



Module: English

Branch: Banking Marketing

Level: Master One

Lecture 03: Banking Techniques (loans and advances)

After going through this lesson, the student would be able to:

- Understand various types of credit facilities granted by banks
- Legal frame work and regulatory applications in lending by banks
- Importance of priority sector lending to Agriculture, SMEs, Women Entrepreneurs, etc.
- Deployment of funds to various loans and advances

1-The principles of lending

Safety

As the bank lends the funds entrusted to it by the depositors, the first and foremost principle of lending is to ensure the safety of the funds lent. By safety is meant that the borrower is in a position to repay the loan, along with interest, according to the terms of the loan contract. The repayment of the loan depends upon the borrower's (a) capacity to pay, and (2) willingness to pay. The former depends upon his tangible assets and the success of his business; if he is successful in his efforts, he earns profits and can repay the loan promptly. Otherwise, the loan is recovered out of the sale proceeds of his tangible assets. The willingness to pay depends upon the honesty and character of the borrower. The banker should, therefore, taken utmost care in ensuring that the enterprise or business for which a loan is sought is a sound one and the borrower is capable of carrying it out successfully. He should be a person of integrity, good character and reputation. In addition to the above, the banker generally relies on the security of tangible assets owned by the borrower to ensure the safety of this funds.

Liquidity

Banks are essentially intermediaries for short term funds. Therefore, they lend funds for short periods and mainly for working capital purposes. The loans are, therefore, largely payable on demand. The banker must ensure that the borrower is able to repay the loan on demand or

within a short period. This depends upon the nature of assets owned by the borrower and pledged to the banker. For example, goods and commodities are easily marketable while fixed assets like land and buildings and specialized types of plant and equipment can be liquidated after a time interval. Thus, the banker regards liquidity as important as safety of the funds and grants loans on the security of assets which are easily marketable without much loss.

Profitability

Commercial banks are profit-earning institutions; the nationalized banks are no exception to this. They must employ their funds profitably so as to earn sufficient income out of which to pay interest to the depositors, salaries to the staff and to meet various other establishment expenses and distribute dividends to the shareholders (the Government in case of nationalized banks). The rates of interest charged by banks were in the past primarily dependent on the directives issued by the Reserve Bank. Now banks are free to determine their own rates of interest on advances. The variations in the rates of interest charged from different customers depend upon the degree of risk involved in lending to them. A customer with high reputation is charged the lower rate of interest as compared to an ordinary customer. The sound principle of lending is not to sacrifice safety or liquidity for the sake of higher profitability. That is to say that the banks should not grant advances to unsound parties with doubtful repaying capacity, even if they are ready to pay a very high rate of interest. Such advances ultimately prove to be irrecoverable to the detriment of the interests of the bank and its depositors.

Purpose of the Loan

While lending his funds, the banker enquires from the borrower the purpose for which he seeks the loan. Banks do not grant loans for each and every purpose—they ensure the safety and liquidity of their funds by granting loans for *productive purposes only*, viz., for meeting working capital needs of a business enterprise. Loans are not advanced for speculative and unproductive purposes like social functions and ceremonies or for pleasure trips or for the repayment of a prior loan. Loans for capital expenditure for establishing business are of long-term nature and the banks grant such term loans also. After the nationalization of major banks loans for initial expenditure to start small trades, businesses, industries, etc., are also given by the banks.

Principle of Diversification of Risks

This is also a cardinal principle of sound lending. A prudent banker always tries to select the borrower very carefully and takes tangible assets as securities to safeguard his interests. Tangible assets are no doubt valuable and the banker feels safe while granting advances on the security of such assets, yet some risk is always involved therein. An industry or trade may face recessionary conditions and the price of the goods and commodities may sharply fall. Natural calamities like floods and earthquakes, and political disturbances in certain parts of the country may ruin even a prosperous business. To safeguard his interest against such unforeseen contingencies, the banker follows the principle of diversification of risks based on the famous

maxim “do not keep all the eggs in one basket.” It means that the banker should not grant advances to a few big firms only or to concentrate them in a few industries or in a few cities or regions of the country only. The advances, on the other hand, should be over a reasonably wide area, distributed amongst a good number of customers belonging to different trades and industries. The banker, thus, diversifies the risk involved in lending. If a big customer meets misfortune, or certain trades or industries are affected adversely, the overall position of the bank will not be in jeopardy.

2- Assessing the Creditworthiness of Borrowers

The creditworthiness of a person means that he/she deserves a certain amount of credit, which may safely be granted to him. Such creditworthiness is judged by the banker on the basis of his/her (1) character, (2) capacity, and (3) capital.

. **Character:** In assessing the creditworthiness of a person, the first consideration is that of the character of the person concerned. The word character implies and includes a number of personal characteristics of a person, e.g., his honesty, integrity, regularity and promptness in fulfilling his promises and repaying his dues, sense of responsibility, good habits and the reputation and goodwill which he enjoys in the eyes of others. If a person possesses all these qualities, without any doubt or suspicion in the minds of others, he possesses an excellent character and will be considered creditworthy by the banker.

. **Capacity:** The success of an enterprise largely depends upon the ability, competence and experience of the entrepreneur. If the borrower possesses necessary technical skill, managerial ability and experience to run a particular industry or trade, success of such unit may be taken for granted (barring some unforeseen circumstances) and the banker will consider him a deserving case for granting an advance. The significance of this factor is now growing as the banks are willing to grant unsecured loans to technicians and competent persons on the basis of soundness of their business projects, irrespective of their own capital.

. **Capital:** The importance attached by the banker to the adequacy of capital of the borrower is not without significance. Banks are the repositories of the public money and lend the borrowed money. The banker, therefore, does not lend money to an entrepreneur who does not have adequate funds of his own. In case of failure of the business enterprise, the banker will be able to realize his money if the borrower’s own capital is sufficient.

3-TYPES OF CREDIT FACILITIES :

- Cash credit

Cash credit is the main method of lending by banks in total bank credit. Under the system, the banker specifies a limit, called the cash credit limit, for each customer, up to which the customer is permitted to borrow against the security of tangible assets or guarantees. Cash credit is a flexible system of lending under which the borrower has the option to withdraw the funds as and when required and to the

extent of his needs. Under this arrangement the banker specifies a limit of loan for the customer (known as cash credit limit) up to which the customer is allowed to draw. The cash credit limit is based on the borrower's need and as agreed with the bank. Against the limit of cash credit, the borrower is permitted to withdraw as and when he needs money subject to the limit sanctioned. It is normally sanctioned for a period of one year and secured by the security of some tangible assets or personal guarantee. If the account is running satisfactorily, the limit of cash credit may be renewed by the bank at the end of year. The interest is calculated and charged to the customer's account. Cash credit, is one of the types of bank lending against security by way of pledge or /hypothecation of goods. 'Pledge' means bailment of goods as security for payment of debt. Its primary purpose is to put the goods pledged in the possession of the lender. It ensures recovery of loan in case of failure of the borrower to repay the borrowed amount. In 'Hypothecation', goods remain in the possession of the borrower, who binds himself under the agreement to give possession of goods to the banker whenever the banker requires him to do so. So hypothecation is a device to create a charge over the asset under circumstances in which transfer of possession is either inconvenient or impracticable.

- Overdrafts

When a customer is maintaining a current account, a facility is allowed by the bank to draw more than the credit balance in the account; such facility is called an '**overdraft**' facility. At the request and requirement of customers temporary overdrafts are also allowed. However, against certain securities, regular overdraft limits are sanctioned.

- Bills Finance

In order to ease the pressures on cash flow and facilitate smooth running of business, Bank provides Bill finance facility to its corporate / non corporate clients. Bill finance facility plugs in the mismatches in the cash flow and relieves the corporates from worries on commitments. Besides the fund based bill finance, we also provide agency services for collection of documentary bills/cheques. Under bills finance mechanism a seller of goods draws a bill of exchange (draft) on buyer (drawee), as per payment terms for the goods

supplied. Such bills can be routed through the banker of the seller to the banker of the buyer for effective control.

- Working Capital

The term “Working Capital” means, the funds required by a company, enterprise to carry on with daily operations.

The features of Working Capital (WC) are:

(a) WC is the short term funds required to meet the daily operating expenses.

(b) $WC = \text{Current Assets} - \text{Current Liabilities}$.

(c) Managing the short term fund requirements through the firm’s short term assets and short liabilities is

known as “Working Capital Management”.

(d) One of the main objective of Working Capital Management is to convert **Cash to Cash (C to C)** in a cyclical form called as “working capital cycle”.