CHAPTER 4

CREDIT APPRAISAL

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Introduction

As stated earlier, after nationalisation of banks, the lending system has been shifted from 'Class' to 'mass' from a 'security oriented', to a 'project oriented' and 'need-based' approach and from developed to 'underdeveloped' sectors and regions.

Because of these radical changes, a thorough analysis of financial statements of borrowers becomes a fundamental task for appraising working capital and term loans.

However, the credit appraisal is limited by us to only industrial borrowers proposals. This is for two reasons. Firstly, the credit appraisal techniques are almost uniform for all the parties (including agriculture as well as trade). Secondly, the industrial sector absorbs more than 50 % of the total bank credit and also the recent techniques of credit appraisal developed by Indian bankers pertain mainly to industry.

The objective of this Chapter is to study briefly the techniques of credit appraisal for working capital and term loan. The main focus is done on the appraisal of working capital with specific reference to the new techniques for working capital appraisal developed by Indian bankers.

Section I

Techniques for Working Capital Appraisal

The traditional techniques for working capital appraisal are Cash Flow Statement, Funds Flow Statement, and Ratio Analysis. The main limitation of these techniques is their subjective nature. That to say, they lead to different interpretations.

In India, due to the limitations of the traditional techniques and the emergence of public sector banks, uniform techniques of working capital appraisal had to be worked out not only for the public sector banks but also for all commercial banks including those operating in the private sector.

It is in this light that the Tandon and Chore Study Groups[20] had been constituted by the Reserve Bank of India to study among other terms of reference, the existing techniques for working capital appraisal and to propose a new approach to lending.

I - The Tandon Study Group Recommendations

The Tandon Study Group has come with new concepts such as the 'Working Capital Gap', the 'norms' the 'reasonable level of current assets', the 'Methods of lending - I, II and III', the 'maximum bank borrowing permissible', the 'core assets', the 'style of credit', and the 'information system'.

Regarding the Methods of lending as suggested by the Study Group, two observations can be formulated.

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20. For more details refer to :
    (a) RBI, Report of the Study Group to Frame Guidelines for Follow-up and supervision of Bank Credit (Tandon Committee Report) RBI, Bombay, 1975, and
    (b) Reserve Bank of India, Report of the Working Group to Review the system of Cash Credit (Chore Committee Report) RBI, Bombay, 1979.

Firstly, there should be a reasonable relationship between current assets and current liabilities. That is to say bankers cannot give credit to a borrower who is using short term funds for acquiring fixed assets. As a consequence, the minimum current ratio required is 1 : 1 for Method I, and 1.33 : 1 for Method II.

Secondly, borrowers have to depend less and less on bank's credit. They have to contribute capital upto a certain limit depending on the method of financing choosen for the borrower.

Another advantage is that, when taking into account the lowest level of inventory or receivables as per norms, bankers avoid somehow double/multiple financing for the same inventory or receivables.

The repayment of the Working Capital term loan, which is the difference between the Bank Finance required by the borrower and the Permissible Bank Finance, that is the excess financing, should be done within a specified period and will depend on the borrower's fund generating capacity and ability to raise long term funds from his own or borrowed sources. Therefore, the entire borrower's financial requirement is to be met by banks even though the excess financing involves a higher rate of interest.

The Tandon Committee Report, even though, a fundamental innovative technique for credit appraisal has its own limitations.

The norms were computed only for 15 industries which cover about one half of the banks' industrial advances. To start with, the norms were expected to be applied to all industrial borrowers including small scale industries and public sector units, with aggregate limit from the banking system in excess of Rs. 10 lakhs and extended to small borrowers progressively as early as possible. As a consequence, the Study Group seems not to take into account the priority character of the small scale industries in the Indian Economy. This is so true that in any part of the Report, no privilege was mentioned for the small scale industries inspite of the Takkar Committee Report,[21] which recommended a segregation of dues to small industries by medium and large industries when assessing the credit limit of industrial borrowers.

The Tandon Study Group did not establish norms for heavy engineering industries and recommended the bankers to keep in mind the spirit of norms when assessing the needs of such industries. This did not really avoid the diversion of funds because a borrower from these industries can approach a banker at any time with large stocks and get credit since there are no norms to comply with.

It can also be noted that the methods of lending as suggested by the Tandon Group did not stipulate the rational allocation of bank credit but only a reduction of it. This can be seen when moving from Method I to Method III.

However, the Tandon Committee has paved the way to a new approach to lending and still play a determinent role in credit appraisal since the norms

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21. Reserve Bank of India, Report of the Committee on Delayed Payment of Bills of Small Industries on Government Departments and large Industries, (Takkar Committee Report), RBI, Bombay, 1972.

suggested by it continue to be used for determining the Permissible Bank Finance. To make it more suitable to the needs of bankers as well as to that of borrowers, the RBI constituted another study Group known as Chore Committee to review the implementation of the Tandon Group's recommendations.

II - The Chore Committee Recommendations

The Chore Committee through its 'enhancement of borrower's contribution', 'separate limits for peak - level' and non-peak level 'period and' ad-hoc limits' has brought some improvements in the credit appraisal techniques suggested by the Tandon Study Group.

The Chore Committee suggested that the borrowers should be placed under the Second Method of Lending. This would give a minimum current ratio of 1.33 : 1 . In case where borrowers are not in a position to comply with this, excess borrowings on account of adoption of Method II should be segregated and converted into a working capital term loan. This loan should be made repayable in half - yearly instalments over a period not exceeding five years. A higher rate of interest may be fixed at 2 % over the rate applicable in the relative cash credit limits in respect of working capital term loan.

While assessing the credit requirements of borrowers, the Committee suggested that banks should fix separate limits, wherever feasible, for the normal non-peak level as well as for the peak level credit requirements indicating the periods during which the separate limits would be utilised by borrowers.

However, in case where there is no pronounced seasonal trend, only one limit may be fixed. The peak level requirements of the borrower would be normally for short periods. What is being attempted is to widen the application of this procedure and extend it to all borrowers currently under the revised lending discipline prescribed by the Tandon Committee i.e. borrowers having limits of Rs. 10 lakhs and above.

This separate limit for peak level and non peak level will not only apply to agro-based industries but also to certain industries where either the input or output is seasonal like industries manufacturing vegetable oil/ghee, rice, fans etc.

The working Group recommended that borrowers should be discouraged from approaching banks frequently for ad-hoc limits in excess of the sanctioned limits. These ad-hoc or temporary limits should be considered in exceptional circumstances and only for a pre-determined short duration. This should be subject to close scrutiny otherwise the purpose of fixing limits on the basis of normal non-peak level/peak level requirements could be defeated.

The measures recommended under 'enhancement of borrower's contribution', 'separate limits for peak level period' and 'ad-hoc limits' are to be compulsorily implemented in the case of all borrowers with aggregate working capital limit of Rs. 50 lakhs and above from the banking system, while sick units may be allowed exemption under provision on merits.

Under the above major recommendations, the working Group has also recommended, when assessing the working capital, the segregation of dues of small scale industries in Sundry Creditors by medium/large industries in the private and public sector.

As a consequence of the above, it can be observed that the Chore Committee has filled up the major gaps left by the Tandon Study Group by introducing the peak and non-peak levels for seasonal as well as for non-seasonal industries. The problem of dues to small industries by medium and large industries and Government Departments has also been taken into account.

However, with the enhancement of the borrower's contribution in adopting the Second Method of Lending, the working Group did not take into consideration the last investments in fixed assets realised by a business concern because more funds are demanded from long term sources for short term finance. It would be more interesting before placing the borrower under the Second Method, to study his last and future investments envisaged. In case of two borrowers applying for working capital, the one who invested in the recent year(s) will face more problems of bringing additional funds than the one who did not do so. In other words, based on the investment criteria, there should be some relaxations for borrower's whose past investments potentialities are considerable.

Continuing the qualitative transformation of the lending techniques, the RBI appointed another study Group known as the Marathe Study Group.[22] One of

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22. Reserve Bank of India, Report of the Committee to Review the working of the Credit Authorisation Scheme, RBI, Bombay, 1982.

its terms of reference was to examine the adequacy or otherwise of the Credit appraisal machinery/procedures in commercial banks.

The Study Group felt that the main objectives of the scheme should be to further strengthen competence for credit appraisal in commercial banks and to ensure that the discipline in lending is as far as possible, imposed by the banks themselves.

This study group did not come out with any new techniques of credit appraisal, except revising the forms to be submitted by big borrowers covered under the scheme. This revision of forms has been done according to the Chore Study Group's recommendations. In other words, the modifications brought under the CAS, are nothing but the alignment of the scheme to the Tandon and Chore Committee recommendations.

On the basis of the Tandon and Chore Study Groups, recommendations, the R B I has recommended commercial banks to assess the Permissible Bank Finance as under.[23]

(i) below Rs. 10 lakhs, after checking, reviewing the past performance of the borrower and/or his projected financial statements, provide, if satisfied, 75 % of the total bank finance requirement. The remaining 25 % constitutes the borrower's contribution,

(ii) Over Rs. 10 lakhs and below Rs. 50 lakhs apply

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23. Based on the study of different materials pertaining to the implementation of Tandon and Chore Study Groups recommendations.

Tandon Committee recommendations and try to bring borrowers under the Second Method of Lending, and

(iii) from Rs. 50 lakhs and above apply Chore Committee recommendations and place the borrowers under the Second Method of Lending.

Despite working capital credit facilities, commercial banks are also granting term loans to their customers. The following section deals with the appraisal of term loans.

Section II

Appraisal of Term Loans

Term loans are sanctioned for acquisition of various items of fixed assets like land, building, plant/machinery, office equipments, furniture and fixtures, electrification and power installation, erection and installation of machinery etc. Such loans-medium or long term are normally repayable in a fixed period varying from 10 to 25 years or more depending on the agreed period, the repayment depending on the profit generation capacity of borrowers.

Term finance is given for a 'term' because it cannot be repaid like the repayment of working capital finance from out of sale of current assets over a short period. It should be repaid from the earnings of the concern in using these fixed assets in generating surpluses. Then, the risk is greater than that of a working capital because the repayment depends on the future earnings of the business concern which may not materialise as projected, if adverse conditions prevail contrary to expectations.

Commercial banks cannot grant term loans to any extent they like because they should also fulfil the requirements of the statutory measures prescribed by the RBI . This is because commercial banks' deposits are repayable on demand and as a consequence, if they grant term loan entirely out of their own funds, they might be facing liquidity problems when current demand is asked for. That is why, the RBI demands, commercial banks to keep a Cash Reserve Ratio of 9 % of their demand and time liabilities and a statutory Liquidity Ratio of 37 % . Therefore, the capacity of commercial banks to lend is reduced by 46 % and consequently their involvement in term financing is also limited.

However, the following main factors affect the ability of a commercial bank to grant term loans.

(i) a commercial bank having more of paid up capital and reserves can more readily extent medium - term loans,

(ii) the size of fixed deposit in relation to total deposits is an important factor. A fairly large proportion of time and saving deposits permits the granting of term credit to a larger extent even in case of demand deposits , there will always be a substantial of a minimum below which the fluctuating deposits never fall,

(iii) a bank which has a larger percentage of liquid assets in cash with other banks and Government securities is in a better position to take on more term loans than the one which is less liquid, and

(iv) if a bank has already given number of term loans or mortgage loans, it may not be able to engage appreciably in any further financing of term loans.

Because of the importance of term loan in promoting agriculture and industry and the reluctance of commercial banks in providing long term finance to a large extent, the Government of India felt the necessity to set up public limited financial institutions to fill up the gap in long term financing. This was one of the Government of India's priorities immediately after the independence of the country. The role of these financial institutions is mainly to meet the financial requirements of the various sectors of the Indian Economy and particularly of the priority sectors. They also give refinance facilities to commmercial banks for their long term credit to various types of borrowers.

These financial institutions are mainly the Industriel Finance Corporation of India (I F C I), the State Financial Corporations (SFCs), the Industrial Credit and Investment Corporation of India (ICICI) and in the last recent years, the Industrial Development Bank of India (IDBI), the National Small Industries Corporation of India (NSIC), the Industrial Reconstruction Corporation of India (IRCI) , the National Bank for Agriculture and Rural Development(NABARD),

... With the proliferation of such financial institutions, the way is therefore open to commercial banks to involve themselves in long term financing. But due to the specific function of commercial banks which consists in providing working capital credit, they cannot go further in term loans due to their legal restrictions.

I - Legal Restrictions on Commercial banks for providing term loans.

Inspite of the statutory measures prescribed by the R B I, commercial banks have also other legal constraints in providing term loans upto a certain extent. In case of a large term loan, commercial banks are requested to finance jointly the project in consortium with financial institutions.

In this regard, the Ramanujan Study Group,[24] constituted in October, 1970 made important recommendations.

The Study Group stated ''In our view, the essential features of a scheme for such co-ordination should be (i) common appraisal, (ii) sharing of security and (iii) common follow-up. Common appraisal will mean that the appraisal of one body, say the term lending institutions will be accepted by the other joint financier, say a commercial bank. The term loan application would also take into account the requirements of working capital and would seek the advice of

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24. RBI, Report of the Study Group on Term Loan Partcipation Arrangements (Ramanujan Study Group),RBI, Bombay, 1971.

the commercial bank in assessing this requirements''.

The Study Group's recommendations have been accepted and arrangements for joint financing have also been devised to ensure a coordinated flow of credit to small industries on concessional terms. Some of the State Financial Corporations and Commercial banks have agreed to do so. For example, the Gujarat Investment Corporation Ltd. and the United Commercial Bank, the Haryana Financial Corporation and the Bank of India, to name only some of them. Later on in March, 1978, the RBI appointed another Study Group known as the Bhuchar Study Group[25] to go into more details about joint financing .

In terms of the Bhuchar Committee's recommendations, the RBI issued guidelines[26] in November, 1978 according to which :

(i) term loan arrangements of industries with project cost not exceeding Rs. 1.50 crores may be financed by banks preferably in participation with the State level institutions such as State Financial Corporation and State Industrial Development Corporation,

(ii) banks are not ordinarily participating in giving term loans for projects the cost of which exceeds Rs. 1.50 crores but does not exceed Rs. 5 crores, and

(iii) in case of large projects where the project cost exceed Rs. 5 crores, the commercial banks

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25. RBI, Report of the Study Group on Inter-Institutional Group regarding term lending by Commercial banks(Bhuchar Study Group),RBI,Bombay, 1978.

26. Based on the study of several documents available in commercial banks pertaining to joint financing.

could participate to the extent of 25 to 39 % of the total term loan (including deferred payment guarantee) requirements of the project.

The objective of the requirements as mentioned by the Bhuchar Committee Report is that the share of the banking system in term loan on an aggregate basis does not exceed about 25 % of the total term loans sanctioned by the term lending institutions.

The rationale behind the restrictions imposed by the RBI and the parameters laid down by the Bhuchar Committee on term lending by banks is that the principal function of commercial banks is to provide working capital finance for productive activities and neither their expertise nor the quantum and pattern of their resources permit them to go much deeper into the field of project financing on their own, i. e. without the support of the IDBI refinance or participation of all India term lending institutions , in a big way.

Since commercial banks are therefore involved in a way or another in term loans, they should appraise the viability of projects. However, commercial banks are adviced to seek the guidance of financial institutions which are experts in term financing when they have to study the viability of projects. Therefore, the techniques of credit appraisal are briefly described in the following paragraphs.

II - Appraisal of the Vialibility of a Project

The banker, when studying the viability of a project has to investigate on the technical feasibility of the project, its economic and financial soundness and the managerial competence of the borrower. Among all these, bankers have the capability to assess only the financial soundness of borrowers in using the techniques of financial analysis such as the Pay Back Method, the Accounting Rate of Return, the Discounted Cash Flow, the Net Present Value etc. For the remaining criteria of the viability of projects, they rely mainly on outside consultants.

A project which satisfies the above four criteria viz., technical feasibility, economic viability, financial soundness and managerial competence could be eligible for term loan.

However, commercial banks face many problems in conducting such studies. In fact, they rely mostly on outside consultants. This creates some delay in collecting all these information from different sources. But luckily, in some large size commercial banks such as the Punjab National Bank and the Bank of India, technical personnel are appointed to conduct such studies. They are mainly mechanical, electrical and civil engineers. These initiatives should be encouraged so to enable commercial banks to rely on their own personnel.

The techniques for appraising working capital have been pointed out in the first section of this chapter. For the new entrepeneur, his working capital requirements should be assessed on the light of the Tandon and Chore Study Groups' recommendations. But for the term loan granted to him for expansion , modernisation or setting up of an industry, the project should satisfy the criteria of technical feasibility, economic viability, financial soundness and managerial competence. It is only when all these conditions for working capital and/or term loans are satisfied that the credit limit is sanctioned by the appropriate authority.

The banker, after having sanctioned the credit limit, should now pass to the next stage which is credit monitoring as dealt with in the following Chapter.