**Credit Evaluation**

Credit evaluation refers to the process borrowers are subjected to for them to be eligible for funding, or to pay for products within a specified period. It as well refers to the step's lenders undertake while examining the request for credit.

**Evaluation of the Credit Process**

In order to evaluate the bank's credit process, the examiner will first need to ascertain what kinds of lending activities the bank participates in. What the bank chooses to do sets the requirements for the specific types of risk management systems used. After determining the credit areas that will be the focus of the examination, the examiner will begin by reviewing the bank's credit policy, standards and procedures. The policy, standards and procedures establish the bank's credit risk management system, from the general to the specific. The examiner must determine whether or not the policy and credit risk management system it sets forth is adequate for the types of loans the bank extends to its customers, the bank's credit risk profile. Further, the examiner must assess whether or not the credit process is adequate.

Adequacy means that all of the necessary components of the credit process have been fully implemented, are routinely executed and verified independently. If the process includes a sound credit risk evaluation process that leads to justifiable internal credit risk ratings, then the examiner should do limited testing or validation of that process. If gaps or weak points in the process are evident, then the examiner should focus on those areas in the examination, discuss them with bank management and detail them in the examination report. The credit risk management section of the supervisory plan should then focus on these areas and the examiner should monitor them, or perhaps even follow up with a targeted exam, until the bank has made the necessary improvements.

This is the essence of risk-based supervision, focusing on weak points or gaps in the risk management system and monitoring them continuously until the examiner is satisfied that they have been corrected and the system as a whole is adequate and operating as it should. The goal is for the risk management system to be operating as intended by management, so that examiners need only validate during the examination that the process remains adequate

to the risk profile of the bank and no serious weaknesses are evident. One of the primary validation actions is to test a sample of new loans to ensure that the current process remains adequate, that the loans are in compliance with the bank's credit policy and procedures, and that the internal credit risk ratings are appropriate.

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

**Stages in the Credit Analysis Process**

The credit analysis process is a lengthy one, lasting from a few weeks to months. It starts from the information-collection stage up to the decision-making stage when the lender decides whether to approve the loan application and, if approved, how much credit to extend to the borrower.

The following are the key stages in the credit analysis process:

**1. Information collection**

The first stage in the credit analysis process is to collect information about the applicant's credit history. Specifically, the lender is interested in the past repayment record of the customer, organizational reputation, financial solvency, as well as their transaction records with the bank and other financial institutions. The lender may also assess the ability of the borrower to generate additional cash flows for the entity by looking at how effectively they utilized past credit to grow its core business activities.

The lender also collects information about the purpose of the loan and its feasibility. The lender is interested in knowing if the project to be funded is viable and its potential to generate sufficient cash flows. The credit officer or analyst assigned to the borrower is

required to determine the adequacy of the loan amount to implement the project to completion and the existence of a good plan to undertake the project successfully.

The bank also collects information about the collateral of the loan, which acts as security for the loan in the event that the borrower defaults on its debt obligations. Usually, lenders prefer getting the loan repaid from the proceeds of the project that is being funded, and only use the security as a fall back in the event that the borrower defaults.

**2. Information analysis**

The information collected in the first stage is analyzed to determine if the information is accurate and truthful. Personal and corporate documents, such as the passport, corporate charter, trade licenses, corporate resolutions, agreements with customers and suppliers, and other legal documents are scrutinized to determine if they are accurate and genuine.

The credit analyst also evaluates the financial statements, such as the income statement, balance sheet, cashflow statement and other related documents to assess the financial ability of the borrower. The bank also considers the experience and qualifications of the borrower in the project to determine their competence in implementing the project successfully.

Another aspect that the lender considers is the effectiveness of the project. The lender analyzes the purpose and future prospects of the project being funded. The lender is interested in knowing if the project is viable enough to produce adequate cash flows to service the debt and pay operating expenses of the business. A profitable project will easily secure credit facilities from the lender.

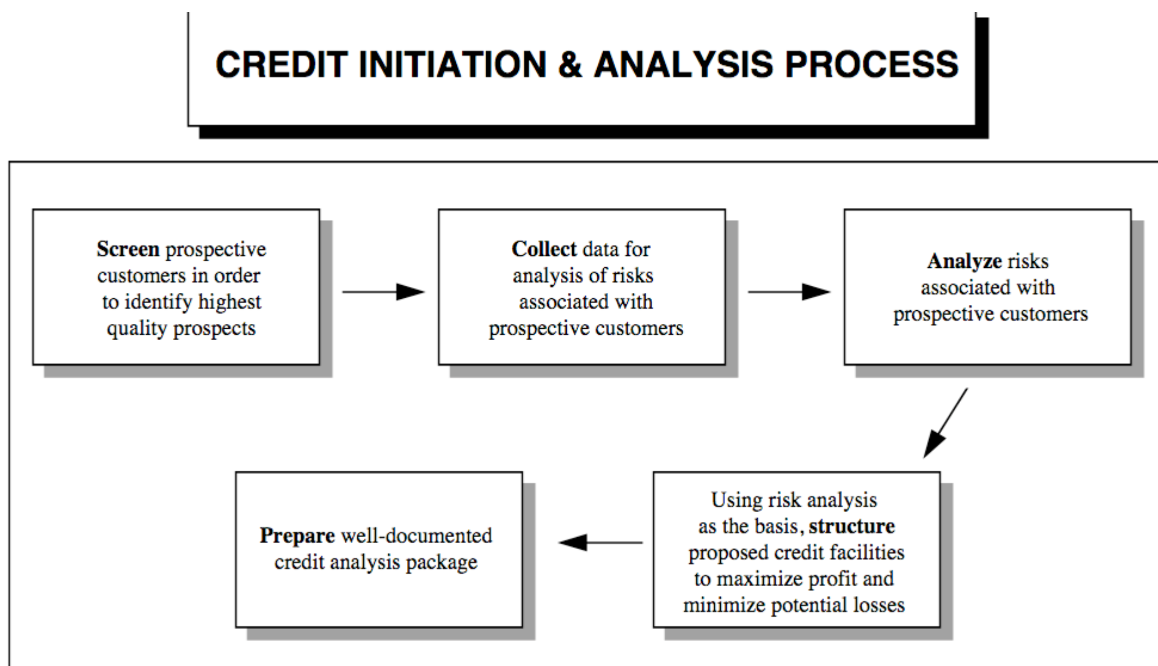
On the downside, if a project is facing stiff competition from other entities or is on a decline, the bank may be reluctant to extend credit due to the high probability of incurring losses in the event of default. However, if the bank is satisfied that the borrower's level of risk is acceptable, it can extend credit at a high interest rates to compensate for the high risk of default.

**3. Approval (or rejection) of the loan application**

The final stage in the credit analysis process is the decision-making stage. After obtaining and analyzing the appropriate financial data from the borrower, the lender makes a decision on whether the assessed level of risk is acceptable or not.

If the credit analyst assigned to the specific borrower is convinced that the assessed level of risk is acceptable and that the lender will not face any challenge servicing the credit, they will submit a recommendation report to the credit committee on the findings of the review and the final decision.

However, if the credit analyst finds that the borrower's level of risk is too high for the lender to accommodate, they are required to write a report to the credit committee detailing the findings on the borrower's creditworthiness. The committee or other appropriate approval body reserves the final decision on whether to approve or reject the loan.




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

1. 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.
2. 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.
3. 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.
4. 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.

The credit officer must have some knowledge of the industry in which the borrower operates, in order to assess the key industry factors that impact the borrower today and may influence the borrower tomorrow. Key factors may include the level of competition, domestic and foreign, barriers to entry, government regulation, labor relations in the industry, cyclicality of the industry, and others.

Analysis of the financial condition of the borrower may require an extensive effort, depending on the size and complexity of the borrower's business. The more complex the borrower, the more difficult it will be to analyze the financial statements and understand the interrelationship among the balance sheet, income statement and cash flow statement. If the borrower is part of a larger corporate structure, it will require an experienced lender, perhaps even a team of lenders, to fully understand the borrower's financial condition.

Evaluation of the competence, capability and honesty of management requires serious due diligence on the part of the lender. This evaluation requires an experienced lender who is

capable of probing into the borrower's relationships with customers, suppliers and other creditors in order to understand the borrower's business relationships. Does the borrower enjoy a good reputation in its industry? Does it have longstanding customer relationships?

At the same time, the lender must evaluate the skill and competence of management. Has management experienced several business cycles? Is management respected in its industry? Does the borrower have longstanding supplier and customer relationships? What is the history of the borrower's banking relationships? Does the owner hire competent managers and other pesonnel around him/her? Has the owner planned for succession? Is personnel turnover high?

In the end, the management factor is the most important of the four credit foundations. In the absence of competent, skilled, honest management (or an owner), in whom the bank has confidence, the loan should not be approved, even if all other factors are rated excellent. Management/the owner is in control and decides if and when to repay loans.

The credit analyst or officer must investigate the security or collateral that the borrower proposes to provide as support for the extension of credit and assure himself/herself of the value of the collateral in a liquidation scenario. In the worst case, what can the lender realistically expect to realize from sale of the collateral? The time value of money should also be factored in, especially if the collateral is real estate or a fixed asset whose sale is time consuming.

There should be evidence in the credit file of each borrower that the credit analyst and/or officer has thoroughly analyzed the four credit foundations and identified the strengths and weaknesses of each foundation in relation to the borrower. How this analysis should be performed should be guided by the credit policy and corporate priorities of the bank.

Once the analysis is complete, the internal credit risk rating should be assigned as the culmination of the analysis. The bank's credit policy should provide detailed guidance on assigning borrower risk ratings, including both quantitative and qualitative factors.

**Financial Statement Analysis**

There is no substitute for thorough and rigorous analysis of a borrower's financial statements when attempting to determine a borrower's creditworthiness. The balance sheet, income statement, cash flow statement, and financial projections all provide critical information about the borrower's creditworthiness and capacity to repay. Analysis of revenues and profit margins, cash flow, leverage, liquidity, and capitalization is required in sufficient detail to determine strengths that the lender wants to preserve and weaknesses that may impact the borrower's repayment capacity. If the bank fails to undertake rigorous analysis upfront, its capacity to protect itself against future repayment problems is limited and the quality of the loan portfolio will inevitably suffer.

However, despite the importance of financial statement analysis in determining creditworthiness, the final credit decision is subjective because the most important factor in the decision is management of the borrower. An evaluation of management is based on both objective and subjective factors but is, in the end, subjective because there is no ratio or number that will inform the banker of management's intention or willingness to repay a loan.

Therefore, the credit officer should make a serious effort to determine the competence, honesty and integrity of borrower management in each case. This effort should include what is called "due diligence," that is, the attempt to "know your customer" through contacting customers, suppliers and others in the industry who have experience with the borrower and its management. Where possible and legal, in the case of smaller companies with single owners where personal guarantees will be required, a credit history should be obtained to determine the owner's record of fulfilling his/her financial obligations. Court records should be reviewed to determine if there have been any court proceedings against the borrower and/or borrower management.

The question is whether or not borrower management, or the business owner, will honor its obligations to the lender in the best case and worst case. If the borrower encounters

difficulties in repaying its obligation(s) to the bank, will management, or the owner, be willing to collaborate with the bank to "work out" repayment, however long it requires