HAVING FINANCE APPROVED

A financial institution will analyse the risk and return involved in lending a small business funds, before approving any finance. They will attempt to balance the risk of lending the funds with the potential **return** that can be earned from the client.

Risk

Financial institutions, such as banks, exist to make a profit. Therefore when a client applies for a loan the bank will consider whether they can make enough return from the loan. The bank will have target profit objectives which need to be met. Profit targets cannot be met if clients default on their loans and do not repay. The financial institution must take this into account as the **risk** associated with lending money.

Criteria are used to decide the risk involved in giving a client a loan. If the client does not meet these criteria the risk is too high and the loan is not granted.

The **3Cs Test** can be applied by a financial institution to determine risk.

3Cs Test

1. **Character (History):** this is an assessment of the clients' ability to pay back the loan by examining their credit **history**, for exampl, how long they have been employed, periods of unemployment, their credit rating.
2. **Capacity (Liquidity):** this assesses the ability of the client to make regular repayments of the debt as they fall due. It considers the disposable income of the client, which is the amount of income left after paying living expenses. Other information that might be gathered includes their current debt level, salary and occupation.
3. **Collateral:** this is an asset or assets that will be taken if the client is unable to repay the loan. Money is rarely lent without some form of collateral being provided. The asset provides security for the loan.

   If a client does not have enough of his/her own assets to offer as collateral then a guarantor for the loan may be acceptable. This is a written agreement that if the client cannot pay the loan the **guarantor** will have to make the payments or provide the security for the loan.

Return

The return is the amount the financial institution has calculated it can earn from giving a client a loan. There are two types of **return** that could be assessed:

1. Interest rate
2. Future business

1. Interest rate

The interest rate is basically the cost of borrowing money. Similar interest charges tend to be applied to investments of similar risk. Interest is calculated as a percentage of the loan amount. The client must repay the loan in addition to the interest.

For example: Harrold takes out a twelve month loan of $10 000 with an interest rate of 5%. By the end of the twelve months he will have to pay back $10 000 plus 5% interest of $500. This 5% interest is the return the bank has made from financing Harrold's business.

2. Future business

All businesses want to survive long term and in order to do this they need to constantly plan for the future. The financial institution can ask the client to produce sales projections and budgets, in order to prove their potential to repay the loan amount. The more potential for repayments, the less riskier the loan.

Any evidence of an increase in future profits for the business will indicate to the financial institution that they are a worthwhile long term investment. This is because the business will expand and future business dealings with the bank will increase. Expansion could result in a wider range of services being required from the financial institution, such as merchant banking facilities, internet banking and cash management accounts as well as more lending thus more interest repayments.

REVIEW QUESTIONS 2.2

1. What is a guarantor?
2. Explain how financial institutions attempt to balance risk and return when lending funds.
3. What is collateral? Provide examples.
4. Describe the most common return earned by a bank.
5. Explain how each of the following is used to determine risk:
   a. collateral
   b. liquidity
   c. history
   d. guarantors.
6. Why would a bank be interested in the amount of future business of a potential client?