Principles of Sound Lending

Bank performs different functions. Lending of money to different kinds of borrowers is one of the most important functions of commercial bank. A major portion of its fund is used for this purpose and this is also the major sources of bank's income. However, lending is not without risk. The borrowers of a bank range from individuals to partnership, companies, institutions, societies etc. The nature of their activities, the location of business, financial stability, earning and repaying capacity, purpose of advance, securities all differ and their degree of risks also differ. Therefore, a banker must take proper precaution in this process. Some of the important considerations to be kept in mind by a banker in this respect are discussed below:

Safety: Safety means that the borrower should be able to repay the loan and interest in time at regular intervals without default. Banks are trustee of public money. Bank's deposits are always payable on demand. Bank has to maintain trust of depositor forever. As such the first and foremost principle of lending is to ensure safety of funds lent. Further, it is just not the capacity of the borrower to repay but also his willingness to repay. The former depends on his tangible assets and the success of his business. The latter depends on the borrower's character. Now the question is how to ensure safety of lending? To ensure the safety of lending the following factors may be considered:

Five Cs	Five Ps	Five Ms	Five Rs
Character/conduct	Person	Man	Reliability
Capacity	Purpose	management	Responsibility
Capital	Product	Money	Resources
Condition	Place	Materials	Respectability
Collateral	Profit	Market	Returns

Liquidity: The term liquidity refers to the extent of availability of funds with the banker for providing credit to borrowers. It is to be seen that money lent is not going to be locked up for a long time. The money should return to the bank as per the repayment schedule. This schedule that is drawn up by the banker has to adhere to the requirement that at any point of time the banker should possess liquidity to meet the withdrawals of the depositors. It is to be kept in mind that various deposits have various maturities and some of it would also be payable on demand. A bank's inability to meet the demand of its depositors can lead to a run on the bank which is a threat to its basic survival. Hence the banker has to always monitor the cash flows and carry out the exercise of ensuring liquidity with the borrower as this in turn means liquidity with the banker. Further, liquidity would also refer to the quality of assets, which should be easily convertible into cash without any loss of value. Thus the concept of liquidity entails the banker to look for easy salability and absence of risk of loss on sale of asset, which has been taken as collateral.

Purpose: The purpose should be productive so that the money not only remain safe but also provides a definite source of repayment. Loans may be required for productive purposes, trading purposes, agriculture, transport, self-employment etc. If a loan is required for a non-productive or speculative purpose, the banker should be very much cautious in entertaining such proposals. It is very difficult to ensure that the loan has been utilized for the purpose for which it was sanctioned. Banker should take follow-up measures to ensure end use of fund exactly for the same purpose for which it is borrowed.

Profitability: Banks are not charitable institutions. All banks are profit-earning institutions. The ultimate objective of lending is to earn profits. Banks receive interest on loans and advances lent, and they pay interest to their depositors. This difference between the receipts and payments will be the bank's gross profit. Banks further incur various expenses as any organization does. After accounting for all such expenses and provisions, banks have to earn reasonable amount as net profit (NIM) so that dividends can be paid to its shareholders. The trust and confidence level of the customer and investor will be high with a bank that has a good track record of profits and dividend rates. Hence it is important that whatever the business the bank engages itself with, the business be profitable enough not just to cover its costs but to ensure generation of surplus funds or margin. It is prudent for the banker to consider overall profitability of the entire business that is undertaken rather than the profitability against each component of business or service offered.

Security: The security offered by a borrower for an advance is as like as the insurance to the banker. It serves as the safety valve for an unforeseen emergency. So another principle of sound lending is the security of lending. Security offered against loan may be various. It may be a plot of land, building, flat, insurance policies; term deposits etc. There may even be cases where there is no security at all. The banker must realize that is it only a cushion to fall back upon in case of need. The security and its adequacy alone should not form the sole consideration for judging the viability of a loan proposal. Nevertheless, the security if accepted must be adequate and readily marketable, easy to handle and free from encumbrance. It is the duty of the banker to check the nature of the security and assess whether it is adequate for the loan granted.

Diversification: A prudent banker always tries to select the borrower very carefully and takes tangible assets as security to safeguard his interests. While this is no doubt an adequate measure, there are other unforeseen contingencies against which the banker has to guard himself. Further if the bank lends large amounts to a single industry or borrower, then the default by that customer can affect the banking industry as a whole and will affect the basic survival of the industry. To safeguard his interest against all such risks, the banker follows the principle of diversification of risks based on the famous maxim 'never keep all the eggs in one basket'. By lending funds to different sectors, a bank can save itself from the slump in some sectors by way of prosperity in the others. Banks have to lend to a large number of industries and borrowers so that the risk gets diversified

National Interest: Even when an advance satisfies all the aforesaid principles, it may still not be suitable. The advance may run counter to national interest. Bank has a significant role in the economic development process of a country. They should keep in mind the national development plan/program while going for lending but maintaining safety, liquidity and profitability.

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