**SHRIMATI INDIRA GANDHI COLLEGE**

**(Nationally Accredited at ‘A’ Grade (3rd Cycle) by NAAC)**

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### SEMESTER- IV ( STUDY MATERIAL)

 **SUBJECT CODE -16CCCBM7**

**CREDIT MANAGEMENT**

**INTRODUCTION:**

Credit management is the process of granting credit, setting the terms it's granted on, recovering this credit when it's due, and ensuring compliance with company credit policy, among other credit related functions. The goal within a bank or company in controll credit is to improve revenues and profit by facilitating sales and reducing financial.

**Commercial Bank Credit functions:**

Credit management by commercial banks is a part of banking activities of normal course where banks constitute as a largest group of financial intermediaries. There are two core activities of commercial banks one to accept deposits and second to give loans and advances. The deposits are liabilities for any bank as these are required to be paid back to customers either on demand or on completion of a term.

Where as credit and advances made by banks are their financial Assets. But banks’ credit has to be productive and must contribute to the generation of the borrower’s income and also towards increasing the rate of growth of the economy as a whole.

Banks mobilize deposits to contribute to gross national product through their different kind of deposit schemes. About 60% of these funds are deployed as bank credit in various sectors of economy.

Thus deposit mobilisation and credit dispensation are the two most important functions of commercial banks. In a way, these banks are the trustees of the savings and idle funds of the society. How efficiently they are able to discharge this responsibility depends largely upon the quality of their credit portfolio.

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**Bank’s Sources and Uses of Funds:**

The selection of uses and sources of funds is not applicable to banks only but to all organizations engaged in business activities to earn profit.

**In case of banks, the main source of funds (liabilities) comes from:**

**Deposits:**

1. Current Deposits,

2. Saving Deposits,

3. Fixed Deposits, and

4. Certificate of deposits.

**Borrowed Funds:**

1. Borrowing from other banking companies etc.

2. Borrowing from Reserve Bank of India.

3. Borrowing from financial institutions.

**Owned Funds:**

1. Paid-up Capital.

2. Reserve funds.

3. Balance of Profit and Loss Account.

**Uses of Funds by Banks:**

**The main source of assets comes from:**

1. Cash (cash in hand or with RBI in the form of CRR or SLR).

2. Balance with other banks.

3. Money at call and short notice.

4. Investment.

5. Loans and Advances.

6. Fixed Assets.

**Credit management of banks is confined to the Loans and Advances:**

**Functions of Banking Industry:**

These functions are co-related with the credit policies of banks which are subject to a great extend, by the national policies. Keeping in view of the security of depositors (whose funds are used by banks for lending) certain restriction on lending functions are imposed by the regulations. Also the lending operations of banks are subject to restrictions imposed by the Reserve Bank of India from time to time in the interest of monetary stability.

Indian banks operate under several restrictions of credit policy like social lending, DRI lending, SSI lending, Priority sector lending, agriculture sector lending, Micro and SME lending etc. and in addition to all the reserve requirements and socio-economic objectives. In fact a sizable portion of banks resources is virtually taken out of bank’s discretion by pre-emption of funds reserve requirements and other Government sponsored schemes.

Banks in India cannot give out their entire deposit amount in loans. The regulatory authorities issue necessary guideline in this regard based on the monitory and financial policy of the government. The banks in India chalk out their own credit policies in view of the guide lines issued by the regulatory authorities.

In broad prospective banks deploy their funds into three main uses Cash, Investments, Loan and advances. But the cash and investments are determined largely by the RBI according the which it is mandatory for banks to maintain liquidity level to protect the banks and customers by way of Cash Reserve Ratio and Statutory Liquidity Ratio at present the cash reserve ratio is 6% (with effect from 24.4.2010) of total time and demand liabilities. This ratio is subject to changes depending upon the monetary policy.

**The statutory Liquidity Ratio comprises:**

1) Cash in hand and with other banks.

2) Investment in government and other approved securities.

All the above combined together take out sizable portion of bank resources and for the purpose of lending bank has to depend what is left out after meeting these constraints.

**Importance of Credit, Loan & Advances Portfolio in Banks:**

For each bank efficient management of credit portfolio is of utmost importance as it has tremendous impact on the banks’ profitability. The ongoing financial reforms have no doubt provided various opportunities to the banks for growth, but have exposed them to various risk, which need to be effectively managed.

With financial reforms and liberlisation policies of the government such new venues have come where credit exposure of banks has increased with the inherent risks. The situation became aggressive with increase of sick loan accounts. In order to arrest the situations RBI made credit norms more strict.

In the wake of continued tightening of norms of income recognition, asset classification and provisioning, increased competition and emergence of new types of risk in the financial sector, it has become imperative that the credit functions are strengthened by each bank.

**Loan Products:**

Banks in ordinary course of business extend loan facilities by way of fund based facilities and/or non-fund based facilities. The fund based facilities are usually allowed by way of term loans, cash credit, bills discounted/purchased, demand loans, overdrafts etc.

In case of non-fund based facilities by way of issuance of inland and foreign letters of credit, issuance of bank guarantees, deferred payment guarantees, bills acceptance facilities etc. All these are usual type of loan facilities provided by banks. There are several other fields for which banks provide financial assistance.

**A brief description of usual type of loans is given below:**

**1. Fund Bases Credit Facilities Overdrafts:**

All overdrafts accounts are treated like current accounts where a cheque book is issued to the borrowers to withdraw the loan amount as per requirement. Normally overdrafts are allowed against the Bank’s own deposits, Government securities, approved shares and debentures of companies, life insurance policies, government supply bills, cash incentives and duty drawbacks, personal security etc.

**2. Demand Loans:**

A demand loan account is an advance for a fixed amount and no debits are made subsequent to the initial advance except for interest, insurance premia other sundry charges. Loan is secured by way of a promissory note and therefore subsequent drawing are not allowed. In fact it has the effect of permanently reducing the original advance.

Normally demand loans are allowed against bank’s own deposits, government securities, approved shares/debentures of companies, life insurance policies, pledge of gold/silver, mortgage of immoveable property, etc.

**3. Term Loans:**

Term loans are sanctioned normally for acquisition of fixed assets like land, building, plant/machinery, office equipments, furniture-fixture etc. for purchase of transport vehicles and other vehicles, agricultural equipments etc.

Term loans are granted for different periods, short term, medium term and long term and the duration varies normally 3-7 years but in exceptional cases banks do extend this period from case to case. Term loans for infrastructure Projects can be allowed even with longer repayment period which depends on the type of projects’ completion and commencement of the purpose be may production, service or any other field.

**4. Cash Credit Advances:**

Cash Credit account is drawing account against credit granted by the bank and is opened exactly the same way as a current account on which an overdraft has been sanctioned. These types of account are secured by way of pledge/hypothecation of goods or produce, mortgage of immoveable property, book-debts, trust securities etc.

A limit of particular amount depending on the need of the borrower and the securities available is fixed and the borrower can draw on account within the prescribed limit. Drawing more than fixed limit makes it an irregular account.

**5. Bill Finance:**

Advances against Indian bills are sanctioned in the form of limits (the amount fixed) for purchase of bills or discount of bills or bills sent for collection. Such limits are fixed for genuine trade transactions only. Bill are either payable on demand or at sight. In case of Usance bills which are payable on maturity after certain period of time nature of account mostly differs than that of bills payable on sight.

**6. Packing Credit:**

Packing credit is an advance given to an exporter who holds a Code Number assigned to him by the Directorate General of Foreign Trade, for financing the, purchase, processing, packing of goods against an export letter of credit or a firm export order, or evidence of an export order.

**Non- Fund Based Credit Facilities:**

**(i) Letters of Credit:**

Letter of credit is issued by the bank at the request of its customer in favour of a third party informing him that the bank undertakes to accept the bills drawn on its customers up to the amount stated in the letter of credit subject to the fulfillment of the conditions stipulated therein. This way, when a bank issues LC, it assumes responsibility to pay its beneficiary on production of bills drawn in accordance with the terms and conditions of the LC.

It is also known as “Documentary Credit” and is most popular method of payment/receipt in the international as well as domestic trade. Under documentary credit, the buyer’s promise to pay the seller on presentation of the documents, is Substituted by Banks’ undertaking to pay, on seller fulfilling the prescribed terms and conditions. Therefore the buyer’s liability to pay is to the credit issuing bank rather than to the seller.

There are several definitions of documentary credit but following definition appears to be more accurate.

**“Documentary credit represents a commitment or**

**Parties to Documentary Credit:**

**1. The Buyer:**

The Buyer A person or entity willing to buy goods/services.

**2. Issuing Bank:**

Issuing Bank is the Bank which issues or opens a letter of credit on the request of the buyer (in practice this bank is also the banker of the buyer).

**3. The Seller:**

The Seller is the one in whose favour the L/C is opened and to whom the L/C is addressed. He is also known as Beneficiary of L/C entitled to obtain payment under L/C.

**4. Advising Bank:**

Advising Bank is the intermediary bank which advises the L/C to the beneficiary. By advising it undertakes the responsibility of authenticity of the L/C.

**5. Confirming Bank:**

Confirming Bank is a bank who may be requested by the issuing bank to add its confirmation. If agreed to, the bank becomes a party to the L/C and undertakes the responsibility to honour the bills. In practice Advising bank is asked to add confirmation.

**6. Negotiating Bank:**

Negotiating Bank is bank to whom the seller is supposed to submit the documents for negotiation and get the payment as per the drawn bill.

**7. Reimbursing Bank:**

Reimbursing Bank is bank who is authorized by issuing bank to reimburse the paying or negotiating bank.

**Credit Exposure Limits:**

The Reserve Bank of India has issued specific directions prescribing exposure limits for banks and long-term lending institutions in respect of their lending to individual borrowers and to all companies in a single group.

1. Exposure ceiling for a single borrower is 15% of capital funds effective from March 2002. Group exposure limit is 40% of capital funds effective from March, 2002. In case of financing for Infrastructure Projects, the single borrower exposure limit is extendable by another 5% i.e., up to 20% of capital funds and the group exposure limit is extendable by another 10% (i.e. up to 50 % of capital funds). Capital fund is the total capital as defined under capital adequacy norms (Tier I and Tier II capital).

2. Non-fund bases exposures are calculated at 100 % and in addition, banks include forward contracts in foreign exchange and other derivative products, like currency swap and options, at their positive market value (including potential future exposure) in determining individual or group borrower exposure ceilings, effective from April 1, 2003.

**Credit exposure is aggregate of:**

i) All types of funded and non-funded credit limits.

ii) Investment in shares, debentures, bonds and units of mutual funds.

iii) Facilities extended by way of equipment leasing, hire-purchase finance and factoring services.

iv) Advances against shares, debentures, bonds, and units of mutual funds to stock brokers and market makers.

v) Bank loan for financing promoters’ contributions.

vi) Bridge loan against equity flows/issues.

vii) Financing of IPO (Initial Public Offerings).

In order to ensure that exposures are evenly distributed the Reserve Bank of India requires banks to fix internal limits of exposure to specific sectors. These limits are subject to periodical review by the banks.

**Directed lending: (Priority Sector):**

In order to achieve the targets of monetary, economic and financial policies the government of India decides to elevate certain sections for extended bank facilities. Under such policies it remains the main objective to spread the economic growth even to lowest level of the society. As such different sectors are selected for such purposes which are given priority over other schemes of lending by banks.

In view of above the RBI requires commercial banks to lend a certain percentage of their net bank credit to specific sectors known as Priority Sector. Total priority sector advances should be 40% of net bank credit with agricultural advances required to be 18% of net bank credit and advances to the weaker sections required to be 10 % of net bank credit and 1% of the previous year’s net bank credit required to be lent under the Differential Rate of Interest scheme popularly known as DRI scheme.

**Common Guidelines on financing of Priority sector loans:**

**While Priority sector has not been defined either by government or by RBI but categories of PS are set forth as follows:**

**Categories of Priority Sector:**

**1. Agriculture (Direct or Indirect Finance):**

Direct finance to agriculture shall include short, medium and long term loans given for agriculture and allied activities (dairy, fishery, piggery, poultry, beekeeping etc.) directly to individual farmers, Self Help Group (SHGs) or joint liability groups (JLGs) of individual farmers without limit and to others (such as corporate, partnership firms and institutions) up to the limits prescribed for taking up agricultural/allied activities. Direct and indirect agriculture finance is defined in detail by the RBI.

**2. Small Enterprises: (Direct and Indirect finance):**

Direct finance to small enterprises shall include all loans given to micro and small (manufacturing) enterprises engaged in manufacturing/production, processing or preservation of goods, and micro and small (service) enterprises engaged in providing or rendering of services, and whose investment in plant and machinery and equipments respectively does not exceed the amounts of Rs. 5 crores.

**3. Retail Trade:**

Retail trade shall include traders/private retail traders dealing in essential commodities (fair price shops) and consumer co-operative stores with credit limits not exceeding Rs. 20 lacs.

**4. Micro Credit:**

Provision of credit and other financial services and products of very small amounts not exceeding Rs. 50000/- per borrower, either directly or indirectly through a SHG/JLG mechanism or to NBFC/MFI for on-lending up to Rs. 50000/- per borrower, will constitute micro credit.

**5. Education Loan:**

Education loans include loans and advances granted to only individuals for educational purposes up to Rs. 10 lacs for studies in India and Rs. 20 lacs for studies abroad, and do not include those granted to institutions.

**6. Housing Loan:**

Loans up to 20 lacs to individuals for purchase/construction of dwelling unit per family, (excluding loans granted by banks to their own employees) and loans given for repairs to the damaged dwelling units of families up to Rs. 1 lac in rural and semi-urban areas and up to Rs. 2 lacs in urban areas and metropolitan areas.

Credit Management policy

This is an operational document defining a number of operating rules for the sales process that must be followed by the entire company including of course the credit team.

It defines the standard conditions of sale (standard payment terms, early payment discount rate... etc.) and the processes to apply the rules (how to open an account, how to set a credit limit, how to recover the bills ...etc.).

These rules are intended to do "good" sales and to converge business strategy, commercial stakes and financial issues (credit risk, cash, profitability, working capital improvement).

IMPLEMENT:

The establishment of a procedure for [credit management](https://www.creditmanagement-tools.com/credit-management-c5.php) is necessary and critical in business since the number of employees exceeds ten and unwritten rules that are no longer appropriate. It defines the rules of operation at each stage of the sales process and clarifies the responsibilities in line with the business strategy.



The division of tasks between employees can generate antagonists interests, as may be the case between finance and sales department. But the supreme interest of the company must prevail. This is the role of the procedure for credit management. It reconciles interests by setting limits to each of them and providing for arbitration in specific cases.

Operating rules established by the procedure may in some cases be overridden but within a framework defined in advance. Thus, it includes a chart of authority which determines for each decision committing an additional risk to the company the power of validation of each .

Main stages of sales process:



**1) commercial prospection**

Business development incurs costs and should be well oriented to be effective. It is for example against-productive to spend time and money to win an order with an insolvent potential client:

* The financial position of the buyer intends more to regression or disappearance through a bankruptcy rather than becoming a key player in the market,
* Win a business with this company will result in payment delays or even unpaid invoices and losses,

It is therefore essential to take into account the financial situation of companies before prospecting them. Better canvass companies in good financial health and with good potential.

**2) Quotations**

These deals can be engaging for the seller, it is necessary to include commercial conditions (conditions and mean of payment, guarantees... etc) coherent with the context and the creditworthiness of the buyer. Credit risk starts at this stage. It is therefore necessary to define how it is assessed (financial analysis, credit rating etc ...) and how it is managed.

**3) Customer account opening**

The customer opening account must follow certain basic rules to obtain necessary information in order the administrative flows are fluid and do not disrupt the business relationship. Defined rules specify what documents / information to be obtained prior to account opening and who must obtain them.

**4) Payment terms and credit limit set up**

This stage occurs during the trade negotiations and may be before or after the opening of account. It is here that are approved payment terms (payments, deferred payment, method of payment, invoicing schedule ... etc), and any guarantees (bank guarantees, [parent company guarantees](https://www.creditmanagement-tools.com/parent-company-guarantee-c2-r25.php), delegation of payment, [documentary credit](https://www.creditmanagement-tools.com/the-documentary-credit-c8-r810.php) ... etc).

This is the heart of the prevention of outstanding risk. These conditions should be an integral part of commercial negotiations and result from risk analysis that was done previously. The credit management process defines the standard conditions, checks if it is possible to grant them to the client and manage any deviations from this rule.

**5) Delivery and invoicing**

This step should not be overlooked as it is often a source of disputes that generate late payment and have negative impacts on the business relationship. The credit management process specifies the prerequisites for billing in a timely manner and the key steps to check to do a good billing and not make errors (price, date of invoice, customer name, etc ...).

**6) Friendly collection**

Essential phase not to suffer late payments, the [cash collection](https://www.creditmanagement-tools.com/collect-your-invoices-c3.php) should be structured and professionalized to be effective. Well done, debt collection lends credibility to the seller, significantly improves cash flow and contributes positively to build a commercial relationship.

The recovery process must be defined in a combined result of recovery actions (phone calls, email, mail return receipt, intervention of the sales representative ... etc) and agreed between the recovery service or accounting and sales managers.

It also specifies how are used [late payment penalties](https://www.creditmanagement-tools.com/late-payment-penalties-c3-r37.php) to get customers to pay in a timely manner.

**7) Litigation**

In case of failure of amicable collection that ended with sending a letter of formal notice, collection action continues but with other means. These are numerous and depend on the organization of each company and its customer types:

* Lawsuits handled by the seller with the contribution of a lawyer (referred provision, payment order or assignment payment),
* Collection agencies,
* Bailiffs,
* Credit insurers.

**Principles and Methods of Collections**

Fortunately, most customers pay their bills in the normal course of business. In fact, based on historical data compiled by the Foundation, delinquency generally averages between 7 and 9 days across all industries at any given time. Additionally, delinquency in excess of 91 days for all industries rarely surpasses 2 percent.

Good business requires that collection of invoices be made promptly and without any damage resulting to the customer relationship. It is this latter requirement, namely, to retain the customers' goodwill, which makes the collection problem a difficult one and which makes skill and tact essential in the handling of collections. Just how much pressure is to be brought to bear to obtain prompt collections and to what extent the relationship may be jeopardized in the effort are questions of policy. The collection problem should be analyzed and the collection policy defined in accordance with such objectives as:

* the policies of the selling division involved with the problem
* the economic climate in general
* the importance of the customer
* the effect of the combination of dollars and number of customers delinquent on the entire receivables portfolio.

operation, the former through direct credit losses and the latter through a more insidious rise in the costs of recovery. The time to terminate a collection effort is crucial. The decision can make or lose money. Possibly outsourcing of collections based on dollars of exposure should be considered to control collection costs.

**Principles of Collection**
Certain principles have been found especially useful in the field of collection and may be grouped into the following areas:

* collect the money
* maintain a systematic follow-up
* get the customer to discuss the account
* and, preserve goodwill

***Collect the money***
The primary job of the person responsible for collections is to collect the money as close to the terms of the obligation as possible. There should never be any doubt as to why the individual is engaged in this particular task. The debtor has an obligation to pay within the terms of the agreement. It is the job of the collection person to make sure that this obligation is met. The tone may be indulgent at first, but should be intensified and accelerated as much as necessary to ensure payment by a debtor.

***Systematic follow-up***
After the initial contact with the delinquent customer, it is important to keep additional contacts on a strict schedule. If the collector, for example, is told that a check will be mailed in a few days, it should be noted. If the check is not received at the promised time, a follow-up is essential, otherwise the collection effort will become ineffective.

Systematic follow-up of accounts, even those which can not pay immediately, reinforces the serious nature of the outstanding debt and emphasizes the importance attached to it by the creditor. That in itself is an important collection advantage.

***Discussing the account***
Once the collector gets the customer to talk about the delinquent account, the collector is well on the way to receiving payment. That is why emphasis is placed on inviting the debtor to talk. The object of the discussion is to get the debtor's explanation of the delinquency. It may be a question of a dispute; it may be due to a temporary shortage of funds; or the customer may intend to hold off payment so the creditor's money can be used in its own business.

During the discussion, the collector may begin to see the debtor's situation more clearly. If the slow payment is the result of a tempory cash flow problem, tolerence of slower payments may be accepted, but it should be emphasized to the customer that the new schedule of payments must be completed.

***Preserve goodwill***
Even though the customer may be experiencing some difficulty in meeting payments, it does not preclude them from becoming a good customer in the future. Therefore, it is important to preserve goodwill while pressing for collection. This requires not only tact, but knowledge of the customer and industry. One of the advantages claimed by specialized collection personnel is that they can develop these techniques to their fullest. On the other hand, the team concept presents the opportunity for credit and customer service personnel to better understand the relationship of the customer to the industry and overall marketing objectives of the company.

**Methods for Improving Collections**
Awareness is the first step in collections--awareness of what is happening in the economy, in your industry, in your own company, and with your customer. The same investigative and analytical techniques which are used for credit approval are valid for the collection process. Unless you have some idea of what your customer's problems may be and WHY they are paying you slowly (or not paying at all), you may not take the correct first crucial step in collection.

 **BAD DEBT AND WRITE OFF**

**Bad debt** is when someone owes you money, but the debt becomes worthless (amounts to nothing) because you can’t collect it. Both businesses and individuals can incur bad debt.

A business bad debt is a debt you incur from a business-related activity. You cannot collect the debt, but you previously reported it in your books and [gross income](https://www.patriotsoftware.com/blog/accounting/gross-income/). Here are some ways you can incur a bad debt:

* Credit sales to customers
* Loans to clients and vendors
* Business loan guarantees

Generally, the number one reason a business has a bad debt is because they sold a good or service to a customer on credit, and the customer never paid. With credit, a customer receives their good or service and later receives an invoice for the amount they owe.

 **WRITE OFF**

Accounting for bad debt expenses can be time-consuming and costly. If you use [accrual accounting](https://www.patriotsoftware.com/blog/accounting/an-overview-of-accrual-accounting/), you mark owed payments as [accounts receivable](https://www.patriotsoftware.com/blog/accounting/what-are-accounts-receivable/). Accounts receivable is money someone owes you.

When money owed to you becomes a bad debt, you need to write it off. Writing it off means adjusting your books to represent the real amounts of your current accounts.

To write off bad debt, you need to remove it from the amount in your accounts receivable. Your [business balance sheet](https://www.patriotsoftware.com/blog/accounting/what-is-a-balance-sheet/) will be affected by bad debt. There are two methods you can use to write off a bad account:

* Direct write-off method
* Allowance method.

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