CREDIT APPRAISAL

What is Credit Appraisal?

Credit appraisal is the process of evaluating a borrower's creditworthiness before sanctioning a loan.

It involves assessing the borrower's ability and willingness to repay a loan ensuring the safety & profitability of the funds lent.

The objective is to minimize credit risk & ensure that the loan remains a **Performing Asset** (not an NPA).

The 8 P's of Credit Appraisal

1 **Project** – What is the purpose of the loan?

2 **People** – Who are the promoters/management behind it?

3 **Process** – How will the business operate?

4 **Product** – What is being offered?

5 **Prospects** – What is the market potential?

6⃣ **Projections** – Expected revenue, costs & financial health □

7⃣ **Profitability** – How much profit is anticipated? □

8⃣ **Proposed Repayment** – Will the borrower repay on time? □

□ Steps in Credit Appraisal Process □

Step	**Description**
1⃣ Credit Processing	Borrower submits loan request with necessary documents □
2⃣ Credit Sanction/Approval	Bank evaluates & approves/rejects the loan request ✅❌
3⃣ Credit Documentation	Legal & security documents are prepared & signed □□
4⃣ Credit Disbursement	Loan amount is credited to the borrower's account □
5⃣ Credit Monitoring	Regular follow-ups & checks to ensure repayment □

? Key Factors in Credit Appraisal

1? Financial Analysis ?

? Examining past financial records (Balance Sheet, P&L, Cash Flow Statement).

? Debt-to-equity ratio, liquidity ratio, profitability margin, etc.

? Checking credit history (CIBIL Score for individuals, CRILC for companies).

2? Business Viability ?

? Industry trends & competition analysis.

? Break-even analysis (when will the business start making profits?).

? Market demand & revenue potential.

3? Management Evaluation ??

? Experience, reputation & track record of promoters.

? Past performance in loan repayment.

4? Security & Collateral ?

? Assets pledged against the loan (property, inventory, shares, etc.).

? Legal verification of collateral ownership.

5⃣ Risk Assessment ⚠

▪ Political, economic & operational risks.

▪ Credit risk mitigation strategies (insurance, guarantees).

▪ The Shift from Traditional Credit Appraisal to Risk-Based Credit Appraisal ▪▪▪

▪ Traditional Approach

▪ Subjective judgment by loan officers ▪

▪ Relied more on borrower's reputation ▪

▪ Less emphasis on financial & market analysis ▪

▪ Modern Approach (Risk-Based Lending)

▪ Quantitative risk measurement using financial models ▪

▪ Emphasis on credit risk rating & financial projections ▪

▪ Data-driven decision-making ▪

▪ Why is Credit Appraisal Important? ▪

▪ Ensures that loans remain standard assets (not NPAs).

▪ Helps banks avoid bad loans & financial losses.

Improves profitability & reduces credit risk.

Protects depositor funds by lending responsibly.

5.2.1 DUE DILIGENCE

What is Due Diligence?

Due Diligence (DD) is a process of verifying a borrower's credentials to assess credit risk and compliance with laws like KYC, AML & PMLA.

It ensures that the borrower is genuine, financially stable, and has a clean credit history before sanctioning a loan.

Banks conduct due diligence on all stakeholders—Promoters, Directors, Partners, Guarantors, and Trusts.

Types of Due Diligence

1 Financial Due Diligence

Examines financial records, income, debt, creditworthiness, and repayment history.

Uses **CIBIL, CRIF Highmark, Experian, and Equifax** reports to check credit history.

 Analyzes balance sheets, P&L statements, cash flow statements, and tax filings.

2 Commercial Due Diligence

 Evaluates the industry, market position, competitors, and revenue model.

 Verifies sales data, GST records, and business contracts.

 Analyzes supply chain risks and future growth prospects.

3 Legal Due Diligence

 Verifies company registration, DIN (Director Identification Number), and compliance records.

 Checks **MCA (Ministry of Corporate Affairs) website**, legal cases, and fraud alerts.

 Confirms compliance with PF, ESI, GST, Labour Laws, Income Tax, etc.

? Phases of Due Diligence ?

Phase	Activity
1? Initial Interactions	Basic verification of the borrower's credentials. ?
2? Business Data Review	Examines financial & operational documents. ?
3? Active Evaluation	Analyzes industry, credit risk, and compliance. ?
4? Physical Verification	Conducts site visits, interviews employees, and verifies assets. ?
5? Data Analysis & Report	Generates a risk assessment report for final decision-making. ?

? Due Diligence Checklist ✅

? **KYC Verification** (PAN, Aadhaar, DIN, GST, MCA filings)

? **CIBIL/CRILC Checks** (For credit history & outstanding loans)

? **Banking Conduct** (Past repayment records & NPA status)

? **Legal Compliance** (Court cases, fraud records, tax dues)

Market Reputation (News reports, industry feedback)

Financial Health (Debt-equity ratio, liquidity, profitability)

Role of Fintech in Due Diligence

Banks are increasingly utilising o**pen development and Software-as-a-Service (Saas) solution**s offered by FinTech start-ups in an effort to easily integrate and streamline operational capabilities and move toward digital/ mobile delivery.

Fintech Startups & Banks collaborate through APIs & Open Banking solutions

Automated Data Fetching – Fetches financial & legal data from multiple sources instantly.

AI & ML-based Credit Scoring – Improves loan risk assessment with predictive analytics.

Digital Account Aggregators – To ease the accessibility of financial data and boost financial inclusion

RBI's Account Aggregator (AA) Framework – **1.1 billion bank accounts integrated** across India.

SEBI, PFRDA & Mutual Fund Data – Expands credit assessment for better financial inclusion.

? Why is Due Diligence Important? ?

? **Prevents NPAs & fraud risks.**

? **Ensures compliance with RBI, SEBI & AML regulations.**

? **Improves credit decision-making with data-driven insights.**

? **Enhances financial inclusion through digital tools.**

? 5.2.3 INTRODUCTION OF LEGAL ENTITY IDENTIFIER (LEI) FOR LARGE CORPORATE BORROWERS ?

? What is a Legal Entity Identifier (LEI)?

? **LEI is a 20-digit globally unique code** that helps in identifying corporate borrowers and tracking financial transactions.

? **Introduced after the Global Financial Crisis** to improve financial data accuracy and risk management.

? **Implemented in India by the Reserve Bank of India (RBI)** for corporate borrowers having total fund-based and non-fund-based exposure of **₹5 crore and above**.

? Implementation Timeline for LEI in India ?

Total Exposure to SCBs (Scheduled Commercial Banks)	LEI Compliance Deadline
Above ₹25 Crore	April 30, 2023
Above ₹10 Crore, up to ₹25 Crore	April 30, 2024
₹5 Crore & above, up to ₹10 Crore	April 30, 2025

? What Happens if a Borrower Fails to Obtain LEI? ?

? **No new loan approvals**

? **No renewal or enhancement of existing credit limits**

? **Credit facilities can be restricted by banks**

? **Exemption:** Govt. Departments & Agencies **(excluding PSUs & Statutory Corporations)** do not need to obtain LEI.

? How Can a Borrower Obtain an LEI Code? ?

? Borrowers need to apply through an **authorized Local Operating Unit (LOU)** such as the **Legal Entity Identifier India Ltd. (LEIL)**, a subsidiary of **Clearing Corporation of India Ltd.**

(CCIL).

 Submission of **corporate documents (CIN, PAN, GST, MOA/AOA, and Board Resolution)** is required.

 LEI needs to be **renewed annually**.

5.2.4 PASSPORT DETAILS OF BORROWERS OF PUBLIC SECTOR BANKS

Why Are Passport Details Required?

 To prevent loan defaults & economic offenses (like Vijay Mallya & Nirav Modi cases).

 Enables banks to report defaulters to immigration authorities.

 Helps in tracking promoters & directors of borrowing companies.

Applicability Criteria

 Public Sector Banks (PSBs) must collect passport details for:

 Promoters, Directors, and Authorized Signatories

Companies with loans of ₹50 Crore & above

Existing and new borrowers (Mandatory from 2018 onwards)

What if a person does not have a passport?

A **self-declaration certificate** stating that the individual does not hold a passport is sufficient.

How Does This Benefit the Banking System?

Improves transparency & compliance in corporate lending.

Reduces fraud risk & prevents willful defaulters from escaping India.

Enhances risk monitoring by RBI & government agencies.

5.3 VALIDATION OF THE PROPOSAL

Credit Validation refers to the process of verifying and confirming the accuracy and authenticity of credit-related information provided by an individual or business.

Importance of Credit Validation ✅

Validation ensures that a borrower is **genuine, creditworthy, and meets all banking risk criteria**.

 The credit officer must collect **all relevant information** before taking a decision.

 Information overload can **derail the appraisal process**, so the banker must **filter necessary details**.

 Steps in Credit Proposal Validation

**1 Verifying the Borrower's Identity & Business Legitimacy **

 KYC Verification - Ensure all statutory documents are in place.

 Site Visit - Inspect the factory, office, or business unit to confirm legitimacy.

 Regulatory Compliance - Check approvals, licenses, and tax payments.

 Borrowing Authority - Verify **Board Resolution (for companies)** and **Partnership Deed (for firms)**.

 Key Documents Checked:

 Certificate of Incorporation & Commencement of Business

 GST Returns & Financial Statements

 Board Resolution/Partnership Deed

 PAN, TAN, and other statutory registrations

2� Assessing Credit Risk & Probability of Default �

� **Credit Risk = Probability of Borrower Default**

A default can occur due to:

� **Internal Factors**: Poor management, bad financial decisions, weak cash flow.

� **External Factors**: Market changes, new competitors, government policies, economic downturns.

� How is Credit Risk Measured?

� **Credit Reports (CIBIL, CRIF Highmark, Experian, Equifax)**

� **Credit Rating (External Rating Agencies & Bank's Internal Rating Models)**

� **Financial Statement Analysis (Debt-Equity Ratio, Current Ratio, Cash Flow Projections, etc.)**

� **Business Model & Market Positioning (Customer Base, Industry Trends, Competitor Strengths)**

3⃣ Analyzing Borrower's Financial Strength 📊

📌 Key Financial Ratios Analyzed:

📍 **Liquidity Ratios** - (Current Ratio, Quick Ratio)

📍 **Leverage Ratios** - (Debt to Equity, Interest Coverage)

📍 **Profitability Ratios** - (ROCE, ROA, Net Profit Margin)

📍 **Turnover Ratios** - (Inventory Turnover, Debtor Turnover)

📌 How is Financial Risk Managed?

✅ **Ensuring strong cash flow management**

✅ **Avoiding over-financing or under-financing**

✅ **Maintaining optimal capital structure**

💡 **Example:** If a company's Debt-Equity Ratio is **too high**, it indicates excessive reliance on debt, increasing default risk.

4⃣ Credit Rating & Risk Assessment 📊

📌 How Credit Rating Works?

📍 A **credit score/rating** is assigned based on:

- Financials (Profitability, Solvency, Liquidity)
- Market Positioning (Competition, Brand Equity)
- Management Quality & Track Record

� Risk Segmentation:

Credit Rating	Risk Category	Loan Approval Status
AAA - A	Low Risk	Approved Easily ✅
BBB - BB	Medium Risk	Requires Additional Collateral �
B & Below	High Risk	Rejected �

5� Policy Compliance & Exposure Limits �

� Does the proposed loan align with the bank's credit policy?

� Is the industry in the bank's restricted/banned list?

� Does the loan comply with RBI's Large Exposure Framework?

� Concentration Limits:

- Industry Exposure Limit
- Borrower Exposure Limit
- Group Exposure Limit

If any of these **limits are exceeded**, the loan is **rejected** or sent for special approval.