





Credit Relationship & Monitoring

CCP CHAPTER 25 MODULE E

25.1 Long-term Banker-Customer Relationship

A banker-customer relationship, particularly credit relationships, aims at long-term engagement. **Fundamental requirements** to sustain a healthy credit relationship include:

1.  **Intended use of credit:** Ensuring borrowed funds are used for the agreed purposes.
2.  **Timely repayments:** Paying interest and principal/installments as per terms.
3.  **Transparency:** Regular submission of required information regarding securities and business performance.
4.  **Mutual respect:** Both parties act in a way that safeguards their **shared financial interests** and ensures a long-lasting, trustworthy partnership.

25.2 Credit Monitoring – Meaning & Importance 🔍

- It refers to the continuous **tracking and assessment of a borrower's financial activities and creditworthiness** by a financial institution or credit agency.
- It helps lenders ensure that **borrowers are maintaining good financial health** and can meet their repayment obligations.

KEY ASPECTS OF CREDIT MONITORING

Key Aspect	Explanation
Continuous supervision 🔄	Regular and ongoing monitoring, not a one-time task.
Quality assurance 📁	Ensuring assets remain high-quality and comply with IRAC guidelines.
Performance tracking 📊	Verifying borrower compliance with loan covenants and business assumptions made at sanction.

Standard Monitoring Tools:

- Submission of periodic stock statements (Assets, Stocks, Book Debts).

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- Financial statements (MSOD, QIS I, QIS II, FFR-I quarterly, QIS III/FFR-II, half-yearly fund flow).

Customized Covenants (Examples):

Scenario	Covenant Example
High credit rating borrower 🏆	Negative lien – Borrower cannot create mortgages without bank consent.
Moderate debt-equity borrower ⚖️	Restriction on raising additional debt without bank's consent.
Cash-flow sensitive borrower 💰	Maintenance of minimum public deposit levels.

Credit Administration: After loan sanction, Credit Administration ensures:

- Proper communication of terms via sanction letters.
- Documentation execution and security perfection.
- Registration of charges (e.g., Form CHG-01 with ROC).

25.3 Goals of Credit Monitoring 🔄

The primary objectives include:






- Minimizing or eliminating NPAs.

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- Ensuring funds utilization for sanctioned purposes.
- Evaluating borrower performance against projections.
- Maintaining asset quality as per regulatory guidelines.



Key Monitoring Activities:

Activity 	Purpose
Transaction monitoring 	Ensuring transactions align with estimated business activities.
Stock statement review 	Validating stock levels and valuations.
Performance indicators 	Tracking sales, debtor/creditor levels, and profitability.
Early Warning Signals (EWS) 	Identifying risks promptly to prevent NPAs.

Summary Table

Section	Highlights
Long-term Relationship 	Commitment to intended usage, timely repayment, transparency, mutual respect.

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Section	Highlights
Credit Monitoring 	Continuous supervision, compliance with covenants, quality maintenance.
Monitoring Goals 	Prevention of NPAs, ensuring compliance, early identification of risks.

25.4 Credit Monitoring Process

Effective credit monitoring involves a structured approach to **ensure asset quality and timely identification of risks**. The process is **broadly divided into three stages**:

25.4.1 Pre-Disbursement Stage

Objective: Ensuring due diligence and compliance with legal requirements before loan disbursement.

Key Activities:

- Fulfillment of sanction terms (creation of mortgages, CERSAI registration, ROC filings).
- Completion of necessary documentation.
- **Legal audit and periodic reverification of title deeds for exposures above ₹5 crores, as mandated by RBI.**

25.4.2 Disbursement & End-Use Verification 💰

Objective: Prevent diversion of loan funds, ensuring usage for sanctioned purposes.

End-use Verification:

- **Term Loans:** Obtain original invoices for machinery, vehicles, equipment, etc.; payments to suppliers directly.
- **Project Financing:** Obtain Chartered Accountant's certification; supplement with internal due diligence.
- **Working Capital:** Monitor cash credit draws strictly for sanctioned purposes; avoid cash payments or unjustified transfers.

Insurance:

- Stocks must have adequate insurance with Bank Clause.

25.4.3 Post-Disbursement Monitoring 📺

Continuous monitoring after disbursement is crucial for early detection of potential risks.

25.4.3.1 Loan Review Mechanism (LRM) 🧐

- Independent evaluation of loan administration.
- Ensures compliance with sanction and post-sanction procedures.

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- Reviews credit rating accuracy and loan-loss provisions.

25.4.3.2 Credit Audit

- Reviews compliance with bank guidelines.
- Identifies early warning signals and suggests corrective measures.
- Improves credit administration quality.

25.4.3.3 Analysis of Financial Statements

- Examining or reviewing s periodic financial returns (QIS, MSOD).
- Compare actual performance against projections.
- Investigate and address significant variances promptly.

25.4.3.4 Periodical Borrower Performance Review

- Regularly compare borrower's actual results against initial projections.
- Engage closely with borrowers to understand operational challenges.
- Proactively address repayment difficulties through restructuring or rescheduling.
- Identify and manage potential NPAs timely; explore exit options if required.

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25.4.3.5 Annual Advances Review

- Annual evaluation of borrower's credit needs and asset quality.
- Ensure working capital limits align with current business needs.



25.4.3.6 Stock Statements Scrutiny

- Periodic analysis of stock statements and physical stock verifications.
- Identify discrepancies in inventory levels, raw materials, and finished goods.
- Promptly investigate significant irregularities.







Agency for Specialised Monitoring (ASM)

- External agency monitoring of large loans (above ₹250 crore) quarterly.
- Ensures focused, specialized oversight for high-value exposures.




25.5 Key Monitoring Tools

Tool 	Usage & Importance
Exception Reports 	Highlights deviations from normal transactions

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Tool 	Usage & Importance
Stock Statements 	Monitor inventory levels and valuation accuracy
Factory Inspections 	On-site verification of stock and operations
Audit Reports 	Independent audit findings and recommendations
Periodic Statements (QIS/MSOD) 	Regular financial health check
Annual Reviews 	Comprehensive yearly performance evaluation

Summary Table

Stage	Key Activities
Pre-Disbursement 	Compliance checks, documentation, legal audits
Disbursement & End-Use 	Direct payments, end-use certification, insurance coverage
Post-Disbursement 	Loan reviews, credit audits, financial analysis, stock scrutiny



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☑ Systematic credit monitoring reduces risks, enhances asset quality, and ensures the bank's interests remain protected throughout the loan lifecycle.

📄 25.6 Additional Monitoring Tools 🔧

Banks utilize a range of specialized monitoring tools to ensure robust credit management and risk mitigation:

Tool 📄	Description & Importance 🔍
Certified Project Cost Statement	<ul style="list-style-type: none">• This document compares the actual costs incurred in a project with the initially projected costs.• It helps banks track cost overruns, identify financial discrepancies, and assess whether the project is progressing within budget.
Monthly Cash Budget	<ul style="list-style-type: none">• This tool ensures that the borrower's cash flow aligns with the budgeted cash flows.• It helps in monitoring liquidity, ensuring the borrower can meet short-term obligations like loan repayments and operational expenses.
Credit Audit Reports	<ul style="list-style-type: none">• These reports evaluate the credit monitoring process at the branch level.• They help identify gaps in loan assessment, documentation, or risk evaluation.

Tool 	Description & Importance 
Factory Visit Reports	<ul style="list-style-type: none">• These reports provide physical verification of a borrower's manufacturing or business operations.• Banks use these reports to confirm that loan funds are being utilized for the intended purpose.
Audited Financial Statements	<ul style="list-style-type: none">• Banks review audited financial statements to validate a borrower's reported financial position.• These statements, prepared by independent auditors, offer insights into profitability, solvency, and liquidity.
Sales Tax/GST Returns	<ul style="list-style-type: none">• Sales tax and GST returns help verify a borrower's actual revenue and tax compliance.• Any mismatch between declared revenue in financial statements and tax returns may signal financial misrepresentation.
Market Intelligence	<ul style="list-style-type: none">• Banks collect external information about a borrower's market reputation and business environment.• This includes competitor analysis, customer reviews, industry trends, and credit ratings.

Tool 	Description & Importance 
RBI Inspection Reports	<ul style="list-style-type: none">• The Reserve Bank of India (RBI) periodically inspects banks to ensure regulatory compliance.• These reports highlight weaknesses in credit monitoring, risk management, and policy implementation.
Controlling Office Visit Reports	<ul style="list-style-type: none">• Senior bank officials visit branches to assess their credit monitoring practices.• These reports validate whether branch-level risk assessments align with central office policies.
Consortium Meeting Minutes	<ul style="list-style-type: none">• In cases where multiple banks lend to the same borrower (consortium lending), periodic meetings are held.• The meeting minutes document discussions on borrower performance, risks, and collective decisions.

Checklist for Analyzing Financial Statements

The following critical **financial parameters** should be closely scrutinized:

Sales

- **What to check?** Compare actual sales with the budgeted or expected sales.
- **Why?** Large increases or decreases could indicate **changing market conditions, mismanagement, or inaccurate projections.**

2. Cost of Goods Sold (COGS)

- **What to check?** Whether **production costs have increased unexpectedly.**
- **Why?** A sudden rise in costs **without a clear reason might indicate inefficiencies or financial misreporting.**

3. Operating Profit

- **What to check?** Compare operating profit with previous periods.
- **Why?** A major rise or fall could mean **changes in sales, costs, or business efficiency.**

4. Profit Before Tax (PBT)

- **What to check?** Any **unexpected** rise or fall in profit before tax.

- **Why?** Taxable profit affects **financial stability and tax liabilities**.

5. Current Assets & Liabilities

- **What to check?** Sudden changes in cash, inventory, or receivables and payables
- **Why?** Unexpected increases in receivables or inventory could mean **poor sales collections or overstocking**.

6. Statutory Liabilities (Taxes, PF, etc.)

- **What to check?** Ensure the company is paying its **statutory dues** (e.g., GST, employee provident fund) **on time**.
- **Why?** Unpaid statutory liabilities can lead to **legal penalties or government action**.

7. Long-term Investments

- **What to check?** Any **large investments** beyond approved limits.
- **Why?** Big investments without approval can **create financial risk and liquidity issues**.

Information Systems for Monitoring

Banks adopt structured systems for financial follow-ups:

Monthly Select Operational Data (MSOD):

- Actual sales vs. budget, explanations for variances.
- Receivables position, with a detailed report on outstanding debts over six months.
- **Stock verification** aligned with monthly stock statements.

Quarterly Information System (QIS):

Type	Purpose
QIS I (Pre-Quarter)	Validates sales/production estimates against annual projections.
QIS II (Post-Quarter)	Compares actual performance with earlier estimates; significant variance ($\pm 10\%$) requires explanation. Checks current ratio compliance.
QIS III (Half-Yearly)	Evaluates sales alignment with annual budget; analyses net fund generation discrepancies.

Annual Review of Advances 

An annual review critically evaluates:

- Operational performance (production, sales, profits).

- Financial position and compliance with covenants.
- Repayment punctuality and limit adequacy.
- Decision on continuation, modification, or termination of facilities.

25.7 Supervision & Follow-Up






Supervision and follow-up activities aim to:

- ✓ **Ensuring Compliance** – Borrowers must follow the agreed loan terms.
- ✓ **Identifying Risks Early** – Detecting financial distress before it worsens.
- ✓ **Upgrading Accounts** – Helping struggling accounts recover to a stable status.
- ✓ **Adjusting Credit Facilities** – Modifying loan limits based on business needs.
- ✓ **Monitoring Financial Health** – Regularly checking financial statements and business performance.

Key Indicators to Monitor:

- ✓ **Reduction in Security Coverage** – If the value of collateral (e.g., property, stock) decreases, the bank's loan security weakens.
- ✓ **Financial Distress & Inefficiencies** – Signs like delayed payments, declining profits, or operational losses indicate potential risk.

 **Summary Table:**

Tool/Process	Purpose
Specialized Monitoring Tools 	Comprehensive monitoring and early risk detection.
Financial Analysis 	Identifying significant variances and taking corrective actions.
Information Systems (MSOD/QIS) 	Structured periodic financial reviews.
Annual Reviews 	Thorough assessment of credit facility continuation.
Supervision & Follow-Up 	Ensuring ongoing compliance and financial health.

Robust monitoring tools and diligent follow-ups significantly enhance credit quality and reduce risks in lending operations.

 **25.8 Periodical Scrutiny of Exception Reports** 

- In a digitally-driven banking environment, **transaction deviations or breaches of controls** are captured in daily "end-of-day exception reports".

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- **Regular scrutiny of these reports** by designated officials is critical. Post-facto authorization of such exceptions should be strictly enforced.

Best Practices:

- **Clear designation of officials** responsible for reviewing exception reports.
- **Defined procedures** for handling and authorizing breaches.
- **Regular review and oversight** by management and Board of Directors.

25.9 Predicting Defaults Using AI/ML-based Analytics Tools

- **Credit risk management** directly impacts a bank's **profitability and stability**.
- Modern approaches leveraging **Artificial Intelligence (AI)** and **Machine Learning (ML)** offer superior predictive capabilities and comprehensive risk assessment.

Key Benefits of AI/ML in Credit Risk Management:

- Enhanced accuracy in default prediction.
- Identification of early warning signals.
- Prevention of fraud and money laundering.

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- Improved management of prepayment risks.

Essential Inputs for AI/ML Models:

Category	Inputs
Income Sources	Assured, windfall, stray incomes
Demographics	Age, gender, dependents, location (urban/rural)
Loan Details	Amount, tenure, type, loan cycle
Credit History	Past loans, local credit environment
Business Indicators	Financial ratios, industry type, competitor/supplier/customer analysis

Process of AI/ML-based Credit Analysis:

1. **Data Collection:** Comprehensive borrower data from diverse sources.
2. **Data Cleaning:** Removal of irrelevant or incomplete data entries.
3. **Algorithm Application:** Models trained on historical data to predict default probabilities.

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4. **Real-time Monitoring:** Continuous analysis of borrower activities, industry trends, and public information.

Challenges & Preconditions:

- Availability of comprehensive and high-quality data.
- Continuous algorithm updates to adapt to market changes.
- Skilled expertise in AI/ML technologies.




Comparison: Traditional vs AI/ML-based Monitoring

Feature	Traditional Monitoring 📅	AI/ML-based Monitoring ⚙️
Predictive capability	Limited or none	High predictive accuracy and proactive risk detection
Scope of monitoring	Narrow and isolated	Comprehensive, covering internal and external data
Communication	Role-based, isolated	Integrated alerts across teams from origination to recovery
Review Frequency	Fixed schedule annual	Flexible, continuous monitoring
Perspective	Horizontal and limited	Multi-dimensional (cross, vertical, holistic views)

Future Scope:

As banks move towards **Advanced Internal Rating-Based (IRB) approaches for credit risk**, incorporating AI/ML for predictive analytics will be critical for **estimating Loss Given Default (LGD) and optimizing capital allocation**.

 **Summary Table:**

Area	Key Highlights
Exception Reports 	Regular scrutiny, defined authorization protocols, oversight by management
AI/ML Tools 	Enhanced prediction, comprehensive data analysis, proactive risk detection
Monitoring Comparison 	AI/ML outperforms traditional methods with real-time, multi-dimensional insights

Implementing AI/ML in credit monitoring transforms risk management, enabling proactive interventions, optimized resources, and enhanced credit quality.