# Due Diligence in Credit Portfolio

**Credit growth of Indian commercial banks had been showing a decelerating trend from December 2010 on the back of elevated inflation, interest rates and intensification of supply-side constraints. The Finance Year 2011-12 ended with bank credit growth of 19.3% as against 21.5% growth during FY 2010-11. While the deceleration in bank credit growth was contributed by all the sectors, i.e., agriculture, industry, services and personal loans, the RBI data showed that the deceleration was particularly sharp in agriculture, real estate, hotels & restaurants, professional services, telecommunication, power, cement, textiles, iron & steel and personal vehicle loans.**

**CA. Suresh Kumar Agarwal**

(The author is a member of the Institute. He can be contacted at suresh.lko@gmail.com)

Classification of assets, income recognition and provisions, maintenance of quality of assets has become the core content of a bank's credit portfolio. Banks should strengthen their due diligence, credit appraisal and post-sanction loan monitoring systems to minimise and mitigate the problem of increasing NPAs. As per the data realised by the Reserve Bank of India, gross NPA ratio increased to 3.1% in finance year 2011-12 from 2.5% reported in finance year 2010-11. Similarly, net NPA rose to 1.4% in finance year

**Credit Portfolio Management (CPM) deals not only with pure credit risk management but has the mandate to optimise risk/return profile of the bank's credit portfolio.**

12-13 from 1.1% compared to the previous year. Gross NPA stood at ₹1,423 billion at March 2012, while the net NPA stood at ₹649 billion. The step increase in gross NPAs during 2011-12 was accompanied by a considerable pick-up in the growth of restructured advances by public sector banks, particularly by nationalised banks.

The Reserve Bank of India has been laying considerable emphasis on ensuring adequate and timely credit at reasonable rates to different sectors of the economy. For achieving the objective of sustainable and inclusive economic growth, it is important to bring the under-served sectors/sections of society within the banking fold. Against this backdrop, several initiatives were taken, which include revising the priority sector norms to refocus direct agricultural lending by banks; setting up a new short-term refinance facility for on-lending to agriculture; and introducing measures to enhance the flow of credit to micro and small enterprises (MSEs).

Credit Portfolio Management (CPM) deals not only with pure credit risk management but has the mandate to optimise risk/return profile of the bank's credit portfolio. The quality of a bank's assets will suffer if the performances of the small scale units are not carefully and regularly monitored and timely actions are not taken to help them out in the present scenario of cutthroat competition. Lending involves number of risks. In addition to the risk related to creditworthiness of the counterparty, the banks are also exposed to interest rate, forex and country risks. Credit risk or default risk involves inability or unwillingness of a customer or counterpart to meet commitments in relation to lending, trading, hedging, settlement and other financial transactions. 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 for credit risk 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 borrower's financial position,
- Excessive dependence on collaterals and inadequate risk pricing
- Absence of loan review mechanism and post-sanction surveillance etc.

The primary role of the commercial banks is to cater to both the short term and long term requirements of the industry. A bank's lending policy is not merely profit motivated but has to also keep in mind the socio-economic development of the country. Some of the facilities provided by the banks are as:

- **Term loans:** Banks provide long term loans & short term loans for the purpose of expansion or setting up of new units. Their repayments are usually scheduled over a long period of time and in case of short term loans for up to three years. The liquidity of such loans is said to depend on the anticipated income of the borrowers. As a part of long term funding for a company, banks also fund the long term working capital requirement.
- **Cash Credit:** Cash Credit is an arrangement under which a customer is allowed an advance up to certain limit against credit granted by a bank. Generally cash credit limits are sanctioned against the security of tradable goods by way of pledge or hypothecation. These accounts are repayable on demand.
- **Overdraft:** Under this facility, customers are allowed to withdraw in excess of credit balance standing in their current/cash credit account.
- **Clean Overdraft:** Request for clean advances are entertained only from parties which are financially sound and reputed for their integrity. The bank has to rely on the personal security of the borrowers. A clean advance is generally granted for a short period and must not continue for long.
- **Pre-shipment finance:** This generally takes the form of packing credit facility: packing credit is an advance extended by the banks to an exporter for the purpose of buying, manufacturing, processing, packing and shipping goods to overseas buyers. Any exporter, having at hand a firm export order placed with him by his foreign buyer or an irrevocable letter of credit opened in his favour, can approach a bank for availing of packing credit.
- **Post-shipment finance:** Finance is provided to exporters by purchasing export bills drawn payable at sight or by discounting usance export bills

covering confirmed sales and backed by documents including documents of title of goods such as bill of lading, post parcel receipts, or air assignment notes.

- **Bridge Finance:** Bridge finance refers to loans taken by a company normally from commercial banks for short period because of pending disbursement of loans sanctioned by financial institutions. Bridge loans are repaid/adjusted out of the terms loans as and when disbursed by the concerned institutions.

### Credit Portfolio Management

Working in credit portfolio is no doubt a good opportunity, however, the profile requires in-depth knowledge and expertise in credit matters. Lenders should ensure that there is proper assessment of credit application by borrowers. They should not use margin and security stipulation as a substitute for due diligence on credit worthiness of the borrower. Following points are required to be taken care of while handling credit portfolio:

- **Customer Due Diligence:** Due diligence refers to the care a reasonable person should take before entering into an agreement. Due diligence is a way of preventing unnecessary harm to either party involved in a transaction. The concept of customer due diligence begins with verifying the customer's identity and assessing the risk associated with that customer. Process should also include enhanced customer due diligence for higher risk customers and ongoing due diligence of the customer base. Effective CDD policies, procedures, and process provide the critical framework that enables the bank to comply with regulatory requirements and to report suspicious activity. Much of CDD information can be confirmed through an information reporting agency, banking reference (for larger account), correspondence and telephone conversations with the customer, and visits to the customer's place of business. As due diligence is an ongoing process, an officer should take measures to ensure account profiles are current (e.g. change in employment or business operations) and monitoring should be risk based. Nowadays, there are lots of reputed external agencies in the market those submit due diligence reports as per the requirement of the banks.
- **Pre-Sanction/Credit Appraisal:** Credit Appraisal is a process of appraising the creditworthiness of applicant/borrowers. A detailed study about the promoters is required to carry out to ensure experience in the line of business and is capable to implement and run the business. A detailed study about the technical aspects is required to determine the technical soundness of the project. Financial viability of the project is to be done to ensure the project will generate sufficient surplus to repay the loan instalment and interest. The sensitivity analysis helps in arriving at profitability of the project wherein critical or sensitive elements are identified which are assigned different values, and the values assigned are both optimistic and pessimistic such as increasing or reducing the sale price/sale volume, increasing or reducing the cost of inputs etc., and then the project viability is ascertained. While appraising a project or a loan proposal, all the data/information furnished by the borrower should be counter-checked and wherever possible, inter-firm and inter-industry comparisons should be made to establish their veracity.
- **KYC/AML/CFT Compliance:** The objective of Know Your Customer (KYC)/Anti Money Laundering (AML)/Combating Financing of Terrorism (CFT) guidelines is to prevent banks from being used, intentionally or unintentionally, by criminal elements for money laundering or terrorist financing activities. KYC procedures also enable banks to know/understand their customers and their financial dealings better which in turn help them manage their risks prudently. Banks should follow certain customer identification procedures for opening of accounts and monitoring transactions of a suspicious nature for the purpose of reporting it to the appropriate authority. Banks should keep in mind that the information collected from the customer for the purpose of opening of an account is to be treated as confidential and details thereof are not to be divulged for cross-selling or any other like purposes. Banks should, therefore, ensure that information sought from the customer is relevant to the perceived risk, is not intrusive, and is in conformity with the guidelines issued in this regard. Any other information from the customer should be sought separately with his/her consent and after opening the account.

**The primary role of the commercial banks is to cater to both the short term and long term requirements of the industry. A bank's lending policy is not merely profit motivated but has to also keep in mind the socio-economic development of the country.**

- **Justification of loan or limits:** While processing the accounts processing officers should incorporate details about the borrowers, requirements, credit rating, securities available, inspection finding, and other related information along with the analysis of the financials of the borrowers/companies. Recommending officers should recommend the facility based on these facts. Banks should not provide full value of credit. A suitable amount, depending upon the risk perception of the bank, is deducted from the value of the charged assets to take care of any downward fluctuations in the market value of the assets is called Margin.
- **Analysis of financial statements:** The assessment of financial risk involves appraisal of the financial strength of the borrower based on performance & financial indicators. The overall financial risk is assessed in terms of static ratios, future prospects and risk mitigation (collateral securities/financial standing). The basis data required for financial feasibility appraisal can be broadly grouped under the following heads:
  1. Cost of the project including working capital
  2. Cost of production & estimates of profitability
  3. Cash flow estimates & sources of finance.

  Audited profit & loss account and balance sheet for the past three years (if the latest audited balance sheet is more than 6 months old, a provisional balance sheet as on a recent date) along with Income Tax return, Sales Tax return should be obtained and analysed. Officers should also go through the auditor's reports to find out any adverse remarks if any. Analysis of financial indicators and ratios (i.e. current ratio, debt equity ratio, DSCR, TOL/TNW, Interest Coverage ratio, etc.) should be done and examined on the prescribed guidelines of the banks. Ratio analysis is used as a major tool for financial analysis.
- **Rate of interest and other charges:** Banks are permitted to determine their lending rates taking into account their cost of funds, transaction costs etc. and should also incorporate risk premium as considered reasonable and justified having regard to the internal rating of the borrowers with the approval of their Board. However, banks should ensure that the interest rates along with proposal processing charges, documentation charges, mortgages charges etc. charged by them are transparent and known to the customers.
- **Delegation of powers:** The Board of Directors should delegate specific powers to the branch managers and other functionaries at the regional/ national/head office level as also to the Chairman in the matter of sanction of advances. A system should also be introduce to ensure if there is any unauthorised exercise of powers, it should be brought to the notice of the head office. Banks should take suitable precautions to avoid practices such as sanctioning of advances beyond discretionary powers and/or without proper credit appraisal in order to minimise chances of frauds.
- **Proper record of deviations:** In case of exigencies, where sanctions are made on oral instructions of higher functionaries or sanctions beyond discretionary powers have to be resorted to. Written confirmation of the competent sanctioning authority should be obtained by the disbursing authority/official within a week/fortnight. Sanctioning/disbursing authorities should maintain record of such instructions/sanctions explaining the circumstances under which sanctions were made. Sanctions within discretionary powers should also be reported to the head office within a stipulated time and the head office should meticulously follow up upon receipt of such reports/returns. Officials should exercise powers delegated to them judiciously and should not exceed their discretionary powers for granting loans and advances.
- **Valuation of properties:** Banks should have a

**Working in credit portfolio is no doubt a good opportunity, however, the profile requires in-depth knowledge and expertise in credit matters.**

Board-approved policy in place for valuation of properties including collaterals accepted for their exposures. The valuation should be done by professionally-qualified independent valuers i.e., the valuer should not have a direct or indirect interest. As per the RBI, banks should obtain minimum two independent valuation reports for properties valued at ₹50 crore or above. Banks should have a procedure for empanelment of professional valuers and maintain a register of approved list of valuers. Officers may also be guided by the relevant Accounting Standards issued by the Institute of Chartered Accountants of India while studying the valuation report.

- **Title deeds & Title search:** The origin of the property is very important to trace the title of the property. It is otherwise called 'Root of Title'. It is the safest way to determine the origin of the property and trace its marketable title. Documents covering a minimum period of 42 years must be scrutinised. In the case of Adverse Possession against individuals or Conflicting Claims (other than mortgage) against individuals, documents covering a minimum period of 12 years must be checked. As regards the period of limitation against the Government, documents covering a minimum period of 30 years must be checked. If a person is enjoying the property for more than 30 years, however, it is illegal title by adverse interest against the Government as per the limitation Act. Also, as per Section 90 of the Indian Evidence Act 1872, a document executed 30 years before is presumed to be valid. The nature of various statutory clearances obtained from the relevant authorities like revenue, land reforms, income-tax, etc., required for completing the transaction must be informed to the parties. In case of purchase of agricultural land, various clearances must be obtained before executing the deed of conveyance. The advocate must find out in whose name the *khatha* stands, whether the *khatedar* possesses up-to-date tax paid receipt in his name and up-to-date encumbrance certificate to establish his right, title and interest in the property. The advocate has to check the encumbrance certificate covering a relevant period, generally above 1-2 years up to 42 years from which it would be known what kind of charge has been created on the property and whether such an encumbrance is subsisting or not. Municipal and other revenue authorities also maintain records as to who is in possession of the property, what is the amount of tax payable on the property and up to what period tax has been paid. All this can be learnt from these records. 'Present status' is one of the important factors to establish the present ownership of the property. Certified copy of the title deed offered as security to be obtained from the sub-registrar office and the same should be compared with the original documents deposited for creating mortgage, to ensure genuineness. Officials should also follow the banks' prescribed guidelines.

**Insurance coverage over security should be appropriate under bank clause. The bank's name board should be prominently displayed indicating the goods hypothecated.**

- **Registration with CERSAI:** The Central Registry of Securitisation Asset Reconstruction and Security Interest of India (CERSAI), a government company licensed under Section 25 of the Companies Act, 1956, has been incorporated for the purpose of operating and maintaining the Central Registry under the provisions of the SARFAESI Act, 2002. This Registry has become operational on March 31, 2011. It may be noted that initially transactions relating to securitisation and reconstruction of financial assets and those relating to mortgage by deposit of title deeds to secure any loan or advance granted by banks and financial institutions, as defined under the SARFAESI Act, are to be registered in the Central Registry. The records maintained by the Central Registry will be available for search by any lender or any other person desirous of dealing with the property. Availability of such records would prevent frauds involving multiple lending against the security of the same property as well as fraudulent sale of property without disclosing the security interest over such property. It may be noted that under the provisions of Section 23 of the SARFAESI Act, 2002, particulars of any charge creating security interest over property is required to be filed with the Registry within 30 days from the date of creation.
- **Stock statements / Book Debts:** Securing for bank credit could be in the form of a direct security or an indirect security. Direct security includes the stocks and receivables of the customers on which a charge is created by the bank through various security documents. If in the view of the bank, the primary or direct security is not considered adequate, or is

risk-prone, that is subject to heavy fluctuations in prices, equity etc., the bank may require additional security either from the customer or from a third party on behalf of the customer. Goods/stocks include raw materials, work-in-process, finished goods, consumables spares and stores. Old stocks, obsolete & rejected goods should not be considered while calculating the drawing power. Officers should also deduct the creditors while calculating the drawing powers to avoid double finance. Officers should cross-check the statements submitted by the borrowers with the audited/provisional financials and in case of any deficiencies the same should be report to the higher authority along with the justification of the borrowers. Officers should also demand & analyse the stock statements, list of book debts and list of creditors during inspection of unit/factory. Non-receipts of monthly/quarterly statements should be reported to the higher authority and borrowers will be liable to pay penal interest. Insurance coverage over security should be appropriate under bank clause. The bank's name board should be prominently displayed indicating the goods hypothecated.

- **Physical Inspection of assets and securities:** Physical verification of securities charged to the banks should be conducted as per the procedure laid down by the controlling authorities of the bank. Insurance coverage over security should be appropriate under bank clause. Ensure that asset register is maintained properly and all assets are in working/saleable condition. Valuation of these assets should be done as per the bank's guidelines. Any addition or deletion should be reported in the inspection report. Inspection register should be maintained at branch level and name of officer who has conducted inspection along with finding should be recorded in the register.
- **Diversion of funds:** There should be a mechanism for proper monitoring of the end-use of the funds. Whenever diversion is observed, appropriate action including recalling of the loans, reduction of sanctioned limits, charging penal interest etc. for protecting the bank's interest should be taken. There should be proper vigilance over requests of their clients for cash withdrawals from their accounts for large amounts. Diversion of funds would be construed if:
  1. Funds from short-term working capital limits/ accounts are utilised for long-term purposes not in conformity with the terms of sanctions.

**The complexity and scope of LRM normally varies based on banks' size, type of operations and management practices.**

  2. Deploying borrowed funds for purpose or creation of assets other than those for which the loan was sanctioned.
  3. Routing of funds through any bank other than the lender bank or members of consortium without prior permission of the lenders.
  4. Investment in other companies by way of acquiring equities/debt instruments without approval of lenders.
  5. Transferring funds to the subsidiaries/group companies or other corporates by whatever modalities.
- **End use of loans:** In cases of project financing, banks should seek to ensure end use of funds by, *inter alia*, obtaining certification from Chartered Accountants for the purpose. In case of short-term corporates/clean loans, such an approach ought to be supplemented by 'due diligence' on the part of lenders themselves. Lenders should monitor and ensure end-use of funds by the following illustration:

  1. Regular inspection of borrower's assets charged to the lenders as security.
  2. Scrutiny of monthly/quarterly progress reports/ operating statements of the borrowers.
  3. Periodical scrutiny of borrower's books of accounts.
  4. Periodical visits to the business units/factory or office of the borrowers.
  5. System of periodical stock audit as per the credit policy of the banks/lenders.
- **Post-sanctions Monitoring:** The basic concept of post-sanctions monitoring is to ensure compliance with the terms and conditions of sanctions, adequacy of credit on an ongoing basis depending on the needs of the borrowers and to monitor the health of the unit/factory and detect sign of weakness in the financial position of the borrower. Regular and *ad-hoc* credit limits need to be reviewed/regularised not later than 3 months from due date/date of *ad-hoc* sanction. An account where regular/*ad-hoc* limits have not been reviewed/renewed within 180 days from due date/date of *ad-hoc* sanction will be treated as Non Performing Asset (NPA).
- **Exchange of information:** Banks need to

strengthen their information back-up about the borrowers enjoying credit facilities from multiple banks. At the time of granting fresh credit facilities, banks must insist on declaration from the borrowers about the credit facilities already enjoyed by them from other banks which should include their group companies and associates. In case of consortium/ multiple banking arrangements, banks should exchange information about the conduct of the borrower's accounts with other banks at least at quarterly intervals. Banks should obtain regular certification by a professional i.e. Chartered Accountant/Company Secretary/Cost Accountant regarding compliance of various statutory prescriptions that are in vogue. Banks should always use credit reports available from Credit Information Companies i.e. CIBIL, Experian Credit Information Company of India Ltd, Equifax Credit Information Services Pvt. Ltd and High Mark Credit Information Services Pvt. Ltd. Banks should incorporate suitable clauses in the loan agreements regarding exchange of information so as to address confidentiality issues.

- **No objection certificate:** Banks should not finance a borrower already availing credit facility from another bank without obtaining a "No Objection Certificate" from the existing financing bank. IBA has prescribed a format on which a bank can obtain status report from the existing banks. The purpose of the same is to ensure financing of standard accounts only.
- **Annual review:** For the effective monitoring of the advances, it is imperative for the banks to undertake an exercise for review of the advances on a regular basis. Apart from the usual objective of such a review of assessing on regular basis, the review should specifically attempt to make an assessment of the requirements of the borrower based on the latest data available, whether limits continue to be within the need-based requirements and according to the bank's prescribed lending norms. The loan reviews are designed to provide feedback on effectiveness of credit sanction and to identify incipient deterioration in portfolio quality. The scope of the review should cover all loans above a cut-off limit. In addition, banks should also target other accounts that present elevated risk characteristics. The review should focus on the following points:
  1. Approval process.
  2. Accuracy and timeliness of credit rating assigned by loan officers.

  3. Adherence to internal policies and procedures and applicable laws/ regulations.
  4. Compliance with loan covenants.
  5. Post-sanction follow up.
  6. Sufficiency of loan documentation.
  7. Portfolio quality.
  8. Recommendations for improving portfolio quality.

The findings of reviews should be discussed with line managers/branch managers and the corrective actions should be elicited for all deficiencies. Deficiencies that remain unresolved should be reported to top management. Banks should, therefore, put in place proper **Loan Review Mechanisms (LRM)** 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 complexity and scope of LRM normally vary based on banks' size, type of operations and management practices. It may be independent of the CRMD or even separate department in large banks. The main objectives of LRM could be:

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