Syllabus

Module 1 **(8 Hours)**

Credit management in banks-Screening of applications-Appraisal of credit-Sanction limit-Post sanction compliance – Monitoring supervision –Review- Government policies for credit extension- Credit institutions- Principles of good lending- Borrower study and bankers opinion-Credit policy by banks- Government regulation of credit -Prudential norms.

Module 2: **(8 Hours)**

Over view of credit policy and loan characteristics-The credit process –Characteristics of different types of loans- Evaluating commercial loan requests – Financial statement analysis-Cash flow analysis- Projections-Management of the firm and other factors –Feasibility study – Fundamental credit issues - Credit analysis-Different types of borrowers – Balance sheet analysis for lending – Forms of advances secured and unsecured advances- Short term and long term advances.

Module 3: **(7 Hours)**

Evaluating consumer loans – Types- Credit analysis of consumer loans- Risk–return analysis of consumer loans- Customer profitability analysis and loan pricing- Fixed Vs floating rates

Module 4: **(8 Hours)**

Loan and advances against pledge- Hypothecation- Mortgage – Lien- Advances against goods-Document to title to goods – Life insurance policies – Stock exchange securities-Fixed deposit receipts –Book debts- Supply bills- Real estates – Advance against collateral securities.

Module 5: **(8 Hours)**

Agricultural finances and Retail lending- Crop loans- Crop insurance schemes- Dairy-Sericulture- Poultry- Animal husbandry – Horticulture – Gobar gas – Kissan credit cards – NABARD initiatives – Lead bank schemes – Retail banking advances – Concept – Retail banking products – Consumer credit financing.

Module 6: **(8 Hours)**

Financing to small scale industries and large scale industries- Term lending- Syndicated loan system- Role of development banks in industrial finance- Working capital finance- Turnover method – Modified version of MPBF – Cash budget approach- Long term finance-Project financing –Industrial sickness and BIFR.

Module 7: **(9 Hours)**

NPA management – Introduction- Identification of NPAs- Asset classification- Prudential norms- Capital adequacy – International Banking Regulation-Basel II – asset classification provisioning – effect of NPA on profitability - Assessment procedure- Pre-sanction appraisal – Post sanction supervision- Monitoring systems for existing and likely NPAs—Tools to manage NPAs –Compromise scheme, Lok Adalats, Debt Recovery Tribunals, Corporate Debt Restructuring, Willful defaulters, SARFAESI Act, Asset Reconstruction Companies-CIBIL

Module 1
Credit management in banks

Loan application
Document that provides the essential financial and other information about the borrower on which the lender bases the decision to lend. For a business loan, it normally requires a detailed business plan that includes current and projected (usually for 3 years, or for the period of the loan) income statement (profit and loss account), balance sheet, and cash flow statement. The applicant firm must specify the loan amount and purpose, period and means of repayment, and guaranties and/or collateral offered. For consumer loans, banks generally use standard forms for the applicant to fill-in the information. A loan application entails neither a pledge by the applicant nor a commitment by the lender. Also called credit application.

Loan Application Process

Stage 1: Loan applications from applicants in eligible countries (i.e. with less than 10 registered CDM activities at the time of application) will go through initial screening as first step. This will include a) review of basic eligibility criteria and b) basic due diligence on the applicant. It will also include screening of the proposed CDM consultant. UNOPS/UNEP DTU may not process applications if the proposed CDM consultant does not meet the basic eligibility criteria. In such cases, the loan applicant is encouraged to select another pre-approved consultant (within given timeline).

Stage 2: Once deemed eligible and in absence of any integrity concerns or concerns regarding the project's potential registration as a CDM project activity, applications may, if necessary, be further verified , through a site visit usually conducted by a designated country team.

Stage 3: Based on the initial screening and information collection a detailed technical assessment will be undertaken, i.e. thorough evaluation of the proposed methodology, the expected emission reduction and the feasibility of the proposed approach, as outlined in the Loan Application Form.

Stage 4: Having assessed the application, the loan secretariat will submit a recommendation for a decision by the Technical Review Committee (TRC) at its next meeting, if the application has been submitted in time. Otherwise the application will be evaluated at the following TRC meeting. The TRC, comprised of external and independent CDM technical experts and UNOPS, will decide if the loan shall be approved or not.

The above stage-based structure with independent parties involved throughout the process shall ensure best possible screening and selection formation.

CREDIT APPRAISAL PROCESS

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

LOAN ADMINISTRATION – PRE SANCTION PROCESS

Preliminary appraisal:

1. Sound credit appraisal involves analysis of the viability of operations of a business and the capacity of the promoters to run it profitably and repay the bank the dues
2. The company's Memorandum and Articles of Association should be scrutinized carefully to ensure that there are no clauses prejudicial to the Bank's interests
3. Towards this end the preliminary appraisal will examine the following aspects of a proposal. Bank's lending policy and other relevant guidelines/RBI guidelines:
   - Industry related risk factors
   - Credit risk rating
   - Profile of the promoters/senior management personnel of the project
   - List of defaulters
   - Caution lists
   - Government regulations impacting on the industry
4. Whether the project cost acceptable or not
5. Debt/ Equity ratio whether acceptable
6. Organizational set up with a list of Board of Directors & indicating the qualifications & experience in the industry
7. Demand and supply projections based on the overall market prospects together with a copy of the market survey report
8. Estimates of sales, cost of production and profitability

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9. Projected profit and loss account and balance sheet for the operating year
10. Audited profit loss account and balance sheet for the past three years

LOAN ADMINISTRATION – POST SANCTION PROCESS

The post-sanction credit process can be broadly classified into three stages:

- Follow-up
- Supervision
- Monitoring

Which together facilitate efficient and effective credit management and maintaining high level of standard assets.

Extension of credit

(a) An extension of credit is a making or renewal of any loan, a granting of a line of credit, or an extending of credit in any manner whatsoever, and includes:
(1) A purchase under repurchase agreement of securities, other assets, or obligations;
(2) An advance by means of an overdraft, cash item, or otherwise;
(3) Issuance of a standby letter of credit (or other similar arrangement regardless of name or description) or an ineligible acceptance, as those terms are defined in§ 208.24 of this chapter;
(4) An acquisition by discount, purchase, exchange, or otherwise of any note, draft, bill of exchange, or other evidence of indebtedness upon which an insider may be liable as maker, drawer, endorser, guarantor, or surety;
(5) An increase of an existing indebtedness, but not if the additional funds are advanced by the bank for its own protection for:
(i) Accrued interest; or
(ii) Taxes, insurance, or other expenses incidental to the existing indebtedness;
(6) An advance of unearned salary or other unearned compensation for a period in excess of 30 days; and
(7) Any other similar transaction as a result of which a person becomes obligated to pay money (or its equivalent) to a bank, whether the obligation arises directly or indirectly, or because of an endorsement on an obligation or otherwise, or by any means whatsoever.
(b) An extension of credit does not include:
(1) An advance against accrued salary or other accrued compensation, or an advance for the payment of authorized travel or other expenses incurred or to be incurred on behalf of the bank;
(2) A receipt by a bank of a check deposited in or delivered to the bank in the usual course of business unless it results in the carrying of a cash item for or the granting of an overdraft (other than an inadvertent overdraft in a limited amount that is promptly repaid, as described in§ 215.4(e) of this part);
(3) An acquisition of a note, draft, bill of exchange, or other evidence of indebtedness through:
(i) A merger or consolidation of banks or a similar transaction by which a bank acquires assets and assumes liabilities of another bank or similar organization; or

(ii) Foreclosure on collateral or similar proceeding for the protection of the bank, provided that such indebtedness is not held for a period of more than three years from the date of the acquisition, subject to extension by the appropriate Federal banking agency for good cause;

(4) (i) An endorsement or guarantee for the protection of a bank of any loan or other asset previously acquired by the bank in good faith; or

(ii) Any indebtedness to a bank for the purpose of protecting the bank against loss or of giving financial assistance to it;

(5) Indebtedness of $15,000 or less arising by reason of any general arrangement by which a bank:

(i) Acquires charge or time credit accounts; or

(ii) Makes payments to or on behalf of participants in a bank credit cardplan, check credit plan, or similar open-end credit plan, provided:

(A) The indebtedness does not involve prior individual clearance or approval by the bank other than for the purposes of determining authority to participate in the arrangement and compliance with any dollar limit under the arrangement; and

(B) The indebtedness is incurred under terms that are not more favorable than those offered to the general public;

(6) Indebtedness of $5,000 or less arising by reason of an interest-bearing overdraft credit plan of the type specified in§ 215.4(e) of this part; or

(7) A discount of promissory notes, bills of exchange, conditional sales contracts, or similar paper, without recourse.

(c) Non-interest-bearing deposits to the credit of a bank are not considered loans, advances, or extensions of credit to the bank of deposit; nor is the giving of immediate credit to a bank upon uncollected items received in the ordinary course of business considered to be a loan, advance or extension of credit to the depositing bank.

(d) For purposes of§ 215.4 of this part, an extension of credit by a member bank is considered to have been made at the time the bank enters into a binding commitment to make the extension of credit.

(e) A participation without recourse is considered to be an extension of credit by the participating bank, not by the originating bank.

Credit institutions

All India Financial Institutions

All India Financial Institutions (AIFI) is a group composed of Development Finance Institutions (DFI) and Investment Institutions that play a pivotal role in the financial markets. Also known as "financial instruments", the financial institutions assist in the proper allocation of resources, sourcing from businesses that have a surplus and distributing to others who have deficits - this also assists with ensuring the continued circulation of money in the economy. Possibly of greatest significance, the financial institutions act as an intermediary between borrowers and final lenders, providing safety and liquidity. This process subsequently ensures earnings on the investments and savings involved.

List of AIFIs

According to Economic Survey 2012-13,[1] at the end of March 2012, there were four institutions regulated by Reserve Bank of India as all-India Financial Institutions:

1. **Industrial Development Bank of India**

The IDBI was established to provide credit for major financial facilities to assist with the industrial development of India. It was established in 1964 by RBI, and was transferred to the government of India in 1976. The government holdings in IDBI, after the IPO, is 51.4%. By the end of September 2004, the IDBI asset base was Rs. 36850 crore.

Functions

- Direct assistance: helps the industrial sector by granting project loans, underwriting of and direct subscription to the industrial securities (shares and debentures), soft loans, and technical development funds.
- Coordinating functions: coordinates the functions of financial institutions such as ICICI, IFCI, LIC and GIC, with respect to industrial development.
- Indirect assistance to small and medium enterprises by granting loans. It also refinances industrial loans of the SFC's, SIDCs, commercial banks and RRBs, along with the billing related to the sale of the indigenous machinery.
- Raising funds from the international money markets.

2. State Industrial Development Corporations

In 1960, the first State Industrial Development Corporations (SIDC) was established in Bihar. These mainly autonomous bodies are controlled by the State government, who may own a stake in the corporation. There are approximately 29 SIDCs in India.

Their main functions include the promotion of rapid industrialization in India. They mainly work at the grass roots level, providing development in the backward and less frequented parts of India. They offer financial leases and offer guarantees. They also administer the schemes of the central and state governments. The projects and surveys of the industrial potential are conducted by them, as well as the evaluation of SEZs.

3. Export - Import Bank of India (Exim Bank)

Export-Import Bank of India is the premier export finance institution in India, established in 1982 under the Export-Import Bank of India Act 1981. Since its inception, Exim Bank of India has been both a catalyst and a key player in the promotion of cross border trade and investment. Commencing operations as a purveyor of export credit, like other Export Credit Agencies in the world, Exim Bank of India has, over the period, evolved into an institution that plays a major role in partnering Indian industries, particularly the Small and Medium Enterprises, in their globalization efforts, through a wide range of products and services offered at all stages of the business cycle, starting from import of technology and export product development to export production, export marketing, pre-shipment and post-shipment and overseas investment.

4. National Bank for Agriculture and Rural Development (NABARD)

National Bank for Agriculture and Rural Development (NABARD) is an apex development bank in India having headquarters based in Mumbai (Maharashtra) and other branches are all over the country. The Committee to Review Arrangements for Institutional Credit for Agriculture and Rural Development (CRAFICARD), set up by the Reserve Bank of India (RBI) under the Chairmanship of Shri B. Sivaraman, conceived and recommended the establishment of the National Bank for Agriculture and Rural Development (NABARD). It was established on 12 July 1982 by a special act by the parliament and its main focus was to uplift rural India by increasing the credit flow for elevation of agriculture & rural non-farm sector and completed its 25 years on 12 July 2007. It has been accredited with "matters concerning policy, planning and operations in the field of credit for agriculture and other economic activities in rural areas in India". RBI sold its stake in NABARD to the Government of India, which now holds 99% stake. NABARD is active in developing financial inclusion policy and is a member of the Alliance for Financial Inclusion.

NABARD is the apex institution in the country which looks after the development of the cottage industry, small industry and village industry, and other rural industries. NABARD also reaches out to allied economies and supports and promotes integrated development. And to help NABARD discharge its duty, it has been given certain roles as follows:

1. Serves as an apex financing agency for the institutions providing investment and production credit for promoting the various developmental activities in rural areas
2. Takes measures towards institution building for improving absorptive capacity of the credit delivery system, including monitoring, formulation of rehabilitation schemes, restructuring of credit institutions, training of personnel, etc.
3. Co-ordinates the rural financing activities of all institutions engaged in developmental work at the field level and maintains liaison with Government of India, State Governments, Reserve Bank of India (RBI) and other national level institutions concerned with policy formulation
4. Undertakes monitoring and evaluation of projects refinanced by it.
5. NABARD refinances the financial institutions which finances the rural sector.
6. The institutions which help the rural economy, NABARD helps develop.
7. NABARD also keeps a check on its client institutes.
8. It regulates the institution which provides financial help to the rural economy.
9. It provides training facilities to the institutions working in the field of rural upliftment.
10. It regulates the cooperative banks and the RRB's, and manages talent acquisition through IBPS CWE.

5. **<u>Small Industries Development Bank of India (SIDBI)</u>**

Small Industries Development Bank of India is a non-indepeinancial institution aimed to aid the growth and development of micro, small and medium-scale enterprises (MSME) in India. Set up on April 2, 1990 through an act of parliament, it was incorporated initially as a wholly owned subsidiary of Industrial Development Bank of India. Currently the ownership is held by 33 Government of India owned / controlled institutions. Beginning as a refinancing agency to banks and state level financial institutions for their credit to small industries, it has expanded its activities, including direct credit to the SME through 100 branches in all major industrial clusters in India. Besides, it has been playing the development role in several ways such as support to micro-finance institutions for capacity building and on lending. Recently it has opened seven branches christened as Micro Finance branches, aimed especially at dispensing loans up to ₹5 lakh.

It is the Principal Financial Institution for the Promotion, Financing and Development of the Micro, Small and Medium Enterprise (MSME) sector and for Co-ordination of the functions of the institutions engaged in similar activities.

SIDBI has also floated several other entities for related activities. **Credit Guarantee Fund Trust for Micro and Small Enterprises** provides guarantees to banks for collateral-free loans extended to SME. **SIDBI Venture Capital Ltd.** is a venture capital company focused at SME. SME Rating Agency of India Ltd. (**SMERA**) provides composite ratings to SME. Another entity founded by SIDBI is **ISARC** - India SME Asset Reconstruction Company in 2009, as specialized entities for NPA solution.

6. National Housing Bank (NHB)

The Sub-Group on Housing Finance for the Seventh Five Year Plan (1985-90) identified the non-availability of long-term finance to individual households on any significant scale as a major lacuna impeding progress of the housing sector and recommended the setting up of a national level institution. The Committee of Secretaries considered' the recommendation and set up the High Level Group under the Chairmanship of Dr. C. Rangarajan, the then Deputy Governor, RBI to examine the proposal and recommended the setting up of National Housing Bank as an autonomous housing finance institution. The recommendations of the High Level Group were accepted by the Government of India.

The Hon'ble Prime Minister of India, while presenting the Union Budget for 1987-88 on February 28, 1987 announced the decision to establish the National Housing Bank (NHB) as an apex level institution for housing finance. Following that, the National Housing Bank Bill (91 of 1987) providing the legislative framework for the establishment of NHB was passed by Parliament in the winter session of 1987 and with the assent of the Hon'ble President of India on December 23, 1987, became an Act of Parliament. The National Housing Policy, 1988 envisaged the setting up of NHB as the Apex level institution for housing. In pursuance of the above, NHB was set up on July 9, 1988 under the National Housing Bank Act, 1987. NHB is wholly owned by Reserve Bank of India, which contributed the entire paid-up capital. The general superintendence, direction and management of the affairs and business of NHB vest, under the Act, in a Board of Directors. The Head Office of NHB is at IHC, Lodhi Road, New Delhi.

Important Principles Followed by the Banks for Lending Money

1. Liquidity:

Liquidity is an important principle of bank lending. Bank lend for short periods only because they lend public money which can be withdrawn at any time by depositors. They, therefore, advance loans on the security of such assets which are easily marketable and convertible into cash at a short notice.

A bank chooses such securities in its investment portfolio which possess sufficient liquidity. It is essential because if the bank needs cash to meet the urgent requirements of its customers, it should be in a position to sell some of the securities at a very short notice without disturbing their market prices much. There are certain securities such as central, state and local government bonds which are easily saleable without affecting their market prices.

The shares and debentures of large industrial concerns also fall in this category. But the shares and debentures of ordinary firms are not easily marketable without bringing down their market prices. So the banks should make investments in government securities and shares and debentures of reputed industrial houses.

2. Safety:

The safety of funds lent is another principle of lending. Safety means that the borrower should be able to repay the loan and interest in time at regular intervals without default. The repayment of the loan depends upon the nature of security, the character of the borrower, his capacity to repay and his financial standing.

Like other investments, bank investments involve risk. But the degree of risk varies with the type of security. Securities of the central government are safer than those of the state governments and local bodies. And the securities of state government and local bodies are safer than those of the industrial concerns. This is because the resources of the central government are much higher than the state and local governments and of the latter higher than the industrial concerns.

In fact, the share and debentures of industrial concerns are tied to their earnings which may fluctuate with the business activity in the country. The bank should also take into consideration the debt repaying ability of the governments while investing in their securities. Political stability and peace and security are the prerequisites for this.

It is very safe to invest in the securities of a government having large tax revenue and high borrowing capacity. The same is the case with the securities of a rich municipality or local body and state government of a prosperous region. So in making investments the bank should choose securities, shares and debentures of such governments, local bodies and industrial concerns which satisfy the principle of safety.

3. Diversity:

In choosing its investment portfolio, a commercial bank should follow the principle of diversity. It should not invest its surplus funds in a particular type of security but in different types of securities. It should choose the shares and debentures of different types of industries situated in different regions of the country. The same principle should be followed in the case of state governments and local bodies. Diversification aims at minimising risk of the investment portfolio of a bank.

The principle of diversity also applies to the advancing of loans to varied types of firms, industries, businesses and trades. A bank should follow the maxim: “Do not keep all eggs in one basket.” It should spread it risks by giving loans to various trades and industries in different parts of the country.

4. Stability:

Another important principle of a bank's investment policy should be to invest in those stocks and securities which possess a high degree of stability in their prices. The bank cannot afford any loss on the value of its securities. It should, therefore, invest it funds in the shares of reputed companies where the possibility of decline in their prices is remote.

5. Profitability:

This is the cardinal principle for making investment by a bank. It must earn sufficient profits. It should, therefore, invest in such securities which was sure a fair and stable return on the funds invested. The earning capacity of securities and shares depends upon the interest rate and the dividend rate and the tax benefits they carry.

It is largely the government securities of the centre, state and local bodies that largely carry the exemption of their interest from taxes. The bank should invest more in such securities rather than in the shares of new companies which also carry tax exemption. This is because shares of new companies are not safe investments. A person that has applied, met specific requirements, and received a monetary loan from a lender. The individual initiating the request signs a promissory note agreeing to pay the lien holder back during a specified timeframe for the entire loan amount plus any additional fees. The borrower is legally responsible for repayment of the loan and is subject to any penalties for not repaying the loan back based on the lending terms agreed upon.

Credit policy by banks

It means, Clear & written guidelines that set (1) the terms and conditions for supplying goods on credit, (2) customer qualification criteria, (3) procedure for making collections, and (3) steps to be taken in case of customer delinquency. Also called collection policy.

1. Providing links monetary policy to the overall strategy of economic development. Credit policy should be considered as one of the essential elements of the overall economic development strategy of the bank and requires coordination with its deposit, the interest in politics, policy, and management of banking risks. As one of the major elements that make up the overall economic development strategy, credit policy must be consistent in their goals with the overall strategy and not to enter into conflict with it.

2. Consideration in the development of monetary policy situation in the country and its development in a given period. Bank's credit policy is largely associated with the external environment, which is determined by the state of the state's economy. At the stage of Ukraine's transition to a market economy is the environment undergoes substantial transformation, which defines the new economic opportunities for individual areas of the bank credit policy.

3. Consideration in the development of monetary policy forecasting financial market conditions. In determining the strategic objectives of the bank on the volume of its lending activities, the formation level of lending rates, forms and types of credit customers need to be projected and included some changes that are expected in this period in the financial market in general and in those market segments in which the bank holds (or is going to spend) their lending activities.

4. Ensuring compliance with legal norms of state regulation of lending activities of banks. As with other areas of economic activities of individual business entities, the credit activity of banks is subject to active regulation by the state. Forms of such regulation are the specific laws and regulations of the National Bank of Ukraine (for example, he established economic standards for the implementation of credit transactions). Strategic objectives and credit policy and mechanism for their implementation should not be in conflict with applicable federal, state regulation of lending activities.

5. Consideration of internal capacity and capabilities of the bank's development. The volume of credit the bank's activities, diversification of directions, the possibility of individual operations and the application of certain debt instruments are largely determined by the size of its share capital, the level of material-technical base and innovative technology, skilled credit managers, organizational structure, management and some other elements that characterize its internal resource potential. Category: Management Operations Commercial Bank.

Government regulation of credit -Prudential norms.

"Prudential norms" are definitionally the guidelines and general norms issued by the regulating bank (the central bank) of the country for the proper and accountable functioning of bank and bank-like establishments. In other words, the norms are the practices that all banks are expected to follow.

Most usually, these norms relate to cash reserves, overnight call rates, income recognition, asset classification, provisioning of non-performing assets, and capital adequacy ratios. In recent years we have across the term 'prudential norms' too often particularly in relation to the non-performing assets of the commercial banks. In the light of the existence of huge non-performing asset in the balance sheets of the commercial banks leading to the erosion of their capital base the relevance of these prudential has acquired particular significance. The main elements of prudential norms are income recognition, assets classification, provisioning for loans and advances and capital adequacy. In keeping with latest practices at the international levels, commercial banks are not supposed to recognize their incomes from non-performing assets on an accrual basis and these are to be booked only when these are actually received.

If the balance sheet of a bank is to reflect the factual and true financial state of affairs of the bank it is pragmatic and desirable to have a system of recognition of income, classification of assets and provisioning for sticky debts on a prudential basis. Banks have been directed not to charge and take interest on non-performing assets to the income account and classify their assets under three broad categories of Standard Assets, Sub-standard Assets, Doubtful Assets and Loss Assets. Taking into account the time-lag between an account becoming doubtful of recovery, its recognition as such, the realization of the security and the erosion over time in value of security charged to the banks, banks are required to make provision against sub-standard assets, doubtful assets and loss assets.

Module 2
Over view of credit policy and loan characteristics

Credit (from Latin credere translation. "to believe") is the trust which allows one party to provide money or resources to another party where that second party does not reimburse the first party immediately (thereby generating a debt), but instead arranges either to repay or return those resources (or other materials of equal value) at a later date. The resources provided may be financial (e.g. granting a loan), or they may consist of goods or services (e.g. consumer credit). Credit encompasses any form of deferred payment. Credit is extended by a creditor, also known as a lender, to a debtor, also known as a borrower.

The Credit Process:
The credit process begins with a thorough analysis of the borrower's creditworthiness, or capacity and willingness to repay the loan. The examiner should find an assessment by the credit officer of:
♦The borrower's current and expected financial condition.
♦The borrower's ability to withstand adverse conditions or "stress."
♦The borrower's credit history and a positive correlation between historical and projected repayment capacity.
♦The optimal loan structure, including loan amortization, covenants, reporting requirements – the underwriting elements.
♦Collateral pledged by the borrower – amount, quality and liquidity; bank ability to realize the collateral under the worst case scenario. And,
♦Qualitative factors, such as management, the industry and the state of the economy.

This process begins with the collection, analysis and evaluation of information required to determine the creditworthiness of the borrower seeking credit from the bank. After the credit analysis is completed and borrower has been determined to be an acceptable risk, the credit officer proposes a loan structure for approval that preserves the strengths and protects against identified weaknesses of the borrower. The process ends with extermination of a risk rating for the credit and loan approval (or rejection). The bank's credit policy, lending standards and procedures create the parameters for this process, thereby establishing the bank's appetite for risk, conservative or aggressive.

The credit policy and standards should define acceptable loan purposes, types of loans and loan structures, and industries to which the bank is willing to lend, as well as the types of information the lender is required to obtain and analyze. The policy and standards help to create the framework, requirements and tolerance limits for lending in which all bank credit personnel will engage. The lender must understand the bank's credit risk management system and his/her role in it, as s/he engages in lending activities – analysis, underwriting and monitoring.

The Credit Initiation and Analysis Process

The objective of the credit initiation and analysis process is to ensure that loans extended by the bank meet credit policy guidelines and that credit standards and procedures established in the credit policy are observed in all geographic areas where the bank is active. The credit policy, updated periodically as necessary, should clarify what types of loans are acceptable to the bank, what loan purposes, tenor, collateral, structure, and guarantees the bank will accept in its lending activities. In other words, the credit policy establishes threshold requirements that any prospective borrower must meet.

The credit initiation and analysis process should follow a typical diagnostic process flow, beginning with screening of potential customers and data collection, followed by identification, analysis and measurement of risks, and then moving to a series of specific risk evaluation and risk mitigation actions in preparing for a credit decision, as shown on the following page.

Analysis of risks associated with any borrower should focus on the four foundations of creditworthiness, shown below:

Industry: involves the industry dynamics and the company's position within the industry. Weakness in the industry itself can significantly impact loan repayment ability and the company's position within the industry is an important issue.

Financial Condition: focuses on the borrower's ability to generate sufficient cash, the first source of loan repayment, or to draw on existing resources, e.g., capital or assets, to repay bank borrowings. The credit analyst examines the income statement, the balance sheet and the cash flow statement to evaluate this foundation of creditworthiness, focusing on profitability, efficiency, liquidity, and leverage, in particular.

Management Quality: entails the competence, integrity and alliances of the key individuals running the company. Management weakness or dishonesty can have an impact on both repayment capacity and security realization. Depth of management is always a concern, especially in smaller, family run organizations.

Security Realization: determines the level of the bank's control over collateral and the likely liquidation value, factoring in time, i.e., net present value. Weakness in security realization threatens the second source of loan repayment.

COMMON TYPES OF LOANS

Consumers and small businesses obtain loans with varying maturity periods to fund purchases of real estate, transportation, equipment, supplies, and a vast array of other needs. According to W. Keith Schilit in *The Entrepreneur's Guide to Preparing a Winning Business Plan and Raising Venture Capital,* they receive these loans from a number of sources, including friends and relatives, banks, credit unions, finance companies, insurance companies, leasing companies, and trade credit. The state and federal governments sponsor a number of loan programs to support small businesses. Following are examples of some common types of loans.

SHORT-TERM LOANS A special commitment loan is a single-purpose loan with a maturity of less than one year. Its purpose is to cover cash shortages resulting from a one-time increase in current assets, such as a special inventory purchase, an unexpected increase in accounts receivable, or a need for interim financing. Trade credit is another type of short-term loan. It is extended by a vendor who allows the purchaser up to three months to settle a bill. In the past it was common practice for vendors to discount trade bills by one or two percentage points as an incentive for quick payment.

A seasonal line of credit of less than one year may be used to finance inventory purchases or production. The successful sale of inventory repays the line of credit. A permanent working capital loan provides a business with financing from one to five years during times when cash flow from earnings does not coincide with the timing or volume of expenditures. Creditors expect future earnings to be sufficient to retire the loan.

INTERMEDIATE-TERM LOANS Term loans finance the purchase of furniture, fixtures, vehicles, and plant and office equipment. Maturity generally runs more than one year but less than five. Consumer loans for autos, boats, and home repairs and remodeling are also of intermediate term.

LONG-TERM LOANS Mortgage loans are used to purchase real estate and are secured by the asset itself. Mortgages generally run between ten and forty years. A bond is a contract held in trust with the obligation of repayment. An indenture is a legal document specifying the terms of a bond issue, including the principal, maturity date, interest rates, any qualifications and duties of the trustees, and the rights and obligations of the issuers and holders. Corporations and government entities issue bonds in a form attractive to both public and private investors. A debenture bond is unsecured, while a mortgage bond holds specific property in lien. A bond may contain safety measures to provide for repayment.

CHARACTERISTICS OF LOANS:

Loans have the following distinguishing characteristics:

1. *Time to maturity.* Time to maturity describes the length of the loan contract. Loans are classified according to their maturity into short-term debt, intermediate-term debt, and long-term debt. Revolving credit and perpetual debt have no fixed date for retirement. Banks provide revolving credit through extension of a line of credit. Brokerage firms supply margin credit for qualified customers on certain securities. In these cases, the borrower constantly turns over the line of credit by paying it down and borrowing the funds when needed. A perpetual loan requires only regular interest payments. The borrower, who usually issued such debt through a registered offering, determines the timing of the debt retirement.
2. *Repayment Schedule.* Payments may be required at the end of the contract or at set intervals, usually on a monthly or semi-annual basis. The payment is generally comprised of two parts: a portion of the outstanding principal and the interest costs. With the passage of time, the principal amount of the loan is amortized, or repaid little by little

until it is completely retired. As the principal balance diminishes, the interest on the remaining balance also declines. Interest-only loans do not pay down the principal. The borrower pays interest on the principal loan amount and is expected to retire the principal at the end of the contract through a balloon payment or through refinancing.

3. *Interest.* Interest is the cost of borrowing money. The interest rate charged by lending institutions must be sufficient to cover operating costs, administrative costs, and an acceptable rate of return. Interest rates may be fixed for the term of the loan, or adjusted to reflect changing market conditions. A credit contract may adjust rates daily, annually, or at intervals of 3, 5, and 10 years. Floating rates are tied to some market index and are adjusted regularly.
4. *Security.* Assets pledged as security against loan loss are known as collateral. Credit backed by collateral is secured. In many cases, the asset purchased by the loan often serves as the only collateral. In other cases the borrower puts other assets, including cash, aside as collateral. Real estate or land collateralize mortgages. Unsecured debt relies on the earning power of the borrower.

TYPICAL CHARACTERISTICS OF TYPES OF LOANS

Class	Relative Size	Normal Loan Length	Relative Risk	Relative Interest Rate	Source
Operating Credit	small or varied	short-term	Low in urban; higher in agriculture	high	Family or relative/ trader/bank/MFI/SHG
Investment Credit	Large	Medium to long	Low	low	Supplier/bank/coop.
Commerce	Small or varied	Short	Medium	high	Bank/coop./seller/MFI
Marketing	Large	Short to medium	High	high	Bank/Marketing Company/buyer agent
Consumer	Small or varied	Short	Medium to high	high	Bank/coop./Retailer
Housing	Large	Long	Low	Low	Bank/Coop./Finance Co.

Evaluating Commercial Loan Request:

Two types of errors in judgment regarding lending:

1. Type I Error: Making a loan to a customer who will ultimately default
2. Type II Error: Denying a loan to a customer who would ultimately repay the debt.

Five key questions/issues:

1. What is the character of the borrower and the quality of information provided?
2. What are the loan proceeds going to be used for?
3. How much does the customer need to borrow?
4. What is the primary source of repayment and when?
5. What collateral is available? (Secondary source of repayment)

Four steps in evaluating credit requests

1. Overview of management and operations
2. Spread the financial statements
3. Cash flow analysis
4. Pro forma projections and analysis

Overview of management and operations

Gather information on:

- Business and related industry
- Management quality
- Nature of loan request
- Quality of the data

Spread the financials and compute common size ratios

- Compare with industry averages
- Compare over time (on trend)

Calculate a series of financial ratios that indicate performance and risk

- Compare with industry averages
- Compare over time

Financial statement analysis

Overview of Financial Statement Analysis

Financial statement analysis involves the identification of the following items for a company's financial statements over a series of reporting periods:

- *Trends*. Create trend lines for key items in the financial statements over multiple time periods, to see how the company is performing. Typical trend lines are for revenues, the gross margin, net profits, cash, accounts receivable, and debt.

- *Proportion analysis*. An array of ratios are available for discerning the relationship between the sizes of various accounts in the financial statements. For example, you can calculate a company's quick ratio to estimate its ability to pay its immediate liabilities, or its debt to equity ratio to see if it has taken on too much debt. These analyses are frequently between the revenues and expenses listed on the income statement and the assets, liabilities, and equity accounts listed on the balance sheet.

Financial statement analysis is an exceptionally powerful tool for a variety of users of financial statements, each having different objectives in learning about the financial circumstances of the entity.

Users of Financial Statement Analysis:

There are a number of users of financial statement analysis. They are:

- *Creditors*. Anyone who has lent funds to a company is interested in its ability to pay back the debt, and so will focus on various cash flow measures.
- *Investors*. Both current and prospective investors examine financial statements to learn about a company's ability to continue issuing dividends, or to generate cash flow, or to continue growing at its historical rate (depending upon their investment philisophies).
- *Management*. The company controller prepares an ongoing analysis of the company's financial results, particularly in relation to a number of operational metrics that are not seen by outside entities (such as the cost per delivery, cost per distribution channel, profit by product, and so forth).
- *Regulatory authorities*. If a company is publicly held, its financial statements are examined by the Securities and Exchange Commission (if the company files in the United States) to see if its statements conform to the various accounting standards and the rules of the SEC.

Methods of Financial Statement Analysis

There are two key methods for analyzing financial statements. The first method is the use of horizontal and vertical analysis. Horizontal analysis is the comparison of financial information over a series of reporting periods, while vertical analysis is the proportional analysis of a financial statement, where each line item on a financial statement is listed as a percentage of another item. Typically, this means that every line item on an income statement is stated as a percentage of gross sales, while every line item on a balance sheet is stated as a percentage of total assets. Thus, horizontal analysis is the review of the results of multiple time periods, while vertical analysis is the review of the proportion of accounts to each other within a single period. The following links will direct you to more information about horizontal and vertical analysis:

- Horizontal analysis
- Vertical analysis

The second method for analyzing financial statements is the use of many kinds of ratios. You use ratios to calculate the relative size of one number in relation to another. After you calculate a ratio, you can then compare it to the same ratio calculated for a prior period, or that is based on an industry average, to see if the company is performing in accordance with expectations. In a typical financial statement analysis, most ratios will be within expectations, while a small number will flag potential problems that will attract the attention of the reviewer.

Cash flow analysis

A cash flow statement is one of the most important financial statements for a project or business. The statement can be as simple as a one page analysis or may involve several schedules that feed information into a central statement.

A cash flow statement is a listing of the flows of cash into and out of the business or project. Think of it as your checking account at the bank. Deposits are the cash inflow and withdrawals (checks) are the cash outflows. The balance in your checking account is your net cash flow at a specific point in time.

A *cash flow statement* is a listing of cash flows that occurred during the past accounting period. A projection of future flows of cash is called a *cash flow budget*. You can think of a cash flow budget

A cash flow statement is not only concerned with the amount of the cash flows but also the timing of the flows. Many cash flows are constructed with multiple time periods. For example, it may list monthly cash inflows and outflows over a year's time. It not only projects the cash balance remaining at the end of the year but also the cash balance for each month.

Working capital is an important part of a cash flow analysis. It is defined as the amount of money needed to facilitate business operations and transactions, and is calculated as current assets (cash or near cash assets) less current liabilities (liabilities due during the upcoming accounting period). Computing the amount of working capital gives you a quick analysis of the liquidity of the business over the future accounting period. If working capital appears to be sufficient, developing a cash flow budget may be not critical. But if working capital appears to be insufficient, a cash flow budget may highlight liquidity problems that may occur during the coming year.

Cash Flow from Operations:

This is the key source of a company's cash generation. It is the cash that the company produces internally as opposed to funds coming from outside investing and financing activities. In this section of the cash flow statement, net income (income statement) is adjusted for non-cash charges and the increases and decreases to working capital items - operating assets and liabilities in the balance sheet's current position.

Cash Flow from Investing:

For the most part, investing transactions generate cash outflows, such as capital expenditures for plant, property and equipment, business acquisitions and the purchase of investment securities. Inflows come from the sale of assets, businesses and investment securities. For investors, the most important item in this category is capital expenditures (more on this later). It's generally assumed that this use of cash is a prime necessity for ensuring the proper maintenance of, and additions to, a company's physical assets to support its efficient operation and competitiveness.

Cash Flow from Financing:

Debt and equity transactions dominate this category. Companies continuously borrow and repay debt. The issuance of stock is much less frequent. Here again, for investors, particularly income investors, the most important item is cash dividends paid. It's cash, not profits, that is used to pay dividends to shareholders.

Feasibility study:

An analysis of the ability to complete a project successfully, taking into account legal, economic, technological, scheduling and other factors. Rather than just diving into a project and hoping for the best, a feasibility study allows project managers to investigate the possible negative and positive outcomes of a project before investing too much time and money.

Credit analysis

Credit analysis is the method by which one calculates the creditworthiness of a business or organization. In other words, it is the evaluation of the ability of a company to honor its financial obligations. The audited financial statements of a large company might be analyzed when it issues or has issued bonds. Or, a bank may analyze the financial statements of a small business before making or renewing a commercial loan. The term refers to either case, whether the business is large or small.

The objective of credit analysis is to look at both the borrower and the lending facility being proposed and to assign a risk rating. The risk rating is derived by estimating the probability of default by the borrower at a given confidence level over the life of the facility, and by estimating the amount of loss that the lender would suffer in the event of default.

Credit analysis involves a wide variety of financial analysis techniques, including ratio and trend analysis as well as the creation of projections and a detailed analysis of cash flows. Credit analysis also includes an examination of collateral and other sources of repayment as well as credit history and management ability. Analysts attempt to predict the probability that a borrower will default on its debts, and also the severity of losses in the event of default. Credit spreads the difference in interest rates between theoretically "risk-free" investments such as U.S. treasuries or LIBOR and investments that carry some risk of default reflect credit analysis by financial market participants.

Before approving a commercial loan, a bank will look at all of these factors with the primary emphasis being the cash flow of the borrower. A typical measurement of repayment ability is the debt service coverage ratio. A credit analyst at a bank will measure the cash generated by a business (before interest expense and excluding depreciation and any other non-cash or extraordinary expenses). The debt service coverage ratio divides this cash flow amount by the debt service (both principal and interest payments on all loans) that will be required to be met. Commercial bankers like to see debt service coverage of at least 120 percent. In other words, the debt service coverage ratio should be 1.2 or higher to show that an extra cushion exists and that the business can afford its debt requirements.

Classic credit analysis

Traditionally most banks have relied on subjective judgment to assess the credit risk of a corporate borrower. Essentially, bankers used information on various borrower characteristics – such as character (reputation), capital (leverage), capacity (volatility of earnings), conditions (purpose of the loan), and collateral – in deciding whether or not to make a given loan. These characteristics are commonly referred to as the 5 Cs. Developing this type of expert system is time-consuming and expensive. That is why, from time to time, banks have tried to clone their decision-making process. Even so, in the granting of credit to corporate customers, many banks continue to rely primarily on their traditional expert system for evaluating potential borrowers.

Different types of borrowers

Depending upon your personal circumstances and residential mortgage requirements, lenders will identify you as a particular type of borrower. Understanding your borrowing type and requirements will help you to select the most suitable residential mortgage for you.

First time buyer

A person who has never had a mortgage before.

Home-owner

A person who owns his/her own home either with or without a mortgage.

Remortgage

A person who owns a property with a mortgage and is looking to refinance.

Large loan borrower

A person who is looking for a mortgage in excess of £500k.

Shared owner

In an industry with high property prices shared ownership helps people who cannot afford to buy a home outright. With shared ownership you purchase a percentage of a property with the help of a mortgage whilst a housing association or local authority will purchase the remaining share. You will pay a rent on the share which you do not own.

Let to buy

Many people now choose to let their existing property rather than sell when they move into a new home. The new mortgage lender will not necessarily take your existing mortgage into consideration as a commitment as long as the rent covers the existing mortgage payment. A deposit maybe required for the new mortgage however this maybe released from the existing property by remortgaging or a secured loan.

Pros:

- You can rent out your existing property in order to buy another home locally or in a completely different location within the UK.
- Let to buy is a really good way to retain your property if you're relocating as a result of a job or change of circumstance for a period of time and have a need to purchase a new property whilst you're away.
- Let to buy is a way to retain your original property as an investment and benefit from the mortgage being paid by a tenant?
- Let to buy can be of real benefit when used to break the buyers and sellers chain if you are having trouble selling your property or if you have little or no equity and would rather wait before selling.
- Let to buy can be a start to building a property portfolio that you could benefit form in the future, acting like a form of long term pension provision, once the mortgage on the property is paid off.
- The rules are different from buy to let as you may be able to borrow a higher proportion of the property value, which means you may need a smaller deposit or if you have plenty of equity in your current property possibly no deposit is required at all.

Cons:
It is a requirement by the new mortgage lender that you ask for your existing mortgage lender to give permission to let to buy.

Balance sheet analysis

Meaning and definition of Balance Sheet Analysis

Balance sheet analysis can be defined as an analysis of the assets, liabilities, and equity of a company. This analysis is conducted generally at set intervals of time, like annually or quarterly. The process of balance sheet analysis is used for deriving actual figures about the revenue, assets, and liabilities of the company.

Goal of Balance Sheet Analysis

The balance sheet analysis is helpful for the investors, investment bankers, share brokers, and financial institutions, for verifying the profitability of investment for a specific company.

How to perform a Balance Sheet Analysis

It is not a difficult task to perform a Balance Sheet Analysis. The main steps include:

- The primary step involves adding up liabilities and the paid up equity share capital. The sum must tally with the sum of total assets. After the process of tallying is done, contrast the total assets with total liabilities. However, this evaluation does not include the issued shares' amount in the liabilities. If the total assets are exceeding the total liabilities, the financial standing and performance of the company is considered to be good.

- The next step involves looking at the current assets and liabilities. Sometimes, it is considered as a good sign to have more unsecured liabilities.
- Another important step is calculating the ROA by dividing the net income by assets. Producer companies feature a high ROA unlike the real estate and leasing companies which feature a low ROA.
- The fourth step involves special concern for copyrights and patents. It is important to consider the ratio between invested amount for research and the consequent returns.
- Next step involves calculating the debt asset ratio by dividing total liabilities by total assets. A lower liability dimension reflects a better performance by the company.
- Another step includes estimating the receivables turnover ratio which signifies the relation between investment in sales and money receivable. A better financial status is reflected in high amount of money receivables.
- Another important ratio is the inventory turnover ratio which indicates the company's capability of producing goods with available assets.
- The final step includes analyzing other features of company including goodwill, credit ratings, and current projects. This analysis is helpful in evaluating the company activities in near future.

<u>Forms of Advances Given by Banks</u>

Commercial banks advances are made in different forms such as cash credit, overdraft, loans, purchasing and Discounting Bills etc. Commercial banks advances are made in different forms such as cash credit, overdraft, loans, purchasing and Discounting Bills etc. These forms of advances are explained below.

Cash Credit:

A cash credit is essentially a drawing account against credit granted by the bank and is operated in the same way as a current account in which an overdraft limit has been sanctioned. The principal advantages of a cash credit account to a borrower are that, unlike the party borrowing on a fixed loan basis, he may operate the account within the stipulated limit as and when required and can save interest by reducing the debit balance whenever he is in a position to do so. The borrower can also provide alternative securities from time to time in conformity with the terms of the advance and according to his own requirements. Cash credits are normally granted against the security of goods e.g. raw materials, stock in process, finished goods. It is also granted against the security of book-debts. If there is good turnover both in the account and in the goods, and there are no adverse factors, a cash credit limit is allowed to continue for years together. Of course a periodical review would be necessary.

Cash credit provides an elastic form of borrowing since the limit fluctuates according to the needs of the business. Cash credits are the most favorable mode of financing by large commercial and industrial concerns.

Overdraft:
Oxford Dictionary of Finance and Banking defines overdraft as "a loan made to a customer with a cheque account at a bank or building society, in which the account is allowed to go into debit, usually up to a specified limit".

According to Cambridge Advanced Learner's Dictionary, overdraft means "an amount of money that a customer with a bank account is temporarily allowed to owe to the bank, or the agreement which allows this".

The Economist defines overdraft as "a credit facility that allows borrowers to draw upon it (up to a specified limit) as and when they need to. Borrowers pay only for what they use".

Overdraft is an arrangement between a banker and his customer by which the latter is allowed to withdraw over and above his credit balance in the current account up to an agreed limit. This is only a temporary accommodation usually granted against security.

The borrower is permitted to draw and repay any number of times, provided the total amount overdrawn does not exceed the agreed limit. The interest is charged only for the amount drawn and not for the whole amount sanctioned.

A cash credit differs from an overdraft in one respect. A cash credit is used for long-term by businesses in doing regular business whereas overdraft is made occasionally and for short duration.

Banks sometimes grant unsecured overdraft for small amounts to customers having current account with them. Such customers may be government employees with fixed income or traders. Temporary overdrafts are permitted only where reliable source of funds are available to a borrower for repayment.

Loans:
As defined in Oxford Dictionary of Finance and Banking, loan is the "money lent on condition by a bank that it is repaid, either in installments or all at once, on agreed dates and usually that the borrower pays the lender an agreed rate of interest (unless it is ail interest-live loan)". Oxford Dictionary of Finance and Banking defines bank loan as "a specified sum of money lent by a bank to a customer, usually for a specified time, at a specified rate of interest".

According to Cambridge Advanced Learner's Dictionary, loan means "a sum of money which is borrowed, often from a bank, and has to be paid back, usually together with an extra amount of money that you have to pay as a charge for borrowing". I imotby W. Kocli defines loans as "formal agreement between a bank and borrower to provide a fixed amount of credit for a specified period".

The loans may be repaid in installments or at the expiry of a certain period. The loan may be made with or without security. A loan once repaid in full or in part cannot be withdrawn again by the customer. In case a borrower wants further loan, he has to arrange for a fresh loan.

Demand Loan Vs Term Loan:

Loan may be a demand loan or a term loan. Demand loan is payable on demand. It is for a short period and usually granted to meet working capital needs of the borrower. Term loans may be medium-term or long-term. Medium-term loans are granted for a period ranging from one year to five years for the purpose of vehicles, tools, and equipment. Long-term loans are granted for capital expenditures such as purchase of land, construction of factory building, purchase of new machinery and modernization of plant.

Secured Vs Unsecured Loan:

According to section 5(e) of The Bank Companies Act, 1991, “Secured loan or advance means such a loan or advance as made against the security assets, market value of which is not at any means less than the amount of such loan or advance and unsecured loan or advance is that loan or advance or part of it does not require sanctioning against the security”.

Participation Loan or Consortium Loan:

Where one single loan is granted by more than one financing agency, it is termed as a participation or consortium loan. Such participation becomes necessary where either the risk involved is too large for one or more of the participating institutions to take individually or there are administrative or other difficulties in servicing and follow up of the loan.

Purchasing and Discounting Bills:

Bills of exchange, as defined in The Negotiable Instruments Act, 1 SSI, is “an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay (on demand or at a fixed or determinable future time) a certain sum of money only to, or to the order of, a certain person or to the bearer of the instrument”.

Banks grant advances to their customers by discounting bills of exchange. The net amount, after deducting the amount of interest/discount from the amount of the installment, is credited in the account of the customer. In this form of lending, the interest is received by the banker in advance.

Banks sometimes purchase the bills instead of discounting them. Bills which are accompanied by documents or title to goods such as bills of lading or railway receipt are purchased by the bankers. In such cases, the banker grants loan in the form of overdraft or cash credit against the security of the bills. The term ‘bill purchased' seems to imply that the bank becomes the purchaser or owner of such bills. But in almost all cases the bank holds the bill only as a security for the advance.

Loan against trust certificate:

When bank grant any loan to the customer keeping his/ her various trust certificates as guarantee, that kinds of credit is called as loan against trust receipt. Generally customer keeps his DPS certificates; FDR certificates to the bank sanction the credit on the guarantee of the trust certificates.

SME loan:

SME stand for Small and Medium Enterprise. Nowadays SME loan is most common and popular credit item of any commercial bank. All the bank concentrate on the SME sector, because new established small business are playing vital role in the national economy. For this purpose along with National bank, Multinational bank also open their SME units in all branch.

Module 3
Evaluating consumer loans

Definition

A secured or unsecured loan with fixed terms issued by a bank or financing company that may be used for any purpose but is typically tied to the purchase of a specific item. Unsecured loans are issued based on the creditworthiness of the borrower while secured loans are collateralized by the personal property of the borrower.

Consumer Loans

Consumer loans in the aggregate currently produce greater percentage profits for banks than commercial loans. This is true despite the higher default rates on consumer loans. Not surprisingly, consumer loan rates typically exceed commercial loan rates.

Evaluating Consumer Loans

An analyst should addresses the same issues discussed with commercial loans:

- The use of loan proceeds
- The amount needed
- The primary and secondary source of repayment

However, consumer loans differ so much in design that no comprehensive analytical format applies to all loans

Types of Consumer Loans:

1. Installment Loans

- Require the periodic payment of principal and interest
- Can be extremely profitable

- Direct: Negotiated between the bank and the ultimate user of the funds
- Indirect: Funded by a bank through a separate retailer that sells merchandise to a customer

2. Credit Cards and Other Revolving Credit

Credit cards and overlies tied to checking accounts are the two most popular forms of revolving credit agreements. In 2004 consumers charged approximately $2.5 trillion on credit cards. Most banks operate as franchises of MasterCard and/or Visa. Bank pays a one-time membership fee plus an annual charge determined by the number of its customers actively using the cards. Credit cards are attractive because they provide higher risk-adjusted returns than do other types of loans. Card issuers earn income from three sources:

- Cardholders' annual fees
- Interest on outstanding loan balances
- Discounting the charges that merchants accept on purchases.

Credit Card Systems and Profitability: Returns depend on the specific role the bank plays. A bank is called a card bank if it administers its own credit card plan or serves as the primary regional agent of a major credit card operation. A non-card bank does not issue its own card

3. Overdraft Protection and Open Credit Lines

Overdraft Protection against Checking Accounts. A type of revolving credit

Open Credit Lines: A recent trend is to offer open credit lines to affluent individuals whether or not they have an existing account relationship. Typically, the bank provides customers with special checks that activate a loan when presented for payment

4. Home Equity Loans

Grew from virtually nothing in the mid-1980s to over $250 billion in 2004. They meet the tax deductibility requirements of the Tax Reform Act of 1986, which limits deductions for consumer loan interest paid by individuals, because they are secured by equity in an individual's home. Some allow access to credit line by using a credit card.

5. Non-Installment Loans

Often require a single principal and interest payment. Bridge loans are representative of single payment consumer loans. Bridge loans often arise when an individual borrows funds for the down payment on a new house. The loan is repaid when the borrower sells the previous home

6. Subprime Loans

One of the hottest growth areas during the 1990s. Subprime loans are higher-risk loans labeled "B," "C," and "D" credits. They have been especially popular in auto, home equity, and mortgage lending. Typically have the same risk as loans originated through consumer finance companies. Subprime loans have greater risk and must be priced consistently higher than prime-grade loans.

Example Definitions:

- B: Typically scores 600+ under the Fair Isaac system; has some 90-day past dues but is now current. Typical delinquencies are 2%-5%; repossessions are 2.5%-6%; and losses are 1.5%-3%
- C: Typically scores between 500 and 600 and has had write-offs and judgments. The borrower has made subsequent payments of some or all of the loans. Typical delinquencies are 5%-10%; repossessions, 5%-20%; and losses 3%-10%
- D: Typically scores between 440 and 500 and has charge-offs and judgments that have not been repaid and has not made payments on these loans. Delinquencies are 10%-20%; repossessions, 16%-40%; losses, 10%-20%.

7. High LTV Loans

High Loan-To-Value. Many lenders upped the stakes by making "high LTV" loans based on the equity in a borrower's home. Where traditional home equity loans are capped at 75 percent of appraised value minus the outstanding principal balance, high LTV loans equal as much as 125% of the value of a home.

Consumer Credit Regulations: - Equal Credit Opportunity

Credit Scoring Systems:

Credit scoring systems are acceptable if they do not require prohibited information and are statistically justified. Credit scoring systems can use information about age, sex, and marital status as long as these factors contribute positively to the applicant's creditworthiness. Credit scoring models are based on historical data obtained from applicants who actually received loans. Statistical techniques assign weights to various borrower characteristics that represent each factor's contribution toward distinguishing between good loans that were repaid on time and problem loans that produced losses

Credit Reporting:

Lenders must report credit extended jointly to married couples in both spouses' names. Whenever lenders reject a loan, they must notify applicants of the credit denial within 30 days and indicate why the request was turned down

Credit Analysis

Objective of consumer credit analysis is to assess the risks associated with lending to individuals. When evaluating loans, bankers cite the Cs of credit:

- Character: The most important element, but difficult to assess
- Capital: Refers to the individual's wealth position
- Capacity: The lender often imposes maximum allowable debt-service to income ratios
- Conditions: The impact of economic events on the borrower's capacity to pay
- Collateral: The importance of collateral is in providing a secondary source of repayment

Two additional Cs

- Customer Relationship: A bank's prior relationship with a customer reveals information about past credit and deposit experience that is useful in assessing willingness and ability to repay.
- Competition: Has an impact by affecting the pricing of a loan. All loans should generate positive risk-adjusted returns. Lenders periodically react to competitive pressures by undercutting competitors' rates in order to attract new business. Competition should not affect the accept/reject decision

Evaluation Procedures:

- Judgmental
- Quantitative, Credit Scoring

Judgmental: The loan officer subjectively interprets the information in light of the bank's lending guidelines and accepts or rejects the loan

Quantitative credit scoring / Credit scoring model: The loan officer grades the loan request according to a statistically sound model that assigns points to selected characteristics of the prospective borrower. In both cases, judgmental and quantitative, a lending officer collects information regarding the borrower's character, capacity, and collateral

Risks and Return Characteristics of Consumer Loans

- Revenues from Consumer Loans

The attraction is two-fold:

Competition for commercial customers narrowed commercial loan yields so that returns fell relative to potential risks. Developing loan and deposit relationships with individuals presumably represents a strategic response to deregulation. Consumer loan rates have been among the highest rates quoted at banks in recent years. In addition to interest income, banks generate substantial non-interest revenues from consumer loans. With traditional installment credit, banks often encourage borrowers to purchase credit life insurance on which the bank may earn a premium

- Consumer Loan Losses

Losses on consumer loans are normally the highest among all categories of bank credit. Losses are anticipated because of mass marketing efforts pursued by many lenders, particularly with credit cards. Credit card fraud losses amounted to more than $2.4 billion in mid-2004.

- Interest Rate and Liquidity Risk with Consumer Credit

The majority of consumer loans are priced at fixed rates. New auto loans typically carry 4-year maturities, and credit card loans exhibit an average 15- to 18-month maturity.

Bankers have responded in two ways:

- Price more consumer loans on a floating-rate basis
- Commercial and investment banks have created a secondary market in consumer loans, allowing loan originators to sell a package of loans

Customer profitability analysis

Two significant differences alter the analysis when evaluating the profitability of individual accounts:

1. Consumer loans are much smaller than commercial loans, on average

2. Processing costs per dollar of loan are much higher than for commercial loans

Loans will not generate enough interest to cover costs if they are too small or the maturity is too short, even with high interest rates. Thus, banks set minimum targets for loan size, maturity, and interest rates.

Break-even analysis of consumer loans

The break-even relationship is based on the objective that loan interest revenues net of funding costs and losses equal loan costs:

Net Interest income = Interest expense + Loan losses + Acquisition costs + Collection costs

Break-even analysis of consumer loans general analysis: If:

R = annual percentage loan rate (%)
D = interest cost of debt (%)
L = average loan loss rate (%)
S = initial loan size
B=avg. loan balance outstanding (% of initial loan)
M = number of monthly payments
Ca = loan acquisition cost, and
Cc = collection cost per payment

- Then:

$(r - d - l)\ SB\ (M/12) = C_a + (C_c)(M)$

Pricing new commercial loans:

The approach is the same, equating revenues with expenses plus target profit, but now the loan officer must forecast borrower behavior. For loan commitments this involves projecting the magnitude and timing of actual borrowings, compensating balances held, and the volume of services consumed. The analysis assumes that the contractual loan rate is set at a markup over the bank's weighted marginal cost of funds and thus varies coincidentally.

Risk-adjusted returns on loans

When deciding what rate to charge, loan officers attempt to forecast default losses over the life of the loan. Credit risk, in turn, can be divided into expected losses and unexpected losses.

- Expected losses might be reasonably based on mean historical loss rates.
- In contrast, unexpected losses should be measured by computing the deviation of realized losses from the historical mean.

Commercial loans are frequently underpriced at banks today. Strong competition for loans tends to increase the banks underpricing of loans. Lenders appear to have systematically understated risk. The appropriate procedure is to identify expected and unexpected losses and incorporate both in determining the appropriate risk charge.

Fixed rates versus floating rates

Floating-rate loans: increase the rate sensitivity of bank assets, increase the GAP & reduce potential net interest losses from rising interest rates Because most banks operate with negative funding GAPs through one-year maturities, floating-rate loans normally reduce a bank's interest rate risk.

Floating-rate loans transfer interest rate risk from the bank to the borrower. Given equivalent rates, most borrowers prefer fixed-rate loans in which the bank assumes all interest rate risk. Banks frequently offer two types of inducements to encourage floating-rate pricing:

1. Floating rates are initially set below fixed rates for borrowers with a choice

2. A bank may establish an interest rate cap on floating-rate loans to limit the possible increase in periodic payments

Module 4
Loan and advances against pledge

Pledge

Pledge is used when the lender (pledgee) takes actual possession of assets (i.e. certificates, goods). Such securities or goods are movable securities. In this case the pledgee retains the possession of the goods until the pledger (i.e. borrower) repays the entire debt amount. In case there is default by the borrower, the pledgee has a right to sell the goods in his possession and adjust its proceeds towards the amount due (i.e. principal and interest amount). Some examples of pledge are Gold /Jeweler Loans, Advance against goods,/stock, Advances against National Saving Certificates etc.

Hypothecation

Hypothecation is used for creating charge against the security of movable assets, but here the possession of the security remains with the borrower itself. Thus, in case of default by the borrower, the lender (i.e. to whom the goods / security has been hypothecated) will have to first take possession of the security and then sell the same. The best example of this type of arrangement are Car Loans. In this case Car / Vehicle remains with the borrower but the same is hypothecated to the bank / financer. In case the borrower, defaults, banks take possession of the vehicle after giving notice and then sell the same and credit the proceeds to the loan account. Other examples of these hypothecation are loans against stock and debtors. [Sometimes, borrowers cheat the banker by partly selling goods hypothecated to bank and not keeping the desired amount of stock of goods. In such cases, if bank feels that borrower is trying to cheat, then it can convert hypothecation to pledge i.e. it takes over possession of the goods and keeps the same under lock and key of the bank].

Mortgage

Mortgage: is used for creating charge against immovable property which includes land, buildings or anything that is attached to the earth or permanently fastened to anything attached to the earth (However, it does not include growing crops or grass as they can be easily detached from the earth). The best example when mortgage is created is when someone takes a Housing Loan / Home Loan. In this case house is mortgaged in favour of the bank / financer but remains in possession of the borrower, which he uses for himself or even may give on rent.

Lien

A lien is a form of security interest granted over an item of property to secure the payment of a debt or performance of some other obligation. The owner of the property, who grants the lien, is referred to as the *lienee* and the person who has the benefit of the lien is referred to as the *lienor* or *lien holder*.

The etymological root is Anglo-French *lien*, *loyen* "bond", "restraint", from Latin *ligamen*, from *ligare* "to bind". In the United States, the term lien generally refers to a wide range of encumbrances and would include other forms of mortgage or charge. In the USA, a lien characteristically refers to *non-possessory* security interests (see generally: Security interest categories).

In other common-law countries, the term lien refers to a very specific type of security interest, being a passive right to retain (but not sell) property until the debt or other obligation is discharged. In contrast to the usage of the term in the USA, in other countries it refers to a purely *possessory* form of security interest; indeed, when possession of the property is lost, the lien is released. However, common-law countries also recognize a slightly anomalous form of security interest called an "equitable lien" which arises in certain rare instances.

Liens Enable Creditors to Assert Rights over Property

Unless the debtor is prudent and has taken measures to safeguard his assets, there is a risk that the creditors can seize assets and take your wealth. In order to know if your assets are at risk, it is imperative that you have an understanding of the different types of liens you may encounter as a small business owner:

- Consensual
    - Purchase-Money Security Liens
    - Non-Purchase-Money Security Liens
- Statutory
    - Mechanic's Liens
    - Tax Liens
- Judgment

Once we discuss the different types of liens, we'll then examine how creditors might seek to get your assets through these types of liens, and what you can do, as an individual and as a small business owner, to maximize your protection against those creditors. The strategies outlined will address a broad spectrum of topics, from forms of property ownership to structuring debt to minimize exposure.

Consensual Liens Are Voluntary

As the name implies, consensual liens are those to which you voluntarily consent, as a result of a loan or other advance of credit. The property purchased secures the buyer's obligation to pay for the property. One common example is the residential mortgage: a home buyer consents to a bank taking a security interest in the home when a mortgage is obtained. Similarly, a security interest also is created when a car dealer arranges for financing for a car buyer.

There are two broad classes of consensual liens:

- Purchase-Money Security Interest Liens. Here, the creditor extends credit to the debtor specifically for the purchase of the property that secures the debt. Examples include a first mortgage on a home, a car loan, and situations in which the seller finances the purchase of property, such as furniture, through a credit agreement.
- Non-Purchase-Money Security Interest Liens. Here, the debtor puts up property he or she already owns as collateral for a loan. The loan proceeds are then used to pay expenses (or perhaps to buy other property). Examples include a second mortgage (or refinancing of a mortgage) on a home or a loan used to pay operating expenses with previously owned office equipment put up as collateral.

Both types of consensual liens are usually non-possessory. This means that the creditor does not take or retain possession of the property; rather, the debtor takes, or retains, possession of the property. However, it's possible for either type of consensual lien to be possessory. In that case, the creditor takes possession of the collateral. A loan from a pawnbroker, for example, usually would create a possessory, non-purchase-money security interest lien in the collateral.

While this seems very straightforward, the type of debt can have a large impact on the creditor's rights if a debtor defaults. The rules vary from state to state, but characteristics of a debt are critical to understand if assets are to be protected. Issues include:

- Who is holding the property that secures the debt: the debtor or the creditor? In a car loan, the debtor has possession of the property. When a loan is obtained from a pawnshop, the creditor has possession of the property securing the loan.
- Was the debt incurred to purchase property or not? For example, a first mortgage loan is a purchase money loan since the proceeds were used to purchase a residence. In contrast, a refinancing loan is not a purchase money loan. The homeowner already owned the property.
- What is the nature of the property to which the lien is attached? This is often the essential inquiry when it comes to asset protection. The states, as well as the federal government, have a wide variety of laws relating to what assets are protected from creditors and how they are protected. The primary mechanism for protecting selected assets is a concept called exemptions. In essence, the law may declare that certain property simply cannot be seized by a creditor.

The other common types of liens are statutory liens and judgment liens.

<u>Statutory and Judgment Liens Arise by Operation of Law</u>

In addition to consensual liens, there are many different types of liens that creditors can use to get at your assets to satisfy a debt. In certain circumstances, creditors obtain security interests by the operation of state (or federal) laws. These liens include:

- Mechanic's Liens. This type of lien arises when a contractor or mechanic performs work on property and is not paid. Examples include a contractor who installs a furnace in a home, or an auto mechanic who performs repairs to a car. This lien is a security interest in the property. If the owner tries to sell the property, the debtor will have a secured interest in the portion of the proceeds needed to pay the debt. In addition, having a mechanic's lien can delay or prevent the sale of real property until debt is satisfied and the lien released.

- Tax Liens. This type of lien is placed against property by the local, state or federal government, as authorized by statute, for delinquent taxes, including property, income and estate taxes.

<u>Advances against Goods/Stock in Trade</u>

Advances needed to the customers when they feel crisis of fund. When the customers need advances they went to bank for help. Then bank help the customers by giving advances against Goods/Stocks in Trade. About 2/3 of the total secured advances are sanctioned by banks against the security of goods which include food articles, industrial raw material plantation products, manufactured articles and minerals. Goods have many distinct advantages over other forms of securities:

(i) They are easily realizable on account of their having a ready market.
(ii) Their value can easily be ascertained from the market.
(iii) They are tangible assets and, therefore, can be realized in case the necessity arises.
(iv) Loans against commodities are of a seasonal character. They are repaid before the commencement of the next season. Therefore, there is no unnecessary locking up of funds.
(v) In case of commodities which are used as necessaries of life, there is not much of price fluctuations.

<u>However, goods as 'security' have their own limitations.</u>

(i) Effective supervision over goods, may not be possible particularly when they are hypothecated. Dishonest persons may cheat the banks.
(ii) Quality of goods is difficult to verify. The goods actually pledged n1aybe quite different than those which were promised to be pleaged.
(iii) Goods deteriorate in quality with the passage of time. This results in erosion in bank's security.
(iv) Heavy transportation costs may have to be incurred for realizing the best possible price for the goods.

<u>Precautions and Procedures</u>

The bank should keep in mind the following points while advancing money on the security of goods.

(i) Selection of the borrower. The banker should satisfy himself regarding the character, capacity and capital of the borrower. Since in case of goods, chances of fraud are more, this is all the more important.

(ii) Selection of the commodities. Commodities should be such which have fairly stable prices. The Head Office should prepare a list of such commodities and in case a branch wants to lend money on the security of a commodity which is outside this list, the branch should take permission of the Head Office. .

(iii) Charging the security. Goods can be deposited by way of security either in the form of a pledge or hypothecation. In case of hypothecation the borrower must be dependable since the banker has little control over the movement of goods.

The banker must also obtain a declaration from the borrower stating that

(I) The borrower is the owner of the goods hypothecated and
(II) The shall not charge the same goods to any other person without the prior consent of the bank.

(iv) Storage of goods, following points should be taken into account while storing the goods offered by way of security:

(a) The godown should safe from water, fire etc. and situated in a good locality.
(b) In case of hypothecation of goods the borrower should give an undertaking that he will allow inspection of godown and stock books as and when desired by the bank's officials.
(c) In case of pledge the godown should have a bank lock with the bank's name engraved on it. Some name plates declaring that the goods are pledged should be prominently displayed in the godown.
(d) In case of payment of loan in installments it should be seen that the goods released are in proportion to the amount paid by the borrower.
(e) The goods should be insured for full value so that the bank may not have to suffer on account of "average clause m case of under insurance.

(v) <u>Conduct of the account</u>

(a) No loan should be granted before the bank obtains either actual, constructive delivery of goods. In case of the bank permits the borrower process out the raw materials hypothecated into a finished product, appropriate name plate that the goods are hypothecated with the bank should. Be prominently displayed.
(b) The balance in the borrower's account should not be allowed exceed the drawing limit.
(c) The drawing limit should be fixed by taking into account the value of the goods (calculated on the basis of cost or market price, whichever is less) and appropriate margin in respect of those goods. While valuing the goods both quantity and quality of goods should be seen.

(d) The borrower should clear the old debt before the commencement of the next season. In case he has not done so, necessary explanation should be called for.
(e) The advances should be made for genuine trade needs and, not for speculation activities.

(vi) Legal requirements:

Under its selective credit control scheme, Bangladesh Bank issues from time to time directives regarding granting of loans against selective commodities. The banker should abide by these directives.

Document to title to goods

Formal commercial document (such as bill of sale, certificate of title, title deed) or shipping document (such as a bill of lading, dock receipt, warehouse receipt) that confers and/or proves ownership. A document of title enables its holder (possessor) to receive, retain, sell, or otherwise dispose of the document and the goods or property listed therein.

Life insurance policies

Life insurance (or commonly final expense insurance or life assurance, especially in the Commonwealth) is a contract between an insured (insurance policy holder) and an insurer or assurer, where the insurer promises to pay a designated beneficiary a sum of money (the "benefits") in exchange for a premium, upon the death of the insured person. Depending on the contract, other events such as terminal illness or critical illness can also trigger payment. The policy holder typically pays a premium, either regularly or as one lump sum. Other expenses (such as funeral expenses) can also be included in the benefits.

Life policies are legal contracts and the terms of the contract describe the limitations of the insured events. Specific exclusions are often written into the contract to limit the liability of the insurer; common examples are claims relating to suicide, fraud, war, riot, and civil commotion.

Life-based contracts tend to fall into two major categories:

- Protection policies – designed to provide a benefit, typically a lump sum payment, in the event of specified event. A common form of a protection policy design is term insurance.
- Investment policies – where the main objective is to facilitate the growth of capital by regular or single premiums. Common forms (in the U.S.) are whole life, universal life, and variable life policies.

What is a life insurance policy?

A life insurance policy provides financial protection to your family in the unfortunate event of your death. At a basic level, it involves paying small sums each month (called premiums) to cover the risk of your untimely demise during the tenure of the policy. In such an event, your family (or the beneficiaries you have named in the policy) will receive a lump sum amount. In case you live till the maturity of the policy, depending on the type of life insurance policy you have opted for, you will receive returns the policy may have earned over the years. Today, there are many variations to this basic theme, and insurance policies cater to a wide variety of needs.

What are the various types of life insurance policies?

Given below are the basic types of life insurance policies. All other life insurance policies are built around these basic insurance policies by combination of various other features.

Term Insurance Policy

- A term insurance policy is a pure risk cover policy that protects the person insured for a specific period of time. In such type of a life insurance policy, a fixed sum of money called the sum assured is paid to the beneficiaries (family) if the policyholder expires within the policy term. For instance, if a person buys a Rs 2 lakh policy for 15 years, his family is entitled to the sum of Rs 2 lakh if he dies within that 15-year period.
- If the policy holder survives the 15-year period, the premiums paid are not returned back. The advantage, apart from the financial security for an individual's family is that the premiums paid are exempt from tax.
- These insurance policies are designed to provide 100 per cent risk cover and hence they do not have any additional charges other than the basic ones. This makes premiums paid under such life insurance policies the lowest in the life insurance category.

Whole Life Policy

- A whole life policy covers a policyholder against death, throughout his life term. The advantage that an individual gets when he / she opts for a whole life policy is that the validity of this life insurance policy is not defined and hence the individual enjoys the life cover throughout his or her life.
- Under this life insurance policy, the policyholder pays regular premiums until his death, upon which the corpus is paid to the family. The policy does not expire till the time any unfortunate event occurs with the individual.
- Increasingly, whole life policies are being combined with other insurance products to address a variety of needs such as retirement planning, etc.
- Premiums paid under the whole life policies are tax exempt.

Endowment Policy

- Combining risk cover with financial savings, endowment policies are among the popular life insurance policies.

- Policy holders benefit in two ways from a pure endowment insurance policy. In case of death during the tenure, the beneficiary gets the sum assured. If the individual survives the policy tenure, he gets back the premiums paid with other investment returns and benefits like bonuses.
- In addition to the basic policy, insurers offer various benefits such as double endowment and marriage/ education endowment plans.
- The concept of providing the customers with better returns has been gaining importance in recent times. Hence, insurance companies have been coming out with new and better ULIP versions of endowment policies. Under such life insurance policies the customers are also provided with an option of investing their premiums into the markets, depending on their risk appetite, using various fund options provided by the insurer, these life insurance policies help the customer profit from rising markets.
- The premiums paid and the returns accumulated through pure endowment policies and their ULIP variants are tax exempt.

<u>Money Back Policy</u>

- This life insurance policy is favoured by many people because it gives periodic payments during the term of policy. In other words, a portion of the sum assured is paid out at regular intervals. If the policy holder survives the term, he gets the balance sum assured.
- In case of death during the policy term, the beneficiary gets the full sum assured.
- New ULIP versions of money back policies are also being offered by various life insurers.
- The premiums paid and the returns accumulated though a money back policy or its ULIP variants are tax exempt.

<u>ULIPs</u>

- ULIPs are market-linked life insurance products that provide a combination of life cover and wealth creation options.
- A part of the amount that people invest in a ULIP goes toward providing life cover, while the rest is invested in the equity and debt instruments for maximising returns. .
- ULIPs provide the flexibility of choosing from a variety of fund options depending on the customers risk appetite. One can opt from aggressive funds (invested largely in the equity market with the objective of high capital appreciation) to conservative funds (invested in debt markets, cash, bank deposits and other instruments, with the aim of preserving capital while providing steady returns).
- ULIPs can be useful for achieving various long-term financial goals such as planning for retirement, child's education, marriage etc.

Annuities and Pension

- In these types of life insurance policies, the insurer agrees to pay the insured a stipulated sum of money periodically. The purpose of an annuity is to protect against financial risks as well as provide money in the form of pension at regular intervals.

Stock exchange

A stock exchange is a form of exchange which provides services for stock brokers and traders to buy or sell stocks, bonds, and other securities. Stock exchanges also provide facilities for issue and redemption of securities and other financial instruments, and capital events including the payment of income and dividends.

Securities traded on a stock exchange include stock issued by listed companies, unit trusts, derivatives, pooled investment products and bonds. Stock exchanges often function as "continuous auction" markets, with buyers and sellers consummating transactions at a central location, such as the floor of the exchange.

To be able to trade a security on a certain stock exchange, it must be listed there. Usually, there is a central location at least for record keeping, but trade is increasingly less linked to such a physical place, as modern markets are electronic networks, which gives those advantages of increased speed and reduced cost of transactions. Trade on an exchange is by members only.

The initial public offering of stocks and bonds to investors is by definition done in the primary market and subsequent trading is done in the secondary market. A stock exchange is often the most important component of a stock market. Supply and demand in stock markets are driven by various factors that, as in all free markets, affect the price of stocks (see stock valuation).

There is usually no compulsion to issue stock via the stock exchange itself, nor must stock be subsequently traded on the exchange. Such trading is said to be *off exchange* or over-the-counter. This is the usual way that derivatives and bonds are traded. Increasingly, stock exchanges are part of a global market for securities.

In recent years, various other trading venues, such as electronic communication networks, alternative trading systems and "dark pools" have taken much of the trading activity away from traditional stock exchanges.

Role of stock exchanges

1. Raising capital for businesses

A stock exchange provides companies with the facility to raise capital for expansion through selling shares to the investing public. Besides the borrowing capacity provided to an individual or firm by the banking system, in the form of credit or a loan, there are four common forms of capital raising used by companies and entrepreneurs. Most of these available options might be achieved, directly or indirectly, through a stock exchange.

2. Going public

Capital intensive companies, particularly high tech companies, always need to raise high volumes of capital in their early stages. For this reason, the public market provided by the stock exchanges has been one of the most important funding sources for many capital intensive startups. After the 1990s and early-2000s hi-tech listed companies' boom and bust in the world's major stock exchanges, it has been much more demanding for the high-tech entrepreneur to take his/her company public, unless either the company already has products in the market and is generating sales and earnings, or the company has completed advanced promising clinical trials, earned potentially profitable patents or conducted market research which demonstrated very positive outcomes.

3. Limited partnerships

A number of companies have also raised significant amounts of capital through R&D limited partnerships. Tax law changes that were enacted in 1987 in the United States changed the tax deductibility of investments in R&D limited partnerships. In order for a partnership to be of interest to investors today, the cash on cash return must be high enough to entice investors.

4. Venture capital

A third usual source of capital for startup companies has been venture capital. This source remains largely available today, but the maximum statistical amount that the venture company firms in aggregate will invest in any one company is not limitless (it was approximately $15 million in 2001 for a biotechnology company).

5. Corporate partners

A fourth alternative source of cash for a private company is a corporate partner, usually an established multinational company, which provides capital for the smaller company in return for marketing rights, patent rights, or equity. Corporate partnerships have been used successfully in a large number of cases.

6. Mobilizing savings for investment

When people draw their savings and invest in shares (through an IPO or the issuance of new company shares of an already listed company), it usually leads to rational allocation of resources because funds, which could have been consumed, or kept in idle deposits with banks, are mobilized and redirected to help companies' management boards finance their organizations.

7. Facilitating company growth

Companies view acquisitions as an opportunity to expand product lines, increase distribution channels, hedge against volatility, increase their market share, or acquire other necessary business assets. A takeover bid or a merger agreement through the stock market is one of the simplest and most common ways for a company to grow by acquisition or fusion.

8. Profit sharing

Both casual and professional stock investors, as large as institutional investors or as small as an ordinary middle-class family, through dividends and stock price increases that may result in capital gains, share in the wealth of profitable businesses. Unprofitable and troubled businesses may result in capital losses for shareholders.

9. Corporate governance

By having a wide and varied scope of owners, companies generally tend to improve management standards and efficiency to satisfy the demands of these shareholders, and the more stringent rules for public corporations imposed by public stock exchanges and the government. Consequently, it is alleged that public companies (companies that are owned by shareholders who are members of the general public and trade shares on public exchanges) tend to have better management records than privately held companies (those companies where shares are not publicly traded, often owned by the company founders and/or their families and heirs, or otherwise by a small group of investors).

10. Creating investment opportunities for small investors

As opposed to other businesses that require huge capital outlay, investing in shares is open to both the large and small stock investors because a person buys the number of shares they can afford. Therefore, the Stock Exchange provides the opportunity for small investors to own shares of the same companies as large investors.

<u>Fixed deposit receipts</u>

A fixed deposit (FD) is a financial instrument provided by banks which provides investors with a higher rate of interest than a regular savings account, until the given maturity date. It may or may not require the creation of a separate account. It is known as a term deposit or time deposit in Canada, Australia, New Zealand, and the US, and as a bond in the United Kingdom and India. They are considered to be very safe investments.

ELIGIBILITY

1. Any Resident Individual - Single Accounts, Two or more individuals in Joint Accounts, Illiterate Persons, Blind persons, Purdanasheen Ladies, Minors, Associations, Clubs, Societies, etc. Trusts, Institutions/Agencies specifically permitted by the RBI eligible to open a ""Fixed Deposit Receipt" Account" in single/joint name/s.

2. Minimum amount:-

Rs.10,000/- for FDR in Metro and Urban Branches and Rs.5,000/- in Rural and Semi urban branches, and for senior citizens the minimum amount will be Rs. 5000/-

Minimum Amount criteria will not be applicable to Subsidy kept under GOVT Sponsored Schemes, Margin Money, earnest money and court attached/ordered deposits

3. Payment of Interest: (Subject to applicable TDS)
Interest will be paid on quarterly basis and in case the date of interest payment falls on holidays then on the next working day

4. Payment and Renewal of Deposits Before Maturity
Depositors may request repayment of their deposits before maturity. Repayment of term deposits before maturity is permissible.
In the event of the FDR being closed before completing the original term of the deposit, interest will be paid at the rate applicable on the date of deposit, for the period for which the deposit has remained with the Bank, the contracted rate whichever is lower without charging any penalty for premature closure. No interest will be paid on term deposit which remain with the bank for less than 7 days. In case the depositor desires to renew the deposit by seeking premature renewal, the deposit is renewed for a period longer than the balance period of the original deposit.
5. Provision for nomination.:- Nomination facilities are available
Rate of Interest: - Rate of interest differs from depending upon tenure of the deposits and as and when the Bank changes the Rate.
Senior citizens are offered additional interest of 0.50 % for deposits placed for 1 year and above period.

Book debts

Book debts is the term used for sums of money owed to the bankrupt, partnership or company at the date of the insolvency order, usually for goods or services supplied or work carried out. Sums due under loans may also be treated as book debts as can sums due from partners or directors under any loan accounts they may have had with the partnership business or company, although detailed information must be available regarding the loan etc for it to be collectable.

The fact that an insolvency order has been made does not mean that the sums are no longer due and the official receiver is therefore entitled to claim the amount owed from the book debtor for the estate.

Where the book debts have a realizable value, the official receiver should not seek the appointment of an insolvency practitioner unless requested to do so by creditors. If, however, there are other assets of a complex nature in the estate, the official receiver may consider seeking the appointment of an insolvency practitioner.

Supply bill

A money bill or supply bill is a bill that solely concerns taxation or government spending (also known as appropriation of money), as opposed to changes in public law.

Procedure for a Money Bill:

1. Money Bills can be introduced only in Lok Sabha (the directly elected 'people's house' of the Indian Parliament).
2. Money bills passed by the Lok Sabha are sent to the Rajya Sabha (the upper house of parliament, elected by the state and territorial legislatures or appointed by the president). The Rajya Sabha may not amend money bills but can recommend amendments. To make sure that Rajya Sabha doesn't amend the bill by adding some non-money matters (known as Financial Bill), the Lok Sabha Speaker certifies the bill as a money bill before sending it to the upper house, and the decision of the Speaker is binding on both the Houses.[2] A money bill must be returned to the Lok Sabha within 14 days or the bill is deemed to have passed both houses in the form it was originally passed by the Lok Sabha.
3. When a Money Bill is returned to the Lok Sabha with the recommended amendments of the Rajya Sabha it is open to Lok Sabha to accept or reject any or all of the recommendations.
4. A money bill is deemed to have passed both houses with any recommended amendments the Lok Sabha chooses to accept, (and without any that it chooses to decline).
5. The definition of "Money Bill" is given in the Article 110 of the Constitution of India. A financial bill is not a Money Bill unless it fulfills the requirements of the Article 110.
6. The Speaker of the Lok Sabha certifies if a Finance bill is a Money Bill or not.

Real estate

Real estate is "property consisting of land and the buildings on it, along with its natural resources such as crops, minerals, or water; immovable property of this nature; an interest vested in this (also) an item of real property; (more generally) buildings or housing in general. Also: the business of real estate; the profession of buying, selling, or renting land, buildings or housing.

Residential real estate

Residential real estate is a type of leased property, containing either a single family or multifamily structure that is available for occupation for non-business purposes.

Residences can be classified by, if, and how they are connected to neighboring residences and land. Different types of housing tenure can be used for the same physical type. For example, connected residents might be owned by a single entity and leased out, or owned separately with an agreement covering the relationship between units and common areas and concerns.

Major categories in India and the Asian Subcontinent

- Co-operative Housing Societies (CHS): A type of multiple ownership in which the residents of a multi-unit housing complex own shares in the cooperative corporation that owns the property, giving each resident the right to occupy a specific apartment or unit.

- Condominiums: Building or complex, similar to apartments, owned by individuals. Common grounds and common areas within the complex are owned and shared jointly. There are *townhouse* or *rowhouse* style condominiums as well.
- Builder flats
- Villas
- Lanes Houses[2]
- Havelis
- Independent Floors
- Lal Dora – Where people carry out commercial and residential activities both.

The size is measured in Gaz (square yards), Quila, Marla, Beegha, and acre.

Collateral securities

By collateral security is meant stocks, bonds, and other evidences of property deposited by the borrower to secure a loan made to him by the bank. Such securities are deposited as a pledge or guarantee that the loan will be repaid at maturity; if not paid the securities may be sold to reimburse the lender. Collateral loans though made generally to brokers on such security as stocks are made also to merchants and commercial houses, and all kinds of collateral are offered. They may be made on "time," running for thirty days to several months, or on "call," that is, subject to payment on demand. The various forms of collateral offered to secure bank loans may be roughly grouped into three divisions: stocks and bonds, merchandise, and real estate. Some of the more important types of collateral loans may now be briefly considered.

Sometimes a merchant, instead of discounting the notes he receives in the course of business, may prefer to offer his own note to the bank for discount, pledging the "bills receivable" as collateral. If any of the bills thus pledged fall due during the term of the loan they must be "taken up" and replaced with other security or a corresponding part of the loan must be paid.

These collateral securities are advantageous form the banker's stand-point because, in the case of insolvency of the customer, the can prove for his whole amount of debt against the assets of the debtor and receive form the customer's estate all he can in the course of distributing by the official assigned, and thereafter fall back upon the collateral security for the deficiency. The usual practice should be to obtain a memorandum of deposit of security in a proper form. This is most essential because even though in law such memorandum is not necessary, the banker, by using it, protects himself by inserting in the clauses necessary for such protection.

The most significant categories of security lodged as cover are:

- Goods and commodities
- Fixed Deposit Receipt
- Real estate iv) stock exchange securities
- Life Insurance policies

- Gold and gold ornaments
- Documents of title to goods
- Book debts
- Supply bills.

Module 5
Agricultural finances and Retail lending

AGRICULTURAL FINANCE

Meaning:

Agricultural finance generally means studying, examining and analyzing the financial aspects pertaining to farm business, which is the core sector of Pakistan. The financial aspects include money matters relating to production of agricultural products and their disposal.

Definition of Agricultural finance:

Murray (1953) defined agricultural. Finance as "an economic study of borrowing funds by farmers, the organization and operation of farm lending agencies and of society's interest in credit for agriculture."

Tandon and Dhondyal (1962) defined agricultural. Finance "as a branch of agricultural economics, which deals with and financial resources related to individual farm units."

Crop Loans

Crop Loans are also called short term loans for "Seasonal Agricultural Operations." The Seasonal Agricultural Operations connote such activities as are undertaken in the process of raising various crops and are seasonally recurring in nature. The activities include, among others, ploughing and preparing land for sowing, weeding, and transplantation where necessary, acquiring and applying inputs such as seeds, fertilizers, insecticides etc. and labour for all operations in the field for raising & harvesting the crops. Thus, the credit required to meet the current expenditure for raising the crops on land till the crops are harvested is construed as production or short term credit for seasonal agricultural operations.

Crop insurance

Crop insurance is purchased by agricultural producers, including farmers, ranchers, and others to protect themselves against either the loss of their crops due to natural disasters, such as hail, drought, and floods, or the loss of revenue due to declines in the prices of agricultural commodities. The two general categories of crop insurance are called crop-yield insurance and crop-revenue insurance.

Dairy

A dairy is a business enterprise established for the harvesting or processing (or both) of animal milk – mostly from cows or goats, but also from buffaloes, sheep, horses or camels – for human consumption. A dairy is typically located on a dedicated dairy farm or in a section of a multi-purpose farm (mixed farm) that is concerned with the harvesting of milk.

This is a list of dairy products. A dairy product is food produced from the milk of mammals. A production plant for the processing of milk is called a dairy or a dairy factory. Dairy farming is a class of agricultural, or an animal husbandry, enterprise, for long-term production of milk, usually from dairy cows but also from goats, sheep and camels, which may be either processed on-site or transported to a dairy factory for processing and eventual retail sale.

Sericulture

Sericulture, or silk farming, is the rearing of silkworms for the production of silk. Although there are several commercial species of silkworms, Bombyx mori is the most widely used and intensively studied silkworm. Silk was first produced in China as early as the Neolithic period.[1] Sericulture has become an important cottage industries in countries such as Brazil, China, France, India, Italy, Japan, Korea, and Russia. Today, China and India are the two main producers, with more than 60% of the world's annual production.

Covered Risks
Covered perils are fire, lightening, flood, inundation, storm, tempest, earthquake, landslide, rockslide, impact by rail/road/air craft. The insurance will also cover diseases like Grasserie, Flacherie, Mascardine, Pebrine and attack of uzifly subject to the exclusions given in the policy.

Major Exclusions
Malicious damage, improper management, diseases contracted prior to the commencement of risk, losses due to infected eggs insufficient mulberry leaves, theft natural mortalities, loss due to Perbrine and attack of ants, rodents, lizards, war, nuclear radiation. Transport, theft, decoity, missing of the worm, natural mortality, normal trade losses

Poultry

Poultry are domesticated birds kept by humans for the eggs they produce, their meat, their feathers, or sometimes as pets. These birds are most typically members of the superorder Galloanserae (fowl), especially the order Galliformes (which includes chickens, quails and turkeys) and the family Anatidae, in order Anseriformes, commonly known as "waterfowl" and including domestic ducks and domestic geese. Poultry also includes other birds that are killed for their meat, such as the young of pigeons (known as squabs) but does not include similar wild birds hunted for sport or food and known as game. The word "poultry" comes from the French/Norman word poule, itself derived from the Latin word pullus, which means small animal.

There are many risks in the poultry business. Extreme weather is just one condition that could lead to significant poultry losses. So it is important to protect the investment you've made in your poultry operation with the right insurance solutions.
The Hartford's Poultry Insurance Program can help – with flexible coverage that can be tailored to the risks that could threaten the future of your business.

Poultry Insurance Program

Our poultry insurance program provides broad perils coverage for direct physical damage to covered poultry resulting in death. It also includes coverage for:

- Debris removal
- Covered poultry in the custody of a common or contract carrier
- Covered poultry on your vehicles
- Fire department service charges
- Newly acquired locations

Animal husbandry

Animal husbandry is the management and care of farm animals by humans for profit, in which genetic qualities and behaviour, considered to be advantageous to humans, are further developed. The term can refer to the practice of selectively breeding and raising livestock to promote desirable traits in animals for utility, sport, pleasure, or research.

A large number of farmers in India depend on animal husbandry for their livelihood. In addition to supplying milk, meat, eggs,wool and hides, animals, mainly bullocks, are the major source of power for both farmers and drayers. Thus, animal husbandry plays an important role in the rural economy. The gross value of output from this sector was ₹ 358 billion (US$5.7 billion) in FY 1989, an amount that constituted about 25 percent of the total agricultural output of ₹ 1.4 trillion (US$22.2 billion).

Horticulture

Horticulture is the branch of agriculture that deals with the art, science, technology, and business of plant cultivation. It includes the cultivation of medicinal plant, fruits, vegetables, nuts, seeds, herbs, sprouts, mushrooms, algae, flowers, seaweeds and non-food crops such as grass and ornamental trees and plants. It also includes plant conservation, landscape restoration, landscape and garden design, construction, and maintenance, and arboriculture.

Horticulturists apply their knowledge, skills, and technologies used to grow intensively produced plants for human food and non-food uses and for personal or social needs. Their work involves plant propagation and cultivation with the aim of improving plant growth, yields, quality, nutritional value, and resistance to insects, diseases, and environmental stresses. They work as gardeners, growers, therapists, designers, and technical advisors in the food and non-food sectors of horticulture.

Horticultural Products

Horticultural products include all products, raw or processed, that arise from the horticultural industry. This broadly inclusive definition is appropriate and even necessary in a time when traceability from the producer to the ultimate consumer is of growing interest to government and industry. Products from horticultural industry that go to market still respiring (fresh produce) are clearly horticultural products. When juiced, sliced or pureed, fermented, frozen, preserved, canned, dried, irradiated, or used in an ornamental construct (such as a flower arrangement) they remain, in our view, a horticultural product. However, when a horticultural product becomes a major ingredient of another manufactured item the categorization becomes more complex. Thus, when apples are used to make apple pie or yogurt is fortified with fruit, the product can be considered both a horticultural product and a bakery or dairy product.

Biogas

Biogas typically refers to a mixture of different gases produced by the breakdown of organic matter in the absence of oxygen. Biogas can be produced from raw materials such as agricultural waste, manure, municipal waste, plant material, sewage, green waste or food waste. It is a renewable energy source and in many cases exerts a very small carbon footprint. Biogas can be produced by anaerobic digestion with anaerobic bacteria, which digest material inside a closed system, or fermentation of biodegradable materials.

Biogas is primarily methane (CH 4) and carbon dioxide (CO_2) and may have small amounts of hydrogen sulphide (H 2S), moisture and siloxanes. The gases methane, hydrogen, and carbon monoxide (CO) can be combusted or oxidized with oxygen. This energy release allows biogas to be used as a fuel; it can be used for any heating purpose, such as cooking. It can also be used in a gas engine to convert the energy in the gas into electricity and heat

Kisan Credit Card Scheme

Crop loans are generally disbursed by the banks through the mode of Kisan Credit Card (KCC). The Kisan Credit Card Scheme is in operation throughout the country and is implemented by Commercial Banks, Cooperative Banks and RRBs. All farmers including small farmers, marginal farmers, share croppers, oral lessees and tenant farmers are eligible for issuance of KCC. KCC holders are also covered under Personal Accident Insurance Scheme (PAIS) against accidental death/permanent disability. Bank assesses farmer's eligibility on the basis of land available for cultivation and the scale of finance fixed by the District Level Technical Committee in that district and the credit history of the farmer. The scope of the KCC has recently been broad-based to include term credit and consumption needs. Government has advised the banks to convert Kisan Credit Card into a Smart Card cum Debit Card.

Some of the main features of KCC scheme are:

- Assessment of crop loan component based on the scale of finance for the crop plus insurance premium x Extent of area cultivated + 10% of the limit towards post-harvest / household/consumption requirements + 20% of limit towards maintenance expenses of farm assets.
- Flexi KCC with simple assessment prescribed for marginal farmers.

- Validity of KCC for 5 years.
- For crop loans, no separate margin need to be insisted as the margin is in-built in scale of finance.
- No withdrawal in the account to remain outstanding for more than 12 months; no need to bring the debit balance in the account to zero at any point of time.
- Interest subvention /incentive for prompt repayment to be available as per the Government of India and / or State Government norms.
- No processing fee up to a limit of Rs. 3.00 lakh.
- One time documentation at the time of first availment and thereafter simple declaration (about crops raised/ proposed) by farmer.
- KCC cum SB account instead of farmers having two separate accounts. The credit balance in KCC cum SB account to be allowed to fetch interest at saving bank rate.
- Disbursement through various delivery channels, including ICT driven channels like ATM/ PoS/ Mobile handsets.

NABARD

NABARD has been working as Friend, Philosopher & Guide for Cooperatives and has taken many initiatives since inception to make Cooperatives strong and vibrant institutions. A summary of such initiatives is indicated below.

- Assistance in Implementation of Revival Package for improving the health of Short Term Rural Cooperative Credit system (STCCS).
- Sanction of credit limits under Short Term Seasonal Agricultural and other Operations to StCBs
- Direct refinance assistance to CCBs for short term multipurpose credit.
- Support for Seasonal Agricultural Operations to Commercial Banks for financing PACS
- Refinance for lending to farmers against Negotiable Warehouse Receipts.
- Support from PODF to develop PACS as Multi Service Centers.
- Refinance and Credit Facility to Marketing Federations
- Special Package with concessional rate of interest for North Eastern and other regions.
- Interest subvention for short term crop loans on the own funds involved by Cooperative Banks.
- Creations of Cooperative Development Fund (CDF), primarily for Capacity Building & Infrastructure Development of PACS.
- Setting up of STCRC to augment NABARD resources for Short Term Credit facilities to Cooperatives.
- Providing level playing field to Co-operatives through Core Banking Solution (CBS).
- Assistance for Setting up of PACS Development Cell (PDC) in Cooperative Banks.
- Establishment of Centre for Professional Excellence in Co-operatives (C-PEC) by NABARD in collaboration with GIZ for supporting the Co-operative Training Institutes (CTIs) in STCCS to impart quality training.

Lead Bank Scheme

The origin of the LBS in India can be traced to the late 60's. LBS was introduced in 1969, based on the recommendations of the Gadgil Study Group. The Gadgil group has recommended "Area Approach" for the development of financial structure through intensive efforts.

To transform the Gadgil's groups recommendation into reality, RBI set up a committee under F.S.Nariman, to fine tune the details. This banker's committee, headed by F. S. Nariman, concluded that districts would be the units for area approach and each district could be allotted to a particular bank which will perform the role of a Lead Bank.
As a consortium leader, the Lead Bank would

1. co-ordinate with government office' s, banks and other stakeholders,
2. undertake planning and formulation of Annual District Credit Plans through Block and District Consultative Committees and
3. Help in synergizing all efforts to fulfill Plan priorities and district-specific requirements.

The LBS has been able to achieve great success in the rural areas, and also it has aided in building up a cadre of Bank Officers devoted to Rural Banking. A central component of LBS is the SLBC's (State Level Bankers Committee) Meetings. These SLBC Meetings are a great tool for networking and driving the Annual District Credit Plan.

Objectives of Lead Bank Scheme:

- Eradication of unemployment and under employment
- Appreciable rise in the standard of living for the poorest of the poor
- Provision of some of the basic needs of the people who belong to poor sections of the society

Retail Banking

Meaning:

Typical mass-market banking in which individual customers use local branches of larger commercial banks. Services offered include savings and checking accounts, mortgages, personal loans, debit/credit cards and certificates of deposit (CDs).

Retail banking services
The objective of the Retail Bank is to provide its target market customers a full range of financial products and banking services, giving the customer a one-stop window for all his/her banking requirements

Accounts & Deposits
 ATM Savings Accounts Current Accounts Trading accounts Fixed Deposits Internet Banking Mobile Banking

Loans
 Home Loans Personal Loans Car Loans Commercial Vehicle Loans Loans against Securities Education loan

The future of retail banking: A global perspective

- Indian retail banking has been showing phenomenal growth
- In 2004-05, 42% of credit growth came from retail
- Over the last 5 years CAGR has been over 35%
- Rural areas offer tremendous potential too which needs to be exploited

Advantages:

- Your money is much more secure than in a box under your bed and you can buy goods, be paid, and sell things without cash changing hands
- The bank you are familiar with and which knows you can also offer you a wide range of other services, such as mortgages and insurance.
- Retail banks offer a variety of ways you can access your account and manage your money
- Retail Banking focuses on individual and small units
- The risk is spread and the recovery is good
- Surplus deployable funds can be put into use by the banks
- Customize and wide ranging products are available

Disadvantages

Banks are a business, and they need to make money from looking after yours. If the bank decides to apply charges to your account (within the terms of the account), you may only find out about it afterwards—for example if you accidentally go overdrawn without permission. If you disagree with a charge, you will need to contest it to recover the money.

Consumer credit financing

Short- and intermediate-term loans used to finance the purchase of commodities or services for personal consumption or to refinance debts incurred for such purposes. The loans may be supplied by lenders in the form of cash loans or by sellers in the form of sales credit.

Consumer credit in industrialized countries has grown rapidly as more and more people earn regular income in the form of fixed wages and salaries and as mass markets for durable consumer goods have become established.

Consumer loans fall into two broad categories: installment loans, repaid in two or more payments; and non-installment loans, repaid in a lump sum. Installment loans include (1) automobile loans, (2) loans for other consumer goods, (3) home repair and modernization loans, (4) personal loans, and (5) credit card purchases. The most common non installment loans are single-payment loans by financial institutions, retail-store charge accounts, and service credit extended by doctors, hospitals, and utility companies.

Module 6
Financing to small scale industries and large scale industries

Term loan

Definition: A loan for equipment, real estate and working capital that's paid off like a mortgage for between one year and ten years.

Term loans are your basic vanilla commercial loan. They typically carry fixed interest rates, and monthly or quarterly repayment schedules and include a set maturity date. The range of funds typically available is $25,000 and greater.

Bankers tend to classify term loans into two categories:

Intermediate-term loans. Usually running less than three years, these loans are generally repaid in monthly installments (sometimes with balloon payments) from a business's cash flow. According to the American Bankers Association, repayment is often tied directly to the useful life of the asset being financed.

Long-term loans. These loans are commonly set for more than three years. Most are between three and 10 years, and some run for as long as 20 years. Long-term loans are collateralized by a business's assets and typically require quarterly or monthly payments derived from profits or cash flow. These loans usually carry wording that limits the amount of additional financial commitments the business may take on (including other debts but also dividends or principals' salaries), and they sometimes require that a certain amount of profit be set-aside to repay the loan.

Term loans are most appropriate for established small businesses that can leverage sound financial statements and substantial down payments to minimize monthly payments and total loan costs. Repayment is typically linked in some way to the item financed. Term loans require collateral and a relatively rigorous approval process but can help reduce risk by minimizing costs. Before deciding to finance equipment, borrowers should be sure they can they make full use of ownership-related benefits, such as depreciation, and should compare the cost with that leasing.

The best use of a term loan is for construction; major capital improvements; large capital investments, such as machinery; working capital; purchases of existing businesses. Fortunately, the cost of such a loan is relatively inexpensive if the borrower can pass the financial litmus tests. Rates vary, making it worthwhile to shop, but generally run around 2.5 points over prime for loans of less than seven years and 3.0 points over prime for longer loans. Fees totaling up to 1 percent are common (though this varies greatly, too), with higher fees on construction loans.

What do banks look for when making decisions about term loans?

Well, the "five C's" continue to be of utmost importance.

- **Character.** How have you managed other loans (business and personal)? What is your business experience?
- **Credit capacity.** The bank will conduct a full credit analysis, including a detailed review of financial statements and personal finances to assess your ability to repay.
- **Collateral.** This is the primary source of repayment. Expect the bank to want this source to be larger than the amount you're borrowing.
- **Capital.** What assets do you own that can be quickly turned into cash if necessary? The bank wants to know what you own outside of the business-bonds, stocks, apartment buildings-that might be an alternate repayment source. If there is a loss, your assets are tapped first, not the bank's. Or, as one astute businessman puts it, "Banks like to lend to people who already have money." You will most likely have to add a personal guarantee to all of that, too.
- **Comfort/confidence with the business plan.** How accurate are the revenue and expense projections? Expect the bank to make a detailed judgment. What is the condition of the economy and the industry--hot, warm or cold?

Syndicated Loan

A loan offered by a group of lenders (called a syndicate) who work together to provide funds for a single borrower. The borrower could be a corporation, a large project, or a sovereignty (such as a government). The loan may involve fixed amounts, a credit line, or a combination of the two. Interest rates can be fixed for the term of the loan or floating based on a benchmark rate such as the London Interbank Offered Rate (LIBOR).

Typically there is a lead bank or underwriter of the loan, known as the "arranger", "agent", or "lead lender". This lender may be putting up a proportionally bigger share of the loan, or perform duties like dispersing cash flows amongst the other syndicate members and administrative tasks.

Also known as a "syndicated bank facility".

Types of Syndications

Globally, there are three types of underwriting for syndications: an underwritten deal, best-efforts syndication, and a club deal. The European leveraged syndicated loan market almost exclusively consists of underwritten deals, whereas the U.S. market contains mostly best-efforts.

1. Underwritten deal

An underwritten deal is one for which the arrangers guarantee the entire commitment, then syndicate the loan. If the arrangers cannot fully subscribe the loan, they are forced to absorb the difference, which they may later try to sell to investors. This is easy, of course, if market conditions, or the credit's fundamentals, improve. If not, the arranger may be forced to sell at a discount and, potentially, even take a loss on the paper. Or the arranger may just be left above its desired hold level of the credit.

Arrangers underwrite loans for several reasons. First, offering an underwritten loan can be a competitive tool to win mandates. Second, underwritten loans usually require more lucrative fees because the agent is on the hook if potential lenders balk. Of course, with flex-language now common, underwriting a deal does not carry the same risk it once did when the pricing was set in stone prior to syndication.

2. Best-efforts syndication

A best-efforts syndication is one for which the arranger group commits to underwrite less than or equal to the entire amount of the loan, leaving the credit to the vicissitudes of the market. If the loan is undersubscribed, the credit may not close—or may need significant adjustments to its interest rate or credit rating to clear the market. Traditionally, best-efforts syndications were used for risky borrowers or for complex transactions. Since the late 1990s, however, the rapid acceptance of market-flex language has made best-efforts loans the rule even for investment-grade transactions.

3. Club deal

A club deal is a smaller loan—usually $25–100 million, but as high as $150 million—that is remarketed to a group of relationship lenders. The arranger is generally a first among equals, and each lender gets a full cut, or nearly a full cut, of the fees.

Development Banks in Industrial Finance

In the field of industrial finance, the concept of development bank is of recent origin. In a country like India, the emergence of development banking is a post-independence phenomenon.

In the Western countries, however, development banking had a long period of evolution. The origin of development banking may be traced to the establishment of 'Society General Pour Favoriser I' lndustrie Nationale' in Belgium in 1822. But the notable institution was the 'Credit Mobiliser' of France, established in 1852, which acted as industrial financier.

In 1920, Japan established the Industrial Bank of Japan to cater to the financial needs of her industrial development. In the post-war era, the Industrial Development Bank of Canada (1944), the Finance Corporation for Industry Ltd. (FCI) and the Industrial and Commercial Finance

Corporation Ltd. (ICFC) of England (1945), etc., were established as modern development banks to provide term loans to industry. In 1966, the U.K. Government set up the Industrial Reorganization Corporation (IRC).

Definition of Development Bank:

There is no precise definition of development bank. William Diamond and Shirley Bosky consider industrial finance and development corporations as ‘development banks’ Fundamentally a development bank is a term lending institution.

Development bank is essentially a multi-purpose financial institution with a broad development outlook. A development bank may, thus, be defined as a financial institution concerned with providing all types of financial assistance (medium as well as long term) to business units, in the form of loans, underwriting, investment and guarantee operations, and promotional activities — economic development in general, and industrial development, in particular.

In short, a development bank is a development- oriented bank. In India, the first development bank called the Industrial Finance Corporation of India was established in 1948. Development banks in India- NABARD, ICICI, IDBI, IFCI, SIDBI, Commercial Banks, State Financial Cooperation.

Objectives

- Lay Foundations for Industrialization
- Meet Capital Needs
- Need for Promotional Activities
- Help Small and Medium Sectors

Following are the main characteristic features of a development bank:

1. It is a specialized financial institution.
2. It provides medium and long term finance to business units.
3. Unlike commercial banks, it does not accept deposits from the public.
4. It is not just a term-lending institution. It is a multi-purpose financial institution.
5. It is essentially a development-oriented bank. Its primary object is to promote economic development by promoting investment and entrepreneurial activity in a developing economy. It encourages new and small entrepreneurs and seeks balanced regional growth.
6. It provides financial assistance not only to the private sector but also to the public sector undertakings.
7. It aims at promoting the saving and investment habit in the community.
8. It does not compete with the normal channels of finance, i.e., finance already made available by the banks and other conventional financial institutions. Its major role is of a gap-filler, i. e., to fill up the deficiencies of the existing financial facilities.

9. Its motive is to serve public interest rather than to make profits. It works in the general interest of the nation.

Role of development banks in financial system

- Providing funds
- Infrastructural facility
- Promotional activity
- Development of backward area
- Planned development
- Accelerating industrialization
- Employment creation

WORKING CAPITAL FINANCING

- Spontaneous Financing
- Factoring Accounts Receivable
- Bank Finance
- Public Deposits
- Commercial papers
- Inter corporate deposits
- Short term loans from financial institutions

Spontaneous financing

Types of spontaneous financing are –

- Trade Credit and
- Accrued expenses
- Stretching Accounts payable is also known as a type of spontaneous financing.

Trade credit

Customer gets from supplier of goods in normal course of business. An informal arrangement, granted on an open account basis, not formally acknowledge as a debt. Trade credit may also take the form of bills payable.
Credit Terms refers to the conditions of due date and cash discount.

Examples - **Open Accounts**: the seller ships goods to the buyer with an invoice specifying goods shipped, total amount due, and terms of the sale.

Notes Payable: the buyer signs a note that evidences a debt to the seller.
Trade Acceptances: the seller draws a draft on the buyer that orders the buyer to pay the draft at some future time period.

Advantages

1. Easy Availability.
2. Flexibility.
3. Informality.

Disadvantages

1. Implicit Cost.
2. Stretching A/P can prove to be very costly.

Cost of trade credit

Cost of trade credit is the approximate annual cost to forgo cash discount and paying on the last day of credit period.

Accrued expenses

Accrued expenses means the expenses incurred but not paid

Examples

Accrued Wages and Salaries. Accrued taxes and Interest. It is regarded as short term finance because some services are enjoyed by the concern without making any payment for a short period

S-t-r-e-t-c-h-i-n-g Account Payables

Postponing payment beyond the end of the net (credit) period is known as "stretching accounts payable" or "leaning on the trade."

Possible costs of "stretching accounts payable" are -

1. Cost of the cash discount (if any) forgone
2. Late payment penalties or interest
3. Deterioration in credit rating

Factoring accounts receivable

Factoring is selling of receivables to a financial institution, the factor, usually "without recourse."

Functions –

1. Outright purchase of the A/R of client and immediate cash payment
2. Collection of A/R
3. Administration of A/R
4. Credit protection – against bad debts
5. Credit control

Turnover Method (originally suggested by Nayak Committee for SSI units)

The WC requirements may be worked out on the basis of Naik Committee recommendations for working capital limit upto Rs.6 crores from the banking system, on the basis of minimum of 20% of their projected annual turnover for new as well as existing units, beyond which WC be computed on the basis of WC cycle, after fixing stipulated margins, on each component of the WC. In case of borrowers desiring facilities under Naik Committee recommendations and having a WC cycle of more than 3 months in a year, the WC requirements will be funded after assessing his requirements on the basis of his WC cycle, after fixing proper margins.

Example:

Applicable for limits upto Rs.6 crores :

(a) Projected sales = Rs. 10,00,000
(b) Working capital requirements: 25% of projected sales i.e. Rs.2,50,000
(c) Margin (contribution of Owner) : 5% of projected sales i.e. Rs.50,000
(d) Working capital to be funded by bank : Rs.2,00,000

Maximum Permissible Banking Finance (MPBF)

Like many other activities of the banks, method and quantum of short-term finance that can be granted to a corporate was mandated by the Reserve Bank of India till 1994. This control was exercised on the lines suggested by the recommendations of a study group headed by Shri Prakash Tandon.

The study group headed by Shri Prakash Tandon, the then Chairman of Punjab National Bank, was constituted by the RBI in July 1974 with eminent personalities drawn from leading banks, financial institutions and a wide cross-section of the Industry with a view to study the entire gamut of Bank's finance for working capital and suggest ways for optimum utilisation of Bank credit. This was the first elaborate attempt by the central bank to organise the Bank credit. The report of this group is widely known as Tandon Committee report. ***Most banks in India even today continue to look at the needs of the corporates in the light of methodology recommended by the Group***.

As per the recommendations of Tandon Committee, the corporates should be discouraged from accumulating too much of stocks of current assets and should move towards very lean inventories and receivable levels. The committee even suggested the maximum levels of Raw Material, Stock-in-process and Finished Goods which a corporate operating in an industry should be allowed to accumulate These levels were termed as inventory and receivable norms. Depending on the size of credit required, the funding of these current assets (working capital needs) of the corporates could be met by one of the following methods:

Methods of lending:

First Method of Lending:
Banks can work out the working capital gap, i.e. total current assets less current liabilities other than bank borrowings (called Maximum Permissible Bank Finance or MPBF) and finance a maximum of 75 per cent of the gap; the balance to come out of long-term funds, i.e., owned funds and term borrowings. This approach was considered suitable only for very small borrowers i.e. where the requirements of credit were less than Rs.10 lacs

Second Method of Lending:
Under this method, it was thought that the borrower should provide for a minimum of 25% of total current assets out of long-term funds i.e., owned funds plus term borrowings. A certain level of credit for purchases and other current liabilities will be available to fund the buildup of current assets and the bank will provide the balance (MPBF). Consequently, total current liabilities inclusive of bank borrowings could not exceed 75% of current assets. RBI stipulated that the working capital needs of all borrowers enjoying fund based credit facilities of more than Rs. 10 lacs should be appraised (calculated) under this method.

Third Method of Lending:

Under this method, the borrower's contribution from long term funds will be to the extent of the entire CORE CURRENT ASSETS, which has been defined by the Study Group as representing the absolute minimum level of raw materials, process stock, finished goods and stores which are in the pipeline to ensure continuity of production and a minimum of 25% of the balance current assets should be financed out of the long term funds plus term borrowings.

Cash budget

Cash budget is the budget which is prepared under the finance budget. It is an estimation of the expected cash receipts and cash payments during the budget period. By preparing cash budget it becomes possible for the organization to predict whether at any point of time there will be excess or shortage of cash. Two main points should be remembered before preparing cash budget: Time period of the cash budget and the items to be included in the cash budget.

Following methods are used to prepare cash budget:

1. Receipts and payments method:

This method is useful for short term estimations. Under this method items should be categorized in two ways Operating Cash Flows and Non-Operating Cash Flows

2. Balance Sheet method: This method is useful for long term estimations.

3. Adjusted Profits/Losses Method: This method is useful for long term estimations.

Project Finance

Defined by the International Project Finance Association (IPFA) as the following:

The financing of long-term infrastructure, industrial projects and public services based upon a non-recourse or limited recourse financial structure where project debt and equity used to finance the project are paid back from the cash flow generated by the project.

Project finance is the long-term financing of infrastructure and industrial projects based upon the projected cash flows of the project rather than the balance sheets of its sponsors. Usually, a project financing structure involves a number of equity investors, known as 'sponsors', as well as a 'syndicate' of banks or other lending institutions that provide loans to the operation. They are most commonly non-recourse loans, which are secured by the project assets and paid entirely from project cash flow, rather than from the general assets or creditworthiness of the project sponsors, a decision in part supported by financial modeling. The financing is typically secured by all of the project assets, including the revenue-producing contracts. Project lenders are given a lien on all of these assets and are able to assume control of a project if the project company has difficulties complying with the loan terms.

Parties to a project financing

There are several parties in a project financing depending on the type and the scale of a project. The most usual parties to a project financing are;

1. Sponsor
2. Lenders
3. Financial Advisors
4. Technical Advisors

5. Legal Advisors
6. Debt Financiers
7. Equity Investors
8. Regulatory Agencies
9. Multilateral Agencies

INDUSTRIAL SICKNESS

Industrial sickness is defined in India as "an industrial company (being a company registered for not less than five years) which has, at the end of any financial year, accumulated losses equal to, or exceeding, its entire net worth and has also suffered cash losses in such financial year and the financial year immediately preceding such financial year.

Causes of sickness

1. Internal causes for sickness

We can say pertaining to the factors which are within the control of management. This sickness arises due to internal disorder in the areas justified as following:

a) *Lack of Finance:* This including weak equity base, poor utilization of assets, inefficient working capital management, absence of costing & pricing, absence of planning and budgeting and inappropriate utilization or diversion of funds.

b) *Bad Production Policies*: The another very important reason for sickness is wrong selection of site which is related to production, inappropriate plant & machinery, bad maintenance of Plant & Machinery, lack of quality control, lack of standard research & development and so on.

c) *Marketing and Sickness*: This is another part which always affects the health of any sector as well as SSI. This including wrong demand forecasting, selection of inappropriate product mix, absence of product planning, wrong market research methods, and bad sales promotions.

d) *Inappropriate Personnel Management*: The another internal reason for the sickness of SSIs is inappropriate personnel management policies which includes bad wages and salary administration, bad labour relations, lack of behavioral approach causes dissatisfaction among the employees and workers.

e) *Ineffective Corporate Management*: Another reason for the sickness of SSIs is ineffective or bad corporate management which includes improper corporate planning, lack of integrity in top management, lack of coordination and control etc.

2. External causes for sickness

a) Personnel Constraint: The first for most important reason for the sickness of small scale industries are non-availability of skilled labour or manpower wages disparity in similar industry and general labour invested in the area.

b) *Marketing Constraints*: The second cause for the sickness is related to marketing. The sickness arrives due to liberal licensing policies, restrain of purchase by bulk purchasers, changes in global marketing scenario, excessive tax policies by govt. and market recession.

c) *Production Constraints*: This is another reason for the sickness which comes under external cause of sickness. This arises due to shortage of raw material, shortage of power, fuel and high prices, import-export restrictions.

d) *Finance Constraints*: The external cause for the sickness of SSIs is lack of finance. This arises due to credit restrains policy, delay in disbursement of loan by govt., unfavorable investments, fear of nationalization.

e) Credit squeeze initiated by the government policies.

BOARD OF INDUSTRIAL AND FINANCIAL RECONSTRUCTION (BIFR)

As per section 3(1) (o) of The Sick Industrial Companies Act, 1985 (SICA), an industrial company is a sick company, when its accumulated losses are equal to or exceeding entire worth. Further as per section 23 of SICA of the accumulated losses of an industrial company as at the end of any financial year have resulted in erosion of 50% or more of peak net worth of immediately preceding four financial years is considered to be a potentially sick industrial company.

To fall under the purview of SICA:

- A company should be engaged in any scheduled industry (i.e any industry specified in First Schedule to Industries (Development and Regulation) Act, 1951.
- Scheduled industries include metallurgical industries, telecommunication, transportation, chemicals, textiles but not financial services and software technology.
- Criteria of 'sickness' – Such company should have at the end of any financial year accumulated losses equal to or exceeding its entire net worth.

Introduction

Board of industrial and Financial Reconstruction (BIFR) was established by the Central Government, under section 3 of the Sick Industrial Companies (Special provisions) Act, 1985 and it became fully operational in May, 1987. BIFR deals with issues like revival and rehabilitation on sick companies, winding up of sick companies, institutional finance to sick companies, amalgamation of companies etc. BIFR is a quasi-judicial body.

The role of BIFR as envisaged in the SICA (Sick Industrial Companies Act) is:

(a)Securing the timely detection of sick and potentially sick companies
(b) Speedy determination by a group of experts of the various measures to be taken in respect of The sick company
(c)Expeditious enforcement of such measures

BIFR has a chairman and may have a maximum of 14 members,1[7] drawn from various fields including banking, labour, accountancy, economics etc.2[8] It functions like a court and has constituted four benches.

Preparation and sanction of scheme for revival

Once a company has been found sick, the BIFR may grant time to the sick company to enable it to make its net worth positive and bring the company out of sickness, without any external financial assistance. If it is found infeasible for company to make its net worth positive without any external financial assistance, or if the BIFR decides that the company cannot make its net worth positive within a reasonable time, then the Board appoints an operating agency under section 17(3) of the Act, then the operating agency is required to prepare and submit a schedule in respect of the referred company by providing any or more of the following measures:

- Financial Reconstruction of the sick industrial company;
- The proper management of the sick industrial company by change in, or takeover of, the management of the sick industrial company;
- Amalgamation with another company or vice-versa;
- Sale or lease of its undertaking;
- Rationalization of its staff;
- Any other preventive or remedial measures; and
- Incidental or consequential measures.

The revival package may vary from case to case depending on the nature of the problem and may include additional financial assistance, postponement of recovery of loan already lent by banks and financial institutions, change in management, amalgamation, and sale of redundant assets, lease of assets or any other suitable measure. The revival package should be submitted to the BIFR within a time limit of 90 days or such extended period as may be granted by the BIFR.

Module 7
NPA management

A **Non-performing asset** (NPA) is defined as a credit facility in respect of which the interest and/or installment of principal has remained 'past due' for a specified period of time. In simple terms, an asset is tagged as non performing when it ceases to generate income for the lender.

Identification

A **Non-performing asset** (NPA) is defined as a credit facility in respect of which the interest and/or installment of Bond finance principal has remained 'past due' for a specified period of time. NPA is used by financial institutions that refer to loans that are in jeopardy of default. Once the borrower has failed to make interest or principle payments for 90 days the loan is considered to be a non-performing asset. Non-performing assets are problematic for financial institutions since they depend on interest payments for income. Troublesome pressure from the economy can lead to a sharp increase in non-performing loans and often results in massive write-downs.

With a view to moving towards international best practices and to ensure greater transparency, it had been decided to adopt the '90 days' overdue' norm for identification of NPA, from the year ending March 31, 2004. Accordingly, with effect from March 31, 2004, a non-performing asset (NPA) is a loan or an advance 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' for a period of more than 90 days, 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,
- Interest and/or installment of principal remains overdue for two harvest seasons but for a period not exceeding two half years in the case of an advance granted for agricultural purposes, and
- Any amount to be received remains overdue for a period of more than 90 days in respect of other accounts.
- Non submission of Stock Statements for 3 Continuous Quarters in case of Cash Credit Facility.
- No active transactions in the account (Cash Credit/Over Draft/EPC/PCFC) for more than 91days

Classification

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 realisability of the dues:

1. Sub-standard assets: a substandard asset is one which has been classified as NPA for a period not exceeding 12 months.
2. Doubtful Assets: a doubtful asset is one which has remained NPA for a period exceeding 12 months.
3. Loss assets: where loss has been identified by the bank, internal or external auditor or central bank inspectors. But the amount has not been written off, wholly or partly.

Sub-standard asset is the asset in which bank have to maintain 15% of its reserves. All those assets which are considered as non-performing for period of more than 12 months are called as Doubtful Assets. All those assets which cannot be recovered are called as Loss Assets.

Provisioning norms

- Standard Assets – general provision of a minimum of 0.25%
- Substandard Assets – 10% on total outstanding balance, 10 % on unsecured exposures identified as sub-standard & 100% for unsecured "doubtful" assets.
- Doubtful Assets – 100% to the extent advance not covered by realizable value of security. In case of secured portion, provision may be made in the range of 20% to 100% depending on the period of asset remaining sub-standard
- Loss Assets – 100% of the outstanding

Reasons for Occurrence of NPAs

NPAs result from what are termed "Bad Loans" or defaults. Default, in the financial parlance, is the failure to meet financial obligations, say non-payment of a loan installment. These loans can occur due to the following reasons:

- Usual banking operations /Bad lending practices
- A banking crisis (as happened in South Asia and Japan)
- Overhang component (due to environmental reasons, business cycle, etc.)
- Incremental component (due to internal bank management, like credit policy, terms of credit, etc...)
- Lack of proper pre-enquiry by the bank for sanctioning a loan to a customer.
- Nonperformance of the business or the purpose for which the customer has taken the loan.
- Willful defaulter. Loans sanctioned for agriculture purposes.
- Change in govt. policies leads to NPA.

The Problems caused by NPAs

NPAs do not just reflect badly in a bank's account books, they adversely impact the national economy. Following are some of the repercussions of NPAs:

- Depositors do not get rightful returns and many times may lose uninsured deposits. Banks may begin charging higher interest rates on some products to compensate Non-performing loan losses
- Bank shareholders are adversely affected
- Bad loans imply redirecting of funds from good projects to bad ones. Hence, the economy suffers due to loss of good projects and failure of bad investments
- When bank do not get loan repayment or interest payments, liquidity problems may ensue.

Result of NPAs on an organization

1. They decrease profitability.
2. They reduce capital assets and lending limits.
3. They increase loan loss reserves.
4. They bring unwanted attention from government regulators.
5. It may affect goodwill.
6. NPAs changes the credit ratings of the organization.

Guidelines for classification of assets

• Take into account the degree of well-defined credit weaknesses and the extent of dependence on collateral security for realization of dues.
• Banks should establish appropriate internal systems to eliminate the tendency to delay or postpone the identification of NPAs, especially in respect of high value accounts
• The classification of an asset as NPA should be based on the record of recovery.
• Bank should not classify an advance account as NPA merely due to the existence of some deficiencies which are temporary in nature such as non-availability of adequate drawing power based on the latest available stock statement
• Up gradation of loan accounts classified as NPAs- If arrears of interest and principal are paid by the borrower in the case of loan accounts classified as NPAs, the account should no longer be treated as nonperforming and may be classified as 'standard' accounts.
• Asset Classification to be borrower-wise and not facility-wise All the facilities granted by a bank to a borrower and investment in all the securities issued by the borrower will have to be treated as NPA/NPI and not the particular facility/investment or part thereof which has become irregular
Accounts where there is erosion in the value of security/frauds committed by borrowers

• In respect of accounts where there are potential threats for recovery, such accounts should go through various stages of asset classification
• NPA classification should be done taking into account the degree of credit weaknesses and availability of collateral security for realization of dues.
•Banks should avoid the tendency to delay or postpone identification of NPAs especially in respect of high value accounts;

Capital Adequacy Ratio

CAR, also known as **Capital to Risk (Weighted) Assets Ratio** (**CRAR**), is the ratio of a bank's capital to its risk. National regulators track a bank's CAR to ensure that it can absorb a reasonable amount of loss and complies with statutory Capital requirements.

It is a measure of a bank's capital. It is expressed as a percentage of a bank's risk weighted credit exposures. This ratio is used to protect depositors and promote the stability and efficiency of financial systems around the world.

Two types of capital are measured: tier one capital, which can absorb losses without a bank being required to cease trading, and tier two capital, which can absorb losses in the event of a winding-up and so provides a lesser degree of protection to depositors.

International Banking Regulation-Basel II

Basel II is the second of the Basel Accords, (now extended and partially superseded by Basel III), which are recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision.

Basel II, initially published in June 2004, was intended to amend international standards that controlled how much capital banks need to hold to guard against the financial and operational risks banks face. These rules sought to ensure that the greater the risk to which a bank is exposed, the greater the amount of capital the bank needs to hold to safeguard its solvency and economic stability. Basel II attempted to accomplish this by establishing risk and capital management requirements to ensure that a bank has adequate capital for the risk the bank exposes itself to through its lending, investment and trading activities. One focus was to maintain sufficient consistency of regulations so to limit competitive inequality amongst internationally active banks.

Basel II was implemented in the years prior to 2008, and was only to be implemented in early 2008 in most major economies, that year's financial crisis intervened before Basel II could become fully effective. As Basel III was negotiated, the crisis was top of mind and accordingly more stringent standards were contemplated and quickly adopted in some key countries including in Europe and the USA.

Objective
The final version aims at:

1. Ensuring that capital allocation is more risk sensitive;
2. Enhance disclosure requirements which would allow market participants to assess the capital adequacy of an institution;
3. Ensuring that credit risk, operational risk and market risk are quantified based on data and formal techniques;
4. Attempting to align economic and regulatory capital more closely to reduce the scope for regulatory arbitrage.

The accord in operation: Three pillars
Basel II uses a "three pillars" concept –
(1) Minimum capital requirements (addressing risk),
(2) Supervisory review and
(3) Market discipline.

The Basel I accord dealt with only parts of each of these pillars. For example: with respect to the first Basel II pillar, only one risk, credit risk, was dealt with in a simple manner while market risk was an afterthought; operational risk was not dealt with at all.

The first pillar: Minimum capital requirements

The first pillar deals with maintenance of regulatory capital calculated for three major components of risk that a bank faces: credit risk, operational risk, and market risk. Other risks are not considered fully quantifiable at this stage.

1. The credit risk component can be calculated in three different ways of varying degree of sophistication, namely standardized approach, Foundation IRB, Advanced IRB and General IB2 Restriction. IRB stands for "Internal Rating-Based Approach".
2. For operational risk, there are three different approaches – basic indicator approach or BIA, standardized approach or TSA, and the internal measurement approach (an advanced form of which is the advanced measurement approach or AMA).
3. For market risk the preferred approach is VaR (value at risk).

As the Basel II recommendations are phased in by the banking industry it will move from standardised requirements to more refined and specific requirements that have been developed for each risk category by each individual bank. The upside for banks that do develop their own be spoke risk measurement systems is that they will be rewarded with potentially lower risk capital requirements. In the future there will be closer links between the concepts of economic and regulatory capital.

The second pillar: Supervisory review

This is a regulatory response to the first pillar, giving regulators better 'tools' over those previously available. It also provides a framework for dealing with systemic risk, pension risk, concentration risk, strategic risk, reputational risk, liquidity risk and legal risk, which the accord combines under the title of residual risk. Banks can review their risk management system.

The Internal Capital Adequacy Assessment Process (ICAAP) is a result of Pillar 2 of Basel II accords.

The third pillar: Disclosures

This pillar aims to complement the minimum capital requirements and supervisory review process by developing a set of disclosure requirements which will allow the market participants to gauge the capital adequacy of an institution.

Market discipline supplements regulation as sharing of information facilitates assessment of the bank by others, including investors, analysts, customers, other banks, and rating agencies, which leads to good corporate governance. The aim of Pillar 3 is to allow market discipline to operate by requiring institutions to disclose details on the scope of application, capital, risk exposures, risk assessment processes, and the capital adequacy of the institution. It must be consistent with how the senior management, including the board, assess and manage the risks of the institution.

When market participants have a sufficient understanding of a bank's activities and the controls it has in place to manage its exposures, they are better able to distinguish between banking organizations so that they can reward those that manage their risks prudently and penalize those that do not.

These disclosures are required to be made at least twice a year, except qualitative disclosures providing a summary of the general risk management objectives and policies which can be made annually. Institutions are also required to create a formal policy on what will be disclosed and controls around them along with the validation and frequency of these disclosures. In general, the disclosures under Pillar 3 apply to the top consolidated level of the banking group to which the Basel II framework applies.

Management/Resolution of NPAs

A reduction in the total gross and net NPAs in the Indian financial system indicates a significant improvement in management of NPAs. This is also on account of various resolution mechanisms introduced in the recent past which include the SARFAESI Act, one time settlement schemes, setting up of the CDR mechanism, strengthening of DRTs. From the data available of Public

Sector Banks as on March 31, 2003, there were 1,522 numbers of NPAs as on March 31, 2003 which had gross value greater than Rs. 50 million in all the public sector banks in India. The total gross value of these NPAs amounted to Rs. 215 billion. The total number of resolution approaches (including cases where action is to be initiated) is greater than the number of NPAs, indicating some double counting. As can be seen, suit filed and BIFR are the two most common approaches to resolution of NPAs in public sector banks. Rehabilitation has been considered/ adopted in only about 13% of the cases. Settlement has been considered only in 9% of the cases. It is likely to have been adopted in even fewer cases. Data available on resolution strategies adopted by public sector banks suggest that Compromise settlement schemes with borrowers are found to be more effective than legal measures. Many banks have come out with their own restructuring schemes for settlement of NPA accounts. State Bank of India, HDFC Limited, M/s. Dun and Bradstreet Information Services (India) Pvt. Ltd. and M/s. Trans Union to serve as a mechanism for exchange of information between banks and FIs for curbing the growth of NPAs incorporated credit Information Bureau (India) Limited (CIBIL) in January 2001.

Pending the enactment of CIB Regulation Bill, the RBI constituted a working group to examine the role of CIBs. As per the recommendations of the working group, Banks and FIs are now required to submit the list of suit filed cases of Rs. 10 million and above and suit filed cases of wilful defaulters of Rs. 2.5 million and above to RBI as well as CIBIL. CIBIL shares this information with commercial banks and FIs so as to help them minimize adverse selection at appraisal stage.

Wilful Defaulters

RBI has issued revised guidelines in respect of detection of wilful default and diversion and siphoning of funds. As per these guidelines a wilful default occurs when a borrower defaults in meeting its obligations to the lender when it has capacity to honor the obligations or when funds have been utilized for purposes other than those for which finance was granted.

The list of wilful defaulters is required to be submitted to SEBI and RBI to prevent their access to capital markets. Sharing of information of this nature helps banks in their due diligence exercise and helps in avoiding financing unscrupulous elements. RBI has advised lenders to initiate legal measures including criminal actions, wherever required, and under take a proactive approach in change in management, where appropriate.

Legal and Regulatory Regime

1. Debt Recovery Tribunals (DRT):

In order to expedite speedy disposal of high value claims of banks Debt Recovery Tribunals were setup. The Central Government has amended the recovery of debts due to banks and financial institutions Act in January 2000 for enhancing the effectiveness of DRTs. The provisions for placement of more than one recovery officer, power to attach dependents property before judgment, penal provision for disobedience of Tribunals order and appointment of receiver with powers of realization, management, protection and preservation of property are expected to provide necessary teeth to the DRTs and speed up the recovery of NPAs in times to come DRTs were set up under the Recovery of Debts due to Banks and Financial Institutions Act, 1993. Under the Act, two types of Tribunals were set up i.e. Debt Recovery Tribunal (DRT) and Debt Recovery Appellate Tribunal (DRAT). The DRTs are vested with competence to entertain cases referred to them, by the banks and FIs for recovery of debts due to the same. The order passed by a DRT is appealable to the Appellate Tribunal but no appeal shall be entertained by the DRAT unless the applicant deposits 75% of the amount due from him as determined by it. However, the Affiliate Tribunal may, for reasons to be received in writing, waive or reduce the amount of such deposit. Advances of Rs. 1 million and above can be settled through DRT process. An important power conferred on the Tribunal is that of making an interim order (whether by way of injunction or stay) against the defendant to debar him from transferring, alienating or otherwise dealing with or disposing of any. Property and the assets belonging to him within prior permission of the Tribunal. This order can be passed even while the claim is pending. DRTs are criticized in respect of recovery made considering the size of NPAs in the Country. In general, it is observed that the defendants approach the High Country challenging the verdict of the Appellate Tribunal which leads to further delays in recovery. Validity of the Act is often challenged in the court which hinders the progress of the DRTs. Lastly, many needs to be done for making the DRTs stronger in terms of infrastructure.

DRT cases of Chhattisgarh are currently operational at Jabalpur. (M.P).

Efforts are on to establish a DRT at Raipur. A letter was issued by the Committee of State bankers to the department of financial Services and the matter is with the Finance ministry of C.G

They would be writing a letter strongly to the appropriate authorities in the Ministry of finance, Government of India recommending and establishment at DRT at C.G. It is expected that there would be a DRT at C.G by the end of 2012. 7.15.2

2. <u>Lok Adalats:</u>

The Lok Adalats institutions help banks to settle disputes involving accounts in doubtful and loss categories. These are proved to be an effective institution for settlement of dues in respect of smaller loans. The Lok Adalats and Debt Recovery Tribunals have been empowered to organize Lok Adalats to decide for NPAs of Rs. 10 lakhs and above.

The institution of Lok Adalats constituted under the Legal Services Authorities Act, 1987 helps in resolving disputes between the parties by conciliation, mediation, compromise or amicable settlement. It is known for effecting mediation and counselling between the parties and to reduce burden on the court, especially for small loans. Cases involving suit claims up to Rs. 1 million can be brought before the Lok Adalats and every award of the Lok Adalats shall be deemed to be a decree of a Civil Court and no appeal can lie to any court against the award made by the Lok Adalats. Several people of particular localities various social organizations are approaching Lok Adalats which are generally presided over by two or three senior persons including retired senior civil servants, defense personnel and judicial officers. They take up cases which are suitable for settlement of debt for certain consideration. Parties are heard and they explain their legal position. They are advised to reach to some settlement due to social pressure of senior bureaucrats or judicial officers or social workers. If the compromise is arrived at, the parties to the litigation sign a statement in presence of Lok adalats which is expected to be filed in court to obtain a consent decree. Normally, if such settlement contains a clause that if the ompromise is not adhered to by the parties, the suits pending in the court will proceed in accordance with the law and parties will have a right to get the decree from the court. In general, it is observed that banks do not get the full advantage of the Lok adalats. It is difficult to collect the concerned borrowers willing to go in for compromise on the day when the Lok adalat meets. In any case, we should continue our efforts to seek the help of the Lok adalat.

3. <u>Compromise Settlement Schemes</u>

- Banks are free to design and implement their own policies for recovery and write off incorporation compromise and negotiated settlements with board approval
- Specific guidelines were issued in May 1999 for one time settlement of small enterprise sector.
- Guidelines were modified in July 2000 for recovery of NPAs of Rs.5 crore and less as on 31 st March 2007.

4. <u>Enactment of SARFAESI Act</u>

The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act" (SARFAESI) provides the formal legal basis and regulatory framework for setting up Asset Reconstruction Companies (ARCs) in India.

<u>Asset Reconstruction Company (ARC)</u>:
The Narasimham Committee on financial system (1991) has recommended for setting up of Asset Reconstruction Funds (ARF). The following concerns were expressed by the committee.
It was felt that centralized all India fund will severely handicap in its recovery efforts by lack of widespread geographical reach which individual bank possess and given the large fiscal deficits, there will be a problem of financing the ARF. Subsequently, the Narasimham committee on banking sector reforms has recommended for transfer of sticky assets of banks to the ARC. Thereafter the Varma committee on restructuring weak public sector banks has also viewed the separation of NPAs and its transfer thereafter to the ARF is an important element in a comprehensive restructuring strategy for weak banks. In recognition of the same ARC Bill was passed to regulate Securitization and Reconstruction of financial assets and enforcement of security interest. The ICICI BANK, State Bank of India and IDBI have promoted the country’s

first Asset Reconstruction Company. The company is specialized in recovery and liquidation of assets. The NPAs can be assigned to ARC by banks at a discounted price. The objective of ARC is floating of bonds and making necessary steps for recovery of NPAs from the borrowers directly. This enables a onetime clearing of balance sheet of banks by sticky loans In addition to asset reconstruction and ARCs, the Act deals with the following largely aspects.:
1) Securitization and Securitization Companies
2) Enforcement of Security Interest
3) Creation of a central registry in which all securitization and asset reconstruction transactions as well as any creation of security interests has to be filed.

The Reserve Bank of India (RBI), the designated regulatory authority for ARCS has issued Directions, Guidance Notes, Application Form and Guidelines to Banks in April 2003 or regulating functioning of the proposed ARCS and these Directions/ Guidance Notes cover various aspects relating to registration, operations and funding of ARCS and resolution of

NPAs by ARCS. The RBI has also issued guidelines to banks and financial institutions on issues relating to transfer of assets to ARCS, consideration for the same and valuation of instruments issued by the ARCS. Additionally, the Central Government has issued the security enforcement rules ("Enforcement Rules"), which lays down the procedure to be followed by a secured creditor while enforcing its security interest pursuant to the Act. The Act permits the secured creditors (if 75% of the secured creditors agree) to enforce their security interest in relation to the underlying security without reference to the Court after giving a 60 day notice to the defaulting borrower upon classification of the corresponding financial assistance as a non-performing asset.
The Act permits the secured creditors to take any of the following measures:

- Take over possession of the secured assets of the borrower including right to transfer by way of lease, assignment or sale;
- Take over the management of the secured assets including the right to transfer by way of lease, assignment or sale;
- Appoint any person as a manager of the secured asset (such person could be the ARC if they do not accept any pecuniary liability); and recover receivables of the borrower in respect of any secured asset which has been transferred. After taking over possession of the secured assets, the secured creditors are required to obtain valuation of the assets. These secured assets may be sold by using any of the following routes to obtain maximum value.
- By obtaining quotation s from persons dealing in such assets or otherwise interested in buying the assets;
- By inviting tenders from the public;
- By holding public auctions; or
- By private treaty.

Credit Information Bureau (India) Limited

CBIL is India’s first Credit Information Company (CIC) founded in August 2000. CIBIL collects and maintains records of an individual’s payments pertaining to loans and credit cards. These records are submitted to CIBIL by member banks and credit institutions, on a monthly basis.

This information is then used to create Credit Information Reports (CIR) and credit scores which are provided to credit institutions in order to help evaluate and approve loan applications. CIBIL was created to play a critical role in India's financial system, helping loan providers manage their business and helping consumers secure credit quicker and on better terms.