INTERNATIONAL JOURNAL OF INNOVATIVE RESEARCH & DEVELOPMENT

ISSN 2278 – 0211 (Online)

Effective Credit Approval and Appraisal System: Loan Review Mechanism of Commercial Banks

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Abstract:
The biggest risk faced by commercial banks is the credit risk, which is associated with the uncertainty of borrowers default to pay the loan amount. It is the obligation of bankers to adopt the effective credit approval and appraisal mechanism while granting the loan. It involves evaluation of borrowers' current and future ability to fulfill its interest and principal repayment. The bankers should act pro-actively in administering credit approval and appraisal system. For this Loan Review Mechanism can be used as an effective tool aiming to cover the entire portfolio of credit and credit cycle starting from the documentation process, sanctioning of loan, disbursement, grading, monitoring the post sanction of loan and problem of recovery. Bankers should have through knowledge of prudential norms and Basel accord guidelines on credit risk in managing and administering of loan review mechanism. In this process of Loan Review Mechanism identifying and assessing the credit quality and timely credit grading of loan portfolio forms the basic components in effective credit approval and appraisal system. Hence the Loan Review Mechanism can be termed as a key factor in determining the soundness and financial health of banks. The present study is based on secondary data gathered and reviewed from previous studies, guidelines given by RBI, Prudential norms and Basel accord guidelines. It aims at understanding the concept of credit risk, need of credit approval and appraisal system, rationale in administering Loan Review Mechanism of commercial banks and to suggest the measures to be adopted by bankers in mitigating their losses caused due to loan assets.

Keywords: *Credit Approval and Appraisal, Loan Review Mechanism, Credit Risk, Loan asset, Basel Accord, Prudential Norms*

1. Conceptual Framework

The banking business is the life blood of economy, which has gained as vital importance in regulating financial and economic aspects of the economy. Reserve Bank of India is a regulatory body of banking business in India. In the general course of their business, banking industry is exposed to risk of uncertainty having an adverse impact on profitability of banks financial performance. It may be due to the environmental factors such a size, complexity business activities, volume etc exposed by banks. In this process to have an expeditious efforts were being taken by banks to minimize the risk.

Risk generally believed that banks face Credit, Market, Liquidity, Operational, Compliance / legal / regulatory and reputation risks. Thus management of banks should have an eye and give importance to improve the ability to identify measure, monitor and control the overall level of risks undertaken.

2. Statement of Problem

Banking financial institutions are being facing difficulties over the years for a multitude of reasons, the major cause of serious banking problems continues to be directly related to lax credit standards for borrowers and counterparties, poor portfolio risk management, or a lack of attention to changes in economic or other circumstances that can lead to a deterioration in the credit standing of a bank's counterparties. It is an issue of banking and financial institutions to develop improved processes and systems to deliver better visibility into future performance. Hence to achieve this bank(s) can have a change in their loan monitoring processes. The paper is to determine the effect of various credit risk management techniques and strategies that are adapted by commercial banks in order to mitigate the losses due to loan assets.

3. Objectives of the Study

It aims at understanding the concept of credit risk, need of credit approval and appraisal system, rationale in administering Loan Review Mechanism of commercial banks and to suggest the measures to be adopted by bankers in mitigating their losses caused due to loan assets.

4. Credit Risk Management & Its Perception

Credit risk is the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms in relation to lending, trading, hedging, settlement and other financial transactions. It impacts on financial institution; in turn it will incur losses from the decline or elimination of the value of assets due to deterioration in the financial condition of an entity to which credit is provided. In particular, the risk that a financial institution will incur losses with regard to credit provided to an overseas customer due to changes in the foreign currency situation or the political and economic conditions of the country to which the customer belongs is a country risk.

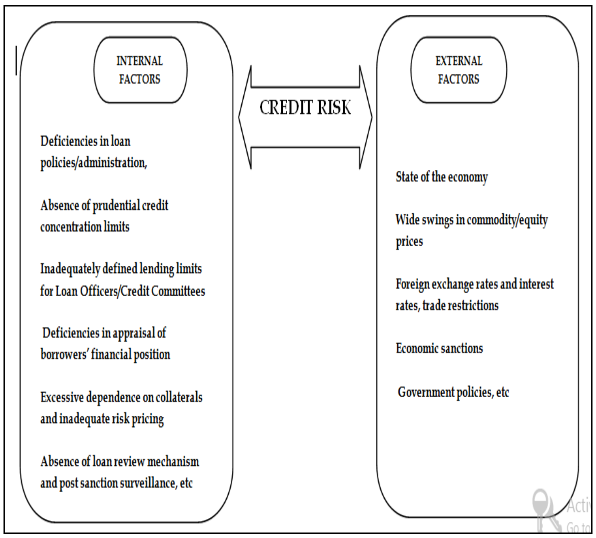

Figure 1

The Credit Risk is generally made up of

- transaction risk or default risk
- portfolio risk
  - intrinsic risk
  - concentration risk

The credit risk of a bank's portfolio depends on both external and internal factors. The external factors are the state of the economy, wide swings in commodity/equity prices, foreign exchange rates and interest rates, trade restrictions, economic sanctions, Government policies, etc.

The internal factors are deficiencies in loan policies/administration, absence of prudential credit concentration limits, inadequately defined lending limits for Loan Officers/Credit Committees, deficiencies in appraisal of borrowers' financial position, excessive dependence on collaterals and inadequate risk pricing, absence of loan review mechanism and post sanction surveillance, etc. Another variant of credit risk is counterparty risk.

Banks need to manage these credit risks inherent in the entire portfolio as well as the risk in individual credits or transactions. Banks should also consider the relationships between credit risk and other risks. The effective management of credit risk is a critical component of a comprehensive approach to risk management and essential to the long-term success of any banking organization.

5. Risk Management – Risk Profile

It involves identification, measurement, monitoring and controlling risks to ensure that

- The individuals who take or manage risks clearly understand it.
- The organization's Risk exposure is within the limits established by Board of Directors.
- Risk taking Decisions are in line with the business strategy and objectives set by BOD.
- The expected payoffs compensate for the risks taken.
- Risk taking decisions are explicit and clear.
- Sufficient capital as a buffer is available to take risk.

The goal of credit risk management is to maximize a bank's risk-adjusted rate of return by maintaining credit risk exposure within acceptable parameters.

6. Loan Review Mechanism

Loan Review Mechanism (LRM) is an effective tool for constantly evaluating the quality of loan book and to bring about qualitative improvements in credit administration. Banks should, therefore, put in place proper Loan Review Mechanism for large value accounts with responsibilities assigned in various areas such as, evaluating the effectiveness of loan administration, maintaining the integrity of credit grading process, assessing the loan loss provision, portfolio quality, etc. The purpose of LRM is to detect problem accounts early and to mitigate against probable losses either through loan restructuring or the termination of poor quality loans.
The main objectives of LRM could be:

- To identify loans promptly which develop credit weaknesses and initiate timely corrective action;
- To evaluate portfolio quality and isolate potential problem areas;
- To provide information for determining adequacy of loan loss provision;
- To assess the adequacy of and adherence to, loan policies and procedures, and to monitor compliance with relevant laws and regulations; and
- To provide top management with information on credit administration, including credit sanction process, risk evaluation and post-sanction follow-up.

The loan approval process comprises of processing and evaluating loan applications, documenting loan decisions and distributing loan funds. It is important that management establish a loan approval process which includes controls over lending authority and accountability.
A properly functioning loan approval process requires the following:

- Loans follow a pre-established loan processing flow, which sets out the proper movement of loan applications within the credit union;
- Borrower information and credit analysis are properly documented against established credit criteria;
- Loans decisions are made and approved by appropriate staff, with the appropriate authorization and accountability;
- Loan funds are disbursed, after applicable security is in place, through proper channels, with proper safeguards against theft or fraud.

The process should cover the entire credit cycle starting from the origination of the credit in a financial institution's books to the point the credit is extinguished from the books. It should provide for sound practices in:

- Credit Processing/Appraisal;
- Credit Approval/Sanction;
- Credit Documentation;
- Credit Administration;
- Disbursement;
- Monitoring And Control Of Individual Credits;
- Monitoring The Overall Credit Portfolio (Stress Testing)
- Credit Classification; And
- Managing Problem Credits /Recovery.

6.1. Credit Processing/Appraisal

Credit processing is the pre-qualification screening criteria where all required information on credit is gathered and applications are screened. The criteria may include rejecting applications from blacklisted customers. In this connection, financial institutions should have a checklist to ensure that all required information is, in fact, collected. This would help institutions avoid processing and screening applications that would be later rejected.
The next stage to credit screening is credit appraisal where the financial institution assesses the customer's ability to meet his obligations. Banks should be equipped with well designed credit appraisal criteria to ensure that facilities are granted only to creditworthy customers who can make repayments from reasonably determinable sources of cash flow on a timely basis.
Financial institutions usually require collateral or guarantees in support of a credit in order to mitigate risk. Banks must have a policy for valuing collateral, taking into account the Reserve Bank of India guidelines dealing with the matter. Such a policy shall, among other things, provide for acceptability of various forms of collateral, their periodic valuation, process for ensuring their continuing legal enforceability and realization value.
The appraisal criteria look into the following issues while granting loan:

- Determining the amount and purpose of lending
- Determining credit worthiness of the applicant to assume the credit obligation;
- Understanding risk profile of the borrower
- Forecast operating environment of the borrower
- Inspection of the borrower's business premises as well as the facility that is the subject of the proposed financing
- Ensuring goodwill of applicant

- Ensuring adequacy and enforceability of collateral or guarantees
- Collecting information on shareholders, directors and beneficial owners for corporate customers; and management capacity of corporate customers.

6.2. Credit-Approval/Sanction

Approval authorities sanctioned by the board of directors are prudent credit practitioner. Who will cover new credit approvals, renewals of existing credits, and changes in terms and conditions of previously approved credits, particularly credit restructuring, all of which should be fully documented and recorded. Approval authorities of individuals should be commensurate to their positions within management ranks as well as their expertise. The approval process should be based on a system of checks and balances.

Depending on the size of the financial institution, it should develop a corps of credit risk specialists who have high level expertise and experience and demonstrated judgment in assessing, approving and managing credit risk. An accountability regime should be established for the decision-making process, accompanied by a clear audit trail of decisions taken, with proper identification of individuals/committees involved. All this must be properly documented.

6.3. Credit Documentation

Documentation is an essential part of the credit process and is required for each phase of the credit cycle, including credit application, credit analysis, credit approval, credit monitoring, collateral valuation, impairment recognition, foreclosure of impaired loan and realization of security. Credit applications must be documented regardless of their approval or rejection. It is the responsibility of credit administration to ensure completeness of documentation (loan agreements, guarantees, transfer of title of collaterals etc) in accordance with approved terms and conditions. Outstanding documents should be tracked and followed up to ensure execution and receipt.

Documentation establishes the relationship between the financial institution and the borrower and forms the basis for any legal action in a court of law. Institutions must ensure that contractual agreements with their borrowers are vetted by their legal advisers.

For security reasons, banks should create separate credit file and maintained for each customer (copies of critical documents i.e., those of legal value, facility letters, signed loan agreements) in credit files while retaining the originals in more secure custody. Credit files should also be stored ensuing safe custody measures such as securing them in fire-proof cabinets and should not be removed from the institution's premises.

A checklist should be maintained for identity of individual(s) and/or committee(s) involved in the decision-making process acknowledging themselves, the policies and procedures ranging from receiving the credit application to the disbursement of funds have been complied with.

6.4. Credit Administration

Credit administration policies and procedures shall provide guidance to the banks staff on various types of lending including corporate, SME, consumer, agriculture, etc. Banks must ensure that their credit portfolio is properly administered and regulated i.e. loan agreements are duly prepared, renewal notices are sent systematically and credit files are updated on regular basis. An institution may allocate its credit administration function to a separate department or to designated individuals in credit operations, depending on the size and complexity of its credit portfolio. A financial institution's credit administration function should, as a minimum, ensure that:

- Maintenance of credit files with cross-indexed and their removal from the premises is not permitted
- The borrower has registered the required insurance policy in favor of the bank and is regularly paying the premiums
- Ensuring that the borrower is making timely repayments of lease rents in respect of charged leasehold properties
- Disbursement of credit facilities to be done only after all the contractual terms and conditions have been met and all the required documents have been received
- Regularity in monitoring the collateral value of charged property
- The borrower is making timely repayments on interest, principal and any agreed to fees and commissions
- Review and maintenance of information provided to management is both accurate and timely
- Responsibilities to the staff are to be adequately segregated
- Regular monitoring of funds disbursed under the credit agreement i.e. scrutiny of loan process is whether utilized for the purpose for which they were granted
- Banks staff are to entitled to ensure that policies and procedures as well as relevant laws and regulations are complied

6.5. Disbursement

Once the credit is approved, the customer should be advised of the terms and conditions of the credit by way of a letter of offer. The duplicate of this letter is duly signed and returned to the bank by the customer. The Disbursement should be effected only after completion of covenants, and receipt of collateral holdings, insurance cover in the institution's favour and the vetting of documents by a legal expert. In case of exceptions funds are to be released after prior approval from competent authorities to compliance with pre-disbursement conditions and approval by the relevant authorities in the financial institution.

6.6. Monitoring and Control of Individual Credits

In order to safeguard banks and financial institutions should ensure proper monitoring and control system in identifying potential losses at early stages alarming warning signals such as unauthorized drawings, arrears in capital and interest and a deterioration in the borrower's operating environment. Include unauthorized drawings, arrears in capital and interest and a deterioration in the borrower's operating environment.. After the loan is approved the loan should be continuously watched over. This helps in keeping track of borrowers' compliance with credit terms, identifying early signs of irregularity, conducting periodic valuation of collateral and monitoring timely repayments. A proper credit monitoring system will provide the basis for taking prompt corrective actions when warning signs point to deterioration in the financial health of the borrower.

Extensively the credit monitoring activity of the banks aims at ensuring

- Funds advanced are to be used only for the purpose stated in the customer's credit application and advanced accordingly
- Financial condition of a borrower is regularly tracked and banks management should advised the borrower about his credit status
- Administering of collateral coverage is regularly assessed and related to the borrower's financial health
- Identifying the contractual payment delinquencies
- Designing of remedial action
- Banks are vested with power to question the borrower to explain any major variances in projections provided in support of his credit application and the actual performance, in particular variances respecting projected cash flows and sales turnover.

6.7. Monitoring the Overall Credit Portfolio (Stress Testing)

An important element of sound credit risk management is analysing what could potentially go wrong with individual credits and the overall credit portfolio if conditions/environment in which borrowers operate change significantly. The results of this analysis should then be factored into the assessment of the adequacy of provisioning and capital of the institution. Such stress analysis can reveal previously undetected areas of potential credit risk exposure that could arise in times of crisis.

Each stress test should be followed by a contingency plan as regards recommended corrective actions. Senior management regularly reviews the results of stress tests and contingency plans. The results must serve as an important input into a review of credit risk Management framework and setting limits and

provisioning levels. This would involve a stress-test on the debt-servicing ability of a portfolio of borrowers under alternative scenarios.

6.8. Classification of Credit

Credit classification process grades individual credits in terms of the expected degree of recoverability by banks. Financial institutions must have in place the processes and controls to implement the RBI and board approved policies, which will, in turn, be in accord with the guidelines amended. They should have appropriate criteria for credit provisioning and write off.

Banks establishes and ensures appropriate systems and processes to identify credits with similar characteristics in order to assess the degree of their recoverability on a portfolio basis and to control the collateral securities. This is particularly important for any delinquent credits, before netting off the collateral's value against the outstanding amount of the credit for determining provision.

6.9. Managing Problem Credits/Recovery

A financial institution's credit risk policy gives solution how problem credits are to be managed by shouldering the responsibility to various credit operations department. It forms part of the credit monitoring section of the credit department called the credit workout unit. The workout unit will follow all aspects of the problem credit, including rehabilitation of the borrower, restructuring of credit, monitoring the value of applicable collateral, scrutiny of legal documents, and dealing with receiver/manager until the recovery matters are finalized.

Financial institutions will put in place systems to ensure that management is kept advised on a regular basis on all developments in the recovery process, may that emanate from the credit workout unit or other parts of the credit department.

Banks should maintain the list delinquent customer including any legal steps initiated to realize on the collateral. In case of any delay the banks in the liquidation of collateral or other credit recovery processes, the rationale is administered properly by authentic documented and anticipated actions recorded, and taking into account any revised plans submitted by the borrower. The accountability and responsibility of the staff should be reviewed in checking the credit. The experiences learned in this process of loan review process is duly documented maintained in a separate file to counter the same instances in future in case any.

DEPOSITS AND CREDIT OF SCHEDULED COMMERCIAL BANKS – ACCORDING TO POPULATION GROUP (2008 – 2013) (Amount in Billion) (No. of Accounts in Thousands)										
	Rural		Semi Urban		Urban		Metropolitan		Total	
	No. of Accounts	Amount Outstanding	No. of Accounts	Amount Outstanding	No. of Accounts	Amount Outstandin	No. of Accounts	Amount Outstandin	No. of Accounts	Amount Outstanding
2008	168034	3034.23	148361	4302.8	128021	6576.99	137241	18585.4	581657	32499.46
2009	199695	3639.1	169725	5297.58	142272	8229.14	150611	22054	662303	39219.81
2010	224155	4203.38	189457	6140.47	152323	9449.92	168934	25816.5	734869	45610.29
2011	250254	4932.66	212043	7168.31	168037	11105.1	179796	30689.4	810130	53895.51
2012	283072	5731.86	239951	8425.45	180626	12725.9	199551	33899.2	903200	60782.44
2013	335347	6698.89	283990	9791.94	203091	14970.1	222677	38665.3	1045105	70126.21

Table 1
Source: Reserve Bank of India

The table-1 illustrates about the deposit accounts and outstanding loan amount according to group of population in rural, semi urban, urban and metroploitan areas from 2008 to 2013. Here population group is considered as number of accounts in specified areas; Outstanding amount in terms of billions and No. of accounts in terms of thousand is measured. It shows as of 2008, 2009, 2010, 2011, 2012, 2013 the no. of accounts are 581657, 662303, 734869, 810130, 903200 and 1045105 respectively and outstanding amount as 32499.46, 39219.81, 45610.29, 53895.51, 60782.44 and 70126.21respectively.
The same data is clearly depicted and understood as shown by chart-1.

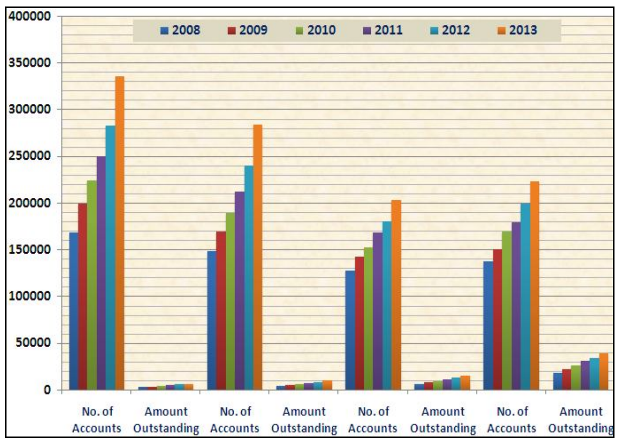

Figure 2: Chart-1

AVERAGE AMOUNT OUTSTANDING PER THOUSAND LOAN ACCOUNT'S (Amount in Billion's)					
Year	Rural	Semi Urban	Urban	Metropolitan	Total
2008	0.018057238	0.029002231	0.051374306	0.135421922	0.055873926
2009	0.018223291	0.031212726	0.057840896	0.146430141	0.059217322
2010	0.018752113	0.03241089	0.062038694	0.152820155	0.062065878
2011	0.019710614	0.033805926	0.066087409	0.170690171	0.066526989
2012	0.020248771	0.035113211	0.07045453	0.169877425	0.067296767
2013	0.019975995	0.034479876	0.07371144	0.173638274	0.067099679

Table 2
Source: Reserve Bank of India

The table-2 illustrates the average amount outstanding per thousand loan accounts. The average outstanding amount is ascertained by dividing the outstanding amount by no. of accounts in the respective population group. From 2008 to 2013, the total average stands about 0.055873926 to 0.067099679.
The same data is clearly depicted and understood by chart-2 shown below.

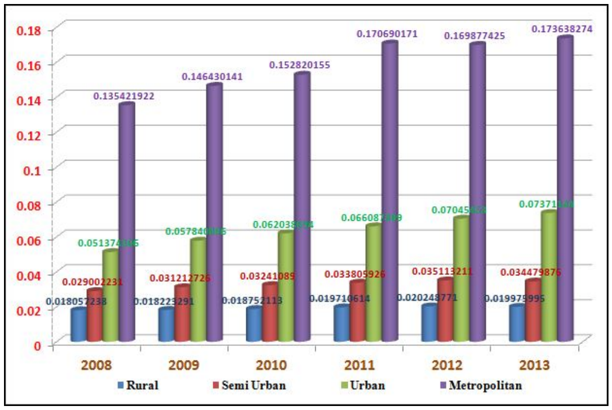

Figure 3: Chart-2

PERCENTAGE OUTSTANDING LOAN AMOUNT IN EACH POPULATION GROUP IN EACH YEAR (in%)					
Year	Rural	Semi Urban	Urban	Metropolitan	Total
2008	32.318	51.906557	91.9468	242.370516	418.542
2009	30.774	52.708777	97.6756	247.275858	428.434
2010	30.213	52.220142	99.9562	246.222495	428.612
2011	29.628	50.815355	99.3392	256.572817	436.355
2012	30.089	52.176668	104.692	252.430291	439.388
2013	29.771	51.386052	109.854	258.77661	449.787

Table 3

The table-3 illustrates percentage outstanding loan amount in each population group from 2008 to 2013. The percentage outstanding loan amount is ascertained by dividing the average outstanding loan amount in each year in each population group by total average outstanding loan amount. The percentages from 2008 to 2013 are ranging from 418.54, 428.43, 428.61, 436.35, 439.38 and 449.78 respectively.

The same data is clearly depicted and understood from below chart-3.

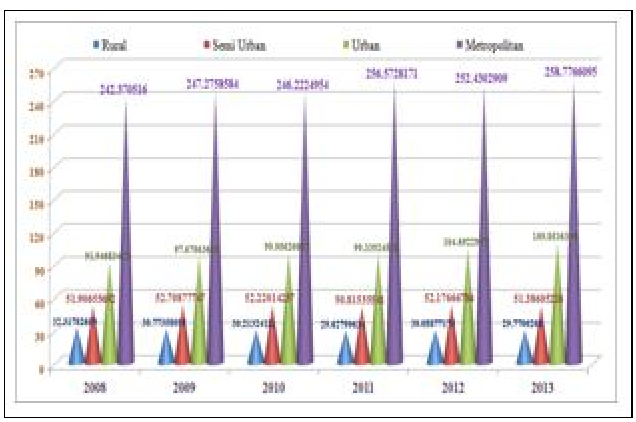

Figure 4: Chart 3

7. Suggestions

- In order to attain better practice in managing uncertainties and mitigate those, banks must make better use of managerial and personnel staff by providing adequate training time-to-time. Simultaneously monitoring of credit risk across all the bank staff to ensure credit risk management policies on sound lines.
- Approval authority of credit may be entrusted only to trained, qualified and experienced personnel, so as to mitigate loan recovery risk.
- Banks can develop an efficient and appropriate framework to have a check monitor, control and manage credit risk, to take review on timely basis and scrutinize whether the policy is inherently consistent and take necessary corrective action.
- The Bank efforts can be aimed to maintain the aggregate credit risk to be within their risk tolerance level and act accordingly irrespective of political conditions and come out from the clutches of loss of loan assets.

- Consistency in follow up of established of credit policies and credit standards can adhere to regulatory requirements whereby they can enhance their profitability and financial position and to limit the level of credit risk exposure.

8. Conclusion

The paper reveals that banks and financial institutions are striving to maintain an appropriate credit structure to limit their risk to an extent and capability can be borne by those respective institutions. The institutions are adhering to the objectives govern them to an extent to which the institution is willing to accept credit risk. The appropriate credit structure and loan review policies enables the banks and financial institutions to enable themselves and to establish prudent limits on their exposure towards credit risk and to have design and use appropriate an appropriate tools to identify and resolve the problem of credit risk in different areas of the institution's credit portfolio. Mitigation of credit risk certainly enables the higher credit disbursement to the needy people, moreover the percentage of nonperforming assets can be reduced at a considerable level and parallel the profitability of the banks significantly increases and this will lead to the growth of economy.

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