Chapter 1

Introduction

1.1 Origin of the Report

A country is financially rich when it has modern financial institutions of its own. These institutions play a vital role in the field of financial stability of a country. Banking sector is one of the stable financial institutions of a country. Due to globalization and technological change, the banking business has become very competitive now a days. All banks are competing to give effective real time service to their customers. For giving friendly service to the customers they need experienced and well-educated working force. Bangladesh is one of the countries of manifestation. Financial institutions are very much essential for the overall development of the country. Especially banks play an important role in the field of promotion of capital, encouragement of entrepreneurship, generation of employment opportunities etc. Market economy or free economy is widely used-concept about the present economy of Bangladesh. The country adopted the concept in the late seventies with the privatization of significant number of enterprises. The practices of free market economy started from the eighties with the changing of the world economy. A number of initiatives were taken from the nineties to increase the competition and efficiency in money market, relaxation of unwanted rules and regulations, improvement of loan related law and other situations and improve the financial base of the banks of the country. As a requirement of the completion of the Bachelor of Business Administration degree under the Sonargaon University (SU), I was assigned to do my internship at the Mercantile Bank Limited for a specified period of 45 days to work as an intern. The objective of my internship program was to understand the different aspects of credit risk management activities of Mercantile Bank Limited. This report is a formal documentation of this internship program. Financial institutions play an important role to develop economical conditions of any country. Banking sector is one of the largest sectored among them. Bangladesh is a developing country. There are two types of banks like private and private banks. These banks specially work in the field of promotion of capital encouragement of entrepreneurship, employment opportunist etc. Due to globalization, money transfer and other important task is easily done by banks.

1.2 Objectives of the Report:

The objective of this report can be viewed from two perspectives

1. General Objective
2. Specific Objective

General Objectives:

This internship report is primarily prepared as a requirement of the completion of Bachelor of Business Administration at Sonargaon University (SU).

Specific objectives:

1. To know the practices of credit structure of the bank Mercantile Bank Limited.
2. To identify the credit recovery system performed by the bank.
3. To asses and highlight the legal actions followed by the Branch in terms of credit recovery.

1.3 Scope of the Report:

Mercantile Bank Ltd. is the second largest commercial Bank in Bangladesh. It operates through 889 branches including 4 overseas branches at United Arab Emirates. It is linked with 1203 foreign correspondents all over the world. I was assigned to learn practical knowledge from Mercantile Bank Limited, Foreign Exchange Corporate Branch, Dhaka**.** In this study I would try to concentrate on the theoretical aspect of credit management, that is, the definition of credit management, policy of credit management, tools for managing credit etc. I would analyze the data on the bank and various programs for loan recovery, problems in loan recovery, pattern of loan recovery and the performance of the bank under study loan recovery with regression analysis, the information in respect to the classification of unsound credit and provision thereon and also concentrates on the performance of the bank. And finally I would conclude with the critical evaluation of the credit management under the guidelines of the Bank Companies Act, 1991 and a discussion on the major findings and recommendations.

1.4 Methodology of the Report:

The report is descriptive in nature. To fulfill the objectives of this report total methodology has divided into two major parts:

Sources of Data Collection:

The “primary sources" of data are as follows :

1. Face-to-face interview with the concerned employees of the bank
2. Conversations with my classmates
3. Practical work experience in Mercantile Bank Limited at the Fakira pool Branch

The "secondary Sources "of data are as follows:

1. Annual Report of Mercantile Bank Ltd
2. Auditor’s Report
3. Periodicals Published by Bangladesh Bank
4. Office Files and Documents
5. Report related Books and Journals
6. Web Sites

1.5 Limitations of the Report:

To prepare a report on the topic like this in a short duration is not easy task. In preparing this report some problems and limitations have been encountered which are as follows:

1. The main constraint of the study was insufficiency of information, which was required for the study. There are various information the bank employee cannot provide due to security and other corporate obligations

2. As the data, in most cases, are not available in organized way, the bank failed to provide all information

3. Due to time limitation, many of the aspects could not be discussed in the present report

4. Since the bank personnel were very busy, they could not pay enough time
5. Lack of opportunity to access to internal dat.
6. Mostly based on secondary data for preparing this report
7. Legal action related information was also not available

Chapter 2

Overview of the Mercantile Bank Ltd.

2.1 Historical Background of Mercantile Bank Ltd.

Mercantile Bank Limited emerged as a new commercial bank to provide efficient banking services and to contribute socio-economic development of the country. The Bank commenced its operation on June 2, 1999.

The Bank provides a broad range of financial services to its customers and corporate clients. The Board of Directors consists of eminent personalities from the realm of commerce and industries of the country.

Mercantile Bank Limited, a bank for 21^{st} century, is not a mere slogan. The bank has been manned with talented and brilliant personnel, equipped with most modern technology so as to make it most efficient to meet the challenges of 21^{st} century.

As regards the second slogan of the bank Efficiency is our strength is not mere pronouncement but a part of our belief that will inspire and guide us in our long and arduous journey ahead.

Mercantile Bank Limited has been licensed by the Government of Bangladesh as a scheduled bank in the private sector in the process of the policy of liberalization of banking and financial services of Bangladesh. In view of the above, the bank has, within a period of nine years of its operation, achieved a remarkable success and has always met up capital adequacy requirement set by Bangladesh Bank. The Authorized Capital of the Bank as of 2008 is Tk. 3,000 million and the Paid-up Capital is Tk. 1,798.68 million.

The Bank provides a broad range of financial services to its customers and corporate clients. The Board of Directors consists of eminent personalities from the realm of commerce and industries of the country. The bank has set up a new standard in financing in the industrial trade and foreign exchange business. Its various deposits and credit products have also attracted the clients both corporate and individuals who feel comfort in doing business with the bank.

2.2 Objectives of Mercantile Bank Ltd.

Strategic objectives

1. To increase shareholders' value
2. To achieve economic value addition
3. To be market leader in product innovation
4. To be one of the top three financial institutions in Bangladesh in terms of efficiency
5. To be one of the top five financial institutions in Bangladesh in terms of market share in all significant market segments we serve

2.3 Vision of Mercantile Bank

1. Would make finest corporate citizen

2.4 Mission of Mercantile Bank

1. Will become most caring, focused for equitable growth based on diversified deployment of resources and nevertheless would remain healthy and gainfully profitable bank

2.5 Values of Mercantile Bank

1. Customer delight

Customer satisfaction pervades all our activities. We appreciate that Customer's satisfaction is critical for our success.

2. Innovation

Spurring innovation for reinforcement of our business.

Origination and materialization of change management for attainment of perfection and we believe change is always constant.

3. Ethical Values

We continue to be responsible, ethical, sincere and transparent in our thoughts and actions.

4. Caring for Human Resources

Realization of latent potentialities of employees, respecting individual worth and dignity to ensure smooth career progression as well as welfare orientation in Human Resources management policy and practices.

5. Commitment

We always keep high on the agenda our commitment towards valued depositors as their trustworthy custodian and to maintain the same spirit for all other stakeholders.

6. Socially Responsible

Constant endeavor to act and respond in a socially responsible manner keeping in mind society and our country.

To care for our environment.

7. Shareholders Value

Creation and Maximization of values for our shareholders.

Source : Annual report of Mercantile Bank Ltd, 2020

2.6 Services of Mercantile Bank Ltd.

Mercantile Bank Ltd. offers all the major banking facilities and services to its customers. The Bank with its network spreading throughout the country has a unique feature of plugging back savings from those places and then investing them into different loan portfolios.

Mercantile Bank Ltd. with its wide ranging branch network and skilled personnel provides prompt and personalized services like issuing:

1. Demand Draft
2. Telegraphic Transfer
3. Mail Transfer
4. Pay Order
5. Security Deposit Receipt
6. Transfer of fund by special arrangement
    a. Normal transfer

    b. Electronic transfer through Ready Cash Card
7. Foreign Remittance Payment

The Bank provides the following Internet facilities:

1. Current/Savings/STD account status
2. FDR account status
3. Advance account status
4. Loan account status
5. NRB Accounts

Remittance services are available at all branches and foreign remittances may be sent to any branch by the remitters favoring their beneficiaries. Remittances are credited to the account of beneficiaries instantly or within shortest possible time. Mercantile Bank has correspondent banking relationship with all major banks located in almost all the countries/cities. Expatriate Bangladeshis may send their hard earned foreign currencies through those banks or may contact any renowned banks nearby where they reside/work to send their money to their dear ones in Bangladesh.

Mercantile Bank has already established a worldwide network and relationship in international banking through its 4 (four) overseas branches and 1239 foreign correspondents.

International Banking

1. Mercantile Bank Limited has already established a worldwide network and relationship in international Banking through its 4 (four) overseas branches and 1216 foreign correspondents.
2. The bank has earned an excellent business reputation in handling and funding international trade particularly in boosting export & import of the country.
3. The bank finances exports within the frame-work of the export policy of the country.
4. It is one of the pioneers in promoting back to back Letter of Credit for the RMG (Ready Made Garments) sectors.

Export Finance

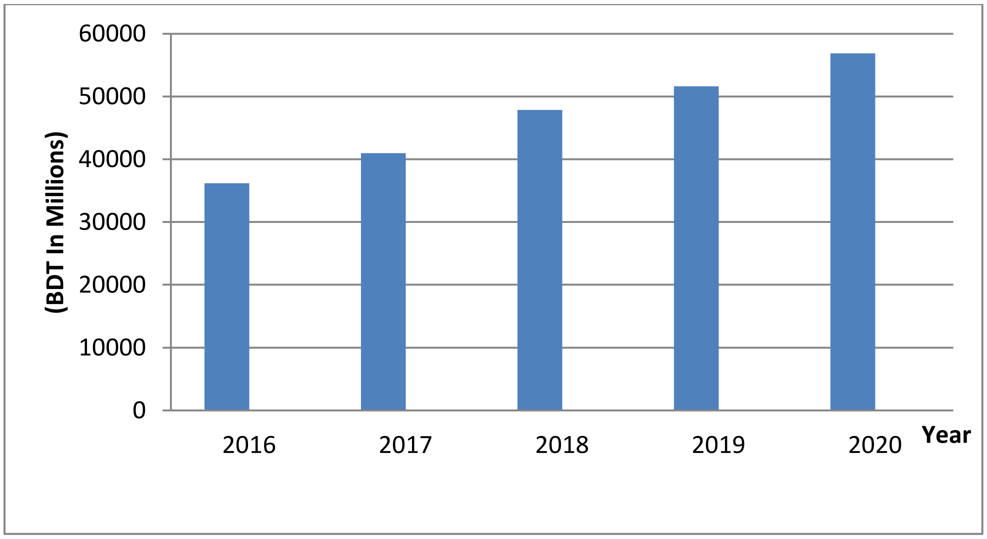
To boost up country's Export, Mercantile Bank Limited has been providing different kinds of assistance to exporters. Some of which are as below:

1. Providing Pre-Shipment and Post-Shipment Finance, Export Guarantee and bonding facility etc.
2. Concessional rate of interest for exports finance.
3. Back to Back L/C under bonded Warehouse facility.
4. Sight L/C under EDF.
5. Banking at Export Processing Zone.
6. The sole bank to disburse Government Export Promotion Fund against export of computer software & data entry processing.
7. Consultancy and advisory services by an expert group of officials.
8. Special export financing program towards computer software data entry and service export.

2.7 Principal activities of Mercantile Bank Ltd.

Mercantile Bank is the second largest commercial bank in Bangladesh. The aim of the Bank is to actively participate in the socio-economic development of the nation by operating a commercially sound Banking system. It provides credit to deserving borrowers and at the same time, protects depositor's interest.

Figure 2.1: Deposit position of last five Years (TK. In Millions)

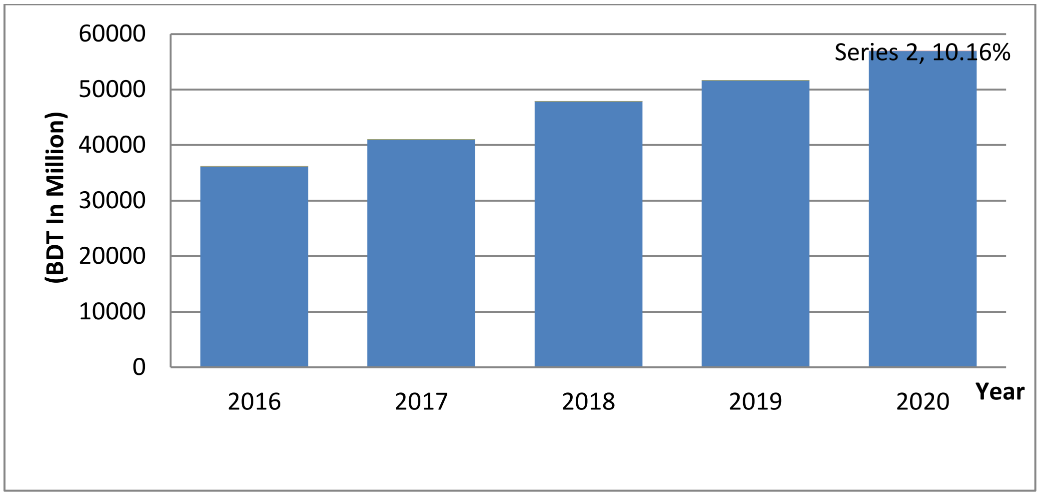


Source: Annual Report of Mercantile Bank Ltd, 2020

Interpretation:

Overall deposits of the bank improved by 10.25 percent and stood at BDT 568,911.13 million at the end of 2020.Savings deposits increased to BDT 114,590.51 million from BDT 102,636.05 million of the preceding year showing a growth of 11.65 percent, which helped to reduce cost of fund and brought the ratio of high cost and low cost deposit to 55:45.The growth was facilitated by opening of 4 new branches and improved service provided to customers. Besides initiatives carried out for mobilization of deposits did help.

Figure 2.2: Investments of five years Tk. In Million



Source: Mercantile Bank Limited, Annual Report 2020

Interpretation:

To earn profit, the Bank Prudently invests its fund to different sectors. The investment portfolio of the Bank is comprised of Treasury bill, other bonds, Debenture, Shares etc. The Bank earns a handsome profit from this investment portfolio. Overall investment stood at the end of 6,110 million and the 18250 million.

Table 2.3: Portfolio wise investment

(Taka in millions)

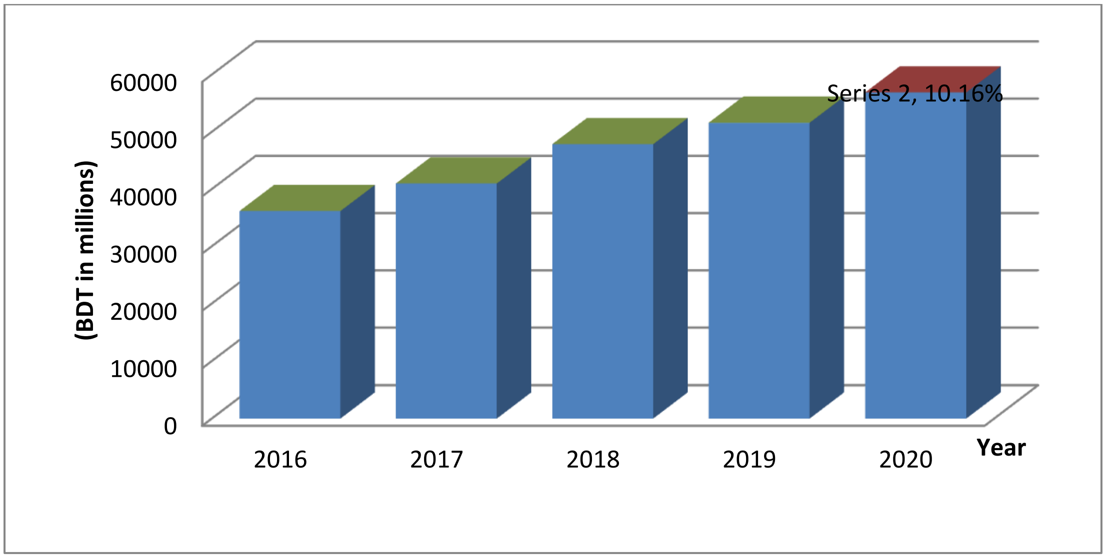
SL.#	Particulars	2020 (Tk.)	%	2019 (Tk.)	%
1	Govt. Securities (Treasury bill, Note/Bond, Prize bond)	81,082.83	89.19	52,365.41	91.05
2	Debentures	301.27	0.33	260.37	0.45
3	Corporate Bonds	890.00	0.98	690	1.20
4	Shares	8613.87	9.48	4180.34	7.27
5	Others	17.89	0.02	17.89	0.03
Total		**90,905.86**	**100**	**57,514.00**	**100**

Interpretation:

In 2020 Govt. Securities 81,082.83, Debentures 301.27, Corporate bonds 890.00, Shares 8613.87. And 2019 Govt. Securities 52,365.41, Debentures 260.37, Corporate bonds 690, Shares 4180.34

Net after profit tax

Figure 2.3: Net Profit (Figures in millions)



Source: Annual Report of Mercantile Bank Ltd, 2020

Rural Credit, Micro Ent. Program Financing:

Loan is provided to the rural people for agricultural production and other off-farm activities.

i. Loan pricing system is customer friendly.
ii. Prime customers enjoy prime rate in lending and other services.
iii. Quick appreciation, appraisal, decision and disbursement are ensured.

Credit facilities are extended as per guide-lines of Bangladesh Bank (Central Bank of Bangladesh) and operational procedures of the Bank. The rates may, however, change from time to time depending on the level of competition in the financial sector

Table 2.4: Different products under Rural Credit Micro Program

Sl. No.	Name of products	No. of Loaned	Outstanding At Dec.2020	%
1	Cyber-café loan	13	2.70	0.01
2	Credit for forestry/ horticulture nursery	751	32.90	0.13
3	Credit program for employees	78,368	3814.20	14.82
4	Financing " women entrepreneurship"	267	86.92	o.34
5	Financing goat and sheep farming	11,370	154.70	0.60
6	Gharoa project	3,812	148.80	0.58
7	Crop loan program	3,46,528	1130.20	44.79
8	Doctor's loan	66	24.96	0.10
9	Small business Dev. Loan	161	28.63	0.11
10	Credit for disable people	113	2.59	0.01
11	Consumer's credit	1,069	90.80	0.36
12	Agro-based project/industry	1,567	1080.90	4.20
13	Fisheries &Shrimp Culture Credit	321	260.30	1.01
14	Agricultural & irrigation	229	26.90	0.11

	equipment			
15	Others	1,40,699	8450.20	32.83
	Total	**5,85,328**	**25744.70**	**100.00**

SME Financing Scheme

Small and Medium Enterprise (SME) Financing Scheme has been introduced to assist new or experienced entrepreneurs to invest in small and medium scale industries. Small business development loan, project, credit for forestry/Horticulture/Nursery, crop loan project all are designed for this purpose. Light engineering, cottage industry, handy craft, CNG station, power loom, garments accessories etc. are considered as thrust segment under this sector.

Doctors' Credit Scheme

Doctors' credit scheme is designed to facilitate financing to fresh medical graduates and established physicians to acquire medical equipments and set up clinics and hospitals. Total loan outstanding in 2020 was Tk12.96 million. The no. of loaned were 66.

Women Entrepreneurs Development Scheme

The another important concept of SME financing is to develop the women entrepreneurship. Under the framework of SME, MBL is giving special emphasis in developing women entrepreneurs and in line with the regulatory instruction' MBL provides credit facilities in support of home decoration ,boutique, printing services etc.

Foreign Trade:

In the pace of resurfacing the economy from world financial crisis, import and export financing business was impressive in 2020.During the year, the Bank achieved export credit growth of 3.78% while import credit growth reduced by 8.40% .

Loan Loss and Other Provisioning

The aim of loan Loss provision is to create fund against future probable loss. At present, the bank is required to make a general provision@ 1% of the total unclassified loan for meeting any risk of unexpected losses. The Bank has also made specific provision for loan loss@5% , 20%, 50% and 100% against SMA, Sub-standard, Doubtful and bad/Loss respectively.

2.8 SWOT Analysis of the MBL

Every Organization is composed of some internal strength and weakness and also has some external opportunities and threats in its whole life cycle. The following will briefly introduce the customer to the Mercantile Bank's internal strength and weaknesses, and external opportunities and threats as I have explored those are:

Strengths:

Strengths are listed below:

1. Stable source of fund
2. Strong liquidity position
3. Wide network of branches
4. Experienced top management
5. Diversified product line

Weaknesses:

Weakness are listed below:

1. Need proper planning formulating budget.
2. Employees' dissatisfaction
3. Asset infection rate is still high
4. Relatively high overhead expense
5. Unsatisfactory IT infrastructure and online banking

Opportunities:

Opportunities are listed below

1. Strong financial condition
2. Regulatory environment favoring
3. Q-cash business
4. SME and Agro based industry loan

Threats:

Threats are listed below

1. Deposits as well as quality assets
2. Market pressure for lowering the interest rate
3. Shrinkage in export –import and guarantee
4. Business due to economic slump and war
5. Emergence of competitor

Chapter 3

Credit Risk Management of Mercantile Bank Ltd.

3.1 What is Credit?

In banking terminology, credit refers to the loans and advances made by the bank to its customers or borrowers. Bank credit is a credit by which a person who has given the required security to a bank has liberty to draw to a certain extent agreed upon. It is an arrangement for deferred payment of a loan or purchase. Credit means a provision of, or commitment to provide, funds or substitutes for funds, to a borrower, including off-balance sheet transactions, customers' lines of credit, overdrafts, bills purchased and discounted, and finance leases.

3.2 Credit Risk

Credit risk refers to the risk that a borrower will default on any type of debt by failing to make payments which it is obligated to do. The risks are primarily that of the lender and include lost principal and interest, disruption to cash flows, and increased collection costs. The loss may be complete or partial and can arise in a number of circumstances. Risk means the exposure to a chance of loss or damage. Risk is the element of uncertainty or possibility of loss that exist in any business transaction. Credit risk is the likelihood that a borrower or counter party will be unsuccessful to meet its obligation in accordance with agreed terms and conditions. Credit risk means the risk of credit loss that results from the failure of a borrower to honor the borrower's credit obligation to the financial institution.

3.3 Credit Risk Management

While financial institution have faced 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 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. Credit risk is most simply defined as the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms. 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. Banks need to manage the credit risk inherent in the entire portfolio as well as the risk in individual credits or transaction. Banks should also consider the relationship 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.

As Mercantile Bank Ltd. is providing credit facility out of its total available funds, it has to manage these credits very efficiently. An efficient credit risk management system comprises many things and this cover the pre-sanction activities to post-sanction activities. Credit risk management is important as it helps the banks and financial institutions to understand various dimensions of risk involved in different credit transactions.

3.4 Tools of Credit Management

For credit management, a firm may use tools available to them. Such tools include Credit Risk Grading and Financial Spread Sheet. Credit risk grading is an important for credit risk management as it helps the banks and financial institutions to understand various dimensions of risk involved in different credit transactions. The aggregation of such grading across the borrowers, activities and the lines of business can provide better assessment of the quality of credit portfolio of a bank or branch.

The Lending Risk Analysis manual introduced in 1993 by the Bangladesh Bank has been in practice for mandatory use by the banks and financial institutions for loan size of BDT 1.00 crore and above. However, the LRA manual suffers from a lot of subjectivity, sometimes creating confusion to the lending bankers in terms of selection of credit proposals on the basis of risk exposure. Meanwhile in 2003 end, Bangladesh Bank provided guidelines for credit risk management of banks wherein it recommended, interlaid, the introduction of Risk Grade Score Card for risk assessment of credit proposals.

Bangladesh Bank expects all commercial banks to have a well defined credit risk management system which delivers accurate and timely grading. In practice, a bank's credit risk grading system should reflect the complexity of its lending activities and the overall level of risk involved.

Definition of Credit Risk Grading (CRG)

1. The Credit Risk Grading (CRG) is a collective definition based on the pre- specified scale and reflects the underlying credit-risk for a given exposure.
2. A Credit Risk Grading deploys a number/ alphabet/ symbol as a primary summary indicator of risks associated with a credit exposure.
3. Credit Risk Grading is the basic module for developing a Credit Risk Management system.

Functions of Credit Risk Grading

Well-managed credit risk grading systems promote bank safety and soundness by facilitating informed decision-making. Grading systems measure credit risk and differentiate individual credits and groups of credits by the risk they pose. This allows bank management and examiners to monitor changes and trends in risk levels. The process also allows bank management to manage risk to optimize returns.

Use of Credit Risk Grading

1. The Credit Risk Grading matrix allows application of uniform standards to credits to ensure a common standardized approach to assess the quality of individual obligor, credit portfolio of a nit, line of business, the branch or the bank as a whole.

2. As evident, the CRG outputs would be relevant for individual credit selection, wherein a borrower or a particular exposure/ facility is rated. The other decisions would be related to pricing (credit-spread) and specific features of credit facility. These would largely constitute obligor level analysis.
3. Risk grading also be relevant for surveillance and monitoring, internal MIS and assessing the aggregate risk portfolio level analysis.

Mercantile Bank Ltd. applies the following credit risk grading matrix as provided by Bangladesh Bank guidelines.

Table 3.1 : Credit Risk Rating

Risk Rating	Grade	Definition
Superior – Low Risk	1	Facilities are fully secured by cash deposits, government bonds or a counter guarantee from a top tier international bank. All security documentation should be in place.
Good – Satisfactory Risk	2	The repayment capacity of the borrower is strong. The borrower should have excellent liquidity and low leverage. The company should demonstrate consistently strong earnings and cash flow and have an unblemished track record. All security documentation should be in place. Aggregate Score of 95 or greater based on the Risk Grade Scorecard.
Acceptable – Fair Risk	3	Adequate financial condition though may not be able to sustain any major or continued setbacks. These borrowers are not as strong as Grade 2 borrowers, but should still demonstrate consistent earnings, cash flow and have a good track record. A borrower should not be graded better than 3 if realistic audited financial statements are not received. These assets would normally be secured by acceptable collateral (1st charge over stocks / debtors / equipment / property). Borrowers should have adequate liquidity, cash flow and earnings. An Aggregate Score of 75-94 based on the Risk Grade Scorecard.
Marginal - Watch list	4	Grade 4 assets warrant greater attention due to conditions affecting the borrower, the industry or the economic environment. These borrowers have an above average risk due to strained liquidity, higher than normal leverage, thin cash flow and/or inconsistent earnings. Facilities should be downgraded to 4 if the borrower incurs a loss, loan payments routinely fall past due, account conduct is poor, or other untoward factors are present. An Aggregate Score of 65-74 based on the Risk Grade Scorecard.

Special Mention	5	Grade 5 assets have potential weaknesses that deserve management's close attention. Facilities should be downgraded to 5 if sustained deterioration in financial condition is noted (consecutive losses, negative net worth, excessive leverage), if loan payments remain past due for 30-60 days, or if a significant petition or claim is lodged against the borrower. Full repayment of facilities is still expected and interest can still be taken into profits. An Aggregate Score of 55-64 based on the Risk Grade Scorecard.
Substandard	6	Financial condition is weak and capacity or inclination to repay is in doubt. Loans should be downgraded to 6 if loan payments remain past due for 60-90 days, if the customer intends to create a lender group for debt restructuring purposes, the operation has ceased trading or any indication suggesting the winding up or closure of the borrower is discovered. An Aggregate Score of 45-54 based on the Risk Grade Scorecard.
Doubtful and Bad(non-performing)	7	Full repayment of principal and interest is unlikely and the possibility of loss is extremely high. However, due to specifically identifiable pending factors, such as litigation, liquidation procedures or capital injection, the asset is not yet classified as Loss. Assets should be downgraded to 7 if loan payments remain past due in excess of 90 days, and interest income should be taken into suspense (nonaccrual). Loan loss provisions must be raised against the estimated unrealizable amount of all facilities. The adequacy of provisions must be reviewed at least quarterly on all non-performing loans, and the bank should pursue legal options to enforce security to obtain repayment or negotiate an appropriate loan rescheduling. In all cases, the requirements of Bangladesh Bank in CIB reporting, loan rescheduling and provisioning must be followed. An Aggregate Score of 35-44 based on the Risk Grade Scorecard

Loss (non-performing)	8	Assets graded 8 are long outstanding with no progress in obtaining repayment (in excess of 180 days past due) or in the late stages of wind up/liquidation. The prospect of recovery is poor and legal options have been pursued. The proceeds expected from the liquidation or realization of security may be awaited. The continuance of the loan as a bankable asset is not warranted, and the anticipated loss should have been provided for. Bangladesh Bank guidelines for timely write off of bad loans must be adhered to. An Aggregate Score of 35 or less based on the Risk Grade Scorecard

Source: Annual Report of Mercantile Bank Ltd, 2020

Credit Risk Management: Industry Best Practices, Managing Core Risks of Financial Institutions, Bangladesh Bank.

If any facility is to be downgraded, the RM prepares The Early Alert Report and it is duly forwarded to the higher authority for approval. After approval, the report is forwarded to Credit Administration, who is responsible to ensure the correct facility/borrower Risk Grades are updated on the system.

3.5 Process of Credit Risk Management

Credit risk management 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. It should provide for sound practices in:

1. Credit processing/appraisal
2. Credit approval/sanction
3. Credit documentation
4. Credit administration
5. Disbursement
6. Monitoring and control of individual credits
7. Monitoring the overall credit portfolio (stress testing)
8. Credit Classification and
9. Managing problem credits/recovery

Credit Processing/Appraisal

Credit processing is the stage where all required information on credit is gathered and applications are screened. Credit application forms should be sufficiently detailed to permit gathering of all information needed for credit assessment at the outset. In this connection, financial institutions should have a checklist to ensure that all required information is, in fact, collected. Financial institutions should set out pre-qualification screening criteria, which would act as a guide for their officers to determine the types of credit that are acceptable. For instance, the criteria may include rejecting applications from blacklisted customers. These criteria 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. Institutions should establish 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.

In the case of loan syndication, a participating financial institution should have a policy to ensure that it does not place undue reliance on the credit risk analysis carried out by the lead underwriter. The institution must carry out its own due diligence, including credit risk analysis, and an assessment of the terms and conditions of the syndication. As a general rule, the appraisal criteria will focus on:

1. Amount and purpose of facilities and sources of repayment
2. Integrity and reputation of the applicant as well as his legal capacity to assume the credit obligation
3. Risk profile of the borrower and the sensitivity of the applicable industry sector to economic fluctuations
4. Physical inspection of the borrower's business premises as well as the facility that is the subject of the proposed financing
5. Current and forecast operating environment of the borrower
6. Management capacity of corporate customers

Credit-approval/Sanction

A financial institution must have in place written guidelines on the credit approval process and the approval authorities of individuals or committees as well as the basis of those decisions. Approval authorities should be sanctioned by the board of directors. Approval authorities 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. Prudent credit practice requires that persons empowered with the credit approval authority should not also have the customer relationship responsibility.

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.

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, and collateral valuation, and impairment recognition, foreclosure of impaired loan and realization of security. The format of credit files must be standardized and files neatly maintained with an appropriate system of cross-indexing to facilitate review and follow up.

The Bangladesh Bank will pay particular attention to the quality of files and the systems in place for their maintenance. 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, financial institutions should consider keeping only the 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 in fire-proof cabinets and should not be removed from the institution's premises.

Financial institutions should maintain a checklist that can show that all their policies and procedures ranging from receiving the credit application to the disbursement of funds have been complied with. The checklist should also include the identity of individual(s) and/or committee(s) involved in the decision-making process.

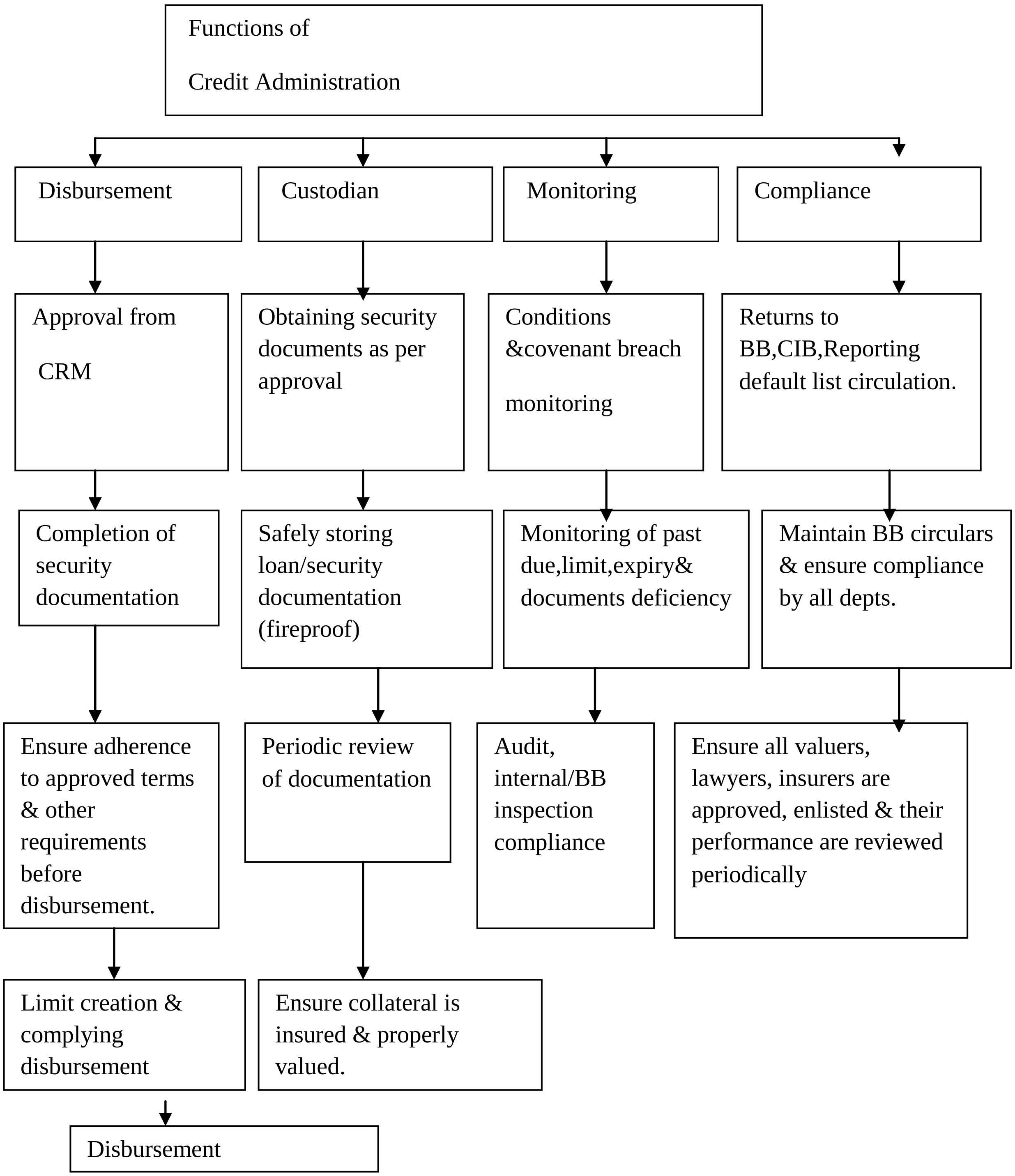
Credit Administration

Financial institutions must ensure that their credit portfolio is properly administered, that is, loan agreements are duly prepared, renewal notices are sent systematically and credit files are regularly updated. 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:

1. Credit files are neatly organized, cross-indexed, and their removal from the premises is not permitted
2. The borrower has registered the required insurance policy in favor of the bank and is regularly paying the premiums
3. Credit facilities are disbursed only after all the contractual terms and conditions have been met and all the required documents have been received
4. Collateral value is regularly monitored
5. The borrower is making timely repayments on interest, principal and any agreed to fees and commissions
6. The established policies and procedures as well as relevant laws and regulations are complied with
7. On-site inspection visits of the borrower's business are regularly conducted and assessments documented

Figure 3.1: Functions of Credit Administration Department



Source: Annual Report of Mercantile Bank Ltd, 2020

3.6. 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 should be duly signed and returned to the institution by the customer. The facility disbursement process should start only upon receipt of this letter and should involve, inter alia, the completion of formalities regarding documentation, the registration of collateral, insurance cover in the institution's favor and the vetting of documents by a legal expert. Under no circumstances shall funds be released prior to compliance with pre-disbursement conditions and approval by the relevant authorities in the financial institution.

3.7 Monitoring and Control of Individual Credits

To safeguard financial institutions against potential losses, problem facilities need to be identified early. 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. Examples of such warning signs include unauthorized drawings, arrears in capital and interest and deterioration in the borrower's operating environment Financial institutions must have a system in place to formally review the status of the credit and the financial health of the borrower at least once a year. More frequent reviews (e.g. at least quarterly) should be carried out of large credits, problem credits or when the operating environment of the customer is undergoing significant changes.

In broad terms, the monitoring activity of the institution will ensure that:

1. Funds advanced are used only for the purpose stated in the customer's credit application
2. Financial condition of a borrower is regularly tracked and management advised in a timely fashion
3. Collateral coverage is regularly assessed and related to the borrower's financial health
4. The institution's internal risk ratings reflect the current condition of the customer

3.8 Monitoring the Overall Credit Portfolio

An important element of sound credit risk management is analyzing 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.

Possible scenarios that financial institutions should consider in carrying out stress testing include:

1. Significant economic or industry sector downturns;
2. Adverse market-risk events; and
3. Unfavorable liquidity conditions.

Financial institutions should have industry profiles in respect of all industries where they have significant exposures. Such profiles must be reviewed /updated every year. Each stress test should be followed by a contingency plan as regards recommended corrective actions. Senior management must regularly review 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.

Classification of credit

It is required for the board of directors of a financial institution to establish credit risk management policy, and credit impairment recognition and measurement policy, the associated internal controls, documentation processes and information systems.

Credit classification process grades individual credits in terms of the expected degree of recoverability. Financial institutions must have in place the processes and controls to implement the board approved policies, which will, in turn, be in accord with the proposed guideline. They should have appropriate criteria for credit provisioning and write off. Financial institutions must, therefore, establish appropriate systems and processes to identify credits with similar characteristics in order to assess the degree of their recoverability on a portfolio basis.

Financial institutions should establish appropriate systems and controls to ensure that collateral continues to be legally valid and enforceable and its net realizable value is properly determined. 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. As to any guarantees given in support of credits, financial institutions must establish procedures for verifying periodically the net worth of the guarantor.

Managing Problem Credits/Recovery

A financial institution's credit risk policy should clearly set out how problem credits are to be managed. The positioning of this responsibility in the credit department of an institution may depend on the size and complexity of credit operations. The monitoring 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.

The collection process for personal loans starts when the account holder has failed to meet one or more contractual payment (Installment). It therefore becomes the duty of the Collection Department to minimize the outstanding delinquent receivable and credit losses. This procedure has been designed to enable the collection staff to systematically recover the dues and identify / prevent potential losses, while maintaining a high standard of service and retaining good relations with the customers. It is therefore essential and critical, that collection people are familiar with the computerized system, procedures and maintain effective liaison with other departments within the bank .

3.9 SIGNS FOR CLASSIFICATION

First and foremost requirement for any and all credit managers is to identify a problem credit in its earlier stages by recognizing the signs of deterioration. Such signs include but not limited to the following:

1. Nonpayment of interest or principal or both on due dates or past dues beyond a reasonable period or recurring past dues
2. In case of Overdraft no movement in the account beyond a reasonable period
3. Deterioration in financial condition of the client, as gathered from client's latest financial statement
4. A shortfall in collateral coverage, particularly if the collateral was a key factor in the decision-making
5. Death or withdraw of key-owners or management personnel
6. Company filing for bankruptcy or voluntary dissolution
7. Adverse market report about the company itself or its principal owners

According to this circular loans and advances were classified on a loan by loan basis rather sample classification. This process was continued till 1994. Bangladesh Bank further issued a circular in 2020. The title of the circular was "Revised rules of classification and provisioning of loans and advances," which came into implementation from January 1, 2020.

Table 3.3: Classification and provision program

a. Types of classification	**1st stage**	**2nd stage**	**3rd stage**	**4th stage**	**5th stage**
	Period overdue	Period overdue	Period overdue	Period overdue	Period overdue
Unclassified	Less than 18 months	Less than 12 months	Less than 19 months	Less than 6 months	Less than 3 months
Substandard	18 months	12 months or	9 months or	6 months or	3 months or

	or more but less than 36 months	more but less than 24 months	more but less than 24 months	more but less than 12 months	more but less than 6 months
Doubtful	36 months or more but less than 48 months	24 months or more but less than 36 months	12 months or more but less than 24 months	9 months or more but less than 12 months	3 months or more but less than 6 months
Bad	More than 48 months	36 months or more	36 months or more	24 months or more	12 months or more
b. Rate of provision					
Unclassified:					
Standard	5%	2%	2%	2%	1%
SMA	5%	5%	5%	5%	5%
Classified:					
Substandard	20%	20%	20%	20%	20%
Doubtful	50%	50%	50%	50%	50%
Bad	100%	100%	100%	100%	100%
c. Period of classification	Annual basis	Half yearly basis	Half yearly basis	Quarterly basis	Quarterly basis

Source: Bangladesh Bank, BRPD Circular No. 16 of 2020

3.10 Impact of Provision for Rates of loan Provision

Provisioning by the bank has not been isolated action, but represents one component in an ongoing set of negotiations and relationships between borrowers and the banks, while the borrowers wish to minimize their servicing obligations without damaging their prospect of future market access, the lending bank wish to maximize their receipts. Such maximization may involve agreeing to terms which are not so stringent as to encourage borrowers to opt for all out default. Provisioning has the effect of bringing the bank's actual balance sheet more in line with the market perception of what they should look alike.

Bangladesh Bank provides specific guidelines for loan provisioning and bases for calculating such provisions. Provisions for unclassified as well as classified loan are as follows:

Table 3.4: Rates of Loan Provision

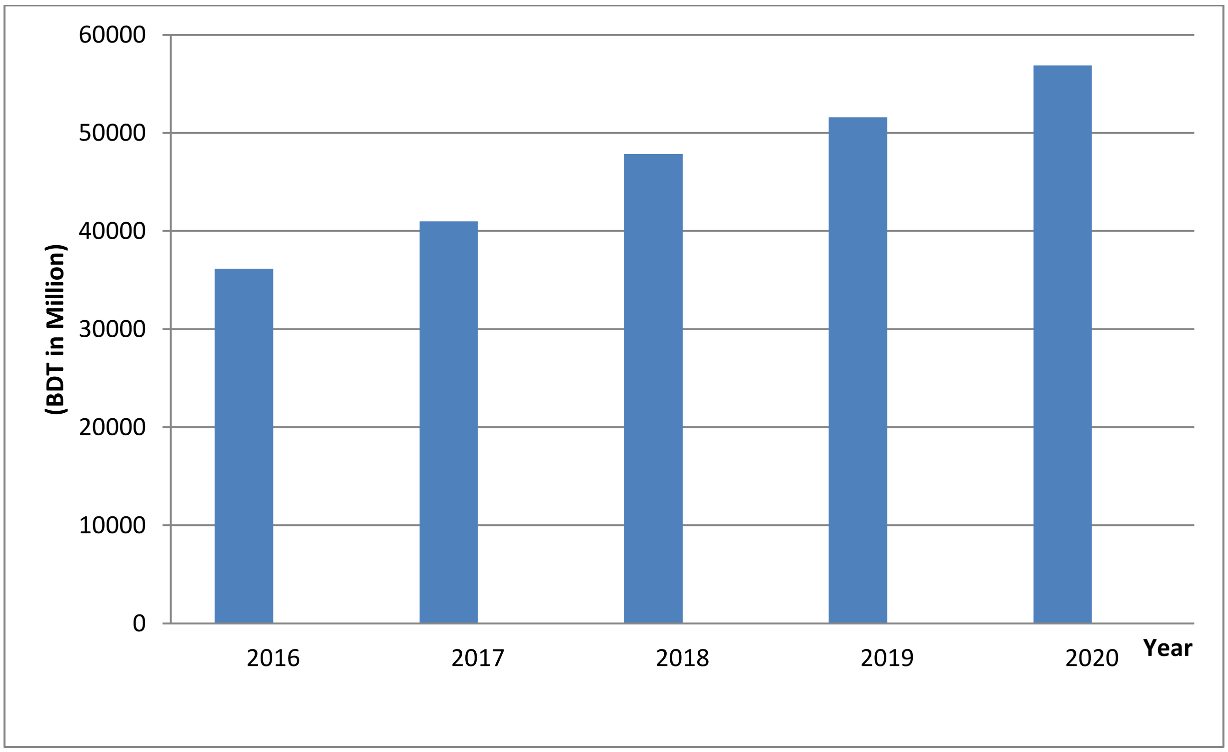
Unclassified loan	**Provision**	**Classified**	**provision**
Small enterprise financing	2%	Substandard	2.00%
Consumer financing	2%	Doubtful	5.60%
Except SEF, CF and SMA	1%	Bad or loss	10.00%
Special account	Mention 5%		

Bank and financial sector may be termed as the vital complementary power of the economy. But the uncertainty in respect to effectiveness of this sector in the economy continuously increases over time. Now a days it open secret that MBL is under direct control of the Finance Ministry. Credit management of MBL was so meaningless and corrupted as it is now assumed that more than Tk. 30000 Crore have become unrealizable within the last 10 years.

3.11 LOANS AND ADVANCES

Loans & advances increased by BDT 30,088.03 million during the year 2020 and stood BDT 349,861.30 million which was BDT 319,773.25 million in 2019 showing a sustainable growth of 9.41 percent over the previous year. Concentration of loans and advances was well managed and details of concentration are given at notes to the financial statements.

Figure 3.2: Loan and Advances



Source: Annual report Mercantile Bank 2020.

Table 3.5: Sector wise Loans and Advances

Year	2018	2019	2020
Jute Industries	9201.20	12703.80	4,627.90
Jute Trade	166.70	237.60	159.50
Tannery (Industry & Trade)	5315.80	4722.50	4,100.00
Textile (Industry & Trade)	5662.60	7452.02	7,802.50
Transport	31.20	31.80	32.20
Steel & Engineering	2217.70	2726.50	2,663.60
Tea	87.70	88.50	88.70
Sugar Mills	2962.00	3790.10	3,732.20
House Building	1159.50	1512.10	1,491.10
Rural Credit	12854.90	14578.20	16,352.20
Bricks	1203.30	1427.50	1,502.50
Cold Storages	66.70	285.00	478.50
Food (Industry & Trade)	1642.20	1895.70	2,085.00
Export Credit	19082.70	28266.50	38,195.60
Import Credit	32704.80	52760.00	60,633.70
Industrial Credit	22372.07	40054.00	41,551.00
Others	49628.41	53201.42	72,304.83
Total	**166359.48**	**225733.22**	**257,801.03**

Sources: Annual Report of Mercantile Bank Ltd, 2020

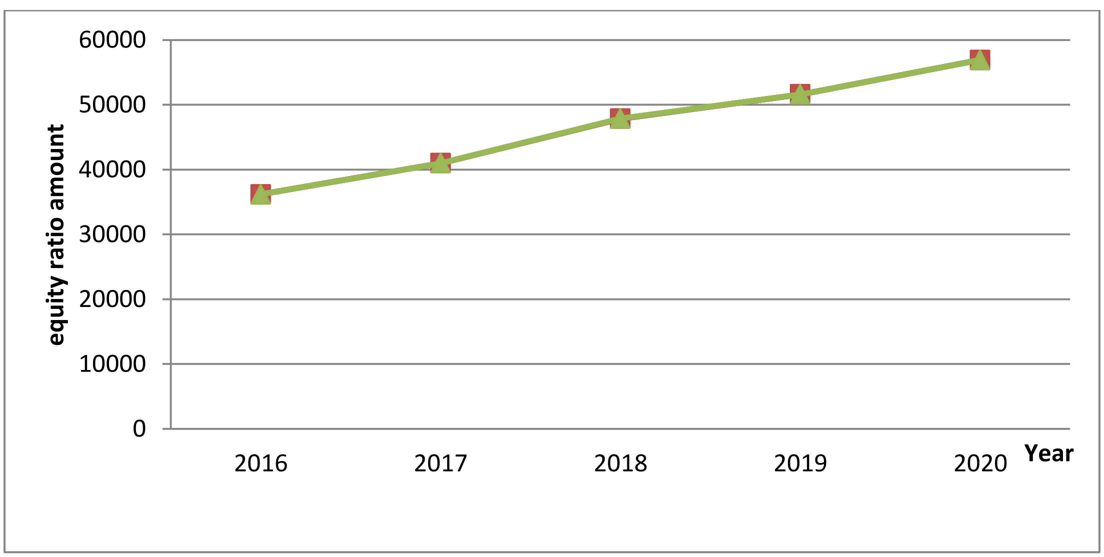
3.12 Ratio Analysis

Ratios are mathematical comparisons of financial statement accounts or categories. These relationships between the financial statement accounts help investors, creditors, and internal company management understand how well a business is performing and areas of needing improvement.

Debt equity Ratio:

Year	2016	2017	2018	2019	2020
Total debt/Total Equity(Debt to Equity Ratio)	12.95	11.85	11.85	11.23	10.25

Figure 3.3: Debt and equity ratio



Source: Annual Report of Mercantile Bank Ltd. 2020

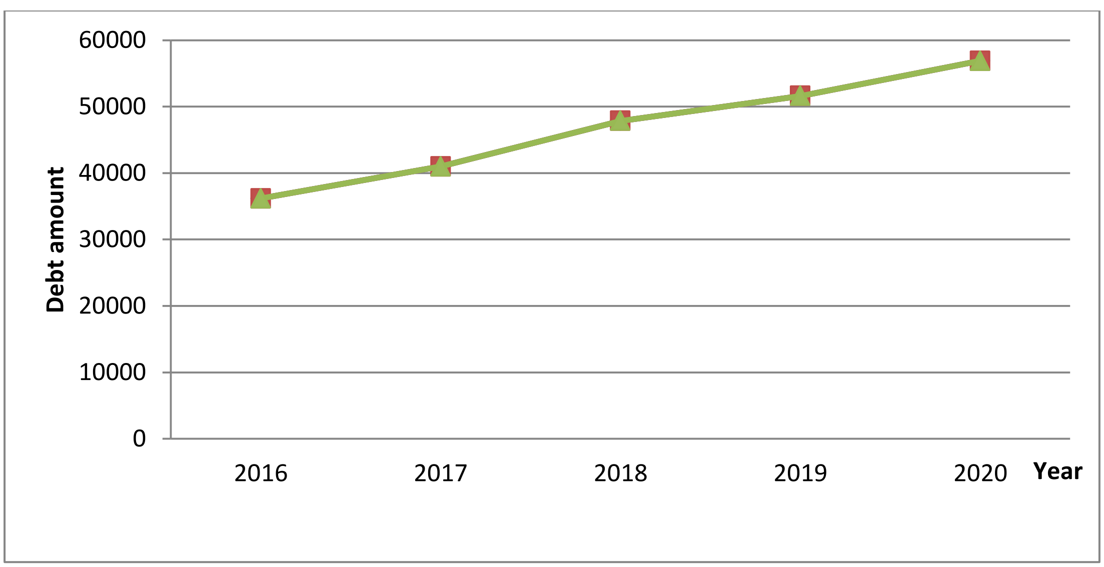
Interpretation:

The debt-equity ratio shows the amount of debt in proportion to the equity. The more the debt equity ratio the more the company earns profit but for this the company has to face high risk. From the above graph it is clear that the company's debt-equity ratio is decreasing at a decreasing rate.

Debt Ratio

	2016	2017	2018	2019	2020
Total debt/Total Asset(Debt Ratio)	0.93	0.92	0.92	0.92	0.91

Figure 3.4: Debt ratio



Source: Annual Report of Mercantile Bank Ltd, 2020

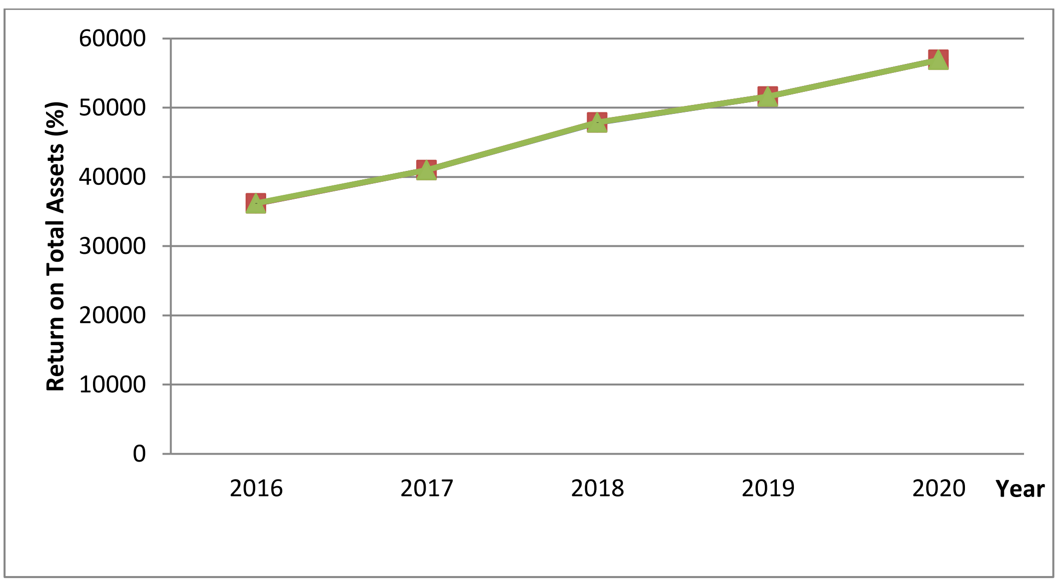
Interpretation:

Debt-asset ratio shows the amount of debt in proportion to the asset. The more the debt-asset ratio the more the company earns profit but for this the company has to face high risk. From the above graph it is clear that the company's debt-assets ratio is decreasing at a decreasing rate. From this ratio it is clear that the company is becoming dependable.

Return On Total Assets (ROA)

Profitability Ratio	2016	2017	2018	2019	2020
Return on total assets (%)	1.65%	1.30%	1.45%	1.74%	1.61%

Figure 3.5: Return on Total Assets



Source: Annual Report of Mercantile Bank Ltd. 2020

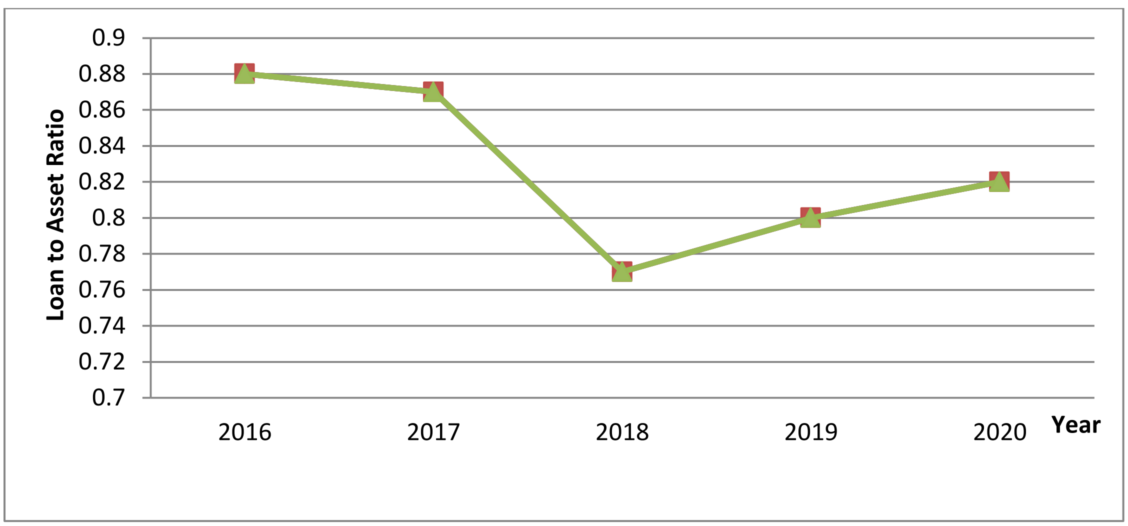
Interpretation:

Return on assets shows the income rate on total assets. The return on total assets is fluctuating at a significant rate.

Loan to Asset Ratio

Risk Ratios	2016	2017	2018	2019	2020
Loans/Total Asset (Loan to Asset)	0.88	0.87	0.77	0.80	0.82

Figure 3.6: Loan to Asset Ratio



Source : Annual Report of Mercantile Bank Ltd. 2020

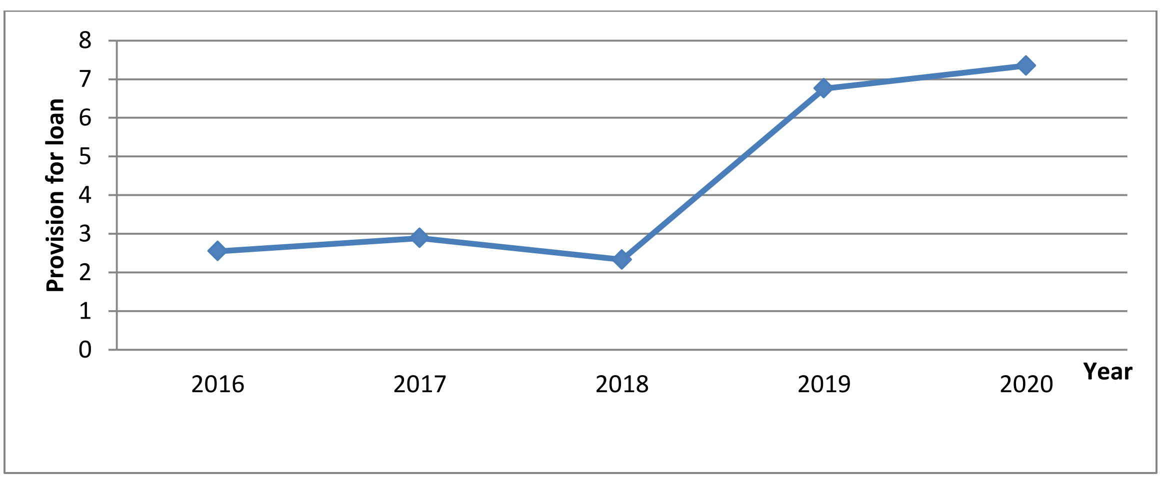
Interpretation:

The long term debt to total assets ratio is a measurement representing the percentage of a corporation's assets that are financed with loans and financial obligations lasting more than one year. The ratio provides a general measure of the financial position of a company, including its ability to meet financial requirements for outstanding loans. My analyzed company maintained different forms of ratios.

Provision for Loan

Year	2016	2017	2018	2019	2020
Reserve/Total Loans (Provision for Loan Losses)	2.55	2.89	2.33	6.76	7.35

Figure 3.7: Provision for loan



Source: Annual Report of Mercantile Bank Ltd, 2020

Chapter 4

Findings, Recommendations & Conclusions

4.1 Findings

Based on observation and interpretation I found some positive and negative side of MBL. Those are given below:

1. The main objective of the Mercantile Bank Ltd. is to maximize profit by utilizing its resources at the optimum level and to ensure the best possible service towards the customer.
2. Credit risk is an investor's risk of loss arising from a borrower who does not make payments as promised. Such an event is called default. Other terms for credit risk are default risk & counterparty risk.
3. The importance of credit risk management for banking is tremendous because Banks and other financial institutions make profit from their credit disbursement. So it is very important for banks and other financial institution to manage credit risk properly. Effective CRM helps to increase the present and future financial performance of a bank.
4. The main challenges of Credit Risk Management are additional cost for training and employee motivation.
5. The process of Credit Risk Management contains several elements such as Credit processing, Approval, Documentation, Administration, Disbursement, Monitoring Credit classification and Credit recovery etc.
6. The MBL follows the rules and regulation given by the Bangladesh Bank in practicing Credit risk management. It generally focuses on industrial credit policy rather than general credit. The Credit department of MBL includes approval, operation, and recovery and asset management unit.

4.2 Recommendations

1. The Following recommendations can be prescribed for the MBL, like:
2. Loan and advance department should be brought under computerized system integrated with online networks with local office. It will save the time of employees and will make the transaction easier.
3. The amount of non- performing loan should be reduced by analysis proper evaluation of loan proposal and monitoring.
4. All the loan documentations have to done honestly. The bank should concentrate more on proper documentation of all types of loans to make the department trust worthy & healthy.
5. MBL should built separate loan recovery division if it happen then their classified loan amount will reduce.
6. MBL should give the competitive interest rate, so that the clients are not shifting loan accounts to other bank.
7. The bank should introduce short term schemes like micro credit for poor & urban people.
8. It may be a fair deal if the high-risk borrowers and the low risk borrowers should not have to pay the same interest rate. Interest rate could be arranged according to the sum they borrower.

4.3 Conclusion

Credit risk management is becoming more and more important in today's competitive business world. It is all the more important in the context of Bangladesh. The tools for improving management of consumer credit risk have advanced considerably in recent years. Therefore, as a responsible and reputed commercial bank, Mercantile Bank has instituted a contemporary credit risk management system. From the study, it is evident that the bank is quite sincere in their approach to managing the consumer credit risk though there are rooms for improvement. They have to be more cautious in the recovery sector and preferential treatments to some big clients should also be stopped. However, they follow an in-depth procedure in assessing the credit risk by using the credit risk grading techniques which provides them a solid ground in the time of any settlement. From the discussion in this report, it has become clear that credit risk management is a complex and ongoing process and therefore financial institutions must take a serious approach in addressing these issues. They have to be up to date in complying with all the required procedures and must employ competent people who have the ability to deal with these complex matters. Utmost importance should be given to the improvement of the networking system which is essential for modern banking environment and obviously for efficient and effective credit risk management process.

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Appendix

Five Years Financial Summary of Mercantile Bank Limited

Particulars	2020	2019	2018	2017	2016
Authorized capital	20000.00	20000.00	20000.00	20000.00	20000.00
Paid-up capital	19140.00	11000.00	8125.00	5000.00	5000.00
Reserve fund & surplus	17976.20	6476.66	25944.20	15390.32	9924.74
Total Shareholder’s equity	37116.20	17476.66	34069.20	20390.32	14924.74
Total Assets	586982.98	511129.41	446111.42	345234.00	294727.00
Current liabilities	275,583.75	219,102.72	199,259.27	167,016.15	153,319.69
Long-term liabilities	273,483.04	274,821.01	212,782.95	157,827.53	126,482.57
Interest income	36,189.68	34,239.12	26,266.12	19,027.54	14,867.96
Investment income	13,736.50	7811.43	6,109.43	6,956.05	5,602.31
Non-interest income	5,145.67	7465.08	8259.58	4630.33	3603.03
Total Income	55,071.85	49,515.63	40635.53	30613.92	24074.10
Net profit after tax	9608.39	(15280.34)	4444.91	4907.97	2804.25
Import	176671.00	188284.00	197285.00	183744.00	118525.00
Export	153252.00	156525.00	153758.00	118515.00	88653.00
Foreign Remittance	103982.00	100089.00	72285.00	52640.00	56190.00
ROA	1.81%	(2.51%)	1.99%	2.27%	1.92%
ROE	30.09%	(49.74%)	16.32%	27.80%	23.38%
ROI	9.39%	8.01%	7.72%	4.89%	4.13%
Efficiency ratio	15.86%	15.11%	17.54%	21.61%	21.26%
Debt-equity ratio	13.13	24.09	10.62	14.05	16.49
Gross profit ratio	44.43%	56.39%	57.74%	68.17%	71.52%
Net profit ratio	23.90%	38.66%	13.70%	21.83%	15.81%
EPS	86.31	138.91	43.46	98.16	73.37
Dividend Cash	10	-	10	10	10
Bonus	-	-	-	2875	-
Current ratio	1.04	1.02	1.06	1.03	0.98
Capital Adequacy	10.27%	3.70%	10.20%	9.19%	13.81%
Statutory liquidity	44.39%	33.24%	33.47%	27.72%	40.84%

Source: Annual Report of Mercantile Bank Ltd, 2020