



## A Study on Credit Appraisal System in India with Special Reference to South Indian Banks

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### ABSTRACT

This study helps in understanding the credit appraisal system of Banks in India and to understand how to reduce various parameters, which are broadly categorized into financial risk, business risk, industrial risk and management risk associated in providing any loans or advances or project finance.

The research design was analytical in nature. Only secondary data was collected to this project. Using this collected data; analysis work was done in the area of Micro and Small enterprises.

After the analysis of this study, it was found that the following are the factors that will be considered by the Banks in credit appraisal process. They are financial performance, business performance, industry outlook, quality of management and conduct of account. In the factor of financial performance, the operating and financial viability of the proposal was found.

This study helps to know the credit appraisal process and understand the operating and financial viability of the proposal.

**KEY WORDS:** *Credit Appraisal, Financial Risk, Business Risk, Industrial Risk, Management Risk, Financial Viability*

### 1. INTRODUCTION

Credit appraisal means an investigation/assessment done by the Banks prior before providing any loans & advances/project finance & also checks the commercial, financial & technical viability of the project proposed its funding pattern & further checks

the primary & collateral security cover available for recovery of such funds.

### 2. MAIN THEME OF THE PROJECT

#### 2.1 STATEMENT OF THE PROBLEM

The study is to examine credit appraisal system based on the three enterprises and the problems identified by the researcher related to Micro and Small enterprises and the factors responsible for their sickness are infrastructure, limited financial resources, obsolesce technology, financial problems, low quality image. This study is to compare the three enterprises with financial viability and to find out the conclusion.

#### 2.2 OBJECTIVES

To study the Credit appraisal system in Micro and Small enterprises sector the following objectives are framed

- To Study about the Credit appraisal process.
- To Study about the factors of operating and financial viability.
- To Study about how they are giving rating's to the sectors.
- To provide necessary findings based on the given data.

## 2.3 SCOPE AND LIMITATION

### 2.3.1 SCOPE

The study will help in understanding the credit appraisal system at Banks and to understand how to reduce various risk parameters associated in providing any loans or advances or project finance.

### 2.3.2 LIMITATION

1. The credit appraisal is one of the crucial areas for any Banks, some of the technicalities are not revealed. This system includes various types of detail studies for different areas of analysis, but due to time constraint, the analysis was in the area of Micro and Small enterprises only.

## 2.4 RESEARCH METHODOLOGY

### 2.4.1 RESEARCH DESIGN

**Research type:** The study is based on analytical research. Analytical research describes to use facts or information already available and analyze these to make a critical evaluation of the material.

### 2.4.2 TOOLS

The tools used in Credit Appraisal System are

- **Pre-sanction process-** The loan will be sanctioned only before analyzing various details of the enterprises is pre-sanction process.
- **Post-sanction process-**After analyzing various details of the enterprises in pre-sanction process the loan will be sanctioned.

## 2.5 REVIEW OF LITERATURE

**Allen N. Berger, Gregory F. Udell (2012)** illustrates the inner workings of relationship lending, the implications for Banks organizational structure, and the effects of shocks to the economic environment on the availability of relationship credit to small businesses.

**Michael B Gordy (2014)** illustrates that within the past two years, important advances have been made in modelling credit risk at the portfolio level. Researchers offer a comparative anatomy of two especially influential benchmarks for credit risk

models, the Risk Metrics Group's Credit Metrics and Credit Suisse Financial Product's Credit Risk+.

**Michael B Gordy (July 2014)** Credit Risk+ is an influential and widely implemented model of portfolio credit risk. As a close variant of models long used for insurance risk, it retains the analytical tractability for which the insurance models were designed.

**Jan Pieter Krahnem, Martin Weber (2015)** Banks internal ratings of corporate clients are intended to quantify the expected likelihood of future borrower defaults. It develops a comprehensive framework for evaluating the quality of standard rating systems. It suggest a number of principles that ought to be met by "good rating practice".

**Seth B. Carpenter, William Whitesell, Egon Zakrajsek (2016)** A researcher evaluates the potential cyclical effects of the "standardized approach" to risk evaluation in the new Accord, which involves the ratings of external agencies. Researchers find that the level of required capital against business loans would be noticeably lower under the new Accord compared with the current regime.

## 3. ANALYSIS AND INTERPRETATION

### 3.1 INTRODUCTION TO CREDIT TOOLS

The Banks has developed tools for better credit risk management. These focus on the areas of rating of corporate (pre-sanctioning) of loans and monitoring of loans (post-sanctioning). The focus of this manual is to familiarize the user with the credit rating tool.

### 3.2 PARAMATERS USED IN CREDIT RATING OF SME

The rating tool for Small and Micro Enterprise borrowers assigns the following weightages to each one of the four main categories as in the table 1.

Parameter	Weightage (%)
Financial performance	40
Operating performance	22.5
Quality of management	22.5
Industry outlook	15

**Various parameters under each of the above stated parameters**

### 3.3 PARAMETERS OF FINANCIAL PERFORMANCE AND ITS WEIGHTAGE

S.No	Sub Parameters	Weightage (%)
F1	Net sales growth rate (%)	10
F2	PBDIT growth rate (%)	7
F3	PBDIT/Sales (%)	10
F6	TOL/TNW	10
F7	Current ratio	10
F8	Operating cash flow	8
F9	DSCR	8
F12*	Foreign exchange risk	10
F13	Expected values of D/E, if 50% of NFB credit devolves(Corrected for margin)	5
F24	Reliability of Debtors	12
F27*	State of export country economy	5
F28*	Fund repatriation risk	5
	<b>TOTAL</b>	<b>100</b>

\*Applicable for export units

### 3.4 PARAMETERS OF OPERATING PERFORMANCE AND ITS WEIGHTAGE

S.No	Sub Parameters	Weightage (%)
B7	Credit period allowed	10
B8	Credit period availed	10
B9	Working capital cycle	20
B10	Tax incentives	10
B13	Production related risks	10
B14	Product related risks	10
B15	Price related risks	10
B20	Client risk	10
B21	Fixed asset turnover	10
	<b>TOTAL</b>	<b>100</b>

#### CASE - 1

Name of the Company	M/s Sivakumar Spinner
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#### Present proposal

Nature	Limit	Proposed	Purpose
Cash Credit Open Loan(CCOL)	100 lakhs	100 lakhs	Working capital
Term loan	90 lakhs	90 lakhs	To purchase machinery
Fully Security Loan (FSL)	120 lakhs	120 lakhs	To import machinery valued Euro 1,80,000

#### Security details

##### a) Primary

Particulars of asset	Value / Margin	Mode of charge
Cash Credit Open Loan	25% for stock and 50% for debtors	Hypothecation
Fully Security Loan	25%	Hypothecation

**b) Collateral**

Nature	Owner	Present valuation 13.1.17	year dated	Previous valuation 23.3.16	year dated	Expert valuation 18.1.17
Unit property	Sivakumar spinners	255.04		118.61		302.00
The mill	Sivaswamy, Rajkumar and Sukumar	219.78		75.49		329.18

Purpose of loan : To purchase machinery

Validity of limits : 12 months

Term loan (OD) : 1 year

Ratings by Banks : AA with 76% (High safety)

**Unit Visit**

The unit was visited and the overall operations of the unit were found to be satisfactory.

**CASE - 2**

Name of the Company	M/s Rajsanthi Spinners
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**Present proposal**

Nature	Limit	Proposed	Purpose
<b>Cash Credit Open Loan(CCOL)</b>	150.00 lakhs	200 (of which 50.00 lakhs seasonal)	Working capital
<b>Fully Security Loan (FSL)</b>	22.00 lakhs	22.00 (reduced to 19.23 lakhs)	Continuance

**Security details****a) Primary**

Particulars of asset	Value / Margin	Mode of change
Stock and Book debts	25% for stock and 50% for debtors	Hypothecation
Machines	WDV Rs.211.91 lakhs	Hypothecation

**b) Collateral**

Nature	Owner	Present valuation 20.12.17	year dated	Previous valuation 03.01.16	year dated	Expert valuation 25.12.17
<b>Land with Factoring</b>	Mr.M.Thankaraj	398.82		317.03		318.24
<b>Vacant Land</b>	Mr.M.Thankaraj	144.70		99.00		99.80

Purpose of loan	:	To purchase machinery
Validity of limits	:	12 months
Term loan (OD)	:	1 year
Ratings by Banks	:	A with 68% (Adequate safety)

### Unit Visit

The unit was visited and the overall operations of the unit were found to be satisfactory.

### 4. FINDINGS

Credit appraisal is done to check the technical and financial viability of the project proposed its funding pattern and checks the primary or collateral security cover available for the recovery of such funds. Credit is the core activity of the Banks and important source of their earnings which go to pay interest to depositors, salaries to employees and dividend to shareholders. Banks main function is to lend funds or provide finance but it appears that norms are taken as guidelines not as a decision making.

### 5. CONCLUSION

Banks loan policy contains various norms for sanction of different types of loans. These all norms do not apply to each and every case. Banks norms for providing loans are flexible and it may differ from case to case. Usually it is seen that credit appraisal is basically done on the basis of fundamental soundness. But, after different types of cases studies, the conclusion was such that the credit appraisal system is not only looking for financial wealth.

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