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An Overview of Credit Appraisal Techniques of Term/Project Loans: With Special Reference to Punjab National Bank.

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Abstract:
The root cause of economic and financial crisis is credit default of big companies and individuals, which has badly affected the world economy. In the present scenario analyzing one's credit worthiness is very important for any financial institution before providing any form of credit facility so that situation of credit risks does-not arise in near future. Every Industry need financial Aid to get establish and to run the business , for it they raise money from different sources and one of the major source used is Bank Financing. Credit appraisal is the overall steps starting from application for credit to granting loan for that applied credit.

Credit appraisal is the overall assessment of the creditworthiness of the projects and individuals associated with the projects. The analysis of the scope of the project and risks associated with it leads to the decision of sanctioning or rejecting the proposal. Credit sanction can only be made through appropriate judgment of the project and least chances of getting nonperforming assets for the banking organizations. The bank uses appraising techniques to secure the credit sanction. The credit rating model/technique in Punjab national bank considers some important parameters depending on the industry type to sanction loans. The analysis of the efficiency of the project shows the profit making capacity and the repayment capacity of the project.

Key words: financial crisis, credit default, credit facilities, credit risks, creditworthiness, non performing assets, credit sanction

Introduction

Credit appraisal is the full process starting from the time a potential customer demands for it till the sectioning of the credit.
Analysis of the credit worthiness of the borrowers is known as, Credit Appraisal. The basic criteria to be judged before stating the credit sanctioning process are: Age, Income of the applicant, Number of dependents, Nature of employment, Continuity of the employment, Repayment capacity, previous loan, Credit taken, Security and its releasable value.

Credit funding in bank are done through two methods i.e. fund based and non fund based financing. Fund based financing is the involvement of direct cash whereas non fun based financing are cash free and indirect.

Fund based financing includes: **working capital financing or cash credit limit, term loans, overdrafts against immoveable properties.**

Non Fund based financing includes: Bank guarantee, letter of credit, and bill discounts.

Working capital financing/cash credit limit: Working capital financing is the financing for the day to day working of the organizations. Cash credit limit – CC limit as termed is only granted for business purposed only, the cash provided cannot be used other than that business for which the loan is granted to the borrower. The Bank provides CC limit to required customers who fulfill eligibility criteria as per bank norms and whose repayment capacity is strong enough to repay the interest and continue business with the CC limit. In this type of credit financing the banks holds the hypothecation of socks and equitable mortgage- EM of the collateral security provided by borrower. The amount sanctioned can be increased or decreased as per the requirement of the customer and after considering the present condition of the business. CC limit is sanctioned against interest and not under EMI's.

Term Loans: Term loans are the most sanctioned loans by the banks to its customers. It includes project loans, MSMEs loans, and retail loans. It is granted for a fixed time period so it is termed as term loan. Term loans can be for project loans i.e. for setting up new units or its expansion purpose and secondly for non project loans i.e. for acquisition of fixed assets etc.

Term loan is sanctioned against interest that can be charged on fixed rate or floating rates.

Overdrafts against immoveable properties: Overdraft against Immoveable property is the loan granted to customers to meet Personal as well as Business needs. Loan for personal use is sanctioned in shape of Term Loan /Overdraft on monthly reducing Drawing power (DP) basis. In case of loans sanctioned for the purpose of business needs in shape of overdraft on monthly reducing Drawing Power (DP) basis.

Bank guarantee: A bank guarantee is a written contract given by bank on behalf of its customer. It is done by issuing guarantee and taking responsibility for payment of sum of money, in return bank charges some commission for issuing the guarantee.

Letter of credit: It is a letter from bank guaranteeing that a buyer's payment to a seller will be received on time and for the correct amount. In case of buyer is unable to make payment on the purchase his bank will be required to cover full or remaining amount of the purchase. It is mostly used for international transactions.

Credit Appraisal Process:

Customers approach to the bank

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Receipt of Application from the applicants

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Receipts of Documents required

(Company Registration Certificate, MOA, AOA, CA Certificate, Proposed Balance Sheet, Income Sources)

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Pre-sanction visit by bank officer

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Clearance by Credit Rating Agencies, PNB Trac, PNB Score, SME Score, defaulters list)

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Title clearance reports of the properties to be obtained from the empanelled advocates and valuers

(Mortgaged securities valuation)

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Analysis and Clearance of chartered accountant on the proposed balance sheet and their credit repayment status

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Preparation of proposal for clearance of loan by the credit officer

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Sanction of loan from the sanctioning department

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Disburdenment of loan from the bank

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Post-sanction follow-up

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- Monthly Basis
- PMS – Preventive Monitoring System. (More than 1 cr.)
- LSS : Limit Sanction Statement
- Quarterly basis
- QRS report -Quarterly Review Sheet (less than 1 cr.)

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Reminders send to branches regarding non repayment of credits and non performing assets.

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Follow-up of NPA's

(On regular basis)

Objective of study:

1. To study meaning and procedure of credit appraisal system of project/term loans
2. To study the credit risk management of PNB..

Scope of study:

1. Study of credit management in banks.
2. Study various credit facilities provided by the bank.
3. Study credit appraisal system and risk rating models.

Literature Review:

Dr.Ram Jass Yadav, in his journal: credit is inevitable in banking: A Case Study of Premier Bank on Credit Appraisal & Assessment, 2013, stated Credit appraisal is done to assess the technical, economical, and financial viability of the project. Loan policy of Bank contains various norms for sanction of different types of loans under SME

Segment and all these norms do not necessarily apply to each & every case. The credit risk assessment 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, and management risks.

Credit appraisal is the analysis of the project to make sure its financial viability and credit worthiness of the applicant. The process is undertaken by banks to analyze the credit position of the customers to get the economical and financial status of the project to manage the risk associated with a loan. The author explained a number of tasks and activities associated with the risk assessment as:

Lender's task	***Credit & Risk are Twins***
1. Identify the risk factors 2. Measurement of Risk 3. Mitigate the risk	1. Both are two sides of the same coin. 2. All credit proposals have some inherent risks 3. Go hand in hand
Probable reasons of risk	***Factors for good credit***
1. Deficiencies on the part of the management 2. Uncertainties in the business & industrial environment 3. Weaknesses in the financial position 4. Un-hedging market risks etc.	1. Managerial ability 2. Favorable business & industrial environment 3. Adequate financial strength 4. Proper due diligence & hedging of risk.

A banker's task is to identify the risk parameters & to mitigate them on a continuous basis.
It is prudent to have some idea about the degree of risk associated with any credit proposal and banker should take calculated risk, based on risk-absorption & hedging capacity of the Bank.

Njeru, Michael, Dr. Shano Mohammed, Mr. Alex Wachira in their journal Effectiveness of credit appraisal on loan performance of commercial banks in Kenya, stated in the conclusion that Credit appraisal was found to be very important in influencing performance of commercial banks. This is because it is the screening stage and those would be bad payers are sieved out and those expected to be good payers given their credit history and credit score are granted. Findings revealed that lending placed much reliance on use of past information and thus credit referencing and credit history were applied more in credit appraisal. The other techniques were also deemed effective but not as much as credit referencing and use of credit history of the borrower.

The success of commercial banks largely depend on the effectiveness of their credit management system because these institutions generate most of their income from interest earned on loans extended to small and medium entrepreneurs. Bad credit can be stemmed out by proper risk identification and appraisal. Thus effectiveness of risk appraisal has a direct influence on loan performance.

They said the credit appraisal in commercial banks lead to screening good and bad projects at the initial stage to make the risk at minimum. The techniques are used to monitor the credit history of the borrowers. The credit appraisal helps in identification of the borrower and its credit worthiness so to make the decision regarding the sanctioning of loan to the projects.

Ms. Sugandha Sharma, Ms. Pooja Kalra in their journal named an overview of credit appraisal system with special reference to micro small and medium enterprises explains credit appraisal as the credit appraisal is a complete exercise which stats from the time a potential borrower walks into the branch and concludes in credit delivery and monitoring with the objective of certifying and monitoring with the objective of certifying and maintaining the quality of lending and managing credit risk. Credit appraisal is the assessment of the viability of proposed long term investments in terms of shareholder wealth and the formal analysis of all project costs and benefits which is used to justify the project proposal.

The credit appraisal is the assessment of the project and the lender so to insure the credit status of the applicant. The project is studied in detail and all proposed factors are assessed by the bank and then the credit is sanctioned to the borrowing party. The overall purpose of credit appraisal is to check the feasibility of the investment the bank is going to make and to level of risk associated with the borrower and the project.

The two main functions of a bank is to accept the deposits and secondly by granting loans of different types and charging interest on the same. Bank grant loans in two main categories i.e. project / term loan and the other is retail loan. The term loans are given bigger investments that require a good amount of credit. All the capital requirements cannot be fulfilled by the promoters or equity share issues and that is where the term loans come into the picture. Term loan or project finance is a long term source of finance for a company normally extended by financial institutions or banks. Term loans are the industrial loans like hotel projects, mill projects, real estate projects or ODIP - overdraft facility on immoveable properties that is for above 2crores.

Retail loans are Education loan, Housing loan, Vehicle loan, Personal loan, ODIP Overdraft facilities on immoveable property (up to 2 crores).

The list of documents mandatory for the term loans are:

- Company Registration Certificate
- Memorandum Of Association, Articles Of Association.
- Ca Certificate
- Land Certificate With Picture Of The Land
- Proposed Balance Sheet
- Meeting All Policies Of Bank
- Securitas Against Loan
- Proprietors Contribution To The Project
- Funds Raise from Sources.
- Bank Account And Its Non Deficiency Certificate
- Clearance From Credit Rating Agency
- Sources of Income (Income Statement).
- Property Denoted In The Proposal Shall Tally The Product In Same As Value And Company.
- Total Period Proposed For The Construction And Date Of Commencement Of The Business. Regular Check on the Installments to Be Received To Check the Risk Analysis.

Credit Risk

Credit risk means the possibility of loss associated with diminution in the credit quality of borrowers. In a bank's portfolio, losses stem from outright default due to inability or unwillingness of a customer or counter party to meet, commitments in relation to lending, trading, settlement and other financial transactions.

Credit Risk Management System in PNB

A comprehensive credit risk management system, which is in place in the bank, encompasses the following processes:

Identification of Credit Risk

Measurement of Credit Risk

Grading of Credit Risk

Reporting and analysis of rating related data

Control of Credit Risk

Credit Risk Identification

In order to take informed credit decisions, it is necessary to identify the areas of credit risk in each borrower as well as each industry. Risk Management Division HO, in coordination with other HO divisions involved in disbursal of credit and also the risk management departments of various zonal offices identifies these risks areas and develops necessary tools and processes to measure and monitor the risk.

Credit Risk Measurement

The credit risk rating models have been developed with a view to provide a standard system for assigning a credit risk rating to all the borrowers on the basis of the overall credit risk involved in them. The evaluation of a borrower is done by assessment on various objective/subjective parameters. The model evaluates the credit risk rating of a borrower on a scale of AAA to D with AAA indicating minimum risk and D indicating maximum risk.

In order to provide a standard definition and benchmarks under the credit risk rating system, following matrix has been prescribed in all the risk rating models.

Rating Grade	Risk Significance	Description
PNB -A1	Minimum Risk	Excellent business credit, superior asset quality and excellent track record of debt repayment capacity and coverage.
PNB-A2	Marginal Risk	Very good business credit, asset quality and Liquidity, debt repayment capacity and coverage.
PNB-A3	Modest Risk	Good business credit, asset quality, debt paying capacity and coverage.
PNB-A4	Lower Risk	Satisfactory business credit, asset quality, liquidity, good debt repayment capacity and Coverage.
PNB-B1	Average Risk	Acceptable business credit with average risk, acceptable asset quality, modest debt capacity. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitments.
PNB-B2	Marginally Acceptable Risk	An obligor is less vulnerable in the near term. However, it faces major ongoing uncertainties and exposure to adverse business, financial, or economic conditions which could lead to the obligor's inadequate capacity to meet its financial Commitments.

PNB-B3	Cautiously Acceptable Risk	An obligor is more vulnerable than the obligors rated 'B2', and currently the obligor has the capacity to meet its financial commitments. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitments.
PNB-C1	High Risk	Not creditworthy, generally acceptable on case to case basis, Currently vulnerable and dependent on favorable business, financial and economic conditions to meet financial commitments.
PNB-C2	Very high Risk	Not creditworthy. An obligor has minimal margin of principal and interest payment protections, currently highly vulnerable, and is totally dependent upon favorable business, financial and economic conditions to meet its financial commitments.
PNB-C3	Exceptionally high Risk	Unacceptable business credit, Currently highly vulnerable obligations, normal repayment in jeopardy, inadequate projected net worth and paying capacity. Default of some kind appears imminent

Ratings with PNB refers to as:A1, PNB-A2, PNB-A3, PNB-A4, PNB-B1, PNB-B2, and PNB-B3 grades that signifies as "Investment Grade" and C1, C2 and C3 rating grades are called "High Risk Grade".

Loaning Power: Loaning Power of the officers is disclosed according to the banks circular. Different Powers are delegated by different levels. Those are BRANCHES - CIRCLE OFFICE- FGM OFFICE (Field General Manager) HEAD OFFICE. According to the level of branch headed by the level of officer, the branch carries different limits of loaning power under its head. After the power limit, the loan proposal is send to the circle office. If the loan is above the power of the circle office, the loan proposal is send to the FGM office and above that, it is sent to the Head Office.

Conclusion: The credit appraisal is done after calculating the credit risk involved in the project. While sanctioning the loan analyzing the risk associated with the party is one the major part of credit department of the banks. Only financial aspects are not observed but non-financial and legal terms are also analyzed before sanctioning of the loan that can be of small amount or of big amount. This analysis is extremely important for the lender banks to assess the risk associated with credit; to make ensure the security for the funds deposited by the depositors are worth of the sanctioning amount in case of bad-debts. There are clear guidelines on how the credit analyst or lending officer has to analyze a loan proposal that they have to follow accordingly. Credit appraisal includes phase-wise analysis, which consists of 6 phases: Financial statement analysis, Working capital and its assessment techniques, Techno Economic Feasibility Analysis, Credit risk assessment, Documentation and Loan administration. To guarantee asset quality, proper risk assessment right from the beginning is extremely essential. That is why Credit Risk Management system is a vital ingredient of the Credit Appraisal exercise. The credit rating model in Punjab national bank considers some important parameters like profitability, repayment capacity, efficiency of the project, historical industry comparison, depending on the project and the industry.

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