CAIIB PAPER-1 MODULE-D
Credit Management

PDF

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Unit 1: Overview of Credit Management

Credit

Credit is the trust which allows one party to provide money or resources to another party wherein the second party does not reimburse the first party immediately, but promises either to repay or return those resources at a later date.

Principles of Credit

Over a period of time, bankers have evolved certain basic principles for their lending operations. Bank’s loan policies, and other aspects of credit management, are influenced to a great extent by these unwritten principles, which are as under:

- Safety of funds
- Purpose
- Profitability
- Liquidity
• Security
• Risk spread

**Types of Borrowers**

A borrower can be:

• An individual
• Sole proprietary firm
• Partnership firm and joint ventures
• Hindu undivided family
• Companies
• Statutory corporations
• Trusts and co-operative Societies

**Types of Credit**

• **Fund Based:** In fund-based credit, there is actual transfer of money from the bank to the borrower.

• **Non-Fund Based:** In non fund based credit, there is no transfer of money, but the commitment by the bank on behalf of the client, may result in future transfer of money to the beneficiary of such a commitment. **Example** of this is a bank guarantee issued in favour of government departments (or any other beneficiary) on behalf of a contractor, who is bank’s customer.

• **Credit can also be classified based on purpose,** like working capital finance, project finance, export finance, crop loan, etc. Banks often classify their credit portfolio based on the type of the customers like, Corporate, retail, agriculture, international, institutional credit, etc.

**The laws applicable to all these different kinds of borrowers are different.**

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Components of Credit Management

- Loan Policy of the Bank
- Appraisal
- Delivery
- Control and Monitoring
- Rehabilitation and Recovery
- Credit Risk Management
- Refinance

Role of RBI's Guidelines In Bank's Credit Management

End Use of the Funds:

- It is the primary responsibility of banks to ensure proper end use of bank funds/monitor the funds flow. It is, therefore, necessary for banks to evolve such arrangements as may be considered necessary to ensure that withdrawals from cash credit/overdraft accounts are strictly for the purpose for which the credit limits are sanctioned by them.

Priority Sector:

The main sectors, included in the priority sector are as follows:

- Agricultural finance
- Finance to micro and small enterprises
- Housing finance \([\text{loans up to Rs 20 lakh} \text{ to individuals for purchase or construction of dwelling unit}), \text{Loans up to Rs 1 lakh and Rs 2 lakh} \text{ for repairing of houses in rural or semi-urban and urban areas respectively}]\)
• Educational loans (up to **Rs 10 lakh for studies in India and Rs 20 lakh** for studies abroad)

• **Export credit**: export credit by domestic banks is not treated as finance to priority sector for the purpose of priority sector target. But, export credit by foreign banks is treated as finance to priority sector.

• **Micro-credit provided by banks either directly or through any intermediary**: Loans to self help groups (SHGs) [Non Governmental Organizations (NGOs) for on-lending to SHGs

• Retail trade

• **Khadi and Village Industries Sector (KVI)**: All advances granted to units in the KVI sector irrespective of their size of operations, location and amount of original investment in plant and machinery, are covered under priority sector advances and are eligible for consideration under the sub-target (60 per cent) of the small enterprises segment within the priority sector.

**Targets for Priority Sector Lending**

The targets and sub-targets set under priority sector lending for domestic and foreign banks operating in India are furnished here: (Figures are given as per cent of Adjusted Net Bank Credit (ANBC) or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher)

• **Segment ‘a’**, Total Priority Sector advances, Target for **Domestic Banks, both public and private sectors, 40 per cent** and Target for Foreign Banks operating in India, 32 per cent.

• **Segment ‘b’**, Total Agricultural advances, Target for Domestic Banks, both public and private sectors, **18 per cent** and Target for Foreign Banks operating in India, No target.

• **Segment ‘c’**, Small enterprise advances, Target for Domestic Banks, both public and private sectors, **No target** and Target for Foreign Banks operating in India, **10 per cent**.

• **Segment ‘d’**, Export Credit, Export credit does not form part of priority sector.

• **Segment ‘e’**, Advances to weaker sections, Target for Domestic Banks, both public and private sectors, **10 per cent** and Target for Foreign Banks operating in India, No target.

**The weaker sections under priority sector include the following:**

• Small and marginal farmers with land holding of 5 acres and less and landless labourers, tenant farmers and share croppers.
• Artisans, village and cottage industries where individual credit limits do not exceed Rs 50,000/-
• Beneficiaries of Swarnjayanti Gram Swarojgar Yojana (SGSY)
• Scheduled Castes and Scheduled Tribes
• Beneficiaries of Differential Rate of Interest (DRI) scheme
• Beneficiaries under Swama Jayanti Shahari Rojgar Yojana (SJSRY)
• Beneficiaries under the Scheme for Liberation and Rehabilitation of Scavangers (SLRS).
• Self Help Groups (SHGs)
• Individual Women beneficiaries up to Rs 1lac per borrower.
• Distressed persons other than farmer, with loan amount not exceeding Rs 1lac per borrowers to repay their to non-institutional lenders.

Note: No loan related ad andhoc service charges/ inspection charges should be levied on priority sector loans up to Rs 25000. In the case of eligible priority sector loan to SHGs/JLGs, this limit will be applicable per member and not to the group as a whole.

**MSMED Act 2006**

Enterprises engaged in the manufacture or production, processing or preservation of goods

• A **micro enterprise** is an enterprise where investment in plant and machinery does not exceed Rs. 25 lakh;

• A **small enterprise** is an enterprise where the investment in plant and machinery is more than Rs. 25 lakh but does not exceed Rs. 5 crore;

• A **medium enterprise** an enterprise where the investment in plant and machinery is more than Rs. 5 crore but does not exceed Rs.10 crore.

Enterprises engaged in providing or rendering of services

• A **micro enterprise** is an enterprise where investment in equipment does not exceed Rs. 10 lakh;

• A **small enterprise** is an enterprise where the investment in equipment is more than Rs. 10 lakh but does not exceed Rs. 2 crore;

• A **medium enterprise** an enterprise where the investment in equipment is more than Rs. 2 crore but does not exceed Rs.5 crore.
RBI revises priority sector lending guidelines

- The Reserve Bank of India (RBI) on 4th September 2020 said it has revised priority sector lending (PSL) guidelines to include entrepreneurship and renewable resources, in line with emerging national priorities.

- Bank finance to start-ups (up to Rs 50 crore), loans to farmers for installation of solar power plants for solarisation of grid-connected agriculture pumps and loans for setting up Compressed BioGas plants have been included as fresh categories eligible for finance under priority sector.

Other Highlights of revised priority sector lending guidelines

- The new guidelines are applicable to all commercial banks including regional rural banks, small finance banks, local area banks and primary (urban) co-operative banks other than salary earners’ banks. PSL guidelines were last reviewed for commercial banks in April 2015 and for urban co-operative banks in May 2018.

- Higher weightage has been assigned to incremental priority sector credit in ‘identified districts’ where priority sector credit flow is comparatively low.

- The targets prescribed for “small and marginal farmers” and “weaker sections” are being increased in a phased manner.

- “Revised PSL guidelines will enable better credit penetration to credit deficient areas; increase the lending to small and marginal farmers and weaker sections; boost credit to renewable energy, and health infrastructure.

Statutory and Other Restrictions on Some Credits

The following credit restrictions have been placed on the banks:

(Details as per RBI circular No. Dir. BC. 13113.03.00/2009-10 dated 1, July 2009)

- Advances against Bank’s own shares: In terms of Section 20(1) of the Banking Regulation Act, 1949, a bank cannot grant any loans and advances on the security of its own shares.

- Restrictions on granting loans and advances to relatives of Directors

- Restrictions on Grant of Loans & Advances to Officers and Relatives of Senior Officers of Banks

- Restrictions on Grant of Financial Assistance to Industries Producing or Consuming Ozone Depleting Substances (ODS)

- Restrictions on Advances against Sensitive Commodities under Selective Credit Control (SCC)
• Advances against Fixed Deposit Receipts (FDRs) Issued by Other Banks
• Loans against Certificate of Deposits (CDs)
• Restrictions on Credit to Companies for Buy-back of their Securities

Unit 2: Analysis of Financial Statements

Financial Statements

There are basically two financial statements which every business enterprise is required to prepare. These are:

• Balance sheet
• Profit & Loss account (Income & Expenditure statement in case of non-profit organizations)

Apart from these, the auditors' report, explanatory schedules and notes on accounts, if applicable, provide useful information to the bankers.

A funds flow statement also provides useful information but, this is only a mathematical analysis of changes in the structure of two consecutive balance sheets and can be easily prepared by the banker/analyst himself if the basic statements, i.e. the balance sheets, are available. Accounting Standard-3 makes it mandatory for some enterprises to prepare Cash Flow statement for the accounting period (these enterprises are those whose equity or debt is listed or is in the process of being listed on a recognized stock exchange and also all other commercial, industrial and business enterprises whose turnover for the accounting period exceeds Rs.50 crore. These enterprises are also required to do segment-wise reporting as per A S -1 7.

Users of Financial Statements

Apart from bankers, the other users of financial statements are:

• Other creditors and lenders
• Investors
• Government agencies
• Rating agencies
• Customers
• Employees
• General public
• Analysts

Basic Concepts Used in Preparation of Financial Statements
The important concepts are as under:

- Entity Concept
- Money Measurement Concept
- Stable Monetary Unit Concept
- Going Concern Concept
- Cost Concept
- Conservatism Concept
- Dual Aspect Concept
- Accounting Period Concept
- Accrual Concept
- Realization Concept
- Matching Concept

The format of balance sheet can be either Vertical or Horizontal as illustrated below (activities like banking, insurance, electricity generation etc, which are governed by acts other than Companies Act, need not follow these formats)

**Horizontal Form**: Horizontal form is maintained in two columns. The first column shows the Liabilities and the second one shows the Assets.

**The items shown in the first column against Liabilities are:**

- Share Capital Reserves
- Surplus Secured loans
- Unsecured loans
- Current liabilities
- Provisions

**The items shown in the second column against Assets are:**

- Fixed assets
- Investments
- Current assets
- Loans and advances
- Miscellaneous expenditure

**Vertical Form**: In the Vertical Form, the different items are shown one below the other.

**(A) Sources of funds**

1. Shareholders’ funds
   (a) Share capital
   (b) Reserves and surplus
2. Loan funds
(a) Secured loans
(b) Unsecured loans

(B) Application of funds

1. Fixed assets
2. Investments
3. Current assets, loans and advances

Less: Current liabilities and provisions Net current assets
4. Miscellaneous expenditures

I. Equity and Liabilities

Shareholder’s funds

- Share capital
- Reserve and Surplus
- Money received against share warrants

Share application money pending allotment

Non-current liabilities

- Long-term borrowings
- Deferred tax liabilities (Net)
- Other long term liabilities
- Long term provisions

Current liabilities

- Short-term borrowings
- Trade payables
- Other current liabilities
- Short-term provisions

Total-

II. Assets

Non-current assets

- Fixed assets

(i) Tangible assets
(ii) Intangible assets

(iii) Capital work-in-progress

(iv) Intangible assets under development

- Non-current investments
- Deferred tax assets (net)
- Long-term loans and advances
- Other non-current assets

**Current Assets**

- Current investments
- Inventories
- Trade receivables
- Cash and cash equivalents
- Short-term loans and advances
- Other current assets

**Total Accounting**

As per Income Tax rules, April to March is considered as the financial year for tax purposes. However, as per Companies Act, this can be different. Only restriction, as per Companies Act, is that the maximum duration of the financial year can be 15 months, and can be extended up to 18 months with the permission of Registrar of Companies (ROC).

**Profit And Loss Account**

It is a statement of income and expenditure of an entity for the accounting period. Every P & L account must indicate the accounting period for which it is prepared. The items of a P & L account are:

- Gross and Net sale
- Cost of goods sold
- Gross profit
- Operating expenses
- Operating profit
- Non-operating surplus/deficit
- Profit before interest and tax
- Interest
- Profit before tax
- Tax
- Profit after tax (Net Profit)
Analysis of financial statements

- Assrt of fin position/performance
- Projections of future performance
- Warning signals
- Credit requirement assessment
- Exam fund flow
- Cross checking
- Fund flow analysis: diversion/idle funds
- Trend analysis: trends/op.efficiency
- Ratio analysis: profitability, liquidity, capital structure(der), ability to service debt/int, inventory/debtor turnover

Bankers mostly use three methods for analysis of financial statements

- Funds Flow Analysis
- Trend Analysis
- Ratio Analysis

While different users of financial statements are interested in different ratios, the ratios which interest a banker most, are the following:

- Profitability Ratios
- Liquidity Ratios
- Capital Structure Ratios
- Ratio Indicating Ability to Service Interest and Instalments
- Turnover Ratios
- Inventory Turnover Ratio
- Debtors’ Turnover Ratio

Unit 3: Working Capital Finance

Working Capital

Whenever a business enterprise is started, some fixed assets like office, furniture, machines/computers etc, depending upon the need, are acquired. But this alone may not be sufficient for running the business of that enterprise, except for a few activities like broking/commission agent, etc. Most of the business enterprises, in the course of their business, have to carry some current assets like raw materials, finished goods, receivables etc. The money blocked in these current assets is called working capital.

Working Capital Cycle
The normal operations of a business enterprise consist of some or all of the actions like, purchase of raw materials, processing and conversion of raw materials into finished goods, selling these goods on cash/credit basis, receive cash on sale or end of credit period and again purchase raw materials. This is called working capital cycle. The length of this cycle depends on:

- The stocks of raw materials required to be held
- The work in process, which in turn depends on the process involved in manufacturing and processing the raw materials
- The credit required to be provided to the purchasers

**Importance of Liquidity Ratios**

- For a banker, providing working capital finance, the liquidity ratios, specially the current ratio, play a very important role in assessment, sanctioning decision, and monitoring.
- The assessment involves stipulation of a minimum Net Working Capital (NWC) to be brought in by the enterprise from its long term sources. This results in a minimum current ratio (more than one) which the bank wants the enterprise to maintain at all the times. This is, normally, mentioned in the terms and conditions of sanction and becomes an important tool for the bank to monitor the use of funds by the enterprise.

**Method of Assessment of Bank Finance**

Deciding on the level of Turnover of the Enterprise: This is a very important step in any method of assessment of working capital limits. In case of existing enterprises, the past performance is used as a guide to make an assessment of this. In case of new enterprises, this is based on the production capacity, proposed market share, availability of raw materials, industry norm etc.

Assessment of Gross or Total Working Capital: This is the sum total of the assessment of various components of the working capital.

- Inventory
- Receivables and Bills
- Other Current Assets

Sources for Meeting Working Capital Requirement:

- Own Sources (NWC)
- Suppliers’ Credit
• Other Current Liabilities like salaries payable, advances from customers, etc.
• Bank Finance

**Calculation of Bank Finance**

Though banks are now free to formulate their own policies, the methods of lending, mentioned there, still find place in the calculations followed by the banks. **The methods are;**

• **First Method of Lending:** Under this, the enterprise was required to bring in at least 25 per cent of the working capital gap (total current assets minus total current liabilities excluding bank finance).

• **Second Method of Lending:** Under this, the enterprise was required to bring in at least 25 per cent of the total current assets.

• **Third Method of Lending:** Under this, the enterprise was required to bring in 100 per cent of those current assets which are considered 'core assets' and at least 25 per cent of the remaining current assets.

**Cash Budget Method of Assessment**

Any economic activity, however small it may be, involves outflows (expenditure) of money for procurement of inputs and inflows of money (income) from the sale of output. The nature, amount and periodicity of outflows and inflows is peculiar to the type of activity, level of operations, market conditions and the policies adopted by the owners/managers etc.

A normal statement / budget, will look as under:

**Inflows**

1. Opening balance
2. Term loan from Bank
3. Sales (Total sales-credit sales + realization for earlier sales)
4. Other cash inflows

**Total inflows**

**Outflows**

1. Capital expenditure
2. R. M. Purchase
3. Labor
4. Power and fuel
5. Payment of Interest
6. Repayment of Term loan installment
7. Other cash outflows

**Total outflows**

**Cash surplus or (deficit)**
- Bank finance needed
- Closing balance

**Bills / Receivables Finance by the Banks**

Receivables are part of the current assets of a business enterprise. These arise due to sales on credit basis to the customers. The bank provides finance against these in a fashion similar to that for inventory.

Another method of sales is through Bills of exchange drawn by the seller on the purchaser in the following manner;

- If no credit is to be provided to the customer, a demand bill is drawn.
- If the credit is to be provided on the sales, a bill of exchange, called usance bill, mentioning the period of payment, is drawn on the purchaser and is accepted by him. The outstanding amount is shown in the accounts as 'bills receivables'.

The terms used in bills finance are **purchase, discount and negotiation**. Normally, 'purchase' is used in case of demand bills, **'discount' in case of usance bills and 'negotiation'** in case of bills which are drawn under letters of credit opened by the purchaser’s bank.

**Non-Fund-Based Working Capital Limits**

- Guarantees
- Co-acceptance of Bills
- Letters of Credit
- Commercial Paper (CP)
- Unsecured money market instrument
- Issued in the form of a promissory note
• Introduced in India in
• Cost of borrowing through CP is normally lower compared to other sources of short term finances

**Guidelines of RBI for Discounting / Rediscounting of Bills by Banks**

• Banks may sanction working capital limits, as also bills limit, to borrowers after proper appraisal of their credit needs and in accordance with the loan policy as approved by their Board of Directors.

• Banks should open letters of credit (L Cs) and purchase / discount / negotiate bills under L Cs only in respect of genuine commercial and trade transactions of their borrower constituents who have been sanctioned regular credit facilities by the banks.

• If a beneficiary of the LC wants to discount the bills with the LC issuing bank itself, banks may discount bills drawn by beneficiary only if the bank has sanctioned regular fund-based credit facilities to the beneficiary.

• Bills purchased/discounted/negotiated under LC will be treated as an exposure on the LC issuing bank and not on the borrower.

• While purchasing / discounting / negotiating bills under LCs or otherwise, banks should establish genuineness of underlying transactions/documents.

• The practice of drawing bills of exchange clausbed 'without recourse' and issuing letters of credit bearing the legend 'without recourse' should be discouraged because such notations deprive the negotiating bank of the right of recourse it has against the drawer under the NI Act.

• Accommodation bills should not be purchased/discounted/negotiated by banks.

• Banks should be circumspect while discounting bills drawn by front finance companies set up by large industrial groups on other group companies.

• Bills rediscounts should be restricted to usance bills held by other banks.

• Banks may exercise their commercial judgment in discounting of bills of the services sector.

**Factoring**

• Method of financing the receivables of a **business enterprise**.

• The financier is called **'Factor'** and can be a financial institution.
• Banks are not permitted to do this business themselves but they can promote subsidiaries to do this. **Under factoring, the factor not only purchases the book debts/receivables of the client**, but may also control the credit given to the buyers and administer the sales ledger.

• The purchase of book debts/receivables can be with recourse or without recourse to the client.

• If without recourse, the client is not liable to pay to the factor in case of failure of the buyer to pay.

**Forfaiting**

• This is similar to factoring but is used only in case of exports and where the sale is supported by **bills of exchange/promissory notes**.

• **The financier discounts the bills and collects the amount of the bill from the buyer on due dates.** Forfaiting is always without recourse to the client. Therefore, the exporter does not carry the risk of default by the buyer.
Unit 4: Term Loans

Important Points about Term Loans

- **Working capital loans are normally sanctioned** for one year but are payable on demand. Term loans are payable as per the agreed repayment schedule, which is stipulated in the terms of the sanction. Therefore, for the purpose of matching assets and liabilities of the bank, term loans are considered long term assets while working capital loans are considered as short term assets.

- Banks provide term loans normally for acquiring the fixed assets like land, building, plant and machinery, infrastructure etc., (personal loans, consumption loans, educational loans etc. being exceptions)

- As a term loan is expected to be repaid out of the future cash flows of the borrower, the D S C R assumes great importance while considering term loans, while for working capital loans, the liquidity ratios assume greater importance.

- In exceptional cases, banks provide term loans for current assets This is called Working Capital Term Loan (WCTL)

- There is no uniform repayment schedule for all term loans. Each term loan has its own peculiar repayment schedule depending upon the cash surplus of the borrower.

Deferred Payment Guarantees (DPGs)

- When the purchaser of a fixed asset does not pay to the supplier immediately, but pays according to an agreed repayment schedule, and the bank guarantees this repayment, the guarantee is called DPG. This is a Non-fund based method for financing purchase of fixed assets.

Difference Between Term Loan Appraisal And Project Appraisal

The differences can be summarized as under:

- In project finance all the financial needs of the enterprise, including working capital requirements, are appraised. This is because the total requirement of long term funds includes margin money for working capital. After assessing the total requirement of long term funds, the banks decide upon the amount of term loan to be sanctioned and the contribution of the promoters.
If an existing enterprise wants to purchase a few machineries, which are not going to have a major impact on the volume or composition of the business, it will serve little purpose to have a detailed examination of techno-economic feasibility, managerial competence, IRR etc. It may be enough for the bank to examine the projections for next 2 to 3 years to find out that DSCR is at satisfactory level. In case of loans to individuals also, like housing loans, educational loans etc., it may be enough to examine the projected DSCR to judge the viability. However, the basic principles of appraisal of a project or a standalone term loan are not different and if one is clear about project appraisal, the appraisal of a standalone term loan proposal is even simpler.

**Project appraisal**

Project appraisal can be broadly taken in the following steps:

- Appraisal of Managerial Aspects
- Technical Appraisal
- Economic Appraisal

**Appraisal of Managerial Aspects:** The appraisal of managerial aspects involves seeking the answer to the following questions:

- What are the credentials of the promoters’?
- What is the financial stake of promoters in the project? Can they bring additional funds in case of contingencies arising out of delay in project implementation and changes in market conditions?
- What is the form of business organization? Who are the key persons to be appointed to run the business?

**Technical Appraisal:** The technical feasibility of a project involves the following aspects:

- Location
- products to be manufactured, production process
- availability of infrastructure
- provider of technology
- details of proposed construction
- contractor for project execution
- waste-disposal and pollution control
- availability of raw materials
• marketing arrangements

**Economic Appraisal:** The economic or financial feasibility of a project involves the following aspects:

• **Return on Investment:** The usual methods used are the NPV, IRR, payback period, cost benefit ratio, accounting rate of return etc.

• **Break-even Analysis:** A project with a high break-even point is considered more risky compared to the one with lower break-even point.

• **Sensitivity Analysis:** As market conditions are uncertain, a small change in the prices of raw materials or finished goods may have a drastic impact on the viability of a project. Sensitivity analysis examines such impact.

**Appraisal and Financial of Infrastructure projects**

• Transport
• Energy
• Water & Sanitation
• Communication
• Social and Commercial Infrastructure

**Types of Financing by Banks**

• Take-out Financing
• Inter-institutional
• Financing Promoter’s Equity

**Appraisal**

• In respect of financing of infrastructure projects undertaken by Government owned entities, banks or Financial Institutions should undertake due diligence on the viability of the projects. Banks should ensure that the individual components of financing and returns on the project are well defined and assessed. State government guarantees may not be taken as a substitute for satisfactory credit appraisal and such appraisal requirements should not be diluted on the basis of any reported arrangement with the Reserve Bank of India or any bank for regular standing instructions or periodic payment instructions for servicing the loans or bonds.

• Infrastructure projects are often financed through Special Purpose Vehicles. Financing of these projects would, therefore, call for special appraisal skills on the
part of lending agencies. Identification of various project risks, evaluation of risk mitigation through appraisal of project contracts and evaluation of creditworthiness of the contracting entities and their abilities to fulfill contractual obligations will be an integral part of the appraisal exercise.

- In this connection, banks or Financial Institutions may consider constituting appropriate screening committees or special cells for appraisal of credit proposals and monitoring the progress or performance of the projects.

**Prudential Requirements**

- Prudential Credit Exposure Limits
- Assignment of Risk Weight for Capital Adequacy Purposes
- Asset Liability Management
- Administrative arrangements

**Take-out Financing or Liquidity Support**

- Take-out Financing or Liquidity Support
- Liquidity support from IDFC

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Unit 5: Credit Delivery

Credit Delivery

Documentation

- The documents should be properly stamped
- The date of execution of documents should never be earlier than the date of stamping. Date and place of execution should be properly mentioned in the documents.
- It should be ensured that the parties executing the documents have the necessary authority and the capacity to enter into a contract and executed the documents in that capacity. For example, a partner should sign on behalf of the firm and not in his individual capacity.
- It should be ensured that the person signing the documents is doing so with his free will
- The documents should be filled in before these are signed.
- In case of companies, the charge should be registered with ROC. Within 30 days from the date of execution of the documents.
- If any document is required to be registered with the Sub-registrar, it should be done within the prescribed time limit.

Third Party Guarantees

- While the enterprise or individual, who has taken the loan from the bank is legally bound to repay the principal and the interest, in some cases, banks stipulate guarantees of third parties, as an additional safety against default.
- These third parties can be individuals or any other legal entity. In case of finance to firms, the personal guarantee of proprietor or partners is not stipulated as they have unlimited liability and their personal assets can be attached for recovery of bank loans.
Charge Over Securities

- Mortgage
- Hypothecation Pledge
- Lien
- Assignment
- Pledge

Disbursal of Loans

Working Capital Loans

In case of sole banking, the bank providing working capital limits opens a cash credit account of the borrower and all his financial transactions should be routed through this account. Without bank's permission, no account can be opened with any other bank. Banks give permission to open current account with other bank only if they are convinced about its necessity. In such cases, periodic statements of that account are obtained to keep a tab on the transactions.

With this, if the borrower wants to draw very little amount or no amount, there will be debit in the loan account (fixed amount) while the cash credit account may have credit balance. RBI guidelines in this respect are as follows:

- In the case of borrowers enjoying working capital credit limits of Rs 10 crore and above from the banking system, the loan component should normally be 80 percent. Banks, however, have the freedom to change the composition of working capital by increasing the cash credit component beyond 20 percent or to increase the 'Loan Component' beyond 80 percent, as the case may be, if they so desire. Banks are expected to appropriately price each of the two components of working capital finance, taking into account the impact of such decisions on their cash and liquidity management.
- In the case of borrowers enjoying working capital credit limit of less than Rs. 10 crore, banks may persuade them to go in for the 'Loan System' by offering an incentive in the form of lower rate of interest on the loan component, as compared to the cash credit component. The actual percentage of 'loan component' in these cases may be settled by the bank with its borrower clients.
- In respect of certain business activities, which are cyclical and seasonal in nature or have inherent volatility, the strict application of loan system may create difficulties for the borrowers. Banks may, with the approval of their respective Boards, identify such business activities, which may be exempted from the loan system of delivery.

Term loans

RBI guidelines in respect of disbursement of project loans are as under:

'At the time of financing projects banks generally adopt one of the following methodologies as far as determining the level of promoters' equity is concerned.
Promoters bring their entire contribution upfront before the bank starts disbursing its commitment. Promoters bring certain percentage of their equity (40% — 50%) upfront and balance is brought in stages. Promoters agree, ab initio, that they will bring in equity funds proportionately as the banks finance the debt portion.

**Syndication of Loans**

The term 'Syndication' is normally used for sharing a long-term loan to a borrower by two or more banks. This is a way of sharing the risk, associated with lending to that borrower, by the banks and is generally used for large loans. The borrower, intending to avail the desired amount of loan, gives a mandate to one bank (called **Lead bank**) to arrange for sanctions for the total amount, on its behalf. The **lead bank approaches various banks** with the details. These banks appraise the proposal as per their policies and risk appetite and take the decision. The lead bank does the liaison work and common terms and conditions of sanction may be agreed in a meeting of participating banks, arranged by the lead bank. Normally, the lead bank charges *Syndication fee* from the borrower.

**Unit 6: Credit Control and Monitoring**

**Important and Purpose**

Credit control and monitoring, often referred as Loan Review Mechanism (L R M), plays an important role in the following aspects:

- To ensure that the funds provided by the bank are put to the intended use and continue to be used properly.
- To ascertain that the business continues to run on the projected lines.
- If the deterioration of the business continues despite appropriate action, the bank should decide if any harsh action like, recalling the advance or seizing the security, etc. is necessary.

**Available Tools for Credit Monitoring / LRM**

- Conduct of the Accounts with the Bank
- Periodic Information Submitted as per the Terms of the Advance
- Audit of Stocks and Receivables Conducted by the Bank
- Financial Statements of the Business, Auditors’ Report
• Periodic Visits and Inspection
• Interaction
• Periodic Scrutiny
• Market Reports about the Borrower and the Business Segment
• Appointing Bank’s Nominee on Company’s Board
• Credit Audit
• Document Audit of title documents in respect of large value loan accounts (RBI circular dated June 7, 2013)

**Unit 7: Risk Management and Credit Rating**

**Credit Risk Monitoring**

*The risks faced by the business of banking can be classified into three broad categories;*

• **Operational Risks:** The examples of such risks are losses due to frauds, disruption of business due to natural calamities like floods etc.

• **Market Risks:** These are the risks resulting from adverse market movements of interest rates, exchange rate etc.

• **Credit Risks:** The credit risk can be defined as the unwillingness or inability of a customer or counterparty (e.g. the L C opening bank in a bills negotiation transaction under that L C) to meet his commitment relating to a financial transaction with the bank.

**Factors Affecting Credit Risk**

• **External Factors:** These factors affect the business of a customer and reduce his capability to honor the terms of financial transaction with the bank. The main external factors affecting the overall quality of the credit portfolio of a bank are exchange rate and interest rate fluctuations, Government policies, protectionist policies of other countries, political risks, etc.

• **Internal Factors:** These mainly relate to overexposure (concentration) of credit to a particular segment or geographical region, excessive lending to cyclical industries, ignoring purpose of loan, faulty loan and repayment structuring, deficiencies in the loan policy of the bank, low quality of credit appraisal and monitoring, and lack of an efficient recovery machinery.

**Steps Taken To Mitigate Credit Risks**
The major objective of credit risk management is to limit the risk within acceptable level and thus maximize the risk adjusted rate of return on the credit portfolio. **Following are the main steps taken by any bank in this direction:**

- **Macro Level:** The risks to the overall credit portfolio of the bank are mitigated through frequent reviews of norms and fixing internal limits for aggregate commitments to specific sectors of the industry or business so that the exposures are evenly spread over various sectors and the likely loss is retained within tolerable limits. Bank also periodically reviews the loan policies relating to exposure norms to single and group borrowers as also the structure of discretionary powers vested with various functionaries.

- **Micro Level:** This pertains to policies of the bank regarding appraisal standards, sanctioning and delivering process, monitoring and review of individual proposals/categories of proposals, obtention of collateral security etc.

### Credit Ratings

The level of credit risk involved in each loan proposal depends on the unique features of that proposal. Two similar projects, with different promoters, may be appraised by a bank as having different credit risks. Similarly, two different projects, with same promoters, may also be appraised by the bank as having different credit risks. While appraising a credit proposal, the risk involved is also measured and often quantified by way of a rating with the following objectives:

- To decide about accepting, rejecting or accepting with modifications/ special covenants
- To determine the pricing, i.e. the rate of interest to be charged
- To help in the macro evaluation of the total credit portfolio by classifying it on the ratings allotted to individual accounts. This is used for assessing the provisioning requirements, as also a decision making tool, by the management of the bank, for reviewing the loan policy of the bank.

### Internal and External

- Most of the banks in India have set up their own credit rating models as till recent past, the rating agencies were not equipped well enough to provide the ratings, so reliable as to banks depending on these for credit decisions. However, with experience gained in last few years, these rating agencies have gained confidence of the banks.

- A few of such rating agencies are **CARE, ICRA, CRISIL and SMERA.**

### Methodology of Credit Rating
• Promoters/Management aspects and the securities available
• Financial aspects based on analysis of financial statements
• Business/project risks

**Use of Credit Derivatives For Risk Management**

• **Credit Default Swaps (CDSs):** This is a bilateral contract in which the risk seller (lending bank) pays a premium to the buyer for protection against credit default or any other specified credit event. Normally, CDS is a standardized instrument of ISDA (International Swaps and Derivatives Association).

• **Credit Linked Notes (CLN):** In this, the risk seller gets risk protection by paying regular premium to the risk buyer, which is normally a SPV which issued notes linked to the underlying credit. These notes are purchased by the general investors and the money received from them is used by the SPV to buy high quality securities.

**Credit Information System**

**Credit Information Companies (CIC’s)**

• CIC or Credit Information Company is an independent third party institution that collects financial data regarding loans, credit cards and more about individuals and shares it with its members. Banks, Non-Banking Financial institutions are usually the customers of Credit Information Companies.

• The Credit Card Company collects financial information about all these individuals and forms a credit report based on their financial history. This credit report plays a very important role as it helps banks and other financial institutions determine the creditworthiness of an individual applying for a loan or credit card with them.

**Credit Information Companies Regulation Act (CIC Act)**

• Credit Information Companies in India are licensed by the Reserve Bank of India and governed by the Credit Information Companies Regulation Act, 2005 and various other rules and regulations issued by the Reserve Bank of India.

• The CIC Act, 2005 is a legislation that is enacted by the Government of India, in order to regulate the actions of the Credit Card Companies in India. Following the CIC Act, 2005, the RBI and the Government of India enacted the CIC Act, 2006.

**List of Credit Information Companies In India**

There are exactly four well known CICs in India as of now. Given below is a list of CICs in India:

• CIBIL
• Equifax
Rules and regulations for CIC’s

The actions of Credit Information Companies is regulated by the *Credit Information Companies Regulation Act, 2005*, enacted by the Government of India. Following the CIC Act of 2005, the RBI and the Government of India followed up with the Credit Information Companies, *Regulations and Rules Act, 2006*.

According to the Act, only certain entities are allowed to be members of the Credit Information Companies. Given below is a list of entities that can be members of CICs.

- Credit Institutions under *Section 2(f) of CIC Act*.
- Credit information companies under *section 2(e) of the CIC Act*.

A CIC, a credit institution or any authorised individual can request for a credit report anytime. A CIC will adapt to a format approved by RBI during such instances and furnish the requested information within a given time.

If there is any dispute between the CIC and its member related to credit information, the dispute shall be settled by conciliation under the as provided in the *Arbitration and Conciliation Act, 1996*.

**Unit 8: Rehabilitation/ Rehabilitation and Recovery**

**Credit Default/Stressed Assets/NPAs**

Credit default means the inability or the unwillingness of a customer or counterparty to meet commitments in relation to lending, trading, or any financial transactions. 

*This may take the following forms;*

- **In the case of direct lending**: principal and/or interest amount may not be repaid as per the terms of repayment.
- **In the case of guarantees or letters of credit**: funds may not be forthcoming from the constituents upon crystallization of the liability;
- **In the case of treasury operations**: the payment or series of payments due from the counter parties under the respective contracts may not be forthcoming or ceases;
- **In the case of securities trading businesses**: funds/securities settlement may not be effected;
- **In the case of cross-border exposure**: the availability and free transfer of foreign currency funds may either cease or restrictions may be imposed by the sovereign.

**Non Performing Assets (NPAs)**
As per RBI directives, banks in India have to classify their assets into Performing or Standard assets or Non performing assets (NPAs). NPAs are further classified into (a) Sub-standard, (b) doubtful and (c) loss assets.

The classification is based on the period of default as also the availability of security. The amount of provision required to be made on the asset portfolio of a bank depends on its classification into the four categories of standard, sub standard, doubtful and loss.

**Willful Defaulters**

The default in payment as per agreed terms could be intentional or due to the reasons beyond the control of the borrower. The intentional default is referred to as willful default. As per RBI guidelines, a 'willful default' would be deemed to have occurred if any of the following events is noted:

- The unit has defaulted in meeting its payment or repayment obligations to the lender even when it has the capacity to honour the said obligations.
- The unit has defaulted in meeting its payment or repayment obligations to the lender and has not utilized the finance, borrowed for the specific purposes for which the finance was availed of but has diverted the funds for other purposes.
- The unit has defaulted in meeting its payment or repayment obligations to the lender and has siphoned off the funds so that the funds have not been utilized for the specific purpose for which finance was availed of, nor are the funds available with the unit in the form of other assets.
- The unit has defaulted in meeting its payment or repayment obligations to the lender and has also disposed off or removed the movable fixed assets or immovable property given by him or it for the purpose of securing a term loan without the knowledge of the bank or lender.

**Options Available To Banks for Stressed Assets**

Every credit default does not necessarily result in loss to the bank. In many cases, bank may be able to recover its dues fully. In other cases, the recovery may be with some loss or, in the worst scenario there may be no recovery at all.

The timely action and an appropriate strategy play very important role in achieving the best recovery for any stressed asset. While formulating the strategy, the bank has to keep in mind the legal system as also the social aspects prevailing in the country. Normally, a bank follows the following steps in case of a stressed asset:

- Exit from the account
- Rescheduling or Restructuring
- Rehabilitation
- Compromise
- Legal action
Write off

**Legal Action:** In cases where even the compromise does not materialize, banks have to initiate recovery proceedings. The forums available to the banks are as under;

- Government Machinery
- Civil Courts
- Lok Adalats
- Debt Recovery Tribunals (DRTs)
- SARFAESI Act, 2002

**Corporate Debt Restructuring (CDR)**

**Mechanism**

The **Corporate Debt Restructuring (CDR) Mechanism** has been designed to facilitate restructuring of advances of borrowers enjoying credit facilities from more than one bank/Financial Institution (FI) in a coordinated manner. The CDR Mechanism is an organizational framework institutionalized for speedy disposal of restructuring proposals of large borrowers availing finance from more than one bank/Fl. This mechanism will be available to all borrowers engaged in any type of activity **subject to the following conditions:**

1. The borrowers enjoy credit facilities from more than one bank or Fl under multiple banking or syndication or consortium system of lending.
2. The total outstanding (fund-based and non-fund based) exposure is Rupees 10 crores or above. **CDR system in the country will have a three tier structure**

- **CDR Standing Forum:** The CDR Standing Forum would be the representative general body of all financial institutions and banks participating in CDR system. All financial institutions and banks should participate in the system in their own interest. CDR Standing Forum will be a self-empowered body, which will lay down policies and guidelines, and monitor the progress of corporate debt restructuring.

- **CDR Empowered Group:** The individual cases of corporate debt restructuring shall be decided by the CDR Empowered Group, consisting of ED level representatives of Industrial Development Bank of India Ltd., ICICI Bank Ltd. and State Bank of India as standing members, in addition to ED level representatives of financial institutions and banks who have an exposure to the concerned company.

- **CDR Cell:** The CDR Standing Forum and the CDR Empowered Group will be assisted by a CDR Cell in all their functions. The CDR Cell will make the initial scrutiny of the proposals received from borrowers/creditors, by calling for proposed rehabilitation plan and other information and put up the matter before the CDR Empowered Group, within one month to decide whether rehabilitation is prima facie feasible.
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