industry competence and knowledge level of loan officers.
- Integration of credit department with the overall functioning of the bank.
- Change in officers in charge of sanction of loan and those that are involved with the follow up of the loan.
Hindrances in Credit Evaluation

• Focus on asset based lending than cash flow based lending.

• Industry specific evaluation tools not being used.

• RBI guidelines on committee approval for credit sanction not being followed fully since the committee members do not meet frequently as and when required.

• Additional evaluations required in case of sensitive sectors such as funding of capital market securities or real estate proposals or commodity markets.