LECTURE No.5

ASSETS OPERATIONS/TRANSACTIONS (GRANTING CREDITS/LOANS)

Assets operations of the credit institutions represent mainly granting credits.

The main assets operations of credit institutions are:

- the available amounts of money from the treasury;
- current account and deposits placed to other credit institutions;
- current accounts opened with the central bank;
- different types of credits;
- claims resulted from leasing;
- other assets.

Credits actually represent the relation between two entities in which one entity has the money (creditor) and gives to the other entity (debtor) a certain sum of money that the latter has to return in an agreed time period and under certain conditions.

or briefly

A loan means immediate possession of resources in exchange of a future payment promise involving also an interest payment that rewards the lender.

The main **c**onditions are related to the following elements:

a) **The identification of the two contracting parties: debtor and creditor;**

***Creditors* –** banks, individuals and legal entities which buy bonds, as well as local and central authorities

b) **the promise of the repayment of the principal and the interest (debt).**

The debtor takes the responsibility for the repayment at the moment of the acceptance of the credit contract conditions by signing it.

The amount of money granted may be summated to the risk of the non –repayment. This is the result of a bankruptcy of the debtor because of financial difficulties.

In order to avoid this risk, the bank asks for guarantees to the beneficiary of the credit.

c) interest rate

The interest rate represents the price paid by the debtor to the bank for the granted credit. The price of the credit may have as a reference a fixed or variable interest rate. The fixed interest rate shall be not modified during the credit contract period if the contract shall not state otherwise. This interest rate includes: the nominal interest, the risk premium and the banking spread.

The most utilised reference interest rates in Europe are: EONIA and EURIBOR.

EONIA (*Euro Overnight Index Average*) represents the reference interest rate for overnight operations to EURO. EONIA is utilised for the financial derivatives operations.

EURIBOR (*Euro Interbank Offered Rate*) represents the interest rate for the term deposits for EURO offered by bank to another.

d) the repayment deadline.

In Romania, we may have the following types of credits:

1. short-term credits (under 1 year);

2. medium-term credits (terms between 1 and 5 years);

3. long-term credits (over 5 years).

Classification from the point of view of the debtor and creditor:

1. bank credits – the creditor is a bank;
2. commercial credits – the creditor is the supplier, and the debtor id the beneficiary of the goods;
3. mortgage credits – the creditors may be: the bank, the state, and the non-banking financial institutions;
4. consumer credits – the creditor is a bank or a non-banking financial institutions;

It should be remembered that the funds that are put out on loans belong to customers. It is their money that is put at risk, so that if a bank is continually making bad or unprofitable loans, this will sooner or later be reflected in the deposits.

Before giving an advance, it is necessary for the manager to know the purpose of the loan.

The lending officer may wonder whether the loan is for a legal purpose, or not.

Generally, banks have their specific lending policies, which may change from time to time due to the market conditions or government regulations.

Their policies are essentially based on the evaluation of the related risks such as the credit risk, interest rate risk and concentrated risk. The lending may be also authorised at a branch level if the branch portfolio allows that.

In order to make proper lending decisions, banks purposely observe a set of general lending principles such as age and state of health, stability, integrity and honesty, sources of income, regular expenditure, existing connections, ability to manage financial affairs as well as margin, purpose, amount, repayment capability and security.

As corporations, companies, individuals or the government represent the category of bank customers; the types of loans vary accordingly and can be generally divided into country loans, business loans and personal loans.

So, as to be able to achieve national political, social and economic goals, governments may need finance and, in this respect, the international financial institutions are expected to grant them a large variety of loans including apex, distressed, economic recovery, emergency reconstruction, sovereign, standby loans as well as balloon, call, carryover, equity, hard and soft loans, colons, indexed, outstanding, jeopardy, jumbo, non-accruing or non-performing loans, overage, participation and package loans, pipeline, pooled, premature, programme, project and sector loans, secured, quality, quick disbursing loans, senior, subsidiary, syndicated, time-slice, top-rated, revolving, working capital loans, sub-loans etc.

CLIENTS OF THE BANK WHO MAY OBTAIN CREDITS:

- Companies with state or private capital and other institutions which carry out their activity within the national economy;
- Companies with total foreign or mixed capital established in accordance with the provisions of the law;
- Companies which carry out their activity in the agriculture;
- associations;
- other

Classification of credits:

1) Depending on the maturity date:
- short-term credits;
- medium-term credits;
- long-term credits.

2) Depending on the type of insurance:
- non-insured credits;
- insured credits.

3) Depending on the type of creditors:
- banking credits;
- commercial credits.

4) Depending on the type of debtors:

- agricultural credits;
- industrial credits;
- real estate credits;
- personal credits.

5) Depending on the type of destination:
- consumer credits;
- commercial credits;
- industrial credits;
- credits for starting up/establishing companies;
- credits for operations with securities meaning investment credits;
- seasonal credits;
- importing credits;
- exporting credits;
- construction loans;
- small business loans.

6) Depending on the domicile of creditor:
- domestic;
- foreign.

7) Depending on the interest rate of the credit.
- Fixed interest rate loans;
- Variable interest rate loans;
- Floating interest rate loans.

8) Revolving lines of credits;

9) Depending on the borrower:
    - CORPORATE BANKING credits– when granting credit to companies;
    - REI AIL BANKING credits – when granting credits to individuals.

Corporate lending

As corporations and companies represent the major category of clients, for the corporate lending banks do analyse a set of basic and additional criteria such as the ability of continuing business, the expected future cash flows, security and collateral, the rate of return to the bank as well as the level of the whole business which the bank has done with them.

The usual procedures which banks apply in the loan granting to corporate borrowers specifically include submission of the application and required information, evaluation of the information, initial evaluation of the proposed security, negotiation, approval, legal examination of the security, signing of the contract, disbursement of the amount and recovery of the capital and interest.

The credit granted to companies, whether public or private, generally comprises loans for working capital and for fixed assets, financing such as overdrafts, term loans, syndicated loans, and revolving credit and working capital loans.

Export Financing

As most major companies deal with exports, banks can offer short time credit to exporters until they recoup the money from importers, upon a collectibles guarantee for the lending bank.

Loans for Fixed Assets Financing

Such loans essentially include short-term, medium-term and long-term loans with respect to maturity. The security for such a lending may be uncovered, covered by cash equivalent, by personal guarantees or mortgage assets, collateral and, according to the type of repayment; it may comprise equal capital amortisation, equal instalment payment, specific terms, fixed or floating interest etc. When loans in foreign currency are expected to be granted, banks usually tend to hedge their positions in the foreign currency but, very often, they rather speculate.

Syndicated Loans

Unlike the participation loans, the syndicated ones consist of an agreement specifying that two or more banks accept to directly lend to the same borrower or borrowers. In such a case, one of the banks plays the role of the agent bank while the others participate by own portions in the syndicate, the risks being shared by all of them.

Retail Lending

Besides the corporate lending, the personal lending is also an important activity of banks. Before credit is granted to individuals, the bank thoroughly analyses the income status of the applicant, the stability, the permanency of his or her cash inflows, guarantees by third parties as well as the existing collateral.

The usual procedures in the lending to individuals include the receipt of the applications and required information, evaluation of the collectibles and collateral, decision on the loan amount, approval from the proper committee, legal evaluation and examination of the collateral, signing the contract and disbursement of the amount. Specifically, the retail lending includes the categories of consumer credit and house financing.

Consumer Credit

Individual borrowers, including professionals, sole traders, partnerships, students and youth, clubs, associations and societies may be granted personal loans, including the following facilities: overdrafts, credit card, revolving credit, acceptance credits, hire purchase, conditional sale, credit sale, probate advances, instalment and non-instalment credit. Under such arrangements, the interest rate may be fixed, variable, obtained either at the sale point or at the bank.

Personal Loans

They are of a fixed amount, for a fixed period of time and at fixed interest rates and they are usually spent on the purchase of personal items, travels, holidays etc.

These are rather similar to loan accounts, with regular payments, mentioning that the interest on the total loan is calculated before the advance is given, then once it has been accepted, the principal and interest are debited to the loan account and the customer repays the total sum by regular instalments. No security is required for a personal loan as most banks will incorporate some form of insurance, so that in the event of the customer's death; there will be no charge to his dependants.

Overdrafts

Overdrafts are usually granted to those companies desirous to use the credit amount not as a whole but rather in accordance with their needs and for a certain period without having to pay interest on the entire amount but on the term agreed for interest calculation. In such cases, whenever the company gets excess of capital it can repay parts of the credit and, consequently, decrease the amount outstanding.

Banks can grant overdrafts to individual customers at an agreed interest rate.

Under such a facility, the borrower can take the needed amount for a particular desired period and does not have to pay interest on the entire amount. Thus, an overdraft occurs when a customer is permitted by the bank to have a debit balance on the current account, up to an agreed amount.

Interest is charged at a given percentage above the base rate.

Credit Cards

The facility of the credit card enables the customer to borrow up to certain limited amounts either at lending places or at points of sale and to withdraw cash from cash dispensers whenever he wants.

Budget accounts

This account is for those persons who find it difficult to monitor their expenditure. It is a form of borrowing and the interest is incorporated in the bank's overall charges.

Revolving Credit

Under such an arrangement, customers disposing of such types of accounts are given the option of borrowing amounts up to a certain multiple of their deposit.

Some banks offer the customer an arrangement in which he or she places a regular amount of money into this account and then has the facility to withdraw, without further authority, up to thirty times the regular credit.

House Financing

Specifically, the amounts lent by banks for house financing represent a certain percentage of the house total value and the repayment period vary from 15 to 50 years. The interest rate is also variable and essentially is based on short-term and long-term rates determined as rollover mortgages.

The repayment patterns of such loans include the following types: annuity mortgages with constant monthly instalments, endowment mortgages repaid at maturity upon a life assurance contract, only-interest mortgages for a certain period, gradually increasing payments and linear mortgages with equal capital repayments and decreasing interest.

NECESSARY DOCUMENTS FOR OBTAINING CREDITS

- the application for credit signed by the persons authorised to represent the company and which has to include the description of the credit conditions;
- balance sheet, the profit and loss account for latest years;
- cash flow for the period of the credit;
- the stocks and expenditures situation for the period of the credit;
- the situation of the supply contracts for the goods which are the object of the contract;
- the schedule of the repayments of the credit (capital and interest);
- list of the guarantees proposed to the bank in order to cover the required credit and their assessment;
- business plan;
- any other necessary documents required by the bank.

Analysing a new lending proposition

There are five stages to any analysis of a new lending proposition:

1. Introduction of the customer;
2. The application of the customer;
3. Review of the application;
4. Evaluation;
5. Monitoring and control.

Introduction

Lenders do not have to do business with people they do not feel comfortable with.

An important source of new business for most lenders is introductions from professional advisers such as accountants and solicitors. But, a bank is not obliged to lend to customers introduced in this way.

The application can take many forms but should include a plan for repaying the loan and an assessment of the contingencies, which might reasonably arise, and how the borrower would intend to deal with them.

It might be in detailed written form, or not.

Review of the Application

During this stage all the information must be tested. It is sometimes difficult to remember all the points to be covered during an interview and many lenders use a check list (a mnemonics) including:

- character (about the individual's character);
- capital;
- capability/ability;
- purpose/destination;
- amount;
- repayment;
- terms;
- security/insurance.

Ability - this aspect relates to the borrower's ability in managing financial affairs and is similar to character (about skill, experience of the manager).

Purpose - the lender will want to verify that the purpose is acceptable (legal, moral etc.).

Amount - Is the customer asking for either too much or too little? There are dangers in both and it is important therefore to establish that the amount requested is correct. The amount requested should be in proportion to the customer's own reasons and contribution.

Repayment - It is important that the source of repayment is made clear.
Where the source of repayment is income, the lender will need projections to ensure that there is a surplus of funds to cover the repayment after meeting other commitments.
Insurance - The canons of lending should be satisfied of available security.
Evaluation - The aim of the evaluation is to establish the risk involved.
Listing the pros and cons of a proposition is helpful.
As a summarise, It should be mentioned that before any loan is granted, the following questions must be answered by the customer:

how much is required?

the purpose of the loan (legal, moral and within the policy of the government and the bank, National Bank of Romania);

length of time the advance is requested? (how long the money is required and whether the outstanding debt will be repaid monthly, quarterly etc).

the source of repayment - the answer to this question is important to the bank. Any customer must have sufficient resources to repay (capital + interest) the bank within the stipulated agreed time. The sources of the repayment could be from wages, dividends, an inheritance, and profits and so on.

Banks have as one of their basic functions lending money to both physical and juridical persons. The banks charge a certain interest rate on these loans, that represents the earnings used to pay expenses, such as salaries and wages of the workers, rents, other administrative expenses, give interest payments to those holding their money in deposits at the bank, pay shareholders dividends and also retain funds as reserves for the own expansion of the banks.
Bank loans finance different groups in the economy. Manufacturers, distributors, service firms, farmers, builders, homebuyers, commercial real estate developers, consumers, and others all depend on bank credit.
The ways in which banks allocate their funds can strongly influence the economic development of the community and nation. Every bank bears a degree of risk in its granting of credit, and, without exception, every bank experiences some loan losses when certain borrowers fail to repay their loans. Whatever the degree of risk taken loan losses can be minimised through highly professional organisation and management of the lending function.
The composition and quality of a bank’s loans should be reflected in its loan policy. The policy sets out the bank’s lending philosophy and specifies procedures and means of monitoring lending activity. A written loan policy should serve to obtain three results:
- produce sound and collectible loans;

- provide profitable investment of bank funds;
- encourage extensions of credit that meet the legitimate needs of the bank's market.

A meaningful loan policy will express strategies in concrete terms. The desired loan mix should be quantified. The loan mix expresses the diversification sought by the bank in its loan placements. Diversification reduces the level of default risk that is associated with large concentrations of loans in a single category.

The bank's liquidity strategy should be indicated, because it acts as a constraint on lending activity and because liquidity is partly determined by the maturity structure of the loan portfolio. The desired size of the loan portfolio expresses the bank's intended aggressiveness in expanding its loan portfolio. A highly aggressive loan policy has both a bright side and a dark. The bright side is that a large loan portfolio might increase bank earnings. The dark side is that an aggressive policy might lead to lower credit standards, marginal loans, and an unacceptable amount of risk.

Most borrowers are exposed to risks that threaten their ability to repay their bank loans. Key-man life insurance is especially important to protect against loss if death or disability strikes the borrower or one of the borrower's indispensable employees. A catastrophic fire or flood may interrupt the borrower's business or destroy the loan's collateral.

The loan policy should indicate the types of borrowers who must be insured.

The policy must designate the bank as the loss payee, or when the cash value of a life insurance policy is offered as protection, it must be properly assigned to the bank. An increasingly common form of protection is the credit life policy written by the bank. It is simply term life insurance written on consumer loan customers. It pays off outstanding balances due to the bank in the event of the customer's death. A somewhat different form of protection is obtained through reinsurance. If the borrower defaults, reinsurance pays out and the insurance company pursues collection on its behalf on the bank's defaulted note. Reinsurance premiums are rather costly, and policy should indicate what classes of borrowers, if any, should be under reinsurance programs.

Most banks conduct loan reviews to reduce losses and monitor loan quality.

Loan reviews consist of a periodic audit of the on-going performance of some or all of the active loans in a bank's loan portfolio. Its essence is credit analysis, although, unlike the credit analysis conducted by the credit department as part of the loan approval process, credit analysis in loan review occurs after the loan is in the books. Other than its basic objective of reducing loan losses, some intermediate objectives of loan review are as follows:

- to detect actual or potential problem loans as early as possible;
- to provide incentive for loan officers to monitor loans and report deterioration in their own loans;
- to enforce uniform documentation;
- to ensure that loan policies, banking laws, and regulations are followed;

- to inform management and the board about the overall condition of the loan portfolio;
- to aid in establishing loan loss reserves.

Whatever means are used to conduct loan reviews; the following points should be covered:
- financial condition and repayment ability of borrower;
- completeness of documentation;
- consistency with loan policy;
- perfection of security interest on collateral;
- legal and regulatory compliance;
- apparent profitability.

When a problem loan is detected, the responsible officer should take immediate corrective action to prevent future deterioration and minimize potential loss.

Credit analysis

Credit analysis is the process of assessing the risk of lending to a business or individual*. The so-called credit risk must be evaluated against the benefits that the bank expects to derive from making the loan. The direct benefits are simply the interest and fees earned on the loan and possibly, the deposit balances required as a condition of the loan. Indirect benefits consist of the initiation or maintenance of a relationship with the borrower that may provide the bank with increased deposits and demand for a variety of bank services.

Credit risk assessment has both qualitative and quantitative dimensions; the former are generally the more difficult to assess. The steps in qualitative risk assessment are primarily gathering information on the borrower's record of financial responsibility, determining his or her true purpose for wanting to borrow funds, identifying the risks confronting the borrower's business under future industry and economic conditions, and estimating the degree of commitment the borrower will have regarding repayment. The quantitative dimension of credit risk assessment consists of the analysis of historical financial data and the projection of future financial results to evaluate the borrower's capacity for timely repayment of the loan and, indeed, the borrower's ability to survive possible industry and economic reverses.

The essence of all credit analysis can be captured in four basic factors or lines of inquiry:
- the borrower's character – most bankers agree that the paramount factor in a successful loan is the honesty and goodwill of the borrower;
- the use of loan funds – determining the true need and use of funds requires good analytical skills in accounting and business finance;

- primary source of repayment – the analyst's accounting and finance skills are crucial in determining the ability of the borrower to repay a loan from cash flows. He must ascertain the timing and sufficiency of these cash flows and evaluate the risks of cash flows falling short.

- secondary source of repayment – the collateral value should cover, in addition to the loan amount and interest due, the legal costs of foreclosure and interest during foreclosure proceeds. Even if the collateral is the preferred secondary source of repayment, others can be guarantors and co-makers, but in such cases, the collection usually requires expensive litigation and results in considerable ill will between the bank, borrower, and guarantor.

In credit investigation, banks usually resort to the following sources of information:

- customer interview – it provides the most important information needed in credit investigation, including the type and amount of the loan required, sources and plans of repayment, eventual collateral and guarantors, previous and current creditors, primary customers and trade suppliers, accountants, main officers and shareholders etc.

- internal sources – credit files on any current or previous borrowings, checking account activity, other previous or current deposits, liabilities, income sources, assets, expenses and revenues etc.

- external sources of information – specialised service agencies, newspapers, magazines etc.