

Quadrant II – Transcript and Related Materials

Paper Code: COG111

**Module Name: Loans and Advances-Importance of lending,
Principles of lending and Credit Management**

Module No: 16

Notes

INTRODUCTION

Granting of advances is the second primary function of a bank after accepting deposits. A major portion of its funds is used for this purpose and this is also the major source of bank's income. However, while making loans the bank realises that these funds are actually its liabilities towards the depositors. These funds, so lent must come back to the bank so that the depositors are able to withdraw and if not the bank is able to make fresh loans. Banks act as custodian of public deposits. Since the depositors require safety and security of their deposits, want to withdraw deposits whenever they need and also adequate return, bank lending must necessarily be based on principles that reflect these concerns of the depositors.

IMPORTANCE

1. For the bank

Constitute a major chunk of a bank's assets. These also yield returns by way of interest income which contributes the largest percentage of a bank's profits. Banks charge interest at periodic intervals (generally monthly) on the funds lent to the borrowers and the total interest collected during the financial year constitute a major portion of its gross interest income. After the bank deducts the total interest payable on its deposits from such interest income, the net interest income is arrived at.

2. For development of the economy

By lending savers money to the users it helps them in setting up and expanding business and trade in the country, thereby contributing to its economic development. Without bank-loans, the country's industry, trade and commerce will stagnate or grow very slowly, as the own savings or retained earnings are inadequate for the required growth

3. For the monetary system

In the process of lending, banks also create fresh deposits on account of the fractional reserve system under which banks are required to keep only a specified small portion of their deposits in cash as Cash Reserve Ratio (CRR) and the remainder is lent out. The funds lent out accrue

as fresh deposits in the banking system and these deposits are again lent out, leaving a small portion as cash or liquidity reserves with banks. The money supply in the economy thus increases.

The actual extent of credit creation by banks would depend on the demand of credit in the economy and how widely people are inclined to the bank deposits and negotiable instruments like cheques, bank drafts, bills of exchange, promissory notes etc. for settling transactions.

The extent of 'monetization' of the economy would also determine the velocity of circulation and credit creation by banks, as the non-monetized segment (hoarding of money, commodities etc) contributes to seepages by blocking some portion of money supply from not coming back to the banking system at all or coming after a prolonged period.

4. For the society

Bank's lending function helps the society indirectly through employment and income generation which increases as the economy develops. Bank's as responsible corporate citizens, plough back portion of their profits in community welfare activities. Bank's also give loans at very low/concessionary interest rates for the government's poverty alleviation programmes

PRINCIPLES OF SOUND LENDING

1. Safety

Banks need to be sure that advances made by them are safe and money lent out by them will come back. Since the repayment of loans depends on the borrowers' capacity and intention to pay, the banker must be satisfied before lending that the borrower is credit worthy. If the borrowing is made for a business purpose the business is viable and sound. To ascertain creditworthiness is most essential in case of unsecured loans i.e. loans which do not have an underlying security to fall back upon. Bankers while making loans many times insist on security against the loan, which they fall back on if things growing for the business. The security must be adequate, readily marketable and free of encumbrances.

2. Liquidity

Liquidity refers to an asset's ability to convert to cash at the time of need. To maintain liquidity, banks have to ensure that money advanced by them is repaid in the given time period. Banks match their asset (loans) and liability (deposits) maturities for overall loans and deposits to increase liquidity and optimize returns. Banks ensure that the loans they make are not locked up for long time by designing the loan maturity period appropriately. Further, money must comeback as per the repayment schedule. If loans become excessively illiquid, it may not be possible for bankers to meet their obligations vis-à-vis depositors.

3. Profitability

To remain viable, a bank must earn adequate profit on its investments and loans. For making loans this calls for adequate margin between deposit rates and lending rates. In this respect, appropriate fixing of interest rates on both advances and deposits is critical. Unless interest

rates are competitively fixed and margins are adequate, banks may lose customers to their competitors and become unprofitable.

In order to keep proper balance, the bank keeps in its investment portfolio three types of investments- liquid, semi-liquid and income earning investments in optimum proportions.

4. Risk diversification

To mitigate risk, banks should lend to a diversified customer base. Diversification should be in terms of geographic location, nature of business etc. If, for example, all the borrowers of a bank are concentrated in one region and that region gets affected by a natural disaster, the bank's profitability can be seriously affected. Likewise, making loans only to a particular sector say, IT or only Real estate, in case of any adverse impact of economic changes, if these sectors get hit, the banks will suffer gravely due to concentration of risks. It's like the famous saying " Do not put all your eggs in one basket".

5. Purpose of loan

The banker has to examine carefully the purpose for which the advance is applied for. In case the advance is intended to be utilized for productive purposes, it could reasonably be anticipated that cash flows arising from the productive activities will result in prompt repayment. Of course, the banker has to be careful to monitor the exact purpose for which the advance is actually utilized. There is always the possibility that the advance, once granted, may be diverted for purposes other than that indicated by the borrower at the time it is applied for. Thus, proper provisions should be there for effective post credit supervision

5C's of Credit Management

Banks while making loans use an approach called "5 C's of Credit" that has been in use by many other credit analysts to assess the prospective customer's situations with respect to loans:

1. **Character:** Character refers to the borrower's reputation so far in handling debts; his willingness to honour his obligations in paying back the loan completely as per schedule. If the borrower has an image of someone who always honours his debt commitment and gets good references from lenders will be considered to have good character for taking loans. So, the borrower's integrity is an important parameter for assessment by credit managers.
2. **Capacity:** Capacity refers to the ability of the borrower to meet credit obligations from the operating cash flows in case of company and regular income in case of retail borrower. If the borrower is expected to have regular cash/income in future, at least till the life of the loan, that is sufficient to service the loan obligation, the borrower is considered to have the capacity to borrow.
3. **Capital:** Capital refers to the financial reserves of the customer. If the customer has difficulty in meeting his credit obligations from its operating cash flows, the focus shifts to its capital. If he has sufficient capital base, temporary irregularity can be handled but if

there is lack of capital and there is a possibility of irregular cash flow, the lender will need to make exceptions which depends on the case.

4. Collateral: Collateral refers to the security offered by the customer in the form of pledged assets. Collateral serves as a backup for the lender in case the borrower defaults in payment. The collateral or the underlying security should be adequate to meet the debt obligations and should have as much shelf life as the tenor of the loan. It should not become redundant in due course of time that brings down its market value which at any time may be lesser than the loan outstanding.

5. Conditions: Conditions refer to the general economic conditions that affect the customer and his business. They may be external like the business environment or regulatory aspects or competition but since they impact the productivity of the borrower, they are extremely important. For example, a polythene bag manufacturer applying for a loan when there is general environmental concern of pollution and focus on bio-degradable products, there certainly exists a risk for the business viability unless the manufacturer looks for different markets or product variation.