BANK LENDING

Chapter Two

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Assist Proof Dr. Idrees Ramadhan Haji

Idrees.haji@su.edu.krd

INTRODUCTION TO BANK LENDING

- In 1906, Italian economist Vilfredo Pareto created a mathematical formula to describe the unequal distribution of wealth in his country, observing that twenty percent (20%) of the people owned eighty percent (80%) of the wealth. This principles of 80/20, later came to be known as Pareto principles. Uneven distribution of wealth in the society necessitated the need for banks to intermediate between the surplus and deficit units for economic growth and development.
- Lending is thus central and fundamental to the financial intermediation role of banks, making banks to granting different types of loans, with different periods of moratorium, rate of interest and repayment terms to their customers. The lending function of banks is equally ingrained in the need to generate maximum return for the shareholders and maximum liquidity for the investors, as well as achieve their objectives.

THE CONCEPT OF BANK LENDING

- Bank lending is the granting of credit facilities to borrowers (individuals, companies and organizations) at an interest rate, based on collateral security to be repaid after a period of time. An effective lending therefore is one that maximized profit to shareholders and liquidly to investors, as well as, ensure societal economic development.

OBJECTIVES OF BANK LENDING

- The **Objectives** of bank lending include:

a. **Stimulate economic growth and development:** This is done by lending money to businesses to purchase the assets (e.g.; raw material or a machine and vehicle etc..) with that will grow their business, which will in turn produce more goods, create more sales, and stimulate the economy, while at the same time making enough profit off of the new assets to be able to pay the money back at the maturity with interest thereby making the bank to earn profits and deliver returns to its shareholders.

b. **Encourage savings and investment:** Bank lending encourage savings by individuals, business and organizations which are taking to the bank for safe keeping or eventually give the money as loans and overdrafts to their customers.

OBJECTIVES OF BANK LENDING

c. **Maintain maximum profitability to shareholders and liquidity to investors:** Bank lending enable banks to earn profit through the difference between the interests paid on savings and fixed deposits and that charged on loans and overdrafts. Part of the profit earned is given as dividend to shareholders while the remaining part is retain in the bank to enhance liquidity and provide for expansion and growth in the business.

d. **Realize government policy objectives:** Bank lending is used as a vehicle/tool for driving government monetary policy through <u>expansion and contraction</u> in the amount of credit facilities due to the economic situation of a country.

Principles of Bank Lending Policies

There are basic principles which normally come into play when the commercial banks consider the establishment of lending policies for their operations. Such principles of bank lending are as identified and discussed below.

a. **Safety:** This is the most important principle of good lending. When a banker lends that the borrower is going to repay. If for example the borrower invest the money in unproductive and speculative venture (project) or the borrower himself is dishonest the advance would be in jeopardy. Similarly if the borrower or suffer losses in his business due to incompetence the recovery would be difficult. The bank ensures that the money advanced by him goes to the right type of borrower and is utilized in such a way that it will not only be safe at the time of lending but remain so throughout the period, and after serving a useful interest purpose in the trade or industry where it is employed to repaid with interest.

Principles of Bank Lending Policies

b. **Liquidity**: It is not enough that the money will be repaid back, it is also necessary that it must be repaid back on demand or in accordance with agreed terms of repayment. The borrower must be in position to repay within a reasonable time after demand for repayment is made and the source of repayment must be definite. This is because bulk of the bank deposits are repayable on demand or short notice and liquidity of the borrower can affect the ability of the bank to repay its depositors on demand in spite of the safety.

aram.fattah@su.edu.krd

Principles of Bank Lending Policies

c. **Profitability**: Loans and advances are not just granted customers for the fun of it. They are usually granted with the intention of earning some income for the banks. This income can only be earned by the bank through the interest charges being made from the loans granted to customers. The interest on loans from the banks to customers are normally established taking into consideration the valid market rate and the established bank rate by the apex bank (Central Bank) in the economy, which is called the monetary policy rate.

The interest rate being charged on loans by the commercial banks is normally higher than the bank rate being charged by the apex bank, and building into it other charges as may be determined by the banks.

Principles of Bank Lending Policies

d. **Diversification**: In the process of granting loans to customers, the banks consider the composition of the loan portfolio so as to strike the desired diversity of the investment. The loans being granted to customers are not normally concentrated in a particular type of sector but in different types of sectors, which will have to conform to the policy of sectorial distribution of loans as demanded by the apex bank (central bank). The distribution of the loan portfolio is also imperative towards minimizing risks that are always inherent in lending of funds. The principle of diversity is also applicable to spreading loans to various industries, firms, businesses and trades. Hence, commercial banks do strive to spread of risks of investment in loan portfolio by giving out credits to various trades and industries.

Principles of Bank Lending Policies

e. **Stability**: Commercial banks only advance loans to customers whose businesses generate stable incomes. For instance, a customer who applies for a loan facility should have his project or business evaluated to determine the possibility of such ventures generating constant income with which to serve the loan and make repayment on regular basis.

(A) Therefore, *for a new project* the **<u>technical feasibility</u>** and **<u>economic viability</u>** report will be evaluated to determine the nature of cash inflows in terms of stability of earnings, which will be used for repaying the loan and servicing it. The regularity of the earnings is very important and this will depend on the prudent management of the project.

(B) *In the case of existing business*, the financial reports for a period of not less than five years on consecutive basis will be evaluated to determine the regularity and quantum of earnings. Such assessment is used to evaluate the stability of such earnings towards definite repayment of loan facility.

Principles of Bank Lending Policies

f. **Purpose**: The purpose should be productive so that the lending would not only remain safe but would provide definite source for repayment. It would be important if the purpose is short and the risk is small and the money be applied for the purpose intended.

LENDING PROCEDURE 1/8

- The lending of loans and advances to the customers of banks goes through a rigorous events. Such events or procedures are normally initiated by both the bank and the customers who are seeking for credits with which to run their business operations. The process involves contact between the bank and the applicant for loan, during which the bank would initiate necessary actions to conduct a thorough investigation on the loan applicant and his business or the project for which the funds would be utilized.

LENDING PROCEDURE 2/8

1. **Loan Request from Customer:** In the process of lending of credits, it is the normal practice that a request be put forward by an applicant who is customer of the bank for a credit facility for the operations of a business entity or to prosecute a certain project which is expected to be self-liquidating. Nevertheless, some customers of the bank may be approached by the bank managers or credit officials of the bank to convince them to apply for credit facilities. The bank officials normally take into consideration certain factors before initiating the move in drawing the attention of some customers that they are entitled and qualified for credit facilities. Such move by the bank officials is normally based on the following considerations:

LENDING PROCEDURE 3/8

- **Loan Request from Customer:**

a) performance of such customers in the operations of their bank accounts;

b) the size of their business undertakings;

c) the nature of their business operations;

d) their market share in the industry;

e) the personal integrity of the customers;

f) level of liquidity of the bank;

LENDING PROCEDURE 4/8

2. **Interview with Loan Officer:** The scheduled interview of personal interaction between the loan officer and the applicant for loan facility is considered necessary in lending procedure. The interview is very critical in view of the fact that there is need to confirm the necessary claims by the customer who is seeking for the credit facility. The interview is normally conducted on the strength of the loan form filled and the analysis of same by the loan officer or loan committee as the case may be. The loan interview is desirable because it can be used to extract some additional information from the loan applicant, which can go a long way to help in giving favorable consideration, or otherwise, to the loan request. The loan interview provides an opportunity for the bank's loan officer to assess:

LENDING PROCEDURE 5/8

- **Interview with Loan Officer:**

a) the customer’s character and sincerity of purpose;

b) planned utilization of the funds;

c) actual amount of funds sufficient for the project involved;

d) applicant’s business acumen in utilization of the funds;

e) nature of applicant’s business operation;

f) means of ensuring prompt repayment of the loan; and

g) applicant’s understanding of the implications of loan obligations.

LENDING PROCEDURE 6/8

3.**Site Visit by Bank Officials:** It is desirable that the bank officials, and not only the loan officer, pay schedule visit to the business premises of the loan applicant. The visit of a team of bank officers to the customer’s business is imperative because the applicant for the loan facility may not supply the necessary information upon which a decision will be taken. The visit to the customer’s business becomes inevitable for the following reasons:

a) If a business loan or mortgage loan is applied for;
b) When a mortgage loan is involved;
c) To verify the claims of the customer;
d) To assess personally the nature of customer’s business
e) To determine the actual scale of the customer’s operations;
f) Assessment of the location of landed property for security;
g) Assessment of organizational setup of the customer’s business; and
h) Determine supplementary information for decision on the request.

LENDING PROCEDURE 7/8

4. **Preparing A Loan Agreement:** Once the loan and the proposed collateral are satisfied after the evaluation, the necessary loan agreement form and other documents that make up the agreement are prepared. The documents are both signed by the loan officer of the bank and the customer who benefits the loan facility. There is also the need for the guarantors to sign the documents before the final seal. The necessary documents, such as financial statements, security agreements, etc., that must accompany each loan application, must be kept in the bank's credit files with loan agreement and guarantors' forms signed by them. The principal components of a loan agreement include the following:

LENDING PROCEDURE 8/8

- **Preparing A Loan Agreement:**

a) **Loan Commitment Agreement:** This refers to pledges entered into by the bank as lender to make credit available to borrowers in the future for a stipulated time under specific terms.

b) **Collateral Security:** This refers to the assets or pledges of value that can be turned into cash to support the repayment of a loan.

c) **Covenants:** These are restrictions in the loan agreement that require a borrower to do or not do certain things while the loan agreement is in force without first receiving lender approval.

d) **Warranty:** It refers to a written stipulation or assurance by a borrower that information supplied in a loan application is true.

e) **Events of Default:** There is always a portion of a loan agreement which describes or spells out what action or inaction by a borrower would violate the terms of a loan.