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Measurement of Credit Appraisal System in Banking Sector – A Study of SBI Bank, Hisar

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Abstract – Credit appraisal is done to check the commercial, financial & technical viability of the project proposed its funding pattern & further checks the primary or collateral security cover available for the recovery of such funds. This study will help in understanding the credit appraisal system in banks & to reduce various risk parameters, which are broadly categorized into financial risk, business risk, industrial risk & management risk associated in providing any loans or advances or project finance. The study is based on secondary data.

Key Words: - Credit Appraisal, Risk, Management

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INTRODUCTION

The Reserve Bank of India (RBI), as the central bank of the country, closely monitors developments in the whole financial sector. The banking sector is dominated by Scheduled Commercial Banks (SCBs). As at end-March 2002, there were 296 Commercial banks operating in India. This included 27 Public Sector Banks (PSBs), 31 Private, 42 Foreign and 196 Regional Rural Banks. Also, there were 67 scheduled co-operative banks consisting of 51 scheduled urban co-operative banks and 16 scheduled state co-operative banks. Scheduled commercial banks touched, on the deposit front, a growth of 14% as against 18% registered in the previous year. And on advances, the growth was 14.5% against 17.3% of the earlier year. State Bank of India is still the largest bank in India with the market share of 20% ICICI and its two subsidiaries merged with ICICI Bank, leading creating the second largest bank in India with a balance sheet size of Rs. 1040bn. Higher provisioning norms, tighter asset classification norms, dispensing with the concept of 'past due' for recognition of NPAs , lowering of ceiling on exposure to a single borrower and group exposure etc., are among the measures in order to improve the banking sector. A minimum stipulated Capital Adequacy Ratio (CAR) was introduced to strengthen the ability of banks to absorb losses and the ratio has subsequently been raised from 8% to 9%. It is proposed to hike the CAR to 12% by 2004 based on the Basle Committee recommendations. Retail Banking is the new mantra in the banking sector. The home loans alone account for nearly two-third of the total retail portfolio of the bank. According to one estimate, the retail segment is expected to grow at 30-40% in the coming years.Net banking, phone banking, mobile banking, ATMs and bill payments are the new buzz words that banks are using to lure customers. With a view to provide an institutional mechanism for sharing of information on borrowers / potential borrowers by banks and Financial Institutions, the Credit Information Bureau (India) Ltd. (CIBIL) was set up in August 2000. The Bureau provides a framework for collecting, processing and sharing credit information on borrowers of credit institutions. SBI and HDFC are the promoters of the CIBIL. The RBI is now planning to transfer of its stakes in the SBI, NHB and National bank for Agricultural and Rural Development to the private players. Also, the Government has sought to lower its holding in PSBs to a minimum of 33% of total capital by allowing them to raise capital from the market. Banks are free to acquire shares, convertible debentures of corporate and units of equity-oriented mutual funds, subject to a ceiling of 5% of the total outstanding advances (including commercial paper) as on March 31 of the previous year. The finance ministry spelt out structure of the government-sponsored ARC called the Asset Reconstruction Company (India) Limited (ARCIL), this pilot project of the ministry would pave way for smoother functioning of the credit market in the country. The government will hold 49% stake and private players will hold the rest 51%- the majority being held by ICICI Bank (24.5%).

REVIEW OF LITERATURE

Hans (2000) examined that the internal aspects of bank lending, information production and interaction between debtor and bank lending officers, are still a black box to banking theory. To

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achieve some empirical insight into these aspects of financial intermediation, the credit files of six lending relationships between a German universal bank and medium sized firms are analysed. **Howell (2000)** analysed that governmental bodies are increasingly incorporating the work of private credit rating agencies into regulatory standards. **Jean and Fatma (2000)** studied that market-based evaluation of deposit insurance premia has modeled the bank as a corporate firm with risky assets and insured liabilities. **Alan (2001)** investigated that credit derivatives market provides a liquid but opaque forum for secondary market trading of banking assets. **Francis, Jun and Ravit (2001)** studied that market price of credit risk incorporated into one of the most important credit spreads in the financial markets: interest-rate swap spreads. This study approach consists of jointly modeling the swap and Treasury term structures using a four-factor and credit framework and estimating the parameters by maximum likelihood. **Lawrence (2001)** analysed that June 1999 and January 2001 proposals by the Bank for International Settlements (BIS) Basel Committee on Banking Supervision to include borrowers' credit ratings in assessments of the adequacy of banks' capital have heightened general interest in the credit rating industry. **Abhijit (2002)** examined the micro-evidence on credit markets from a large number of studies from all over the world, with the goal of identifying a number of stylized facts. **Jianjun, Dirk and Erwan (2003)** analysed the impact of macroeconomic conditions on credit risk and dynamic capital structure choice. **Biagio (2004)** examined that interactions between banks and nonbank financial intermediaries affect economic development, stability, and efficiency. **Mircea (2006)** conducted banking transactions over the Internet using the information and communication technology.

RESEARCH METHODOLOGY

Objectives of the Study

The objectives of the study are as follows:

- To study the Credit Risk Assessment Model of SBI Bank.
- To observe the movements to reduce various risk parameters which are broadly categorized into financial risk, business risk, industrial risk & management risk.
- To check the commercial, financial & technical viability of the project proposed & its funding pattern.
- To check the primary & collateral security cover available for recovery of such funds.

Research Design –

During the study, analytical Research has been used.

Coverage

The present study is restricted to branch of SBI bank in Hisar.

Data Collection

In the present study, secondary data have been used. For the purpose, the following sources have been used such as

- Books & magazines
- Database at SBI
- Websites
- E-circulars of SBI

Credit Appraisal

Credit appraisal means an investigation/assessment done by the bank prior before providing any loans & advances/project finance & also checks the commercial, financial & technical viability of the project proposed its funding pattern & further checks the primary & collateral security cover available for recovery of such funds. Credit Appraisal is a process to ascertain the risks associated with the extension of the credit facility. It is generally carried by the financial institutions which are involved in providing financial funding to its customers. Credit risk is a risk related to non repayment of the credit obtained by the customer of a bank. Thus it is necessary to appraise the credibility of the customer in order to mitigate the credit risk. Proper evaluation of the customer is performed which measures the financial condition and the ability of the customer to repay back the loan in future. Generally the credit facilities are extended against the security know as collateral. But even though the loans are backed by the collateral, banks are normally interested in the actual loan amount to be repaid along with the interest. Thus, the customer's cash flows are ascertained to ensure the timely payment of principal and the interest. It is the process of appraising the credit worthiness of a loan applicant. Factors like age, income, number of dependents, nature of employment, continuity of employment, repayment capacity, previous loans, credit cards, etc. are taken into account while appraising the credit worthiness of a person. Every bank or lending institution has its own panel of officials for this purpose. There is no guarantee to ensure a loan does not run into problems; however if proper credit evaluation techniques and monitoring are implemented then naturally the loan loss probability

/ problems will be minimized, which should be the objective of every lending officer. Credit is the provision of resources (such as granting a loan) by one party to another party where that second party does not reimburse the first party immediately, thereby generating a debt, and instead arranges either to repay or return those resources (or material(s) of equal value) at a later date. The first party is called a creditor, also known as a lender, while the second party is called a debtor, also known as a borrower. Credit allows you to buy goods or commodities now, and pay for them later. We use credit to buy things with an agreement to repay the loans over a period of time. The most common way to avail credit is by the use of credit cards. Other credit plans include personal loans, home loans, vehicle loans, student loans, small business loans, trade. A credit is a legal contract where one party receives resource or wealth from another party and promises to repay him on a future date along with interest. In simple terms, a credit is an agreement of postponed payments of goods bought or loan. With the issuance of a credit, a debt is formed.

► **Credit Appraisal Process :**

- Receipt of application from applicant
- Receipt of documents
- (Balance sheet, KYC papers, Different govt. registration no., MOA, AOA, and Properties documents)
- Pre-sanction visit by bank officers
- Check for RBI defaulters list, willful defaulters list, CIBIL data, ECGC caution list, etc.
- Title clearance reports of the properties to be obtained from empanelled advocates
- Valuation reports of the properties to be obtained from empanelled values/engineers
- Preparation of financial data
- Proposal preparation
- Assessment of proposal
- Sanction/approval of proposal by appropriate sanctioning authority
- Documentations, agreements, mortgages
- Disbursement of loan
- Post sanction activities such as receiving stock statements, review of accounts, renew of accounts, etc.
- (On regular basis)

CONCLUSIONS AND SUGGESTIONS

- Credit appraisal is done to check the commercial, financial & technical viability of the project proposed its funding pattern & further checks the primary or collateral security cover available for the recovery of such funds
- SBI loan policy contains various norms for sanction of different types of loans such as Ganesh Roadlines Transport Company case
- These all norms does not apply to each & every case.
- SBI norms for providing loans are flexible & it may differ from case to case
- The CRA models adopted by the bank take into account all possible factors which go into appraising the risk associated with a loan
- These have been categorized broadly into financial, business, industrial, management risks & are rated separately
- The assessment of financial risk involves appraisal of the financial strength of the borrower based on performance & financial indicators
- After case study we found that in some cases, loan is sanctioned due to strong financial parameters
- From the case study analysis it was also found that in some cases, financial performance of the firm was poor, even though loan was sanctioned due to some other strong parameters such as the unit has got confirm order, the unit was an existing profit making unit & letter of authority was received for direct payment to the bank from ONGC which is public sector
- Different appraisal scheme has been introduced by the bank to cater different industries such as:-

  Doctor plus scheme for doctors

Transport plus scheme for transport

School, collages & educational institutions

Trader's easy loan

Warehouse receipt financing for commodity traders

(Agriculture related stock, cotton ginning, etc.)

- In the business world risk arises out of:-

  Deficiencies / lapses on the part of the management

  Uncertainties in the business environment

  Uncertainties in the industrial environment

  Weakness in the financial position

- Credit is the core activity of the banks & important source of their earnings which go to pay interest to depositors, salaries to employees & dividend to shareholders

- Credit & risk go hand in hand

- Bank's main function is to lend funds/ provide finance but it appears that norms are taken as guidelines not as a decision making

- A banker's task is to identify/assess the risk factors/parameters & manage/mitigate them on continuous basis.

SUGGESTIONS

- To enable the banks take more objective decisions, the Government plans to introduce a rating mechanism for designated industrial clusters; this may be designed jointly by Crisil, IBA, Sidbi and SSI Associations. This would enable institutional funding to be channeled through homogenous recognised clusters.

- There is a critical need to devote substantial resources to improving the skills and capabilities of banks' lending officers, especially with regard to the analysis of the SMEs' financial statements. Understanding the nature of the borrower's business and the cash-flow required is paramount to preventing the creation of NPAs.

- Another way of extending loans to the SMEs is the relationship-lending rule, where the lending partly bases its decision on proprietary information about the firm and its owner through a variety of contacts over time. The information may be gathered from such stakeholders as suppliers and customers, who may give specific information about the owner of the firm or general information about the business environment in which it operates.

- Insufficient data on the SMEs, the lack of credible published information about their financial health, the high vulnerability of small players in a liberalising market and the inadequacy of risk management systems in banks are factors leading to higher NPAs and lower profitability than potential in SME lending. This can be overcome by collection of authentic data on the SME segment, educating the enterprises on the need for reliable financial data, evolving suitable risk models and close monitoring of accounts by the bank.

- SMEs are increasingly using products such as derivatives to manage their forex flows. Bank needs to offer sophisticated products to the SMEs in a simplified manner.

- They need to innovate their delivery platforms by using Internet banking, mobile banking and card-based platforms for delivery of transaction-banking as well as credit products, and enhance the service element. SMEs look for convenience and simplicity in their banking requirements and banks should deliver these through an effective use of technology.

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