Industrial Engineering Journal
ISSN: 0970-2555
Volume : 52, Issue 7, July : 2023

A COMPREHENSIVE STUDY CREDIT APPRAISAL METHOD

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ABSTRACT : The Loan To keep lending at a high standard and successfully control associated risks, banks constantly assess the creditworthiness of borrowers, beginning with their first visit to a branch and continuing through loan delivery and monitoring. A "credit appraisal" is a method used to determine if a prospective long-term investment would provide an adequate return for the company's shareholders. The bank established the Best Practices Code over time. The bank has adopted this policy to demonstrate its dedication to sound Corporate Governance practices. As a result of financial deregulation, banks and other financial institutions are under greater pressure than ever to increase profits, calling for cutting-edge technical solutions. Credit analysis, risk assessment, and loan selection are just few of the areas that are covered in this book as they relate to corporate banking strategy. This book is perfect for managers of all experience levels because it delves into both the fundamentals of credit appraisal and more advanced issues, such as scenario planning. Numerous real-world examples have been provided to emphasize the gravity of the recent changes to the financial system. The possible lending institution is also considered in determining the borrower's creditworthiness. A risk rating can be determined by estimating the likelihood of borrower default during the life of the facility and the potential loss to the lender as a result of failure.

Keywords: Credit risk and monitoring, Corporate governance, Best practices code, Credit appraisal, Lending strategies, Financial market, Risk rating.

1. INTRODUCTION

That loan A borrower's creditworthiness is evaluated from the moment they walk into a branch all the way through the life of the loan, from delivery to monitoring. The process through which a firm determines whether or not a potential long-term investment would yield a suitable rate of return for the company's stockholders is known as a "credit appraisal." Over time, the bank developed its Best Practices Code. The bank's commitment to following best practices in Corporate Governance is shown in this document. If the verdict is favorable, then the project is worth funding. Everything about the task at hand needs careful thought. The following considerations are essential for evaluating projects:

Options

Analyzing possible paths to a desired end result is known as "options analysis." This is a tricky part of a project to assess, especially when there is contradictory advice on how to do so. Trying out fresh approaches is the best way to achieve critical goals and resolve significant regional problems.

Inputs

Assemble all of the resources and people you'll need to successfully complete the task. Things like time, money, and space may need to be considered. Every assessment needs to factor in cost.

OUTPUTS AND OUTCOMES

The project's immediate results are not as relevant as its long-term effects. The benefits to both inhabitants and tourists are reflected in the price increase. The potential for the desired results (more jobs, higher wages, improved public health,

etc.) is assessed.

This exploratory study draws its conclusions solely from a review of the current literature, which includes numerous other studies, papers, periodicals, and books on the subject. This study's results can be used as a jumping off point for additional exploration of the topic. The thesis that will shed light on the importance of credit assessment is formulated and analyzed in the aforementioned literature, and it is also theorized about in this body of work.

OBJECTIVES OF STUDY

- Critical Examination of Credit Ratings
- Study of the Entire Loan Procedure
- skill in approaching financial institutions for a loan.
- Market conditions that are conducive to credit evaluation procedures merit exploration.
- In order to understand the consequences of their actions and the benefits of their good behavior,
- Examining the Methods Behind Credit Ratings
- To find out how much of a loan the company might qualify for based on the bank's standards.
- The purpose of this research is to examine the methods used to assess the creditworthiness of micro, small, and medium-sized businesses (MSME).

NEED FOR APPRIASAL

- Knowing both the costs and the results of a project is essential for determining its worth.
- We also need to know when you expect this to happen.
- But there can be no evaluations or suggestions without thorough investigation.
- This will help get rid of the obviously bad or ineligible ones, cut down on redundant work, and provide an early indicator of the measure's overall success.

LIMITATIONS OF THE STUDY

- Because it was compiled from so many sources, the data is suspect.
- These projections are only that—guesstimates.
- It is never wise to blindly trust a project's viability analysis.
- Use caution while implementing any of the proposed monetary strategies.
- The investigation's viability was greatly impacted by time constraints.

2. LITERATURE REVIEW

Bhattacharya "analyzes lending strategies, credit appraisal, risk analysis, and lending decisions within the broad framework of corporate banking strategy, and he helps us understand the vast and significant changes in the financial market." Analogies in business are useful. According to Hrishikesh Bhattacharya's Lending Strategy, Credit Appraisal, and Lending Decision, new technologies are needed to meet mounting limits on bank and financial sector profitability as a result of financial industry deregulation. Strategy, credit analysis, risk assessment, and lending decisions in corporate banking are all discussed in detail. Finance is not asset-based. Without requiring any prior expertise, this book guides managers and students of business and financial management through the entire process, from credit appraisal to advanced decision making. Major developments in the financial sector are explained with examples from business.

Credit risk, as defined by "Credit is inevitable in banking by Dr.RamJassYadav," refers to the possibility that a bank's client would not repay a loan. Therefore, the ability of a customer to make payments on a bank loan. Bank risk is calculated through a technological, financial, and economic review of credit applications and client information. Safeguarding and recouping funds from a bank requires both primary and collateral checks. Bank loan risk is assessed using Credit Appraisal.

"Credit Risk Assessment Model by Nancy Arora" defines credit risk as a client failing to repay bank credit. Reliability as a buyer reduces

vulnerability. Loan repayment terms are set by borrowers. Analysis of financial standing. Lending to consumers. There must be analyses of cost, feasibility, and technical feasibility. Track efforts to mitigate financial, business, industrial, and management risk.

Credit appraisal, according to "Credit Policy& Credit Appraisal of Banks" by SathyaVarathan, PriyaKalyanasundaram, and S.Tamilenthi, is a continuous cycle that starts when a potential borrower walks in the door and continues through credit delivery and monitoring. This cycle exists to guarantee lending quality and keep credit risk within reasonable bounds. Proposal approval relies on the creditworthiness of the submitter. There are two distinct types of projects that banks will back. The next step is working capital.

Credit evaluation of the borrower. The probability of a borrower defaulting and the potential damage to the lender inform the risk rating. Financial institutions accept deposits and make loans. Banks make loans. Banks benefit from credit. Profits for Lenders. There are five conditions that banks must meet before making loans:

Character:

Borrowers must be reliable. Even if the customer has great security, his honesty and integrity must be demonstrated before granting credit. Borrower performance indicates future performance. Borrowers matter. Ask about the customer's past dealings in the local market.

Capacity:

Management's commercial acumen. Corporate management ensures safety. Qualification, experience, and leadership determine the borrower's business capacity.

Capital:

Borrower's company investment. Owner's business stake. Borrowers need business stake. Earned credit is capital.

Collateral:

Credit exposure requires security for banks. Title, stability, and marketability are essential. Security prevents unexpected events. Security only helps decent loans. Security cannot replace borrower character or capacity. By neglecting character and aptitude for security, the lender is inviting trouble and devaluing security. The security should be properly charged, a true equitable mortgage can be done, and all legal conditions are met so it can be realized quickly if needed.

Condition:

Industrial advances depend on the country and prospective borrower's industrial cycle position at credit request. Examine corporate and government regulations. One must assess the business cycle, industry, overseas situations that could affect the company, and technical development in the company's field. Banks should assess advance margin, repayment source, profitability, and account value.

Credit analysts should evaluate these criteria before accepting proposals. Loans make banks successful. Managers must investigate prospective debtors and their credit plans. Branch or Zonal/Head office decision-making is unimportant. Manager/Credit Officer must gather and analyze data. The following credit proposal element must be positively assessed to justify credit facility sanction.

The prospective borrower:

He must trust and implement his business plan. Market trend/cyclicality must promote good product/service demand. Creating enough surplus to pay business needs, bank instalments/interest, and borrower draws.

Technical feasibility:

The borrower must have know-how, location, land, building, machinery, fixed assets, transport, manufacturing shed (if needed), electricity, raw material, and other inputs like licenses/clearances from appropriate authorities.

Feasibility:

The project cost must be realistic for an optimized business size, and the funding sources must be sufficient and secure for the projected

advance. Guarantee/collateral issues.

They're vital. Use these sources to research the above topics:

Personal interview of the prospective borrower:

Effective interviewing requires calming the borrower and encouraging him to talk about his idea without digressing. Listening and observing nonverbal communication. Slowly gathering all relevant information without probing. Avoiding communication gaps and letting the applicant open up. Solve uncertainty, not criticize it.

Market inquiries:

According to the personal interview, he should contact other businessmen in his field, especially those who know him, as well as friends and relatives from his company.

Report from other banks:

Get a borrower's confidential IBA credit report from other institutions. Receive credit reports from banks by registered mail or in person to avoid fraud.

Study of the account:

Check the borrower's bank transactions. Check all company transactions for fund diversion. Returned cheques indicate a borrower's trustworthiness.

Financial statements:

Examine the borrower's last three years' audited financial statements. Current assets and liabilities should be evaluated to guarantee balance sheet integrity. Key Financial Indicators can evaluate the firm's health and the borrower's ability to repay loans.

Statutory returns:

Gather income, wealth, sales, and assessment orders. Determine legal duty and request statement.

Property statements:

The borrower/guarantor should supply a complete inventory of immovable properties, their location and value, and a signed, dated statement of means

Personal visit:

Visit the prospective borrower's business/site for information. The potential borrower's transactional needs may not be met by an outright advance/contingent demand for bank loan.

- Common overdrafts.
- Cash credit.
- Request loan.
- Term loan.
- Bills bought/discounted.
- Payment guarantees.
- Other warranty.
- LC, etc.

The sanction must list supported securities and restrictions for each.

Summary of securitization methods. Caution granted in advance to allow the parties to develop stocks during specific seasons, industry or commerce availability, or productivity/sales costs:

Against hypothecation of goods:

Stock statements allow borrower hypothecation accounts. Managers authorize hypothecated stocks.

- Bank valuations apply.
- Drawpower allows facility.
- Security margin.

Against book debts:

After thorough debtor credit assessment, cash credit against book debts should be offered. Avoid double-financing. A party with numerous banks can guarantee the same commodities with another bank in times of distress, making advances riskier. Marking pledged products prevents confusion with other banks. Effective, constructive, obvious, and indisputable commodity possession is needed.

Against Government Supply Bills:

It's a clean advance, so bankers assess the borrower's means, financial condition, business integrity, market credit, business experience, and the bank's past experience with the party, as well as security.

Against pledge of goods:

Pledge diamonds for agricultural linked or nonproductive (medical, educational, marital) goals. Bank-locked, warehouse-received, or

clearing agency goods.

Against assignment of policies:

LIC of India and IRDA-regulated private sector life insurance companies offer overdrafts and demand loans. A policy secures the bank.

Compliance of Terms and Conditions of Sanction AndAdvances

Advances and Sanctions Compliance

Important rules:

- Borrower unconditionally accepted sanction terms.
- KYC, CIBIL report reviewed.
- All required documentation and sanctions were completed.
- Stamped papers.
- Securities, mortgages, and asset guarantor letters were authorized.
- Bank-formatted deeds were compared to certified copies.
- Bank-lien FDs, NSC/KVP, and LIC insurance (SRM menu). Bank staff or registered mail should deliver these instruments to Post office/LIC office.
- Branch receives cash credit stock statement often.
- Limit cash and get receipts when paying suppliers directly.
- Personal inspection of bank-loaned assets should verify the project's end purpose.
- Mortgage securities are checked before and after disbursement.

3. CREDIT APPRAISAL PROCESS

Receipt of application from the applicant

- Hypothecation of goods clause paperwork, including a projected balance sheet, all financial indicators, etc., a Mortgage Deed, and a Project Report from the business.
- The CIBIL DATABASE also contains crucial details on the defaulters' list. Credit Score (In this case, ONICRA is used to generate the company's credit score, while the borrower's score is determined by the bank's internal ratings.)
- An attorney is consulted for guidance, and then the bank-appointed valuer is contacted to obtain a clearance report on the property. Mortgages require encumbrance certificates, whereas joint ownership of property calls for memorandums of partition.
- Interpreting Financial Reports
- Cash Advance Limitation Prerequisite PSVRs 1, 2, and 4 must be met before a loan can be approved.
- Loan is authorized by the relevant agencies and then disbursed in accordance with the borrower's needs.

Credit Pricing: Pricing include following components:

Base rate-

The lowest interest rate at which a financial institution will extend credit. The criteria for making this call are:

Cost of funds-

Interest earned on borrowed money is added to the cost of reserves.

Operational cost-

The cost of running a business includes things like paying employees, buying supplies, and paying for utilities.

Margin- This the minimum profit of the bank.

Tenure of the credit- Higher the tenure, higher willbe the pricing.

Rating of the company-

There are two scales considered. independent agency ratings from places like CARE, ICRA, FITCH, and CRISIL. The greatest possible grade is AAA, while the lowest possible grade is D. A Credit Rating Assessment (CRA) rating is the rating assigned by the bank itself.

Value of connection-

If you have been working with a company for a longer period of time, you will receive a discounted pricing.

Risk premium-

The term "risk premium" refers to the cost of borrowing money at a particular interest rate. The risk premium increases as risk goes up and

Industrial Engineering Journal
ISSN: 0970-2555
Volume : 52, Issue 7, July : 2023

decreases as risk goes down.
Small and medium-sized enterprises (SMEs) commonly face a credit check when seeking for either working capital financing or a term loan. What I'm thinking is:

Working capital Finance:

A company can only run at Break Even Point (BEP) and make money if it keeps a certain level of current assets at all times. The term "working capital" can also be used to refer to a company's cash on hand.

Working capital comprises	Means to finance
a)Value of raw material in store or in transport.	Credit available from suppliers on purchase
b)Amount of consumable stores and other material required for production purpose	Other current liabilities
c)Value of stock in process.	Surplus of long term funds over long term uses
d)Value of all finished goods including in transit.	Short term bank borrowing
e)Amount of all outstanding receivables or sundry debtors	
f)Monthly expenses generally reflected through the current assets such as cash, advances allowed, prepaid expenses.	

Factors Determining Working Capital

- Policies of production
- Credit policies of the unit
- Pace of turnover
- Manufacturing process
- Seasonality

4. PROCESS FOR ASSESSMENT OF WORKING CAPITAL REQUIREMENTS

- There are three main ways in which banks estimate a company's working capital needs.
- The standard strategy recommended by the Tandon Committee
- The Reorganization Plan Developed by the Nayak Committee.
- The cash budget technique must be used when working with money.

Traditional Method:

Working capital needs have historically been determined using operational cycle length and sales volume (Tandon Committee). If your company's operating capital is more than Rs 5 lakhs, you can employ this method. RBI has removed the requirement that banks use this system and instead permits them to create their own. Taking into consideration sales forecasts and conventional industry practices for inventories and receivables, working capital is the total amount of cash and short-term investments that can be utilized to run the firm for a specific period of time. Withdrawal limits from financial institutions are based on:

The ratio of net working capital to total current assets (the gap between long-term sources and long-term uses) should be at least 25% and preferably closer to 50%. Find out how much money you can borrow from a bank by deducting your net working capital and other current liabilities from your total current assets.

First method of lending:

If the borrower chooses Option 1, they must come up with the equivalent of 25% of the Working Capital Gap in the form of NWC. 75% of the cash flow gap is the maximum amount that can be borrowed from a bank. Only borrowers with credit demands of less than Rs.10 lacs were considered for this approach.

Second method of lending:

Second, the borrower may use MPBF for up to 75% of the loan amount provided that NWC constitutes at least 25% of total current assets. All borrowers who received fund-based credit facilities in excess of Rs. 10 lacs were required by the Reserve Bank of India (RBI) to have their working capital needs appraised (calculated) using this method.

Net working capital = current assets – current liability			
Working capital gap = current assets – (current liability –bank borrowing)			
First Method of lending		Second Method of lending	
Working capital gap	(1)	Working capital gap	(1)
Minimum 25% of WCG from long term sources	(2)	Minimum 25% of WCG from long term sources	(2)
Estimated NWC	(3)	Estimated NWC	(3)
Items (1-2)	(4)	Items	(4)
Items (1-3)	(5)	Items	(5)
MPBF	4 and 5 whichever is less	MPBF	4 and 5 whichever is less
Excess Borrowing	(2)-(3)	Excess borrowing	(2)-(3)

When a company's net working capital falls below the safety buffer, it is considered overborrowed. The following options are available for addressing this matter:

- If the NWC is below the minimal level (i.e., 25% of current assets /WCG), Lender may demand Borrower to increase it using additional long-term funds given by Lender (e.g., capital, long-term borrowing, etc.).
- The company's production and processing cycles are taken into account while planning the sale of idle current assets.
- A Working Capital Term Loan (WCTL) could be adjusted to allow for repayment of the projected Excess Borrowing over a period of three to five years using proceeds from the following Unit if the aforementioned alternatives are not viable.

Exception under second method of lending

Borrowing units that finance sports-related expenses are not required to provide a contribution equal to 25% of export receivables from long-term funds. Bills of exchange issued in accordance with the terms of a Letter of Credit (whether revocable or irrevocable) and negotiated in accordance with the Letter of Credit's requirements provide long-term funding at a rate of 25% of receivables arising from domestic/inland sales.

Turnover method:

According to the Nayak committee's suggested formula, working capital needs to be at least 25% of sales turnover, with bank financing accounting for at least 20% and borrowers' contributions accounting for at least 5% of predicted sales. No accounting principles, such as those for inventory or receivables, or for money lending, will be followed. If the margin offered is higher than 5%, the bank limit will be reduced accordingly. The maximum amount of working capital that can be employed with this method is Rs 5 crore for manufacturing and Rs 2 crore for all other uses.

Cash Budget Method:

Using this method, your credit limit will be based on the highest monthly difference between your cash inflows and outflows. When cash is king: when financial institutions use the cash budget method

- Seasonal industries
- Software development
- Film production
- Service sector activities including construction activities

Methods of Lending And Assessment of Working Capital:

Financial institutions are free to come up with their own methods of calculating working capital requirements after the Reserve Bank of India (RBI) abandoned its Maximum Permissible Bank Finance (MPBF) restrictions, so long as they have the required clearances from their boards of directors. In light of the aforementioned, the following criteria should be applied to assessments:

Methods of Lending and Assessment of Working CapitalFinance:

Since the Reserve Bank of India (RBI) no longer enforces its Maximum Permissible Bank Finance (MPBF) standards, banks are free to develop new strategies for determining how much money they need on hand to operate.

Industrial Engineering Journal
ISSN: 0970-2555
Volume : 52, Issue 7, July : 2023

SEGMENT	WORKING CAPITAL REQUIREMENT	METHODS OF ASSESEMENT
Industry and Trade	Below Rs 2 crores	Projected turnover method / 2nd method of lending whichever is higher.
	Rs 2 crores and above	2nd method of lending
SME units	Below Rs 5 crores	Projected turnover method / 2nd method of lending whichever is higher.
	Rs 2 crores and above	2nd method of lending
Seasonal industry such as sugar, tea, real estate, construction, software		Cash budget method
Adhoc advances sanction based on bunching of sales		Cash budget method
Leasing and hire purchase companies.		2nd method of lending
Retail or wholesale traders under UCO trader scheme		As per scheme guidelines

Term Loan

Capital goods—excluding used buildings, machinery, autos, and land—are eligible for term loans. Used machinery loans are prohibited. It is repaid in installments regardless of length or security cover. Term loans finance capital expenditures such land, buildings, plant, machinery, and transportable fixed assets. Modernization, remodeling, and other term loans boost product quality, output, and profitability. Term loans are 3–7 years or longer. Profits must repay fixed asset term loans.

Appraisal of Term Loans:

- Earnings and cash surpluses determine term loan assessments. After expenses, taxes, and other provisions, the unit should have enough surplus earnings to swiftly repay the loan and interest. Term loan appraisals examine purpose, project cost, and integration.
- Loan production, revenue, cost, spending, profit, and cash flow estimates.

Assessing term loan proposals involves four fundamentals:

- Technical Feasibility of the project.
- Financial Feasibility of the project.
- Market Feasibility of the project.
- Managerial competence.

Technical Feasibility :

which analyzes the feasibility of putting up a project to achieve a given level of operations (quantity, quality, and timely delivery) and takes into account all technical elements like machinery or equipment suitability, inputs powers talents, commodities mix, implementation, etc.

Financial Feasibility:

To compensate the entrepreneur and pay bills.

Market Feasibility:

It explores market availability or creation to meet sales goals. Demand forecasting considers global conditions, product marketing, selling methods, pricing, completion, export possibilities, product life cycle, and more.

Management Competence:

It evaluates the project's management structure to ensure its success and meet its goals.

Documents necessary for the credit proposal:

- Project report and bank application signed by applicant.
- KYC documents include borrower's partnership agreement, memorandum and articles of incorporation, trust deed, bylaws, and board resolution.
- RBI approval for SSI, VAT, EPC, IE, and NBFC registration.
- ST23 Board Memo.
- Credit and income.
- Other bank's IBA private credit opinion.
- Exemption from pollutants or legal constraints.
- Factory stock condition report.
- Assessing prospects.
- Three-yearly audits.
- Attorney-recommended property search and legal opinion.
- Valuation of security properties.
- Quote or invoice the machine purchase.
- Statutory audit of firm's accounting system and controls.
- Guarantor/applicant CIBIL score.
- Fard, Jamabandi, and TS-1 approved construction designs and terms. 1.2.3.4 PSVR.
- Three-year audited group financials.
- Discipline compliance report.

- The borrower/guarantor's financial declarations, signed and dated.
- New MCMR.
- Accounting and inventory.
- Financial statement.
- The CMA supplier or opposing party must clarify and alter.
- Cash-based budgeting.
- Online credit rating agreement.
- Financial report.

5. CONCLUSION

Credit appraisal involves managerial evaluation, technical feasibility, financial viability, risk analysis, and credit rating. Borrower collateral securities depend on credit risk. Credit evaluates the company's debt capacity and needs. Conservatively, banks evaluate initiatives. Forecasts rise 20%. Before being graded, credit is evaluated multiple times. MSME hard effort was rewarded by the financial and banking sector. Sectors should profit. Sector and society gain. MSME has good credit. MSME is reliable.

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