OVERVIEW OF CREDIT MANAGEMENT

CHAPTER 17 MODULE C PART 1 By Ashish Sir

Credit management is concerned with making sure that organizations, which buy goods or services on credit, or individuals who borrow money, can afford to generate surplus so that they pay their debts on time.

IMPORTANCE OF CREDIT

- Lending is one of the **core functions of a bank**
- **Funds mobilized from deposits are deployed** by banks in making loans and advances
- Banks are "financial intermediaries" and lend the funds of depositors who themselves do not want to take the risk of lending
- **also important for the economic development of a country.**

The importance of bank lending is for the following:

(i) For the bank (ii) For development of the economy (iii) For the monetary system. (iv) For the society

PRINCIPLES OF LENDING

a) SAFETY AND SECURITY PRINCIPLE

- **timely return the funds** lend by a bank.
- While granting a loan, a **bank carefully examines the economic, commercial and financial ability** of the applicant's business, quality of its management (integrity, honesty, willingness to repay loan, reputation in market etc.) and the past track record.

b) RISK DIVERSIFICATION PRINCIPLE

The credit risk is sought to be diversified by banks **by avoiding concentration of loans** to a few borrowers / industries / sectors as per the prudential norms set internally and updated by the regulatory authorities

c) PROFITABILITY PRINCIPLE

- Price for taking risk
- Banks seek to earn profit by charging an interest higher than that payable by them on their deposits

d) LIQUIDITY PRINCIPLE

- A bank has to manage is assets and liabilities in such a manner that it can meet all its deposit liabilities in time, out of the money acquired as repayment of loans.
- It has to attune the maturities of its assets (loans) with the maturities of its liabilities (deposits)

TYPES OF BORROWERS

A borrower can be classified as follow:

1) An Individual
2) Sole Proprietary Firm
3) Partnership Firm
4) HUF
5) Companies
6) Statutory Corporation
7) Trust
8) Cooperative Societies

VARIOUS TYPES OF CREDIT FACILITIES

Banks offer many types of credit facilities based on the requirements of the borrower and Bank's policies / RBI guidelines

BANK FINANCE						
FUND BASED				**NON-FUND BASED**		
WORKING CAPITAL	**LOANS**	**RETAIL PRODUCTS**	**Export CREDIT**	**BANK GUARANTEES**	**LETTERS OF CREDIT**	**DERIVATES**
Cash credit	Term Loans	Housing Loans	Pre-shipment	Financial guarantees	Documentary letters of credit	credit derivatives
Cash credit (pledge)		Education Loans	Post-shipment	Performance guarantees	Standby letters of credit	
Bills purchased (BP)/discount (BD)		others		DPG		
Overdraft				There are other types of derivatives such currency & interest rate derivatives also but are not credit related		

RBI guidelines

- The banks have to report their business.
- As per RBI guidelines, banks have adopted the business segment approach for reporting purposes from 31st March, 2008.

TREASURY

For the purpose of reporting entire investment portfolio will be included.

RETAIL BANKING

Retail lending must fulfill 4 criterion:

ORIENTATION CRITERION:

- The **exposure is to an individual person or persons** or to small business.
- Person under this clause would mean **any legal person** capable of entering into contracts and would also include HUF, partnership firm, private limited company, trust.
- **Small business is the one where total annual turnover is less than Rs 50 crore.**

- The **turnover criterion will be linked to the average of the last three years** in case of existing entities and to the projected turnover in case of the new entities

PRODUCT CRITERION

The **exposure takes the form of any of the following:** revolving credits and line of credit, term loans and leases and small business facilities and commitments

GRANULARITY CRITERION

No aggregate exposure to one counterparty should **exceed 0.2 per cent of the overall regulatory retail portfolio.**

LOW VALUE OF INDIVIDUAL EXPOSURES

The maximum aggregated retail exposure to one counterpart should not exceed the absolute threshold limit of Rs. 5 crores.

Corporate or wholesale Banking

Wholesale banking includes all advances to trusts, partnership firms, companies and statutory bodies which are not included under retail banking

Other banking business

- It includes banking operations that are not covered by any of the other three categories.
- It also includes all the other Residue all operations such as para banking transactions or activities

COMPONENTS OF CREDIT MANAGEMENT

LOAN POLICY OF THE BANK

- Each bank formulates its own policy for sanction of credit proposal has to be within the framework of this policy.
- Loan policy is influenced by various factors like market conditions, competitor's policies, SWOT analysis and RBI guidelines.

It provides:

I. **Exposure limits** for individual and group borrowers
II. Exposure limits for different sectors
III. **Discretionary powers** at various levels within the bank for sanctioning of the credit proposals.

APPRAISAL

Objective of the appraisal

I. **Trustworthiness** of borrower
II. **Need** of the funds, terms of repayment, interest etc.
III. **Security** availability and charge to be created

It can be done with:

I. It can be done with the help of, **market report** of the borrower, credit history
II. **Financial track record** of the borrower is represented by the financial statements
III. **Techno economic feasibility** report of the activity proposed
IV. **Securities available**, their value and reliability

Delivery

- It relates to the legal aspects of documentation and creation of charge over security.
- It also covers a method of delivery and procedures for disbursal of a term loan

Control and monitoring

- To ensure the **end usage of the banks' funds** and ensure safety of it.
- It involves **post-sanction follow up** with a view to ensure that the conditions of the loan are being complied with and the economic activity is as planned at the time of sanction.
- It also involves **monitoring the recovery of loan** as per schedule fixed.
- Delay in taking suitable action in cases of activity not being carried out as projected, reduces the chances of recovery.

Rehabilitation and Recovery

- Even with the best of loan policies, appraisal, delivery, control and monitoring, credit default is possible either due to genuine business problems due to wilful default.
- If an economic activity faces some problem and borrower is unable to repay the loan, the bank may have to go for re-structuring of the loan.
- **If the normal operations are not possible with rehabilitation etc., bank may have to initiate recovery action including sale of securities.**

Credit risk management

- credit risk is a major risk faced by the bank
- suitable policies are to be put in place to identify, measure and control this risk within the acceptable limits

Refinance

- This aspect assumes importance when there is tight liquidity situation.

- It can be availed from institutions such as NABARD, SIDBI, RBI, NHB etc. in case of certain priority sector advances.

ROLE OF RBI: GUIDELINES IN BANK CREDIT MANAGEMENT

End use of funds

- It is **primary responsibility of the bank** to ensure proper and use of the bank funds and monitor the funds flow
- **Systems and procedures must be in the place** to ensure the withdrawals from the cash credit or overdraft accounts are strictly for the purpose for which the credit limits are sanctioned.
- **No diversion of working capital finance** should be there.

Priority Sector

As per Reserve Bank of India guidelines the priority sector includes agriculture, micro small and medium enterprises, export credit, education loans, housing loans, social infrastructure, renewable energy and others

Weaker Sections

Priority sector loans to the following borrowers will be considered under Weaker Sections category:

1. Small and Marginal Farmers
2. Artisans, village and cottage industries where individual credit limits do not exceed Rs.1 lakh
3. Beneficiaries under National Rural Livelihoods Mission (NRLM), National Urban Livelihood Mission (NULM) and Self-Employment Scheme for Rehabilitation of Manual Scavengers (SRMS)
4. Scheduled Castes and Scheduled Tribes
5. Beneficiaries of Differential Rate of Interest (DRI) scheme
6. Self Help Groups
7. Distressed farmers indebted to non-institutional lenders
8. Distressed persons other than farmers, with loan amount not exceeding Rs.1 lakh per borrower to prepay their debt to non-institutional lenders
9. Individual women beneficiaries up to Rs. 1 lakh per borrower

10. Persons with disabilities
11. Overdrafts up to Rs. 10,000/- under Pradhan Mantri Jan-Dhan Yojana (PMJDY) accounts, provided the borrowers' household annual income does not exceed Rs. 100,000 for rural areas and Rs. 1,60,000 for non-rural areas
12. Minority communities notified by Govt. of India from time to time

Categories	Domestic scheduled commercial banks (excluding Regional Rural Banks and Small Finance Banks) and Foreign banks with 20 branches and above	Foreign banks with less than 20 branches
Total Priority Sector	40 per cent of Adjusted Net Bank Credit or Credit Equivalent Amount of Off-Balance Sheet Exposure, whichever is higher.	40 per cent of Adjusted Net Bank Credit or Credit Equivalent Amount of Off-Balance Sheet Exposure, whichever is higher, to be achieved in a phased manner by 2020.
Agriculture	18 per cent of ANBC or Credit Equivalent Amount of Off-Balance Sheet Exposure, whichever is higher.	Not applicable

	Within the 18 percent target for agriculture, a target of 10* percent of ANBC or Credit Equivalent Amount of Off-Balance Sheet Exposure, whichever is higher is prescribed for Small and Marginal Farmers.	
Micro Enterprises	7.5 percent of ANBC or Credit Equivalent Amount of Off-Balance Sheet Exposure, whichever is higher.	Not applicable
Advances to Weaker Sections	**12 percent** of ANBC or Credit Equivalent Amount of Off-Balance Sheet Exposure, whichever is higher	Not applicable

Common guidelines for priority sector advances

- **Time limit for disposal of loan application** is as per discretion of the bank concerned.
- **Rejection of loan proposal:** reasons to be given in writing. For rejection to the application related to SC or ST it should be at a level higher than that of the branch level.

MICRO SMALL & MEDIUM ENTERPRISES (MSMEs)

- As per the Micro Small & Medium Enterprise Development (MSMED) Act 2006. MSME would henceforth mean to include Micro Small & Medium Enterprises (MSMEs).
- The activities of these enterprises are classified into Manufacturing and Service categories
- New definition notified on June 01, 2020
- Became operational w.e.f. July 01, 2020
- New definition **based on two parameters** investment in plant machinery/ equipment (based on cost factor) and turnover.

Classification	**Micro**	**Small**	**Medium**
Investment	Up to 1 cr	>1 cr – 10 cr	>10 cr – 50 cr
Turnover	Up to 5 cr	>5 cr – 50 cr	>50 cr – 250 cr

- Loans to MSME are covered under Priority Sector.
- Very important role in GDP, employment generation and exports.

- If an enterprise crosses any of the criteria it will not be classified in that category and will be based on higher category & not in lower category.
- Units have to file the ITR and GSTR to maintain the status of MSME.
- Units listed with GSTIN for same PAN will be treated collectively as one enterprise.
- The classification parameters will also be considered collectively with the same PAN card basis.
- While calculating the investment in plant and machinery/ equipment the GST will be excluded.
- Also cost of pollution control, R&D, industry safety devices, land, building, furniture and fittings will be excluded from the cost.
- Under the turnover parameter the exports of goods/services will be excluded while calculating the turnover..