

Underwriting Guidelines

For Small Business Loans

Definition for Small Business Loans

For the purpose of these underwriting guidelines, Small Business Loans are defined as loans that:

- Are provided to individual entrepreneurs (and not to a corporate entity, partnership firm, sole proprietorship or any other legal person) for the purpose of financing working capital or capital investment;
- Have a ticket size between INR 25,000 to INR 200,000;
- Have a total tenor not exceeding three years;
- Are repayable in daily, weekly, fortnightly or monthly instalments; and
- Are either secured or unsecured (in case of secured loans, an addendum to the underwriting guidelines would be required in relation to the nature of collateral security that is obtained by the lender).

Eligibility Criteria

Criteria	Standard
Governance, Strategy and Organization aspects	The promoters must have: <ul style="list-style-type: none"> i. Credible reputation ii. Track record in lending/financing (secured or unsecured loans) of at least five years iii. Proven ability to raise financial resources in the form of equity and/or debt – specifically for the small business loan activity
	The Originator should have an experienced Board with at least one Independent Director. The Board should play an active role in guiding management.
	Audited financial statements must be available within three months of audit. Audit must have been conducted by a reputed firm.
	The business/sales, credit and credit-operations/back-office functions must be clearly separated, both in terms of the organisation structure and operations.
	The Originator must have a strong second line of leadership. Specifically, the heads of key functions – business/sales, finance, HR, MIS, operations and internal audit/risk – must have at least five years’ experience in their respective functions, preferably in financial services. In addition, the Head of the credit function must have at least five years of specific experience of having appraised loan/investment proposals of ticket sizes and type similar to the proposed line of business
Management, System and Technology	Adequate training must be provided to the business/sales team staff as well as to the credit team staff. Training to credit staff must cover in sufficient detail, modules related to business assessment, risk assessment and house-hold cash-flow analysis. In addition, credit staff must be provided training on any specific business types/segments that the Originator has studied, covering the value chain and typical sale price and margins. In case the Originator also has group based micro-lending operations, staff must be separately trained for group-based loans and for individual loans, in each of the functions of business, credit and operations
	Through house visits and business visits and personal interviews, the origination process must be structured towards evaluating: <ul style="list-style-type: none"> i. The main business, covering: <ul style="list-style-type: none"> a. Level of capital investment and installed capacity b. Average units sold & size/quantity of each unit sold c. Quality of the product sold & any seasonality in sales d. Market to which products are sold (any captive linkages?) e. Number of years of successful operation

	<p>f. Number of years of experience of the entrepreneur in this business</p> <p>g. Raw material costs</p> <p>h. Labour costs</p> <p>i. Cost of other inputs (land & building, plant & machinery, electricity)</p> <p>j. Maintenance & repair cost</p> <p>k. Cost of insurance required (if any)</p> <p><i>ii. The creditworthiness of the individual entrepreneur, covering:</i></p> <p>a. Educational background of the entrepreneur</p> <p>b. No. of persons in the household</p> <p>c. Average earnings of all earning members including that of the entrepreneur</p> <p>d. Average household expenses</p> <p>e. Household assets and liabilities</p> <p>f. Repayment history on other loans (including credit bureau data if available)</p> <p>g. Past credit record and record of business interactions (through interviews with suppliers and buyers)</p> <p><i>This information must form an input for the appraisal of loans.</i></p>
	<p>Proof of identity and residential address must be collected from every client and this must be admissible under the RBI “Know Your Clients” guidelines.</p>
	<p>The loan origination process must have sufficient “maker-checker” arrangements, to ensure that the sales/sourcing team’s activities are checked at the branch level and the branch level activities (especially, preparation of loan forms and collection of KYC documents) are also checked centrally.</p>
	<p>All loans must require at least one a/c payee post-dated cheque, preferably of the borrower’s main operative bank account drawn in favour of the</p> <p>Originator, to aid in the process of recovery of loans as per provisions under Indian law and legal precedents.</p>
	<p>The Originator must have a computerised MIS. The MIS software must be tamper proof, with differential access facility for staff at different levels.</p>
	<p>The MIS must provide for a clear process for checking the demand-collection -Balance (DCB) and any balance must be reported to the HO immediately</p>
	<p>The MIS must be capable of ‘flagging’ of loans to different funding sources. MIS should also provide the ability to change the ‘flagging’ from one source to another</p>
	<p>The MIS must have the capability to link every loan to the sourcing and/or credit personnel and keep the link active till the loan is closed.</p>
	<p>The performance assessment of the sourcing personnel must also be based on the quality of the loans originated by each staff member</p>

	MIS must correctly report on amount of arrears, PAR and ageing of the portfolio.
	The Originator must have a clear process for collecting & collating accounting information from the branches and preparing consolidated accounting statements. Consolidated financial statements should be ideally prepared at least on a monthly basis
	The Originator must have an internal audit system, which is designed with a focus on operational risk management. The audit system must especially check for the possibility of 'ghost' loans, loans disbursed without proper KYC or without proper analysis of business and household cash flows and entrepreneur creditworthiness
	Strong arm tactics must not be used for collections
	The Originators must have robust systems for storage of cash in branches and the same must be regularly monitored centrally and also be subject to frequent physical checks by the audit/risk management team. Cash at branches beyond pre-specified retention limits must be deposited in bank the same day or the next day, so as to minimise overnight balance of cash.
	The Originator must have availed of adequate insurance of cash-in-transit and cash-in-premises
	The Originator must operate in compliance with applicable law and guidelines, e.g. RBI guidelines for NBFCs.
	The Originator must have a capital adequacy ratio of at least 18%, measured as defined under the Prudential Norms prescribed for NBFCs by the Reserve Bank of India
	The Originator must regularly map its Asset-Liability Mismatch (ALM) and must have means of financing negative mismatches (i.e., liquidity gaps)

Guidelines for Evaluation

Criteria	Standard
Governance, Strategy and Organization aspects	<p>The legal structure of the Originator should preferably be an NBFC or Bank, as the structure provides for:</p> <ul style="list-style-type: none"> • Regulation • Incentive structures due to the presence of shareholders • Capital adequacy • Ability to raise additional capital <p>While NBFC or Bank is the preferred structure, Northern Arc Capital would also look at working with Originators organised in legal forms such as a co-operative society or a co-operative bank</p>
	<p>The Originator should have a business plan including financial projections. The projections should be supported by:</p> <ol style="list-style-type: none"> I. Details of new geographies to enter into, including branch locations II. Fundraising plans – debt and equity
	<p>The Originator should have clear delegations of authority, and over-sight mechanisms to insure these are properly adhered to</p>
Management, System and Technology	<p>The Originator should have a clearly defined recruitment policy for field staff and staff at other levels. This policy should be followed, with the involvement of senior HO staff & regional level field staff</p>
	<p>The Originator should have put in place a proper process for hand-over of customer relationships and job responsibilities in case of change in front-line staff on account of transfer, termination or general attrition. Specific cases of such hand-over should be checked by the internal audit or risk management team of the Originator at least on a sample basis</p>
	<p>All loans should require at least one guarantor who is preferably neither a client of the Originator nor a relative of the borrower</p>
	<p>The origination process should consist of the following steps:</p> <ol style="list-style-type: none"> I. Sourcing of potential clients II. Collection of information - business strength and entrepreneur’s creditworthiness III. House and business visit by sourcing personnel IV. Collection of KYC documents V. Collection of documents as evidence of running business VI. Preparation of loan application form (including information on guarantor, if any) VII. “Health check” of application form by Operations/Back-office VIII. Credit appraisal of loan application by credit department personnel

	<p>IX. <i>Cross-checking of business and entrepreneur’s household information through site verification/house visit by credit department personnel</i></p> <p>X. Triangulation of information and evaluation of “willingness to pay” through interviews of relatives, neighbours, traders, suppliers etc.</p> <p>XI. Final credit decision-making (should ideally be centralised at region or HO level), supported by a tele-call with the customer by senior credit department staff</p> <p>XII. Collection of title documents/cash/FD/Post-dated cheques or any valuables as pledge or security, if applicable</p> <p>XIII. Execution of loan agreement</p> <p>XIV. Issue of sanction letter to client</p> <p>XV. Disbursement, preferably into client’s operative bank account</p>
	<p>The product features, rules and regulations, including those related to effective interest rates, upfront fees and other charges, any security or pledge against the loan, penalties for delays in repayment or for prepayment/pre-closure, must be clearly communicated to each borrower. The understanding of the borrower may also be verified at the branch level or at the central level by the internal audit/risk management team of the Originator.</p>
	<p>The Originator should have:</p> <ul style="list-style-type: none"> i. Identified specific market segments, including the business types and businesses that will be catered to and those that are in the exclusion list ii. Documented the typical sale price and margins (across all product quality types) that are made in the businesses iii. Documented the typical capital and working capital investment required for different scales of operations of the business iv. Identified the common market linkages specific to each business and the typical trading levels for each type of market linkage <p>This information should form an input to credit decision making.</p>
	<p>All customer level and loan level information should be stored in an electronic format with periodic backups, and should be regularly updated to a centralized location</p>
	<p>The MIS should be able to track historical loan information for each client</p>
	<p>The Originator should have clearly laid down policies and procedures for checking utilisation of loan (if applicable) and for maintaining regular contact with borrowers, including but not limited to visits to the client’s place of business, in order to be up-to-date with and/or anticipate any</p>

	<p>changes to the business that could affect the client’s ability to service the loan</p> <p>The Originator must have a clearly defined policy for follow-up on overdue accounts, which should ideally consist of the following steps in accordance with the number of days of delay in payment:</p> <ol style="list-style-type: none"> I. Follow-up visit to client’s house and business site by staff II. Make contact with guarantor(s) III. Written intimation of default (with copy to guarantor), including therein, the penalties and charges due as well as notice of placing post-dated cheques (if any) IV. Placing of post-dated cheque (if any) V. Legal notice for bouncing of cheque, as required under relevant legal provisions VI. Legal notice for filing of suit for recovery of all dues, including penalties and charges VII. Initiation of suit in accordance with relevant legal provisions <p>While following the above steps, regular personal contact must be maintained with the borrower and the guarantor(s).</p> <p>Sufficient escalation mechanisms to either more senior sales staff or the credit/recovery/delinquency management team must be in place during each step of the above process.</p> <p>The Originator may allow for out-of-court settlement of cases of delinquency and rescheduling/restructuring of the loan. The process for such settlement or restructuring of loan should be clearly laid out and must involve a recommendation from the customer relationship management team, approval from senior credit department staff as well as from senior staff of the recovery/collections department.</p>										
<p>Financial</p>	<p>PAR (>90 days) should not be more than the following benchmarks, as measured prior to any write-off or rescheduling of portfolio.</p> <table border="1" data-bbox="504 1630 1430 2018"> <thead> <tr> <th style="text-align: left;"><i>Repayment frequency</i></th> <th style="text-align: right;"><i>PAR (>90 days) Benchmark (% of Gross Total Loan Portfolio)</i></th> </tr> </thead> <tbody> <tr> <td><i>Daily</i></td> <td style="text-align: right;"><i>2.00%</i></td> </tr> <tr> <td><i>Weekly</i></td> <td style="text-align: right;"><i>2.00%</i></td> </tr> <tr> <td><i>Fortnightly</i></td> <td style="text-align: right;"><i>3.00%</i></td> </tr> <tr> <td><i>Monthly</i></td> <td style="text-align: right;"><i>4.00%</i></td> </tr> </tbody> </table>	<i>Repayment frequency</i>	<i>PAR (>90 days) Benchmark (% of Gross Total Loan Portfolio)</i>	<i>Daily</i>	<i>2.00%</i>	<i>Weekly</i>	<i>2.00%</i>	<i>Fortnightly</i>	<i>3.00%</i>	<i>Monthly</i>	<i>4.00%</i>
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	<p>The PAR (>180 days) should not be more than 1% of the gross total loan portfolio</p> <p>The volatility of PAR, as measured by the maximum historical PAR (>30 days) on loans originated at different points of time and the variation between the PAR from different origination periods must not be significantly high.</p>
	<p>Loan loss provisions should be no less than:</p> <ul style="list-style-type: none"> • 10% for 31-60 days in default • 20% for 61-90 days in default • 30% for 91-180 days in default • 50% for 181-270 days in default • 75% for 270-360 days in default, and • 100% for loans above 360 days in default
	<p>The Originator should maintain a robust liquidity position, as assessed by the analysis of static liquidity (projected month-on-month cash outflows and inflows in terms of maturity of assets and repayment of existing liabilities, assuming no further inflow of external funds and no further disbursement of new loans).</p>
	<p>The Originator should aim for a diversified loan portfolio at least in terms of different types of businesses that are financed to mitigate concentration risk.</p>
	<p>The Originator should demonstrate ability to continue operations in the following stress scenarios:</p> <ul style="list-style-type: none"> • Inability to access additional funding for a period of 6 months • Decline in net spread of 2% • Increase in default rates of 5% for a period of 12 months

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