# Unit 3: Loans and Advances

**Contents**

3.0 Aims and Objectives

3.1 Introduction

3.2 Meaning of Loans and Advance

 3.3 Classification of Loans and Advances

* + 1. Based on the Nature of the Loan

3.3.2 Based on the Purpose of the Loan

3.3.3 .Based on the Period of the Loan Granted

3.3.4 Based on the Nature of Security

3.4 Principles of Guidelines for Secured Advances

3.5 Consideration for sound lending

3.6 Factors Limiting the Level of Advance

3.7 Principles for Sound Lending & Investment

3.8 Types of Securities

3.9 Loan policy

 3.9.1 Factors that influence a Bank’s loan policy

 3.9.2. Items Included in a loan policy

 3.9.3. Loan pricing

 3.9.4. Administration of the loan Policy

3.10 Organization of Bank Lending

3.11 Follow-up and Supervision

 3.11.1 The process of Supervision

 3.11.2 The Technique of supervision

3.12 Summary

3.13 Answer to Check Your Progress Exercise

**3.0 Aims and Objectives**

At the end of this unit, you are expected to:

* define a loan
* discuss the types of loans
* understand the purpose of loan policy in a given bank
* discuss about the components of a loan policy
* identify the price of a loan and the factors which determine the loan price
* understand the loan administration process
* understand the loan follow-up and supervision processes.

**3.1 INTRODUCTION**

Lending is one of the most important functions of banks. It is one of the oldest functions of a bank just next to the function of accepting deposits. Actually, both accepting deposits and advancing loans are known as the main functions of the bank. Accepting deposits is to create loan able funds to borrowers. Therefore, they are supportive functions of a bank. The bank creates loans on funds it accepts from the public in a form of deposits. Hence, the bank is lending, in practice, not his own money, but the public money. Therefore, the bank should take the necessary precautions while lending money so as to insure the repayment of once advanced money. Otherwise, it will be closed if the loan is not collected and money is not available at his possession to honor cheques issued by customers. In order to avoid this problem banks develop loan policies. This enables them to follow uniformity and minimizes possible errors while lending.

This unit discusses about the meaning of a loan, its classification, loan policy, loan pricing, loan administration, etc.

**3.2 Meaning of Loans and Advances**

Loans are money granted by creditor to a debtor to be paid in a future fixed period with an interest. To the debtor, loan means getting the purchasing power (i.e., money) now by a promise to pay at some time in future. In a sense, the words credit, debt and loan are synonymous: credit or loan is the liability of the debtor and the asset of the bank(creditor).

The word credit is derived from a Latin word 'credo' which means "I believe". This indicates that loans are granted on the bases of trust and belief. Advancing credit or loan essentially depends upon the confidence, character, capacity, capital and collateral of the debtor.

**3.3 Classification of Loans and Advances**

One of the main questions of Banks is advancing loans to customers in different ways for different purposes and for different time span. Hence Bank Loans and advances can be classified into different categories using different criterion such as nature purpose, time, security and method of repayment.

**3.3.1 Based on the Nature of the Loan**

A bank may make advances to traders and industrialists and others in many ways. But the main forms in which money is advanced by the bank are: loans, cash credits, overdrafts, purchase and discounting bills and call/notice loans.

1. **Call/Notice Loans:** are types of loans that are granted for a customer for a period of from an overnight to a maximum of 14 days. It is used for temporary purposes and are granted with out securities.
2. **Cash Credit:** it is an arrangement under which a borrower is allowed to borrow up to a certain limit against the security of tangible assets or guarantees. Thus, cash credit may be regrouped as a secured cash credit and a clean cash credit. Under secured cash credit, the customer is required to provide tangible assets as security to cover the amount borrowed from the bank. In case of clean cash credit, the customer provides the bank with a promissory note, which is signed by one or more security or securities.

In case of a cash credit, the customer need not withdraw the entire amount as in case of a loan. He can withdraw from his cash credit account any amount within the limit specified as and when required and can deposit any amount of money, which he finds surplus with him. Thus, unlike loan account, cash credit account is a running account from and to which withdrawals and deposits can be made frequently. The customer has to pay the interest only on the amount actually utilized by him and not on the limit granted. If the cash credit is a secured one, securities furnished by the customer can be increased or decreased according to the amount withdrawn and the customer is allowed to replace one kind of security with another.

The limit of cash credit is fixed by the bank very carefully after considering a number of factors such as production, sales, inventory levels, credit worthiness of the borrower etc. A cash credit is repayable on demand though in practice the limit is available for a stipulated period. The securities offered by the borrower can be adjusted according to the amount withdrawn.

When a bank grants cash credit to a customer, it fixes a ceiling or limit beyond which the customer cannot draw but within which he can draw any amount he likes. The customer need not withdraw the amount in one lump sum; he can withdraw according to his requirements. The drawback of cash credit system is the existence of large unutilized credit limits. The unutilized portion of the credit limit is to be taken as the difference between the borrower's requirement and the average use of credit during each quarter. This portion of the cash credit remains unutilized and idle which the borrower normally do not pay interest. It will not be income-earning asset to the banker. Therefore, the banker charges a penalty rate usually 1% to compensate the loss encountered by the banker while maintaining idle cash for the benefit of the customer.

1. **Overdrafts:** a person is said to be availing overdraft from a bank, when his account with the bank shows a debit balance. Under this arrangement, the bank allows its customer to overdraw his current account so that it shows a debit balance. Any business person can enter into this arrangement to tide over a temporary shortage of funds. The bank may take some tangible security of the borrower. The customer can draw his fund as and when he requires and repay it when it is convenient for him. The operation of overdraft is same as that of cash credit with the main difference that cash credit is a little long-period accommodation. The customer is charged interest on the amount actually overdrawn by him and not on the limit sanctioned. He will be charged no interest if he does not overdraw at all during a particular period.

In practice, the arrangement for overdraft and cash credit is identical except that in the case of an overdraft the arrangement is in relation to a person's current account. Thus, the extension of overdraft facility presupposes the existence of a current account in the name of the borrower. The banker gains from good current accounts which maintain daily cash balances. The moment the customer begins to overdraw amounts, the banker will be deprived of this benefit. The funds of the banker will be in the hands of the customer.

Overdrafts are the withdrawals made according to the convenience of the customer. A sudden spurt in withdrawals will reverse the plans of the banker. However, the banker while permitting the operation of the overdraft account fix the limit of overdraft. Hence, the bankers plan takes into account these arrangements.

Overdrafts facilitates are granted for six months time with subject to renewal up on the agreement of both parties i.e., the banker and the customer. It is used to solve temporary financial deficit by the customer. Whereas, cash credit is granted for a long period of time and used to alivate permanent financial problem of the customer.

1. **Purchase and Discounting of Bills of Exchange:** the bank provides the customers with the facility of purchasing and discounting their bills receivable. This is a method of financial accommodation offered by the banker to the customer. The bank permits the customer to discount his bills receivable and have the value of the bills credited to his account. The bank charges on the face value of the bills. It waits till the maturity of the bill and presents it on the due date to the drawee for payment. After collection, the proceeds of the bill are appropriated towards the loan and interest due by the customer. If the bill is dishonored, the amount will be recovered from the customer.
2. **Loans:** when a bank makes an advance in lump sum the whole of which is withdrawn in cash immediately by the borrower who undertakes to repay it in installments, it is called a loan. Here advance is made on a separate loan account to which the whole amount of loan is immediately credited. The borrower is required to pay the interest on the whole amount from the date of sanction withheld draws the full amount from the loan account or not. If he does not withdraw the entire amount, the real rate of interest will be higher than the rate of interest on cash credits and overdrafts. In some cases, the bank may also agree for the repayment of loan in installments.

A loan is different from a cash credit. Cash credit is of a continuing nature, i.e., money can be withdrawn or paid into the cash credit account and interest will be charged only on the actual credit. But in case of a loan, the interest is charged on the entire amount and a loan once repaid in full or in part cannot be drawn again. A borrower has to apply for a fresh loan if he needs funds. The second transaction will be totally distinct from the first one. Commercial Banks generally advance loans for short-terms and medium terms. Since the banks charge interest on the entire amount of loans, this way of raising funds is costlier to the customer as compared to cash credits and overdrafts.

The banker prefer loans to cash credit because of two reasons:

1. The bank can charge interest on the entire amount of the loan Sanctioned or disbursed.
2. Loan account involves a smaller operating cost than overdraft or cash credit because in the latter case there is a continuity and magnitude of operation.

**3.3.2 Based on the Purpose of the Loan**

On the bases of the purpose, the loan is granted for, loans can be sorted out in to the following groups.

1. **Commercial Loans:** they are types of loans granted for commercial purposes i.e., to facilitate transactions being made between different firms. They have a short-term life i.e., such loans are granted to fulfill short term financial problems of firms so they have short duration. They may be given to businesses so as to pay salaries, to buy raw materials, to pay expenses, or to buy commodities to be resoled.
2. **Industrial Loans:** they are loans granted to industrialists for the purpose of constructing or buying industrial buildings and to buy other fixed assets. Therefore, they have a long-term life.
3. **Agricultural Loans:** they are types of loans to be granted to the agriculturalists. They may be given for the purpose of buying land, cultivating and developing the land, buying tractors, fertilizer, insecticide, selected seeds, etc. They have both short life and long life. Those loans granted to acquire land to cultivate and develop the land and to buy tractors have long repayment life. Whereas loans granted for fertilizers, insecticides, selected seeds have short repayment life.
4. **Educational Loans:** they are granted to finance education expenses of a customer.
5. **Medical Loans:** they are granted to a customer in order to finance his medication expenses.

**3.3.3 Based on the Period of the Loan Granted**

Loans may be granted for different span of time. Some may given for short time span and others for long time span and others for intermediate time span. Accordingly loans are divided into three groups.

1. Short-term loans: they are loans usually granted for a period of time up to and less than one year.
2. Intermediate loans: they are loans usually granted for a period of time of from one up to five years.
3. Long-term loans: they are granted for a period of time above five years.

Note: that this way of classification seem a bit practice, otherwise there is no general rule that dictates loans to be classified on the bases of this time horizon. Different banks can set different time horizon so as to classify as short, intermediate, and long-term loans.

**3.3.4 Based on the Nature of Security**

Loans may be classified based on their level of guarantee as secured and unsecured loans.

1. **Unsecured or Clean Loans/Advances:** the loan, cash credit, overdraft allowed by a bank to a business person without any security of tangible assets is known as unsecured or clean loans/Advances. It is allowed to the customer against his personal security or promissory note. When the customer is a man of outstanding reputation and sound financial position, he may be granted a loan or allowed on overdraft by the bank on personal security. Such an advance is known as clean or unsecured advance and is granted against the promissory note of the borrower. But in order to safeguard its position, the bank may insist on the signature of one or more independent surety(ies) or guarantor(s) on the promissory note executed by such a person. In case the principal debtor does not make the payment and the bank is not able to receive full payment from the property of the debtor, it can claim from the surety or sureties.

Banks may allow unsecured advances in the following ways:

* 1. cash credit against hypothecation of movable property.
	2. purchasing and discounting of bills of exchange
	3. purchasing and discounting of documentary bills covering exports.
	4. advances against promissory notes guaranteed by one or more persons of good credit worthiness.
	5. advances against government supply bills.

Unsecured loans are risky as in such cases, bank relies entirely on the integrity, reputation and strength of character of the borrower. Banks generally advance clean advances to big business persons who command unimpeachable reputation in the business world. Clean limit is generally granted to supplement the limit granted on a secured basis.

While granting a clean credit, a bank should be very cautious as to the character and capacity of the borrower. By character, we mean that a person has a number of attributes like honesty, integrity, and promptness in fulfilling his promises. He should enjoy good reputation in the eyes of others. The borrower's capacity is also an important factor while granting a clean limit. The borrower should have the required ability, competence and experience to invest the credit judiciously and earn profits to pay back the loan. The borrower must be competent to handle the project.

1. **Secured Advances/Loans:** by secured advances we mean those advances which are granted against some tangible securities apart from the promissory note of the borrower. Secured loan or advance means a loan or advance made on the security of assets, the market value of which is not at any time less than the amount of such loan or advance. The securities against advances are also known as "collaterals". Collateral means additional and securities offered by the borrower and called collaterals because they are offered in addition to the personal security of the borrower. They can be disposed of only in the event of the failure of the borrower to repay the loans.

The value of the securities is to be taken at market price and not at the cost price or book value for the purpose of making an advance. If a customer applies for a loan of Br 400,000.00 and offers shares of the nominal value of Br 300,000.00 as security. The bank should immediately try to know the market value of the shares. Let us suppose the real value of the share is Br 200,000.00. In such a case, it is advisable for the bank to advance loan of Br 200,000.00. Bank cannot be called partly secured in this case because there is no such term in the banking practice.

This implies that the market value of the securities should be equal to or more than the amount of advance throughout the currency of the loan. That is why, banks generally restrict the loan up to 60 to 70 percent of the market value of the security offered.

Collateral securities, which are offered in addition to the personal security of the borrower against an advance made to him may take any form of the following.

1. any security in physical form lodged by the borrower or a third party as also the guarantee given by a third party.
2. two or more securities which cover the same debt, e.g., hypothecation of goods and mortgage of property.
3. third party guarantee given in addition to the borrower's guarantee. This would enable the banker to recover the maximum amount possible form the estate of the borrower by claiming the full amount of the advance (or by reducing the amount of any direct security deposited) and thereafter utilizing the third party security for making good the deficit in the amount, if any.

**3.4 Principles or Guidelines for Secured Advances**

An important function of a bank is lending of money to commerce and industry. Money is generally lent to the individuals and organizations in the form of secured advances. The bank earns interest over these advances, which is an important source of income for it. But at the same time, the bank undertakes to entertain so many risks associated with the advances. In order to avoid these risks a bank has to follow some general principles while lending money. The most important principles of sound lending are liquidity, profitability and safety.

Liquidity is important to ensure that the demands of the depositors are met easily. Profitability is essential to meet the expenses of the bank and to earn sufficient profits. Lastly, the advances should be made to those parties, which are likely to repay them along with the interest. Safety of the funds is very essential for the survival of the bank. In order to follow this principle, banks insist on securities against the various types of advances. But, however, a bank is not merely guided by the security. To cover up the advance, it is guided by many other considerations. These considerations can be discussed as follows:

1. **Credit-worthiness of the borrower:** the fundamental principles on which credit is based is the credit worthiness of the borrower. Credit-worthiness of the borrower is based on his reliability, responsibility and resources. The bank should give loan to the person who is reliable and a man of integrity and has the intention to repay the loan. He must be a responsible person, otherwise he will mis-utilize the loaned and will not repay it. Mere reliability and responsibility are not enough. He must have adequate resources also. If some loss takes place, he should have the capacity to bear it. Thus, the first principle requires that a bank must satisfy itself that the proposed borrower is honor, reliable, responsible and financially sound.
2. **Financial position of the borrower:** a bank must examine the financial position of the prospective borrower. It should ask for the profit and loss account and balance sheet of the last few years. This will help the bank to know the nature of the business and liquidity position of the assets of the borrower. Sound financial position of the borrower is necessary to be sure that the borrower has the capacity to repay the loan.
3. **Purpose of the loan:** a bank must examine the purpose for which the loan is required. The loan must be granted to increase the income earning capacity of the borrower because, otherwise, he will not be able to pay back the loan. If a loan is granted to repay an existing debt, it will not increase the income earning capacity of the borrower and it will be difficult for him to repay the loan.
4. **Amount and Period of Loan:** a bank cannot grant big loans to a few individuals or concerns. It has to meet the requirements of many persons. Similarly, a bank cannot grant loan for unduly long periods because a major portion of its deposits represents demand deposits which are repayable on demand, so the bank must consider the period of loan while examining the proposal from the borrower.
5. **Security Offered:** the bank should also consider the nature of security offered for the advance. A bank should accept that type of security, which is easily marketable and stable in value. A bank should keep adequate margins in case of securities whose prices fluctuate widely. The bank should also verify that the borrower is the real owner of the security offered. The bank must take the possession of the security. The borrower must pledge the security, if it is movable, and mortgage it, if it is immovable, pledge or mortgage must be executed by way of legal documents as far as possible.
6. **Adequate Margin:** a bank should not lend up to the full value of the security provided because its value may go down with the passage of time. It must keep a sufficient margin so that it does not suffer loss because of loss in its value due to depreciation or fall in its price when the borrower makes difficult in making the payment. The margin should also be sufficient to cover the cost of realizing the asset and the interest charges in case of default by the borrower. It is clear that if the loan is not paid regularly its outstanding balance go up, but the value of the collateral may go down due to depreciation and other reasons. Therefore, the gap between the loan amount and the value of its collateral must be enough to cover this uncertainty.
7. **Diversification:** the advances of the banks must be spread over different regions, industries and sectors. The bank should not grant loan only to a few persons or concerns. If the advance portfolio of the bank is diversified, the bank will not suffer heavy loss if a firm fails to repay the loan. So a bank should grant short and medium term loans to a number of persons and business organizations whose projects are sound and who offer sufficient security of tangible items. In other words, the bank should avoid keeping all eggs in one basket.

**3.5. Considerations for Sound Lending**

The banker, before advancing loans to customers should take certain considerations. These considerations are related to the bank itself, the borrower and the project.

## A) Consideration About the Bank Itself

The banker should investigate his home regarding its liquidity, solvency and profitability, before advancing loans to customers.

* **Liquidity:** means the ability to meet deposit withdrawals and currency outflows and the availability of sufficient liquid asset.

The banker is obliged to pay cash as customers demand withdrawals and to pay liabilities at maturity date. If the bank fail to fulfill currency outflow as demanded, due to lack of liquid cash (currency) the bank regulators will take an immediate action up to closure of the bank.

* **Solvency:** this is the state of the relationship between its assets and liabilities. When the value of the bank's total asset is greater than the value of the bank's total liability the bank is referred as solvent and when the value of the bank's total asset is less than the value of the bank's liability, the bank is referred as insolvent. In general, the banker's asset value should be solvent to be credit worthy. Otherwise, the banker will be liquidated, if creditors claim their balance. The greater the solvency of the banker, the greater its ability to advance loans to customers.
* **Profitability:** the main purpose of banking business to maximize profit and earnings/returns of shareholders in a form of dividends. Hence, bank loans are the main sources of bank profitability. However, as the bank advances loans, there are certain riskier conditions that may arise from: interest rate fluctuations (interest rate risk), borrowers default (credit risk) and liquidity problem by the bank (liquidity risk).

Therefore, as the banker try to maximize profit, it should at the same time stick the balance with these risks that could arise due to advancing loans.

## B) Consideration About the Customer

Banks do not advance loans to any one who demands credit. Not all applicants are genuine. There are people who apply for loan from the bank either without having a well studied project, or without having the required skill to manage the business or with some purpose other than stated in the application. Therefore, a banker before advancing loans to applicants, be has to evaluate and select the right applicant that can properly utilize the loan amount and who can make more value /surplus/ on the project. So as to do that the bank can appraise the following five C's about a customer.

1. **Character:** here we can raise a number of questions that helps us to weigh the behavior of the applicant. For example, Is the customer dependable? Is the customer willing to repay the loan according to the contract? Is he willing to use the fund advanced for the right purpose that he applied for? Etc
2. **Capacity**: the ability of the borrower to manage his business is a vital consideration made in advancing a loan. In order to measure his capacity to manage his business, we can see his educational level and type and his experience as an entrepreneur or as an employee.
3. **Capital**: here we measure the financial soundness of the customer. If a customer covers majority of the project cost, it is believed that, he will be highly committed to the success of the business/project. The bank can measure not only his contribution to the project, but also his alternative sources of capital to repay the loan in the event of adverse circumstances?
4. **Credit Worthiness**: is the customer honest? Can he be up to his contract? This can be derived either the customers past experience with the bank or the customer's relationship with other banks. Credit information is collected from other banks, too, for that effect.
5. **Collateral**: The purpose of advancing loan is to enable the customer to undertake his business in a better standard and achieve a better value to himself – profit and to enable him to repay the loan within the agreed time period. However, things do not go always right as being expected to be. The business may get bankruptcy and the loan remain unpaid. Therefore, so as to secure the repayment of the loan the banker requires customers to provide adequate collateral/security for the loan. If the loan is not repaid as agreed up on the bank can sell/auction the property and use the proceed to cover the unpaid balance. It must be noted, however, that the purpose of the collateral for the banker is not to disbanded the owner with outright sale.

**C) Consideration About the Proposal/Project**

 Bank loans are not free gifts that can be used by the borrower as he wish, rather it must be used for the right purpose the loan is granted for in a regulated manner. Therefore, the banker while financing projects, it should consider certain paints about the project/proposal such as:

1. **Purpose:** The purpose of a project being financed by the bank should not be contradicting to the law of the nation. It must be legal. Besides, the project should be able to meet certain social benefits. It must contribute the efforts of eliminating certain social problems like poverty, unemployment, disease, famine, illiteracy, etc. Hence we can raise questions related with such issues as: Does the project socially viable? Does it contribute anything to the community and the natural development? Does it create job opportunity to the community members? Etc
2. **Profitability/Viability:** the profitability or viability of the business must be determined. It is wise to invest in projects that attracts positive net inflow than those with negative net-inflow. Therefore, before the bank permit loan to a customer, first the viability of the project must be studied. The projects viability can be measured through project appraisal or feasibility study.

Feasibility study is a detailed evaluation of a project to determine the technical feasibility, the economic necessity, financial viability of the project and managerial competence required for its successful operation. This might be done at two stages:

1st: by the promoter for identifying the right project

2nd: by a banker or financial institution for the purpose of determining whether the project should be financed by it or not.

* **Technical Feasibility:** it is carried out to determine:
1. Location of the project. This can be studied by observing suitability of the business area and by assuming the market share of the client.
2. Technology used: it determines the skill required, nature of product, efficiency of the project, cost effectiveness etc.
3. Plant and Equipment: it determines the suitability of the physical plant to accommodate the operation in the project.
4. Construction and Installation Schedules: this helps to identify the required grace period in relation with the gestation period and to analyze the condition within which the business starts functioning.
* **Economic Necessity:** it is studied to measure the extent to which
	+ the market will absorb the additional production on account of the new project
	+ the project is expected to contribute to the national fund.
	+ the project can bring about development in the area
	+ the project will create more employment
	+ the atmospheric and other pollutions could be contained.
* **Financial Viability:** a study is carried out to measure the financial viability of the project which may include:
1. **the cost of the project:** the project must be viable in terms of its cost analysis. The return from investment must be greater than the investment amount. Therefore, the banker must see the relationship between the size and purpose of the loan before advancing the loan. If the amount required is more than the size and purpose of the loan, the bank must demand clarification from the customer. If the response is not satisfactory, the bank can decline the loan request so as to avoid future unnecessary conflicts that could arise between the bank and the customer due to default in repayment by the customer.
2. **source of finance:** this is to determine how well or bad the business was managed in terms of finance. The promoter's contribution and other sources of finance should be investigated, if any. Therefore, the following ratio analysis should be carried out in this regard.

Debt-Equity Ratio = Total Debt

 Net Worth

Profitability Ratio = Profit

 Sales

Return on Capital Ratio = Profit

 Capital

Liquidity Ratio = All Current Assets

 Current Ratio Current Liabilities

 Quick Ratio = Cash + Cash equipments + Receivables

 Current Liabilities

and others.

Managerial Competence: This is to determine the ability to run a business either in terms of education or experience or both.

1. **Sources of Repayment:** it is to measure the source of funds used to repay the loan and we can ask questions regarding this issue as follows. Is the income from the project sufficient to cover the regular repayment? Is there any other source of repayment in case an adverse effect occurs to the project?
2. **Terms of Repayment:** it is to determine as to when the loan will be paid in full and to determine the schedule for repayment. For example the repayment may be made every month. Quarterly or semi-annually, annually or at lump sum. This should be determined before the loan is advanced.

**3.6 Factors Limiting the Level of Advances**

The following are factors that limit the level of loans to be advanced to borrowers.

1. **The type of deposits at the bank:** banks may provide different alternative deposit accounts as it has been discussed in unit two of this course. It was also discussed that time and saving deposit accounts are relatively long-term than demand deposit accounts. Hence, amount deposited in savings and time deposits can be used for long term loans and those in demand deposit accounts are used for short-term loans. As such, the greater the savings and time deposits the banker has, the greater loan it will create and vice versa and the greater the demand deposit accounts the greater the short term loans the banker can make.
2. **Credit control by the national bank:** national bank is the ultimate regulator of the financial and credit systems of a country through different controlling instruments such as required reserve, discount interest rate and open market operations and other methods. (Refer Money and Banking). The National Bank's financial/credit policy may be expansionary or contracting. If the National Banks Credit Policy is expansionary, the level of credit advanced by commercial banks will be higher than if the National Bank's credit policy is contradicting.
3. **Seasonal variations:** the amount of credit advanced to borrowers is determined by the borrowers themselves. If the demand for loan is greater, the loan advanced will be higher and vice versa. The demand for loan also will depend upon seasonal factors such as: the busy season, the harvest time, the slack season, the festive season etc, that affects the business activities – business activities flourish during the busy season, the harvest time and the festive season and business need more money to run its operation at a higher level. Therefore, its demand for loans will also increase and vice versa.

**3.7 Principles of Sound Lending and Investment**

We know that bank employs most of its resources in advancing money to commerce and industry and in buying the Government and other first class securities. A bank also invests some portion of its funds in discounting and purchasing commercial bills. While investing its funds in various assets, a bank is generally guided by the three cardinal principles: liquidity, profitability and safety or security. They will be discussed as follows.

1. **Liquidity:** by liquidity we mean the capacity of the bank to pay cash in exchange of deposits. According to Sayers, "Liquidity is the word which the banker uses to describe his ability to satisfy demand of cash in exchange of deposits." The position of the bank is liquid when it is able to pay cash to its depositors whenever demanded. It is advisable for a bank to maintain a sufficient degree of liquidity in its assets.

A large part of the deposits received by the bank is in the form of demand deposits which are withdraw able without any notice, i.e., on demand. So the bank must maintain sufficient amount of funds every time to meet the demand of the customers. If a bank keeps most of its funds in the form of cash, it will not earn any income because cash is an idle asset. Bank can invest the money in those assets which are highly liquid and which can be converted into cash without any loss of value. By doing so, the bank will be able to meet the demand of its depositors at all times and in addition, it will also earn some income.

The foundation of the entire banking structure in the country rests on the confidence that the banks are able to create in the minds of the people. People have confidence in a bank when they are sure that they will get back their deposits whenever they demand. So the bank must maintain sufficient cash reserves with it or should invest sufficient funds in near cash assts (i.e., which can be converted into cash at a short notice without any loss of value) so that it is able to meet the demands of its depositors. A bank can maintain liquidity in its assets when it employs funds in liquid assets. A liquid asset can be converted into cash quickly and without any loss. A bank can pay its depositors in full only when its assets can be sold without loss. Therefore, a bank must be able to convert its assets into cash quickly and without loss. In short, the word liquidity has two attributes.

1. ability to convert into cash quickly, and
2. ability to convert into cash without any loss of value.
3. **Solvency:** it represents the state of affairs of the bank under which a bank is able to meet its debts obligations. A bank is said to be solvent when the value of its assets is more than (or at least equal to) the value of its liabilities. But a bank is said to maintain liquidity when its assets can be converted into cash quickly and without loss.

A bank may be solvent but may not be liquid. The implication of this fact is that the value of assets of the bank exceeds the value of the liabilities of the bank, but the bank has not employed its funds in liquid assets, which might be converted into cash quickly and without loss. Liquidity depends on shiftability without loss. It should not be sacrificed for higher profitability and excessive liquidity is also not necessary as it will influence profitability adversely.

1. **Profitability:** a bank is a commercial organization. One of the objectives of a bank is to earn sufficient profit. The bank must earn sufficient income from its assets so as to meet all its expenses and pay a fair percentage of dividend to the share holders. The bank employs its resources to earn income, to pay interest on deposits, to meet expenses of administration, to build up reserve fund and to pay dividend to shareholders. The profits of the bank will be higher if the yield from the assets is greater. The bank should determine the portfolio in such a way that it is able to derive maximum income. The bank should invest its funds in those securities, which give higher yields. But it should be noted that in order to earn higher yield, liquidity of the assets of the bank will have to be sacrificed.

Profitability and liquidity are too complicated considerations which must be reconciled by the bank. Liquidity can be obtained at the expense of profitability, i.e., as liquidity position of the bank increases, either idle asset (cash) or investment on low income securities increases. And profitability can be achieved at the expense of liquidity i.e., as the banker tries to increase its profitability, it has to increase loans and investments that has long duration and which yields higher income but are more riskier. These long term loans and investments attracts more returns but they cannot be easily. Without loss and in a short term convertible into liquid asset (cash). Besides these long term loans and investments beer higher risk such as credit risk, interest rate risk and finally liquidity risk.

A bank can secure perfect liquidity when it keeps all the deposits in cash. At this point, profitability will be zero because cash is an idle asset and does not fetch any income unless it is invested. But if a bank lends all the deposits to merchants and industrialists, it will earn high income at the cost of liquidity. It will not be able to pay the depositors whenever they demand. Because there is a constant conflict between the concepts of liquidity and profitability, the bank should always try to reconcile both the considerations. For this, a bank should keep adequate cash reserves or near cash assets to meet the day-to-day requirements of the depositors and invest the balance in profit earning assets. So it must have some assets which are highly, liquid but less profitable and other assets which are highly profitable but less liquid. In such a case, the bank will have adequate cash to meet every demand or claim of the depositors and will also earn enough income to run the business and pay dividend to the shareholders.

The secret of successful banking is to distribute resources between various forms of assets in such a way as to get a sound balance between liquidity and profitability so that there is sufficient cash to meet the claims of the depositors and at the same time there is enough income from the assets to meet its expenses and distribute profits among the shareholders.

1. **Security or safety:** a bank deals in the money of the public. It receives deposits from the public and promises to repay the same along with interest at the predetermined rate. So a bank cannot afford to invest its funds in risky adventures even though it may earn high income from such investments. A bank is in the nature of the trustee of money belonging to public. It must ensure the safety of the funds of depositors. That is why most of the banks invest their funds in Government securities and do not prefer securities like shares and unsecured debentures. Though Government securities fetch less yield, yet they are highly secured.

The existence of a bank depends on the safety of its investments. So safety of funds should not be sacrificed to earn higher profits. If a bank neglects the consideration of security of funds, it will lead itself to a disaster. The bank will lose its funds because its borrowers may not repay the loan. In such a case, it will not be able to pay the depositors in full due to which confidence of the depositors in the banking system will be shaken. So a bank should be cautious in making investment in various assets. Caution is the essence of successful banking. Particularly while making loans and advances to customers the bank should be sure about their credit worthiness. It should also insist on sufficient security against loans and advances.

In general banks to be profitable while being safe, it has to establish a balanced portfolio. It must represent sufficient liquidity to meet the demands of the depositors and some portion of the funds should also be invested in those assets are highly profitable. While choosing the assets for investment, bank should not forget to see that it is a safe investment in the interest of the depositor and the bank itself. In Ethiopia, the banks are required to keep minimum cash reserves of 15%of time and saving deposit and 5% of demand liabilities. National Bank of Ethiopia has been empowered to regulate the required reserve ration that individual commercial bank can maintain. While determining the structure of assets or at the time of granting loans and advances, a bank should be guided by the three principles of sound investment, namely liquidity, profitability and safety.

**3.8 Types of Securities**

The principle of safety has assumed great significance because a safety of assets of the bank is essential for the very survival of the bank itself. This is why, banks attach great importance to the security offered while advancing credit to their customers. A prudent banker ensures that advances given to the business persons and the industrialists are backed by sufficient collateral securities. These securities must be tangible and easily marketable so that the bank may sell them to realize the debt in case of default by the borrower. The most important types of securities lodged with bank for securing advances are: goods, documents of title to goods, stock exchange securities, real estates, supply bills, life insurance policies and fixed deposits receipts

* 1. **Loan Policy**

The restriction imposed by statutory law and administrative regulation does not provide answers to many questions regarding safe, sound and profitable bank lending. Questions regarding the size of the loan portfolios. Desirable maturities, and the types of loans to be made are left unanswered.

These question and many others about lending must be answered by each individual banks. Thus, it is desirable to have explicit lending policies to establish the direction and use of the funds from the stock holders, depositors, and others, to control the composition and size of loan portfolios, and to determine the general circumstances under which it is appropriate to make a loan. More and more banks have developed formal, written lending policies in recent years. The comptroller of the currency now insists that national banks have such policies. Although written lending policies serve a number of purposes, the most important is that they provide guidance for lending officers and thereby establish greater degrees of uniformity in lending practice.

**3.9.1 Factors that Influence a Bank’s Loan Policy**

Since lending is important for both the bank and the community it serves, loan policy must be worked out carefully after considering many factors. For the most part, these some factors determine the size and composition of the secondary reserve and the investment account of bank .

The most important factors that influence bank loan policy are:

1. Capital position
2. Risk and profitability of various types of loans
3. Stability of deposits
4. Economic conditions
5. Influence of monetary and fiscal personnel
6. Ability and experience of bank personnel
7. Credit needs of the area to be served.

The capital of a bank serves as a cushion for the protection of the depositor’s funds. The size of capital in relation to deposits influences the amount of risk that a bank can afford to take. Banks with a relatively large capital structure can make loans of longer maturities and greater risk,

Since earnings are necessary for the successful operation of a bank, all banks consider this important factor in formulating loan policy. Some banks may emphasis earnings more than others. Banks, with a greater need for earnings, might adopt a more aggressive lending policy than those who do not consider earnings to be paramount. This aggressive policy might be making a collectively large amount of term or consumer loans, which normally are made at a higher rate of interest than short-term business loans.

A bank, in formulating its loan policy, must consider the fluctuation and type of deposits. After adequate provisions have been made for the primary and secondary reserves. Banks can then engage in lending. Even though these two reserves are designed to take care of the predictable deposit fluctuations and loan demand, unpredictable demands force banks to give consideration to the stability of deposits in formulating loan policy.

The economic conditions of the country as well as, to some extent, the world are influential in determining its loan policy. A stable economy is more conducive to liberal loan policy than one that is subject to seasonal and cyclical movements. Deposits of feast or famine economics fluctuate more violently than do deposits in an economy noted for its stability. A great consideration must be given to the national economy. Factors that adversely affect the nation as whole may, if they are of serious magnitude, eventually affect local conditions.

 The lending ability of banks is also influenced by the monetary and fiscal policies. If additional reserves are made available to the commercial banking system, the lending ability of banks will increase. Under these conditions, banks can have a more liberal loan policy than if the opposite situation exists wherein expansion of bank reserves is being curbed or reduced.

The expertise of lending personnel is not insignificant in the process of formulating bank lank loan policy For example, officers may have considerable ability and experience in business lending but practically none in making real estate loans, while in other banks their specialty may be consumer lending. One of the probable reasons banks were slow in entering the consumer-lending field was the lack of skilled personnel same banks may be so specialized in certain fields of lending that their presence may influence the loan policy of other banks.

An obvious factor influencing commercial bank’s policy is the area it serves. The major reason that banks are chartered (licensed) is to serve the credit need of their communities. If this cannot be done, there is little justification for their existence; Banks are morally bound to extend credit to borrowers who present logical and economically sound loan request. Banks in areas where the economy is predominantly one of cattle raising, for example, can not turn their back on this type of lending, but must tailor policy to fit the needs of this economic activity.

**3.9.2 Items Included in a Loan Policy**

The items are included in loan policy and dealt properly as follows:

**a. Loan territory**

The territory to be served by a bank must be defined will depend on many factors, including the amount of its resource, competition, the demand for loans and the bank’s ability to supervise or keep in close contact with the borrowers .

Bank may have no territorial limitations for certain classes or loans. For example, very large banks make loans to large national business firms no matter where their principal offices may be located.

**b. Types of loans to be made**

Bank management must decide what type of loans would be best for the bank. Some of the more important considerations in making this decision are the risks associated with various kinds of loans, the need for diversification to spread the risk, the need for liquidity , the types of customers the bank wants to serve, the capabilities of bank personnel, and certainly, the relative profitability of various kinds of loans. To the extent that it is practicable, banks diversify their loan portfolio among the various broad categories of loans such as business, consumer, real estate and agricultural and strive also for considerable diversification within each of these broad categories.

**c. Acceptable Security and credit worthiness**

To facilitate lending, reduce risks, and maintain standard practices, a bank’s loan policy should deal with the question of what is considered acceptable security and credit worthiness. If certain loans are to be secured, the lending officers should have some indication of what is acceptable security. For example, some banks may not want to accept account receivable as security or household goods for consumer loans. Further more, a bank may disapprove accepting consumer loans that are endorsed by the borrower’s friends or relatives. Banks may not wish to make real estate loans on single-purpose buildings. Construction loans may be made only in cases where the work is being supervised by a competent architect and the contractor has provided a completion bond and acceptable security. Banks may not want to lend more than a certain period of the fair market value of the securities. Some collateral may not be acceptable at all. Such as cars over five years old, or highly perishable commodities. Banks may wish to limit the amount of individual consumer loans to a certain percentage of borrower’s annual disposable income. For acceptable collateral, an indication should be given as to the amount of funds that will be advanced on such security.

Banks may receive requests for loans from applicants who do not have acceptable credit worthiness. To save the time of the credit department and lending officers, it is advisable to outline what is considered acceptable. Consumer loans might be restricted to persons who are presently employed and have been for a minimum period, and who have an assured income and a satisfactory credit record. Loans to businessman may be restricted to those who have been in business for a certain length of time and have demonstrated an ability to produce a commodity or render a service profitably.

 **d. Maturity**

A comprehensive loan policy would certainly cover loan maturity. The maturity of a bank’s loan portfolio will affect bank liquidity as well as its risk exposure. Term loans to business are apt to be less liquid than 30-60-or 90- day business loans, and the 20-year real estate loan lacks the liquidity of one made for a period of ten years. As loan maturities increase, money and credit risk also have a tendency to increase, some banks may not wish to make loans on real estate for exceptionally long periods and some may not want to make many business loans on a term basis. Moreover, some banks may wish to limit loans for the purchase of automobiles to 24 or 30 months rather than longer periods. To serve as a guide for the loan officer, the policy regarding maturities should be definite.

 **e. Excess lines**

One problem confronting many banks is that of loan requests exceeding their legal lending limit. The applicant may be a customer of the bank who is entitled to the credit requested, and the loan would be satisfactory from the standpoint of security and maturity. The bank is then faced with the choice of either working out a satisfactory arrangement with a correspondent bank to carry the excess portion of the loan, or refusing the request and running the risk of losing the applicant’s account, which may be valued highly. Some banks may not handle such requests or even lend up to their limit. Others may have a policy of arranging for a correspondent bank to carry the excess loan. These days, such loans are becoming more frequent than in the past necessitating tocarry the excess loan. These days, such loans are becoming more frequent than in the past necessitating pulling funds by a member banks. Such loan is termed as syndicate loan.

 **f. Loan Commitments**

Many bank customers, especially large business borrowers plan their borrowing needs with the bank in advance of the time the funds will be actually needed Therefore, banks adopt a policy regarding the types of commitments that will be made, the types of enterprises to which they will be made, the amounts that will be made available, and the charge for such commitments. Such planning is of value to the bank in that it gives some indication as to the demand for credit during certain periods of the year and plans can be made regarding the maturity of other loans.

A commitment is an agreement, oral or written, between a bank and a borrower whereby the bank stands ready to extend an agreed amount of credit for a specified period of time. A commitment may have no restriction attached or may be subject to a member of conditions such as security, fixed-asset limitations, officer’s salary limitations etc. Normally, loan commitments do not exceed one year and may take several forms. Probably the simplest form is an oral commitment that a certain amount of credit will be available at a certain time in the future. Many loan commitments take this informal arrangement and are frequently referred to as open lines of credit. Its is not uncommon for such a statement to be in written form, however.

An even more formal commitment would be what is commonly referred to as a stand by commitment. A stand by commitment is usually a more binding and exacting financial arrangement that is a line of credit. The bank and the borrower enter into a formal contract in which the bank agrees to lend a certain amount to the borrower and the borrower enter into a formal contract in which the bank agrees to lend a certain amount to the borrower and the borrower agrees to borrow. The agreement includes a statement regarding the time the funds will be available and such lending terms as security and interest rate of the loan. The borrower pays a fee for this commitment that is usually based on the Un- borrowed amount of the commitment.

A revolving credit is usually of longer maturity than is a line of credit. If firmly obligated the bank to lend a certain amount to a borrower for a stated period. The terms of the agreement are written out in detail since the agreement usually runs from one to three or more years. Under a revolving credit the borrower agrees to borrower for a stated period. Under a revolving credit the borrower agrees to borrow in accordance with the terms set forth and to pay a fee that is computed on the un- borrowed portion of the established maximum. A revolving credit agreement can become quite detailed and can include such items as the use of the borrowed funds, the rate of interest the maturity of the notes, submission of financial statements and other financial and a production data, security and, in case of default, provisions regarding termination of the parchment and repayment of the loans outstanding .

**3.9.3 Loan Pricing**

The pricing of bank loans involves the setting of interest rates and in some cases, the imposition of loan fees. Interest rates may be either fixed or variable. As the term implies, a fixed rate is one that remains the same during the loan contract. A variable rate is one that may change during the term of the loan the prime rate the rate banks charge their most creditworthy business customers-is the most popular variable rate and varies with changes in money market conditions. Banks may also make loans. The interest of which is tied to the prime rate. A loan might be made at a rate of one or two full percentage points above the prime rate. For example as the prime rate increases or decreased. The reason for this type of arrangement is the belief on the part of both borrower and bankers that is more equitable than negotiated rates especially in an environment characterized by considerable amount of inflation. Loan fees are sometimes imposed, depending on the amount of work involved in making a loan; these are found especially in the granting of term loans and in real estate lending.

The numerous factors that are considered in pricing loans include:

1. The cost of funds
2. The degree of risk in the loan
3. The maturity of the loan
4. The costs of originating and administering the loan ( these costs, as a percentage of the loan, are a function of the size of the loan, the amount of credit investigation required, the cost of acquiring and maintaining control of the collateral , and the expense of collecting the loan.)
5. Rates available to the borrower from competitive sources of funds, including other banks and the commercial paper and bond markets
6. The overall relationship between the bank and the borrower ( this included income earned on the borrower’s deposit balances as well as paying cheques and collecting deposited items for the borrower.)
7. The rates of return that can be earned on alternative investments.

**3.9.4 Administration of the Loan Policy**

After the loan policy of a bank has been formulated, provision of its proper execution must be made. Certain individuals must carry out the loan policy, and some provisions should be made for its periodic review and evaluation in order to make any necessary changes. It should be remembered that a loan policy serves as a guide to lending not as a straightjacket Economic conditions change and so should a loan policy. Periodically, the loan portfolio and lending practices should be compared with the loan policy to determine whether it is being followed and if changes should by made.

The person in charge of the overall lending organization should be in charge of supervising the bank’s loan policy. In small banks this may be the manager or of the deputy managers. In banks that rely to a great extent on loan, a loan committee will be given a responsibility to supervise lending; this body would be responsible for effecting the lending policy of the bank. In larger banks the responsibility would probably be assigned to the senior deputy manager in charge of lending , who would explain the provisions of the loan policy to the lending officers and secure their cooperation in carrying it out, which is necessary for a loan policy to be successful. Lending officers cannot consider what is desirable to them; they must consider what is good for the bank. The purpose of a lending policy is to promote the objectives of the lending function, not to serve as an end within itself .

**3.10 ORGANIZATION OF BANK IENDING**

The organization of the lending function depends on numerous factors, including the character and quality of the lending officer, the size of the bank, the size of the loan portfolio, the types of loans to be made, and the board of director’s attitude towards the amount of authority delegated. The legal responsibility for bank lending rests with the board of directors, and some boards play a more important role in lending than do others. In general, large banks delegate lending authority and specialize in lending more than do smaller ones.

The lending officer usually makes personal contact with the borrower, receives application for loans, interview the applicants, decide whether the applications are worthy of consideration, and may obtain all the necessary information about the applicant, or part of it may be obtained by the credit department. The lending officer may make the decision to grant the loan request, or this may rest with a committee or the board of directors, depending on the size of the request. Once the loan has been made, he/she usually supervise the loan: that is, keeps in close contact with the borrower during the life of the loan. This may include plant visits, occasional visits with the borrower in the bank and requests for financial and other credit information from the borrower and from other sources. In the event of difficulty with the loan, the lending officer will exert every effort to collect the amounts outstanding. If renewals or additional funds are requested, he/ she handle these requests, as per the given conditions.

In small unit banks, all the officers may perform lending functions along with their other activities. Each officer may handle all types, of loan requests, whether they are for consumer, business, or real estate purposes. Little formal specialization prevails however; one officer may specialize in some types or type of loans because of special interest or experience. Each officer must secure the necessary credit information and maintain the credit files, since few small banks have a separate credit department. Each officer may have a lending limit within which decisions can be made regarding loan requests. Loans, above a certain amount, may be submitted to a loan or discount committee, which will make the decision or, in smaller banks refer the request to the board of directors for further consideration if the loan is extremely large or in any way unusual. In medium – size unit banks. There is more delegation, of authority and specialization regarding lending. Many medium- size banks have credit departments. Each officer may have an established lending limit, which is usually higher than in small bank. Sometimes a loan committee composed of senior loan officers may exist within the bank to handle loan requests above the lending officer’s limit. Members of the board of directors may be in this committee. I this is the case, only those requests requiring special attention would be referred to the discount committees and the board of directors. As in the small banks, supervision of the loans would be the responsibility of the lending officers.

The lending organization in large unit banks differs considerably from that in mall banks and to some degree, in medium –size banks, in the departmentalization and specialization of lending activities. Large banks may have such lending departments as real estate, business or commercial, consumer and agricultural some of these departments are broken down further. Business loans, for example, can be divided according to industry. With a lending officer in charge of each industry or related industries. One large bank, for example, has separate loan divisions for iron and steel, automobiles, machinery, agricultural implements, electrical products, radio and manufacturing sundries (products). Many banks also divide their lending activities on territorial basis.

Lending officers in large banks have lending limits, limits, but they are usually higher than those in medium and smaller banks. Larger banks make greater use of officer loan committees than do small- and medium-size banks. They may be organized on a formal or informal basis according to departments. For example, a request for a real estate loan larger than the lending officer’s established limit would be referred to an officer’s loan committee composed of real estate lending officer, rather than officers from several departments. With an organization of that kind, only the very large requests are referred to a loan or discount committee, and probably few, if any requests are referred to the board of directors for action.

In larger banks, the credit department plays a much more important role in the lending process than it does in smaller banks. The lending officer turns over to the credit department all the information received from the applicant that would be used in the preparation of a formal loan request.

Additional credit information on the applicant would be secured from many sources and assembled in one folder for the use of the lending officer, who in turn may discuss it with some colleagues or the officers loan committee . The report of the credit department may include, such items as financial statements (with balance sheets and profit and loss statements for a period of years arranged on one sheet so they can be evaluated at a glance) various financial statement ratios that have been calculated by the credit department, credit agency reports, pictures of the applicant’s place of business, budgets, analysis of the industry’s prospects as well as the applicant’s and many other details of value in making a decision on whether to grant the credit request.

The lending organization in branch banks varies considerably. Branch managers and officers may have limited loan authority. Just as in a unit ban, loan requests above this limit might be referred to the head office where consideration would be given to the request by the regional supervisor of that particular branch and a decision reached. The regional supervisor may also have a lending limit. Loans exceeding this limit would be referred to a loan or discount committee.

From a practical standpoint, it is not desirable to have a great deal of centralization of lending authority in the head office. Borrowers do not like to wait for credit decisions, and much of the personal touch important in credit evaluation, is lost if many request to be directed to the head office. When there are many branches, the head office usually performs general policy supervision and permits branch managers’ considerable discretion in lending. This, in fact, is about the only way branches can be operated efficiently.

**3.11 FOLLOW- UP AND SUPERVISION**

Bankers appraise the loan applications carefully with the idea of eliminating such borrowers who may fail to keep their promises by not repaying the loans or diverting money to inappropriate uses. But an appraisal alone can never guarantee protection against such a type of future risk. In any business, forecasting future performance on the basis of present plans and conditions and past performance is subject to wild errors. These errors may take place as the future is full of uncertainties and many changes may occur in various fields, for example, economic conditions, management capabilities , technology, consumer taste, motivation, etc. In order to take care of these changes and thus, protect oneself against such future risks, post- allocation supervision or follow- up becomes imperative. It should be kept in mind by bankers that the loan left to itself is lost, unless properly followed up.

**3.11.1 The Process of Supervision**

Before discussing the supervision of advances, it should be clear that controls are required not because the bank doubts the honesty and integrity of the borrower but for reason that they guard themselves against any fraud , misappropriation and also not allow an honest client to become dishonest.

In fact, supervision or follow-up starts from the point where appraisal ends, that is from the stage of disbursing the loan. At the time of disbursal, the banks should carefully supervise the end – use of money. Often the money is diverted for purposes other than stated in the loan application, thus defeating the basic objectives of providing finance. Very often, over-financing ( that is more than the requirements) also gives rise to problems like diversion of funds, capitalization of funds for non-productive purposes, trading on a much larger scale beyond the capacity and entering into speculative business. Thus, the foremost requirement for an effective follow-up is that the party’s requirement should be assessed exactly and finance equivalent to these needs should only by provided .

**3.11.2 The Technique of Supervision**

There is general acceptance among bankers of the desirability of having a provision of supervision of the bank credit. Each bank, by its experience, should design the supervision or follow – up forms in such a way that all relevant and critical information is collected avoiding an unnecessary and unmanageable store of information.

The small industrial units, in general, have very little resistance power against odds and require intensive care by the bank, even after providing the finance. Normally, supervision is not liked by any one; but the entrepreneurs may not resent supervision if they are convinced that it is in their interest and shall also mean the continuance of financial assistance. Most of the entrepreneurs, who are carrying out the entire gamut of industrial activity single-handed, shall welcome technical or managerial help and guidance. The advice will be definitely heeded for them, when it comes from the people who provide the major share of funds to them. But such advice presupposes a good rapport between the banker and the borrower. In facts, at no time the banker should leave an impression that the is there to act as a ‘policeman’ whose job to trace culprits and book them, rather he should be like a family doctor who comes to the enterprise with the intention of curing ills.

Thus, it would not be wrong to say that what the small borrower need is ‘counsel’ than ‘cash’. This fact is further reinforced by Arthur Lewis remark that Lending money to inexperienced small business people without the drain. What these people need is first supervision and advice and only secondarily capital – And when money is lent, its use should be supervised carefully , the officers of the institution should have powers to enforce changes in managerial practice as a prior condition of the loan and to check unprofitable practices at least until the loan has been paid.

It can be summarized that the main objective of follow- up is to act as a radar indicating how the wind blows so that the signs of developing difficulties could be detected in time and thus minimize the number of sick units, if not able to completely eliminate them.

**Check Your Progress Exercise**

1. What is a loan? Discuss the classifications of bank loans.

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1. What is the relevance of policy to the banker in advancing loans to customers?

**……………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………….**

1. How do you determine the amount of loan you can grant to a customer?

**……………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………….**

1. What are the major components of a loan policy?

**……………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………….**

1. How do you define the price of a loan? Discuss.

**……………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………….**

1. What are the factors that determine the price of a loan?

**……………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………….**

1. Who grants loans? Discuss.

**……………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………….**

1. Show the organization structure of bank lending.

**……………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………….**

1. What is credit follow-up and credit supervision? Discuss.

**……………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………….**

1. List down the principles of secured advances.

**……………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………………….**

**3.12 SUMMARY**

Modern Banks are loan providers. Loans are money or purchasing power given today for future repayment. It is postponement of today’s consumption to the future by the creditor and the consumption of future income today by the borrower.

Banks offer different types of loans which are classified using different criteria. In order to guide the lending activity banks develop loan policies. A policy is a general guideline that directs decisions made by members of a certain company. It gives the boundaries within which decisions are to be made. Therefore, individuals and groups can have the authority to make their own decisions with n the boundaries of the policy. Hence, the quality of decisions made depends not only on the quality of decision makers, but also the quality of the policy designed. Likewise, loan policy developed by bankers gives guidance to the bank members as to what decision are to be made at different times and conditions. This helps, decision makers in particular and the bank in general, to maintain uniformity of activities and decisions.

**3.13 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS**

* + - 1. Refer section 3.2
			2. Refer section 3.6
			3. Refer section 3.6.1
			4. Refer section 3.6.2
			5. Refer section 3.6.3
			6. Refer section 3.6.3
			7. Refer section 3.6.4
			8. Refer section 3.7
			9. Refer section 3.8
			10. Refer section 3.4