Credit Management Policies

Chapter: 4

Credit

Credit is generally defined as a contractual agreement in which a borrower receives something of value now and agrees to repay the lender at a later date—generally with interest.

*"**Credit** is the trust which allows one party to provide money or resources to another party wherein the second party does not reimburse the first party immediately, but promises either to repay or return those resources (or other materials of equal value) at a later date."*

- Wikipedia

"Credit is an exchange which is complete after the expiry of a certain period of time"

- Prof. Gide

Characteristics of Credit

- Confidence
- Capacity
- Security
- Goodwill
- Size of credit
- Period of credit

Credit Instruments

- Cheque
- Bank draft
- Bill of exchange
- Promissory note
- Government bonds
- Treasury bills
- Travelers cheque

Advantages of Credit

- Help in economic development
- Increase consumption
- Capital formation
- Easy Payment
- Assistance in solving national problem
- Employment encouragement
- Saving encouragement
- Development of entrepreneurs

Disadvantages of Credit

- Encouragement of expenditure
- Encourage weakness
- Economic crisis
- Dangers beyond limit
- Evil of monopoly
- Encourage inefficient

Considerable Factors for Granting Bank Loans

- **Consideration in case of bank**

1. Safety
2. Profit
3. Liquidity
4. Security
5. Source of credit
6. Amount of credit
7. Following the principles of central bank

Considerable Factors for Granting Bank Loans

- **Considerations incase of customers**

1. Solvency
2. Purpose of taking credit
3. Goodwill & honesty
4. Capacity of client
5. Legal capability of client
6. Source of payable credit

Credit Management

Credit Management is a branch of accountancy, and is a function that falls under the label of “Credit and Collection’ or ‘Accounts Receivable’ as a department in many companies and institutions. They will usually deal with the credit vetting of customers, the resolution of any invoice queries or disputes, allocations of payments or cash application, internal fund movements, reconciliations and also maintaining positive working relationships with customer during the debt collection or credit review and approval process.

Credit management is the process of granting credit, setting the terms on which it is granted, recovering this credit when it is due, and ensuring compliance with company credit policy, among other credit related functions. The goal within a bank or company in controlling credit is to improve revenues and profit by facilitating sales and reducing financial risks.

LOANS Vs ADVANCES

BASIS	LOANS	ADVANCES
Meaning	Funds borrowed by an entity from another entity, repayable after a specific period carrying interest rate.	Funds provided by the banks to an entity for a specific purpose, to be repayable after a short duration.
What is it?	Debt	Credit facility
Term	Long term	Short term
Legal formalities	More	Less
Security	May or may not be secured.	Primary Security, Collateral Security and Guarantees.

Types of Bank Loan

- **Traditional Credit Products**

1. Cash credit
2. Overdraft
3. Demand loans
4. Term loans
5. Bill purchased
6. Bill discounted

- **Innovative Credit Products**

1. Credit cards
2. Debit cards
3. Housing loans
4. Auto loans
5. Personal loans
6. Educational loans
7. Loans against securities
8. Consumption loans for purchase of durables
9. Hybrid loan products

Classification of Bank Credit

- **Credit based on period**

a) Short term

I. Credit at short call

II. Credit at short notice

a) Mid term

b) Long term

- **Credit based on fund**

- Loan
- Cash credit
- Bank overdraft

Classification of Bank Credit

- Credit based on documents

1. Commercial documentary credit

- Letter of credit
- Bank draft
- Pay order
- Bank guarantee

2. Non-commercial documentary credit

- Traveller's note
- Traveller’s cheque

Classification of Bank Credit

- Traveller's L.C

a) Fixed

b) Circular

- Credit given at other sectors
- LIM(Loan against Imported Merchandise)
- LTR(Loan Against Trust Receipt)
- Post Shipment Credit

Credit Analysis

Credit analysis is a type of financial analysis that an investor or bond portfolio manager performs on companies, governments, municipalities, or any other debt-issuing entities to measure the issuer's ability to meet its debt obligations. Credit analysis seeks to identify the appropriate level of default risk associated with investing in that particular entity's debt instruments.

*“**Credit analysis** is the method by which one calculates the creditworthiness of a business or organization. In other words, It is the evaluation of the ability of a company to honor its financial obligations.”*

- Wikipedia

Steps of Credit Analysis

- **Information Collection Stage**

1) Collecting information about the applicant
2) Collecting information about the business for which loan is required
3) Collecting information about the recovery process
4) Collecting information about the security
5) Collecting additional information if necessary

Steps of Credit Analysis

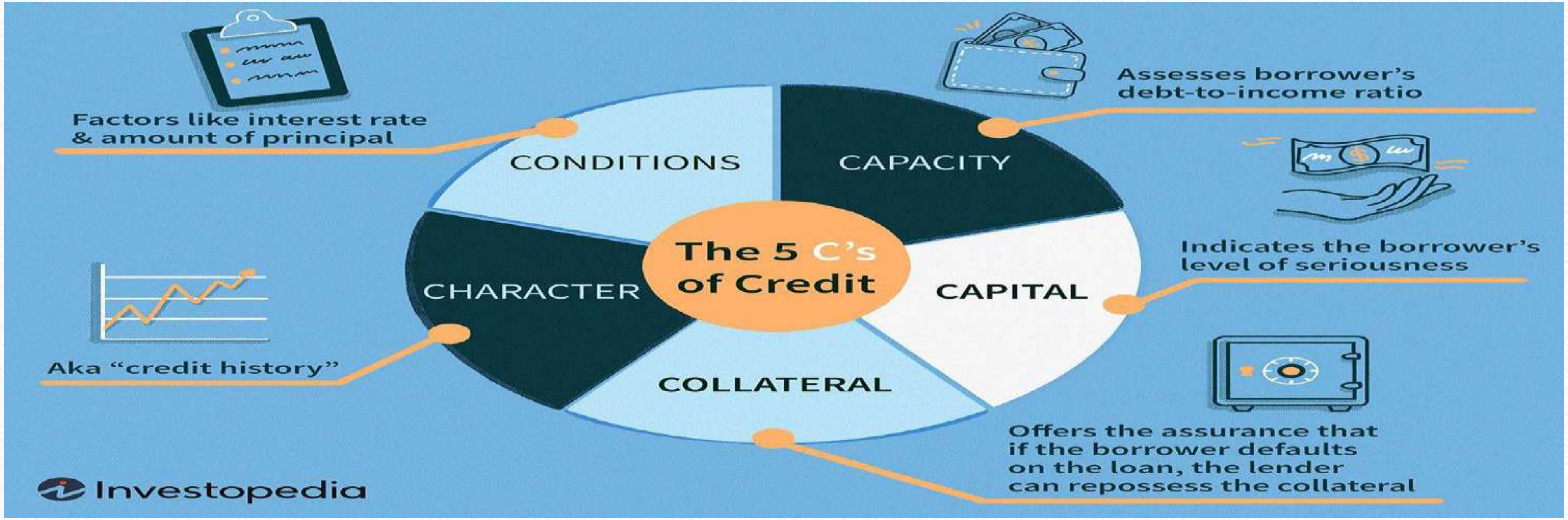
- **Information Analysis Stage**

1) Analyzing the accuracy of information
2) Analyzing the financial ability of the applicant
3) Analyzing the effectiveness of the project
4) Analyzing the possibility of loan repayment

- **Decision-Making Stage**

Approaches of Credit Analysis

Traditional approach to credit analysis:



Approaches of Credit Analysis

Modern approach to credit analysis: 7c’s

1. Character
2. Capacity
3. Cash
4. Capital
5. Collateral
6. Conditions
7. Control

Loan Structure & Documentation

- **Documents required for personal loan:**

1. Complete loan application form with one passport size photograph.
2. Valid proof of applicant’s identity
3. Proof of residence
4. Proof of age
5. Photo identity proof
6. Residence identity proof
7. Residence ownership proof
8. Income proof

Loan Structure & Documentation

9. Job continuity proof
10. Bank statement
11. Salaried individuals
12. Self employed individuals
13. Office address proof
14. Office ownership proof
15. Business existence proof

Loan Structure & Documentation

- **Documents Required for Business Loan**

1. **List of Common Documents Required for Business Loan**

a) Application form

b) Valid proof of applicant's identity

c) Proof residence

d) Proof of age

e) Financial documents

- Self employed(Private Ltd. Co. & Partnership Firms)
- Self employed individuals - Professionals

Loan Structure & Documentation

- Self employed individuals – Non Professionals

2. Documents Required for Self Employed(Private Ltd. Co. & Partnership Firms)

a) Proof of identity of private limited company(sales tax ,VAT, service tax etc.)

b) Proof of individual identity

3. Documents Required for Self Employed Individuals – Professionals

a) Proof of identity of sole proprietorship

b) PAN(Permanent Account Number) ID/ IT return/Municipal tax, water bill, electricity bill in the name of the concern

c) Individual identity proof to be submitted for the sole proprietor

d) Proof of residence address for the sole proprietor

Loan Structure & Documentation

4. Documents Required for Self Employed Individuals – Non Professional

a) Proof of identity of sole proprietorship
b) Proof of individual identity
c) 3 years income tax returns
d) 3 years sales tax returns
e) Copy of periodic stock, age wise book-debt & creditors-statement for latest three months
f) Copy of last 6 months bank statement of main banker / copy of bank statement for the term loan.

Principles Of Sound Lending

- Safety
- Security
- Liquidity
- Suitability
- Risk diversification
- Profitability
- Purpose
- Nature of business
- Margin
- National policies

Components of Loan Policy

- Size of loan account
- Credit for infrastructure
- Types of loan portfolio
- Acceptable security
- Maturity
- Compensating balance
- Lending criteria
- Loan territory
- Limitations of lending authority

Administrative Credit Control

- Appraisal
- Pricing
- Expiry terms
- Sanctioning
- Documentation
- Disbursement
- Supervision
- Monitoring
- Recoveries & rehabilitation
- Income recognition & provisioning
- Internal controls
- Loan review

Influencing Factors of Loan Policy

- Variability in deposit
- Monetary policy
- Capital position
- Competitive position
- Local & national economy
- Ability & experience of loan officers
- Credit needs of the area

Evaluation of Applicant

- **Gathering Credit Information:**
- Interview
- Financial statements
- Report of credit rating agencies
- Bank’s own records
- Market report
- Report from other banks
- Other non formal methods

Evaluation of Applicant

- **Credit Analysis(Credit worthiness of applicants):**
  - Character
  - Capacity
  - Capital
  - Collateral
  - Condition
- **Credit Decision**

Credit Monitoring

- Documentation
- Disbursement of advance
- Inspection
- Submission of various statements
- Annual review
- Market information

Importance of Security for Advance

- Confirmation of credit recovery
- Precaution against intentional delay of customer
- Advantages of selling security
- Assurance of third party
- Increasing the responsibility of borrower
- Safety from bad debt
- Safety from reduction from fund
- Relation between bank & borrower
- Increasing morality of borrower

Classification of Securities

- Personal Security
- Non-personal Security
- Lien
- Particular lien
- General lien
- Banker’s lien
- Mortgage
- Simple mortgage
- Conditional mortgage

Classification of Securities

- Fixed mortgage/English mortgage
- Floating mortgage
- Equitable mortgage
- Registered equitable mortgage
- Possession mortgage
- Pledge
- Hypothecation
- Blue chip security
- Collateral security
- Government security

Suitable Factors for Security

Factors of personal securities

- Financial ability
- Status
- Honesty & reputation
- Social status
- Ability of credit using
- Good relation

Factors of impersonal securities

- Sales ability
- Price
- Liquidity
- Ownership
- Stability of price
- Possession
- Quality of asset

Methods of Calculating Loan Prices

- **A. Interest-Based Loans by traditional banks**

Pricing method	Characteristics
Fixed rate	The loan is written at a fixed interest rate which is negotiated at an origination. The rate remains fixed until maturity.
Variable rate	The rate of interest changes basing on the minimum rate from time to time depending on the demand for and supply of fund.
Prime rate	Usually, relatively low rate offered to the highly honored clients for a track record.
The rate for general customer	This rate is applied for general borrowers'. This rate is usually higher than the prime rate.

Methods of Calculating Loan Prices

Pricing method	Characteristics
Caps and Floors	For loans extended at variable rates, limits are placed on the extent to which the rate may vary. A cap is an upper limit and a floor is the lower limit.
Prime times	This special rate is a number of times greater than the prime rate. If the maturity of the loan is increased or decreased, this rate will also be increased or decreased in a multiple.
Rates on another basis	The interest rate can also be determined on the basis of the current interest rate of debt instruments or the regional index of change of interest/price. This rate is similar to prime rate except that the base is different a rate can be a bit lower or higher than the prime rate. Examples include the regional index or other market interest rate such as the CD rate.

Methods of Calculating Loan Prices

- **B. Determining loan price without interest**

Pricing method	Characteristics
Compensating balances	Deposit balances that a lender may require to be maintained throughout the period of the loan. Balances are typically required to be maintained on average rather than at a strict minimum.
Fees, charges etc.	After sanctioning credit but before disbursing the amount to the borrower, a charge is taken for this interim period. This charge helps to prevent the loan taker from making unnecessary delay in taking a loan. This apart, on special/priority cases, no interest but 3% – 5% service is charged on small loans.