



Module-C ABM

CAIIB PAPER-1

Credit Management





CAIIB Paper 1 (ABM) Module C: Credit Management

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CAIIB Paper 1 (ABM) Module C 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.

Type of Borrower	Applicable Law
Individuals	Indian Contract Act
Partnership firms	Indian Partnership Act
Hindu undivided family	Customary laws pertaining to Hindus
Companies	Companies Act
Statutory corporations	Acts that created them
Trusts	Indian Trusts Act, Public Trusts Act, Religious and Charitable Endowments Act, Wakf Act
Co-operative Societies	Co-operative Societies Act or Societies Registration Act.

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 drawals 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
- Loans to individuals up to **₹35 lakh** in metropolitan centres (with population of ten lakh and above) and up to **₹25 lakh** in other centres for purchase/construction of a dwelling unit per family provided the overall cost of the dwelling unit in the metropolitan centre and at other centres does not exceed ₹45 lakh and ₹30 lakh 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 loans to units in the KVI sector will be eligible for classification under the sub-target of **7.5 percent** prescribed for Micro Enterprises under 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)

Categories	Domestic commercial banks (excl. RRBs & SFBs) & foreign banks with 20 branches and above	Foreign banks with less than 20 branches	Regional Rural Banks	Small Finance Banks
Total Priority Sector	40 per cent of ANBC as computed in para 6 below or CEOBE whichever is higher	40 per cent of ANBC as computed in para 6 below or CEOBE whichever is higher; out of which up to 32% can be in the form of lending to Exports and not less than 8% can be to any other priority sector	75 per cent of ANBC as computed in para 6 below or CEOBE whichever is higher; However, lending to Medium Enterprises, Social Infrastructure and Renewable Energy shall be reckoned for priority sector achievement only up to 15 per cent of ANBC.	75 per cent of ANBC as computed in para 6 below or CEOBE whichever is higher.
Agriculture	18 per cent of ANBC or CEOBE, whichever is higher; out of which a target of 10 percent# is prescribed for Small and Marginal Farmers (SMFs)	Not applicable	18 per cent ANBC or CEOBE, whichever is higher; out of which a target of 10 percent# is prescribed for SMFs	18 per cent of ANBC or CEOBE, whichever is higher; out of which a target of 10 percent# is prescribed for SMFs
Micro Enterprises	7.5 per cent of ANBC or CEOBE, whichever is higher	Not applicable	7.5 per cent of ANBC or CEOBE, whichever is higher	7.5 per cent of ANBC or CEOBE, whichever is higher
Advances to Weaker Sections	12 percent# of ANBC or CEOBE, whichever is higher	Not applicable	15 per cent of ANBC or CEOBE, whichever is higher	12 percent# of ANBC or CEOBE, whichever is higher

Total Priority Sector	40 per cent of ANBC or CEOBE, whichever is higher, which shall stand increased to 75 per cent of ANBC or CEOBE, whichever is higher, with effect from March 31, 2024. UCBs shall comply with the stipulated target as per the following milestones:					
	<table border="1"> <thead> <tr> <th>March 31, 2022</th> <th>March 31, 2023</th> <th>March 31, 2024</th> </tr> </thead> <tbody> <tr> <td>50%</td> <td>60%</td> <td>75%</td> </tr> </tbody> </table>	March 31, 2022	March 31, 2023	March 31, 2024	50%	60%
March 31, 2022	March 31, 2023	March 31, 2024				
50%	60%	75%				
Micro Enterprises	7.5 per cent of ANBC or Credit Equivalent Amount of Off-Balance Sheet Exposure, whichever is higher					
Advances to Weaker Sections	12 per cent# of ANBC or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher.					

The weaker sections under priority sector include the following:

- Small and Marginal Farmers.
- Artisans, village and cottage industries where individual credit limits do not exceed `1 lakh.
- Beneficiaries under Government Sponsored Schemes such as National Rural Livelihood Mission (NRLM), National Urban Livelihood Mission (NULM) and Self Employment Scheme for Rehabilitation of Manual Scavengers (SRMS).



- Scheduled Castes and Scheduled Tribes.
- Beneficiaries of Differential Rate of Interest (DRI) scheme.
- Self Help Groups.
- Distressed farmers indebted to non-institutional lenders.
- Distressed persons other than farmers, with loan amount not exceeding `1 lakh per borrower to prepay their debt to non-institutional lenders.
- Individual women beneficiaries up to `1 lakh per borrower.
- Persons with disabilities.
- Overdraft availed by PMJDY account holders as per limits and conditions prescribed by Department of Financial Services, Ministry of Finance from time to time.
- Minority communities as may be notified by Government of India from time to time.

MSMED Act 2006

Composite Criteria : Investment And Annual Turnover			
Classification	Micro	Small	Medium
Manufacturing & Services	Investment < Rs. 1 cr. and Turnover < Rs.5 cr.	Investment < Rs. 10 cr. and Turnover < Rs.50 cr.	Investment < Rs. 20 cr. and Turnover < Rs. 250 cr.

Common guidelines for priority sector loans

Banks should comply with the following common guidelines for all categories of advances under the priority sector.

- **Rate of interest:** The rates of interest on bank loans will be as per directives issued by Department of Regulation (DoR), RBI from time to time.
- **Service charges:** No loan related and ad hoc service charges/inspection charges should be levied on priority sector loans up to ₹25,000. In the case of eligible priority sector loans to SHGs/ JLGs, this limit will be applicable per member and not to the group as a whole.
- **Receipt Sanction/Rejection/Disbursement Register:** A register/ electronic record should be maintained by the bank wherein the date of receipt, sanction/rejection/disbursement with reasons thereof, etc. should be recorded. The register/electronic record should be made available to all inspecting agencies.
- **Issue of acknowledgement of loan applications:** Banks should provide acknowledgement for loan applications received under priority sector loans. Bank Boards should prescribe a time limit within which the bank communicates its decision in writing to the applicants.

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

Asset Classification

In terms of Reserve Bank of India guidelines, all advances are required to be reviewed and classified into two principal categories at regular intervals as follows:

(a) Performing Assets or Standard Assets, i.e., where the advances are earning interest income on an actual realisation basis. This includes regular and temporarily irregular accounts, as specified from time to time by the RBI.

(b) Non-Performing Assets (NPA), i.e., where advances are not earning interest on an actual realisation basis. An asset, including a leased asset, is considered as non-performing when it ceases to generate income for the bank. This includes irregular accounts and sticky accounts with deep-seated irregularities. A loan or an advance accounts will be considered as NPA where:

- Interest and/or installment of principal remain overdue for a period of more than 90 days in respect of a term loan.
- The account remains 'out of order' in respect of an Overdraft/Cash Credit (OD/CC).
- The bill remains overdue for a period of **more than 90 days** in the case of bills purchased and discounted,
- The installment of principal or interest thereon remains overdue for two crop seasons for short duration crops in respect of agriculture loan and advances,
- The installment of principal or interest thereon remains overdue for one crop season for long duration crops in respect of agriculture loan and advances,
- In respect of derivative transactions, the overdue receivables representing positive mark-to-market value of a derivative contract, **if these remain unpaid for a period of 90 days from the specified due date for payment.**



- In case of interest payments, banks should, classify an account as NPA only if the interest due and charged during any quarter is not serviced fully within 90 days from the end of the quarter.

Categories of NPAs

Banks are required to classify non performing assets further into the following three categories based on the period for which the asset has remained non performing and the reliability of the dues:

- **Substandard Assets:** A substandard asset would be one, which has remained NPA for a period less than or equal to 12 months. Such an asset will have well defined credit weaknesses that jeopardise the liquidation of the debt and are characterised by the distinct possibility that the banks will sustain some loss, if deficiencies are not corrected.
- **Doubtful Assets:** An asset would be classified as doubtful if it has remained in the substandard **category for a period of 12 months**. A loan classified as doubtful has all the weaknesses inherent in assets that were classified as sub-standard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable. When the realizable value of the security is less than 50 per cent of the value assessed by the bank or accepted by RBI at the time of last inspection, as the case may be, such NPAs may be straightaway classified under doubtful category.
- **Loss Assets:** A loss asset is one where loss has been identified by the bank or internal or external auditors or the RBI inspection, but the amount has not been written off wholly. In other words, such an asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted although there may be some salvage or recovery value. If the realizable value of the security, as assessed by the bank/approved valuers/**RBI is less than 10 per cent** of the outstanding in the borrowal accounts, the existence of security should be ignored and the asset should be straightaway classified as loss asset.

Provisioning Norms

The Banks are required to make certain amount of provision on standard assets on fund based outstanding as follows:

- Farm credit for Agriculture Activities: 0.25%
- Advances to Small and Micro Enterprises: 0.25%
- Advances to Commercial Real Estate (CRE) Sector: 1%
- Advances to Commercial Real Estate-Residential Housing Sector (CRE-RH): 0.75%
- All other loans and advances not included above including advances to Medium Enterprises: 0.40% The normal provisioning requirement, and the accelerated provisioning in respect of NPA accounts are as follows:



Asset Classification	Period of NPA	Normal provisioning (%)	Accelerated provisioning (%)
Sub-Standard (Secured)	Up to 6 months	15	15
	6 months to 1 year	15	25
Sub-Standard (Unsecured ab initio)	Up to 6 months	25 (Other than infra loans)	25
		20 (Infrastructure Loans)	
	Above 6 months	25 (Other than infra Loan)	40
		20 (Infrastructure Loans)	
Doubtful I	2nd Year	25 (secured portion)	40 (secured portion)
		100 (unsecured portion)	100 (unsecured portion)
Doubtful II	3rd & 4th Year	40 (secured portion)	100 both secured and unsecured portion
		100 (unsecured portion)	
Doubtful III	5th year onwards	100	100
Loss Assets	Ab Initio	100	100

Modification in Extent of Guarantee Cover

In order to enhance the effectiveness of the Credit Guarantee Scheme for Financial inclusion programme and create greater support to underserved/weaker segments, the extent of guarantee cover for credit facility has been increased to 85% for ZED certified MSEs, units under Aspirational District, Women & SC/ST Entrepreneurs.

The trust shall provide guarantee coverage as under:

Category (including trading activity)	Maximum extent of Guarantee Coverage		
	Where credit facility is		
	Up to ₹ 5 Lakhs	Above ₹ 5 Lakhs & Up to ₹ 50 Lakhs	Above ₹ 50 Lakhs & Up to ₹ 200 Lakhs
Micro Enterprises	85%	75%	75%
MSEs located in North East Region (incl. Sikkim)	80%		
Women Entrepreneurs	85%		
MSEs situated in Aspirational District	85%		
ZED certified MSEs	85%		
SC/ST Entrepreneurs	85%		
All other category of borrowers	75%		

Aligning Guarantee for Retail/Wholesale Trade with Other Segments



Retail/Wholesale Trade is an eligible activity under Credit Guarantee Scheme with an exposure limit up to 100 Lakhs. In view of growing credit needs of MSEs under trading activity, it has been decided to align trading activity (MSE Retail Trade & Wholesale Trade) with other activities of CGS-I in respect of the following parameters:

- Ceiling of credit guarantee cover increased from ` 100 Lakhs to ` 200 Lakhs.
- Extent of Guarantee Coverage at par with other activities.
- Rate of Annual Guarantee Fee at par with other activities. The revised extent of guarantee coverage shall not be applicable in case of enhancement of existing working capital accounts already covered under Guarantee scheme and shall remain 50%.

CAIIB Paper 1 (ABM) Module C 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 and 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)

Cash Flow Statement

- It is critical to evaluate the ability of an enterprise to generate cash and cash equivalents along with the timing and certainty of their generation. It is in this



context that a need has been felt to reiterate the insights which can be derived from proper analysis of Cash Flow Statement (CFS) in understanding the financial capability of an enterprise.

- It states the movement of cash and cash equivalents, into or out of, a business during a given period of time. It narrates the travelogue of opening cash balance at the beginning of the period in its journey to reach the closing cash balance at the end. Cash comprises cash on hand and demand deposits with the Banks, while cash equivalents are short-term and highly liquid instruments readily convertible into cash at any time, without any significant erosion in value.

The following are the components of cash flow:

- **Operating Cash Flows:** Cash received or expended for conducting business operations including expenses therefor. On netting the expenses from receipts, the resultant figure should be positive for the company to remain solvent.
- **Investment Cash Flows:** Cash receipts and expenses, other than for or from operations, in the nature of long term. But this does not include transactions relating to capital and debt.
- **Financing Cash flows:** Cash transactions relating to capital and debt. This is the story of financing the company.

Use of Cash Flow Statement (CFS)

- CFS speaks about the alignment between profitability and net cash flow.
- CFS speaks about the deepness of the pocket the business has.
- CFS speaks about the accuracy of past assessment of future cash flows in terms of the amount, timing and certainty of future cash flows and, thereby, provides insights into operational efficiency of the business during given period against the corresponding past period;
- CFS speaks about the acceptability of income accounted as per accrual concept.
- CFS speaks about the ability of the business to meet in time a specific and sure cash out flows like repayment of an ad-hoc loan or retirement of a usance LC, etc.

Funds Flow Statement

- Each item in the balance sheet represents either source of funds or use of funds. All items on the liabilities side represent the funds provided to the enterprise and all items on the assets side (except cash) represent use of these funds.
- Cash in the balance sheet represents the unutilised portion of funds, available to the enterprise. If cash is also perceived as a use of funds then all the uses of funds are equal to all the sources of funds.
- This perception of available cash, as a use of funds, is what causes the wide spread confusion about difference in a Funds flow statement and a Cash flow statement. When we compare two balance sheets of different dates, change in each item (or introduction of a new item) in the balance sheet of later date, as compared to that item in the balance sheet of earlier date, will represent either addition of funds or additional use of funds in the intervening period.
- Any increase in any item on the liabilities side means additional funds available.



Projected Financial Statements

- Actual financial statements are for the past period and analysis of these gives very useful financial information to the banker. But for assessing the need for bank credit and to examine the viability of the activity, it is necessary to anticipate the financial position of the enterprise in future.
- For example, for assessing the working capital needs, the statement of assets and liabilities of the last year will not be adequate. We will have to anticipate the level of operations during the current year and accordingly project the level of assets and liabilities to arrive at the need for bank's loan.
- Of course, the financial statements for the past period serve as the most important guide for this estimate. Also, in case of a new enterprise, where no financial statements are available, it becomes necessary to decide on a level of activity and accordingly prepare the projected financial statements.
- Generally, in case of smaller enterprises, where adequate financial expertise may not be available, the projected financial statements for the next year are prepared by the bank by interviewing the concerned person.
- In case of term loans for new projects/ expansion, the projected financial statements are normally prepared for the entire duration of bank loan to establish the viability of operations as also to determine the disbursement and repayment schedule.
- Whenever the projected financial statements are submitted by the borrower, these are critically examined for their reasonability and if projections are considered to be unreasonable, the matter is discussed with the borrower and suitable consensus arrived at.

Purpose Of Analysis Of Financial Statements By Bankers

- Assessment of Performance and Financial Position
- Projection of Future Performance
- Detecting Danger Signals
- Assessment of Credit Requirements
- Cross Checking

Rearranging The Financial Statements For Analysis

In keeping with the above objectives, a banker rearranges the figures in the financial statements under distinct groups for a meaningful analysis.

Balance Sheet

The assets and liabilities are normally regrouped as follows:



Liabilities	Assets
Tangible net worth (shareholders' funds)	Fixed assets
Long-term Liabilities	Current assets,
Current liabilities and provisions	Non-current assets

A Balance Sheet, when analysed by a credit officer would look like as follows:

		Liabilities	Assets	
Short-term Sources [Current Liabilities]		WC finance availed [BF]	Total Current Assets [TCA]	Short-term Uses
		Other Current Liabilities [OCL]		
Long-term Sources	TL	Term Liabilities	NWC	Long-term Uses
			Fixed Assets	
	Net Worth	Reserves and Surpluses	Other Non-Current Assets	
Paid Up Capital				

P&L Account

The format prescribed under erstwhile Credit Monitoring Arrangement (CMA), under which banks used to report sanction of large credit proposals to RBI, still serves as a useful guide for rearranging the items in P&L account. The important groups of items are as follows:

	Last year	This year
1. Gross sales		
2. Less GST/VAT/Duty components		
3. Net Sales		
4. cost of sales		
i. Raw materials		
ii. Power and fuel		
iii. Direct labour		
iv. Other manufacturing expenses		
v. Depreciation		
vi. sub total		
vii. Add opening stocks		
viii. Less closing stocks		
ix. Total cost of sales		
5. Selling, general and administrative expenses		
6. Operating profit		
7. Interest		
8. Operating profit after interest		
9. add non operating income		
10. less non operating expenditure		
11. Profit Before Tax (PBT)		
12. Tax		
13. Profit After Tax (PAT)		

Important Points for Rearranging Financial Statements



While rearranging the financial statements, the following points should be examined by the banker and suitable changes made in different items:

- Instalment of term loans due within one year
- Advance tax/provision of tax
- Deferred tax assets and liabilities
- Non moving inventory
- Receivables more than 6 months old
- Revaluation of assets and Intangible assets
- Investments and that in and loans/advances to associates and subsidiaries
- Bills purchased/discounted
- Contingent liabilities
- Provisioning
- Depreciation method
- Inventory valuation
- Expenses relating to earlier years
- Important events after account period.

Techniques Used In Analysis Of Financial Statements

Bankers mostly use three methods for analysis of financial statements

- Funds Flow Analysis
- Trend Analysis
- Ratio Analysis

Funds Flow Analysis

- Funds Flow statement is not part of Financial Statements nor a return certified by auditor. It is a requirement of the lenders to trace diversions, if any. However, while submitting the estimates for current year and projections for next year, most companies use the model of CMA format, which contains Funds Flow statement also.
- If the borrower has not submitted the funds flow statement, bank prepares the same from the last two balance sheets. The total sources of funds are categorised as '**Long term**' and '**Short term**'. Similarly, the total uses are also categorised as '**Long term**' and '**Short term**'. If the short-term sources are more than the short-term uses, (correspondingly long-term uses are more than long-term sources), it indicates diversion of working capital funds and needs to be probed further.

Trend Analysis

Under trend analysis, bankers adopt the following methodology:

- The items, for which trend is required to be seen, are arranged in vertical form, with actual figures of past two years, ensuing year's estimates and next year's projections on the right side of it. The percentage increase (decrease) from the previous year's figure is indicated below it. Generally, this is used to see the trends of sales, operating profit, PBT, PAT, etc. from P&L account. Similarly, the



balance sheet items, arranged in vertical order give the trends of increase or decrease of various items.

- Common Size Statements are prepared to express the relationship of various items to one item in percentage terms. For example, consumption of raw materials is expressed as a percentage of sales for different years and comparison of these figures gives indication of trend of operating efficiency.

Ratio Analysis

- This is the most favourite method of bankers for analysis of financial statements. A ratio is comparison of two figures and can be expressed as a percentage (e.g., profitability is 23.7 per cent), as a number (e.g., current ratio is 1.33) or simply as a proportion (e.g., debt equity is 1:2).
- Both the figures, used in calculation of a ratio, can be from either P&L account, or balance sheet or one can be from P&L account and the other from balance sheet. Ratios help in comparison of the financial performance and financial position of an entity with other entities, as also for comparison with its own status over the years. While different users of financial statements are interested in different ratios, the ratios which interest a banker most, are the following:

Liquidity Ratios

- Current Ratio is the indicator of liquidity, that is the ability to meet commitments in time. It is expressed as simple ratio by dividing Total Current Assets by Total Current Liabilities and is benchmarked normally to 1.33: 1, where the 0.33 over 1 is the surplus of Long Term Sources over Long Term Uses, technically called the Net Working Capital [NWC]
- NWC Ratio gives the long term support available to build-up on current assets, indicating margin available over CL to finance current assets. Expressed in per cent, the formula is $NWC/TCA \times 100$.

Profitability Ratios



1. Raw Material Consumption to Cost of Production Ratio gives the sensitivity of Raw Material Price (the most price-sensitive input of production) on the Cost of Production. The formula is $\frac{\text{Value of RM Consumed}}{\text{Cost of Production}} \times 100$.
2. PBT Ratio gives the share of Profit Before Tax in the sales revenue and is arrived at by formula $\frac{\text{Profit Before Tax}}{\text{Net Sales}} \times 100$. This gauges profitability efficiency of the unit.
3. PAT Ratio gives the share of owner's earnings in sales revenue by using formula $\frac{\text{Profit Before Tax}}{\text{Net Sales}} \times 100$
4. EBIDTA Margin Ratio is an important financial performance indicator and measure of unit's operating performance. The ratio is arrived at by using formula: $\frac{\text{EBIDTA, i.e., PAT + Interest + Depreciation + Tax + Amortisation}}{\text{Net Sales}} \times 100$
5. Return on Capital Employed or ROCE, used to measure operating performance in relation to the total capital employed in business, is calculated by a formula $\frac{\text{EBIDTA}}{\text{Total of Asset Side of Balance Sheet}} \times 100$.
[Different formulae are given by different academicians for calculating ROCE. However, the most accepted one is above, where the EBIDTA, the operating result plus other income is tested against total amount employed in different assets to generate that EBIDTA].
6. Operating Profit Ratio is calculated by $\frac{\text{Operating Profit}}{\text{Net Sales}} \times 100$. Here, non-operative income and non-operative expenses are weeded out to arrive at the true profitability of the business without them, which need not repeat every year.

Leverage Ratio or Solvency Ratio or Gearing Ratios

1. The ratio of owner's funds to borrowed funds is calculated by different schools in different way. Most accepted one is $\frac{\text{Total Outside Liability}}{\text{Tangible Net Worth}}$ where TOL is sum of Term Liabilities and Current Liabilities and 'TNW' is Net Worth *minus* Intangible Assets. It is expressed as number of times. More conservative approach is to eliminate from the TNW the loans, advances and investments to or in Group/Associate/Subsidiary Companies as those monies have gone out of the system while some of the risk elements across the entities are common. The formula is $\frac{\text{Total Outside Liability}}{\text{Adj. Tangible Net Worth}}$ where 'Adjusted Tangible Net Worth' is TNW *minus* loans, advances and investments in Group/Associate/Subsidiary Companies.
2. Debt Equity Ratio has two connotations. One is that the ratio between debt and margin for a project. It is arrived by is $\frac{\text{Debt Component in Means of Finance}}{\text{Margin Component of Means of Project}}$ and is expressed as plain vanilla ratio of numerator : denominator. Long Term Debt/Net worth is the ratio widely used as an indicator of solvency of an existing company. DE Ratio is also used to assess the solvency of a company as a whole, especially by financial analysts and media analysts. For them, the formula is $\frac{\text{Total Outside Liability}}{\text{Net Worth}}$ and again expressed as a plain ratio.

Coverage Ratios



Debt Service Coverage Ratio: It is measurement of a unit's ability to service payment obligation of term debts out of its future earnings. There are two variants, vis, Net DSCR and Gross DSCR, of which the former assesses ability to service instalments while the latter assesses ability to service instalments plus interest. The formula to calculate Net DSCR is:

$$\frac{\text{Cash Accrual, that means Net Profit plus Non-Cash Expenses}}{\text{ETL Instalments of all TLs due during corresponding period}}$$
 and the formula for Gross DSCR calculation is:

$$\frac{\text{Cash Accrual} + \text{Interest on all term loans}}{\text{ETL Instalments on all TLs due during corresponding period} + \text{Interest on all term loans}}$$

As we need to assess the capacity to service interest as well, it needs to be in the denominator. Also, the Net Profit on the numerator is arrived at after reckoning interest, which we are testing for repayment ability. Therefore, it needs to be added back on the numerator also, to neutralise the effect, that is,

$$\frac{\text{Interest on all TL}}{\text{Interest on all TL}} = 1.$$

Vanquish Ratio: Term debts are to be discharged over a period of time by earnings of the same period. EBIDTA is used to service long term debt and as such, at any point of time, we can assess the number of years by which, at the present level of EBIDTA, the entire long term debt can be wiped off, or can vanquish, using formula:

$$\frac{\text{Long Term Debt}}{\text{EBIDTA}}$$

Interest Coverage Ratio is to know the relation between earnings and interest pay outs by using formula
$$\frac{\text{EBIDTA}}{\text{Interest on all borrowings}}$$
.

Fixed Asset Coverage Ratio is arrived at to know the value of security as number of times of debt. The formula used is
$$\frac{\text{Written Down Value of Fixed Assets Under Charge}}{\text{Outstanding in TL the Fa secure}}$$
. This is a perspective from debt side to assess how many times it is secured by fixed assets.

Security Margin Coverage Ratio is also arrived using the same variables used to calculate FACR. But the difference is that the perspective is from security side and what is assessed is cushion of security available by formula's
$$\frac{\text{WDV of FA-TL outstanding}}{\text{WDV of FA}} \times 100.$$

Holding Ratios or Turnover Ratios:

These are basically used to assess the length of the operating cycle and amount of Working Capital Gap, that is TCA-OCL. These ratios are used to estimate the amount of TCA required and OCL available.



RM Holding Ratio = $\frac{\text{Raw Material Average Stock}}{\text{Raw Material Consumed in the Period}} \times 365$ This will give us an idea as to how many days' consumption of raw material needs to be stored as per past data. [Instead of 365, if the multiplication is done by 12, we get the same in terms of number of months instead of days].

SIP Holding Ratio = $\frac{\text{Stock in process Average Stock}}{\text{Cost of production in the period}} \times 365$. This will give us an idea as to how many days' production is held up in the form of stock in process. Production process is the time during which the direct cost is input and therefore, it needs to be related to Cost of Production.

FG Holding Ratio = $\frac{\text{Finished goods Average Stock}}{\text{Cost of sales of the period}} \times 365$. Finished goods are valued at Cost of Sales and hence the linkage. The ratio will tell us, as per past data, how many days' production had to remain with us before its sale.

Receivable Holding Ratio = $\frac{\text{Average level of S.Drs}}{\text{Gross sales of the period}} \times 365$. When we deduct GST or VAT, etc., from gross sale value, we get Net Sales value, which is taken for almost all other assessments, as in the matter of tax, we do only post office job of collecting from customers and paying to government. It is not unit's income. But in the case of Debtors, their debt to us includes tax element also. Therefore, we need to take Gross Sales and the ratio tells us how many days' sales are always remaining with the debtors unpaid to us.

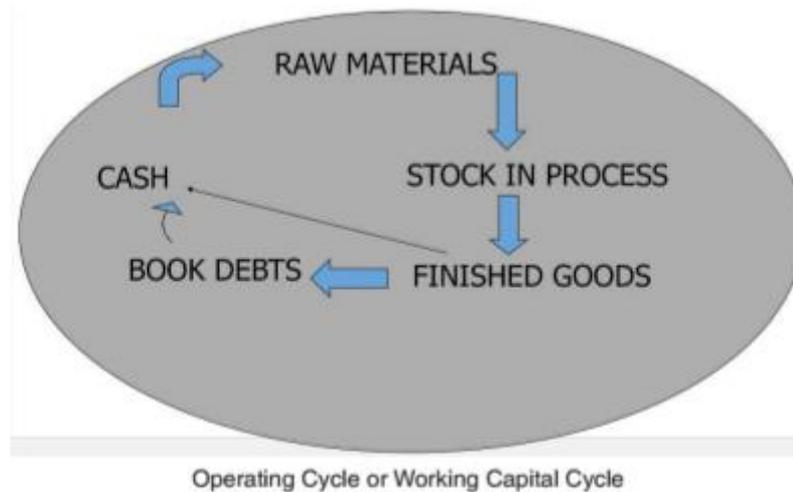
CAIIB Paper 1 (ABM) Module C Unit 3: Working Capital Finance

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 (N W C)
- 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 clause '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 rediscunts should be restricted to usance bills held by other banks.
- Banks may exercise their commercial judgment in discounting of bills of the services sector.

Letters of Credit

The genesis a letter of credit lies in the fact that a seller of good is worried about receipt of money from the buyer if she supplies the goods first, and the buyer is worried about non receipt of contracted goods if she makes the payment first. The bank acts as an intermediary between the two by using its credibility, as it is acceptable to both buyer and the seller. Letter of Credit (LC) is an undertaking by the bank, at the request of the buyer (applicant, who is customer of the bank), to the seller, to pay her the contracted amount if she supplies the goods as per the terms specified and submits the required documents, including the documents of the title of the goods. The conduct of LC business is governed by the publication no. 600 of the International Chamber of Commerce (ICC), commonly known as UCPDC 600.

Appraisal of LC Limit



An LC is used for purchase of goods either through imports or local purchase. **For assessing the LC requirement of an enterprise, we have to know the following:**

- Average Amount of Each LC: This is dependent on the monthly consumption of goods and the economic order quantity. Economic order quantity (EOQ) is estimated by examining the sources of supply, means of transport, discount, etc. In case of imports, the EOQ is often larger in comparison to indigenous purchases.
- Frequency of LC Opening: Once EOQ is estimated, the number of LCs to be opened in a year can be calculated by dividing annual consumption by EOQ. Frequency of opening LCs will be 12 divided by the number of LCs to be opened in a year.
- How many LCs will be outstanding at a particular time: The time taken for one LC to remain in force depends upon the lead time (time taken from the date of opening LC to shipment of goods), the transit time and the usance available to purchaser from the date of receipt of goods. If the frequency of opening LC is less than this, bank will have more than one LC outstanding at any point of time.

Other Issues Related To Working Capital Finance

Commercial Paper

- Commercial Paper (CP), an unsecured money market instrument issued in the form of a promissory note, was introduced in India in 1990 with a view to enabling highly rated corporate borrowers to diversify their sources of short-term borrowings. Subsequently, primary dealers (PDs) and all-India financial institutions (FIs) were also permitted to issue CP to enable them to meet their short-term funding requirements.
- A company would be eligible to issue CP provided its tangible net worth is not less than Rs. 4 crores, it has been sanctioned working capital limit by bank/s or FIs; and the account is classified as a Standard Asset by the financing bank/institution.
- The minimum credit rating for issuance of CP is 'A3' as per rating symbol and definition prescribed by SEBI CP shall be issued for maturities between a **minimum of 7 days and a maximum of up to one year** from the date of issue. The maturity date of the CP shall not go beyond the date up to which the credit rating of the issuer is valid.

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.

Forfeiting

- 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.** Forfeiting is always without recourse to the client. Therefore, the exporter does not carry the risk of default by the buyer.
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CAIIB Paper 1 (ABM) Module C 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, I R R etc. It may be enough for the bank to examine the projections for next 2 to 3 years to find out that D S C R 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 D S C R 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

CAIIB Paper 1 (ABM) Module C 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 crone, 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.

CAIIB Paper 1 (ABM) Module C 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)



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CAIIB Paper 1 (ABM) Module C 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.

The whole credit risk factors can be summarised as follows:



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.

The following are the CRAs accredited by

Type	ECRA
Domestic	1. CARE Limited; 2. CRISIL Limited; 3. India Ratings and Research Private Limited (India Ratings) 4. ICRA Limited. 5. Brickwork Ratings India Pvt. Ltd. (Brickwork) 6. Acuite Ratings and Research Limited (earlier SMERA) 7. Infomerics valuation and Rating Pvt. Ltd
International	(a) FITCH (b) Moody's (c) Standard & Poor's

Methodology of Credit Rating

Based on its loan policies and risk perceptions, each bank has its own rating model. Common feature in all the risk models is that a score is given for different perceived risks by allotting different weightages. The sum of all these scores forms the basis for deciding on risk rating of a proposal. **Normally, the broad categories of risk areas which are scored, are:**

- 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 derivatives are used to hedge the risks inherent in any credit asset without transferring the asset itself. The hedging is comparable to insurance and comes at a cost. Therefore, if the anticipated risk does not materialise, the return from the asset will be less than what it would have been without the hedging.

While simple techniques for transferring credit-risk, such as financial guarantees, collateral security and credit insurance have been prevalent in the Indian banking industry for long, the recent innovative instruments in credit risk transfer (CRT) such as collateralised debt obligations (CDO), etc.,

- **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
- Experian

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**.

CAIIB Paper (ABM) Module C 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

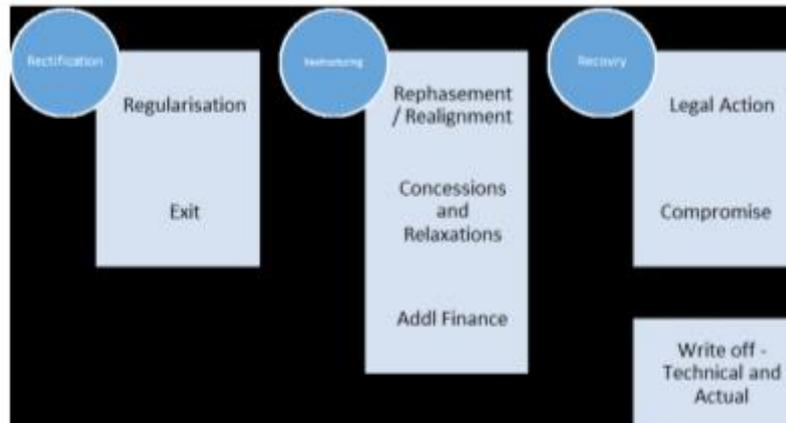
The default in payment as per agreed terms could be intentional or due to the reasons beyond the control of the borrower. **The intentional default is referred to as willful default. As per RBI guidelines, a 'willful default' would be deemed to have occurred if any of the following events is noted:**

- 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 **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/FI. This mechanism will be available to all borrowers engaged in any type of activity **subject to the following conditions:**

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



- **C D R Standing Forum:** The C D R Standing Forum would be the representative general body of all financial institutions and banks participating in C D R system. All financial institutions and banks should participate in the system in their own interest. C D R 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 E D level representatives of Industrial Development Bank of India Ltd., ICICI Bank Ltd. and State Bank of India as standing members, in addition to E D 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.

Available Frameworks For Restructuring Of Assets

Framework for Restructuring/Revival and Rehabilitation of MSMEs RBI has, vide circular dated 17-03-2016, designed a framework in order to provide a simpler and faster mechanism to address the stress in MSME accounts and to facilitate promotion and development of MSMEs. This framework has been adopted and brought into effect by the Bank. The main features of the framework are as below:

- Framework shall be applicable to all stressed MSME accounts having exposure up to Rs. 25 crores, including accounts under Consortium or Multiple Banking Arrangement (MBA).
- For resolution, a committee headed by regional or zonal head of the convener bank, will be formed. The other members of the committee are:
 - ✓ Officer-in-charge of MSME of the convener bank at the regional or zonal office level
 - ✓ An independent expert in MSME,
 - ✓ A representative from the concerned State Government and
 - ✓ Member(s) from the Consortium/MBA, in case of consortium/MBA advances. In the absence of State Government nomination, bank can induct an independent expert in the Committee, namely a retired executive of another bank of the rank of AGM and above.
- While decisions of the committee will be by simple majority of members, the Chairperson shall have the casting vote, in case of a tie.
- Based on the extant guidelines on Early Warning Signals/SMA, the branch or Credit Processing Cell (CPC) maintaining the account shall forward the stressed accounts with **aggregate loan limits above Rs. 10 lakh** to the designated committee for a suitable Resolution Plan (RP) within 5 working days.



- Recovery option under RP by Branch/CPC is to be approved by the designated Committee.
- The cases under Consortium/MBA are to be referred to the Committee of the bank which is having the largest exposure to the borrower.
- The Committee shall decide on appropriate Resolution Plan (RP). In case of restructuring, TEV study is to be got conducted mandatorily by the Committee for accounts with aggregate exposure of certain level and above as per bank's policy.
- The committee shall make suitable provisions for payment of tax or any other statutory dues in the RP and the enterprise shall take necessary steps to submit such plan to the concerned taxation or statutory authority and obtain approval for such payment plan.
- During operation period of RP, the unit shall be allowed to avail both secured and unsecured credit for its business operations as envisaged under the terms of RP.
- The options under RP by the Committee may include:
 - ✓ Rectification
 - ✓ Restructuring and
 - ✓ Recovery
- In cases of consortium/multiple banking arrangement would be considered as the basis for proceeding with restructuring of the account by the designated committee, and will be binding on all lenders.
- In case of recovery option, the minimum criteria for binding decision, if any, under any relevant laws or Acts shall be applicable.
- Provision of additional financial resources to restructure or revive, can be worked out.
- If the promoters are not in a position to bring in additional funds, the Committee may allow the unit to raise secured or unsecured loans.
- In case of failure of 'Rectification' or 'Restructuring' options, Committee shall initiate recovery option.
- Wilful defaulters shall not be eligible for restructuring. However, the Committee may review the reasons for classification of the borrower as a wilful defaulter and satisfy itself that the borrower is in a position to rectify the wilful default. The decision to restructure such cases shall have the approval of appropriate specific authority as per bank's scheme of delegation of powers.
- Cases of fraud and malfeasance are not eligible for structuring. However, in such cases where the existing promoters are replaced by new promoters, the proposal shall be put up to appropriate authority.
- In case the Committee decides for recovery action, the enterprise can seek a review of the decision and it will be examined and decided by the Committee.
- Where an application is filed by a bank and admitted by the Committee, the Committee will notify the concerned borrower about such application within 5 working days. **Within 15 working days** of receipt of such notice, borrower is required to respond or make a representation before the Committee. Borrower is also required to disclose the details of all its liabilities, including the liabilities



owed to the State or Central Government and unsecured creditors, if any. If the borrower does not respond within the above period, the Committee may proceed ex-parte (with respect to or in the interests of one side only).

- On receipt of information relating to the liabilities of the borrower, the Committee may send notice to such statutory creditors as disclosed by the borrower as it may deem fit, informing them about the application under the framework and permit them to make a representation regarding their claims before the Committee **within 15 working days** of receipt of such notice. It is clarified here that these information are required for determining the total liability of the unit in order to arrive at a suitable RP and not for payments of the same by the lender.
- **Within 30 days of convening its** first meeting for a specific borrower, the Committee will take a decision on the option to be adopted under the RP and notify the borrower about such a decision within 5 working days from the date of such decision.
- If the RP decided by the Committee envisages restructuring of the debt of the enterprise, the Committee will arrange for Techno-Economic Viability (TEV) study and finalise the terms of the restructuring in accordance with the extant prudential norms. Timelines for completion the same has to be as per individual bank's instructions from time to time.
- Upon finalisation of the terms of the RP, implementation of that plan has to be completed by the **bank within 30 days from the date of decision** (if the RP is Rectification) and **within 90 days from the date of decision** (if the RP is restructuring). In case recovery is considered as RP, the recovery measures should be initiated at the earliest but **not later than 30 days from the date of decision**.

Sale Of Financial Assets

(RBI Circular titled Framework for Revitalising Distressed Assets in the Economy – Refinancing of Project Loans, Sale of NPAs and Other Regulatory Measures dated 26-02-2014) A financial asset may be sold to the Securitisation company (SC)/Reconstruction company (RC) by any bank/FI where the asset is:

- A NPA, including a non-performing bond/debenture, and
- A Standard Asset where:
 - ✓ The asset is under consortium/multiple banking arrangements,
 - ✓ At least 75% by value of the asset is classified as non-performing asset in the books of other banks/FIs, and
 - ✓ At least 75% (by value) of the banks/FIs who are under the consortium/multiple banking arrangements agree to the sale of the asset to SC/RC.
- Where the financial asset is reported as SMA-2 by the bank/FI to Central Repository for Information on Large Credit (CRILC). However, if restructuring has been decided as the Resolution Plan, then banks will not be permitted to sell



such assets to SCs/RCs, without arranging their share of additional finance to be provided by a new or existing creditor.

CAIIB Paper 1 (ABM) Module C Unit 9: Resolution of Stressed Assets under Insolvency and 25 Bankruptcy Code 2016

Definition Of Insolvency And Bankruptcy

Insolvency is a situation where liabilities of an individual or an entity exceed its assets and is unable to pay debt obligations. Bankruptcy is the legal recognition of the insolvency as beyond resolution. A bankrupt person or entity is a debtor who has been adjudged as bankrupt by a due Adjudicating Authority by passing a bankruptcy order. The court appoints a trustee who is responsible for selling the property and discharge obligations to the creditors. Under IBC, such trustee is the resolution professional.

To Whom The Code Is Applicable

Part-II of the Code is applicable to:

- Companies and LLPs (termed as Corporate Debtor)
- Personal Guarantors to Corporate Debtors
- Any other body incorporated under any Law for the time being in force, as the Central Government may specify by notification.

Part-III of the Code applies to:

- Partnership and Proprietorship Concerns
- Individuals

Legal Elements Of The Code

Insolvency & Bankruptcy Board of India (IBBI, the Regulator)

- Insolvency Professional Agencies
- Insolvency Professionals (Interim Resolution Professionals, Resolution Professionals)
- Information Utilities
- The Creditors
 - ✓ Financial Creditors (FC)
 - ✓ Operational Creditors (OC)
- Committee of Creditors
- The Corporate Debtor (CD)
- The Judiciary
 - ✓ National Company Law Tribunal (NCLT – Adjudicating Authority for Corporate)
 - ✓ National Company Law Appellate Tribunal (NCLAT – Appellate Authority for Corporate)



- ✓ Debt Recovery Tribunals (Adjudicating Authority for individuals and partnerships)
- ✓ Debt Recovery Appellate Tribunals (Appellate Authority for individuals and partnerships)
- ✓ Supreme Court (Supreme Authority)

Regulatory Authority (IBBI)

- The Insolvency and Bankruptcy Board of India is entrusted with the task of regulating both the profession and process of IBC. Insolvency Professionals, Insolvency Professional Agencies, Insolvency Professional Entities and Information Utilities are under the regulatory supervision of IBBI.
- Apart from these four, IBBI is the 'Authority' under the Companies (Registered Valuers and Valuation) Rules, 2017 for regulation and development of the profession of valuers in the country.

Insolvency Professionals (IP)

- Insolvency Professionals (IPs) are the frontline warriors implementing IBC. They are professionals licensed/registered by IBBI to undertake the role of the Interim Resolution Professional (IRP), Resolution Professional (RP), liquidator and/or bankruptcy trustee under any resolution process initiated under the Code. The IP does the end-to-end job, depending upon her role, of IBC

Insolvency Professional Agencies (IPA)

- IPAs are bodies or entities registered with IBBI and are responsible for promoting the best professional standards among Insolvency Professionals (IP). Every IP must be a member of an IPA before seeking registration with IBBI.
- As of now there are three IPAs, namely, a) Institute of Company Secretaries of India, b) Institute of Chartered Accountants of India and c) Institute of Cost Accountants of India

Insolvency Professional Entities (IPEs)

- IPEs are registered firm (Partnership or LLP or Company) of IPs. It is not a mandatory set up but internal between those IPs, who are members, to provide infrastructural support service to IPs themselves.

Information Utilities (IUs)

- IUs are reservoirs of financial information of all entities under the Code. It is a pooling centre of information from entities like banks, FIs, NBFCs, ARCs, Corporates, firms, individuals, utilities on any financial or other credit transaction with them. The information is then authenticated by IU with the counterparties before documenting.
- The information available with the IUs are accessible through a Central Application Programming Interface (CAPI). When a person or entity intends to initiate a CIRP against a Corporate Debtor, it must attach a copy of certificate of



default issued by IU with the CIRP application filed with the Adjudicating Authority.

Creditors and Committee of Creditors (CoC)

- Financial Creditors are those who have lent money to the Corporate Debtor (CD), meant for paying back, without any trade transaction. Operational creditors are those who have supplied goods or services on credit or those who have made advance payment of money to the CD in consideration of receiving back goods or service.
- The Committee of Creditors is a committee of, normally, only financial creditors and is formed by the Interim Resolution Professional based on the claims received from the creditors. Each financial creditor will have a voting power proportionate to the exposure to the corporate debtor. Operational creditors have only observatory role in CoC except where there are no financial creditors. Quorum of CoC is 33% by value.
- Critical matters are passed by the CoC with 66% majority and routine matters with a 51% majority. Withdrawal of Application for Resolution under section 12A requires 90% majority of the Committee (all by value).

Adjudicating Authority

- The National Company Law Tribunal (NCLT) is the adjudicating authority for insolvency resolution process of corporate entities, namely, Companies, LLPs or other corporate entities incorporated under any law in force.
- The Debt Recovery Tribunal (DRT) is the adjudicating authority for non Corporate entities (Individuals, Proprietors, Partners of a Partnership). Appellate authorities are National Company Law Appellate Tribunal (NCLAT) and Debt Recovery Appellate Tribunal (DRAT) for orders of NCLT and DRT respectively.

Paradigm Shift

- IBC made leaning of the law from “Debtors in Possession” to “Creditors in Control” as, on appointment of IRP, she takes over as CEO of the CD and on formation, CoC supersedes the Board of Directors of the CD.
- The original promoters or their related parties are barred from bidding for a resolution of the corporate entity at default, which, effectively takes away the ownership, control and management of the corporate entity from the hands of the existing promoters.

Corporate Insolvency Resolution Process

Initiation of Corporate Insolvency Resolution Process

- Insolvency and bankruptcy resolution process can be initiated when a Corporate Debtor commits a default of Rs. one crore or more. Initiation can be by the Financial Creditors, Operational Creditor or the Corporate Debtor itself, by filing an application before NCLT.



- 'Default' means non-payment of dues either in full or in part to any of the creditors. Therefore, CIRP can be initiated by any third party for dues to her even when the accounts with bank(s) are standard assets.

Interim Resolution Professional/Resolution Professional (IRP/RP)

- The applicant (FC or CD as the case may be) shall propose name of an IP to act as Interim Resolution Professional. In the case of application by OC, proposition of IRP is optional.
- Why 'interim' is because only CoC, when formed later, can decide who is regular Resolution Professional. Once appointed, all powers of the CEO and Board of Directors of CD will vest with the IRP and it is her responsibility to run the CD as a going concern.

Moratorium

- The NCLT will declare moratorium from the date of commencement of insolvency till the completion of the same against institution of suits, transfer of assets, foreclosure, recovery or enforcement under SARFAESI, recovery by owner of property or assets in possession of CD.

Resolution Plan

- A resolution plan must provide for payment of insolvency resolution process costs, pay liquidation value to operational creditor in priority in payment over financial creditors, management of the affairs of the borrower after the plan is approved and implementation and supervision of the approved plan.

Time Norms

- The following Table presents a model timeline of corporate insolvency resolution process on the assumption that the interim resolution professional is appointed on the date of commencement of the process and the time available is hundred and eighty days:



Section/ Regulation	Description of Activity	Norm	Latest Timeline
Section 16(1)	Commencement of CIRP and appointment of IRP	T
Regulation 6(1)	Public announcement inviting claims	Within 3 Days of Appointment of IRP	T+3
Section 15(1)(c)/ Regulations 6(2) (c) and 12 (1)	Submission of claims	For 14 Days from Appointment of IRP	T+14
Regulation 12(2)	Submission of claims	Up to 90 th day of commencement	T+90
Regulation 13(1)	Verification of claims received under regulation 12(1)	Within 7 days from the receipt of the claim	T+21
	Verification of claims received under regulation 12(2)		T+97
Section 21(6A) (b)/Regulation 16A	Application for appointment of AR	Within 2 days from verification of claims received under regulation 12(1)	T+23
Regulation 17(1)	Report certifying constitution of CoC		T+23
Section 22(1)/ Regulation 19(2)	1 st meeting of the CoC	Within 7 days of filing of the report certifying constitution of the CoC, but with five days' notice.	T+30
Section 22(2)	Resolution to appoint RP by the CoC	In the first meeting of the CoC	T+30
Section 16(5)	Appointment of RP	On approval by the AA
Regulation 17(3)	IRP performs the functions of RP till the RP is appointed.	If RP is not appointed by 40 th day of commencement	T+40
Regulation 27	Appointment of valuer	Within 7 days of appointment of RP, but not later than 47 th day of commencement.	T+47
Section 12(A)/ Regulation 30A	Submission of application for withdrawal of application admitted	Before issue of EoI	W
	CoC to dispose of the application	Within 7 days of its receipt or 7 days of constitution of CoC, whichever is later.	W+7
	Filing application of withdrawal, if approved by CoC with 90% majority voting, by RP to AA	Within 3 days of approval by CoC	W+10
Regulation 35A	RP to form an opinion on preferential and other transactions	Within 75 days of the commencement	T+75
	RP to make a determination on preferential and other transactions	Within 115 days of commencement	T+115
	RP to file applications to AA for appropriate relief	Within 135 days of commencement	T+135



Regulation 36 (1)	Submission of IM to CoC	Within 2 weeks of appointment of RP, but not later than 54 th day of commencement	T+54
Regulation 36A	Publish Form G	Within 75 days of commencement	T+75
	Invitation of EoI		
	Submission of EoI	At least 15 days from issue of EoI (Assume 15 days)	T+90
	Provisional List of RAs by RP	Within 10 days from the last day of receipt of EoI	T+100
	Submission of objections to provisional list	For 5 days from the date of provisional list	T+105
Regulation 36B	Final List of RAs by RP	Within 10 days of the receipt of objections	T+115
	Issue of RFRP, including Evaluation Matrix and IM	Within 5 days of the issue of the provisional list	T+105
	Receipt of Resolution Plans	At least 30 days from issue of RFRP (Assume 30 days)	T+135
Regulation 39(4)	Submission of CoC approved Resolution Plan to AA	As soon as approved by the CoC	T+165
Section 31(1)	Approval of resolution plan by AA		T=180

Appointment of Interim Resolution Professional (IRP)

- As proposed by the CIRP Applicant, the NCLT, while admitting the CIRP, by virtue of the same order, also appoints an Interim Resolution Professional (IRP), provided there is no ongoing investigation or disciplinary action against the IP.
- As it is not mandatory for Operational Creditor to propose any IP for appointment as IRP, in the absence of such proposed names, in consultation with IBBI, NCLT appoints **an IRP within 14 days of admission of CIRP**.
- Immediately on her appointment, the IRP takes control of the entire assets and affairs of the corporate debtor as an on-going concern. The powers of the board of directors shall stand suspended from the date of initiation of CIRP.

Public announcement

- Within three days of appointment, the IRP, has to make a Public Announcement of commencement of CIRP, published on the websites of IBBI as well as CD and also in two newspapers including one in regional language to invite all creditors for submission of claims and **proof of claims (PoC) within 11 days from the date of the announcement**.

Constitution of Committee of Creditors (COC)

- Based on the claims received from Financial Creditors, the IRP shall constitute a Committee of Creditors (CoC) consisting of all those financial creditors (who are not a related party to the Corporate Debtor).
- The CoC has to meet within seven days of its constitution. In case there are no financial creditors (other than related parties) at all, the CoC shall consist of only operational creditors with
- ✓ 18 largest such creditors by value,



- ✓ One representative elected by all workmen other than workmen included in top 18 operational creditors and
- ✓ One representative elected by all employees other than employees included in the top 18 operational creditors
- The CoC, in its first meeting, will decide on either continuation of IRP as RP or nomination of another IP as RP by a majority of 66% vote in favour. In case CoC decides to replace IRP, the IRP will immediately file the CoC resolution for appointment of RP together with consent letter from the proposed RP with NCLT.
- The RP, within 7 days of her appointment, must appoint two valuers, who are registered with IBBI, to determine the fair value and liquidation value of the CD. The valuation received from the valuers must be kept by RP in strict confidence and it can be disclosed even to the members of CoC only against a Non-Disclosure Agreement (NDA) individually from each member.
- Each CoC member has voting power proportionate to her share in the financial debt of the Corporate Debtor (immaterial whether debt secured or unsecured, as, both are treated as equal for voting).

Withdrawal of CIRP

- The Adjudicating Authority can allow the withdrawal of CIRP on an application made by the applicant with the approval of 90% voting share of the CoC, but before publication of expression of interest for submitting the resolution plan.

Information Memorandum (IM)

Information memorandum is a compilation of the entire information on the of the CD. It is prepared by the Resolution Professional incorporating following information:

- Assets and liabilities as on insolvency commencement date
- Latest annual financial statements
- Audited financial statements for last two financial years
- A list of creditors, amount claimed, claims admitted, and details of security interest held by them in respect of such claims
- Particulars of debt due from or to Corporate Debtor with respect to related parties.
- Details of Guarantees that has been given in relation to debt of CD by other persons, specifying which of the Guarantors is a related party
- Names of addressed of members or partners holding at least 1% stake in CD with total holding
- The number of workers and employees and liabilities of CD towards them.
- Any Other information, which RP deems relevant to CoC/Potential investors

Liquidation Process

Initiation of Liquidation process A liquidation process is automatically initiated under the Code where,



- The CIRP fails as no resolution plan is received or is not approved by the CoC;
- Any of the stakeholder's defaults or deviates from terms of approved Resolution Plan;
- Creditors representing 66% of the outstanding financial debt resolve to liquidate the corporate debtor at any time before the preparation of the information memorandum.
- The corporate debtor contravenes the CIRP and anyone prejudicially affected applies for liquidation.

If otherwise not ineligible, the RP himself can be appointed as liquidator.

Public Announcement

- The Liquidator, on her appointment, makes a public announcement in minimum one each of English and regional language newspapers stating that the CD is in liquidation, with intimation to Registrar of Companies with whom the CD is registered.
- In the public announcement, liquidator also invites proof of claims from stakeholders **of the CD within 5 days of her appointment.**

Stakeholder List

The liquidator shall prepare a list of stakeholders, category-wise, on the basis of proofs of claims submitted and accepted, with

- The amounts of claim admitted, if applicable,
- The extent to which the debts or dues are secured or unsecured, if applicable,
- The details of the stakeholders, and
- The proofs admitted or rejected in part, and the proofs wholly rejected.

The list of stakeholders is to be filed with the Adjudicating Authority within forty-five days from the last date for receipt of the claims and, as modified from time to time, shall be

- Available for inspection by the persons who submitted proofs of claim;
- Available for inspection by members, partners, directors and guarantors of the corporate debtor;
- Displayed on the website, if any, of the corporate debtor.
- Filed on the electronic platform of the Board for dissemination on its website:

Stakeholders' consultation committee

The liquidator has to constitute a consultation committee within sixty days from the liquidation commencement date, based on the list of stakeholders prepared, to advise her on matters relating to

- Appointment of professionals and their remuneration;
- Sale, including manner of sale, pre-bid qualifications, reserve price, amount of earnest money deposit, and marketing strategy:



The decision(s), if any, taken by the liquidator prior to the constitution of consultation committee shall be placed before the consultation committee for information in its first meeting. The composition of the consultation committee shall be as

<i>Class of Stakeholders</i>	<i>Description</i>	<i>Number of Representatives</i>
Secured financial creditors, who have relinquished their security interests under section 52	Where claims of such creditors admitted during the liquidation process is less than 50% of liquidation value	Number of creditors in the category, subject to a maximum of 2
	Where claims of such creditors admitted during the liquidation process is at least 50% of liquidation value	Number of creditors in the category, subject to a maximum of 4
Unsecured financial creditors	Where claims of such creditors admitted during the liquidation process is less than 25% of liquidation value	Number of creditors in the category, subject to a maximum of 1
	Where claims of such creditors admitted during the liquidation process is at least 25% of liquidation value	Number of creditors in the category, subject to a maximum of 2
Workmen and employees	1	1
Governments	1	1

<i>Class of Stakeholders</i>	<i>Description</i>	<i>Number of Representatives</i>
Operational creditors other than Workmen, employees and Governments	Where claims of such creditors admitted during the liquidation process is less than 25% of liquidation value	Number of creditors in the category, subject to a maximum of 1
	Where claims of such creditors admitted during the liquidation process is at least 25% of liquidation value	Number of creditors in the category, subject to a maximum of 2
Shareholders or partners, if any	--	1

Formation of Liquidation Estate

- For the purposes of liquidation, the liquidator shall form an estate of the assets, which will be called the liquidation estate in relation to the CD and she shall hold the liquidation estate as a fiduciary for the benefit of all the creditors.
- Liquidation estate shall comprise of all assets that may or may not be in possession of the corporate debtor, whether tangible or intangible, whether moveable or immovable; but shall exclude assets owned by a third party which are in possession of the corporate debtor, assets in security collateral held by financial services providers and are subject to netting and set-off in multi-lateral trading or clearing transactions, personal assets of any shareholder or partner of a corporate debtor as the case may be provided such assets are not held on account of avoidance transactions, assets of any Indian or foreign subsidiary of the corporate debtor; or any other assets as may be specified by the Board,



including assets which could be subject to set-off on account of mutual dealings between the corporate debtor and any creditor.

The Powers and Duties of the Liquidator

- To collect and verify the claims of all the creditors
- To acquire custody and control over the assets, properties, effects and actionable claims of the CD
- To evaluate of the assets and properties of the CD and preparation of a report thereof
- To protect and preserve the assets and properties of the CD
- To conduct the business of the CD for its beneficial liquidation
- To sell the immovable and movable properties and actionable claims of the CD in liquidation by public action or private contract along with the power to transfer such property to any person or body corporate.
- To draw, accept, make and Endorse any negotiable instrument
- To obtain professional assistance from any person or appointment of professional in discharge of her duties, obligations and responsibilities
- To invite and settle claims of creditors and distribute proceeds as per the provisions of the Code
- To institute legal proceedings and suits (civil or criminal) in the name or on behalf of the CD
- To investigate the financial affairs of the CD to determine undervalued, fraudulent or preferential transactions
- To execute documents and deeds on behalf of the CD as may be necessary for liquidation, distribution of assets and in discharge of her duties and obligations and functions as liquidator;
- To apply to the Adjudicating Authority for such orders or directions as maybe necessary for the liquidation of the corporate debtor and to report the progress of the liquidation process in a manner as may be specified by the Board.
- To access information system for the purpose of admission or proof of claims and identification of the liquidation estate of CD from any Information Utility or any agency of Central, State Govt. or local Govt. including any registration authority
- To provide information about the CD **when required by creditors within 7 days of such request.**

Reports by Liquidator

The liquidator shall prepare and submit to the NCLT:

- A preliminary report;
- An asset memorandum;
- Progress report(s);
- Sale report(s);
- Minutes of consultation with stakeholders; and
- The final report prior to dissolution



Pre-Packaged Insolvency Resolution Process For Stressed MSMEs

Pre-packaged Insolvency Resolution Process for stressed micro, small and medium enterprises (MSMEs) will allow the stressed debtor, ie, the MSMEs, and its creditors to quickly work out a plan to turn around the MSME corporate entity without a bankruptcy process, which would then be sanctioned by the Adjudicating Authority.

Applicability

- The pre-pack framework is applicable to MSMEs default value up to Rs. 1 crore, beyond which, IBC or other resolution mechanisms can continue to be used. PIRP can be contemplated only after a **period of three years** from the date of previous PIRP or CIRP, if anything of that kind was done earlier.
- However, if any CIRP has been recently filed, then, if **PIRP is filed within 14 days**, PIRP will prevail. **If 14 days have past**, CIRP will be proceeded with.

Initiation/Trigger

- While the CIRP under IBC is creditor-in-control model, that is, the creditors take over the management and find out course of resolution, the PIRP is on a reverse framework of debtor-in-possession model, where the debtor has to approach creditors for resolution with a base resolution plan in place.
- In case of a default by an MSME and if a minimum of 66 per cent creditors vote in favour, the financial creditors can initiate the PIRP and file an application with the adjudicating authority for the same. In case a corporate debtor does not have any financial creditors, it may approve the application filing through a special resolution with a 75 per cent majority and move the court to initiate PIRP. Then the court will appoint an insolvency resolution professional as approved by creditors.

Timelines

- **120 days from the date** of commencement is the time frame given for completion of the entire PIR process.
- Also, within **90 days of date of commencement**, the Resolution Personal has to submit the resolution plan to the adjudicating authority after the same is approved by the committee of creditors. The PIRP will stand terminated in case the plan is not approved by the committee of creditors (CoC) within the time.

Resolution Plan

- Under PIRP also, the **applicability of section 29A of IBC**, which prohibits defaulting promoters or wilful defaulters from participating in the resolution process, has been extended.
- The MSME defaulter, who is under PIRP has to, within two days of PIRP commencement, submit a base resolution plan to the resolution professional.

Any changes thereon have to be done before its approval by the CoC. Nevertheless, if the resolution plan does not envisage payment to the operational creditors in full or in case the resolution plan is not approved by creditors, new bids can be invited.

Comparison of PIRP with CIRP

Criteria	PIRP for MSME	CIRP
Eligibility	Only MSMEs	All corporate debtors
Default threshold	Up to Rs. 1 crore	Over Rs. 1 crore
Initiation by	Only Corporate Debtor (CD), post-approval by shareholders & unrelated Fin Creditors	Financial Creditor/Operational Creditor/Corporate Debtor
Timeline	90 days to submit resolution plan to adjudicating authority, 120 days for entire process. No extension	180 days extendable up to max 330 days
Management control	Corporate Debtor-in-Possession with Creditor-in-Control	Creditor in control
Resolution plan	CD to submit Base Resolution Plan. If CoC rejects, or if Operational Creditors not paid in full, competing bids can be invited.	EOIs invited from all prospective resolution applicants.
Section 29A applicability	Section 29A applicable	Section 29A applicable
Consequence of failure	Termination of PIRP, or liquidation or initiation of CIRP	Liquidation
Moratorium	Moratorium protection from date of commencement	Moratorium protection from date of filing of plea
Termination	Can terminate process with min 66% CoC votes	Section 12A to withdraw from CIRP with 90% vote of CoC
Other terms	(a) If promoters not diluting equity as part of resolution, CoC needs to record reasons for it	No such conditions.
	(b) PIRP cannot run in parallel to CIRP	
	(c) 3-year cool-off period from any other PIRP, CIRP	

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