Welcome students.

In this session we shall cover the second unit functions of banks. Module name loans and advances. Importance of lending, principles of lending and credit management.
Module #16 outline. Importance of lending, principles of lending, credit management.

Learning outcomes.
After completion of this module, the student will be able to explain the importance of lending, explain the principles of lending, know the concept and 5 C's of credit management.

Functions of banks are classified into two: primary functions and secondary functions. Primary functions are further classified into accepting deposits and loans and advances. Secondary functions are classified as agency functions and general utility functions. In the previous modules you have studied the concept of accepting deposits and the various types of deposits. In this module we shall learn the meaning of loans and advances, it's importance and principles.

Loans and advances is the second primary function after accepting deposits. It is a major source of income to a bank.

Importance of lending for the bank.

Loans and advances form a major chunk of banks assets. Banks yield returns in the form of interest. By advancing loans to its customers. Banks charge interest at periodic intervals, which is generally monthly. Interest is received on the loans that are advanced and interest has to be paid on deposits that have been taken from the customers.So the difference between interest that is received, and interest that is paid is the net interest income of the bank.

Second, for the development of the economy. Banks ensure that the money reaches from the savers to the users. It helps in setting up and expanding business and trade in the country. Without bank loans,the country's industry, trade and Commerce will stagnate or grow very slowly. Any industry or business cannot depend solely on its own retained earnings and profits. At some point of time it will require loans from banks.

Third for the monetary system.
Banks are required to keep a specified small portion of their deposits in cash as cash reserve ratio, and the remainder is lent out. The funds lent out accrue as fresh deposits in the banking system, and these deposits are again loaned, so this is a process where the deposit that is head of the customers a certain portion is set aside and the remainder is lent. The amount that is given out asloans again is credited to the account of the borrower which accrues is fresh deposits.This finally increases the money supply. Let us understand this with the help of an example. The process of credit creation.

Here we have an initial deposit of rupees 1000, and assuming that the cash reserve ratio is10%. So keeping aside 10% of 1000, that is 100, the loans that will be advanced is rupees 900. So these loans which are given out that is rupees 900 will be credited to the account of the borrower and they will accrue as fresh deposits. In the first round we have deposits of 900 and a 10% reserve, which is set aside, rupees 810 will be given out as loans. 810 will be deposited in the account of the borrower in the second round and 10% is set aside, which is rupees 81 and the remainder is lent out in a similar manner. This process of credit creation continues.
Demand for credit creation will depend on how much of loans are lent to borrowers.

Next for the society.
Banks create employment opportunities and in turn generate income for the society. It deals with community welfare activities. Loans are given at very low and concessionary interest rates for the government's poverty elevation programs, such as National Rural Employment Program and such other activities.

Principles of lending

Bank has a main responsibility towards depositor's since depositor's keep their money with the bank. Principles of lending is of utmost importance to ensure that the amount that is lent to the borrowers comes back to the bank.

So the first principle is safety. Safety ensures that the amount that is lent to the borrower is paid back by the borrower on time. Safety will depend upon the borrower's integrity in paying back the amount on time.

Second is liquidity. Liquidity is the assets ability to be converted into cash at the time it is needed. As far as possible, banks should keep sufficient amount in a liquid form so that they can pay its depositor's on time. So for this purpose they should match their loans and deposits in such a manner that the loans are repaid on time and the depositor's money also can be paid.

Third is profitability.
Banks earn profits by lending,so the difference between the interest rates of lending and deposits is the profit to a bank.

Fourth risk diversification, risk diversification means living out loans to different types of sectors and at different locations. For example, if a bank gives out loans in one particular location and if there is a natural disaster in that area, there will be default on the part of the borrowers to payback the loan and hence the bank could suffer losses.

Last, purpose of loan. The purpose is the reason why the loan is being taken and for what it will be used finally. So a bank should ensure that the loan is used for the purpose for which it has been sanctioned.

And the purpose should be a productive one, which means that it generates income to the bank.

Credit management.

Credit management means the process of lending, deciding on the terms of lending and also getting back the amount which has been lent to the borrower.

5C's of credit management out of utmost importance in evaluating the borrower.

The first one is the character. The character deals with the borrowers reputation or the integrity of the borrower. The borrower's character will play a very important role because the borrower should have a mindset to pay back the amount that has been lent to him.

Second, capacity
Capacity means the ability to pay back the loan. The borrower will be able to pay back the loan out of the cash inflows that he receives.

Third. Capital
Capital is a financial result if the borrower is not capable enough or does not have the ability to pay back. Capital is of importance here because the borrower can pay out of his own capital.

Next, collateral
Collateral is a security that is given by the borrower. And this security act as a backup in case of default.

Last, condition
Conditions could be any situation that happens in the external environment, but does have an impact on the working of a firm. Any change in regulatory framework, for example, if a polythene bag manufacturer wants to avail of loans and if there is a restriction on use of polythene bags, then such a loan cannot be sanctioned by the bank.

So these are the 5C's of credit management.

Conclusion

Lending is the primary function of a bank.It generates income for the bank, develops the economy,helps in the process of credit creation, and develops the society.
Lending should be based on principles such as safety, liquidity, profitability, risk diversification and purpose of loan.
Credit management is a process of granting credit, setting the terms, and recovering the credit when it is due. 5C's of credit management such as character, capital, capacity, collateral and conditions is of utmost importance in assessing the borrower.

References.

Thank you.