Chapter 1: The principles of lending and lending basics

Solutions to discussion questions

Q1. What factors have to be taken into account by a bank in considering an application for an advance?

The factors that banks generally take in to account when an application for advance is received can be grouped in to three categories: external factors, internal factors and borrower specific factors.

External factors involve examining whether the bank is authorised to lend for the purpose intended. This involves asking questions like: Is the activity for which finance is sought lawful? Does it comply with legislation that regulate bank lending (the Banking Act 1959, Uniform Consumer Credit Code, ASIC Act 1989)? What macroeconomic factors may affect lending decisions? Is the industry to which the borrowing firm belongs in good shape or are there any problems peculiar to this industry? A bank can’t lend for unlawful activity like narcotics trade or financing terrorism, for example.

Internal factors refer to bank specific factors. This involves examination of aspects like whether the activity conforms to the lending policy of the bank, how much loan budget is available for the type of activity for which finance has been sought, and whether staff and other resources are available to scrutinise, approve and subsequently monitor the application? The top management of the bank may have decided not to lend for commercial property in particular region, for example.

Borrowing specific factors include an examination of the traditional five Cs of lending. The five Cs approach involves assessment of character, capacity, capital, conditions, and collateral. Character assessment involves collecting information about the borrower’s track record of integrity, repayment ability and spending habits. Capacity refers to the ability to repay the loan together with interest as per a predetermined schedule. Capital refers to the capital contribution or own contribution that the borrower will make out of the total resources. Conditions refer to the macroeconomic conditions that affect lending as well as the terms and conditions subject to which the bank may be prepared to finance. Collateral refers to the security that underlies the finance. It is something that the bank can fall back up on in the event of default.

If the above factors are favourable, the bank may consider granting an advance.

Q.2. What is creditworthiness and how can it be determined?

Credit worthiness means whether the prospective borrower is worthy of receiving requested credit (finance). This worthiness is determined by following the five Cs approach as explained above. Where a lending institution feels that the prospective borrower may be entitled or worthy of receiving lower than the requested credit, it may slash the amount requested suitably.
Q3. Why do banks require a customer to contribute some of the capital required for a project?

Banks and other lending institutions invariably expect that the prospective borrower contribute at least a part of the total cost of a project, the remaining portion to be financed out of bank loan. The contribution that a prospective borrower makes is called ‘borrower’s margin’ or ‘borrower’s capital’. The reason why lending institutions usually ask for it is to create a stake for the borrower in the project. When the borrower’s own money is involved, the borrower will automatically work sincerely and diligently to ensure success of the project, which in turn will lead to repayment of loan together with interest. The capital contributed by the borrower also reduces the lender’s risk exposure. Hence, the higher such capital contribution, the less risky it is for the bank. In case of home loans, for example, lending institutions require borrower to contribute at least 20 per cent of the total cost, thus ensuring that the loan-to-value ratio is 80 per cent. Where the loan-to-value ratio is more than this, that is, where it is say 90 per cent (10 per cent being contributed by borrower), lenders usually insist on mortgage insurance. The riskier the loan, the more capital contribution lenders require borrower to make. In margin loans (finance for purchase of shares in listed companies), the portion that the borrower contributes is 30 per cent in case of blue chip companies and may be 40 or 50 per cent in case of other companies. Thus, the capital contribution that lenders expect borrowers to make shows how risky the lender considers the activity for which finance is sought.

Q4. Distinguish between a loan and an overdraft.

Traditionally, bank finance is classified between these two major categories, loan and overdraft. There are many points of difference between a loan and an overdraft:

(a) A loan is a fixed sum of money advanced by a bank as one lump sum payment. An overdraft is like a running account subject to a limit.
(b) The purpose for which a loan may be given is generally to purchase an asset like plant and machinery or house. An overdraft is usually given for meeting operational expenses or working capital as it is called in business terminology.
(c) As a running account there could be many debits and credits in an overdraft account. However, in the case of loan account, there will be debits only towards lump sum advanced and periodical interest and fees. There could be credits that represent periodical repayments.
(d) A loan is generally given against collateral. An overdraft may not be secured by collateral, that is, it may be ‘clean’ or unsecured.
(e) A chequebook is usually issued to the borrower who has been allowed an overdraft, while no such chequebook is necessary for borrowers of a loan.
(f) Loan repayments are made by equated periodical instalments. Overdrafts do not involve such periodical repayments. Thus, an overdraft account may come in credit and again go in debit many times during the period of overdraft.
(g) Overdrafts are usually given for a short period of time, say one year. These can, however, be renewed at the end of the year. Loans are generally given for medium to long term. The period may vary from 3 to 5 years or even up to 25 years.
(h) Interest is charged on overdrafts on product basis; that is, interest is charged on the number of days an amount remains in debit. In the case of loan, the interest amount is included in the equated monthly or fortnightly instalment that the borrower has to pay.
(i) The borrower may be charged a prepayment penalty in the case of repayment of a loan earlier than scheduled. There are no prepayment penalties in case of an overdraft. The
borrower can bring the overdraft account in credit and may allow it to remain like that for months.

Q.5. What are the advantages of a framework for credit and lending decision-making?

The framework of credit and lending decisions consists of consideration of external, internal and borrower specific factors. The main advantage of following a framework is that it ensures that decisions are made with due consideration of all aspects of lending. Secondly, the lending officers could be certain that they have not violated any of the relevant requirements. If, for example, lending officers make a decision without consideration of the bank’s policy, they may be subjected to strictures from internal audit. Thirdly, as decisions are made systematically, the credit risk is greatly reduced. Fourthly, the lending institution could be certain that it has not contravened provisions of any legislation. Fifthly, the top management could be certain that bank loan policy is implemented at the branch level by lending officers.

Q6. What is credit analysis? What are the various steps involved in credit analysis?

Credit analysis refers to the assessment of credit worthiness of the borrower or the credit risk associated with a loan approval. The various steps involved in a typical credit analysis are as under:

Step 1: Obtain prescribed loan application form duly completed and signed by the prospective borrower.
Step 2: Obtain required documents and financial statements. This includes basic documents of identity like borrower’s driving licence, for example, or documents of constitution like partnership deed in case of firms.
Step 3: Check the loan application form and attached documents for internal consistency.
Step 4: If all the information has been received, preliminary decision with regard to approval or otherwise of a loan would be made at this stage.
Step 5: Conduct detailed appraisal of technical, commercial, financial and managerial aspects of the loan proposal.
Step 6: Assess the financial requirements of the borrower and the type of facility to be approved.
Step 7: If the proposal is approved send a letter conveying the approval to the borrower advising to execute documents before loan disbursement could be made. Where the proposal is not approved, reasons for rejection need to be recorded.
Step 8: Where the loan is approved it is important to ensure that all required documents are executed before loan is disbursed to the borrower.
Step 9: Monitor the account periodically to ensure that it is running in order.
Step 10: Where the loan account is not in order, a ‘hard core’ has developed in the account for example, lender must take immediate action to avoid it from becoming a problem loan account.

Q7. What does structuring of advances mean?

Structuring advances involves three major aspects: obtaining security and other documentation, deciding debt covenants and pricing.
Security: Security, also known as collateral, is like an insurance that protects the lender in the event of loan default. Where the borrower is unable to repay the loan in full or in part, and other avenues of recovering the loan have been exhausted, the action of last resort is taking possession of security and selling it off in satisfaction of the loan. Lending institutions obtain various types of securities. These could be mortgage of house in home loans, guarantee in case of personal or business loans, inventory, assignment of life policies, charge over assets of the business etc. It is important to remember that security possesses certain qualities like ease of valuation, portability, non-perishability, transferability and the like. It is also important to ensure that all the documents like mortgage deed, guarantee, promissory note are duly executed (stamped as per law, signed in presence of bank officers, alterations if any are authenticated). These documents are subject to period of limitations hence it is important to ensure that these are periodically renewed.

Debt covenants: Covenants refer to terms and conditions laid out in loan contracts. These include covenants with respect to fees and interest rates, security and insurance, repayments and actions in case of default and stamp duty and government charges. Negative pledge, for example, is a covenant whereby the borrower undertakes not to provide any further security to another lender or to do so only on a restricted basis.

Pricing issues: These include interest rates and fees and charges on advances. Most lending institutions will have a base rate to which they add risk premium. Interest rates could be either fixed or variable. There are various types of fees like loan establishment fee, application fee, loan administration fee etc.

Q8. What are the different types of borrowers?

Borrowers are broadly classified into two types: personal borrowers and business borrowers. Personal borrowers are generally individuals, households and families. They require loans to satisfy personal needs like travel, education, home repairs, expenses etc. There are also some special types of personal borrowers. These include: minors, person of unsound mind, insolvents, joint accounts etc. Minors are persons who have not attained 18 years of age. Minors have no capacity to contract and lending institutions should not make loans to minors. Persons of unsound mind can enter into contract during the period in which they are sound mind. Banks should not lend to an undischarged insolvent or a person against whom insolvency proceedings are pending. Where an account is a joint account, the banker must obtain joint holders’ clear and specific authority regarding one or more of the parties overdrawing the account, taking an advance or charging a security.

Business borrowers could be sole proprietorship, partnership or a corporation. A sole proprietorship is a business that an individual owner conducts in his/her own name or a trade name. Partnership is a relation between persons who have agreed to share the profits of a business carried on by all or any one of them acting for all. A company is an artificial person created by law. Some other types of borrowers include local authorities, clubs, literary societies and schools, unincorporated associations and co-operatives.

It is important for a lending banker to know the various types of borrowers because the legal requirements in granting a loan significantly depend up on the category to which a borrower belongs.
Q9. What is meant by credit culture? Why is it so important?

Credit culture refers to institutional priorities, traditions and philosophies that surround credit or lending decisions. Every organisation has its own culture that distinguishes it from other competitors. Credit culture includes things such as strong customer orientation, willingness for risk taking, response time to customers etc. Credit culture is important as it prepares all employees to accordingly respond to customers and situations in credit and lending decisions. It brings uniformity in response of the lending organisation wherever its branch located and whoever may be the officer dealing with a loan proposal. Once a strong credit culture is developed, the organisation gets recognised for certain principles, actions, deterrents and rewards within it. This helps attract customers. Lending organisations take considerable care to develop a proper credit culture. It avoids its officers taking unnecessarily risky decisions and at the same time not losing to competition in the wake of a possible opportunity.

Q10. ‘Lending is an art not a science’. Do you agree with this statement?

The way the lending function was traditionally carried out made one believe that lending is an art. Lending decisions were more subjective in nature. Mostly these were taken depending up on the gut feeling of lending officers. It was thought that every lending proposal was unique and it was hard to put it in a framework that followed definite rules as are normally seen in a scientific paradigm. However, over the years with the advancement of computer capabilities and statistics, many credit risk models have been developed which have brought objectivity in decision making which is a hallmark of science. Credit scoring models, for example, enable vast numbers of loan proposals to be assessed accurately in considerably less time. The sophistication of techniques available for decision making have removed subjectivity to a great extent and lending decisions can now be taken by use of technology and advanced statistics. Hence, it may be appropriate to regard lending more as a science than as an art. However, despite the modern and advanced techniques, it is not possible to altogether replace lenders judgement, which comes only with experience. Hence, lending still continues to be an art. It is often said that technology helps decision making, but it can’t make a decision, which requires human intervention. Thus, it is difficult to give a definite answer to the above question but modern day lending could be regarded as more science than art.