COURSE GUIDE

ENT 209
THEORY OF ENTREPRENEUSHIP

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INTRODUCTION

ENT 209: Bank Lending and Administration 1 is a two credit course for students offering B. Sc. Entrepreneurship and Business Management in the School of Management Science.

The course will consist of fifteen (15) units, that is, three (3) modules of five (5) units for each module. The material has been developed to suit undergraduate students in Entrepreneurship and Business Management at the National Open University of Nigeria (NOUN) by using an approach that treats fundamental areas of risk management. A student who successfully completes the course will surely be in a better position to manage risk exposures of organizations in both private and public organizations. The course guide tells you briefly what the course is about, what course materials you will be using and how you can work your way through these materials. It suggests some general guidelines for the amount of time you are likely to spend on each unit of the course in order to complete it successfully. It also gives you some guidance on your tutor-marked assignments. Detailed information on tutor-marked assignment is found in the separate assignment file which will be available in due course.

WHAT YOU WILL LEARN IN THIS COURSE

This course will introduce you to some fundamental aspects of Bank Lending And Administration generally. It also includes Bank Policies on Lending, Commercial Banks as Extenders of Credit, Credit Protection Methods, Lending Procedures, Objectives of Lending & Credit Administration, Lending Appraisals & Decisions, Term Loans & Real Estate Loans, Working Capital Loans, Agricultural Loans, Installment Loans & Secured Loans, Loan Monitoring & Supervision, Collateral Security Issues, Credit Insurance, and Export Credit Protection.

COURSE AIMS

The course aims, among others, are to give you an understanding of the intricacies of risk management and how to apply such knowledge in managing risk exposures in both private and public enterprises.

The Course will help you to appreciate Banking Policies on Lending, Lending and Credit Administration, Credit Protection Methods, Lending Procedures, Lending Appraisals & Decisions, Term Loans & Real Estate Loans, Working Capital Loans, Agricultural Loans, Installment Loans &

Secured Loans, Loan Monitoring & Supervision, Collateral Security Issues, Credit Insurance, and Export Credit Protection.

The aims of the course will be achieved by:

- Identifying and explaining Banking Policies on Lending;
- Explaining the Lending and Credit Administration;
- Identifying and explaining Credit Protection Methods;
- Highlighting and discussing Lending Procedures;
- Explaining Lending Appraisals & Decisions
- Discussing Term Loans, Real Estate Loans & Working Capital Loans;
- Describing Agricultural Loans, Installment Loans & Secured Loans;
- Explaining Loan Monitoring & Supervision;
- Presenting and discussing Collateral Security Issues; • Listing and discussing the aspects of Credit Insurance; • Describing the Export Credit Protection;

COURSE OBJECTIVES

By the end of this course, you should be able to:

- Define Lending and Credit Administration;
- Mention and explain Banking Policies on Lending;
- Discuss Credit Protection Methods;
- Analyze the Lending Procedures;
- Explain Lending Appraisals & Decisions
- Discuss Term Loans, Real Estate Loans & Working Capital Loans;
- Describe Agricultural Loans, Installment Loans & Secured Loans;
- Analyze Loan Monitoring & Supervision;
- Discuss the Collateral Security Issues;
- Describe the aspects of Credit Insurance;
- Analyze the Export Credit Protection;

WORKING THROUGH THIS COURSE

To complete this course, you are required to read all study units, attempt all the tutor- marked assignments and study the principles and practice of lending and credit administration in this material provided by the National Open University of Nigeria (NOUN). You will also need to undertake practical exercises for which you need access to a personal computer running Windows 95.

Each unit contains self-assessment exercises, and at certain points during the course, you will be expected to submit assignments. At the end of the course is a final examination. The course should take you about a total of 17 weeks to complete. Below are the components of the course, what you have to do, and how you should allocate your time to each unit in order to complete the course successfully on time.

COURSE MATERIALS

Major components of the course are:

- Course Guide
- Study Units
- Textbooks
- Assignment file

STUDY UNITS

The study units in this course are as follows:

Module 1

Unit 1 Bank Policies on Lending
Unit 2 Commercial Banks as Extenders of Credit
Unit 3 Credit Protection Methods Unit 4: Lending Procedures
Unit 5 Objectives of Lending & Credit Administration

Module 2

Unit 1 Lending & Credit Administration
Unit 2 Lending Appraisals & Decisions
Unit 3 Term Loans & Real Estate Loans
Unit 4 Working Capital Loans Unit 10: Agricultural Loans

Module 3

Unit 1 Installment Loans & Secured Loans
Unit 2 Loan Monitoring & Supervision
Unit 3 Collateral Security Issues
Unit 4 Credit Insurance
Unit 5 Export Credit Protection

ASSIGNMENT FILE

In this course, you will find all the details of the work you must submit to your tutor for marking. The marks you obtain for these assignments will count towards the final mark you obtain for this course. Further information on assignments will be found in the assignment file itself and later in the section on assessment in this course guide. There are 15 tutor-marked assignments in this course; the student should attempt all the 15.

PRESENTATION SCHEDULE

The presentation schedule included in your course materials gives you the important dates for this year for the completion of tutor-marked assignments (TMAs) and attending tutorials. Remember, you are required to submit all your assignments by the due date. You should guard against falling behind in your work.

ASSESSMENTS

There are two aspects to the assessment of the course: first are the tutor-marked assignments; and second is a written examination.

In tackling the assignments, you are expected to apply information, knowledge and techniques gathered during the course. The assignments must be submitted to your tutor for formal assessment in accordance with the deadlines stated in the Presentation Schedule and the Assignment File. The work you submit to your tutor will count for 30% of your total course mark.

At the end of the course, you will need to sit for a final written examination of 'three hours' duration. This examination will also count for 70% of your total course mark.

TUTOR-MARKED ASSIGNMENT (TMAs)

There are fifteen tutor-marked assignments in this course and you are advised to attempt all. Aside from the course material provided, you are advised to read and research widely using other references (under further reading) which will give you a broader viewpoint and may provide a deeper understanding of the subject. Ensure all completed assignments are submitted on schedule before set deadlines. If for any reasons, you cannot complete your work on time, contact your tutor before the assignment is due to discuss the possibility of an extension. Unless in exceptional

circumstances, extensions may not be granted after the due date for the submission of the assignments.

FINAL EXAMINATION AND GRADING

The final examination for this course will be of 'three hours' duration and have a value of 70% of the total course grade. All areas of the course will be assessed and the examination will consist of questions, which reflect the type of self-testing, practice exercises and tutor-marked problems you have previously encountered. All areas of the course will be assessed.

Utilise the time between the conclusion of the last study unit and sitting for the examination to revise the entire course. You may find it useful to review your self- assessment tests, tutor-marked assignments and comments on them before the examination.

COURSE MARKING SCHEME

The work you submit will count for 30% of your total course mark. At the end of the course, you will be required to sit for a final examination, which will also count for 70% of your total mark. The table below shows how the actual course marking is broken down.

Table 1: Course Marking Scheme

ASSESSMENT	MARKS
Assignment 6 (TMAs)	4 assignments, best 3 will be used for the Continuous Assessment = 10 x 3 = 30%
Final Examination	70% of overall course marks
Total	**100% of course marks**

ASSIGNMENT FILE

Unit	Title of work	Weeks activity	Assessment (end of unit)
1	Bank Policies on Lending	1	
2	Commercial Banks as Extenders of Credit	1	
3	Credit Protection Methods	1	
4	Lending Procedures	1	
5	Objectives of Lending & Credit Administration	1	
6	Lending & Credit Administration	1	
7	Lending Appraisals and Decisions	1	
8	Term Loans and Real Estate Loans	1	
9	Working Capital Loans	1	
10	Agricultural Loans	1	
11	Installment Loans and Secured Loans	1	
12	Loan Monitoring and Administration	1	
13	Collateral Security Issues	1	
14	Credit Insurance	1	
15	Export Credit Protection	1	
	Revision		
	Total	**15**	

TUTORS AND TUTORIALS

There are 15 hours of tutorials provided in support of this course. You will be notified of the dates, times and location of these tutorials, together with the names and phone numbers of your tutor, as soon as you are allocated a tutorial group.

Your tutor will mark and comment on your assignments, keep a close watch on your progress and on any difficulties you might encounter as they would provide assistance to you during the course. You must submit your tutor-marked assignments to your tutor well before the due date (at least two working days are required). They will be marked by your tutor and returned to you as soon as possible. Do not hesitate to contact your tutor by telephone, e-mail, or discussion group if you need help.

The following might be circumstances in which you would find help necessary, when:

- you do not understand any part of the study units or the assigned readings.
- you have difficulty with the self-tests or exercises.
- you have a question or problem with an assignment with your tutor's comment on an assignment or with the grading of an assignment.

You should try your possible best to attend the tutorials. This is the only chance to have face-to-face contact with your tutor and to ask questions which are answered instantly. You can raise any problem encountered in the course of your study. To gain the maximum benefit from course tutorials, prepare a question list before attending them. You will learn a lot from participations in discussions.

SUMMARY

ENT 209: Bank Lending and Administration 1 intends to expose the undergraduate students to the fundamentals of lending and administration by commercial and other banks in the process of their financial intermediation in the economy. Upon completing the course, you will be equipped with the necessary knowledge required to produce a good research work.

We hope you enjoy your acquaintances with the National Open University of Nigeria (NOUN). We wish you every success in the Future.

MAIN COURSE

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MODULE 1

Unit 1 Bank Policies on Lending
Unit 2 Commercial Banks as Extenders of Credit
Unit 3 Credit Protection Methods
Unit 4 Lending Procedures
Unit 5 Objectives of Lending & Credit Administration

UNIT 1 BANK POLICIES ON LENDING

CONTENTS

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1.0 INTRODUCTION

Commercial banks are business entities which are established for the purpose of carrying out banking operations with the aim of earning reasonable returns for the shareholders. This implies that such organizations cannot be operated effectively and efficiently without internal laws, regulations and procedures for transacting banking business. Hence the need for operating policies by commercial banks cannot be over- emphasized. Therefore, this initial study unit of this material is used for the discussion of relevant bank policies in areas particularly relating to bank lending; such as policies for loan limit and loan supervision, managing difficult loan beneficiary, and credit risk management, among others. The unit is used for the discussion of the basic principles of banking lending, which do influence the policies on bank loans and advances that are normally granted to deserving customers of the banks.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- explain the nature of bank policies on operations
- mention and discuss the principles of bank lending policies
- list and explain major areas of bank policies on lending

3.0 MAIN CONTENT

3.1 Nature of Bank Policies on Operations

The bank policies are normally derived from the objectives of their operations which are products of their mission statements. The bank policies are formulated with the intention of ensuring that the operations of the banks are established on sounding footing which conforms to the best practices of banking operations. This is because bank operations are basically embedded in financial intermediation; sourcing for funds from surplus areas and lending such funds to areas of needs.

Bank policies as observed by Uremadu (2004) affect the organizational structure and by extension also influence the employment of the personnel. Bank policies are also used to mould the bank personality and for shaping the desired course of action in terms of the operational direction of the banks.

Bank policies are normally formulated on operational areas such as follows:

- organizational structure
- employment of the personnel • modalities of operations • lending procedures • investment of funds
- strategies for hedging risks in operations • sectoral allocation of loans and advances • remuneration of personnel
- appointment of external auditors, etc.

The formulation of bank policies can be the responsibility of the board of directors. The policies can also be formulated by the chief executive officers and tabled before the board for consideration and approval before their implementation. In some instances, the policies can be formulated by committees constituted by the management for such purpose.

The formulation of bank policies in unit banks with their operations being restricted to specific areas, such as the microfinance banks in the country, can be easily accomplished. This is because of such banks' nearness to their personnel and the understanding of the particular areas where they operate.

For instance, a microfinance bank would have distinct operational policies given the peculiar socio-economic conditions as compared to the operational policies for a microfinance banks which engage in business in an area like Lagos. These are also different from the

operational policies of microfinance banks that are doing business in Calabar.

The operational policies of the branch banks do differ from those of the unit banks. This is because of the fact that their operations spread over a large geographical areas.

Therefore, the branch managers are expected to make some inputs into the overall corporate policies necessary for successful operations.

Furthermore, the branch manager of each area may like to initiate a different policy on a particular matter which is dictated by the peculiar environment in issues such economic growth, economic activities, socio-economic needs, and people's attitudes towards banks generally. (Uremadu, 2004).

The operational policies of the banks, be they unit banks or branch banks, should be couched on the basis of flexibility due to the changing patterns of environmental conditions. Hence banking policies should be subjected to review on periodical basis because of the changing economic condition and other environmental dictates which shape banks' operations.

Therefore, the need for the formulation and constant review of the bank policies becomes very relevant in the areas of sourcing for deposits from the public, investment of funds on marketable securities, hedging against risks in operations, managing credit risks, and above all lending or granting credits, loans and advances to customers.

SELF ASSESSMENT EXERCISE 1

Enumerate the areas of operations on which bank policies are formulated.

3.2 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 (Jhingan, 2008) are as identified and discussed below.

1. Liquidity

This is the uppermost consideration in bank lending because banks only make use of depositors' money for business, and such depositors are entitled to their funds every time they are in need of the money.

Therefore, banks lend money for a short term in most cases. This is because the banks lend public money which can be withdrawn at any time by the depositors.

Basically, the banks advance loans on the understanding that they will be repaid within a short time. More so, they lend money on the basis of security that can be easily marketable and convertible into cash at a short notice.

2. Safety

The safety of the funds lent out by the banks must be safe in this sense that the borrower should be able to repay the loan and interest in time at agreed regular intervals without defaults.

Essentially, the repayment of loans by the beneficiaries depends on their capacity to generate enough funds from business entities and the character of such borrowers. Furthermore, the repayment also depends on other factors such as the financial standing of the borrowers and nature of collateral securities pledged for the loans.

While the nature of the security is important in the consideration of lending to customers, the banks take into consideration the creditworthiness of the borrowers which governs his character, capacity to repay, and his financial standing. Relatedly, the safety of the bank funds depends on the technical feasibility and economic viability of the project for which the loan is granted.

3. Diversity

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 sectoral distribution of loans as demanded by the apex 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.

4. 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.

Therefore, for a new project the technical feasibility and economic viability 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.

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.

5. 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 prevailing market rate and the established bank rate by the apex 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.

SELF ASSESSMENT EXERCISE 2

Mention and explain the basic principles considered for lending by commercial banks.

3.3 Major Areas of Bank Policies on Lending

There are critical areas relating to lending that the banks do not normally take for grant in the formulation of bank policies. Such areas for policy formulation on bank lending are as identified and discussed below.

3.3.1 Loan Limit

Policies are normally set for the granting of loans by the various officers of the bank that are directing involved in lending. In setting the magnitude of loan that can be approved by the officers in charge of credits, certain factors are usually taken into consideration.

In terms of policy on loan limit for the officers, the following factors, among others, are taken into consideration;

- The position of the officer, e.g., a branch manager, senior loan officer;
- The experience of the officer, e.g., 10 years in loan administration;
- The level of expertise in sector of the economy, e.g., estate, agriculture, etc;
- Performance of the officer in handling loans in the past; and
- Understanding of the customers' product markets.

In terms of the loan limit for the customers, the following factors, among others, are taken into consideration;

- Creditworthiness of the customer;
- Performance on the previous loans, for old customer;
- Performance of the business in the last five years, at least, for new customer;
- His market share in the industry, e.g., 5%, 10%, 25%, 35%, 45%, 60%;
- Geographical area of operations, e.g., a town, city, suburb, village, farm settlement;
- His operational capacity, e.g., medium-scale , large-scale operations;
- Level of demand for his product or service in the economy;
- Magnitude of cash inflows on periodic basis; and
- Customer's character and other personal qualities.

Furthermore, grading system can be used for setting the policies on loan limit such as portrayed by the figure (2.1) below.

Figure 2.1
Categorization of Customers for Loan Limit

Grade	Comments	Loan Limit (N)
A	Blue chip company	50,000,000
B	Government Agency	10,000,000
C	Large Company	5,000,000
D	Medium Company	3,000,000
E	Small Company	1,000,000
F	Individualized Business	500,000

The individualized business refers to business entity such as partnership and sole proprietorship, having operational capacity that is not comparable with an incorporated company whose asset base is very reasonable in terms of operational capital.

However, there is no hard and fast rule in the categorization of customers for the purpose of loan limit. A grading or categorization system being used by any bank for setting loan limits on customers depends on choice.

In related terms, such categorization of loan limits can be also be used to set loan mandate for the officers of the bank when it comes to approval of loans for the customers.

In the case of the branch manager, the usual policy on loan limit is for the bank to set the amount of funds that he or she can lend out to a customer. The limit is regarded as his or her authority in lending, and any loan request in excess of such lending authority will have to be communicated to the head office for advice.

A loan request in excess of the branch manager's authority in lending can as well be communicated to the area manager who may have the authority to sanction it without recourse to the head office for the necessary approval.

3.3.2 Loan Supervision

It is very important for the bank to set policies on loan supervision. The policies on granting of loans, their supervision, and recovery drive are normally established taking into consideration the relevant strategies used in the past and those ones being utilized by other banks.

Bank policies on loan supervision are used to address responsibilities such as:

- Teams to be constituted for checks and balances;
- Superior officer(s) to be in charge of reports and evaluation, e.g., an Executive Director at the head office, a Senior Manager at regional office;
- Time line for periodic reviews of loan portfolio for compliance on laid down regulations;
- Number of loan recovery visits to customers who are loan beneficiaries in a period.
- Charting out procedures for compliance with extant banking laws and regulations on loan facilities;
- The rate of interest to charge in line with prevailing market rate and bank rate;
- Spread of available funds for different sectoral allocations; and
- Repayment drive to keep pace with liquidity needs.

3.3.3 Credit Risk Management

A policy should usually be established for the management of the credit risk in terms of the problems that can emanate from loan recovery by the bank.

The policy is on the following areas of responsibilities:

- Manager's responsibility in preventing credit risks;
- Assistant Manager's responsibility in credit risk management;
- Loan officers' responsibility in preventing credit risks;
- Hierarchical authority for handling credit risks; and
- Actions necessary in managing difficult beneficiaries of loans.

There are other areas of responsibilities for the management of credit risks by various bank officials, which are not covered by above list. Therefore, the list is by no means exhaustive for the purpose of credit management of credit risks by the banks.

3.3.4 Managing Difficult Loan Beneficiary

There should be policy on how a difficult loan beneficiary can be managed by relevant bank officials. Such policy should be used to specify the necessary actions to be initiated and taken by the bank officials to recover the amount of loan involved in the transaction.

The necessary directives in managing difficult account involve the following considerations:

- The use of committee for the recovery of the funds;
- Discussion with the difficult customer by the bank officials;
- Visit to the business premises of the customer for assessment;
- The use of subtle pressure on the customer, e.g., threat of legal action;
- Constant visits for help in managing the affairs of the customer;
- Threat of disposing off the collateral security pledged for the loan; and
- Legal letter on the status of the customer and the plan to take action on the business for the recovery of the outstanding amount of loan.

In addition to the above, there are other areas for policy actions on difficult customers, which various banks can formulate to manage them. More so, necessary responsibilities for the management of the difficult customers are formulated and assigned to various bank officials, which are not covered by above list. Therefore, the list is by no means exhaustive for the purpose of managing difficult customers by the banks.

3.3.5 Controlling Customer Accounts

Policy on controlling the account of the customer who is a loan beneficiary is also necessary for consideration in establishing banking policies. The control of customer account is necessary because of the fact that a customer can be playing pranks on the repayment of loan and payment of interest on such funds.

The policy on control of customer account always emphases the following considerations:

- Constant monitoring of repayment status;
- Periodic statement being issued to the customer;
- Constant reminder on outstanding balance of the loan;
- Computer alert sent to the customer whenever any payment is made;
- Any discrepancy such as delay or amount less than expected in repayment be communicated to the customer immediately;
- Computer alert on due date for next payment be sent to the customer on monthly basis;
- Monitoring of withdrawals from the customer account as not to jeopardize repayment of funds loaned to him or her.

The above list is by no means is exhaustive, and therefore, it is left for individual banks to decide on the necessary considerations in this respect.

3.3.6 Monitoring and Review of Customer Case

This is done to evaluate the performance of a customer's account. It is necessary in the management of the bank's liquidity particularly in the case of big time customers of the bank. In addition, there is every likelihood that such customers will use their accounts to demand for overdraft or loans in the course of their operations.

There are areas on which policies can be established for such purpose. The following can be used to monitor the account of such customer who are known for keeping large amount of funds in their account:

i) Account Turnover

A policy on the account turnover involves giving directive for the monitoring of the amounts of funds earned by the customer by calculating the credits to the account. The performance of such an account will be evident from the assessment.

An action should be initiated on any decline in the figures of deposits in terms of discussion with customer for necessary advice. In the same vein, observed frequency of deposits should be treated with optimism since it measures operational success of the customer's business, which is of tremendous benefit to be bank.

ii) Trends in Account Balance

The periodic deposits can be calculated on average basis at the end of every monthly in order to assess the trends in account deposits of the customer. The analysis thereof can reveal the peaks and declines in the deposits for the use of the bank in considering granting of loans or overdraft in the future.

iii) Amount in Cheques Drawn

The amounts of funds in the cheques drawn by a customer on his account, as a matter of policy, should be assessed on periodic basis to determine cash problems associated with customer's business. An appropriate action on the basis of bank policy is to discuss and offer professional advice on the ways and means of improving the revenue generating capacity of the customer's business operations.

iv) Status of Direct Credits

The customer's performance in standing orders and direct debits can be used, as a matter of policy, to assess the character of the customer in

terms of integrity and keeping to agreements and honouring them as at when they are due for payment.

Hence the personal integrity or character of the customer comes to question if his orders on direct debits or standing orders are frequently cancelled. Such customer can be trusted for regular repayment of loans if granted by the bank.

SELF ASSESSMENT EXERCISE 3

Identify and explain the critical areas relating to lending for which banks normally set policies.

4.0 CONCLUSION

In this initial unit of the study material, you have observed that bank policies are imperative towards ensuring effective and efficient operations of bank business especially as they relate to bank lending. In order to guarantee the efficient operations of commercial banks in terms of the important aspect of financial intermediation, which is lending of funds to business entities and individuals, it is critical for their management to formulate policies on managing loans and their supervision, managing difficult loan beneficiaries, credit risk management as well as monitoring and review of customer case.

5.0 SUMMARY

In this study unit, topics covered include the following:

- Nature of Bank Policies on lending
- Principles of Bank Lending Policies
- Major Areas of Bank Policies on Lending

In the next study unit, you will be taken through the discussion on commercial banks as extenders of credit.

6.0 TUTOR–MARKED ASSIGNMENT

List and discuss the critical areas relating to lending for which banks normally set policies.

Solution to Self Assessment Exercises

SAE 1:

The areas of operations on which bank policies are formulated are as follows:

- Sourcing for deposits from the public;
- Investment of funds in areas of marketable securities;
- Hedging against risks in operations;
- Managing of credit risks; and
- Lending or granting credits, loans and advances to customers.

SAE 2:

The basic principles considered for lending policies by commercial banks are as follows:

i) Liquidity

Basically, the banks advance loans on the understanding that they will be repaid within a short time. More so, they lend money on the basis of security that can be easily marketable and convertible into cash at a short notice.

ii) Safety

The safety of the funds lent out by the banks must be safe in this sense that the borrower should be able to repay the loan and interest in time at agreed regular intervals without defaults. The banks take into consideration the creditworthiness of the borrowers which governs his character, capacity to repay, and his financial standing.

iii) Diversity

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; a loan portfolio in different types of sectors, which will have to conform to the policy of sectoral distribution of loans as demanded by the apex bank. This is used towards minimizing risks that are always inherent in lending of funds.

iv) 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 service the loan and make repayment on regular basis.

v) Profitability

Loans and advances 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. Such interest charges are in with prevailing market rate and the bank rate.

SAE 3:

The critical areas relating to lending for which banks normally set policies are as follows:

i) Loan Limit

Policies are normally set for the granting of loans by the various officers of the bank that are directing involved in lending. There is also policy on loan limit to various categories of customers.

ii) Loan Supervision

It is very important for the bank to set policies on loan supervision. The policies on granting of loans, their supervision, and recovery drive are normally established taking into consideration the relevant strategies used in the past and those ones being utilized by other banks.

iii) Credit Risk Management

A policy should usually be established for the management of the credit risk in terms of the problems that can emanate from loan recovery by the bank.

iv) Managing Difficult Loan Beneficiary

Banks normally set policy on how a difficult loan beneficiary can be managed by relevant bank officials. Such policy should be used to specify the necessary actions to be initiated and taken by the bank officials to recover the amount of loan involved in the transaction.

v) Controlling Customer Accounts

Policy on controlling the account of the customer who is a loan beneficiary is also necessary for consideration in establishing banking policies. The control of customer account is necessary because of the fact that a customer can be playing pranks on the repayment of loan and payment of interest on such funds. vi) Monitoring and Review of Customer Case

This is done to evaluate the performance of a customer's account. It is necessary in the management of the bank's liquidity particularly in the case of big time customers of the bank. Such customers will use their accounts to demand for overdraft or loans in the course of their operations.

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UNIT 2 COMMERCIAL BANKS AS EXTENDERS OF CREDIT

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1.0 INTRODUCTION

Commercial banks operate business that is woven around financial intermediation activities. In fundamental terms, banks are institutions which evolve for the business of keeping, lending and exchanging of money. Therefore, banks are organizations whose principal operations are entrenched in accumulation of idle funds from the general public with the purpose of lending such funds to business entities and individuals as well as the government institutions. The position of the commercial banks is that of retail banking institutions that accept deposits from the public and in turn lend such funds to some members of the public. The discussion in this study unit is invariably on the nature of financial intermediation of the commercial banks.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- explain the nature of commercial banking operations
- identify and the types of deposits commercial banks accept from customers
- list and discuss various types of credit facilities of commercial banks
- discuss credit creation process of commercial banks

3.0 MAIN CONTENT

3.1 Nature of Commercial Banking Operations

Banks generally owe their operations in financial intermediation activities. Historically, the goldsmiths that pioneered the realm of banking business evolved the operations by accepting valuables such as bullions, money and ornaments for safekeeping. For the care of the valuables, the goldsmiths started charging some fees for the safekeeping of the money and the bullions.

In the process of the safekeeping of money, bullion and other valuables, the goldsmiths started lending the money to other people for fees. This serves as the precursor of the modern banking business operations.

In conceptual terms, banks are institutions which evolve for the business of keeping, lending and exchanging of money. In broad terms, there are other views banks in economics discipline which offer succinct explanation on the essence of banking business.

There is the view that banker's business is to take the debts of other people to offer his own in exchange, and in the process create money. Another view posits that banks are organizations whose principal operations are embedded in the accumulation of temporarily idle funds of the general public for the purpose of advancing to others for expenditure.

Jhingan (2008) observes that the ordinary business of banking consists of changing cash for bank deposits and bank deposits for cash, transferring bank deposits from one person or corporation (one depositor) to another; giving bank deposits in exchange for bills of exchange, government bonds, the secured or unsecured promises of businessmen to repay, among others.

Hence, commercial banks as retail banks are institutions that accept deposits from the public and in turn advance loans by creating credit.

The commercial banks, in the opinion of Jhingan (2008), are the banks that perform all kinds of banking functions such as:

- accepting deposits;
- advancing loans;
- credit creation;
- financing foreign trade;
- discounting bills of exchange;
- agency functions;
- keeping of valuables;
- issue credit instruments; and
- serve as underwriters for shares and debentures.

The commercial banks are known for granting short-term loans, in most cases, to customers. Nevertheless, in recent years, they have included medium–term and long- term loans in their loan portfolios.

In terms of ownership, commercial banks are joint stock banks in the sense that they are just like the joint stock companies whose ownership cuts across many strata of the society; and therefore the shareholders of each of such corporate banking entities run into millions.

SELF ASSESSMENT EXERCISE 1

What are the major functions of the commercial banks?

3.2 Accepting Deposits from Customers

The most important function of commercial banks is the acceptance of deposits from members of the public. This is the critical function because all other functions of commercial banks depend on this pre-occupation. The commercial banks charge some commission for the safekeeping of these deposits.

The commercial banks in their normal banking operations accept three types of deposits from members of the public. These are identified and discussed below.

1. Savings deposits

The banks accept deposits for the purpose of savings on which they pay small interest to the depositors. Such depositors are usually small savers. The savers are usually allowed to draw their money subject to some limited amount during a specified period of time; such weekly, monthly, quarterly, half-yearly or yearly.

2. Demand deposits

Current accounts are usually maintained by commercial banks for such deposits. The demand deposits accounts are specifically designed for businessmen and corporate entities. This is because as business operations demand, they are free to withdraw their deposits by cheques without notice or limits. Cheques can even be drawn on the current accounts on daily basis without hindrance.

Therefore, the commercial banks do not pay any interest on such accounts but rather they charge nominal sum for the services rendered on the accounts. Such charge on the current accounts is called commission on turnover.

3. Fixed or Time deposits

The commercial banks also accept deposits which are kept for some specified period of time before the depositors can have access to the funds in their accounts. Savers who have surplus funds that are not meant for use until after some period of time can keep such funds in the time deposit accounts.

In essence, savers who do not need some funds for a stipulated period of time such as some months, a year or many years, are encouraged by the banks to deposit it in the time deposit accounts . They are free to demand for the funds at the maturity of the specified time.

The commercial banks pay higher interest rates on the time deposits. The rate of interest increases with the length of period of the deposit but subject to a maximum limit. Hence, the interest rates on fixed deposits are normally negotiated between the deposited and the bank.

SELF ASSESSMENT EXERCISE 2

Enumerate and explain various types of deposits that commercial banks can keep for the customers.

3.3 Advancing Loans from Deposits

The commercial banks give out loan facilities to the members of the public particularly their customers who are into one form of business undertaking or another. The situation may be different in advanced climes where there are some other forms of loans or credits which can be advanced to customers.

Advancing loans or credits out of the deposits constitutes one of the fundamental functions of the commercial banks. In the process of banking operations, the commercial banks lend out certain percentage of the cash in deposits on a higher rate of interest than they pay on such deposits.

The various forms of loans and credits being granted to customers by the commercial banks are identified and discussed below.

1. Term Loans

The commercial banks advance this type of loans to customers who are businessmen against specified securities. The amount of loan is normally credited to the current account of the borrower. In the case of a

new customer, a loan account for amount of loan is normally opened for the facility.

The customer who is the beneficiary of the loan facility is then free to withdraw money with cheques, from the loan account in the case of the new customer and the cuurent by the existing customer of the bank.

The beneficiary of the loan has to pay the specified or agreed interest rate on the full amount of the loan and necessarily the loan principal would also be repaid back to the bank.

2. Call Loans

These loans are short-term facilities that can be granted to the bill brokers for not more than a fortnight or fifteen days. Such loan facilities are normally advanced against first class bill or securities. Such loans can be recalled at a very short notice and can also be renewed. These are similar to money at calls and short notices normally advanced by banks to other banks in the money market operations in the economy.

3. Overdraft

This is the facility which is designed for the businessmen and corporate entities for which they are allowed to cheques for sums greater than the balance in their current accounts.

The facility is effected by providing the overdraft up to a specific amount to the customers against their future deposits, which would be used to offset the amount involved by the bank.

The commercial banks normally charge interest only on the amount by which the current account is overdrawn and not by the amount of the full amount of the overdraft approved for the customer by the bank.

4. Discounting of Bills of Exchange

This facility is available for use by the creditor who holds a bill of exchange. It is meant for immediate access to the funds in the bill but at a discounted amount which is lower than the face value of the instrument.

The commercial banks through this facility provide the customer who is a holder of a bill of exchange immediate cash by discounting the bill. The banks would deposit the amount of the bill in the current account of the bill holder after deducting their rate of interest for the period of the loan, which is not more than 90 days.

It is instructive to note that the bill of exchange is normally drawn by the creditor and sent to the debtor for acceptance, and then given back to the creditor making it payable after 90 days. At the maturity of the bill of exchange, the bank that discounts it recovers its payment from the banker named by the debtor who accepted the bill.

SELF ASSESSMENT EXERCISE 3

Enumerate and explain various types of credit facilities that commercial banks do extend to their customers.

3.4 Credit Creation from Credit Facility

This function of the commercial banks is associated with granting of loan facilities to their customers. By implication, the commercial banks cannot create credits without engaging in granting loans to their customers.

The credit creation by the commercial banks, unlike other financial institutions that cannot create credits, arises out of their quest to generate profits in their operations. For this rationale, the commercial banks accept deposits and advance loans out of such funds by keeping small cash in reserve for day-to-day transactions.

In this operation, whenever the bank advances a loan, it opens an account in the name of the customer as the beneficiary but does not pay cash to the customer. The bank would allow the customer to draw the funds through the use of cheques according to his needs. Hence, by granting loan to a customer, the commercial bank creates credit or deposit.

4.0 CONCLUSION

You have understood from this study unit that commercial banks are retail banks that engage in lending of funds to members of the general public in the process of performing the financial intermediation activities in the ordinary banking business. In order to obtain funds from the general public, commercial banks make use of different types of accounts such as saving account, cuurent account, and fixed deposit account. For the purpose of advancing loans from such deposits, the banks provide term loans, call loans, overdrafts, and discounting of bills of exchange for their customers. In the process of providing such loans and advances, the commercial banks create credits in the economy.

5.0 SUMMARY

In this study unit, topics covered include the following:

- Nature of Commercial Banking Operations
- Accepting Deposits from Customers
- Advancing Loans from Deposits
- Credit Creation from Credit Facility

In the next study unit, you will be taken through the discussion on credit protection methods.

6.0 TUTOR-MARKED ASSIGNMENT

1. What is financial intermediation?

2. List and discuss the various ways through commercial banks perform financial intermediation in their business operations.

Solution to Self Assessment Exercises

SAE 1:

The major functions of the commercial banks involve the following areas of operations:

- accepting deposits;
- advancing loans;
- credit creation;
- financing foreign trade;
- discounting bills of exchange;
- agency functions;
- keeping of valuables;
- issue credit instruments; and
- serve as underwriters for shares and debentures.

SAE 2:

The various types of deposits that commercial banks can keep for the customers are as follows:

i) Savings deposits

The banks accept deposits for the purpose of savings on which they pay small interest to the depositors; withdrawals are subject to restrictions

such as limit on amount and timing of such withdrawals. ii) Demand deposits

Current accounts are usually maintained by commercial banks for such deposits. The demand deposits accounts are specifically designed for businessmen and corporate entities. They are free to withdraw their deposits by cheques without notice or limits, and therefore, the commercial banks do not pay any interest on such accounts but rather charge nominal sum as commission on turnover. iii) Fixed or Time deposits

The commercial banks also accept deposits which are kept for some specified period of time before the depositors can have access to the funds in their accounts. Depositors are free to demand for the funds at the maturity of the specified time for which they receive higher interest rates on such deposits.

SAE 3:

The various types of credit facilities that commercial banks do extend to their customers are as follows: i) Term Loans

The commercial banks advance this type of loans to customers who are businessmen against specified securities. The amount of loan is normally credited to the current account of the borrower. In the case of a new customer, a loan account for amount of loan is normally opened for the facility. The beneficiary of the loan pays the specified or agreed interest rate on the full amount of the loan in addition to repayment of the principal amount. ii) Call Loans

These loans are short-term facilities that can be granted to the bill brokers for not more than a fortnight or fifteen days. Such loan facilities, just like money at calls and short notices are normally advanced against first class bill or securities. Such loans can be recalled at a very short notice and can also be renewed. iii) Overdraft

This is designed for the businessmen and corporate entities for which they are allowed to cheques for sums greater than the balance in their current accounts. This is a specific amount to the customers against their future deposits, which would be used to offset the amount involved by the bank, and it attracts interest on the amount by which the current account is overdrawn. iv) Discounting of Bills of Exchange

It is a facility available for the creditor who holds a bill of exchange. It is meant for immediate access to the funds in the bill but at a discounted amount which is lower than the face value of the instrument. At the

maturity of the bill of exchange, which is after 90 days, the bank that discounts it recovers its funds from the banker named by the debtor who accepted the bill.

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UNIT 3 CREDIT PROTECTION METHODS

CONTENTS

1.0 Introduction
2.0 Objectives
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 3.2 Collateral Security
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1.0 INTRODUCTION

In the previous units, we have discussed the various loans and credits that the commercial banks make available to their customers. The funds that the banks usually commit into such lending belong to the deposits. Since the funds must be safeguarded and made available on demand to the depositors, the banks are under obligation to evolve viable means of protecting the loans and credits advanced to customers. Therefore, in this study unit, the discussion is on the methods being adopted by banks to ensure the protection of the funds they usually commit into loans and advances.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- mention and explain various agreements on retention of title to assets
- list and discuss various forms of collateral security
- explain the two forms of irrevocable letter of credit

3.0 MAIN CONTENT

3.1 Retention of Title to Assets

One of the prominent methods of protecting bank credits is retention of title to ownership of goods until the funds invested in the articles are recovered. This is an important way of eliminating credit risk. The retention of the articles by the bank does not involve any cost.

This is relevant in the case of leasing of items of equipment that involves acquiring these productive assets and make them available to manufacturers for use on rental basis. The title to the ownership of the assets is normally retained by the banks until they are paid for by the users called lessee at the end of lease period.

The banks as the lessors would only relinquish the title to the items of equipment to the lessee after the payment of the agreed prices by the latter. Such payment is normally predicated on the written-down value of the items of the equipment. In any case, the lessee has taken possession and the usage of these articles right from the time of purchase.

In essence, the bank that financed the purchase of the assets has the right to retain ownership of the equipment until they are paid for by the users. It implies that such arrangement gives the bank the right to recover the items of equipment which are not paid for by the users.

The retention of title agreements falls into two categories, which are identified and discussed below.

I. Simple Agreement

This applies to a situation where a bank provides funds on loan to the buyer of certain goods or articles of trade. Therefore, the bank will seek only to retain ownership of the goods for which the funds have been used to acquire by the beneficiary of the loan.

The bank will involve the trader in the search for the desired articles and submit quotations for consideration. The quotations will be scrutinized by the bank and thereby select the appropriate suppliers. The sale agreement will be struck between the bank and the suppliers which will entitle the bank to take title to the ownership of the articles and thereby retain the documents of the transactions.

The supplier will only make the articles of trade to the seller who takes possession of them in his premises. This is favoured by the bank because it can easily trace the articles to the seller if they are not being for. More so, it is highly considered by the bank especially for the fact that the receiver only takes possession of the goods and not the title.

There are some important reasons which are normally considered by the bank before getting involved in the loan arrangement. These reasons are also the advantages of the lending transaction.

Therefore, the merits are identified and explained in the process as shown below.

- A merit of this form is that the agreement is more easily enforceable by the bank.
- The bank will get involved in the purchase of the articles right from the point of search and purchase of the goods.
- The move by the bank in the search for the right articles, which are always durable goods, will involve appointing the suppliers of the goods.
- The sale agreement will be effected between the bank and the suppliers.
- The bank can recover the goods in the event of default.

Nevertheless, there are some disadvantages that are inherent in this form of lending, which as follows:

- An obvious demerit in the arrangement is that the goods can be disposed off while the seller as the beneficiary of the loan will not pay the money to the bank;
- Another demerit is that in the case of raw materials being acquired with the loan by the manufacturer, these goods in their original form do not stand any chance of being recovered in the event of default;
- The seller may convert the goods to personal use while claiming that they are stolen;
- The seller may be evading the bank officials when the time of repayment of the funds on loan is necessary; and
- The goods may be damaged in the warehouse or shop of the seller if handled carelessly by the workers.

The case of the acquisition of raw materials poses a serious challenge to the bank unless the manufacturer is known by the bank as creditworthy customer. The bank may discover that the raw materials or basic products funded by the loan have been converted into a finished item, or resold, thus making the recovery in the event of default ineffective.

SELF ASSESSMENT EXERCISE 1

What are the advantages and disadvantages of simple agreement in retention of title?

II. Complex Agreement

This form of agreement is designed to forestall the problem that can arise out of the conversion of the raw materials funded by loan into finished without the fund being paid for by the manufacturer.

In order to tackle the problem of recovery of funds on loan in the event of conversion, the bank ensures that there is an agreement that can allow the tracing the value of the raw materials to the finished articles. This provides that the proceeds of the sales of any goods incorporating the raw materials should be made available to settle the outstanding loan repayment.

There is a variant of the agreement which serves as requirement that the customer as the loan beneficiary should establish a separate bank account into which the proceeds from the sale of the finished goods, arising from the conversion of the raw materials, be lodged on periodic basis. Such lodgments will be used to repay the funds that have been advanced as loan to the manufacturer by the bank.

There are important reasons that are normally considered by the bank before using this arrangement. These reasons are also the advantages of the lending transaction. Therefore, the merits are identified and explained in the process as shown below.

- An advantage of this arrangement or agreement is the fact that it can increase the value of recovery of the loan.
- This agreement involves combining unconverted raw materials and the proceeds of the sales of finished goods for the repayment of the loan.
- The agreement entitles the bank to trace the funds to the finished goods which have derived from the raw materials purchased with the loan facility.
- The agreement helps the bank to lay claim to the value of both the raw materials and the finished goods arising from their conversion.
- The title may remain with the bank in case of appointing the suppliers of the raw materials.

However, there are some disadvantages that are inherent in this form of agreement involving the bank and the loan beneficiary. Such demerits inherent in this repayment agreement include the following:

- One of the disadvantages is that though the title of the goods may remain with the bank, it does not have control over them since their possession is with the user.

- The arrangement may involve complex formality on the extension of the security from the raw materials to the value of the finished goods arising from them;
- It has been argued that the tracing element of the agreement, when worded widely, can be construed as charge over assets of the customer, which requires formal registration;
- The proceeds from the sale of the finished goods cannot still be diverted by the manufacturer to whom the loan funds have been advanced by the bank; and
- The bank is not in any position to monitor the sale of the finished goods produced from the raw materials purchased with funds advanced as loan.

In essence, a simple agreement on retention of title can be easily integrated into standard terms and conditions of agreement, which the customer of the bank should formally acknowledge. This becomes a formal complex agreement in the scheme of retention of title.

SELF ASSESSMENT EXERCISE 2

What are the advantages and disadvantages of complex agreement in retention of title?

3.2 Collateral Security

Another method of ensuring the protection of the funds being granted as loans to customers is by way of collateral security. Therefore, the usual practice by banks in the process of lending funds, is to request for some form of collateral security. In the event of customer's default or insolvency, the collateral security can be possessed and sold by the bank to offset the loan or repay any outstanding debt.

The commercial banks normally consider certain categories of property or assets as well as valuable for the purpose of securing collateral from a loan beneficiary. The various forms of collateral security that can be considered by the banks for the purpose of loans include the following.

1. Debenture

This type of loan is granted with a maturity over a period of some years. The maturity is involves a fixed repayment time. The bank as a debenture holder is entitled to receiving annual interest at a fixed rate. The bank as a secured lender has a high priority of repayment in the event that the firm that issues the debenture fails.

The debt instrument for the firm is often charged against the assets in its operations. This implies that the operating assets of the borrower serve as collateral security for the loan. This entitles the bank to have either a fixed charge over some specific assets or a floating charge over the general assets of the business.

The fixed charge that entitles the bank to specific assets of the firm as collateral security in relation to the loan will make the debenture to be regarded as mortgage debenture. In the case of default, the bank has the right to take over the assets on fixed charge and dispose them for the recovery of its funds.

2. Mortgage

This involves a long-term loan granted by the bank with a pledge of a landed property or land as the case may be as collateral security. In this case, the title deeds to the property become documents of possession in the custody of the bank. In addition, the bank receives also receives regular payments over the loan facility.

In the case of default, the bank has the right to do the following:

i. Sue the customer for the recovery of the loan;
ii. Take possession of the estate for which the loan is used for;
iii. Foreclose which involves asking the court to order repayment within a specified time;
iv. Take possession and sell the property involved in the loan; and
v. Appoint a receiver for the estate as an alternative to outright sale of the property.

3. Guarantee

In the case of the usage and accessibility of guarantees and security depend on the form of credit being granted or offered by the bank. In some instances, bank lending tends to be securitized but in the case of corporate credit, such may be very exceptional. This is to the dictates of the market forces of demand and supply of funds. Besides common practices also contributes to such scenario.

The normal practice is that a bank requires the borrower to make available some forms of collateral security which will be effected whichever a customer makes a request for loan facility. In small loans to customers, the practice is for the customer to provide a guarantee to the bank. This involves providing some guarantors who are made to fill appropriate forms for their preparedness to guarantee the repayment of the funds granted for the loan facilities.

Therefore, guarantees can be given by individuals or associated companies to the firms taking the loan facilities. Such guarantors as pointed out earlier are individuals sign agreements with the banks with the understanding that they agree to honour any outstanding installments of the loans in the event of defaults. The extent of the guarantee undertaken by the guarantors can be limited to a fixed or variable amount and time.

More often than not, the security offered in a loan agreement is considered in relation to the creditworthiness of the borrower. Nevertheless, in the case of doubt due to the problem of integrity of the borrower, it may be necessary to demand for some guarantee for the loan facility from the customer. The guarantees made by individuals who stand as guarantors are not all that secured or enough due to issue of integrity.

3.3 Taking Possession of Letters of Credit

1. Irrevocable Letters of Credit

The document embodies a payment term in exporting, which is a means of transferring the final responsibility for payment from the customer to a bank. This is different from the other types of security as identified and discussed above. The bank advancing loan to the exporter of goods will have to demand for the irrevocable letter of credit to hold it as mortgage for the loan.

(a) Unconfirmed Irrevocable Letter of Credit

In the case of this document, the customer arranges with a local bank for the bankers to assume the responsibility of payments for the goods. This is dependent on the condition that shipping terms set by the customer are honoured by the supplier. The supplier or the exporter must normally conform to the letter with the shipping conditions.

The bank that is involved in the arrangement will recover its funds from the customer. The loan attracts commission and interest charges. The risk to the bank is reduced they can recover their funds at the instance of payment to the exporter since such payments will be effected through the bank.

Furthermore, in the event that the bank is prevented from transferring money to the supplier’s account due to either a shortage of foreign currency or exchange regulations being brought into force preventing the transfer, the bank giving out the loan for the payment simply retains its funds.

(b) Confirmed Irrevocable Letter of Credit (CILC)

This arrangement is similar to the line of credit described above but the confirming bank accepting responsibility for payment will be in the supplier's country. The transfer risk is actually removed, though the security does depend on the solvency of the confirming bank. The confirming banks will usually have a relationship with the local bank which can be their correspondent bank.

The role of the confirming bank is distinct. The two types of letter of credit will in practice be honoured by the confirming bank. The bank will note the letter of credit as being established for payment. Nevertheless, it does not necessarily imply that the bank assumes responsibility for payment whatever happens. And this will be specifically stated on these letters of credit.

SELF ASSESSMENT EXERCISE 3

Differentiate between confirmed irrevocable letter of credit and unconfirmed irrevocable letter of credit.

4.0 CONCLUSION

You have learnt from this study unit that there are basic methods that the commercial banks can adopt to protect the funds whenever they are lending to business entities. Such methods include retention of title to assets acquired with loan facility, taking possession of collateral security, and taking possession of letters of credit in the case of loan facilities for export business. The most secured method of protection for the funds advanced to customers as loans is the possession of collateral security. The collateral security confers automatic legal lien on the bank. Therefore, with the possession of documents of title to the property the bank can sell the property to recover its funds that it has committed into loan facility.

5.0 SUMMARY

In this study unit, topics covered include the following:

- Retention of Title to Assets
- Collateral Security
- Taking Possession of Letters of Credit

In the next study unit, you will be taken through the discussion on lending procedures.

6.0 TUTOR-MARKED ASSIGNMENT

Differentiate Mention and discussion the advantages and disadvantages of simple agreement in retention of title to assets? Solution to Self Assessment Exercises

SAE 1:

The advantages of simple agreement in retention of title of assets include:

- The agreement is more easily enforceable by the bank.
- The bank will get involved in the purchase of the articles right from the point of search and purchase of the goods.
- The move by the bank in the search for the right articles will involve appointing the suppliers of the goods.
- The sale agreement will be effected between the bank and the suppliers.
- The bank can recover the goods in the event of default.

The disadvantages of simple agreement in retention of title of assets include:

- The goods can be disposed off while the seller as the beneficiary of the loan will not pay the money to the bank;
- The raw materials being acquired with the loan by the manufacturer do not stand any chance of being recovered in the event of default;
- The seller may convert the goods to personal use while claiming that they are stolen;
- The seller may be evading the bank officials when the time of repayment of the funds on loan is necessary; and
- The goods may be damaged in the warehouse or shop of the seller if handled carelessly by the workers.

SAE 2:

The advantages of complex agreement in retention of title to assets include:

- It can increase the value of recovery of the loan.
- It involves combining unconverted raw materials and the proceeds of the sales of finished goods for the repayment of the loan.

- It entitles the bank to trace the funds to the finished goods which have derived from the raw materials purchased with the loan facility.
- It helps the bank to lay claim to the value of both the raw materials and the finished goods arising from their conversion.
- The title may remain with the bank in case of appointing the suppliers of the raw materials.

The disadvantages of complex agreement in retention of title to assets include:

- Though the title of the goods may remain with the bank, it does not have control over them since their possession is with the user.
- It may involve complex formality on the extension of the security from the raw materials to the value of the finished goods arising from them;
- The tracing element of the agreement, when worded widely, can be construed as charge over assets of the customer, which requires formal registration;
- The proceeds from the sale of the finished goods cannot still be diverted by the manufacturer to whom the loan funds have been advanced by the bank; and
- The bank is not in any position to monitor the sale of the finished goods produced from the raw materials purchased with funds advanced as loan.

SAE 3:

Confirmed Irrevocable Letter of Credit:

This arrangement is similar to the line of credit described above but the confirming bank accepting responsibility for payment will be in the supplier’s country. The transfer risk is actually removed, though the security does depend on the solvency of the confirming bank. The confirming banks will usually have a relationship with the local bank which can be their correspondent bank.

Unconfirmed Irrevocable Letter of Credit:

In the case of this document, the customer arranges with a local bank for the bankers to assume the responsibility of payments for the goods. This is dependent on the condition that shipping terms set by the customer are honoured by the supplier. The supplier or the exporter must normally conform to the letter with the shipping conditions.

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UNIT 4 LENDING PROCEDURES

CONTENTS

1.0 Introduction
2.0 Objectives
3.0 Main Content
3.1 Loan Request from Customer
3.2 Interview with Loan Officer
3.3 Site Visit by Bank Officials
3.4 Evaluation of Loan Request
3.5 Preparing a Loan Agreement:
4.0 Conclusion
5.0 Summary
6.0 Tutor-Marked Assignment
7.0 References/Further Reading

1.0 INTRODUCTION

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. Therefore, this study unit is used to identify and discuss the necessary events for lending by banks.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- explain the nature of loan request from customer
- discuss the essence of loan interview
- mention the reasons for site visit by ban officials
- list and explain essentials of loan evaluation
- explain preparation of loan approval

3.0 MAIN CONTENT

3.1 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:

- performance of such customers in the operations of their bank accounts;
- the size of their business undertakings;
- the nature of their business operations;
- their market share in the industry;
- the personal integrity of the customers;
- level of liquidity of the bank;
- business focus of the bank; and
- type of banking operations, e.g., investment banking.

In general terms, therefore, the request for loan facility of a customer can be initiated by both the customer and the bank. This is often based contacts and good banking relationships between the bank and their customers. Hence, it is not uncommon for the bank's loan officers and the managers to solicit new accounts from individuals and firms operating in the bank's market area with the idea of convincing them with offer of loan facilities.

SELF ASSESSMENT EXERCISE 1

What are the considerations for inviting bank customers to make loan request?

3.2 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 provides an opportunity for the bank's loan officer to assess:

- the customer's character and sincerity of purpose;
- planned utilization of the funds;
- actual amount of funds sufficient for the project involved;
- applicant’s business acumen in utilization of the funds;
- nature of applicant’s business operation;
- means of ensuring prompt repayment of the loan; and
- applicant’s understanding of the implications of loan obligations .

Therefore, 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 favourable consideration, or otherwise, to the loan request.

SELF ASSESSMENT EXERCISE 2

What is the loan interview meant to achieve?

3.3 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:

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

There are other advantages that can be derived from schedule visit by bank officers to the customer who is requesting for a loan facility from the bank. Therefore, the above list is not exhaustive.

SELF ASSESSMENT EXERCISE 3

Mention advantages of visit by bank officials to the premises of a loan applicant?

3.4 Evaluation of Loan Request

The final aspect of the lending procedure is the evaluation of the loan request before a decision is taken on whether or not to grant the request. In order to evaluate the loan request, the following considerations are assessed.

1. Financial Statements and Documentation

The financial statements and documentation needed for loan evaluation include:

- Income statement of the business for some years;
- Balance sheet of the business for some years; and
- board of directors' resolutions authorizing the loan with the bank.

In the case of a new business, the necessary financial projections on income generation and statement of affairs for some years, which are incorporated in the feasibility study report, will have to be used for evaluation.

2. Credit Analysis

The credit analysis is used for determining whether the customer's business will be generating sufficient amount of cash inflows for the regular repayment of the loan. In addition, the backup assets of the business will also be assessed for the purpose of the business' capacity to generate needed funds with which to repay the loan.

3. Reference Checks

The loan officer will have to assess the references made and received on the loan applicant in addition to information form contact with other creditors who have previously loaned money to this customer.

In the case of the new loan applicant, there is the need to crosscheck the guarantors' background information to ensure that such people are credible. This is necessary in order to guarantee that people who are being used as guarantors are not loan defaulters in other banks who, therefore, cannot be trusted for such responsibility.

4. Perfecting the Bank's Claims to Collateral

There is the need for the bank officials to ensure that the bank will have immediate access to the collateral or can acquire title to the property involved if the loan agreement is defaulted by the customer.

SELF ASSESSMENT EXERCISE 4

What are the essential considerations for evaluation of loan request?

3.5 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:

i) The Note:- This is the credit document that incorporates the details regarding the amount a borrower must repay & the terms involved.
ii) 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.
iii) Collateral Security : This refers to the assets or pledges of value that can be turned into cash to support the repayment of a loan.
iv) 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.
v) Warranty : It refers to a written stipulation or assurance by a borrower that information supplied in a loan application is true.

SAE 2:

The loan interview is meant to achieve the following:

- the customer's character and sincerity of purpose;
- planned utilization of the funds;
- actual amount of funds sufficient for the project involved;
- applicant’s business acumen in utilization of the funds;
- nature of applicant’s business operation;
- means of ensuring prompt repayment of the loan; and
- applicant’s understanding of the implications of loan obligations .

SAE 3:

The advantages of the visit to the customer’s business include the following:

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

SAE 4:

The essential considerations for the evaluation of loan request include the following:

i) Financial Statements and Documentation such as:

- Income statement of the business for some years;
- Balance sheet of the business for some years;
- board of directors' resolutions authorizing the loan with the bank; and
- feasibility study report for a new business or project.

ii) Credit Analysis

The credit analysis is used for determining whether the customer’s business will be generating sufficient amount of cash inflows for the regular repayment of the loan.

iii) Reference Checks

The loan officer will have to assess the references made and received on the loan applicant in addition to information form contact with other creditors, and the guarantors' background information to ensure that such people are credible.

iv) Perfecting the Bank's Claims to Collateral

There is the need for the bank officials to ensure that the bank will have immediate access to the collateral or title to the property pledged for the loan.

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UNIT 5 OBJECTIVES OF LENDING & CREDIT ADMINISTRATION

CONTENTS

1.0 Introduction
2.0 Objectives
3.0 Main Content
    3.1 Rational for Lending and Credit Administration
    3.2 Objectives of Lending and Credit Administration
4.0 Conclusion
5.0 Summary
6.0 Tutor-marked Assignment
7.0 References/Further Reading

1.0 INTRODUCTION

Lending of funds to bank customers involves the use of the depositors' money. The implication is that the recoveries of funds from loans and advances granted out to customers must be managed in such manner that the bank would not run into liquidity problems. In essence, recoveries of funds under loans and advances should be managed effectively in order to secure the interest of the depositors in terms of meeting their periodic demands without hitches. Therefore, this study unit is used to identify and discuss the reasons for adopting necessary steps towards effective management of bank lending and credits.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- identify the reasons for lending & credit administration
- mention and discuss objectives of lending & credit administration

3.0 MAIN CONTENT

3.1 Rationale For Lending & Credit Administration

The major operational business of commercial banks revolves around financial intermediation. In carrying out this business the banks would source for funds from various members of the public. The funds of the customers are held in safekeeping of the banks and therefore, such funds must be made available to the depositors whenever they demand for them.

The implication is that banks strive to ensure that the funds are available for payments to the depositors on periodic basis for their needs and commitments. In the process of performing the other aspect of financial intermediation, the commercial banks usually keep the interest in uppermost consideration so as to discharge their delicate function efficiently.

While lending depositors' funds to customers, the banks normally ensure that their recoveries from loans and advances granted out to customers must be managed in such a manner that their operations would not run into murky waters. In performing such function of lending funds to customers the banks usually take necessary steps to protect the interest of the depositors.

In the process of trying to maintain a delicate balance between recovery of loans and advances and periodic payments to the depositors, the banks usually institute appropriate measures to safeguard their position with regards profitability and survival. Based on this discussion, it is possible to identify the basic reasons for the management of lending and credits by the banks, which are critical to their operations.

Such reasons for effective management of lending and credits by the banks include the following:

- Safeguarding the funds of the depositors;
- Generating enough funds to meet depositors' demands;
- Ensuring their profitable operations;
- Protecting the interest of their shareholders;
- Ensuring efficient administration of lending and credits;
- Ensuring positive capital base for their operations;
- Protecting the values of the shares in the capital market;
- Properly aid the growth of industrial undertakings; and
- Creating conducive environment for economic development.

You will observe from above that the need for the commercial banks to manage their loans and advances effectively cannot be over-emphasized. The subsequent discussion in this study unit is devoted to the objectives of lending and credit administration.

SELF ASSESSMENT EXERCISE 1

What are the reasons which inform lending and credit administration by the banks?

3.2 Objectives of Lending & Credit Administration

1. Ensure the Liquidity of the Bank

One of the objectives of lending and credit administration is to ensure that the bank is always in liquid position to meet the demands of the depositors. This is the uppermost objective in bank lending because banks only make use of depositors' money for business. And since such depositors are entitled to their funds as often as they so desire, banks lend money for a short time in most cases.

This is informed by the fact that the banks only lend money which is generated mainly from the deposits which can be withdrawn at any time by the depositors. Basically, therefore, banks advance loans from the deposits on the consideration that their collection will be effected on periodic basis. Furthermore, the major consideration in government securities is that the investment in treasury bills and certificate is secured and they can be easily marketable and convertible into cash at a short notice.

2. Guarantee Prompt Repayment of Loans

Another objective of lending and credit administration is to ensure that the funds committed into loans and advances are promptly repaid by the beneficiaries. Banks always ensure that the depositors' money is safe in the sense that the borrower should be able to repay the principal amount and the interest charges involved in loans.

The administration of lending and credits by the banks is managed in such a manner that the funds are repaid at agreed regular intervals without defaults. The repayment of loans by the beneficiaries depends on their capacity to generate enough funds from their projects, besides the fact that their character which are normally evaluated before loan approval.

In essence, the banks lend funds to the customers based on the financial standing of their business in terms of regularity of cash inflows with which to repay the loans. The banks also take into consideration a less risky business for loans to ensure the safety of the funds and their prompt recovery from the borrowers.

In the case of new business ventures, the banks would also grant loans for those enterprises whose owners command good character and have adequate capacity to repay the loans. The new business venture should have sound financial projections in relation to the technical feasibility and economic viability of the project for which the loan is granted.

3. Ensure Balanced Loan Portfolio

An objective of lending and credit administration is the need to ensure that there is a balanced portfolio in terms of the composition of loans and credits being granted to customers.

This means that in the process of granting loans and credits to customers, the banks consider the composition of the loan portfolio so as to maintain balanced diversity of the assets. This is view of the fact that the spread goes a long way to guarantee the safety of the banks funds. This is important for the banks' profitable operations and liquidity so as to protect the interest of the depositors as well as that of the shareholders.

It implies that the loans and credits being granted to customers are not concentrated in a particular sector but in diverse sectors of the economy. This is in conformity with the policy of the apex bank in terms of extending loans to various productive industries and businesses for balanced growth and development of the economy.

The spread of the loan portfolio to various productive sectors of the economy is also imperative towards minimizing risks that are always associated with lending of funds. In this regards, commercial banks take appropriate measures to spread the risks of investment in loan and advances portfolio by considering various trades and industries.

4. Guarantee Constant Stream of Cash Inflows

Another objective of loan and credit administration is to guarantee constant stream of cash inflows from loans and advances for the banks' liquidity. Therefore, commercial banks will only grant loans and advances to customers whose business ventures have the potential of earning enough funds with which to repay the principal amounts and the interest charges.

In order to ensure constant inflows of funds from loans and advances, the banks normally put in place some administrative measures towards assessing that such credits are the types that would generate stable incomes with which to repay the funds.

For effective management of lending and credits, customers' loan applications are normally scrutinized by appropriate loan officers and committees in charge of credit facilities so as to choose those ventures that are capable of generating constant income with which to service the loan and make repayment on regular basis.

It is the responsibility of the credit officers and the committee to also evaluate new projects using their technical feasibility and economic viability reports to determine the nature of cash inflows in terms of their nature of earnings. Such assessment will be used for the selection of the projects that can generate enough funds for repaying loans and credit facilities.

In the case of existing business, the usual practice is for the bank to request for financial reports of the business which incorporate relevant data for five years. This will be used in evaluating the regularity of generation of earnings. And the assessment is used to determine the stability of income from the business for the repayment of loan facility.

5. Earn Adequate Returns from Lending

An objective of loan and credit administration is to generate adequate earnings from lending and credits, which are very important to the operations of commercial banks. Loans and advances are usually granted to customers with the intention of earning some income for the banks. The income from lending facilities comes mainly from the interest charges being made from loans advances being granted to customers by the banks.

The rate of interest being charged on loans and advances by the banks is normally determined in consideration to the prevailing interest rate and the ruling bank rate sanctioned by the apex bank in the economy. Such bank rate is called the monetary policy rate in the country, as determined by Central Bank of Nigeria.

The interest rate being charged on loans by the commercial banks is normally determined in relation to the bank rate being charged by the apex bank, the former being higher than the later. In addition, the banks incorporate some other charges as may be determined by the lending officers or the credit committee.

6. Ensure Effective Supervision of Lending

Another objective of loan and credit administration is to ensure effective supervision of lending by the banks. In order to ensure that lending operations are proper supervised, the banks normally set administrative policies on loan supervision. In this regards, administrative policies are established on supervision of credit facilities, their recovery drives, and personal visits by bank officials to the loan beneficiaries.

The relevant supervision policies are normally established in relation to the past strategies and those methods being used by the other banks in

the industry. In order to ensure effective loan supervision, these policies are used: supervisory teams, reports and evaluation, time line for periodic reviews of loan recoveries, loan recovery visits, procedures for compliance with banking regulations, appropriate pricing of loans and credits, and loan recovery methods.

7. Efficient Management of Credit Risk

An objective of loan and credit administration is to ensure efficient management of risks associated with loans and advances. In this regard, administrative measures are established by the banks for management of the credit risk in respect of grave problems which can arise from loan recovery by the bank.

The banks do formulate administrative measures for the management of credit risks by assigning responsibilities for;

- branch managers in preventing credit risks;
- senior officers in credit risk management;
- loan officers in recommending only loans with minimal risks;
- credit committee for assessing and handling credit risks;
- effective supervision to minimize defaults in loan repayment;
- managing accounts of loan beneficiaries;
- constant visits to loan beneficiaries; and
- actions necessary in managing difficult loan beneficiaries.

The objective is to eliminate or minimize the hazards and perils that loans and advances can present to the operations of banks. The measures for controlling loans and advances in order to manage their risks may differ from one bank to another.

SELF ASSESSMENT EXERCISE 2

What responsibilities are involved in minimizing credit risks?

8. Effective Management of Difficult Loan Beneficiary

Another objective of loan and credit administration is to ensure effective management of difficult loan beneficiary. Administrative policies are normally formulated for managing difficult loan beneficiaries.

Banks formulate administrative policies and assign them to relevant bank officials for managing problem loans. These policies are used to specify the necessary actions to be taken by relevant bank officials to handle loan beneficiaries that are proving difficult and problematic.

Examples of such administrative measures for managing difficult beneficiaries of loan facilities include the following:

- Committee' s actions for the recovery of difficult loans;
- Mutual discussion with the beneficiary of the loan;
- Planned contact for assessment of beneficiary's premises;
- Threat of legal action against the beneficiaries
- Offer of restructuring of beneficiaries' operations;
- Threat of sale of securities for the loan; and
- Representation to beneficiaries on plan to take over their business operations.

SELF ASSESSMENT EXERCISE 3

What are the necessary administrative measures for managing problem loans?

4.0 CONCLUSION

You have learnt from this study unit that there are basic objectives that are intended to be achieved through lending and credit administration. Such objectives are meant to ensure effective management of loans and credits which are being granted by the banks to the customers. Furthermore, the objectives of lending and credit administration, which include ensuring operational liquidity, prompt repayment of loans, earning reasonable revenue from loans, ensuring balanced loan portfolio, effective management of credit risk and difficult loan beneficiaries, etc, are meant to facilitate the profitable operations and survival of the banks.

5.0 SUMMARY

In this study unit, topics covered include the following:

- Rational for Lending and Credit Administration
- Objectives of Lending and Credit Administration

In the next study unit, you will be taken through the discussion on lending and credit administration.

6.0 TUTOR-MARKED ASSIGNMENT

Mention and explain the main objectives of lending and credit administration.

Solution to Self Assessment Exercises

SAE 1:

The reasons which inform lending and credit administration by the banks include the following:

- Safeguarding the funds of the depositors;
- Generating enough funds to meet depositors' demands;
- Ensuring their profitable operations;
- Protecting the interest of their shareholders;
- Ensuring efficient administration of lending and credits;
- Ensuring positive capital base for their operations;
- Protecting the values of the shares in the capital market;
- Properly aid the growth of industrial undertakings; and
- Creating conducive environment for economic development.

SAE 2:

The responsibilities involved in minimizing credit risks include the following:

- branch managers in preventing credit risks;
- senior officers in credit risk management;
- loan officers in recommending only loans with minimal risks;
- credit committee for assessing and handling credit risks;
- effective supervision to minimize defaults in loan repayment;
- managing accounts of loan beneficiaries;
- constant visits to loan beneficiaries; and
- actions necessary in managing difficult loan beneficiaries.

SAE 3:

The necessary administrative measures for managing problem loans include the following:

- Committee' s actions for the recovery of difficult loans;
- Mutual discussion with the beneficiary of the loan;
- Planned contact for assessment of beneficiary's premises;
- Threat of legal action against the beneficiaries
- Offer of restructuring of beneficiaries' operations;
- Threat of sale of securities for the loan; and
- Representation to beneficiaries on plan to take over their business operations.

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MODULE 2

UNIT 1 LENDING AND CREDIT ADMINISTRATION

CONTENTS

1.0 Introduction
2.0 Objectives
3.0 Main Content
 3.1 Lending and Credit Administration
 3.2 Modalities for Lending & Credit Administration
4.0 Conclusion
5.0 Summary
6.0 Tutor-Marked Assignment
7.0 References/Further Reading

1.0 INTRODUCTION

You would recall that, in the preceding study unit, the reasons for effective management of bank lending and credits are identified and discussed. The fundamental purpose for managing the funds under loans and advances effectively is informed by the fact that lending of funds to bank customers involves the use of the depositors' money. Therefore, the necessary modalities must be instituted to ensure that recoveries of funds under loans and advances are managed in order to protect the interest of the depositors. This is imperative towards ensuring that the profitable operations and survival of the banks are not in jeopardy. Therefore, this study unit is used to identify and discuss the necessary steps involved in effective management of lending and credits being granted to the customers.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- discuss lending and credit administration
- mention and explain modalities for lending and credit administration

3.0 MAIN CONTENT

3.1 Lending and Credit Administration

Essentially, the back business of commercial banks revolves around financial intermediation activities. Therefore, they source for funds from the members of the public, corporate organizations and other institutions

through various forms of deposit accounts. Such funds are then used for the purpose of lending and credit facilities.

The depositors are entitled to the funds whenever they so desired. The banks are invariably under legal obligations to honour the demands of the depositors. The banks therefore, are constantly under obligation to evolve ways of maintaining delicate balance between the recoveries of funds loaned out and the demands of the depositors.

This is where the issue of lending and credit administration comes into play. In essence, the funds which are loaned out to customers have to be managed in such a manner that such funds can be available from the customers whenever they are needed to meet the demand of the depositors.

The delicate balancing of demands for funds by depositors and recoveries of loans and advances from customers is predicted on the necessity for the commercial banks to survive in business and generate reasonable returns for the shareholders. It implies that lending and credits should be managed in such a way that generating funds from loan repayments is tailored towards meeting periodic demands of the depositors.

In order to manage loans and credits effectively for adequately meeting the demands on the deposit accounts of customers, there are operational modalities normally put in place by the banks for administering loans and advances right from inception to the time when they totally liquidated. Such modalities of managing loans and advances are identified and discussed below.

3.2 Modalities for Lending & Credit Administration

1. Loan Budget and Composition

It is an ideal practice for commercial banks to determine the amount of funds which will be devoted for loans and advances in a given period of time taking into consideration the requirements of the regulatory agency. Hence the banks determines total amount of loans and advances for a particular period, maximum amount for a single case, and average amount of lending to be made per case.

In terms of composition of loans and advances that will be granted to customers, the banks consider issues such as types of loan and advances, sectors, sub-sectors and

industry mix, investment or equity participation, and productivity sector favoured by the government.

2. Loan Committee and Authorisation

It is also a common practice for commercial banks to institute a loan and advances committee to deal with major credit decisions. There are some responsibilities which the loan committee is expected to perform.

Such responsibilities or duties of the loan committee may, among others, include the following:

- To review major new loans;
- Review major loan renewals;
- Ascertain the reasons for renewal;
- Assess delinquent loans & determine the cause of delinquency;
- Ensure compliance with established lending policy;
- Ensure full documentation of loans before disbursement; and
- Ensure consistency in the treatment of loan customers.

The responsibilities of a loan committee as stated above may not be exhaustive and therefore, individual bank may include other duties for the committee to discharge.

SELF ASSESSMENT EXERCISE 1

Mention the responsibilities of a loan committee of the commercial bank?

3. Periodicity and Loan Grading System

In terms of periodicity, the duration of loan composition is very critical. Therefore, the basic considerations are call loans, short-term working capital loan, intermediate-term investment loan, and long-term investment loan.

A typical grading system for loans and advances is as presented below, which indicates classification of loans in terms of their likely performance. The classification is as follows:

Figure 6.1: Grading of Loans and Advances

Grade	Classification
A	Top Grade Loan
B	Good Loan
C	Marginal Loan
D	Doubtful Loan
E	Likely Bad Loans

The grading will be used to allocate funds accordingly in terms of the magnitude of money that will be assigned to each grade.

4. Evaluating Credit Worthiness & Securities

There is issue of the evaluation of the creditworthiness of the customer that is prospecting for loan facility. Factors that are taken into consideration, among others, include the following.

- Financial Statements
- Other Required Information
- Personal interview
- Credit investigation
- Information on Operations; personnel, financial, market, etc.

The other important contemplation is the concern of collateral security which is very critical for loan consideration. In this regard, the critical issues to consider are as follows:

- Criteria of acceptable security;
- Listing of acceptable security;
- Allowable margins to be made; and
- Qualifications of becoming guarantors.

The discussion above implies that the issue of securities is just as important as the consideration of the creditworthiness of the customer in loan and credit administration.

SELF ASSESSMENT EXERCISE 2

Mention the areas for which data are required for assessing the credit worthiness of a customer.

5. Expected Revenue from Loan

The expected revenue from any loan facility to the bank is referred to as the pricing of the loan, which is the lending cost plus the profit inherent in the facility. It is expressed formula wise as:

Lending Cost = Cost of fund + Cost of lending operation

+ Liquidity of the advance + Risk.

The rate of interest in relation to the cost of the fund to the bank definitely partly determines the amount of profit that can be earned from

a loan facility. The interest chargeable on loan is normally considered in relation the bank rate of the apex bank; the former being above the latter.

The interest rates being charged on loans by the banks may depend on factors, which are in the following areas:

- The bank's cost of funds;
- The riskiness of the borrower;
- Compensating balances & fees;
- Interest rates charged by competitors;
- The ruling bank rate in the economy; and
- Other banking relationships with the borrower

SELF ASSESSMENT EXERCISE 3

Mention the factors that influence the rate interest being charged for bank loan.

6. Assessment of Credit Risk & Compensating Balance

It is always a practice for the bank to assess the risk involved in the loan being granted to a customer. This calls for determining the risk average in relation to previous loans that are similar to the loan under consideration, the types of risk involved, and the insurable risk that should be insured by the bank.

It is always necessary for the bank to retain some funds in the loan account of the customer which is regarded as the compensating balance. This is considered in line with the bank's right of offsetting deposit balance for an outstanding loan and the method of computation of compensating balance.

7. Loan Approval, Documentation & Accounting Record

The process of the loan approval refers to the necessary considerations which are taken cognizance of towards the final decision on loan request. Such considerations include the following issues:

- Sanctioning limits of various types of loans;
- Delegation of Authority;
- Uniform Presentation Format & Standards;
- Descriptions of the client;
- Assessment of management;
- Pricing Policy;

- Purpose of the loan request;
- Repayment schedule & source of repayment;
- Secondary sources of repayment including collateral values & guarantors;
- History of past borrowing with the bank;
- Required monitoring steps;
- Timing of submissions of financial statement;
- The loan Decision; and
- Loan officer's comments including consistency with policy.

More considerations can be included in the above list for effective loan approval process. The documentation starts from the time that the customer applies for the loan. Therefore, the documents to be kept bank include application form filled by the customer, evidence of security, loan agreement, credit reports, referee forms, and financial statements, among others.

The necessary considerations for the accounting records include recording procedure to be followed, loan and project profiles to be maintained, statements to be provided by the customer, and loan recovery recording, among other accounting records to be maintained by the bank.

SELF ASSESSMENT EXERCISE 4

Mention the necessary considerations normally taken into cognizance towards final decision on loan request.

8. Collection Procedure & Handling Problem loans

In terms of collection procedure, there are critical considerations which include repayment schedule as prepared by loan officers, remainders & circular letters to be

sent out on periodic basis, constant personal visits by the credit officers, and collection the principal payment and interest charges on the loan necessarily through cheques.

The procedures for managing problem loan problems and their beneficiaries involved the following considerations:

- Criteria to be used for identifying problem loans;
- Methods to be used for identification problem loans;
- Steps to be taken in managing the loans and their beneficiaries; and
- The issue of setting up loan reserves for managing such risk

4.0 CONCLUSION

You have learnt from this study unit that it is necessary for commercial banks to institute appropriate measures that would guarantee the effective management of their loans and credits. Such measures are imperative towards ensuring that funds are allocate for classes of loans to be granted to the customers, appropriate documents are secured for assessing credit worthiness of customers, and the risks involved in the credits are understood. The other considerations include pricing of the loans towards making profits, assessing and securing securities for the loans, appropriate compensating balances are maintained for loans, documentation is effected, and necessary ways of managing problem loans are instituted, among others.

5.0 SUMMARY

In this study unit, topics covered include the following:

- Lending and Credit Administration
- Modalities for Lending & Credit Administration

In the next study unit, you will be taken through the discussion on lending appraisals & decisions.

6.0 TUTOR-MARKED ASSIGNMENT

Mention and discuss the modalities for lending and credit administration.

Solution to Self Assessment Exercises SAE 1:

The responsibilities of the loan committee would include the following:

- To review major new loans;
- Review major loan renewals;
- Ascertain the reasons for renewal;
- Assess delinquent loans & determine the cause of delinquency;
- Ensure compliance with established lending policy;
- Ensure full documentation of loans before disbursement; and
- Ensure consistency in the treatment of loan customers.

SAE 2:

The areas for which data are required for assessing the credit worthiness of customer

- Financial Statements
- Other Required Information
- Personal interview
- Credit investigation
- Information on Operations; personnel, financial, market, etc.

SAE 3:

The factors that influence the rate of interest being charged on bank loan include:

- The bank's cost of funds;
- The riskiness of the borrower;
- Compensating balances & fees;
- Interest rates charged by competitors;
- The ruling bank rate in the economy; and
- Other banking relationships with the borrower

SAE 4:

The necessary considerations normally taken into cognizance towards final decision on loan request include:

- Sanctioning limits of various types of loans;
- Delegation of Authority;
- Uniform Presentation Format & Standards;
- Descriptions of the client;
- Assessment of management;
- Pricing Policy;
- Purpose of the loan request;
- Repayment schedule & source of repayment;
- Secondary sources of repayment including collateral values & guarantors;
- History of past borrowing with the bank;
- Required monitoring steps;
- Timing of submissions of financial statement;
- The loan Decision; and
- Loan officer's comments including consistency with policy.

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UNIT 2 LENDING APPRAISALS & DECISIONS

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1.0 INTRODUCTION

You would recall that, in the preceding study unit, we discussed the issue of lending and credit administration. You have observed from such analysis that it is important for the banks to institute appropriate measures for ensure effective lending and credit administration. In response to these measures, the credit officials of the bank often ensure that there is appropriate appraisal of any loan request before a concrete decision is taken. Therefore, the discussion in this study unit is focused on the relevant methods being used by the banks for loan appraisal before decision on the credit facility.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- list and discuss the issues involved in the initial evaluation of loan request
- mention and explain the considerations involved in credit analysis
- identify and discuss the factors considered for decision on loan request

3.0 MAIN CONTENT

3.1 Initial Evaluation of Loan Request

The commercial banks, at the instance of loan request from a customer, have to engage in initial evaluation of the application in relation to relevant areas, which constitute part of the lending procedure. Such

evaluation is very critical because it provides the basis for the engagement in credit analysis of the request.

The relevant issues to be considered in the initial evaluation are identified and discussed below.

1. Purpose of the Loan

The bank will be interested in determining the purpose of the loan so that the funds from the loan would not be used for illegal business activities or unproductive project. Therefore, the bank would assess that the reason for the loan is not related to;

- speculative business;
- illegal business transaction;
- fruitless venture;
- self aggrandizement;
- failed venture;
- money laundering;
- dealing in arms or weapons;
- political agendas, etc

Once the loan request is not connected to any of the above subject or business, the request will be qualified for consideration by the bank.

2. Amount of the Loan

It is also the practice for the commercial banks to take into consideration the amount funds that a customer is prospecting for. The amount of funds that is incorporated in a customer's loan request will be assessed by a commercial bank in relation to:

- available funds for lending;
- the liquid position of the bank;
- regulation of the apex bank;
- amount of loan already committed to the industry;
- pace of loan recovery;
- trend in volume of withdrawals;
- pattern of deposits; and
- quality of deposit accounts.

The assessment of the amount in relation to the above issues will make the bank either to grant the whole amount or decrease it.

3. Reason for the Loan

The banks will also be interested in determining the main reason which informs the customer's request for loan. The reason for the loan will enable the bank to classify the request in relation to broad-based categorization as shown below.

- Real estate loans:- short-term loans for construction and land development and longer-term loans for the purchase of farmland, homes, apartments, commercial structures, and foreign properties.
- Financial institution loans:- loans to other banks, insurance companies, finance companies, and other financial institutions.
- Agricultural loans:- loans to finance farm and ranch operations, mainly to assist in planting and harvesting crops and to support the feeding and care of livestock.
- Commercial and industrial loans: to businesses to cover expenditures on inventories, paying taxes, and meeting payrolls.
- Loans to individuals:- credit to finance the purchase of automobiles, appliances, and other consumer goods, equity lines for home improvements, and other personal expenses
- Lease financing:- to corporate firms on equipment or vehicles.

The categorization of the loan request will enable the bank to determine the appropriate amount to grant for the demand.

4. Sources of Payment

The means of repayment will also be considered by the banks in assessing any loan request by the customer. This consideration is related to the cash inflows from the business, which will be used by the beneficiary to meet the periodic repayments of the principal amount and the interest charges to the bank.

5. Ability of the Beneficiary to Repay

This issue will be assessed in relation to the capital and assets of the business for which the loan is being requested. This is based on the fact that the capital base of the business determines its ability to carry out its operations efficiently.

In the case of a new project, the financial projections for a period of five years will be assessed to determine the ability of the business to generate enough income to meet its cost of operation and meeting the loan repayment.

6. Risk Inherent in the Loan

The loan request will also be assessed in relation to the risks inherent in the facility in the event that it is granted. These credit risks include:

- default in repayment;
- delays in repayment;
- diversion of the funds;
- failure of the project;
- mismanagement of the funds; and
- total loss of the funds.

Once most of these risks are perceived to the inherent in the loan request, the bank officials may not advance further on the analysis of the request. Nevertheless, if the bank is satisfied with above elements of assessment, it will proceed to credit analysis, which is the next area of discussion below.

SELF ASSESSMENT EXERCISE 1

Mention and explain the considerations for initial evaluation of loan request.

3.2 Credit Analysis

The credit analysis is based on the popular considerations such as the character of the applicant, capacity of the customer to repay the loan, capital in relation to contribution of the customer to the project funding, collateral security being offered by the customer for the loan, condition of the economy, cash generation from the project for repayment, and lastly control of the bank over the loan facility.

All these considerations are discussed below.

1. Character

This consideration is the personal integrity of the customer requesting for the loan, which is relation to his business dealings with the bank and other banks. The bank officers or loan officers would take steps to determine the character of the customer to ensure that they are convinced that the customer has a well-defined purpose for requesting bank credit and a serious intention to repay the funds appropriately.

2. Capacity

This involves the authorization of the person making the request to make a demand for loan facility, which is normally defined by virtue of his position. Therefore, the bank always takes steps to ensure that the customer requesting credit has the authority to do so. The bank will also consider the approval of the board of directors and the legal standing of the person to sign a binding loan agreement on behalf of his firm. This customer characteristic is known as the capacity to borrow money.

3. Collateral

The bank will also assess the borrower's security in terms of whether or not it possesses adequate networth. The assessment also applies to the quality of the assets in providing adequate collateral support for the loan. The bank officials will be interested in evaluating the assets of the firm particularly in relation to such considerations as the age, condition, and degree of specialization for the firm's operations.

4. Conditions

This has to do with the assessment of the economic conditions and the industry in which the firm operates. The bank officials or credit analysts are to consider the recent trends in the borrower's line of work or industry and the dynamics of the changing economic conditions might impact on the usage of the funds and the repayment. To assess industry and economic conditions, most banks maintain files of information-newspaper clippings, magazine articles, and research reports-on the industries represented by their major borrowing customers.

5. Capital

This refers to the contribution of the customer's business to the financing of the project for which the loan request is desired. This is important because in the absence of any appreciable contribution or the capital base of the business, the customer will not feel that the firm has any stake in the scheme of things. Therefore, the project may be allowed to fail and the bank will lose its funds.

6. Cash Inflows

The expected cash inflows from the business or the project that may affect the repayment of the loan will be evaluated by the bank. There are three main sources of income from a business to repay the funds of the loans.

These sources include:

- The cash flows generated from sales or turnover of the business;
- the sale or liquidation of operating assets of the business; or
- funds to be raised by way of issuance of debt or equity securities.

The net cash inflows is the net profits from the operations of the business, indicative of total revenue less all expenses, and combined with non-cash expenses such as the amount of depreciation of capital assets.

The other of looking at the cash inflows is that the net cash inflows is the net profits plus non-cash expenses plus additions to accounts payable less additions to inventories and accounts receivable.

This latter view on the concept of cash flow is of importance to the bank. This is because it helps to focus the attention of bank officials or loan officials on those areas of the customer's business that reflect the quality and experience of its management, and above all the strength of the market the business serves.

7. Control

The issue of control is focused on such consideration as to the assessment of the effect of any changes in government rules and regulations on business. Furthermore, the consideration is on the possible adverse effect on the borrower’s ability to repay the funds on the loan. The other issue in the control consideration is relating the loan request to the bank's and the regulatory authorities' standards for loan quality.

SELF ASSESSMENT EXERCISE 2

Mention and explain the considerations for credit analysis in loan request.

3.3 Evaluation of Past Performance of Loan Applicant

This involves assessing the performance of the business of the customer who is prospecting for a loan facility. The relevant information for such assessment involves the data which are embedded in the financial statements of the business operations in the past five years.

The relevant financial statements are the income statement and the balance sheet. A simple approach to the assessment involves the use of financial ratios. The important ratios are identified below.

1. Current Ratio

The current ratio refers to relating the total value of the current assets to the total of the current Liabilities. The quotient obtainable from the calculation is indicative of the ability of the business to meet its current financial obligations.

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

The ideal ratio from the calculation is 2:1 but it all depends on the type of business, many thriving companies continue to operate successfully despite having negative ratio.

2. Acid Test Ratio or Quick Ratio

The ratio relates the total of the current assets minus the value inventories to the total value of the current liabilities. The quotient obtainable from the calculation is indicative of the ability of the business to meet its current financial obligations with available cash and bank balances, debtors and the marketable securities, which can easily be converted into cash.

$$\text{Acid Test or Quick Ratio} = \frac{\text{Current Assets -Inventories}}{\text{Current Liabilities}}$$

The ideal ratio is 1:1 for thriving companies. The ratio is of fundamental importance when assessing the ability of the firm to survive.

3. Debtors Collection Period

The ratio relates the value of sales to debtors or accounts receivables of the business. The ratio measures the efficiency of the business in controlling debts collection. This is in relation to the average length of time that money is owed by debtors.

$$\text{Debtors Collection Period} = \frac{\text{Debtors x 360}}{\text{Sales}}$$

Since the ratio measures the efficiency in debt collection, the ideal collection period is five weeks, which is a good average for thriving or successful companies.

4. Inventory Turnover Ratio

The ratio measures the relationship between the cost of sales and the inventory in the current assets. This measures the speed at which a company sells its stocks. The rate is bound to affect the profitability of the business.

$$\text{Inventory Turnover Ratio} = \frac{\text{Average Stockholding x 360}}{\text{Cost of Goods Sold}}$$

The ratio is very relevant because it assesses the ability of the business to generate cash inflows with meet the current commitments of the business.

5. Interest Coverage Ratio

This measure relates the earnings before interest and taxes of the business to the total interest payments on fixed interest debt obligations. This measures the ability of the business to generate enough earnings to cover the fixed interest debt obligations.

$$\text{Interest Coverage Ratio} = \frac{\text{Earnings before Interest and Taxes}}{\text{Interest Payments}}$$

The ratio is an important consideration because without enough earnings, a business will not be able to service its debts and make loan repayment.

6. Leverage Ratio

The ratio relates the total debt obligations of the business to the networth. This measures the volume of debt obligations that has been used in financing the business compared to the owners funds.

$$\text{Leverage Ratio} = \frac{\text{Total Debt}}{\text{Networth}}$$

The ratio is important to the business because it assesses the degree to which the borrowed funds have been utilized to generate income for the business owners' funds in the business as measured by the noetworth.

7. Return on Total Assets

This measures the volume of earnings which has been generated from the operating assets of the business. The ratio measures the ability of the business to use the available assets to generate earnings for the business.

$$\text{Return on Total Assets} = \frac{\text{Earnings before Taxes}}{\text{Total Assets}}$$

The ratio measures the efficiency of the managers in the utilization of the available to generate reasonable volume of earnings. Hence the ratio measures the efficient management of the assets in the operations of the business.

8. Fixed Assets Turnover

The ratio relates the total volume of sales to the total fixed assets available for the business operations. This measures the efficient utilization of the available fixed assets to generate reasonable level of sales or turnover for the business.

$$\text{Fixed Assets Turnover} = \frac{\text{Total Sales}}{\text{Fixed Assets}}$$

This also measures the efficiency of the managers in utilizing the available fixed assets to generate adequate level of sales in the process of business operations.

SELF ASSESSMENT EXERCISE 3

Mention and show how to calculate relevant financial ratios considered for creditworthiness of customer in loan request.

3.4 Considerations For Decisions On Loan Request

The use of the data in the income statement and the balance sheet is not considered enough to assess the creditworthiness of the customer. Therefore, the commercial banks normally make use of an assessment technique called CAMPARI, an acronym from other relevant considerations in loan assessment.

Such considerations for assessing the creditworthiness of customers seeking for loan facilities are as follows.

- **Character :** – this is a review of the management of the business, the products of the company, and the past performance of the business for which a loan is being requested.
- **Ability : –** this refers to the ability of the business to generate enough income from cash inflows with which to repay the loan facility.

- **Margin : –** this refers to the profit or reward of engaging in the lending facility which will determine the bank's consideration in committing funds.
- **Purpose : –** this relates to the reason which informs the customer's request which should not be connected with abnormal business operations such as speculative business, illegal business transaction, fruitless venture, self aggrandizement, failed venture, money laundering, dealing in arms or weapons, etc.
- **Amount :** – this refers to the value or amount of funds that is being requested by the customer, which will be considered in relations to issues such as available funds for lending, the liquid position of the bank, regulation of the apex bank, amount of loan already committed to loan, pace of loan recovery, trend in volume of withdrawals, etc.
- **Repayment : –** this refers to the possibility of the repayment schedule being appropriate to the bank's liquidity management plan. More so, the bank will also consider the past performance of the business in relation of its ability to meet periodic repayments of the funds in relation to the liquidity plan of the bank.
- **Insurance :** – this refers to the issue of collateral security which is available to secure the loan by the customer. This is very important to the bank because in the event of defaults or inability to repay the loan the bank will use the collateral security for generate funds to settle the loan.

The analysis above indicates that it represents a broad-based evaluation of the loan request compared to the earlier consideration in this unit. These considerations are important in terms attributes which coalesce to form the basis of the lending decision.

Among these considerations, there are five attributes that are linked to the accounts and finances of the prospective borrowers. The remaining two considerations are character and margin, which are related to the customer and the bank's profit contemplation.

In the case of character, the issues are management of the business, which represents subjective assessment, and the others in the areas of the products of the company, and the past performance of the business, the latter which can be specifically quantified from the balance sheet data.

The banks will therefore, be interested in seeing financial information for the past five years before lending any money to the customer. These are the balance sheet and the income statement of the business which incorporates the past data relating to five years consecutively.

SELF ASSESSMENT EXERCISE 3

What are the issues to be considered towards decisions on loan request?

4.0 CONCLUSION

You have learnt from this study unit that there are numerous considerations which a bank employs to evaluate and analyzed a loan request before taking decisions on the facility. This is important for the banks because they are interested in ensuring that funds committed into loans would not go down the drain. The relevant considerations are categorized into initial evaluation, credit analysis, evaluation of past performance of applicant, and issues for decision on any loan facility.

5.0 SUMMARY

In this study unit, topics covered include the following:

- Initial Evaluation of Loan Request
- Credit Analysis
- Evaluation of Past Performance of Loan Applicant
- Considerations for Decisions on Loan Request

In the next study unit, you will be taken through the discussion on term loans and real estate loans.

6.0 TUTOR-MARKED ASSIGNMENT

Mention and discuss the relevant factors to be considered in decision on loan request.

Solution to Self Assessment Exercises

SAE 1:

The considerations for initial evaluation of loan request include the following.

i. Purpose of the Loan

The bank will be interested in determining the purpose of the loan so that the funds from the loan would not be used for illegal business activities or unproductive project.

ii. Amount of the Loan

It is also the practice for the commercial banks to take into consideration the amount funds that a customer is prospecting for.

iii. Reason for the Loan

The banks will also be interested in determining the main reason which informs the customer's request for loan. The reason for the loan will enable the bank to classify the request in relation to broad-based categorization.

iv. Sources of Payment

The means of repayment will also be considered by the banks in assessing any loan request by the customer; in relation to cash inflows from the business for periodic repayments of the principal amount and the interest charges to the bank.

v. Ability of the Beneficiary to Repay

This issue will be assessed in relation to the capital and assets of the business for which the loan is being requested. This is based on the fact that the capital base of the business determines its ability to carry out its operations efficiently.

vi. Risk Inherent in the Loan

The loan request will also be assessed in relation to the risks inherent in the facility in the event that it is granted.

SAE 2:

The considerations for credit analysis in loan request include the following.

i. Character

This consideration is the personal integrity of the customer requesting for the loan, which is relation to his business dealings with the bank and other banks.

ii. Capacity

This involves the authorization of the person making the request to make a demand for loan facility, which is normally defined by virtue of his position.

iii. Collateral

The bank will also assess the borrower's security in terms of whether or not it possesses adequate networth and collateral support for the loan request.

iv. Conditions

This has to do with the assessment of the economic conditions and the industry in which the firm operates.

v. Capital

This refers to the contribution of the customer's business to the financing of the project for which the loan request is desired.

vi. Cash Inflows

The expected cash inflows from the business or the project that may affect the repayment of the loan will be evaluated by the bank.

vii. Control

The issue of control is focused on such consideration as to the assessment of the effect of any changes in government rules and regulations on business.

SAE 3:

The relevant financial ratios considered for creditworthiness of customer in loan request include the following.

i) Current Ratio = $\frac{\text{Current Assets}}{\text{Current Liabilities}}$

ii) Acid Test or Quick Ratio = $\frac{\text{Current Assets - Inventories}}{\text{Current Liabilities}}$

iii) Debtors Collection Period = $\frac{\text{Debtors x 360}}{\text{Sales}}$

iv) Inventory Turnover Ratio = $\frac{\text{Average Stockholding x 360}}{\text{Cost of Goods Sold}}$

v) Interest Coverage Ratio = $\frac{\text{Earnings before Interest and Taxes}}{\text{Interest Payments}}$

vi) Leverage Ratio = $\frac{\text{Total Debt}}{\text{Networth}}$

vii) Return on Total Assets = $\frac{\text{Earnings before Taxes}}{\text{Total Assets}}$

viii) Fixed Assets Turnover = $\frac{\text{Total Sales}}{\text{Fixed Assets}}$

SAE 4:

The issues to be considered towards decisions on loan request include the following.

- **Character:** – this is a review management, the products, past performance of the business.
- **Ability: –** this refers to ability of business to generate income to repay a loan facility.
- **Margin: –** this refers to the profit in lending facility.
- **Purpose:** – this relates to the reason for loan request which should not be connected with abnormal business operations.
- **Amount:** – this refers to the value or amount of funds that is being requested by the customer.
- **Repayment:** – this refers to the possibility of the repayment schedule being appropriate to the bank's liquidity management plan.
- **Insurance: –** this refers to the issue of collateral security which is available to secure the loan by the customer.

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UNIT 3 TERM LOANS & REAL ESTATE LOANS

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1.0 INTRODUCTION

There are many forms of lending that the commercial banks use to arrange for their customers engage in the process of financial intermediation. Such lending facilities include term loans and real estate loans, which are among the medium and long-term credit facilities being made available to individuals and business entities. In this study unit, details relating to both term loan and real estate loan are identified and discussed.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- Explain the concept of term loan
- Mention the characteristics of term loans
- list the uses of term loan
- mention the provisions of term loans
- identify and discuss factors that influence granting of term loam
- explain the meaning of real estate loan
- mention the features of real estate loans
- identify the rights of banks in case of default

3.0 MAIN CONTENT

3.1 Meaning of a Term Loan

This is the loan facility that is granted by the commercial banks for a period of more than one year. In other words, term loan is an intermediate-term credit which is a commercial an industrial loan with maturity of more than one year. It is also regarded as a loan facility that is granted on the basis of revolving credit or standby on which the original maturity of the facility is in more than one year.

The term loan can be granted as a facility for the general use of the business entities such as acquisition of land, purchase of building, and purchase of equipment. In comparison with installment loan, the loan agreement in term loan is not elaborate and does not involve similar obligations and restrictions.

Furthermore, the interest charges on term loan are much less that the interest involved in installment loans, and the installment loans may be restricted for the purchase of specific items of equipment or machinery for the operations of the business entity which is granted the facility.

The term loans from the banks are more flexible than the bond issue because they can be liquidated before their maturity date without the lender subjecting the borrowers to payment of penalty fees.

The term loans generally are associated with shorter maturity dates as compared with bond issue coupled with the less interest rate than what is obtainable with the interest payment for the bonds.

There is no abnormal cost for the arrangement of term loans from the banks when compared to the bond issue that requires special arrangement and the payment of heavy costs, appointment of trustees, and writing of special covenants.

In addition, there is no need to consider the issue of registration and its associated costs, underwriting and selling by issuing houses, which are compulsory in the case of the issuance of bonds by corporate entities.

3.1.1 Characteristics of Term Loans

There are specific characteristics that are associated with the term loans. Therefore, the term loans which can be granted to business organizations have the following characteristics:

- Available to business entities that are associated with heavy industrial undertakings;
- Available to industrial organizations that deal in manufacturing, petroleum refinery, transportation;
- Available to business entities that produce durable goods, chemicals, rubber, and public utilities;
- Available to firms and trading organizations whose main purpose is for enhancing their working capital;
- Available to large business firms with heavy investments in plants and items of equipment;
- It can be used by some small and medium businesses that cannot have access to funds in capital market;
- It can be used by large firms because such firms favour their flexibility for meeting their peculiar needs compared to bond issue;
- It is available to firms that have the ability to renegotiate their terms after being granted; and
- It is granted to business entities that have the financial ability to prepay them without issue of penalty.

SELF ASSESSMENT EXERCISE 1

What are the characteristics of a term loan that can be granted by banks to business entities?

3.1.2 Uses of Term Loans

The term loan can be granted as a facility for the general use of the business entities such as identified below:

i) Acquisition of operational facilities particularly lands, buildings, equipment and machinery by large industrial firms;

ii) The term loan can be used as well for enhancing working capital position of the firms in meeting daily operational commitments;

iii) The loan can be used for financing new projects such as development and financing of new products, acquisition of sales outlets, establishing source of raw materials, etc;

iv) It can be used as a means of drawdown of funds for financing fleet of transport facilities for operational logistics; and

v) The facility can be combined with revolving credit facility for periodic drawdown by business entities for financing periodic commitments by firms.

SELF ASSESSMENT EXERCISE 2

What are the major uses to which the term loans are secured by business entities?

3.1.3 Provisions of Term Loans

The term loans normally come with some provisions that are binding on the borrowers, which are meant to safeguard the interest of the banks lending them to business entities. Such terms of agreement include the following:

1. Collateral Security

The term loans, in general terms, require pledging of collateral security by the borrowers. The collateral security can be for the long-term loans than the short-term one as a result of the differences in risks associated with the term loans.

The reason is that the long-term loans, in general terms, are associated with much risk compared with the short-term loans. The collateral security may also be demanded from smaller enterprises because of the fact that their operations can be much risky as compared to large industrial undertakings.

2. Interest Charges

The interest charges on term loans are generally higher compared to other forms of credit facilities from the banks. In comparison to short-term loan, the interest rate on term loan is higher due to the fact that the latter form of bank lending facility is less liquid and it involves higher risk.

Furthermore, the term loan that involves large amount of funds calls for charges which are higher than the type that involves a small amount of funds because the cost of

packaging and administration of the facility increases with cost of insurance, administrative and paper work, and logistics for periodic contacts with the borrowers.

There are other factors that influence that the charges that are associated with the term loans. Such factors include: the prime rate in the economy; issue of compensating balance, financial position of the borrower, and cash inflows prospects of the project or the business, among others.

3. Maturity

The term loan normally has duration of about 2 – 6 years or even longer periods. This depends on purpose of the loan, the agreed term, liquidity position of the bank, status of the business or projects for which the loan is taken, etc.

In some cases, the term loan can be repaid back before the maturity date but it can attract some extra charges regarded as penalty particularly if it is discovered by the bank that the borrower is using a cheaper funds to repay the loan.

4. Repayment

The repayment of term loans involves installment payments quarterly, semi-annually and annually. The agreed terms may involve a balloon payment at the end of the maturity period in which a new line of facility may be negotiated by the borrower.

The negotiation of a new line of loan facility at the end of the previous one is desirable particularly by the lender for borrowers who may need a long-term credit facility. Therefore, the duration and the whole amount that may be demanded by the borrower can be graduated and granted to him on periodic basis.

SELF ASSESSMENT EXERCISE 3

Mention the provisions that are associated with the term loans.

3.1.4 Factors Influencing Granting of Term Loans

There are salient factor that are normally taken into consideration by the banks when lending on the basis of term loan facilities. Such factors are important in the operations of the commercial banks because of the fact that the lending of funds by commercial banks involves the use of depositors' money, which must be repaid back on periodic basis.

Furthermore, such factors are important for consideration in bank lending generally, so as to ensure that their operations are profitable. This implies that it is important for commercial banks to consider some factors into consideration in the use of depositors' funds since such funds are just for safekeeping. And therefore, it is in their best interest to tread with caution in the process of granting credit facilities such as the term loans to customers.

Such factors that are important for consideration in lending of term loans include the following:

1. Appraisal of bank's liquidity position

The appraisal of the bank's financial position is in relation to the loan request and the trends in deposits and their withdrawals. In essence, the bank takes into consideration issues such as nature and trends in deposits from depositors, and type of deposits that attracting reasonable funds.

The other issues that can be considered by the banks in the appraisal of the liquidity position include the quality of deposits from customers, liquidity and diversification of earning assets, and the capital accounts of the bank necessary to back lending.

2. Composition of Loans

This involves the assessment of the composition of the loan portfolio of the bank so that the loans will be concentrated in the hands of few customers. The banks will ensure that there is a balanced loan portfolio by spreading the credit facilities to different and diverse industrial organizations.

3. Liquidity of Assets

The banks will also consider the liquid position of the earning assets that have been committed or granted out as credit facilities to customers. The volume of lending depends on the liquid state of the funds already committed into loans and credits.

Assuming the bulk of the funds is sunk into marketable securities with maturity of months to one year then the banks will gladly extend more credits in term loans. On the other hand, if the bulk of the bank's is into long-term loans, it will not be favourably disposed to granting the term loans to industrial undertakings and other enterprises.

The marketable securities can always be redeemed by the central bank during the peak periods of withdrawals. This can encourage the commercial banks to grant term loans on the understanding they can use their funds in marketable securities to meet sort- term demands from the depositors.

4. Quality of Loans

The quality of loans already committed in the hands of the customers is also important towards the decision of the banks to grant term loans to customers. In this regards, the composition of borrowers will be considered in relation to the number of them who are marginal borrowers and those that are industrial organizations such as petroleum, communications, transport, vital services generally.

Assuming that the bank is saddled with the bulk of loans in the hands of the marginal borrowers, the bank might not be able to grant term loans. This is because the marginal borrowers are fond of slow repayment or slow in meeting their repayment obligations coupled with the fact that they are always asking for extension for repayments.

5. Quality of Credit Staff

The banks will consider the quality of their credit staff who will be required to carry out professional assessment of the customers requesting for term loans. The banks may need to engage experts in various industries such as estate managers, agricultural engineers, construction engineers, insurers, etc, for use in assessing term loans.

Some commercial banks as well as investment banks normally have these professionals in the staff mix so that they can be used from time to time for evaluation of term loans and other specialized credit facilities. Such mix of lending requires special skills which ordinary bankers cannot handle because these cannot be acquired through training and experience in the banking industry.

6. Creditworthiness of Customers

The banks also consider the creditworthiness of the customers before granting the term loans. The character of the customer is normally taken into consideration before the assessment of other issues concerning the business of the customer requesting the loan facility.

There are factors that are normally considered in the assessment of the customer's creditworthiness. Such other factors include condition in the industry and the economy, contribution of the customer, capital of the business, and capacity of the business to repay the loan which also depends on the management of the business.

The factors that banks normally consider in lending term loan include cash inflows from the operations of the business or the project for the

facility, collateral security to pledge for the loan, and the amount in the facility being sought by a customer.

7. Past Performance of the Business

The performance of the business for which the term loan is being sought is also important for investigation by the bank before considering granting the facility to the customer.

The investigation of the past performance of a business involves the assessment of some financial statements such as the income statement and the balance sheet. The income statement indicates the income generation capacity of the business for a period of five years. This reveals the possibility of earning incomes with which to pay for the loan facility.

The balance sheet indicates the capital position of the business, the debt profile of the business, determines the nature of the fixed assets and the working capital status of the entity. The balance sheet that can be used to assess the relevant should incorporate a period of five years.

In the case a new business, the financial projections of the venture are used to assess the projected cash inflows position of the business which is reflected in the cash budgeting. There are the projected income statement and the projected balance sheet of the new venture in the feasibility study report which can be used for relevant assessment by the bank.

3.2 Real Estate Loans

The real estate loans are credit facilities which are normally granted for the purchase or construction of building structures. Such loan facilities are granted on the basis of the fact that the real estates in terms of the landed property involved constitute the collateral security. Therefore, the real estate loans are more or less mortgage loans.

The real estate loans are like the mortgage loans because they are associated with specific collateral securities such as the building structures for which the loan funds are used to construct by the beneficiaries. Therefore, the bank that grants the loans automatic has a legal lien over the building structures constructed with the funds by the customers.

Mortgage itself is a kind of loan for which land is offered as collateral security for the repayment of the funds involved in the credit facility. This is also applicable to real estate loans for which the building

structures put up by the beneficiaries are automatically pledged as their collateral securities.

It suffices it to say that the real-estate loan facility can indeed assume the trappings of a mortgage loan. It means that all the features of the mortgage loan are also applicable to all real estate loans.

3.2.1 Features of a Real Estate Loan

The following considerations are applicable to the real estate loan, which the bank must ensure are implemented for granting such a facility:

1. There is a deed conferring on it a legal lien on the estate for a stated number of years until the funds involved in the facility are totally repaid back;

2. There is the deposit of title deeds on the building or the estate with the bank;

3. The deeds would be registered with the appropriate authority by the bank;

4. The customer to whom the real estate loan is granted can redeem the facility before the maturity date for the final repayment;

5. Equitable mortgage on the estate is made by written charge;

6. The written charge is registered in order to qualify for a security conferring lien;

7. The registration of the charge is effected promptly, immediately after possession; and

8. Prevent a sale of the estate without the bank's knowledge and consent.

SELF ASSESSMENT EXERCISE 4

Mention the features of a real estate loan that can be granted by banks to their customers.

3.2.2 Rights of the Bank in Case of Default

1. The right to sue the customer for the recovery of the loan;

2. The right to take possession of the estate for which the loan is used for;

3. To foreclose which involves asking the court to order repayment within a specified time;

4. To take possession and sell the property involved in the loan; and

5. To appoint a receiver for the estate as an alternative to outright sale of the property.

4.0 CONCLUSION

You have learnt from this study unit that term loan and real estate loan have some peculiarities and differences in the considerations, lending terms, and the charges. While the term loan is granted generally for business operations, the real estate loan is normally granted for landed property. The property for which a real estate loan is granted is normally secured by the banks as the collateral security for the loan. Such property is automatically mortgaged for the loan facility. In the case of term loan the beneficiary is usually requested to provide collateral security which may not be related to the loan. In terms of similarities, both forms of loan are usually assessed before being granted, attract interest charges, and require collateral security, among others.

5.0 SUMMARY

In this study unit, topics covered include the following:

- Meaning of a Term Loan
- Characteristics of Term Loans
- Uses of Term Loans
- Provisions of Term Loans
- Factors Influencing Granting of Term Loans
- Real Estate Loans
- Features of A Real Estate Loan
- Rights of The Bank in Case of Default

In the next study unit, you will be taken through the discussion on working capital loans.

6.0 TUTOR-MARKED ASSIGNMENT

Mention and discuss the factors that the banks consider in granting term loans.

Solution to Self Assessment Exercises

SAE 1:

The characteristics of a term loan that can be granted by banks to business entities include the following:

- Available to business entities that are associated with heavy industrial undertakings;
- Available to industrial organizations that deal in manufacturing, petroleum refinery, transportation;
- Available to business entities that produce durable goods, chemicals, rubber, and public utilities;
- Available to firms and trading organizations whose main purpose is for enhancing their working capital;
- Available to large business firms with heavy investments in plants and items of equipment;
- It can be used by some small and medium businesses that cannot have access to funds in capital market;
- It can be used by large firms because such firms favour their flexibility for meeting their peculiar needs compared to bond issue;
- It is available to firms that have the ability to renegotiate their terms after being granted; and
- It is granted to business entities that have the financial ability to prepay them without issue of penalty.

SAE 2:

The major uses to which the term loans are secured by business entities include the following:

i) Acquisition of operational facilities particularly lands, buildings, equipment and machinery by large industrial firms;

ii) The term loan can be used as well for enhancing working capital position of the firms in meeting daily operational commitments;

iii) The loan can be used for financing new projects such as development and financing of new products, acquisition of sales outlets, establishing source of raw materials, etc;

iv) It can be used as a means of drawdown of funds for financing fleet of transport facilities for operational logistics; and

v) The facility can be combined with revolving credit facility for periodic drawdown by business entities for financing periodic commitments by firms.

SAE 3:

The provisions that are associated with the term loans.

i) Collateral Security

The term loans, in general terms, require pledging of collateral security by the borrowers. The collateral security can be for the long-term loans than the short-term one as a result of the differences in risks associated with the term loans.

ii) Interest Charges

The interest charges on term loans are generally higher compared to other forms of credit facilities from the banks. In comparison to short-term loan, the interest rate on term loan is higher due to the fact that the latter form of bank lending facility is less liquid and it involves higher risk.

iii) Maturity

The term loan normally has a duration of about 2 – 6 years or even longer periods. This depends on purpose of the loan, the agreed term, liquidity position of the bank, status of the business or projects for which the loan is taken, etc.

iv) Repayment

The repayment of term loans involves installment payments quarterly, semi-annually and annually. The agreed terms may involve a balloon payment at the end of the maturity period in which a new line of facility may be negotiated by the borrower.

SAE 4:

The features of a real estate loan that can be granted by banks to their customers include the following:

1. There is a deed conferring on it a legal lien on the estate for a stated number of years until the funds involved in the facility are totally repaid back;
2. There is the deposit of title deeds on the building or the estate with the bank;
3. The deeds would be registered with the appropriate authority by the bank;
4. The customer to whom the real estate loan is granted can redeem the facility before the maturity date for the final repayment;
5. Equitable mortgage on the estate is made by written charge;
6. The written charge is registered in order to qualify for a security conferring lien;
7. The registration of the charge is effected promptly, immediately after possession; and
8. Prevent a sale of the estate without the bank's knowledge and consent;

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UNIT 4 WORKING CAPITAL LOANS

CONTENTS

1.0 Introduction
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3.2.1 Reasons for Use of Working Capital Loans
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1.0 INTRODUCTION

Working capital is very important in the operations of a firm. This aspect of the operating capital of the business relates to the circulatory assets which are critical towards meeting the demands of the short-term claims on the business. In relating the current assets to the current liabilities, there is always a difference which may be positive or negative. The difference is positive when the amount of current assets is more than the amount of the current liabilities. The negative difference is indicative of the fact that the amount of the current liabilities exceeds the amount of the current assets. This is always a great concern to any business entity. This is where the working capital loan comes into play because such loan will be needed to cushion the effect of such negative position of working capital. This study unit, therefore, is used to discuss this type of operational loan to a business entity.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- discuss the nature of working capital
- explain the working capital loan
- identify the reasons for use of working capital loan
- mention the merits and demerits of working capital loan
- mention and explain types of working capital loan

3.0 MAIN CONTENT

3.1 Nature of Working Capital

Working capital relates to the circulatory assets of a business. In broad terms, the term is used when the current assets of an enterprise are considered in relation to the circulatory assets, which incorporate the current liabilities of the business. Therefore, the working capital can be used as a term to indicate the difference between the current assets and current liabilities.

This implies in essence, that working capital is a term which refers to the total current assets minus total current liabilities. The working capital can be used to measure the amount of liquid assets a company has available to run its business. Since the measure relates current assets to the current liabilities, the difference can be positive or negative. This depends on the amount of current liabilities that the company is indebted to outsiders such as suppliers, banks, and tax authority, among others.

The general consideration is that companies that have a lot of working capital will be more successful than others since such quantum of funds can be used to expand and improve their operations. Companies that operate with more cuurent liabilities than the current assets may lack the required amount of funds necessary for growth and expansion.

The above scenario implies that in the event that the total current liabilities exceed the total current assets, the company's efficiency and its short-term financial health will be in jeopardy. This is because the enterprise will be able is not in a position to to meet its short-term liabilities with its current assets; cash, accounts receivable and inventory.

In the event that the total current assets exceed the total current liabilities, the enterprise is being efficiently managed, and therefore, it is in a position to meet the short-term liabilities such the demands of suppliers, banks, tax authority, and other current liabilities.

The position of a company's working capital also gives investors an idea of the company's underlying operational efficiency. The observed operational inefficiency implies that a lot of funds is tied up in inventory or that the funds in accounts receivables of the company are not available for use in paying off any the company's external obligations.

Furthermore, if a company's operations are not being managed in the most efficient manner (an indication of slow collection), it will show up as an increase in the working capital. This is normally determined by

comparing the working capital from one period to another. Hence uncoordinated collection of account receivables may be indicative of an underlying problem in the company's operations.

In basic terms, the working capital normally serves as a financial mechanism which represents operating liquidity available to a business entity. When it is considered along with fixed assets such as plant and equipment, the working capital is normally regarded as part of operating capital.

A net working capital is normally determined as current assets minus the current liabilities. It represents a derivation of working capital that is commonly used in valuation techniques. Therefore, if current assets are less than current liabilities, the enterprise concerned is regarded to have a working capital deficiency or a working capital deficit.

The various considerations in determination of the working capital are derived using the following formulae:

Working Capital = Total Current Assets – Total Current Liabilities

Net Working Capital = Total Current Assets – Total Current Liabilities

Net Operating Working Capital = Total Current Assets – Non Interest-bearing Current Liabilities

Equity Working Capital = Total Current Assets – Total Current Liabilities – Long-term Debt

A business entity can have assets and profitability but it may have problem with liquidity if its current assets cannot readily be converted into liquid cash with which to meet current obligations. A positive working capital is usually considered necessary to ensure that a firm is able to continue its operations. It also indicates that the entity has sufficient funds to satisfy both maturing short-term liabilities and impending operational expenses.

The basic consideration is that effective management of working capital involves efficiently managing the items of working capital such as inventories, accounts receivable, accounts payable, and cash inventory. The critical consideration in the management of working capital is the current liabilities because the firm must discharge such debts to outsiders. This is cannot be compromised because in the event of failure the firm appropriate steps would be taken to declare it bankrupt.

It has been argued that current assets and current liabilities include three accounts which are of special importance to any business entity. Such items or accounts represent the responsibilities of the business where managers have the most direct impact. These items of working capital include accounts receivable (current asset), inventory (current asset), and accounts payable (current liability).

The portion of working capital that is current debt, which is normally payable within a year, is critical because it represents a short-term claim on current assets and it is often secured by short-term assets. Common types of short-term debt are bank loans and lines of credit. Basically, an increase in working capital indicates that the firm has either increased current assets, that is has increased its receivables, or other current assets or has decreased current liabilities such as paying off some short-term creditors.

The working capital is normally considered as a part of operating capital of a business entity. In the event that some firms fall short on working capital, which is not an abnormal situation, they definitely need to secure a working capital loan. This is the subject of discussion in the section below.

SELF ASSESSMENT EXERCISE 1

Mention the basic items of current assets and current liabilities of a typical firm.

3.2 Working Capital Loans

The working capital loan is a short-term loan which is normally obtained by a firm to finance its day-to-day operations. The loan is normally a facility for a comparably small amount. It is not normally used for long-term operational purposes. In most cases, the funds from working capital loan are normally for immediate needs of the firm, such as meeting payroll and accounts payable.

In essence, the working capital loan is a kind of loan that is normally intended to finance the daily operations of a business entity. There are indicators that are normally monitored by entrepreneurs and executive officers of large companies with which to know the indicators indicating the need for working capital loans from a bank or other alternative credit financing firms.

Normally, business entities need the working capital loans when they are having liquidity crisis within their operations such as inability to meet additional funding to settle short-term obligations or to expand their

operations. Under these circumstances and many others, a working capital loan is really a necessity towards the survival of the operations of many a business such as a small business startup and established business.

3.2.1 Reasons for Use of Working Capital Loans

A business entity may need additional finances for varied factors such as identified below. The working capital loan is needed for reasons such as using it to:

- purchase new equipment in order to increase production;
- develop the present inventory by adding new products;
- open new facilities such as production centers;
- finance expensive promotional campaigns;
- refinance current liabilities which are due for payment;
- build inventory or purchase raw materials;
- enhance the sales of sufficient number of products
- improve the financial condition of a firm.
- avoid financial illiquidity or collapse in operations; and
- realize the true potential of a firm

Working capital loans could be secured or non-secured. Secured loans refer to the type of loan guaranteed by collateral such as a property, equipment or inventory of products. These loans are entirely repayable on the agreed period or else the bank will confiscate the assets under the collateral agreement.

On the other hand, the non-secured loans are not backed up by any form of collateral but they need to be repaid with higher interest rates. Usually banks would approve non- secured loans only to their longtime customers or to a company with less risky operations. Therefore, the unsecured loan is not available to new business entities. New businesses are considered as high-risk ventures and will therefore, be denied access to such facility by the banks.

The working capital loan is among the basic choices for a company in meeting their financial needs. Such main options have their advantages and disadvantages but their effective use depends on how a firm manages the additional funds in its operations.

SELF ASSESSMENT EXERCISE 2

Mention the reasons for the request of working capital loans by firms.

3.2.2 Merits and Demerits of Working Capital Loans

For the advantages of using the working capital loan, considerations are as follows:

- The working capital loan is a source of quick funding;
- It helps a business entity to sustain their operations until it is profitable enough;
- Such a loan could be used to refinance cash flow for meeting the short-term financial obligations to workers and suppliers;
- Working capital loan provides funds to a business entity it needs to keep growing until the business can cover all operating expenses out of revenue.
- The working capital loan also enables businesses to generate enough revenue from additional sales to stay afloat.
- The loan also makes a firm the access to cash which can be used to make payment for rents, mortgage payments, utilities, marketing expenses, inventory, and remuneration for employees, etc.

For the disadvantages of using the working capital loan, considerations are as follows:

- The funding is only intended for short-term solutions;
- These loans will not be relevant to long-term business goals or business projects that will need higher investments;
- The firm needs to make regularly payment on the loan;
- This also calls for ensuring timely payments to avoid being considered as a high- risk or a delinquent customer.
- Another disadvantage is that obtaining capital through this method can be difficult for many businesses, particularly the small and medium enterprises.

The working capital loans can be obtained in many different ways. In order to qualify for the types coming from the banks, the balance sheet of the business is assessed to find out a company’s current working capital. Such assessment can reveal more about the financial condition of a business than any other anything else.

The calculation of the working capital from the items of balance sheet of a business entity will show the bank what a firm will be left with should it evaluate all of its short- term financial resources and compared such with the short-term debts. The more reasonable the working capital is in the operations of the business, the better. Some of the common working capital loans will be needed when a business entity does not have a sufficient working capital for its operations.

SELF ASSESSMENT EXERCISE 3

Mention the advantages and disadvantages of using working capital loans by firms.

3.3 Types Of Working Capital Loan

Generally, there are generally five types of loans that are obtainable for the purpose of enhancing working capital. Such forms of working capital loan include: equity loans

from personal resources, funds from friends or family members, or from investors like venture capitalists ; loans from trade creditor for extend a loan to purchase a specific

amount of product from them; factoring which involves the sale of the business' debts

(or accounts receivable), in exchange for immediate payment at discounted value, which is lower the face value; a line of credit, and short-term loan.

The line of credit and short-term loans as related to working capital loans are applicable to the discussion herein. This is due to the fact that both loans are normally obtainable from the banks.

1. Line of Credit

This is any credit facility that is extended to business entities by a bank for use in enhancing their working capital position. The line of credit from the bank comes in form of a cash credit, overdraft facility, a demand loan, an export packing credit, term loan, or discounting facility.

The lines of credit are very flexible for business use. Nevertheless, they are only made available to the business entities that have meaningful way of repaying them. The consideration is defined cash inflows from the operations of the firm.

The availability of credit is a key determinant in the ability of particularly small and medium firms to expand and grow. In order to lessen the perennial problems of meeting the demands of operations of growing number of small and medium enterprises, working capital loans are normally made available to them by the banks. In fact some of these loans do not need collateral securities but offer of mere promise of

repayment from the business entities in need of such loans to back up their working capital.

2. Short term loan

The short-term loan is another form of working capital loan that is available for the use of business entities. The short-term loans are usually seasonal loans, but their maturity does not always go beyond a period of one year. The thriving and well established business entities are nearly guaranteed automatic access to short term loans, which in most cases do not require collateral securities.

Since the working capital of a company reflects its ability to meet its obligations as they fall due, the short term loans are necessary in avoiding a run towards a position of bankruptcy. Thus, some amount of working capital loans in form of short-term loans are needed more often to direct the character and scope of a business operation. Working capital loans or short-term financing constitute the funds usually required by the firms to finance working capital short-falls.

It is argued by some finance authorities that the financing difficulties for small and medium businesses can be overcome only through the short-term loans. Such business

entities seek short-term funding facility for use in meeting operating expenses, purchasing inventory, receivables financing. The reason is that unlike a loan for the acquisition of fixed assets such as land, buildings, machinery and equipment, a short— term loan for working capital does not require collateral security thought to be as reliable for repayment purposes.

SELF ASSESSMENT EXERCISE 4

Mention and explain the two basic types of working capital loan.

4.0 CONCLUSION

You have learnt from this study unit that business entities need the working capital loans whenever they are in liquidity crisis in their operations. In situation of their inability to meet additional funding to settle short-term obligations or to expand their operations, business entities do approach banks for short-term loans and line of credit. Such facilities do not, in most cases, need collateral securities, which make them attractive to small and medium enterprises in financing their working capital requirements. These loan facilities are always taken by business entities with which to finance operating expenses, purchasing

inventory, and receivables financing. Hence, a working capital loan in form of short-term loan or line of credit is really a necessity towards the survival of the operations of many a business such as a small and medium enterprises as well as well-established firms.

5.0 SUMMARY

In this study unit, topics covered include the following:

- Nature of Working Capital
- Working Capital Loans
- Reasons for Use of Working Capital Loans
- Merits and Demerits of Working Capital Loans
- Types of Working Capital Loan

In the next study unit, you will be taken through the discussion on agricultural loans.

6.0 TUTOR-MARKED ASSIGNMENT

Mention and discuss the two types of working capital loan available for firm's use.

Solution to Self Assessment Exercises

SAE 1:

Items of current assets include, among others, the following:

- Inventory of goods
- Accounts Receivables or Debtors
- Bank balance
- Cash balance
- Prepayment of expenses

Items of current liabilities include, among others, the following:

- Accounts Payables or Creditors
- Bank Overdraft
- Short-term Loan
- Tax Liability
- Prepayment in Arrears

SAE 2:

The working capital loan is needed for reasons such as using it to:

- purchase new equipment in order to increase production;
- develop the present inventory by adding new products;
- open new facilities such as production centers;
- finance expensive promotional campaigns;

- refinance current liabilities which are due for payment;
- build inventory or purchase raw materials;
- enhance the sales of sufficient number of products
- improve the financial condition of a firm.
- avoid financial illiquidity or collapse in operations; and
- realize the true potential of a firm

SAE 3:

The advantages of using working capital loans by firms include the following:

- The working capital loan is a source of quick funding;
- It helps a business entity to sustain their operations until it is profitable enough;
- Such a loan could be used to refinance cash flow for meeting the short-term financial obligations to workers and suppliers;
- Working capital loan provides funds to a business entity it needs to keep growing until the business can cover all operating expenses out of revenue.
- The working capital loan also enables businesses to generate enough revenue from additional sales to stay afloat.
- The loan also makes a firm the access to cash which can be used to make payment for rents, mortgage payments, utilities, marketing expenses, inventory, and remuneration for employees, etc.

The disadvantages of using working capital loan include the following:

- The funding is only intended for short-term solutions;
- These loans will not be relevant to long-term business goals or business projects that will need higher investments;
- The firm needs to make regularly payment on the loan;
- This also calls for ensuring timely payments to avoid being considered as a high- risk or a delinquent customer.
- Another disadvantage is that obtaining capital through this method can be difficult for many businesses, particularly the small and medium enterprises.

SAE 4:

The two types of working capital loan are as identified and explained below.

i) Line of Credit

This is a credit facility that is extended to business entities by a bank for use in enhancing their working capital position. The line of credit from the bank comes in form of a cash credit, overdraft facility, a demand loan, an export packing credit, term loan, or discounting facility.

ii) Short term loan

The short-term loans are usually seasonal loans, but their maturity does not always go beyond a period of one year. The thriving and well established business entities are nearly guaranteed automatic access to short term loans, which in most cases do not require collateral securities.

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UNIT 5 AGRICULTURAL LOANS

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7.0 References/Further Reading

1.0 INTRODUCTION

Agricultural production is very important to the economy. This is because the agriculture sector is the mainstay of an agrarian of the country's economy. In this regard, the sector provides food for the teeming population, ensures steady supply of raw materials for the industries, provides employment, enhance the gross domestic product, and contributes towards the economic growth and development of the country. Therefore, the apex bank makes it mandatory for commercial banks to extend their lending portfolio to the agricultural sector of the economy. The government also establishes agricultural bank to develop the sector. Therefore, in this study unit, the discussion is on the types of agricultural loan that are being granted by commercial banks to the farmers.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- explain the sphere of agricultural loans
- discuss the risky nature of agricultural loans
- identify and explain factors influencing agricultural lending
- discuss the intermediate term loan in agriculture
- explain the current expense loan in agriculture

3.0 MAIN CONTENT

3.1 Realm Of Agricultural Loans

The agricultural loans are the credit facilities that are made available by commercial banks for productive operations in the agricultural sector. These are loans being granted to:

- individual farmers;
- farmers' cooperative societies; and
- and agricultural firms.

The agricultural loans are normally among the various loans in the lending portfolio of commercial banks.

The commercial banks are normally under obligation to make available such loans to farmers for the purpose of encouraging:

- food production;
- generating employment;
- enhancing the gross domestic product;
- checking rural-urban migration; and
- enhancing production of raw materials to feed the manufacturing industries.

This is necessary because banks are generally averse to granting loans to farmers because of the risky nature of agricultural undertakings.

Some of the loan facilities from commercial banks to farmers are facilitated directly to them and not through some intermediaries. Nevertheless, in order to ensure that the risks involved in agricultural lending are greatly curtailed, some commercial banks only engage in indirect financing of agricultural operations.

The indirect financing of agricultural operations implies that these banks grant agricultural loans through the purchasing notes of suppliers of agricultural:

- equipment,
- machinery,
- tools, and
- other implements.

In other words, the funds from such facilities are not diverted for purposes other than farming operations, banks do deal directly with the suppliers of farm implements to the farmers.

There is another method of indirect financing of agricultural operations by commercial banks. This is done by the banks by ensuring that they would only participate through some lending schemes to agriculture which are guaranteed by some government agencies. This is to forestall defaults in repayment by the beneficiaries due to the risky nature of agricultural operations.

The indirect financing of agricultural operations is meant for the acquisition of agricultural assets such as:

- equipment;
- machinery;
- vehicles;
- tractors;
- lands;
- farm house;
- basic durables; and
- farm implements.

There is always an agreement between the bank and the suppliers of such capital assets for farm operations to purchase the items and secured them as mortgages. The agreement between the bank and suppliers of farm implements can also takes the form of conditional sales contract.

Basically, the agreement between banks and suppliers farm implements can incorporate provisions in connection with:

- Reserves;
- Delinquencies;
- Repossession;
- Down payments; and
- Maturities of loans; etc.

This type of arrangement involves less loan supervision, can be very profitable, less expensive in paper work and logistics for contacts, and does not involve much risk the dealers are the ones who serve as contacts between the bank and the beneficiaries.

3.2 Risky Nature Of Agricultural Loans

The agricultural loans are fraught with some problems which make them to be relegated to the backstage in the scheme of lending portfolio of the commercial banks. The riskiness of agricultural loans is inherent in the precarious nature of agricultural undertakings.

The riskiness of agricultural loans is associated with the following issues:

1. Fluctuating Income from Agriculture

Agricultural production is fraught with fluctuations in prices of agricultural produce and by extension, the revenue generation from the farming venture is subject to income instability. Therefore, it becomes difficult for the farmers to generate steady cash inflows with which to meet the periodic principal repayments and interest payments on agricultural loans.

2. Inability to Control Supply

The farmers have no control over the production and supply of agricultural produce due to the fact that agriculture is prone to the vagaries of nature that dictates its fortunes. The production of agricultural products is seasonal in nature and during the peak in rainy season much quantity is produced and prices will fall. On the other hand, during the dry season the production falls and prices of agricultural produce will rise.

In essence, the farmers have no control over production and supply of agricultural produce because of the seasonality of production that is influenced by the dictates and upheavals of nature.

3. Effect of Weather Condition

Agricultural production is subject to the dictates of weather conditions in the moulds of rainfall and sunshine that affect the quantity produced and supplied at any period of the year. The rainfall may be too inadequate at times while at some time it may be remarkable and accompanied by flooding and erosion of the fertile soil nutrients needed for agricultural production.

During the period of abundant rainfall, the level of agricultural production can be remarkable for the farmers. This goes along with reasonable amount of revenue for the farmers. On the other hand, inadequate rainfall spells poor quantity of agricultural production and consequently the farmers’ income will be negatively affected.

In the case of the other aspect of weather, too much sunshine can spell drought with consequence of poor harvest of agricultural produce. In extreme cases, the drought can lead to famine in some areas to the extent that the farmers themselves would not be able to obtain any produce to feed their families.

In the event that there is no farm produce or limited quantity of farm produce, the farmers would not be able to generate any income with which to meet the demands of the so-called agricultural loans. Therefore, the banks would incur loss in their investments in loans.

4. Difficulty in Assessing Framers Creditworthiness

It is always very difficult for the banks to assess the creditworthiness of the farmers because some important pieces of information relevant for such analysis are not just available. Granting of loans by commercial banks is based on the assessment of the customers' creditworthiness using relevant information and data from past performance of their undertakings. This is not possible in the case of the farmers who operate in precarious environment.

Farming in the less advanced countries such as Nigeria is characterized by small holdings whose owners engage in agriculture for the purpose is mainly for subsistence operations. They would sell only surplus quantity to the public. Therefore, the farmers do not keep records which can be used to evaluate their creditworthiness by the banks for the purpose of granting agricultural loans to them.

5. Diversion of Agricultural Loans

Farmers in the country are fond of diverting funds from agricultural loans to meeting family commitments which cannot in way distinguished from the expenses being incurred on farm operations. This is because borrowed funds may be utilized for both productive and or consumption purposes which in many cases could not be distinguished from each other.

Furthermore, farming operations in the country are mostly carried out on the basis of family holdings. This implies that it is difficult to separate expenses on family commitments from costs of running farming operations. The income being generated on periodic basis is being expended on family commitments as well as the farming operations.

Therefore, based on above scenario, it is difficult to determine with some degree of accuracy the actual percentage of the farm income that is expended on farming operations. It becomes very difficult for the farmers to account for the funds obtained

from agricultural loans and also the income being generated from farm produce. This discourages commercial banks from committing their funds on agricultural loans.

SELF ASSESSMENT EXERCISE 1

Mention and explain the factors responsible for the risky nature of agricultural loans.

3.3 Factors Influencing Agricultural Lending

There are some issues that are imperative towards decisions by commercial banks to commit their funds on agricultural loans. Such factors are considered important by the banks so that they would not lose their funds in agricultural lending.

These factors which are imperative in consideration for lending on agricultural operations include the following:

1. Farmers' Ability to Generate Positive Cashflows

The cashflows from the farm operations are considered important in meeting the commitments of repayment of agricultural loans. A bank will not grant agricultural loan to any farmer whose income generation is not positive that can enable the beneficiary to repay the funds on periodic basis.

The bank will only be interested in granting to farmers whose operations are capable of generating net income which can be enough to meet the financial obligations which agricultural loans demand. It implies that at every date that it is necessary for repayment to be made on loans, the farmer who benefits from the facility should be able to have net cashflows to discharge the obligation to the bank.

2. Farmer's Networth

This is related to the position of revenue being generated from the farm operations since the farmer cannot have capital assets if his net income on periodic basis is not reasonable. The availability of capital assets in a farmer's operations can be appropriated and disposed by the bank for the repayment of funds committed the agricultural loan.

The bank, nevertheless, has to ensure that such capital assets of the farmer who is benefitting from agricultural loan are taken as collateral security for the facility. This is necessary as the bank would have a legal lien over the assets before it can sell them for repayment of loan facility in the event of default or non-repayment of the funds by the beneficiary farmer.

3. Employment of Agricultural Experts

Some banks normally consider the employment of agricultural experts who will be entrusted with the responsibility of managing the lending to agricultural sector. This is necessary because such agricultural experts are the bank officials who understand the intricacies of agricultural production and therefore, they will serve as contact between the banks and the farmers.

These agricultural experts as contacts for banks are the ones who will be visiting the farmers benefitting from agricultural loans on periodic basis to handle their problems, complaints, and counseling. These experts would also be responsible for offering technical advice and financial management information on agricultural production to the farmers.

In the process of contacts with the farmers who are beneficiaries of agricultural loans, the agricultural experts would be working with the extension workers and farmers' cooperative societies for the efficient farming operations. The essence is to help the farmers manage their loan funds effectively so that their repayments would not be problematic for them.

4. Personal Qualities of the Farmers

The commercial banks also consider the personal qualities of the farmers for the purpose of assessing their credibility and honesty of purpose in relation to prompt repayment of the funds from agricultural loans granted to them.

The personalities of the farmers that are normally assessed by the banks include the credit character, farm management abilities, personal goodwill among other farmers, and in some instances their educational qualifications. The banks will also be interested in assessing the quality of farm machinery and equipment

5. Use of Modern Farm Equipment

The commercial banks will also consider the nature of the farming implements being used by the farmers before granting loan facilities to them. This is important because the farmers who are not making use of modern implements cannot be able to produce and sell farm produce, and thereby making enough for repayment of loan facilities.

In addition, the banks will also consider the use of farming implements such as fertilizers, pesticides, herbicides, and hybrid seedlings by the farmers while considering committing their funds to agricultural loans to

farmers. These considerations are important because farmers who are not making use of appropriate farm implements may not be qualified to be granted agricultural loans by the commercial banks.

6. Availability of Farm Labour

Another important consideration in granting agricultural loans by commercial banks is the issue of availability of farm labour that can be engaged by loan beneficiaries for improving their farm production and output. This is very important because once a bank grants funds for loan facility, the beneficiary will be expected to expand his farmland holding, increase production and output. This requires the use of extra labour which can be engaged if only they are available.

The use of hired labour for farming purposes is mostly needed during the cultivating and harvesting periods in the production process. The usual practice is for the farmers to search and engage able-bodied youths who have the raw energy to cultivate farmlands. Nevertheless, women can also be engaged during the harvesting period for the basis of paid labour.

SELF ASSESSMENT EXERCISE 2

What are the factors which influence decisions of commercial banks on agricultural lending?

3.4 Types Of Agricultural Loan

There are some types of agricultural loan that can be identified based on the lending practices of the commercial banks. Such forms of agricultural loan are as presented and discussed below.

3.4.1 Intermediate Term Loan

This type of agricultural loan is normally granted to the farmers for the purpose of financing the acquisition of operating assets. The intermediate term loan for the farm operations is usually made available to the farmers for a maturity of several years.

The funds from the loan are normally used for the purchase of:

- farm equipment;
- farm machinery;
- livestock;
- vehicles; and
- durable implements.

All these farm requirements are normally meant for enhancing the production of agricultural products.

Part of the money from the term loan can also be utilized by the beneficiaries in:

- acquiring farmland;
- construction of farm house;
- fish pond;
- piggery; and
- pen house for goats; etc.

The commercial banks normally ensure that the farmers are encouraged to utilize the funds from the term loan to enhance the mechanization of the farm operations.

Therefore, the funds can be utilized by some farmers for the:

- purchase of tractors; and
- acquisition of modern agricultural implements.

These operational assets are meant to encourage the farmers towards the mechanization and improvement of their agricultural production. The commercial banks would be interested in such assets being purchased by the beneficiaries so that they are easily secured as collateral for the loan.

In terms of collateral security, a large percentage of the intermediate loans for agricultural production are secured. Therefore, it is only a small percentage of such loans that is unsecured by the farmers when they are granted by the banks. The reason is the risky nature of farm operations and the fact that the loan is repayable over several years.

The extended length of maturities of this type of agricultural loan increases the riskiness in the loan. This informs the need for collateral security for this form of loan for agricultural production. The items that are purchased with the funds from the loan are normally mortgaged or secured by the banks as the collateral security for such loans.

The real estate for which the loan can be utilized, for the farm operations, can always be accepted by the commercial banks as collateral securities. This is in the event that the funds from the intermediate term loan are utilized by the beneficiaries to improve farm land and buildings.

The maturity period of intermediate term loan for the farm operations varies in accordance with the purpose of the facility. In the case of the

loan being granted for the purpose of livestock the maturity would be for a relatively short term. The maturity becomes a relatively long term if the purpose of the loan is for the acquisition of vehicles and durable farm implements.

3.4.2 Current Expense Loan

This type of loan is normally granted by the commercial banks to farmers for the financing of frequent seasonal expenses for the production of crops and livestock.

Such recurrent expenses in farm operations for which the loan is granted include:

- seedlings;
- hybrid seeds;
- fertilizers;
- fuels; and
- hired labour.

Since this type of agricultural loan is for current farm operations in terms of utilization for current farm expenses, it is normally granted by the commercial banks for a short- term basis. The loan facility is repayable within a period of twelve months.

The loan is usually regarded as current operating facility for expenses such as

- feeder;
- livestock; and
- other recurrent expenditures.

These expenditures are normally incurred in the process of farm operations by the beneficiaries.

Some farmers have the penchant for spending part of the funds from the current expense loan for the upkeep of the family. The loan of this nature that is usually secured is of relative small percentage.

The commercial banks normally ensure a security interest, for the purpose of collateral security, in articles such as:

- harvested crops;
- machinery;
- equipment; and
- livestock.

In the case of feeder livestock loans the collateral security will be taken on the livestock on which the funds are utilized in feeding and related expenses. The banks will take lien on real estate and support in the case of farmers who have a limited networth.

Since the current expenses loan are meant for use in meeting and financing current farm operations, they are usually granted for a short-term maturity basis. The loan is meant for financing of a farmer's needs for preparing (feeding and growing) the livestock for the market if it is granted for livestock.

In most cases, the current expenses loans are normally made available by commercial banks on demand from the farmers. This is informed by the fact that farming income is seasonal and therefore, it is does not come on regular basis.

Nevertheless, farm operations which are normally associated steady income round the year include:

- poultry; and
- dairy production.

By implication, such farm operations are frequently considered for current expenses loans on demand basis by the commercial banks.

The current expenses loans are associated with repayment on single lump-sum basis. It implies that the total amount of funds for repayment by beneficiaries is usually paid back as a lump sum to the bank. The repayment is therefore, not made by the beneficiary on installment basis. This is to forestall default since the income of most farmers is relatively inconsistent and seasonal since it comes but once in a particular period of the year.

SELF ASSESSMENT EXERCISE 3

What are the main types of agricultural loans available from banks?

4.0 CONCLUSION

You have learnt from this study unit that there are some loans that are normally made available by commercial banks to farmers for the purpose of improving agricultural production. Such agricultural loans include intermediate term loan and current expense loan. You should have understood from the analysis that intermediate term loan is usually granted for use by the farmers for the purpose of financing the acquisition of operating assets; farm equipment, farm machinery,

livestock, vehicles, and durable implements. On the other hand, the current expense loan is designed for the farmers in helping them to meet important recurrent expenditures in farm operations. Such funds are utilized for feeder, livestock, dairy production, and other recurrent expenditures.

5.0 SUMMARY

In this study unit, topics covered include the following:

- Realm of Agricultural Loans
- Risky Nature of Agricultural Loans
- Factors Influencing Agricultural Lending
- Types of Agricultural Loan
- Intermediate Term Loan
- Current Expense Loan

In the next study unit, you will be taken through the discussion on installment loans and secured loans.

6.0 TUTOR-MARKED ASSIGNMENT

Mention and discuss the main types of agricultural loans available from commercial banks.

Solution to Self Assessment Exercises

SAE 1:

The factors responsible for the risky nature of agricultural loans include the following:

i. Fluctuating Income from Agriculture

Agricultural production is fraught with fluctuations in prices of agricultural produce and by extension, the revenue generation from the farming venture is subject to income instability.

ii. Inability to Control Supply

The farmers have no control over the production and supply of agricultural produce due to the fact that agriculture is prone to the vagaries of nature that dictates its fortunes. The production of agricultural products is seasonal in nature and during the peak in rainy season much quantity is produced and prices will fall. On the other

hand, during the dry season the production falls and prices of agricultural produce will rise.

iii. Effect of Weather Condition

Agricultural production is subject to the dictates of weather conditions in the moulds of rainfall and sunshine that affect the quantity produced and supplied at any period of the year. The rainfall may be too inadequate at times while at some time it may be remarkable and accompanied by flooding and erosion of the fertile soil nutrients needed for agricultural production.

iv. Difficulty in Assessing Framers Creditworthiness

It is always very difficult for the banks to assess the creditworthiness of the farmers because some important pieces of information relevant for such analysis are not just available. This is not possible in the case of the farmers who operate in precarious environment.

v. Diversion of Agricultural Loans

Farmers in the country are fond of diverting funds from agricultural loans to meeting family commitments which cannot in way distinguished from the expenses being incurred on farm operations. This is because borrowed funds may be utilized for both productive and or consumption purposes which in many cases could not be distinguished from each other.

SAE 2:

The factors which influence decisions of commercial banks on agricultural lending include the following:

i. Farmers' Ability to Generate Positive Cashflows

The cashflows from the farm operations are considered important in meeting the commitments of repayment of agricultural loans. A bank will not grant agricultural loan to any farmer whose income generation is not positive that can enable the beneficiary to repay the funds on periodic basis.

ii. Farmer's Networth

This is related to the position of revenue being generated from the farm operations since the farmer cannot have capital assets if his net income on periodic basis is not reasonable. The availability of capital assets in a

farmer's operations can be appropriated and disposed by the bank for the repayment of funds committed the agricultural loan.

iii. Employment of Agricultural Experts

Some banks normally consider the employment of agricultural experts who will be entrusted with the responsibility of managing the lending to agricultural sector. This is necessary because such agricultural experts are the bank officials who understand the intricacies of agricultural production and therefore, they will serve as contact between the banks and the farmers.

iv. Personal Qualities of the Farmers

The commercial banks also consider the personal qualities of the farmers for the purpose of assessing their credibility and honesty of purpose in relation to prompt repayment of the funds from agricultural loans granted to them.

v. Use of Modern Farm Equipment

The commercial banks will also consider the nature of the farming implements being used by the farmers before granting loan facilities to them. This is important because the farmers who are not making use of modern implements cannot be able to produce and sell farm produce, and thereby making enough for repayment of loan facilities.

vi. Availability of Farm Labour

Another important consideration in granting agricultural loans by commercial banks is the issue of availability of farm labour that can be engaged by loan beneficiaries for improving their farm production and output.

SAE 3:

The main types of agricultural loans available from banks include:

i) Intermediate Term Loan

This type of agricultural loan is normally granted to the farmers for the purpose of financing the acquisition of operating assets for a maturity of several years. The funds from the loan are normally used for acquiring farm equipment, farm machinery, livestock, vehicles, and durable implements.

ii) Current Expense Loan

This type of loan is normally granted by the commercial banks to farmers for the financing of frequent seasonal expenses for the production of crops and livestock. Such recurrent expenses in farm operations for which the loan is granted include seedlings, hybrid seeds, fertilizers, fuels, and hired labour.

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MODULE 3

UNIT 1 INSTALLMENT LOANS & SECURED LOANS

CONTENTS

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2.0 Objectives
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3.1 Installment Loans
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3.1.2 Benefits of Installment Loans
3.1.3 Interest Rates of Installment Loans
3.2 Types of Installment Loan
3.2.1 Cash Installment Loans
3.2.2 Income-Based Installment Loans 3.3 Secured Loans
4.0 Conclusion
5.0 Summary
6.0 Tutor-Marked Assignment
7.0 References/Further Reading

1.0 INTRODUCTION

Another form of lending by commercial banks to their customers is the installment loan. There are a wide variety of terms in installment loans, which ranges from short term, medium term to long term. The principal difference between this loan and other forms of lending to business entity is the fact that its repayment plan is over a fixed time period in equal amounts. The peculiar features of this type of lending from commercial banks to their customers are identified and discussed in this study unit, besides the consideration of secured form of loan.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- discuss the term installment loan
- explain the purpose of installment loans
- mention and explain the benefits of installment loans
- mention factors affecting interest rate on installment loans
- explain cash installment loans
- discuss the income-based installment loans
- explain the term secured loan

3.0 MAIN CONTENT

3.1 Installment Loans

The installment loan involves a sum of money advanced by a bank to a customer for repayment over a fixed time period in equal amounts. In return for the loan, the borrower agrees on a repayment plan, which involves an amount that typically remains the same throughout the life of the loan. The interest charges on an installment loan are normally factored into future repayments.

In another perspective, installment loan can be described as the type of loan that is granted on the understanding that there will be periodic payments. Such amount of payment is based on a specified period of time which can be longer or shorter depending on the term of agreement between the bank and the customer. The cost of the installment loan depends on the interest rate and the terms involved generally.

The terms of repayment of installment loans are normally expressed in months. The common periods of repayment include 36, 48, 60 or 72 months. There are a wide variety of terms, ranging from short term, medium term to long term. For instance, mortgages are installment loans with longer terms such as 180 or 360 months of repayment. It implies that some installment loans may be structured for payment over a period of years.

Installment loans are normally repaid by the beneficiary on a monthly basis with some exceptions. The monthly repayments for an installment loan are usually the same in each month. Nevertheless, the monthly repayment can change if the loan has a variable rate. The total repayment amount of an installment loan normally includes the principal and the interest charges.

It is the banks that determine the monthly payment amount by calculating the total amount of interest due over the duration of the loan and add the figure together with the principal amount of the loan. The bank then divides that total figure into equally sized monthly payments.

There might be some fluctuations in the monthly payment due to the fact that years and months have uneven numbers of days so the interest on a loan does not usually end up being a round figure. Therefore, it implies that monthly payments are not

always exactly the same. Such variations in monthly payments, however, usually amount to some insignificant figure.

3.1.1 Purpose of Installment Loans

The present state of banking operations in the country has made it possible for consumers to have access to installment loans. Therefore, the installment loans are widely available from commercial banks. Such loans can be for personal use, for business operations or for the acquisition of household equipment.

There are a number of types of installment loans that are available to consumers. Some of these types of installment loan include the following:

- A car loan that consists of equal monthly payments.
- A mortgage may also be structured to be paid off every month in installments.
- Loans to acquire household items of equipment.
- Loans for personal commitments advanced for only few days.
- Advances for a worker for urgent use and repayable on borrower's next payday.
- Advances granted for meeting short-term business needs.

3.1.2 Benefits of Installment Loans

The benefits of installment loans include the following considerations inherent in the facility.

- It gives a borrower the freedom to make payments for an extended period of time.
- It allows the customer the chance to make a purchase that he may not otherwise be able to make upfront, e.g., a car or house.
- Each payment is due at the same time each month and for the same amount.
- Installment loans are useful for those who do not have a lot of money in savings.
- It is useful for consumers for avoid putting high-ticket items on a credit card.
- Installment loans offer the ease and convenience of structured, monthly payments.
- Short-term installment loans only require a verifiable income.
- Installment loans can even be obtained over the Internet in some states of the US, depending on state regulations.

SELF ASSESSMENT EXERCISE 1

Mention the benefits of installment loans.

3.1.3 Interest Rates of Installment Loans

The interest rates which determine the charges on installment loans do vary greatly. The variability normally depends on the type of such loan. The interest rates depend on considerations such as identified below.

- The borrower's credit history with the bank.
- Means of repayment of the amount granted.
- Length of time the customer has account with the bank.
- Performance of the customer’s account in he past.
- The length of the repayment period.
- The total amount of the loan being granted to the customer.
- The contribution of the customer or down payment.
- The state or performance of the economy.

In some instances, short-term loan interest rates are much higher, especially those for some days, since they do not require a collateral security. This is particularly applicable to consumers who use such loans to acquire assets for household use.

Furthermore, short-term loan interest rates are much higher in the case of the consumers use such loans to acquire assets for household use making the assets not qualified for collaterals and they are at a higher risk for default.

SELF ASSESSMENT EXERCISE 2

What are the factors that influence the interest charges on installment loans?

3.2 Types Of Installment Loan

3.2.1 Cash Installment Loans

This is the type of installment loan that enables the customer of the bank to have access to cash advance or quick access to money during an emergency. The funds from an installment loan can easily be available and can be used to meet personal commitment or any other purpose.

In countries such as the US, the cash installment loans do not involve credit checks or security, and therefore, most people are easily qualified. The implication is that these loans have high interest charges and they're generally due for repayment in a period of fourteen days. In the event of failure to pay the loan by the agreed date will attract additional charges such as late fees and additional interest.

Cash installment loans, in most cases, are short-term loans, and they are designed to provide borrowers with immediate funds to meet an unexpected expense. The borrowers can apply for a cash advance by merely approaching the branch managers of the banks where they have their accounts.

The cash installment loans can be granted for upwards of one month, two months and three months. The charges involved in cash installment loans vary from one bank to another. Cash installment loans, in most cases, do not require collateral security or guarantors but they are based on personal integrity. The salary account of a worker is enough to serve as security for the cash installment loans for the consumers.

3.2.2 Income-Based Installment Loans

This is the type of installment loan that is based on the income of the consumers. It implies that it is only the salary earners that qualified and considered for the income- based installment loans. The salary earners are allowed to have access to these loans with the understanding that they are paid back over a pre-determined period of time. The terms of these loans, e.g., amount, interest charges and period of repayment, are normally dictated by the commercial banks.

The income-based installment loans are often based on the personal credit history and personal monthly income of the borrowers. The bank may require the borrower to show evidence that he is still gainfully employed and that the salary will continue to come to the bank. This involves obtaining a letter from the employer to that effect. Hence it is based on salary accounts of the borrowers.

In other countries such as the US, the income-based installment loan requires the borrower to provide proof of his or her income in the form of pay slips or stubs and an adequate credit history. Such request is normally assessed on the basis of rating; a lower score qualifies for small amount of loan while a higher score attracts higher approval amount of loan.

The income-based installment loans come in forms of; signature loans (for those with poor credit), and typical installment loan contracts from the bank. The duration for the repayment of the loan is in direct correlation to the amount involved and the borrower’s personal credit history.

The income-based installment loans are associated with high interest rates. Such interest rates are adjustable to ebb and flow with the ruling market rates. The commercial banks normally consider these loans to be

of higher risk due to the fact that installment loans are normally secured with no collateral. Therefore, they will have a higher rate of interest.

SELF ASSESSMENT EXERCISE 3

Differentiate between cash installment loans and income-based installment loans.

3.3 Secured Loans

Secured loans are those credit facilities granted by the banks that are associated with items of property of the debtors as collateral securities. Therefore, a loan is secured when it has a charge on the property of the loan beneficiary. The security may take any form of the following charge:

- A fixed charge; or
- A floating charge.

A fixed charge is one where the actual property is specified by the loan beneficiary or the debtor. By implication, it means that a specific property is pledged by the loan beneficiary as the collateral security with which to secure the facility for the bank.

On the other hand, a floating charge as a security for the loan is one which attaches a general security on the operational assets of the business or project for which the loan has been granted by the loan. The implication is that the actual property involved in the transaction only becomes determinable or recognized when the loan is payable, that is, "when it is said to crystallize."

Secured installment loan refers to a loan facility that allows a customer of the bank to borrow money and repay it over time in fixed monthly payments. The loan facility is normally backed by collateral security. The common forms of collateral security for the secured installment loans are motor vehicles, houses, savings accounts, stocks and retirement accounts.

On the contrary, there is the unsecured loan, which refers to the type of loan that is not attached to any security in terms of the operational assets of the company that has taken the loan. It implies that the funds involved in the loan of the bank cannot be said to be secured since there is no operational asset of the debtor or the loan beneficiary that is pledged for the loan.

The bank that grants unsecured loan to a customer, when compared to the secured loan cannot lay claim to any property of the business for which the facility has be approved. Essentially, therefore, the unsecured loan does not entitle the bank to any property of the beneficiary as a collateral security as far as the assets of the business is concerned.

In related terms, there can be a loan for which the interest payable can be tied to the profits of a company in which case the bank is not paid until other creditors are settled. The implication is that the bank would be subjected to a fragile position in terms of the recovery of the principal funds and the interest charges involved in the loan.

SELF ASSESSMENT EXERCISE 4

Differentiate between secured loans and unsecured loans.

4.0 CONCLUSION

You have learnt from this study unit that the installment loan involves a repayment plan over a fixed time period in equal amounts. In the repayment plan, the amount typically remains the same throughout the life of the loan. It is also understood by you that the interest charge on installment loan is factored into the future repayments. A variety of installment loans includes car loan, mortgage loan, loans for household equipment, loans for personal commitments, and advances to workers and business entities for urgent needs. The secured loans are credit facilities granted by banks with specific items of property as collateral securities. Therefore, this type of loan confers on the bank a charge (fixed or floating) on the property of the beneficiary.

5.0 SUMMARY

In this study unit, topics covered include the following:

- Installment Loans
- Purpose of Installment Loans
- Benefits of Installment Loans
- Interest Rates of Installment Loans
- Types of Installment Loan
- Cash Installment Loans
- Income-Based Installment Loans
- Secured Loans

In the next study unit, you will be taken through the discussion on loan monitoring and supervision.

6.0 TUTOR-MARKED ASSIGNMENT

Differentiate between cash installment loans and income-based installment loans.

Solution to Self Assessment Exercises

SAE 1:

The benefits of installment loans include the following:

- It gives a borrower the freedom to make payments for an extended period of time.
- It allows the customer the chance to make a purchase that he may not otherwise be able to make upfront, e.g., a car or house.
- Each payment is due at the same time each month and for the same amount.
- Installment loans are useful for those who do not have a lot of money in savings.
- It is useful for consumers for avoid putting high-ticket items on a credit card.
- Installment loans offer the ease and convenience of structured, monthly payments.
- Short-term installment loans only require a verifiable income.
- Installment loans can even be obtained over the Internet in some states of the US, depending on state regulations.

SAE 2:

The factors that influence the interest charges on installment loans include the following:

- The borrower's credit history with the bank.
- Means of repayment of the amount granted.
- Length of time the customer has account with the bank.
- Performance of the customer’s account in he past.
- The length of the repayment period.
- The total amount of the loan being granted to the customer.
- The contribution of the customer or down payment.
- The state or performance of the economy.

SAE 3:

Cash installment loan is the type of installment loan that enables the customer of the bank to have access to cash advance or quick access to money during an emergency.

The funds from an installment loan can easily be available and can be used to meet personal commitment or any other purpose.

On the other hand, the income-based installment loan is the type of installment loan that is based on the income of the consumers. It implies that it is only the salary earners that qualified and considered for the income-based installment loans. The salary earners are allowed to have access to these loans with the understanding that they are paid back over a pre-determined period of time. The terms of these loans, e.g., amount, interest charges and period of repayment, are normally dictated by the commercial banks.

SAE 4:

Secured loans are those credit facilities granted by the banks that are associated with items of property of the debtors. Therefore, a loan is secured when it has a charge on the property of the loan beneficiary. The security may take the form of a fixed charge or a floating charge.

On the other hand, the unsecured loan refers to the type of loan that is not attached to any security in terms of the operational assets of the company that has taken the loan. It implies that the funds involved in the loan of the bank cannot be said to be secured since there is no operational asset of the debtor or the loan beneficiary that is pledged for the loan.

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UNIT 2 LOAN MONITORING & SUPERVISION

CONTENTS

1.0 Introduction
2.0 Objectives
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4.0 Conclusion
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6.0 Tutor-marked Assignment
7.0 References/Further Reading

1.0 INTRODUCTION

Lending as you have understood from earlier discussions in this study unit, involves the use of depositors' funds. This is an important aspect of financial intermediation that commercial banks perform in the economy. In the process of lending funds, some measures are normally instituted by the banks to ensure that customers, who are the beneficiaries of the loans and advances, are being monitored so as to recover the funds. Hence supervision of lending is critical to the operations of the banks. This study unit, therefore, is used to discuss the modalities of lending supervision normally employed by the commercial banks.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- discuss the nature of loan monitoring & supervision
- explain loan supervision and control
- discuss the collection procedure of loan repayment
- explain the loan accounting and record
- discuss loan repayment monitoring
- explain the evaluation of loan repayment

3.0 MAIN CONTENT

3.1 Nature Of Loan Monitoring & Supervision

The administration of lending and credits by the banks is managed in such a manner that the funds are repaid at agreed regular intervals without defaults. In order to ensure that the customers perform up to expectation, the banks normally institute concrete measures towards monitoring them.

The repayment of loans by the beneficiaries depends on the appropriate administrative measures which are initiated and implemented by the banks to keep such customers on track. The administrative measures for monitoring prompt repayment of loans by the customers are embedded in loan supervision.

In essence, the issue of monitoring of loans is very critical in keeping watch over the performance of the customers in loan repayment so as to prevent defaults. In order not to toy with the funds of the depositors, commercial banks normally supervise the repayment of loans and advances using appropriate strategies.

Therefore, there are obvious reasons which inform loan supervision. Such reasons for monitoring loan repayment include the following:

- Ensure regular repayment of loans and advances;
- Generate enough funds to meet depositors' demands;
- Prevent loan defaults from the customers;
- Ensure liquidity for the banks' operations;
- Generate reasonable amount of returns on operations;
- Protect depositors' interest;
- Guide against financial distress in operations;
- Ensure regularity of cash inflows from investment in loans;
- Minimize risks inherent in loans and advances;
- Ensure safety of the funds committed into loans;

The reasons as enumerated above inform the monitoring of repayment of loans and advances by the banks using appropriate administrative measures. Such administrative

measures which are necessary for monitoring and supervision of loans are identified and discussed.

SELF ASSESSMENT EXERCISE 1

Mention the reasons responsible for loan monitoring and supervision.

3.2 Methods Of Loan Monitoring & Supervision

3.2.1 Supervision & Control

Supervision and control of loans and advances is very critical to lending management in the operations of the commercial banks. The repayment of loans and advances should be supervised and controlled in such a manner that the interest of both the bank and the depositors whose funds are committed in these investments is protected.

The effective supervision of loans and advances requires that the banks institute appropriate to ensure the following operational actions:

- Assigning responsibilities for supervision to appropriate staff;
- Determining time line for periodic contacts and visits with loan beneficiaries
- Provision of logistics for facilitating supervision by the staff;
- Determining modalities for contacts with loan beneficiaries;
- Constituting supervision team from experience staff;
- Modalities of releasing funds on loans and advances;
- Process and actions for dealing with problem loan accounts;
- Periodicity of supervision reports from relevant staff; and
- Determining necessary actions for handling logistic bottlenecks.

There other administrative actions necessary for effective supervision and control of repayment of loans and advances that must be instituted by the banks. Therefore, the above list on operational actions is not exhaustive.

SELF ASSESSMENT EXERCISE 2

Mention the necessary measures for ensuring effective supervision of loan repayment.

3.2.2 Collection Procedure

It is always necessary for the banks to institute relevant measures for the collection of funds involved in loans and advances which are granted to the customers. The

collection procedure is normally determined at the stage of granting the loans and credits to customers of the bank.

The collection procedure involves the use of the following administrative measures.

1. Schedule of Repayment

In most cases the repayment for any loan by the customer is normally effected with a prepared schedule showing the frequency and amount of principal and interest involved. The schedule is prepared to show the number of repayment installments, the magnitude of principal repayment, and the interest charges to be met by the customer on periodic basis.

2. Reminders and Circulars

Another important responsibility of the credit officers of the bank is the preparation of the periodic reminders and circular letters which are normally sent out to the loan beneficiaries. The reminders and circular letters are normally prepared to incorporate the total loan commitment of the customer, the repayment that has been made, the outstanding payments and their due dates.

3. Personal Visits

Personal visits are very imperative for effective supervision of the repayment of loans and advances by the banks. The visits may be scheduled or on the basis of surprise contacts by the relevant bank officers.

The personal visits by bank officers to loan beneficiaries are normally facilitated by the evaluation visit which is made during the assessment of the loan request from the customers. In the process of loan evaluation, the premises of the customers' business would be visited, and this eliminates problem of difficulty in accessing the loan beneficiaries.

The personal contacts by the bank officers to the customers are on periodic basis and therefore, not reserved for solving problem loan accounts when the beneficiaries might not be forthcoming in terms of meeting regular loan repayment. It implies that the personal visit to customers who are holding the funds of the bank is a regular action, which can be used to forestall repayment defaults.

4. Mode of Collection of Funds

The mode of collection of funds from the loan beneficiaries is normally determined and made known to them at the instance of granting the facilities. The mode of collection can either be cash payment or payment by cheques by the loan beneficiaries. The collection of repayments in cash by the bank officials is not normally encouraged.

The non-repayment of loans and advances by the customers in cash to bank officials is to prevent frauds and fraudulent practices by the staff when handling cash outside the premises of the bank. Therefore, the customers are encouraged to make repayments in cheques directly to the bank and not to the bank officials unless they are crossed cheques.

SELF ASSESSMENT EXERCISE 3

Identify and explain the administrative measures necessary for the collection procedure of loan repayments.

3.2.3 Loan Accounting & Record

Another important consideration in loan supervision is keeping appropriate accounting records on the release of funds to the loan beneficiaries and the repayments of the funds to the bank. This is important for the bank because such accounting record will be used in monitoring the performance of the repayment by the customers.

The bank may have to create separate loan accounts for large of amount of loans while the customers' existing accounts would be used for the records of release of funds as well as the repayments on the facilities.

Furthermore, the customers would be required to be supplying interim financial statements to the bank for evaluating the performance of the business or project for which the bank's funds have been committed. The financial statements are valuable in assessing the income position of the loan beneficiaries' business operations or project performance in terms of their prudent management.

One of the financial statements required from the customers who are the beneficiaries of loans and credits is the income statement, which reveals the returns from operations and how profitable such operations is to the customers' business ventures.

The other important financial statement is the balance sheet which reveals the statement of affairs of the customers' business operations. The balance also reveals outstanding financial commitments to outsiders, position of the capital, magnitude of the assets, which are to be used for running the business and generating revenue from operations.

3.2.4 Loan Repayment Monitoring

The loan repayment agreement is always monitored continuously by the bank officials. This is to ensure that the terms of the loan are being

followed and that all required payments of principal and interest are being made as promised.

The loan officers normally visit the customer's business periodically to check on the firm's progress and to see what professional services the customer may need. The loan officer or other staff member places information about a new loan customer in a computer file known as a bank customer profile .

The customer file shows what bank services the customer is currently using and contains other information required by bank management to monitor a customer's progress and financial-service needs.

3.2.5 Repayment Evaluation

In most cases the repayment schedule for any loan by the customer is normally used to assess the progress of repayment based prepared schedule. The evaluation is based on the frequency and amount of principal and interest being repaid by the customers.

It is normally easier for the bank officials to use the repayment schedule for evaluating customers' performance since it is prepared to show the number of repayment installments, the magnitude of principal repayment, and the interest charges to be met by the customer on periodic basis.

Hence, the details of the repayment schedule would be compared with the records of the actual repayment of the funds involved in the loan in order to assess any discrepancies which may require actions on the part of the bank.

Another important aid to evaluation of loan repayment is the appropriate accounting records maintained by the bank on the release of funds to the loan beneficiaries and the repayments of the funds to the bank. This is important for the bank because such accounting record will be used in evaluating the performance of the loan repayment by the customers.

The evaluation of repayment of loans process also affects the assessment of the entries in the separate loan accounts that have been created for large of amount of loans. The customers' existing accounts used for accounting records of release of funds and the repayments on the facilities would also be evaluated to determine the performance.

4.0 CONCLUSION

You have learnt from this study unit that it is necessary for commercial banks to institute appropriate measures for the monitoring and control of loans and advances being granted to customers. Such action by the commercial bank is normally aimed at ensuring regular repayment of loans and advances, generating enough funds to meet depositors' demands, preventing loan defaults from the customers, ensuring liquidity for the banks' operations, and generating reasonable amount of returns on operations. The relevant measures for ensuring effective loan monitoring and supervision include supervision and control, collection procedure, loan accounting and record, loan repayment monitoring, and repayment evaluation.

5.0 SUMMARY

In this study unit, topics covered include the following:

- Nature of Loan Monitoring & Supervision
- Supervision & Control
- Collection Procedure
- Loan Accounting & Record
- Loan Repayment Monitoring
- Repayment Evaluation

In the next study unit, you will be taken through the discussion on collateral security issues.

6.0 TUTOR-MARKED ASSIGNMENT

Mention and discuss the various modalities that can used for loan monitoring and supervision.

Solution to Self Assessment Exercises

SAE 1:

The reasons responsible for loan monitoring and supervision include the following:

- Ensure regular repayment of loans and advances;
- Generate enough funds to meet depositors' demands;
- Prevent loan defaults from the customers;
- Ensure liquidity for the banks' operations;
- Generate reasonable amount of returns on operations;

- Protect depositors' interest;
- Guide against financial distress in operations;
- Ensure regularity of cash inflows from investment in loans;
- Minimize risks inherent in loans and advances;
- Ensure safety of the funds committed into loans;

SAE 2:

The necessary measures for ensuring effective supervision of loan repayment include the following:

- Assigning responsibilities for supervision to appropriate staff;
- Determining time line for periodic contacts and visits with loan beneficiaries
- Provision of logistics for facilitating supervision by the staff;
- Determining modalities for contacts with loan beneficiaries;
- Constituting supervision team from experience staff;
- Modalities of releasing funds on loans and advances;
- Process and actions for dealing with problem loan accounts;
- Periodicity of supervision reports from relevant staff; and
- Determining necessary actions for handling logistic bottlenecks.

SAE 3:

The administrative measures necessary for the collection procedure of loan repayments include:

i) Schedule of Repayment

The schedule is prepared to show the number of repayment installments, the magnitude of principal repayment, and the interest charges to be met by the customer on periodic basis.

ii) Reminders and Circulars

The reminders and circular letters are normally prepared to incorporate the total loan commitment of the customer, the repayment that has been made, the outstanding payments and their due dates.

iii) Personal Visits

Personal visits, whether scheduled or not, are very imperative for effective supervision of the repayment of loans and advances by the banks. The visits may be scheduled or on the basis of surprise contacts by the relevant bank officers.

iv) Mode of Collection of Funds

The mode of collection of funds from the loan beneficiaries is normally determined and made known to them at the instance of granting the facilities. The mode of collection can either be cash payment or payment by cheques by the loan beneficiaries. The collection of repayments in cash by the bank officials is not normally encouraged.

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UNIT 3 COLLATERAL SECURITY ISSUES

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    3.2.2 Valuables for Collateral Security
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5.0 Summary
6.0 Tutor-Marked Assignment
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1.0 INTRODUCTION

In the previous study unit, we discussed loan monitoring and supervision. Loan supervision and monitoring may not be effective in ensuring the recovery of the funds that may be committed into loans to customers. The issue of the collateral becomes more relevant when considered against the background that the beneficiaries of loan facilities in most cases would not be motivated to make efforts to make repayments. Hence, the banks institute a potent device in cajoling regular repayments of their loan obligations realizing the fact that they stand to lose the security that have been pledged for the facilities to their benefactors. Therefore, this study unit is focused on the discussion of the collateral security issues in relation to loan facilities.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- discuss bank's claim on collateral security
- list and explain forms of property for collateral security
- mention and discuss valuables for collateral security

3.0 MAIN CONTENT

3.1 Bank's Claim On Collateral Security

Collateral security is the property that is pledged by a loan beneficiary towards securing the facility. There are basic reasons that often compel the banks to insist on collateral being pledged by a loan beneficiary.

Such reasons include the following considerations.

i) The pledge of collateral security gives the bank as lender the right to seize and sell the assets designated as loan collateral, using the proceeds of the sale to offset the outstanding funds which the borrower could not pay back.

ii) The use of collateralization for a loan gives the bank as lender a satisfactory leverage or advantage over the borrower. This is due to the fact that when specific assets may be at stake, a borrower would feel more obligated to strive hard to repay the fund involved in loan facility and thus avoiding losing the valuable operational assets.

iii) The basic purpose for banks desire to insist on taking collateral security is to enable them to precisely identify which borrower's assets are subject to seizure and sale.

iv) It is important in using the device to document for all other creditors to believe that the bank has a legal claim to those assets in the event of non-performance on a loan.

v) It is used to ensure the safety of the funds committed into loan facility by the bank; the funds which actually belong to depositors.

SELF ASSESSMENT EXERCISE 1

What are the reasons for the bank's insistent on collateral security for a loan facility?

3.2 Common Types Of Loan Collateral

3.2.1 Property for Collateral Security

1. Real Estate

A real property is acceptable in the consideration for a collateral security on a loan facility. Once the property is accepted by the bank, the bank can put public notice of a mortgage against a real estate. The bank then takes action to file with the relevant authority the pledge of the property for a loan facility from the beneficiary.

Tin some instances, the bank may have to take out title insurance and equally insists that the borrower purchases insurance policy to cover any future damage from environmental hazards and perils. The bank

receives a first claim on any insurance settlement that is made on the policy.

The bank will initiate action to determine the real value of the property once it accepts to advance some funds on loan facility to a borrower. The basic approaches to the valuation of real estate include the

- Cost approach :- this involves considering the reproduction cost of the building and improvements, deducts estimated depreciation, and adds the value of the land.
- Market Data or direct sales comparison approach :- this involves estimating the value of the subject property based on the comparable properties' current selling prices.
- The income approach :- this involves the use of discounted value of the future net operating income streams from the property.
- The direct capitalization approach :- this involves the calculation of the value by dividing an estimate of its average annual income by a factor called capitalization rate.

2. Personal Property:

The practice is for the banks to accept and take a security interest in items of property such as motor vehicles, machinery, equipment, furniture, securities, and other forms of personal property owned by a borrower.

Once it is accept as a collateral security, a financing statement will be filed by the bank publicly in those cases where the borrower keeps possession of any personal property

pledged. This requires a pledge agreement to be prepared may be prepared if the bank or its agent holds the pledged property. This agreement will give the bank the right to control that property until the loan is repaid in full.

SELF ASSESSMENT EXERCISE 2

Mention and discuss the various forms of property that can be pledged as collateral security.

3.2.2 Valuables for Collateral Security

1. Personal Guarantees

The banks may also accept the pledge of the stock, deposits, or other personal assets held by the major stockholders or owners of a company.

The borrower will be required to provide agreement on such pledge and acceptance between the representative of the borrower and the bank as may be required for the collateral to secure a business loan for the entity.

The practice is that guarantees are often requested for by the banks in the cases of lending funds to smaller businesses. This is also required from corporate entities that have fallen on difficult times. The simple reason is that the arrangement will give the owners the prod or considered reason to strive harder so that their firm will prosper and repay their loan.

2. Accounts Receivable

Another practice is that the banks can accept and take a security interest in the form of a stated percentage of the face value of accounts receivable, which involves value of sales on credit, as shown on a business borrower's balance sheet.

Whenever the borrower's credit customers send in cash to settle their outstanding debts, such funds or cash payments are applied for the settlement of the outstanding balance of the borrower's loan. This may to take the form of mortgaging the receipts of the accounts receivable so that the payment would be made to the account opened for such money in the bank’s domain.

The banks often take the necessary measures to evaluate accounts receivable pledged for the loan facility by the borrower. The main types of method of evaluation of

accounts receivable are accounting receivable aging and accounting receivable turnover.

3. Factoring

The banks can also purchase the borrowers’ accounts receivable. The arrangement is that the agreement will be based upon some percentage of the book value of such debtors. The factoring interest is the difference between the book value and the discounted value of the accounts receivable.

The borrower's customers who are the debtors would be required to make payments direct to the purchasing bank, which happens to the lender of funds to the firm whose debts the bank has acquired. The agreement will incorporate the consideration that the borrower promises to set aside some funds with which to cover some or all of the losses that the bank may suffer from any unpaid receivables.

4. Inventory

In this consideration, a bank will lend only a percentage of the estimated market value of the borrower's inventory, which serves as the collateral security for the loan facility. The bank could have a floating lien in the sense that the inventory pledged may be controlled completely by the borrower.

In the case of the floor planning, the lender takes temporary ownership of any goods placed in inventory and the borrower sends payments or sales contracts to the lender as the goods are sold. This arrangement ensures that the bank as the lender is rest assured that he has a proper lien on the inventory.

The practice requires that the bank evaluate the inventory. The basic ways to evaluate the inventory include resale of inventory, inventory turnover, and inventory converted to accounts receivable.

SELF ASSESSMENT EXERCISE 3

Mention and discuss the various forms of valuable that can be pledged as collateral security.

4.0 CONCLUSION

You have learnt from this study unit That the use of collateral security for a loan facility is important because it gives the bank as lender a satisfactory leverage or advantage over the borrower who may not forthcoming in repayment of credit. When specific assets are at stake as collateral security, a borrower would feel more obliged to strive hard to repay the fund involved in loan facility and thus avoiding losing the valuable operational assets. There are various forms of assets that can be accepted by the banks for collateral securities. These include real estate, personal property, personal guarantee, accounts receivables, factoring, and inventory.

5.0 SUMMARY

In this study unit, topics covered include the following:

- Bank’s Claim on Collateral Security
- Common Types of Loan Collateral
- Property for Collateral Security
- Valuables for Collateral Security

In the next study unit, you will be taken through the discussion on

6.0 TUTOR-MARKED ASSIGNMENT

Mention and discuss the basic forms of common collateral security which can be pledged to secure a loan facility.

Solution to Self Assessment Exercises

SAE 1:

The reasons for the bank's insistent on collateral security for a loan facility include the following.

i) The pledge of collateral security gives the bank as lender the right to seize and sell the assets designated as loan collateral, using the proceeds of the sale to offset the outstanding funds which the borrower could not pay back.

ii) The use of collateralization for a loan gives the bank as lender a satisfactory leverage or advantage over the borrower. This is due to the fact that when specific assets may be at stake, a borrower would feel more obligated to strive hard to repay the fund involved in loan facility and thus avoiding losing the valuable operational assets.

iii) The basic purpose for banks desire to insist on taking collateral security is to enable them to precisely identify which borrower's assets are subject to seizure and sale.

iv) It is important in using the device to document for all other creditors to believe that the bank has a legal claim to those assets in the event of non-performance on a loan.

v) It is used to ensure the safety of the funds committed into loan facility by the bank; the funds which actually belong to depositors.

SAE 2:

The various forms of property that can be pledged as collateral security include the following.

i. Real Estate

A real property is acceptable in the consideration for a collateral security on a loan facility. Once the property is accepted by the bank, the bank can put public notice of a mortgage against a real estate. The bank then

takes action to file with the relevant authority the pledge of the property for a loan facility from the beneficiary.

ii. Personal Property:

The practice is for the banks to accept and take a security interest in items of property such as motor vehicles, machinery, equipment, furniture, securities, and other forms of personal property owned by a borrower.

SAE 3:

The various forms of valuable that can be pledged as collateral security include the following.

i. Personal Guarantees

The banks may also accept the pledge of the stock, deposits, or other personal assets held by the major stockholders or owners of a company. The borrower will be required to provide agreement on such pledge and acceptance between the representative of the borrower and the bank as may be required for the collateral to secure a business loan for the entity.

ii. Accounts Receivable

Another practice is that the banks can accept and take a security interest in the form of a stated percentage of the face value of accounts receivable, which involves value of sales on credit, as shown on a business borrower's balance sheet.

iii. Factoring

The banks can also purchase the borrowers' accounts receivable. The arrangement is that the agreement will be based upon some percentage of the book value of such debtors. The factoring interest is the difference between the book value and the discounted value of the accounts receivable.

iv. Inventory

In this consideration, a bank will lend only a percentage of the estimated market value of the borrower's inventory, which serves as the collateral security for the loan facility. The bank could have a floating lien in the sense that the inventory pledged may be controlled completely by the borrower.

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UNIT 4 CREDIT INSURANCE

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1.0 INTRODUCTION

Lending of funds in the process of financial intermediation is fraught with some risks. These risks are the problems associated problems of defaults, diversion of funds, and non-performance of project for which the funds have been used, among others. There are some insurance policies which can be taken by the commercial banks with which to mitigate against the loss of their funds that are committed into loans and other credit facilities. This study unit, therefore, is used to discuss the various forms of credit insurance in terms of insurance policies that are available for moderating risks involved in lending of funds by commercial banks.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- discuss the whole turnover policy in credit insurance
- explain small company whole turnover policy
- discuss the single risk policy in credit insurance
- explain the excess of loss policy in credit insurance

3.0 MAIN CONTENT

3.1 Whole Turnover Policy

It is a very common form of credit insurance which covers customer insolvency and protracted default. This often involves payments not received ninety days after due date or extended due date. The insured

will also be asked to sustain a small proportion of any loss usually not less than ten percent.

The cost of the policy is based on the actual level of insured credit with insurance company, but excluding credits not insured. The premium charges are payable on quarterly installments based on the value of the credits.

The insurer has the authority to control his risk by issuing 'approved limits' on customers. The insured can exceed this limit if desired, but the excess will not be covered in the policy. This policy is subject to variations.

These variables take into account of the peculiar needs of the insured. These include the following considerations.

i) The discretionary limit

This implies that not all customers covered under the policy will have an approved limit, especially if there are many insured customers covered in the policy. On the basis of guidelines laid down incorporated in the policy document, the insurer will have the discretion to set his own limits up to a certain amount. This amount also depends on the size of the business and the expertise of the insured.

ii) Thresholds

In this consideration, an insured such as the bank can choose not to have their smaller credits covered in an insurance policy. This has the effect of reducing the cost and administration of the policy. Therefore, a threshold is indicative of the amount below which any loss or default will not be covered.

iii) Datum Lines

This involves an option available to the insured which is to limit cover to customers whose credits currently exceed, or might have exceeded in the past, a stated amount. Hence, the policy called the datum line is a technique for reducing the number of customers covered by the insurance company. It also has the effect of reducing the cost involved.

iv) Goods Sold or Losses Arising

In the case of banks, inventory pledged by a loan beneficiary can be sold. This is applicable to goods involved in foreign trade. Therefore, this policy can be used by the banks. Goods ordered by an importer may

still be in a state of preparation. More so, they may be non-standard or not especially designed for the customer. Under these circumstances, it is possible to insure for the full loss arising, including work-in-progress, though at extra cost.

v) Waiting Periods

There is the waiting period as often incorporated in the policy by the insurer as earlier specified above. This is the period (ninety days) after which a claim for protracted default can be made. In essence, there exists a waiting period of up to six months before a claim is paid.

This is to give time to banks to take necessary legal to recover the debts involved or to apply for winding-up action for sale of assets towards the collection of the debt involved. In the case of insolvency, the waiting period is thirty days from the date of confirmation of debt. The duty of the insured such as bank is to obtain confirmation of the amount outstanding from the receiver, liquidator or administrator.

vi) Credit Control Procedures

Such credit control policies are incorporated in the policy, and the insured is expected to observe them always. The fact that they are specified by the insured in the first instance, there be strict adherence. It implies that the insurer should be consulted if on-standing action is taken with an approved customer.

vii) First Loss

This is another cost reduction option available to the insured. The insured has to accept the reduction a small sum in his own account. It can usually involve a small amount in the region of a few hundreds of naira, besides the normal ten percent retention by the insurance company.

SELF ASSESSMENT EXERCISE 1

What are the variations involved in the whole turnover policy?

3.2 Small Company Whole Turnover Policy

This is usually packaged for small banks. Small banks such as microfinance banks regarded, for insurance purposes, as having a small turnover can also benefit from credit insurance. They may not have credit management systems, or the manpower to handle the

administration of a standard policy. Any bad loan can significantly influence

their cash inflows, and therefore, they may still be tottering in terms of managing their credit risks as far as their lending is concerned.

An amount regarded as off-the-shelf policy is available for these small banks. The policy is associated with a fixed discretionary limit and first loss figure. It also attracts regularly declarations which are simplified and minimized and there is a standard premium charge for the policy.

3.3 Single Risk Or Specific Account Policy

There are occasions when an exceptional business relationship is developed with a single or small number of customers such as the case of loan facilities to small and medium enterprises. The case of insolvency in such circumstances would have very serious repercussions on the enterprises. It is possible to obtain credit insurance for such form of risk.

The insurance cover is up to ninety percent of the approved level while the premium is charged either as a percentage of the total amount of such credits in lending or as a fixed sum in advance. The customer base of microfinance banks only consists of one or two large exposures to risk, totally out of proportion to the rest.

The issue of the whole turnover insurance would be possible. Nevertheless, this could be more expensive because of the credit lending to smaller customers. In this circumstance, specific account cover is designed to convert a bad risk into a good one.

SELF ASSESSMENT EXERCISE 2

Differentiate between small company whole turnover policy and single risk policy.

3.4 Excess Of Loss Policy

This policy popularly called the excel principle is an insurance policy is aimed at larger banks with well-established credit management systems. The turnover considered is in excess of hundreds of millions of naira. However, smaller banks may be considered if they can show very good credit management systems.

The policy works as follows:

i) The insured continues to bear his normal annual aggregate. This is called the annual aggregate. Protracted default is not covered.

ii) In the event that the annual bad debt losses exceed the norm, or aggregate, the insurer will cover one hundred percent of the excess up to an agreed maximum.

iii) A fixed annual premium is normally payable at inception of the policy for credits.

iv) The insured has total discretion over customer credit levels without reference to the insurer.

v) Smaller losses often called non-qualifying losses do not contribute towards the aggregate. This has the effect of reducing the amount of policy administration and the price.

The premium on this policy is determined by the quality of credit management, industry and customer base and can be further adjusted according to levels of the aggregate, maximum liability and non-qualifying losses.

SELF ASSESSMENT EXERCISE 2

What are the workings of the excess of loss policy in credit insurance?

4.0 CONCLUSION

You have learnt from this study unit that there are some insurance policies, though designed for manufacturing trading companies, that can used by the banks for protecting their loans and credits. Such insurance policies as means of credit protection are relevant as policies for assuring the banks that their funds, which have been committed into loans would not be lost. These credit insurance policies include whole turnover policy, small company whole turnover policy, single risk or specific account policy, and excess of loss policy.

5.0 SUMMARY

In this study unit, topics covered include the following:

- Whole Turnover Policy
- Small Company Whole Turnover Policy
- Single Risk Policy
- Excess of Loss Policy

In the next study unit, you will be taken through the discussion on export credit protection.

6.0 TUTOR-MARKED ASSIGNMENT

Mention and explain the various credit policies that can be taken by banks to protect the funds being committed to loans and advances.

Solution to Self Assessment Exercises SAE 1:

The variations involved in the whole turnover policy include the following.

i) The discretionary limit

This implies that not all customers covered under the policy will have an approved limit, especially if there are many insured customers covered in the policy.

ii) Thresholds

In this consideration, an insured such as the bank can choose not to have their smaller credits covered in an insurance policy. This has the effect of reducing the cost and administration of the policy.

iii) Datum Lines

This involves an option available to the insured which is to limit cover to customers whose credits currently exceed, or might have exceeded in the past, a stated amount.

iv) Goods Sold or Losses Arising

In the case of banks, inventory pledged by a loan beneficiary can be sold. This is applicable to goods involved in foreign trade. Therefore, this policy can be used by the banks.

v) Waiting Periods

This is the period (ninety days) after which a claim for protracted default can be made. In essence, there exists a waiting period of up to six months before a claim is paid.

vi) Credit Control Procedures

Such credit control policies are incorporated in the policy, and the insured is expected to observe them always. It implies that the insurer should be consulted if on-standing action is taken with an approved customer.

vii) First Loss

This is another cost reduction option available to the insured. The insured has to accept the reduction a small sum in his own account.

SAE 2:

The small company whole turnover policy is usually packaged for small banks. Small banks such as microfinance banks regarded, for insurance purposes, as having a small turnover can also benefit from credit insurance. They may not have credit management systems, or the manpower to handle the administration of a standard policy.

On the other hand, single risk policy is for occasions when an exceptional business relationship is developed with a single or small number of customers such as the case of loan facilities to small and medium enterprises. The case of insolvency in such circumstances would have very serious repercussions on the enterprises. It is possible to obtain credit insurance for such form of risk.

SAE 3:

The workings of the excess of loss policy in credit insurance include the following.

i) The insured continues to bear his normal annual aggregate. This is called the annual aggregate. Protracted default is not covered.

ii) In the event that the annual bad debt losses exceed the norm, or aggregate, the insurer will cover one hundred percent of the excess up to an agreed maximum. iii) A fixed annual premium is normally payable at inception of the policy for credits.

iv) The insured has total discretion over customer credit levels without reference to the insurer.

v) Smaller losses often called non-qualifying losses do not contribute towards the aggregate. This has the effect of reducing the amount of policy administration and the price.

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UNIT 5 EXPORT CREDIT PROTECTION

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1.0 INTRODUCTION

In the preceding unit, we discussed credit insurance. The analysis in this unit is a continuation of such discussion. International trade which involves trade transactions between two or more countries is normally fraught with obvious risks. Such risks are associated with grave problems that are inherent in foreign trade. This informs the risky nature of international trade. The commercial banks and the exporters are more vulnerable to the risks that occur in foreign trade. The banks normally provide the exporters with funds before payments are made to them. Therefore, there is need for the banks to take insurance policy to cover the export credits so as to minimize the effect of risks inherent in this form of lending. This last study unit, therefore, is used to discuss the applicable insurance policies for export credits.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- identify the forms of risk in foreign trade
- discuss the comprehensive short-term policy in export credit insurance
- explain the excess of loss policy in export credit insurance

3.0 MAIN CONTENT

3.1 Risks Involved In Export Credit

The sale of goods across the borders of a country to another country can very risky. Therefore, its financing by the commercial banks can be very risky because the banks can lose their funds committed into loans for the export business. Such export risks are associated with some problems embedded in the nature of transactions in international trade.

Some of the risks involved in export business include the following:

(a) Buyer risks

These risks are associated with the issues such as:

i. Delays in payment
ii. Insolvency
iii. Default
iv. Exchange depreciation v. Loss of Goods in transit
v. Rejection of Goods

(b) Transfer risks

These risks are associated with the issues such as:

i. Delays in transferring money
ii. Cancellation of offer
iii. Devaluation of currency
iv. Fraudulent practices in payment
v. Exchange restriction

(c) Political risks

These risks are associated with the issues such as:

i. Government policy
ii. Change in government regulations
iii. Closure of ports
iv. Political instability
vi. Civil war
vii. Exchange Control
viii. Failure of government buyer to fulfill terms of contract

The above risks are associated with a standard sale on short credit terms, which involves a period of up to one hundred and eighty days. This

scenario accentuates the risk of losing funds by banks on credit advanced to importers and exporters alike.

In terms of more complex transactions in international trade, involving large single contracts with credit terms over a longer period of time, there are other grave problems which can heighten the risks of foreign trade.

SELF ASSESSMENT EXERCISE 1

What are forms of risks that can make banks to lose their funds on export credit?

3.2 Export Credit Insurance

The discussion above is indicative of the fact that exporting of goods is well recognized as being riskier than domestic trading. The riskiness of such type of trade necessitates that export credit insurance be more widely used than in the domestic trade. The applicable insurance policies for export credit include the following.

3.2.1 Comprehensive Short Term Policy

This insurance policy is normally taken to cover sales to trade customers and public buyers with payment terms within a period of not longer than six months. The allied companies may also be covered for political risk such as transfer difficulties. Nevertheless, this type of policy does not cover buyer risk.

There is an issue of a discretionary limit is set being determined above which all customers will be given an approved limit by the insurance companies. The major credit insurance companies have access to large reasonable flow of overseas information to rely or call upon for assessment of the policy.

Such amount of information that is generated from overseas countries is often employed for the negotiation of different limit in the policy. The information that has been generated can also able the parties to agree on a new or revised limit within a short time.

An important condition is the inclusion in the approval of certain payment terms that are acceptable to the insurance company that is prepared to issue insurance policy. Hence the exporter is to ensure that the importer fulfill the condition, which the policy holder must make sure the trading transaction falls within.

There are waiting periods before claims which can be varied in accordance with the following circumstances. For each of the circumstances below, certain actions are identified.

(a) For Risk of Insolvency

In this case, there must be immediate proof of the buyer's solvency acceptable to the insurer.

(b) For Issue of Default

In order to avoid a possible default, a period of six months after due date will be acceptable for payment.

(c) For Case of Rejection of Goods

For the refusal to accept goods by the buyer a period of one month after resale is normally stipulated, that is in the event that the original buyer fails to take up the order.

(d) For Cases of Delay in Delivery

The acceptable period of time is a few months. And for other causes of delay in payment, there is a period of four months after due date that will be acceptable to the insurer.

The policy on export credit insurance policy, the insurer will cover between ninety and ninety-five percent of each risk. In the case of the political risk, a higher percentage of coverage is applicable. Therefore, the percentage cover various from one risk to another.

In order to incorporate this policy as part of the risk control system, the insurers would decide on the maximum levels of trade transactions that they can insure in a single or a given country. This approach to the insurance policy cover is reflected in their policies. In addition, a maximum exposure limit for certain countries may have to be stipulated, which is also applicable to customers.

SELF ASSESSMENT EXERCISE 2

Explain comprehensive short term policy in relation to variation of claims in export credit.

3.2.2 The Excess Of Loss Policy

This type of credit policy is available to only larger companies in international trade. By implication, there are certain issues that are normally considered in this type of insurance cover for big-time firms that are involved in foreign trade.

The issues to be considered by insurance companies for this policy include setting in advance the:

- annual aggregate;
- maximum liability;
- approved terms
- maximum exposure;
- non-qualifying level; and
- premium charges.

The terms to be negotiated and approved by the insurance company will be determined in relation to the nature of risk being insured and the country involved in the import trade. For instance, an advanced country with stable economy and democracy will attract higher consideration by insurers.

Another consideration which is the maximum exposure that is permitted is always on the basis of a given country. It implies that the maximum risk exposure that an insurer can accept to insure depends from one country to another. The consideration is also on graduated basis; implying that a larger rate may have to be specifically approved by the insurer.

SELF ASSESSMENT EXERCISE 3

What are the issues to be considered in advance in relation to excess of loss policy in export credit insurance?

4.0 CONCLUSION

You have learnt from this study unit that there are insurance policy covers that are available for protecting the loss of funds committed into export credits by commercial banks. Such insurance policies include comprehensive short term policy and excess of loss policy. The claim from these insurance policies may not cover the total amount that may be involved in export transaction but it is also necessary for banks to insist on them. This is because such measures would go a long way to provide motivation for advancing credits on exports by commercial banks.

5.0 SUMMARY

In this last study unit, topics covered include the following:

- Risks involved in Export Credit
- Export Credit Insurance
- Comprehensive Short Term Policy
- The Excess of Loss Policy

6.0 TUTOR-MARKED ASSIGNMENT

Differentiate between comprehensive short term policy and the excess of loss policy in export credit insurance.

Solution to Self Assessment Exercises

SAE 1:

The forms of risks that can make banks to lose their funds on export credit include the following:

i) Buyer risks:- these risks are associated with the issues such as delays in payment, insolvency, default, loss of goods in transit, rejection of goods, and cancellation of offer.

ii) Transfer risks:- these risks are associated with the issues such as delays in transferring money, exchange control, devaluation of currency, fraudulent practices in payment, and exchange restriction.

iii) Political risks:- these risks are associated with the issues such as government policy, change in government regulations, closure of ports, political instability, civil war, and failure of government buyer to fulfill terms of contract.

SAE 2:

The waiting periods before claims can be varied in accordance with the following circumstances.

i) For Risk of Insolvency:- In this case, there must be immediate proof of the buyer's solvency acceptable to the insurer.

ii) For Issue of Default:- In order to avoid a possible default, a period of six months after due date will be acceptable for payment.

iii) For Case of Rejection of Goods:- For the refusal to accept goods by the buyer a period of one month after resale is normally stipulated, that is in the event that the original buyer fails to take up the order.

iv) For Cases of Delay in Delivery:- The acceptable period of time is a few months, and for other causes of delay in payment, there is a period of four months after due date that will be acceptable to the insurer.

SAE 3:

The issues to be considered in advance in relation to excess of loss policy in export credit insurance include the following:

- annual aggregate;
- maximum liability;
- approved terms
- maximum exposure;
- non-qualifying level; and
- premium charges.

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