CREDIT APPRAISAL

? Decision-Making Process in Large Loans ?

New Business Group (NBG)

? Some banks have an **NBG Committee** to review large credit proposals.

? NBG assesses:

? Borrower Acceptability

? Risk & Exposure Limits

? Loan Pricing & Interest Rates

? **Why NBG?**

? Ensures high-value loans meet strict evaluation criteria.

? Reduces bad loans by **screening risky borrowers**.

▯ Summary: Key Steps in Proposal Validation ▯

Step	Validation Process	Decision Criteria
1. Identity & Business Verification	KYC, Factory Visit, Licenses, Board Resolution	Must be valid & compliant ✓
2. Credit Risk Assessment	Financial Strength, Market Risk, Credit Reports	Risk must be manageable ▯
3. Financial Statement Analysis	Liquidity, Debt-Equity, Cash Flow	Must meet bank's financial norms ▯
4. Credit Rating & Scoring	Internal & External Ratings, Default Probability	Must be above cut-off threshold ▯

Step	Validation Process	Decision Criteria
5. Policy & Exposure Compliance	Industry Limits, Borrower Exposure	Must align with bank & RBI norms ?
6. NBG Approval (if required)	Review by Senior Committee	Mandatory for large loans ?

? **Final Takeaways** ?

? **Validation ensures a loan is financially & legally sound before approval.**

? **Credit Risk & Default Probability are key determinants of loan approval.**

? **Proper due diligence protects the bank from NPAs & financial frauds.**

? **A loan should fit the bank's policy & regulatory framework before sanctioning.**

� 5.4 CARDINAL PRINCIPLES OF LENDING �

Lending decisions are **based on four fundamental principles** that guide the appraisal and approval of a credit facility. These are:

� The Four Cardinal Principles of Lending ✅

1� **Evaluate the Borrower's Creditworthiness** – Determine the borrower's ability and willingness to repay.

2� **Purpose of the Loan** – Verify if the loan is for a legitimate and productive purpose.

3� **Security/Collateral Assessment** – Ensure the loan is backed by sufficient security.

4� **Cash Flow & Source of Repayment** – Assess the borrower's income and cash flow to ensure repayment capability.

Additionally, the **7Cs of Credit Appraisal** further refine the assessment:

� **Creditworthiness** – Borrower's financial history & repayment track record.

- **Character** – Borrower's integrity & reliability.
- **Capacity** – Ability to generate sufficient income for loan repayment.
- **Capital** – Borrower's net worth & investment in the business.
- **Collateral** – Security offered to safeguard the loan.
- **Conditions** – Industry, economic, and business conditions affecting the borrower.
- **Cash Flows** – Borrower's ability to generate regular cash inflows.

5.5 CREDITWORTHINESS OF THE BORROWER

A borrower's creditworthiness is the first and foremost consideration in loan evaluation.

Credit Appraisal Process for Different Borrowers:

1 Individuals (Retail Loans: Personal, Home, Auto, etc.)

- Credit Score (CIBIL, Experian, Equifax, CRIF Highmark)
- Personal financial statements (Income, liabilities, assets)
- Employment verification & salary slips

� Market inquiries (Employer, references)

� Scorecard-based loan evaluation template

2� Partnerships, LLPs & Private Limited Companies

� Financial Statements Analysis (Profit & Loss, Balance Sheet)

� **Search in regulatory databases**:

- **CERSAI** – For encumbrances on secured properties
- **ROC (Registrar of Companies)** – To check company status & filing compliance
- **Defaulters' List** – RBI's wilful defaulters database
- **IBBI (Insolvency & Bankruptcy Board of India)** – For insolvency checks

  � Market Positioning – Competitive edge, demand, and business sustainability

3� Large Corporates & Public Limited Companies

� Detailed Financial Statement Analysis (Liquidity, Solvency, Profitability)

� Credit Reports from external agencies

� Business viability assessment (Industry trends, SWOT analysis)

� Encumbrance verification for pledged assets

� Exposure analysis – Relationship with multiple banks, pending liabilities

� How Financial Statement Analysis Determines Creditworthiness? �

� **Example:**

If a company's **Debtors Turnover Ratio** was **3 months' sales earlier** but now is **4.5 months**, the lender would investigate:

� **Reason for increased debtor days** – Poor collections or slowing market?

� **Competitor influence** – Is the company losing market share?

� **Profitability Impact** – Longer credit periods affect cash flow & profits.

� **Key Ratios Analysed:**

Ratio Type	Purpose	Ideal Benchmark
Current Ratio	Liquidity Assessment	**1.5 – 2.0**
Debt-Equity Ratio	Leverage & Solvency	**≤ 2:1**
Net Profit Margin	Profitability Measure	**≥ 5%**
Interest Coverage Ratio	Debt Servicing Ability	**≥ 2.5x**
Debtor Turnover Ratio	Collection Efficiency	**≤ 90 days**

▯ Conclusion:

A thorough **financial statement analysis** helps the lender determine whether the borrower has a **strong financial position** or poses a **risk of default**.

? Final Takeaways ?

? **Creditworthiness assessment is the first step in lending decisions.**

? **Different borrowers require different levels of appraisal and due diligence.**

? **Financial statement analysis provides insight into a borrower's financial health.**

? **Industry trends, company history, and cash flow projections are critical factors.**

? **Regulatory checks (ROC, IBBI, CERSAI) help identify hidden risks.**

? Need case studies, templates, or practical examples for JAIIB/CAIIB coaching? Let me know! ??

? 5.6 PURPOSE OF THE LOAN ?

Understanding the **purpose of the loan** is a crucial aspect of **credit appraisal**, as it helps in determining:

? The **genuineness** of the borrower's intentions
? The **viability** of the business or project
? Whether the loan aligns with the **bank's lending policies**
? The **likelihood of repayment and risk of default**

? Evaluating the Loan Purpose ✅

A borrower may seek credit for various reasons, but not all purposes are considered legitimate or viable. **The banker must ensure that the funds are used productively and not for speculative activities.**

� Legitimate Loan Purposes:

� Working Capital Requirements

� Business Expansion & Diversification

� Capital Expenditure (Machinery, Equipment, Infrastructure)

� Purchase of Inventory & Raw Materials

� Acquisition of Land/Building for Business

� Technology Upgradation & R&D

� Export Finance

� Government-backed schemes (PMEGP, MSME Loans, etc.)

� Questionable/Restricted Loan Purposes:

❌Speculative Trading & Gambling

❌Investments in High-Risk Ventures (Without Proper Feasibility Study)

❌Real Estate Investment (Unless for Business Premises)

❌Repayment of Other Debts (Unless part of a Structured Refinancing Plan)

❌Personal Luxuries & Non-productive Uses

? Factors Assessed in Loan Purpose Verification ?

? 1? Managerial Competence:

- Does the borrower have the expertise to execute the business plan?
- Is the management team experienced in the industry?

? 2? Technical Feasibility:

- Is the project/business idea technically sound and realistic?
- Are the required raw materials, technology, and infrastructure available?

? 3? Economic Viability:

- Is there a **demand** for the product/service?
- Are there **substitutes** or competitors that could affect success?
- What are the **entry & exit barriers** in the industry?

? 4? Financial Feasibility:

- Is the borrower's financial position strong enough to sustain the business?
- Does the business generate sufficient **cash flow** to repay the loan?

? 5? Commercial Viability:

- Is the **market stable** or subject to frequent fluctuations?
- Are there any **economic, political, or regulatory risks** affecting the business?
- What is the **cost-benefit analysis** of the investment?

? 6? Regulatory & Environmental Compliance:

- Does the business comply with all **legal, tax, and environmental regulations**?
- Are there any **government approvals/licenses required**?

? Industry & Economic Conditions Assessment ?

A proposal might look strong on paper, but external factors could impact its success. Banks often rely on **economic research & industry analysis** to evaluate:

? **Market Trends & Cycles** – Is the industry growing or in decline?

? **Inflation & Interest Rates** – Could higher costs affect business profitability?

? **Regulatory Changes** – Are there new government policies impacting the sector?

? **Competition Analysis** – How strong are competitors?

Sources of Information:

 Industry Reports (RBI, CRISIL, CARE, ICRA)

 Business Research Publications (Economic Times, Financial Express)

 Credit Rating Agencies' Reports (CIBIL, CRIF, Experian)

 Economic Forecasting Reports

 Detecting Diversion of Funds **!**

A key risk in lending is **diversion of borrowed funds** for purposes other than those stated in the loan application. Banks must monitor fund utilization using:

 Working Capital & Cash Flow Analysis

 Funds Flow Statement – Tracks movement of funds between sources & uses

 Bank Statement Analysis – Identifies suspicious transactions

 Surprise Inspections & Audits – Physical verification of assets purchased

? **Vendor Payment Monitoring** – Ensures payments align with business needs

? **Example: Case Study on Loan Purpose Verification**

? **Scenario:**

A company applies for a **₹50 crore term loan** to set up a **manufacturing unit**. However, post-sanction, a funds flow analysis shows a **large portion of the loan diverted** towards speculative stock market investments.

? **Red Flags Identified:**

? Increase in investments, but **no significant capital expenditure**

? Payments made to **stockbrokers instead of machinery vendors**

? Business revenue **remains stagnant despite loan disbursement**

? **Action Taken:**

❌Bank stops further disbursement & recalls the loan

? Internal risk committee flags the borrower for regulatory action

? RBI & credit bureaus are notified to prevent future lending

? **Final Takeaways** ?

? **Loan purpose must align with borrower's core business and bank's policies.**

? **Feasibility studies help assess risks & sustainability of loan utilization.**

? **Macroeconomic & industry analysis ensure long-term viability of the business.**

? **Monitoring fund utilization prevents diversion & credit fraud.**

? **Financial discipline, managerial competence, and responsible borrowing behavior are key factors in loan approval.**

? Need more case studies or practical examples for JAIIB/CAIIB exam prep? Let me know! ??

5.7 SOURCE OF REPAYMENT

One of the **most critical aspects of credit appraisal** is to assess the **borrower's ability to repay the loan.** A **loan should ideally be repaid from the cash flows generated by the business** rather than from **asset sales, refinancing, or external funding.**

Key Sources of Repayment for Different Loan Types

1 **Working Capital Loans (Cash Credit & LC) → Churning of Current Assets**

- **Receivables (Debtors Collection)**
- **Inventory Sales & Turnover**
- **Short-term Cash Flows from Operations**

2 **Term Loans → Profits & Internal Accruals**

- **Operating Profits (EBITDA, PAT)**
- **Depreciation & Non-Cash Expenditures (Used for Loan Repayment)**
- **Long-term Cash Flow Management**

3 **Bank Guarantees → Discharge of Underlying Obligations**

- **Performance or Financial Completion of Project**

- **Release of Security Deposits or Contractual Obligations**

4️⃣ **Government-Backed Projects → Revenue Streams & Not Budgetary Support**

- **Toll Collections (Infrastructure Projects)**
- **Power Purchase Agreements (Energy Projects)**
- **Lease Rentals & User Charges**

📌 Evaluating Profitability & Financial Strength 📌

The lender must assess **whether the firm's profits are sufficient** to:

✅ **Service the loan interest**

✅ **Repay the principal on time**

✅ **Provide returns to shareholders**

✅ **Retain earnings for future growth**

📌 Methods Used for Profitability Analysis:

1️⃣ **Net Profit Margins & EBITDA Margins** → Determines operational efficiency

2️⃣ **Debt Service Coverage Ratio (DSCR)** → Ability to meet debt obligations

3⃣ **Interest Coverage Ratio (ICR)** → Ability to pay interest from profits

4⃣ **Net Present Value (NPV) & Internal Rate of Return (IRR)** → Project Feasibility

5⃣ **Break-Even Analysis** → Minimum revenue needed to cover costs

📌 **Existing Businesses** → Historical **3-5 years profit trends** analysed

📌 **New Projects** → More **rigorous validation of forecasts** required

📌 **Special Consideration for Government-Owned Entities** 📌

📌 **RBI Guidelines for Bank Finance to Government-Owned Projects**

📌 **Project Viability**:

- Due diligence on revenue streams & cash flow sustainability
- No reliance on **State Government Guarantees** as a substitute for appraisal

� **Special Purpose Vehicles (SPVs) for Infrastructure Financing:**

- **Risk Evaluation & Contractual Obligations** assessed
- Lending via **Consortium or Syndication** encouraged

� **Corporate Body Mandate:**

- Loans must be given to **corporate entities only**
- **Repayment from project revenue** (not government budget support)

� **Case Study: Real-Life Example of Loan Repayment Risk** �

� **Scenario:**

A power project secured a ₹500 crore term loan **backed by a state government guarantee**. However, post-disbursement, the **state government delayed subsidies & budget allocations.** The project had **no direct revenue stream** leading to **loan default**.

� **Key Issues Identified:**

� No independent revenue source

� Reliance on government budget support

� Weak project cash flow due to lack of operational revenue

? **Corrective Action Taken:**

❌Loan classified as **Non-Performing Asset (NPA)**

? Restructuring forced under **Insolvency & Bankruptcy Code (IBC)**

? RBI issued guidelines barring budget-backed financing without due diligence

? **Final Takeaways** ?

? **Loan repayment must be from business-generated cash flows, not external funding.**

? **Profitability analysis helps ensure financial sustainability.**

? **Government-owned projects must have self-sustaining revenue streams.**

? **Financial metrics like DSCR, ICR, and NPV are crucial in decision-making.**

? **Banks must ensure due diligence & project bankability before sanctioning loans.**

? Need more insights or real-world case studies for JAIIB/CAIIB prep? Let me know! ??

? 5.9 COLLATERAL & CASH ACCRUAL ?

When assessing a credit proposal, lenders must evaluate **both the cash flow potential** and **collateral security** to mitigate risks.

? 5.8 CASH ACCRUAL: How Does the Business Generate Cash? ?

? Key Sources of Loan Repayment:

1? **Net Cash Flows from Operations (Preferred by Banks)** ✅

- Business-generated profits & cash accruals
- Sustainable revenue growth & positive operating cash flow

2? **Sale/Liquidation of Assets (Last Resort)** ?

- May indicate financial distress
- Weakens business capacity

3? **Borrowings or Debt Financing** ❌

- Leads to higher leverage & repayment burden
- Risky strategy if cash flows are weak

4? **Fresh Capital Infusion (Only in Expansions)** ?

- Acceptable for scaling up business
- Required in cases of financial restructuring

? How to Calculate Cash Accrual? ?

? Formula:

Cash Accrual = Net Profit + Non-Cash Expenses (Depreciation, Amortization, etc.)

OR

? Breakdown Formula:

Cash Accrual = Sales Revenue – Cost of Goods Sold – Operating Expenses – Taxes Paid

? Key Questions for Lenders When Evaluating Cash Flow Trends ?

? **1. Sales Revenue** – Is it stable or declining? Is there excessive credit sales?

? **2. Cost of Goods Sold (COGS)** – Is it increasing as a % of sales? Why?

? **3. Selling & Administrative Expenses** – Are they rising faster than revenue?

? **4. Tax Payments** – Are taxes actually paid or just accounted for?

? **5. Non-Cash Expenses** – Any unusual depreciation/amortization patterns?

? ? Banks should conduct a detailed cash flow analysis before granting credit!

? 5.9 COLLATERAL: The Last Line of Defense in Lending ?

? What is Collateral?

Collateral is an **additional security** that the bank can **sell or liquidate** in case of default. However, collateral does NOT make a bad loan good—it simply reduces the bank's loss if the borrower defaults.

Types of Collateral & Security in Lending

Type	**Description**
Personal Security	Borrower/guarantor's personal liability. Legal action possible.
Tangible Security	Physical assets like property, shares, gold, etc.
Primary Security	The asset financed by the loan (e.g., stocks for working capital, machinery for term loans).
Collateral Security	Additional security apart from the primary security (e.g., property, FD, third-party guarantees).

🔹 Why is Collateral Important? 🔹

1️⃣ **Acts as a "Plan B" if business cash flows fail.**
2️⃣ **Increases borrower's commitment to repaying the loan.**
3️⃣ **Allows banks to recover loan amounts in case of default.**
4️⃣ **Reduces lender's credit risk exposure.**

🔹 **But remember: A loan should NEVER be sanctioned based on collateral alone! Cash flow is the primary repayment source; collateral is a fallback option.**

🔹 Challenges in Enforcing Collateral in India 🔹

🔹 **Reality Check:**

🔹 **Legal Delays:** Court cases on collateral enforcement drag on for years.

🔹 **Value Depreciation:** Assets may lose value before the bank can sell them.

🔹 **Fraudulent Transfers:** Borrowers may illegally transfer assets to avoid seizure.

🔹 **Emotional Attachment:** Borrowers fight aggressively to protect their property.

Due Diligence is Key! Lenders must verify:

Borrower's Net Worth & Asset Quality

Age & Marketability of Asset

Technological Relevance (Avoid obsolete assets)

Legal Clearances & Ownership

Real-Life Example: Loan Default & Collateral Issues

Scenario:

A borrower took a ₹10 crore term loan against **machinery as collateral**. However, the business **failed due to outdated technology**, making the machinery unsellable. The bank could not recover the full amount, leading to an **NPA (Non-Performing Asset).**

Lessons Learned:

Assess if collateral has resale value before accepting it.

Ensure borrowers have strong cash accruals, not just assets.

? Avoid over-reliance on collateral—focus on business sustainability.

? Final Takeaways for Bankers & Credit Officers ?

? Loans should be repaid from business cash flows, not from selling assets.
? Collateral is a backup, NOT the primary repayment source.
? Verify the market value, ownership, and legal status of collaterals.
? Monitor borrower's cash flow trends regularly.
? Loan defaults often occur due to over-reliance on weak collateral.