Credit Appraisal

Credit Appraisal is the process by which a lender/banker appraises the technical feasibility, economic viability and bankability including creditworthiness of the prospective borrower.

It is a very important step in determining the eligibility of a loan borrower for a loan.

“A good thing, well begun, is half done”

Just like every bank charges different rates for different loans from different customers, in the same way, each bank has its own set criteria that one must satisfy to qualify as a certified borrower of money/assets from the bank.

All banks have their own rules to decide the credit worthiness of their borrowers.

Creditworthiness of a customer lies in assessing if that customer is capable of repaying the loan amount in the stipulated time, or not.

Here also, every bank has its own methodology to determine if a borrower is creditworthy or not.

It is determined in terms of the norms and standards set by the banks. Banks employ their own unique objective, subjective, financial and non-financial techniques to evaluate the creditworthiness of their customers.

What are Credit Scoring and Credit Rating?

Bankers talk about credit scoring and credit rating in the same breath. Therefore, it is important to clarify the difference between credit scoring and credit rating.

These are two entirely distinct concepts and are to be employed in distinctly different scenarios.

Credit scoring is a statistical technique that combines several pre-determined characteristics to form a single score to assess a borrower’s credit worthiness.

The score allocated to any application is the sum of the appropriate weights given by the values that the included characteristics take for that application.

Thus, any two identical applications will always receive the same score.

Credit rating, on the other hand, is based more on the experience and judgment of the credit officer and uses financial indicators as key.

The objective of scoring is to replicate manual analysis and approval of loans at a lower cost, with greater speed, while the use of credit rating is reliant on manual analysis by credit officers to supplement the rating provided by the tool.

Credit scoring uses a retail lending approach to credit screening/decision making and is recommended for smaller ticket size loans, where adequate reliable financial data about the borrower is not available.

Credit Rating, on the other hand, is a more appropriate tool for larger, mid-segment or corporate loans which have relevant financial data/ business plans that provide the basis for further credit analysis and information.

SIDBI has developed software for Credit Appraisal called the Credit Appraisal and Rating Tool (CART). With this software, loan proposals can be appraised on any electronic platform. This will also generate the rating of the proposal so as to decide on the pricing.

Some banks use automated processing for handling applications but use a judgmental method for the final credit decision. Approvals are followed by credit review functions including, credit extension, customer service, security and collections.

Criteria for Credit Appraisal:

- ✓ Incomes Of Applicants And Co-applicants,
- ✓ Age Of Applicants,
- ✓ Educational Qualifications,
- ✓ Profession,
- ✓ Experience,
- ✓ Additional Sources Of Income,
- ✓ Past Loan Record,
- ✓ Family History,
- ✓ Employer/Business,
- ✓ Security of tenure,
- ✓ Tax History,
- ✓ Assets Of Applicants And Their Financing Pattern,
- ✓ Recurring Liabilities,
- ✓ Other present and future liabilities and investments (if any).

Based on these parameters, the maximum amount of loan that the bank can sanction and the customer is eligible for is worked out. The broad tools to determine eligibility remain the same for all banks.

nical Feasibility	What the Bank is looking for
ng Standard	**ent living standard with some tangibles like T.V. & fridge will pro rance to bank regarding your residential status.**
ality	**ence of some undesirable elements like local goons or controversial a ersely affects your loan appraisal process.**
phonic Verification	**east one response is needed from person to establish the identity of on from contact point of view.**
cational Qualification	**an essential barrier but essential to understand the complex term litions of bank loan.**

tical Influence	**nteresting reference point in the sense that they are one of major categor defaulters.**
rences	**stablish the residential identity of person from human contact point of v ross check of their loans.**

The 3 methods used to arrive at Eligibility

1. Installment To Income Ratio (IIR)
2. Fixed Obligation To Income Ratio (FOIR)
3. Loan To Cost Ratio (LOCR)

Installment To Income Ratio (IIR)

This ratio is generally expressed as a percentage. This percentage denotes the portion of the customer's monthly installment on the home loan taken. Usually, banks use 33.33 per cent to 40 per cent ratio. This is because it is has been observed that under normal circumstances, a person can pay an installment up to 33.33 to 40 per cent of his salary towards a loan.

Example: If we consider the installment to income ratio equal to 33.33 per cent, and assume the gross income to be Rs. 30,000 per month, then as per the ratio, the applicant is eligible for a loan with the maximum installment of Rs. 10,000 per month or 3:1.

Fixed Obligation To Income Ratio (FOIR):

This ratio signifies the importance of the regularity in the repayment of previous loans. In this calculation, the bank considers the instalments of all other loans already availed of by the customer and still due, including the home loan applied for.

In other words, this ratio includes all the fixed obligations that the borrower is supposed to pay regularly on a monthly basis to any bank. Statutory deductions from salary like provident fund, professional tax and deductions for investment like insurance premium, recurring deposit etc. are exempt from these fixed obligations.

Example: Assume that monthly income of an applicant is Rs 30,000 and the applicant has a car loan instalment of Rs 4,000 per month, a TV loan instalment of Rs 1,000 per month.

In addition to this his proposed housing loan instalment is Rs 10,000 per month. Numerically, the ratio is equal to Rs. 15,000 or 50 per cent (i.e. 50 per cent of the monthly income). If the bank has decided on the standard of 40 per cent of ratio as the criteria, then the maximum total instalments the person can pay, as per the standard, would be Rs 12,000 per month.

As he is already paying Rs 5,000 for the car and TV, he only has Rs 7,000 left out. Hence, the customer would be given only that loan for which the EMI would be equal to Rs 7,000, keeping in mind the repayment capacity of the applicant.

Loan To Cost Ratio (LOCR) :

This ratio is used by banks to calculate the loan amount that an applicant is eligible to pay on the basis of the total cost of the property. This ratio sets the upper limit or the maximum loan amount that a person is eligible for, irrespective of the loan eligibility under any other criteria. The maximum amount of loan the borrower is eligible to pay is pegged as equal to the cost or value of the property.

Even if the banks' calculations of eligibility, according to the above mentioned two criterions, turns out to be higher, the loan amount can't exceed the cost or value of the property. This ratio is set equal to between 70 to 90 per cent of the registered value of the property.

Hence, while deciding on the maximum amount of loan a customer can be given, the banks use these three parameters. These parameters help in computing loan eligibility, which is crucial in calculating the creditworthiness of a customer. It also acts as a guide to determine the loan amount.

conomic Viability	Generally accepted percentage
allment To Income Ratio	for salaried cases would be capped at 60% of Net incon nsion Income cases IIR to be restricted to 40%
d Obligation To Income Ratio	FIOR kept at 55%
n To Cost Ratio	LTC amount to 80%

arameter	Norms	Checkpoints
k Statements	onths bank statements need to be furnished	check the average amount clien ntaining in the account is sufficient to pa llment amount or not.
ness continuity proo	year IT returns made compulsory	nquire primary source of income.
dit interview	the big loan amount credit intervie ssary.	heck the general attitude of customer a efforts are put in to understand their r er.
file of customer	ried professionals get an edge over busi me people.	red source of income give them a edge

ırity	**ːt of value equal to or more than loan amo n has to be put as pledge or collateral.**	**safeguard bank interest against any fu ult.**
ıership title	**ɔe on the name or blood relative of applicant**	**establish the ownership claim of the icant.**

However, if all the three ratios yield a different value, which is commonly the case, what do the banks do? Simple, they generally select the lowest of the three as the loan amount that the applicant is eligible to pay.

STEP I - SUBMISSION OF LOAN APPLICATION

The financial institutions require that an entrepreneur seeking financing assistance should furnish detail information about the project in a prescribed form the borrower submits an application form that seeks comprehensive information about the project.

STEP II - INITIAL PROCESSING OF LOAN APPLICATION

When the application is received, an officer of the financial institution reviews it to ascertain whether it is complete for processing. If it is incomplete the borrower is asked to provide the required additional information. When the application is considered complete, the financial institution prepares a 'flash report' which is essentially a summarization of the loan application. On the basis of the 'Flash Report', it is decided whether the project justifies a detailed appraisal or not.

STEP III - APPRAISAL OF THE PROPOSED PROJECT

The detailed appraisal of the project covers the Marketing, Technical, Financial, Managerial, and Economic aspects. The appraisal memorandum is normally prepared within two months after site inspection. Based on that a decision is taken whether the project will be accepted or not.

STEP IV - ISSUE OF THE LETTER OF SANCTION

If the project is accepted, a financial letter of sanction is issued to the borrower. This communicates to the borrower the assistance sanctioned and the terms and conditions relating thereto.

STEP V - ACCEPTANCE OF THE TERMS & CONDITIONS BY BORROWING UNIT

On receiving the letter of sanction from the financial institution, the borrowing unit convenes its board meeting at which the terms and conditions associated with the letter of sanction are accepted and an appropriate resolution is passed to that effect. The acceptance of the terms and conditions has to be conveyed to the financial institution within stipulated period.

STEP VI - EXECUTION OF LOAN AGREEMENT

The financial institution, after receiving the letter of acceptance from the borrower, sends the draft of the agreement to the borrower to be executed by the authorized persons and properly stamped as per the Indian Stamp Act, 1899. The agreement, properly executed and stamped, along with other documents as required by the financial institution must be returned to it. Once the financial institution also signs the agreement, it becomes effective.

STEP VII – DISBURSEMENT OF LOANS

Periodically, the borrower is required to submit information on the physical progress of the projects, financial status of the project, arrangements made for financing the project, contributions made by the promoters, projected funds flow statement, compliance with various statutory requirements, and fulfilment of the pre-disbursement conditions. Based on the information provided by the borrower, the financial institution will determine the amount of term loan to be disbursed from time to time. Before the entire term loan is disbursed, the borrower must fully comply with all the terms and conditions of the loan agreement.

STEP VIII - CREATION OF SECURITY

The term loans (both rupee and foreign currency) and the deferred payment guarantee assistance provided by the financial institutions are secured through the first mortgage, by way of deposit of title deeds, of immovable properties and hypothecation of movable properties. As the creation of mortgage, particularly in the case of land, tends to be a time consuming process, the institutions permit interim disbursements against alternate security (in the form of guarantees by the promoters). The mortgage, however, has to be created within a year from the date of the first disbursement. Otherwise, the borrower has to pay an additional charge of 1 per interest.

STEP IX – MONITORING

Monitoring of the project is done at the implementation stage as well as at the operational stage. During the implementation stage, the project is monitored through:

1. Regular reports, furnished by the promoters, which provide information about placement of orders, construction of buildings, procurement of plant, installation of plant and machinery, trial production, etc.

2. Periodic site visits

3. Discussion with promoters, bankers, suppliers, creditors, and other connected with the project

4. Progress reports submitted by the nominee directors, and

5. Audited accounts of the company.

During the operational stage, the project is monitored with the help of:

- ✓ Quarterly progress report on the project
- ✓ Site inspection
- ✓ Reports of nominee directors
- ✓ Comparison of performance with promise.

The most important aspect of monitoring, of course, is the recovery of dues represented by interest and principal repayment.

The strategic focus of the management should be upon the rate of new account growth and level of risk taken into the bank credit /loan portfolio.

The ideal would be to find the optimum balance between the approval rate and the risk level.

This is a worthy but elusive goal.