CREDIT MANAGEMENT

BBA- 301

COMPILED BY :
MEEZAB HUSSAIN
SUPERVISION:
SIR SAJAWAL ANWER

According to the assigned course outline of Punjab University.

CREDIT MANAGEMENT BBA- 301

PREPARED AND COMPILED BY COMMERCE DEPARTMENT GCS.

CREDIT HOURS; 3 SEMESTERS; V

COURSE OUTLINE:

1. INTRODUCTION TO CREDIT FUNCTIONS

2. COMMERECIAL CREDIT- HISTORY, COMPONENT, TYPES AND SOURCES

3. ROLE OF CREDIT DEPARTMENT

4. CREDIT POLICY FORMULATION AND DISCRIMINATION

5. COLLECTION OF POLICY APPRAISAL

6. WORKING CAPITAL MANAGEMENT

8. BANK CREDIT, TYPES AND SOURCES

9. APPRAISAL OF CREDIT PROPOSAL AND PREPARATION OF CLP, ASSESEMEMENT OF RISK FACTOR

10. ANALYSIS OF CREDIT INFORMATION, FINANCIAL AND NON-FINANCIAL FACTORS, FINANCIAL STATEMENT ANALYSIS.

11. DETERMINATION OF COLLATERAL RESOURCES

12. MODES OF CREATING CHANGES ON SECURITIES COMMERCIAL VS. BANK CREDIT.

PREPARED BY : **5TH SEMESTER { 2019-23}**

COMPILEDBY **: MEEZAB HUSSAIN**

SUPERVISION**: SIR SAJAWAL ANWER**
COMMERCE DEPARTMENT , GCS LAHORE

CREDIT MANAGEMENT – DETAILED NOTES

Management

It is a process of planning, decision making, organizing, leading, motivation and controlling the human resources, financial, physical, and information resources of an organization to reach its goals in an efficient and effective manner. **Credit** means receiving something of value now and promising to pay for it later, often with a finance charge added by the lender. **Credit management** is the process of granting credit, setting the terms it's granted on, recovering this credit when it's due, and ensuring compliance with company credit policy, among other credit related functions. The goal within a bank or company in controlling credit is to improve revenues and profit by facilitating sales and reducing financial risks. The term credit derived from Latin word "**Credo**", which means "**I Belive**". Without the invention of credit, the whole economic progress of the world is not possible.

Common credit Terms:

It is essential to understand some basic terms used in the credit management system. It will help the reader in better understanding of the credit management in the forthcoming sessions.

Accrued Interest - Interest that has been accumulated since the last loan repayment

Amortization - The reduction of debt through regular payments, or the reduction in value of an asset through depreciation

Balloon Payment - The final payment on a debt, which is much larger than the standard payments.

Bankruptcy - The discharge or forgiving of one's debts by a federal court. There are different types of official bankruptcy under federal law.

Collateral - Items of value that are pledged as security for a loan. If the loan is not paid, the items are forfeited.

Compound Interest - A method by which interest is calculated on the principal amount and on the interest that was earned earlier.

Credit Rating - An evaluation of the credit history of an individual or firm to determine if worthy of the extension of additional credit.

Lien - A claim by a creditor or other party against an asset. If an obligation is not fulfilled, the property may be seized through a court order to satisfy the lien.

Mortgage - A type of debt in which the borrower gives the lender a lien against the property until the funds are paid back. When involving personal property as opposed to real estate, the term is “chattel mortgage”

Promissory Note - A written promise to pay a certain sum under terms acceptable to both the borrower and the lender.

Collection Costs - Those external costs that have been or will be incurred by HFC in connection with the recovery of a debt (other than those associated with the physical sale and realization of specific assets) such as legal and related costs of actions to discover or gain control of assets, to pursue guarantors etc, and which are chargeable against the customer in terms of our documentation.

Trade Credit (Accounts Receivables)

Definition and Meaning:

Trade credit is a kind of business credit which is extended by the seller of goods to the buyer of the same at all levels of production and distribution process down to the retailer. Before the goods and services have reached the ultimate users or consumers, they pass through many hands starting from the producers down to the retailer. Trade credit is used by various agencies operating in the trade channel between the producer and the retailer. For example, the producer may extend credit to the wholesaler, who may also facilitate the retailer’s trade by extending credit to him. Such credits extended by the wholesaler to the retailer or producer to the wholesaler are known as trade credit.

Meaning of credit Management:

Credit management is the process of granting credit, setting the terms it's granted on, recovering this credit when it's due, and ensuring compliance with company credit policy, among other credit related functions. The goal within a bank or company in controlling credit is to improve revenues and profit by facilitating sales and reducing financial risks.

¬ Credit management in simple words is the process of monitoring and collecting payments from the borrowers. ¬ It acknowledges as one of the main sources of income for a bank and constitutes most portions of the bank’s assets. ¬ Credit management is the process of granting credit, setting the terms

it's granted on, recovering this credit when it's due, and ensuring compliance with company credit policy, among other credit-related functions.

Credit Score

A credit score is a numerical expression based on a statistical analysis of a person's credit files, to represent the creditworthiness of that person, which is the perceived likelihood that the person will pay debts in a timely manner. A credit score is primarily based on credit report information typically sourced from credit bureaus / credit reference agencies

Identity Score

An identity score is a system for tagging and verifying the legitimacy of an individual's public identity. Identity scores are increasingly being adopted as a means to prevent fraud in business and as a tool to verify and correct public records. Identity scores incorporate a broad set of consumer data that gauges a person's legitimacy. Identity score components can include (but are not limited to) personal Identifiers , public records, Internet data, government records, corporate data, predicted behavior patterns based on empiric data, selfassessed behavior patterns, and credit records.

Credit Bureau or Credit Reference Agency

A credit bureau (U.S.) or credit reference agency (UK) is a company that provides consumer credit information on individual borrowers. This helps lenders assess credit worthiness, the ability to pay back a loan, and can affect the interest rate applied to loans. Interest rates are not the same for everyone, but instead are based on risk-based pricing, a form of price discrimination based on the different expected costs of different borrowers, as set out in their credit rating.

Credit History

WHAT IS CREDIT HISTORY?

Your credit history is a measure of your ability to repay debts and demonstrated responsibility in repaying them. It is recorded in your credit report, which details the number and types of your credit accounts, how long each account has been open, amounts owed, the amount of available credit used, whether bills are paid on time, and the number of recent credit inquiries. Your credit report also contains information regarding whether you have any bankruptcies, liens, collections, or judgments.

All consumers are guaranteed access to their credit history (via a credit report) and are eligible for one free credit report from each credit bureau on an annual basis

- Credit history is a record of your ability to repay debts and demonstrated responsibility in repaying them.
- Your credit report includes information about the number and types of your credit accounts, how long each account has been open, amounts owed, amount of available credit used, whether bills were paid on time, and the number of recent credit inquiries.
- You will reap rewards for having a good credit history, such as being offered lower interest rates on mortgage loans and car insurance.

WHY CREDIT HISTORY IS IMPORTANT

Potential creditors—such as mortgage lenders and credit card companies—use the information in your credit history to decide whether to extend credit to you.

When creditors review your credit history, they assess several different factors: recent activity, the length of time that credit accounts have been open and active, and the patterns and regularity of repayment over longer periods of time.

GOOD CREDIT HISTORY

Basically, having a good credit history means paying your bills on time and not carrying large amounts of debt. It makes it easier to get credit cards, gives you better loan choices, and offers lower interest rates

BAD CREDIT HISTORY

Conversely, those with a bad credit history do not pay their bills on time and maintain a good deal of outstanding debt.[4]

Factors that contribute to a bad credit history include late or missed payments, excessive credit card usage, applying for a lot of credit in a short window of time, and suffering major financial events such as bankruptcy, foreclosure, repossession, charge-offs, and settled accounts. Bad credit can lead to difficulty in getting loans and credit cards, low credit limits with high interest rates, paying security deposits

WHAT IS A CREDIT INQUIRY?

A credit inquiry is a request by an institution for credit report information from a credit reporting agency. Credit inquiries can be from all types of entities for various reasons, but they are typically made by financial institutions. They are classified as either a hard inquiry or a soft inquiry.

- Companies check credit to make decisions such as lending money for cars, houses, or credit cards.
- A hard inquiry will affect your credit score, while a soft inquiry will not.
- Soft inquiries usually are made when you request a credit report or credit score for yourself.

HOW A CREDIT INQUIRY WORKS

Credit inquiries are a significant component of the credit market. Hard inquiries are a key part of the underwriting process for all types of credit. Soft inquiries help credit companies to market their products and also can be used to help consumers.

HARD INQUIRIES

Hard inquiries are requested from a credit bureau whenever a borrower completes a new credit application. They are retrieved using a customer's Social Security number and are required for the credit underwriting process. Hard inquiries provide a creditor with a full credit report on a borrower. This report will include a borrower's credit score and details on their credit history.

SOFT INQUIRIES

Soft inquiries are not included on a credit report. These inquiries can be requested for a variety of reasons. Credit companies have relationships with credit bureaus for soft inquiries that result in marketing lists for potential customers. These soft inquiries are customized by the credit company to identify borrowers who meet some of their underwriting characteristics for a loan.

CREDIT RATNG

A credit rating assesses the credit worthiness of an individual, corporation, or even a country. Credit ratings are calculated from financial history and current assets and liabilities. Typically, a credit rating tells a lender or investor the probability of the subject being able to pay back a loan. However, in recent years, credit ratings have also been used to adjust insurance premiums, determine employment eligibility, and establish the amount of a utility or leasing deposit. A poor credit rating indicates a high risk of defaulting on a loan, and thus leads to high interest rates or the refusal of a loan by the creditor.

The factors which may influence a person's credit rating are

1. ability to pay a loan
2. interest
3. amount of credit used
4. saving patterns
5. spending patterns
6. debt

Corporate credit ratings

The credit rating of a corporation is a financial indicator to potential investors of debt securities such as bonds. These are assigned by credit rating agencies such as Standard & Poor's or Fitch Ratings and have letter designations such as AAA, B, and CC.

Sovereign credit ratings

A sovereign credit rating is the credit rating of a sovereign entity, i.e. a country. The sovereign credit rating indicates the risk level of the investing environment of a country and is used by investors looking to invest abroad. It takes political risk into account

Short term rating

A short term rating is a probability factor of an individual going into default within a year. This is in contrast to long-term rating which is evaluated over a long timeframe.

What is Credit Worthiness Report (CWR)?

A credit worthiness report (CWR) is a factual statement of the borrowers' credit position, on a certain date, compiled on the basis of information received from the member financial institutions. The CWR contains certain financial and non-financial information on borrowers. The CWR only shows the total liabilities (both fund & non-fund based) but does not reflect the names of lending financial institutions.

What is not included in CWR?

A CWR does not include race, income, religion, political affiliation, ethnic background, medical history, private affairs details, bank deposit accounts details or other information not related to credit.

What is the definition of "consumer" and "corporate" for CIB reporting purposes?

For CIB reporting purposes, credit data of individuals and sole-proprietorships is reported under consumer category whereas credit data of all other business concerns like partnerships, private limited companies, public limited companies and corporations etc. is reported under corporate category.

How groups are formed and group liabilities determined?

The responsibility of formation of group and consequent group liabilities rests with the reporting financial institutions in line with the definition of group and the criteria laid down vide Prudential Regulation for Corporate Commercial Banking.

Credit ratings apply to businesses and governments. For example, sovereign credit ratings apply to national governments while corporate credit ratings apply solely to corporations. Credit rating agencies typically assign letter grades to indicate ratings. S&P Global, for instance, has a credit rating scale ranging from AAA (excellent) to C and D. Credit scores, on the other hand, apply only to individuals and are reported as a number, generally ranging from 300 to 850.

The Group Company and Limited Liability

Group companies (‘corporate groups’) are business enterprises or firms that order their operations using a structure involving parent companies (‘holding companies’) and subsidiaries. In the UK and the US, a common group structure involves a parent company that owns shares, wholly or partially, in a group of subsidiaries, which may themselves hold shares in or be intermediary parent/holding companies for other subsidiaries.[Footnote4] A core conception of the group company is thus one that is comprised of several companies related hierarchically through controlling shareholdings, which can manifest itself in the form of majority as well as indirect and minority shareholdings. In a wider conception, group companies can also refer to structures without hierarchical shareholdings—such as where common control stems from family ownership or in instances of significant but non-controlling cross-holdings or circular holdings in conjunctions with common management[Footnote5] or corporate networks. Although the distinction between groups and networks is not always clear and can overlap, networks are companies whose relationship is not characterized by the potential for equity-based control but rather through ‘detailed cooperation agreements, and/or repeated transactions’.[Footnote6] Typical examples are businesses that cooperate or support each other’s efforts in product development, manufacturing, and distribution

❖ WHAT IS CREDIT FUNCTION?

Credit: **Meaning and Functions**:

With the introduction and use of money credit also came into existence. Credit is created when one party (a person, a firm or an institution) lends money to another party, the borrower. Thus, credit is generally understood to mean the finance provided to others at a certain rate of interest.

The act of lending and borrowing creates both credit and debit. Whereas debt means the obligation to pay the finance borrowed, the credit means the claim to receive these money payments from the other party. Every credit involves debt, that is, obligation to pay money and therefore creates claim.

The act of borrowing and lending and thereby the creation of credit is a special type of exchange transaction which involves future payment of the principal sum borrowed as well as the rate of interest on it. The lending and borrowing of money and the institution of money lending came into vogue ever since money was invented by man. In the modern times there are a variety of institutions which specialize in borrowing and lending of money.

The bank credit is only one form of credit. Money lenders, indigenous bankers, credit cooperative societies, commercial and cooperative banks, industrial financial institutions, L.I.C. export finance houses etc. are all credit institutions and do the business of borrowing and lending money. Different credit institutions lend money for different purposes and are collectively called the financial system. Thus commercial banks are only one segment, though an important one, of the financial or credit system of an economy.

❖ PURPOSE OR END-USES OF CREDIT:

Credit is required for different purposes and by all sectors of the economy. Therefore, there is need for the proper allocation of credit between different uses and sectors if the society is to achieve its objectives. When credit is demanded and used for productive purposes, it may be used to finance the needs of working capital or for fixed investment (i.e. capital equipment, machine

❖ CREDIT CHECKING

Most commercial enterprises are sales-driven, which is to say that a great emphasis is placed on finding new customers and getting customers to place product orders. The function of credit management in this process is to check the creditworthiness of prospective new customers and continue to monitor the creditworthiness of existing customers. It may be that some prospective customers have such a bad credit rating that it is not worth doing business with them. Credit management is also responsible for negotiating payment terms and conditions with new and existing customers with the intention of minimizing the potential exposure to bad debt. For example, if a customer orders products monthly but only has a payment due every three months, credit managers might renegotiate the credit terms offered to this customer if they suspect that the customer’s credit rating has lowered. Monthly terms, or even cash on delivery terms would minimize the amount of outstanding bad debt owed by the customer.

❖ INVOICE BILL

Credit management is responsible for ensuring that invoices, statements and bills are issued to customers, reflecting accurately the current status of the customer’s account and the amounts and details of payments due. Invoices must be dispatched early enough for the customer to have time to evaluate the details contained in them and make payment by the due date. An important credit management function is the checking of the details of invoices and statements for accuracy. Inaccuracies could lead to the customer disputing the invoice, resulting in a subsequent delay in payment, which would then adversely effect cash-flow.

COMMERCIAL CREDIT

•INTRODUCTION TO COMMERCIAL CREDIT:

Commercial credit is a line of credit offered to business that allow them to pay for a variety of business needs when cash is not available. A business can use their commercial credit line to pay for inventory, working capital needs, expenditure and any unexpected expenses that may arise from running a business. It can also be used by companies to help fund new business opportunities that fall out of daily business operations

Definition:

Commercial credit is a pre-approved amount of money issued by a bank to a company that can be accessed by the borrowing company at any time to help meet various financial obligations.

• History of Commercial Credit:

Credit was a relatively simple matter in early America, when businesses were situated close to their customers. After all, merchants probably knew their customers personally and could make wellinformed judgments about their ability to pay. But as the United States expanded westward and distance between creditor and debtor grew, the risk became much greater. This was painfully borne out by the Panic of 1837.

The ensuing six-year depression—and the failure of many, many businesses—led Lewis Tappan to establish the first credit agency, in 1841 in New York City. The Mercantile Agency rated companies' ability to pay their debts and published those ratings in a series of guides. The Mercantile Agency was soon acquired by Robert Dun, who then joined forces with a rival agency founded by John Bradstreet.

Like the companies struggling to establish businesses on the American frontier, Dun & Bradstreet and other credit agencies were pioneers, on several fronts. They endowed credit reports with unprecedented levels of objectivity, understanding that modern 2 commerce required a new kind of foundation. Their collection, pursuit, centralization, and storage of data also heralded the coming information age.

So what did this look like? Starting in the 1840s, the Mercantile Agency (later R.G. Dun & Company) sent reporters into the field to collect information on businesses' creditworthiness. The data was compiled into enormous ledgers and then condensed and distributed in the form of enormous.

- By the 1939 World's Fair, credit-rating agencies made it easier for banks to underwrite the work of western frontiersmen and eastern artisans, who were laying the foundation for the U.S. economy. This is openly represented by a bronze plaque commissioned by Dun & Bradstreet for the fair, positioning commercial credit as the pillar of business.

- The plaque quotes an 1834 speech by U.S. Senator Daniel Webster, who declared,

"Commercial credit…is the vital air of the system…. It has done more, a thousand times more, to enrich nations, than all the mines of the world."

COMPONENTS OF COMMERICAL CREDIT

Lenders customarily analyze the credit worthiness of the borrower by using the Five C's: capacity, capital, collateral, conditions , character. Each of these criteria helps the lender to determine the overall risk of the loan.

The five C's of credit are used to convey the creditworthiness of potential borrowers.

The first C is character—the applicant's credit history.

The second C is capacity—the applicant's debt-to-income ratio.

The third C is capital—the amount of money an applicant has.

The fourth C is collateral—an asset that can back or act as security for the loan.

The fifth C is conditions—the purpose of the loan, the amount involved, and prevailing.

Understanding the 5 C's of Credit

The five-C's-of-credit method of evaluating a borrower incorporates both qualitative and quantitative measures. Lenders may look at a borrower's credit reports, credit scores, income statements, and other documents relevant to the borrower's financial situation. They also consider information about the loan itself.

5Cs of commerical credit:

•Character

•Capacity

•Capital

•Collateral

•Conditions

{EXPLAINATION}

1.CHARACTER:

Although it's called character, the first C more specifically refers to credit history, which is a borrower's reputation or track record for repaying debts. This information appears on the borrower's credit reports.

2. Capacity:

Capacity measures the borrower's ability to repay a loan by comparing income against recurring debts and assessing the borrower's debt-to-income (DTI) ratio.

3. Capital:

Lenders also consider any capital the borrower puts toward a potential investment. A large contribution by the borrower decreases the chance of default. Borrowers who can put a down payment on a home, for example, typically find it easier to receive a mortgage. Even special mortgages designed to make homeownership accessible to more people.

4. Collateral:

Collateral can help a borrower secure loans. It gives the lender the assurance that if the borrower defaults on the loan, the lender can get something back by repossessing the collateral. The collateral is often the object one is borrowing the money for: Auto loans, for instance, are secured by cars, and mortgages are secured by homes.

5.Conditions:

The conditions of the loan, such as the interest rate and amount of principal, influence the lender's desire to finance the borrower. Conditions can refer to how a borrower intends to use the money. Consider a borrower who applies for a car.

SOURCE OF CREDIT

There are many numerous sources of credit following are :

1.Commercial bank:

The first sources of credit and Borrowing that comes to one’s mind is commercial bank. In addition to provide credit to businesses for trade and manufacturing and to Service providers, they also Provide Credit to individual In the form of Personal loan ,student loan, Automobile Loan and home financing, etc

2.financial institution:

Financial institution are dedicate companies work just for disbursing credit .they do not offer any other services like accepting deposits, Providing safety locker’s ,that commercial banks do, financial institution are particularly important When large businesses houses require substantial credit To fund their capital expenditure plans Over modernization plans, that too far from long period ranging several Year’s..

3.trade credit:

Trade credit is a source of That comes along with the day to day Operation of businesses. In trade credit Business Buy goods and services From a seller on credit And agree to make its payment on time Over after a few days. The amount of purchases on credit Is credited to the sellers account Under the head off “Sundry creditors “On the liability side of the balance sheet. It is a form of short credit And it is given at the basis of goodwill and the market reputation of the buyer. Past business frequency and amount ,Payment pattern, Degree of the competition in the market.

4.Credit cards :

Credit cards are very common source of credit. The card issuing Bank over company seller on behalf off the buyer. The credit card holder has to then Return this amount in a specified time. The cardholder hair has an option too withdraw the cash Two against his credit card , Of course with some interest. This credit arrangement is for short term over small amounts Within the card limit of cardholder. Credit cards are easy to use and simple and there is no more documentation required. Credit card is also a source of credit which are used to purchase of a product over services on credit.

5.public deposit:

Public deposit are the source of credit Directly from the general public. The public give a certain sum of money to the company for certain time Against the payment of interest. Since these deposits Have to compete with the banks and government deposits,, Hence the deposit Have to provide the comparatively high interest. It is a small to medium credit option. The cost of borrowing Through the public Is usually lower than that of borrowing from bank. No need of charges on this asset.

6.commercial paper:

Commercial paper is a money market Instrument and is a short term source of credit. Using company issues Commercial paper to the other businesses,, Insurance, And financial Companies, And banks. Commercial paper is Freely use and simple and there is no required more documentation.

7.debenture:

companies issued venture as a long term source of credits. Company taken a loan on a specified interest rate. Debenture holder do not participation in the company’s profit or working. Debenture is eligible for a tax deduction.

8.invoices financing:

Company can raise a credit against it’s invoice Value that is due from their customers. Company can raise our credit against E outstanding invoices Improve their cash Flow.

9.startup financing:

Start up off financing is another form of credit available to new businesses. New businesses have Their special needs of farms as they as Farms as they as required unaware of various types of businesses cost.

TYPES OF COMMERICAL CREDIT

There are two types i.**e secured commercial credit and unsecured commercial credit.**

- **Secured Commercial Credit :**

Secured commercial credit is a line of credit that is backed by collateral. If the borrower is unable to pay back the borrowed funds, then a lender can claim the collateral as payment, liquidate the collateral for cash, and use the cash to settle the outstanding debt.

- **Unsecured Commercial Credit :**

Unsecured commercial credit is a line of borrowing that is not backed by any collateral and is, therefore, riskier for the lender. Unsecured credit is usually offered with higher interest rates and with a lower limit of borrowing. Furthermore, the evaluation process is much more thorough, with the company having to demonstrate a sound financial profile

Commercial Letter of credit ? explain its various types .

Commercial banks issue various letters of credit for the international trade, which are called commercialletters of credit. These letters not only act as money in the international trade but also play an importantrole in the transfer of money and investments. The commercial L.C. provides a reasonable time to the importers for payment and the exporters also don't face any problem for the payment.

DEFINITIONS:

"The letter of credit is a written instrument issued by the buyer's bank authorizing the seller to draw inaccordance with certain terms and conditions".
(Frank HeniousCleai)
"The letter of credit is a commitment on the part of the buyer's bank to pay or accept draft drawn upon
it provided such drafts do not exceed a specified amount".
(Pritchard)

KINDS OF COMMERCIAL L.C.

Following are the main kinds of commercial L.C.

CLEAN L.C:

It is that L.C. in which no condition attached to the bill and the exporter has no need to deposit the bill oflading, invoice and the papers of insurance policy to get his money.

DOCUMENTARY L.C:

A documentary L.C. provides that the drafts drawn under it are to be accompanied by different documentsrelating to the merchandise. E.g.. bill of lading, invoice and insurance policy etc.

CONFIRMED L.C:

A confirmed L.C. is confirmed if it is added the "confirmation" of the intermediary bank by which that bank
also binds itself by giving undertaking to honour the drafts drawn under it.

UN-CONFIRMED L.C:

In case of this L.C. intermediary bank forwards the L.C. (advises or notifies the L.C.) to the beneficiary butdoes not assume any liability in this regard.

REVOCABLE L.C:

The payment of this L.C. is not confirmed because the bank or importer may cancel or alter its contents at any time due to any reason. Therefore the use of revocable L.C is very less in international market.

IRREVOCABLE L.C:

The payment of this L.C. is confirmed because bank or trader cannot cancel or alter it before payment. Sothis L.C. is more reliable in international trade.

FIXED L.C:

This LC is issued for a particular transaction or for the payment of fixed amount and it is automatically cancelled at the completion of transaction or payment.

REVOLVING L.C:

Although this LC is issued for the payment of a specific amount, but at the completion of all the transactions it is automatically renewed for the same specific amount.

SPECIAL L.C:

This L.C. is restricted in its operation to a particular intermediary bank, named in LC. This bank acts as advising as well as negotiating bank.

FREELY NEGOTIABLE L.C:

Under this LC. The exporter can get the money by showing concerned documents to any bank. This bankmay be different from the informatory or advising bank.

TRANSFERABLE L.C:

The LC whose receiver has full right to endorse it is called transferable LC. He can instruct his bank to endorse it completely or partially in the favour of any person.

RED CLAUSE L.C:

In this L.C. the intermediary bank can provide loan to exporter for packing and transportation of goods before the shipment of goods. The statement containing the detail of order is specially written with red ink.

GREEN CLAUSES L.C:

It is the developed form of red clause L.C. in which the exporter can get loan not only for packing or transportation but also for storage as well. The statement containing the detail of order is specially written with green ink

BACK TO BACK L.C:

In this L.C. the receiver of money is not the sender of goods. Means the beneficiary is not the actual supplier. He produces or open his own LC. To his bank and on the strength of it gets opened another L.C. in the favour of the actual suppliers. Thus the beneficiary buys the goods from the actual supplier and supplies the same to the buyer.
Note: Pakistani traders mostly use conformed LC. In their international transactions or trade.

ROLE OF CREDIT DEPARTMENT

Definition.

The properly organized credit department play a critical role in managing account receivable portfolio risk to protect profit , prevent potential losses and help the company see more products are service.

Following are role of credit department.

- Maxamizing sales
- Accelerating cash inflow
- Minimize bad debt loss
- Reviewing and approving new account
- Devolving and updating credit collection policies
- Establishing appreciate credit limit and terms of sales for new and active customer

1. Maximizing sales:

Sales maximizing means to make the most sales revenue possible without the business taking a loss , It's a fairly logical business approach ,After all, businesses generally want to make as much revenue as possible with as little cost as possible, which can lead to greater profits.

2.Accelerating cash inflow

Accelerating cash inflows allows yours business to pay it's own bills and other obligations on time , or even earlier than required, It may allow your business to take advantage of trade discounts offered by some suppliers if you pay them with in a certain period of time.

3.Minimizing bad debt loss

A good credit control system can be considered the life blood of a business .How to reduce the risk if bad debt measure we can take during the covid 19 pandemic.

In these difficult financial times, many businesses are struggling with cash flow problems at worst resulting in them folding all together

Why we need credit control

The main purpose of setting up an efficient credit control system is to achieve a balance between assuring that our business receive payment in a timely manner and keeping our customer happy.

If we setting up new credit control system there are many factors to consider.

1 .Make some responsible for credit control

2. Credit check new customer

3. Put payment term in writing

4. Send invoice out promptly

5. Send out reminders

6.chase unpaid invoice

7. Officer multiple payment methods

4.Review and Approving new account

The review and approve process refer to all of many version , decision ,sign offers, comments, feedback, and stake holders involved in getting a piece of content or marketing compaign from ideation to finished assets approved. Accounts none accounting use, financial account that have been officially accepted by a board of directors.

A credit review also Know as account monitoring r account review inquiry is a periodic assessment of an individual or businesses credit profile. The primary purpose of credit review in the eyes of creditors is three fold.

- To determine if the potential borrowers is a good credit risk
- Examine a prospective borrowers credit history
- Reveal potentially negative

5.Developing and updating credit collection policies

A credit collection policy is a document that includes clear written guidelines that set the terms and conditions for lending credit customer qualifications criteria procedure for making collection and steps to be taken in case of customer delinquency. There are several types of credit management policy

- Automotive
- Academic
- Retail

- Wholesale
- Credit card lending

All may have different credit management policies. A tight credit management policy refers to conservative and restrictive guidelines for the extension of credit. A collection policy systemized the steps taken to recover amount prior to litigation.

6.Establishing appreciate credit limits and term of sale for new and active customer

The term credit limit refers to the maximum amount of credit a financial institution extents to a client .A lending institution extends a credit limit on a credit card or a line of credit .Lenders usually set credit limits based on the information given by the credit seeking applicant .A credit limit is a factor that affects consumer's credit scores and can impact their ability to obtain credit in the future.

- Lenders usually set credit limits based in a consumer's credit report.
- A lender generally gives high risk borrower's lower credit limits because they lack capital and the ability to repay the debt lower risk debtors typically receive high credit limits giving them greater flexibility when they spend…

ROLE OF CREDIT DEPARTMENT IN CREDIT MANAGEMENT ?

The credit and collection function is an important component of any company's business operations. Using creative methods whenever necessary to structure transactions so that sales can be approved, the credit department can make a significant contribution to sales and profit maximization. The key is knowingwhen and how to accomplish the sale safely. The key is to find the best way to minimize the risk of late payment or non-payment by customers. The core activities of the credit department include:

1. Maximizing sales,
2. Accelerating cash inflow
3. Minimizing bad debt losses,
4. Reviewing and approving new accounts
5. Developing and updating credit and collection policies,
6. Establishing appropriate credit limits and terms of sale for new and active customers,
7. Creating new or more appropriate payment terms [terms of sale],
8. Placing accounts on credit hold, and releasing orders from credit hold
9. Managing the collection function
10. Maintaining current information in the credit file on each active customer,
11. Documenting credit decisions and actions,
12. Performing financial analysis on customer financial statements,
13. Researching and resolving disputes and deductions that would otherwise delay or prevent payment of accounts receivable,
14. Communicating with other departments within the company including order entry, sales and shipping,
15. Management reporting, and Safeguarding the company's investment in accounts receivable

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DEFINING CREDIT POLICY

Definition:

A credit policy contains guidelines that structure the amount of credit granted to customers, aswell as how collections are to be conducted for delinquent accounts. The policy is an essential element of the finances of a business, since it impacts the amount of working capital required to support accounts receivable, and also influences the amount ofbad debt losses. A credit policy typically addresses the following topics:

- ***Credit terms***. It covers the normal payment terms that the company will allow to itscustomers, and the circumstances under which alternative terms are allowed.
- ***Credit limits*.** It states the amount of credit that will be allowed to customers, given certaincriteria
- ***Information requirements*.** It identifies the information that must be received before credit will be granted, such as a credit application, personal guarantee, credit report, and financial statements.
- **Collection progression.** It states the order in which the collection staff will engage in collection activities, perhaps beginning with notification calls or dunning letters, and progressing through collection agencies and legal action.

Importance Of Credit Policy:

A written Credit Policy has the following advantages:

- It sets out clearly how you are going to get new customers, what information you need,how much credit you are prepared to offer in time and value.
- It shows customers you care about them enough to explain from the start exactly how youdo business.
- It improves internal communications when everyone knows exactly what they have to do and how to do it.
- It clarifies the work for credit and sales to work together in a positive environment to growthe business.
- It sets out the steps that need to be taken to mitigate risk and minimize losses to maximizeprofits.
- It sets out the authority levels, so the work is delegated to the appropriate level in the organization, so senior manager get to review significant risk and the

smaller values are handled at ground level.

- It should include the commercial cycle from getting a lead to putting the money in the bank.
- It sets out your provisioning policy, to guard against any nasty surprises.
- It must contain a "Right First Time" section detailing not only the steps but the order the steps should be taken, to ensure the smooth running of all your processes.

OBJECTIVES OF CREDIT POLICY:

Some of the main objectives of a credit policy are as follows;

Standardization

A company will be able to remain consistent in their policies that they outlinein their credit agreements with a customer. Standardization helps to but trust between the financial institutionand customer and therefore enable more profitability in the future.

Expectations

Credit policies main objectives also include ensuring that the expectationsOf an organization are met and in compliance with credit department.

Adjustments

Credit policies leave room for the evaluation of decisions relating to creditsi.e., a loan. A credit policy can work as a go between to ensure that a loan ismet or adjusted according to the customersindividual circumstances.

POLICY AND PROCEDURES:

Simply put, a **credit policy** is a set of guidelines that sets credit and paymentterms for customersand establishes a clear course of action for late payments. *A good policy will generally do four things:*

CREDIT AND BILLED:

Determine which customers are extended credit and billed.

PAYMENTS:

Set the payment terms for parties to whom credit is extended.

LIMITS:

Define the limits to be set on outstanding credit accounts.

Steps Or Procedures:

Outline the steps or procedures used to deal with delinquent accounts.

ESTABLISHING CREDIT POLICY:

General Considerations:

Following are the general considerations for establishing credit policy:

- The criteria for customer's qualification.
- The Terms and condition for services on credit.
- The Process of collecting payments.

OTHER INFLUENCES ON CREDIT POLICY:

Sales:

Sales have greater influence on credit policy. The demand for a firm's product is greatly influenced by the ease with which the products can be purchased on credits.

BAD DEBT LOSSES:

Without the credit terms the firm will not incur any bad debts and vice versa.

COLLECTION COSTS:

These are associated with granting credit and managing accounts receivables.

FORMULATING THE POLICY:

For formulating the policy following things should be done:

- Determine which customers are extended credit and billed.
- Set the payments terms between parties.
- Outline the steps to deal with accounts.

REASON FOR WRITTEN CREDIT POLICY:

The main reason for written credit policy is used to determine which clients areeligible for credit and how to collect unpaid debts.

Credit policy keep your clients accountable and boost your cashflow.

IMPLEMENTING CREDIT POLICY:

"A communication policy is a set of prescriptions and norms laid down to guide the behavior of communication institution of the company".

TYPES OF COMMUNICATION:

Internal Communication:

"In internal communication, information, messages and facts are related

to the business are exchanged between those who are part of the organization or between the different organizational units.

EXTERNAL COMMUNICATION

Employees may be contacted at different points of time by the media or outside sources with a request for information about the Company or its employees or policies.

Assignment responsbility:

Responsibilities of the Credit Manager

The person who gives the final approval for loan or credit is known as the **credit manager**. Investment in account receivable of any firm depends on how much it sells in credit and how long it takes for the collection of receivables. The credit managers give their final approval after making sure that the customer is able to pay back the loan. The efficiency of receivable management is judged against its capacity to expand sales and profitability with a reasonable investment in receivables.

Credit Manager responsibilities include:

- Researching and evaluating clients' creditworthiness
- Creating credit scoring models to predict risks
- Approving or rejecting loan requests, based on credibility and potential revenuesand losses

Establishing Procedures:

Procedure:" a procedure is the actual working steps that should be followed in an appropriate order to accompolish a desired result".

- Following are the procedures to establish credit policy:
  - How do we minimize risk?
  - How do we evaluate customer credit?
  - What is the credit department's mission?
  - What authority does the credit staff have?

FACTORS INFLUENCING SHORT-TERM POLICY APPLICATION:

- **Factors having impact on credit policy:**

The credit policy is one of the essential factors determining both the quantity and quality of accounts receivables. Various factors determine the size of the investment a company makes in accounts receivables. They are, for instance:

i. The effect of credit on the volume of sales;
ii. Credit terms;
iii. Cash discount;
iv. Policies and practices of the firm for selecting credit customers;
v. Paying practices and habits of the customers;
vi. The firm's policy and practice of collection; and
vii. The degree of operating efficiency in the billing,record keeping and adjustmentfunction, other costs such as interest, collection costs and bad debts.

A FIRM'S CREDIT POLICY HAS TO BE BASED ON THREE PRINCIPLE:

(i) the risk of being unable to pay the debts should be borne by the firm

(ii) the firm should not be penalised by extending credit to its clients

(iii) the firm should be able to protect its interests.These principles apply whether thecredit arrangement is short term or long term.

CONDITIONS THAT CAN CAUSE CREDIT POLICY TO CHANGE:

Change in credit policy:

Any change made by an organization in its credit policy will have a direct impact on its sales figure. While change in existing credit policy organization need to analyze the change in profitability arising out of such decisions.

DIMENSION

The important dimensions of a firm's credit policy are:\

- credit standards
- credit period
- cash discount
- collection effort

These variables are related and have a bearing on the level of sales, bad debt loss, discounts taken by customers, and collection expenses.

REVIEW OF CREDIT POLICY:

- The policy should be in the form of a written credit manual. Reference to the creditmanual should be made by the entire company (including the sales department). The policy should be communicated to your customers before, during and after thesale process.

- The manual should also specify billing policies and procedures and address the internal collection process based upon age of receivable and amount.

TYPES OF CREDIT POLICY

- **What are the Types of Credit?**

The three main types of credit are:

1. revolving credit
2. Installment credit
3. Open credit

Credit enables people to purchase goods or services using borrowed money. The lender expects to receive the payment back with extra money (called interest) after a certain amount of time.

REVOLVING CREDIT

A line of credit is one type of credit that comes with a capped limit and can be used upuntil you reach the predetermined threshold. It may include regular minimum payments, but usually, there is not a fixed repayment schedule.

- An example would be a credit card as there is a capped limit (the credit card limit),and you can keep using it until you reach such a limit (then over-limit fees apply).
- Another example would be a HELOC (Home Equity Line of Credit)Diagram defines the revolving credit:

INSTALLMENT LOANS:

Installment loans are another type of credit that includes a fixed payment schedule for a specified duration .

- An example of an installment loan would be a car loan — you are required to paya set amount of money at a recurring interval (ex. $280 per month) until the loan ispaid off in full.
- Other examples include mortgages, student loans, and term loans.

OPEN CREDIT

Open credit is a type of credit that requires full payment for each period, such as per month. You can borrow up to a maximum amount, similar to a credit card limit, but you are required to pay the funds borrowed in full at the end of each period.

- An example of this would be a cellphone bill — you can make phone calls, send text messages, and use data each month, and at the end of the month, you are required to pay for the services you used (including any additional usage fees).
- Another example would be a utility bill (such as electricity usage in your household).

CREDIT PROCEDURES MANNUAL:

- **The Importance of Having a Written Credit and Collection Policy andProcedure Manual:**

Many companies do not have a written credit policy. There are a variety of reasons for this. Perhaps the most prevalent is the belief that a written policy is more trouble than it is worth, or that the policy once completed will quickly be forgotten or ignored. One of the benefits of a written policy is the fact that it will reduce bias and subjectivity in the credit decisions being made.

ADVANTAGES :

There are a number of advantages or valid reasons for investing the time and effort to develop a written credit policy. Among the more important reasons are:

- A written policy is one way to ensure continuity in the department in the eventthat key personnel leave the credit department.
- A written policy helps ensure consistent credit decisions - meaning that allcustomers will be treated fairly.
- It can be used as a training tool.
- It can be used to help evaluate or benchmark job performance against establishedstandards documented in the policies and procedures manual.
- The manual can be presented to senior management to ensure consistencybetween credit department operations and management's

RELEVANCE:

A policy must be relevant to the way the credit department actually operates. To be relevant, the credit policy must be current and it must be kept current.

A well-written credit policy will answer the following questions:

- Will a credit application be required?
- Must it be signed? If so, by who?
- Will the application include a personal guarantee?
- When must it be signed?
- Will the guarantor be required to provide personal financial statements?
- How will the creditworthiness of the guarantor be confirmed?
- What are the company's standard terms of sale?
- Who authorizes credit holds?
- Who must be informed of the credit hold?
- How will this notification take place?
- Who has the authority to withdraw open account terms?
- Who has the authority to place accounts for collection?
- What methodology will be used to calculate bad debt reserves?
- When will accounts be considered eligible for write off?

CREDIT POLICY DO'S AND DONT'S.

- Whether you are writing a new policy and procedure manual, or you are reviewingand updating your current manual, you should keep these ideas in mind:
- Do not keep your credit policy a secret. Be certain to share it with your salesdepartment and with senior management.
- Do not make your policy so rigid that that you do not have a certain amount of'wiggle room' in your credit decision-making process.
- Do not make the policy so vague or flexible that it is subject to interpretation byeach member of the credit department.
- Do update your credit policy so it does not go stale.

CREDIT APPLICATIONS:

Definition of Credit Application:

"Credit Application is a form on which you provide information needed by the lender to make a decision about granting credit."

OR

"A credit application is an application filed by a prospective borrower and submitted to a credit lender."

A credit application can be sent either through online or offline modes.

Purpose Of Credit Application:

Credit Application is the foundation of a good credit policy. Following are the purpose of credit application.

DETERMINING THE WILLINGNESS OF CREDIT:

The purpose of a Credit Application is to facilitate the process of determining whether or not to grant credit and to determine the credit limit. Credit Application collects important information for review and can also be produced in court as evidence of the terms of sale and application of credit loan.

HELPING PROFESSIONALS TO MAKE DECISIONS ABOUT CUSTOMERS:

The credit application is designed to help credit professionals make the best, informed "decisions about a customer's" ability and willingness to meet obligations within credit terms.

PERSONAL GUARANTEE:

Another way to assure payment is with the personal guarantee. Having a personal guarantee could wind up being the difference between getting paid and not getting paid. This clause in the application ensures that guarantors cannot escape the debt.

CREDIT APPLICATION INFORMATION:

In all types of credit applications, the information requested is typically the same. A lending decision will be based on a hard credit inquiry that provides details on a borrower's credit score and credit history.

SOURCES OF CREDIT APPLICATION IN BANK:

Internal Sources:

Application: Bankers may get information about the client by analysing the filled in credit application form. It will be the first source of information for a new client.

Interview: A banker can also get information by interviewing or directly contacting with the client and ask him/her the reasons for seeking credit, review the present financial position, types, and nature of the collateral, etc that the clients offer to propose.

Financial Statements: If any business firm wants to take a loan from the bank, it has to submit its financial statements. From the financial statements, banks can get information regarding the trend of the financial position of the firm.

Bank's Own Record: If the client had previous transactions with the bank, the bank can get information about the client from the documents/records. The related information may be the practice of repaying the loan, the amount of deposit in the bank, the nature of banking activities, etc.

EXTERNAL SOURCES:

Income tax office: If a bank wants to know information regarding the tax payment by the potential borrower, it may seek information from the income tax office.

Records from the other govt. office: Bank can also get other information regarding the potential borrower from relevant other government offices with which the loan applicant had to move around for business connections.

Supplementary Information Included in Credit Application:

Information Provided by Applicants to the Lenders:

The application provides the lender with important information about the borrower. Applicants will typically be asked to include the following information on a credit application:

- Customer's Address and Phone Number
- Guarantor's Name, Address, Phone number
- Social Security number
- Employer identification number (EIN) for business loans
- Credit references
- Signature Line

Collection Policy appraisal

A **credit collections policy** is a document that includes “clear, written guidelines that set the terms and conditions for supplying goods on credit, customer qualification criteria, procedure for making collections, and steps to be taken in case of customer delinquency”.
In fewer words, it is a guide offering an organized and repeatable philosophy on selling on the rules, regulations and procedures to manage daily operations. The goal for a credit collections plan is to clearly define these elements so that sales and collections employees conform to documented steps and procedures designed to optimize your resources, reduce credit risk, and improve overall cash flow.

A well written and comprehensive credit collection policy will:

- Ensure continuity in the department in the event that key personnel leave the credit department.
- Help make sure all customers are treated fairly.
- Ensure consistent credit decisions are being made.
- Be used as a training tool for new sales associates and the credit and collections team.
- Be used to ensure consistency of procedure and execution between the credit department, sales, and management.

Your policy can be as general or as specific as you would like, just keep in mind that in order to protect your cash flow, arming your employees with knowledge and predefined A/R best practices and procedures is best so they always know what to do in certain situations and can react quickly and confidently to resolve any problems or answer any questions. Once you’ve developed your collections policy, it is important to update it regularly and make sure it is still relevant and effective. It is recommended that this be done once every year, but a recent survey from Credit Today revealed that nearly 50% of companies are reviewing their policy far less frequently.

Below are sample guidelines to help you build out your company’s collections process. Timelines and collections strategies can be customized to reflect different levels of risk with respect to both your company and your customers.

1. When to Contact Customers

Days 1-3 past due: Confirm invoice was sent, confirm there are no disputes, and send automated email reminder including account statement.	Days 31-45 past due: Mail letter on company letterhead stating payment is now 30 days late. Apply late fees to account.
Days 4 -7 past due: Contact customer by phone and/or email attempting to secure payment. Ensure any discrepancies or disputes have been resolved.	Days 46-60 past due: Begin calling and emailing customer every 3-5 business days. Place account on credit hold and notify sales representative and customer of credit hold.
Days 8-14 past due: Send second automated email and follow up with a professional, scripted phone call. Notify sales representative that payment is now one week late.	Days 61-90 past due: Notify senior management and prepare to send account to collections agency and/or legal counsel and/or write off as bad debt.
Days 15-30 past due: Send third automated email stating account will incur late fees after 30 days. Follow up with a phone call to confirm receipt and remind customer of late fees.	

2. How to Handle Disputes

A comprehensive collections policy should include guidelines on how disputes and deductions should be handled. Before initial contact with a customer, the collections professional should ensure that any internal issues are cleared up. These might include unapplied checks, unused credits, or any special terms offered by the sales representative but not applied to the account. If a dispute arises during interactions with the customer, handle it quickly to avoid slowing down the receivables process. For example, if you wait a week to send the customer a corrected bill, you've just put off getting paid by a week.

3. When to Send Accounts to Collections Agencies

When all internal means of collecting on a past-due account have been exhausted, some companies choose to turn the delinquent account over to a third-party collections agency. A collections agency is a company used to recover funds that are past due or from accounts that are in default. This step in a collections process usually occurs when the account is 60 or more days past due.

There are several factors that influence a company's decision to turn past-due accounts over to a collections agency. One factor is the company's risk tolerance for bad debt. If positive cash flow would not be greatly impacted by a certain level of bad debt, a company may choose not to outsource collections efforts. On the other hand, a company with tighter profit margins would likely be more risk averse and may set forth in their collections policy the transfer of past-due accounts to a collections agency at a designated number of days past due.

4. When to Write Off Bad Debt

If it has been determined by the collections team, in congruence with the collections policy, that the debt has become worthless (because it can't be collected), then it can be written off. Writing it off means adjusting your books by removing it from the accounts receivable balance so that it is not represented in the total amount of your current accounts.

Measurement of Your Collections Policy

Once goals are established and procedures best practices are defined, it's important to identify metrics to help measure and evaluate the effectiveness of your collections policy. Regularly monitoring performance helps identify process issues that could be slowing down collections.

The metrics should align with the goals you have set for your collections policy, be consistent, and aim to improve the quality of work performed by your collections professionals.

As mentioned earlier in the context of setting goals, (DSO) is a common metric used in the collections process. DSO is widely used as an overall measure of accounts receivable relative to credit sales. If your goal was to keep your DSO below a certain number, did you achieve it? If not, what can you do to get there? If you find that the targets are not being hit, consider adjusting your collections policy accordingly.

As an added measure, by calculating DSO for those customers with extended terms and comparing them to all other customers, you can better determine the impact of extended terms on your receivable's performance. Further, the receivable balance for customers with extended terms should be closely monitored to provide insight into any trends and as a point of comparison with standard-term customers. This will help determine whether your extended-term approvals are being honoured, and whether your monitoring and collection efforts are effective.

As a reminder, extended terms are a customer courtesy. In some cases, it is a tactic to preserve sales, while in others the hope is for increased sales. With this in mind, the profits generated by extended-term sales should be tracked at least quarterly as well as year to year, and perhaps even more frequently during times of financial uncertainty.

Following are the benefits of measurement:

- Increased productivity and quality of work.
- Reduced cost of collections.
- Improvement of policies and procedures.
- Increased customer retention and satisfaction.
- Reduced bad debt and increase cash flow.
- Identification of potential areas of growth.

Credit and Collection Policy Checklist:

A well-defined and complete credit policy includes:

Credit Policies Procedures in conducting a credit check and evaluation of existing and new Customers.

Establishment of credit lines, limits or standards.

Establishment of credit terms or terms of sale (e.g., credit period, maximum exposure, discount policy, special terms, late payment).

A Checklist of required documents in the Credit Evaluation process Methods of gathering credit information (internal and external sources).

Time limits or turnaround time for making credit decision/recommendation Procedure in communicating decision/recommendation to management Credit Approvals Credit Documentation required for Credit File Database Maintenance.

Collection Policies:

Collection policies for handling past due accounts.

Collection policies for delinquent accounts.

Collection policies for handling high risk/problematic/marginal accounts Contingency plans for handling "special case" accounts (Customer under "Financial difficulty", "Bankruptcy protection /court Receivership and "Bankruptcy") or Distressed Accounts Management.

Sharing of Information and Report Dissemination:

Guidelines for reporting to upper management (status and monitoring reports and other report requirements, etc.).

Policies on sharing of credit information with other business units within the company (via reports or through linkage meetings).

{OR}

COLLECTION POLICY APPRAISAL:

A collection policy is a set of procedures a company uses to ensure payments of accountreceivables. Collection policy should be written and strictly followed.

Objectives:

The objectives of creating a credit policy are :

- ✓ To Encourage the customer to pay on time.
- ✓ To collect past due accounts within 30 to 90 days.

Principles:

Following are some principles of the collection policy of HBL:

- ✓ Collect the money owed to you.
- ✓ Develop a collection policy.
- ✓ Maintain a systematic follow-up.

Methods of improving collection:

Awareness is the first step in collections-Awareness of what is happening in the economy, in industry, in the company, and with customers.

The collection process begins in your department; and then with other departments in your company. Before contacting the customers make sure you clear up any internal problems such as:

- ➢ Unapplied Checks
- ➢ Unresolved Billing.
- ➢ Merchandise Dispute.

HBL Policy:

Following are the points HBL follow for collection:

- ✓ Not call the customer at n inconvenient time like before 8. am or after 9 pm.
- ✓ Personal data of customers must be fully documented.
- ✓ collection staff of the bank must fully secure the data of the customers.
- ✓ Not harass, oppress or abuse clients.

Not use unfair practices to try to collect a debt

WORKING CAPITAL MANAGEMENT

WHY ORGANIZATIONS NEED CREDIT:

- ➢ Companyneedsd capital to purchase assets and maintain their operations.

- Working capital is the capital of a business thatch is used in its day-to-day tradingoperations.
  W.C = Current Assets – Current Liabilities

WHAT IS A WORKING CAPITAL REQUIREMENT?

- Working Capital Requirement is the amount of money needed to finance the gap betweendisbursements (payments to suppliers) and receipts (payments from customers).
- Almost every company must incur expenses before obtaining the fruits outside labor (thepayment of customer invoices).
- The nature of these costs depends on the activity.

Examples:

- If the business activity consists to buy and resell goods, it will require purchasing a stockof goods before selling.
- If it's an industry, it is necessary to buy the raw material before transforming it and thensell the finished product.

WORKING CAPITAL FINANCE:

A **working capital** loan is a loan that is taken to **finance** a company's everydayoperations.

FACTORS AFFECTING WC REQUIREMENTS:

i. Length of the operating cycle

ii. Nature of Business.

iii. Scale of Operation.

iv. Business Cycle Fluctuation.

v. Seasonal Factors.

vi. Credit Allowed.

vii. Price level changes

viii. Manufacturing Cycle

PURPOSE OF WORKING CAPITAL:

- Purchase of Raw Materials (RMs)
- Purchase of stores and spares
- Funds blocked under
- Stock in process Finished
- Goods Receivables
- Advance payments to the supplier
- Day to day expenses (e.g. wages, salaries, utility bills, etc.)

COMPONENTS OF WORKING CAPITAL:

The components of Working capital are in several forms of current assets:

i. Cash

ii. Raw materials

iii. Finished goods

iv. Value amount from debtors

v. Miscellaneous current assets (e.g. short-term investments and advances).

DETERMINANTS OF WORKING CAPITAL:

- Nature of business
- Size of business
- Growth and expansion

- Production cycle
- Production policy
- Availability of raw Material

CONCEPT OF WORKING CAPITAL:

There are two concepts of working capital:

- Gross working capital
- Net working capital concept.

Gross working capital:

Gross working capital refers to the firm investment in current assets. Current assets are the assthathich can be converted into cash within an accounting year and include cash short term securities account receivables

Gross Working capital = Total current assets

NNETWORKINGCAPITAL:

Networking capital refers to the difference between current assets and current liabilities. Current liabilities are those cclaimsofoutsiderr that are expected for the payment within the accounting year and include the creditor's bill payable and outstanding expenses.

NNetworkingcapital = current assets –current liabilities

CAPITAL BUDGETING

Capital budgeting is the process that a business uses to determine which~~ propos~~ed fixed asset purchases it should accept, and which should be declined. This process is used to create a quantitative view of each proposed fixed asset investment, thereby giving a rational basis for making a judgment.

Capital Budgeting Methods

There are several methods commonly used to evaluate fixed assets under a formal capital budgeting system. The more important ones are:

i. Net present value analysis:

A Sophisticated capital budgeting; is founded by subtracting a project's initial investment from the present value of its cash inflows discounted at a rate equal to the firm's cost of capital.

NPV= Present value of cash inflows- Initial InvestmentDecision

Criteria:

- If the NPV is greater than $0, accept the project.
- IF the NPV is less than $0, reject the project.

ii. Internal Rate of Return:

The discount rate that equates the NPV of an investment opportunity with $0 (because the present value of cash inflows equals the initialinvestment) is the rate of return that the firm will earn if it will invest in the project and receive the given cash inflows.

Decision Criteria:

If the IRR is greater than the Cost of Capital, accept the project.If the IRR is less than the Cost of Capital, reject the project.

iii. Profitability Index:

A variation of the NPV rue is called the profitability index (PI).

Decision Criteria:

If the PI is greater than one, that implies that the present value of cash inflows is greater than cash outflows.The Importance of Capital Budgeting:

The amount of cash involved in a fixed asset investment may be so large that it could lead to the bankruptcy of a firm if the investment fails. Consequently, capital budgeting is a mandatory activity for larger fixed asset proposals. This is less of an issue for smaller investments; in these latter cases, it is better to streamline the capital budgeting process substantially, so that the focus is more on getting the investments made as expeditiously as possible; by doing so, the operations of profit centers are not hindered by the analysis of their fixed asset proposals.

BANK CREDIT -TYPES AND SOURCES

- CREDIT INSTITUTIONS:

Credit institutions are defined in Article 4(1) of Directive 2006/48/EC as undertaking “whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account”. Bank is an example of credit institution.

- BANK:

An organization where people and businesses can invest or borrow money, change it to foreign money, etc.

Commercial Banks and other credit institutions play very important role in financing of business and facilitating trade, and big majority of world trade relies on bank credits and other financial instruments.

Credit management is one of the most important functions of any commercial bank. It acknowledge as one of the main sources of income for a bank and constitutes most portions of the bank’s assets.

TYPES AND SOURCES OF BANK

- TYPES OF CREDIT:
- **HBL small business finance:**

✓ FEATURES

- Financing up to PKR 10 million.
- Demand finance facility up to 70% of the assessed value of your property.
- Affordable installments/mark up.
- Running finance and Guarantee facilities renewable every year.
- Demand finance facility up to 3 years.

    - SEASONAL FINANCE:

HBL seasonal finance caters to the financing needs of Flour mills, cotton Ginning mills, Rice husking, Oilseed and pulses (dal) processing mills based on past performance and installed capacity.

✓ FEATURES:

- Cash finance and Running finance facility to meet working capital needs.
- Adjustment of facilities over a specified time frame.
- Competitive mark-up rates.
- Any other requirement which the bank may deem necessary from time to time.

    - HBL BUSINESS FINANCE:

Today’s business are dynamic and fast paced. At HBL, we recognize the need for quick and convention financing facility that can cater to their financial needs . with HBL business finance ,small and medium sized businesses can now avail financing of up to PKR 25.0 Million .

FEATURES:

- Complete financing package for meeting working capital , trade, guarantees and businessexpansion needs of your business .
- Financing up to PKR 25.0 Million .
- Quick and convenient processing.
- Competitive mark up /installments rates and processing fee .
- No stock insurance is required

- OTHER TYPES OF CREDIT:

Financing facility for storage of Agricultural produce (FFSAP):

- PURPOSE:

To encourage private sector for establishment / expansion / BMR of silos, warehouse & cold storages for storing agriculture produce. Cost of civil work up to 65% is also eligible under the scheme.

- FINANCING SCHEME FOR RENEWABLE ENERGY:
- **Purpose:**
  Financing is availing to address challenge of energy shortages and climate change through promotion Of renewable energy . scheme is available under three categories:

✓ **Long term financing facility (LTFF) for plant & machinery:**

  - PURPOSE:

For local purchase and import of new plant , machinery , equipment and generator / captive power plantto promote export led industrial growth in the country.

  - REFINANCE & CREDIT GUARANTEE SCHEME FOR WOMEN ENTREPRENEURS :
- **Purpose :**

To improve access to finance for women entrepreneurs in the under served areas of the country for setting up new businesses or expansion of existing business .

SOURCES OF CREDIT

- DEPOSITS:

Bank create their finance from deposit they collect from customers. By charging bank service fee and investing these deposits.

- STATE BANK:

Bank also take loan from SB for their proper functioning. They also take loan from SB for opening their new branches.

- RESERVE FUNDS:

Bank reserves are a commercial Bank's cash holdings, that are physically held by the bank and deposits held in the bank's account with the central bank .

The source for credit and borrowing that comes to one's mind is commercial banks. And there are no two opinions that these are the first and best sources of funding all over the world. In addition to providing credit to businesses for trade and manufacturing and to various service providers, they also provide creditto individuals in the form of personal loans, student loans, automobile loans, home financing, etc.Financial institutions are dedicated credit companies that work just for disbursing credit.

- CREDIT CARDS:

Credit cards are a very common source of credit. The card-issuing bank or company pays the seller on behalf of the buyer. The credit cardholder has to then return this amount within a specific period of time.

Credit Appraisal :

Credit appraisal is the process by which a lender /banker appraises the technical feasibility, economic viability and bankability including creditworthiness of the prospectiveborrower for a loan.

"A GOOD THING, WELL BEGUN, IS HALF DONE"

Just like every bank charges different rates for different loan from different customers, in the same way, each bank has its own set criteria that one must satisfy to qualify as a certifiedborrower of money /assess from the bank.

All bank have their own rules to decide the Credit worthiness of thor borrower.

WHAT ARE CREDIT SCORING AND CREDIT RATING?

Bankers talk about Credit scoring and Credit Rating in the same breath. Therefore, it isimportant to clarify the difference between Credit scoring and Credit Rating.

CREDIT SCORING :

Is the a statistical technique that combine several pre determined characteristic to froma single score to assess a borrowers Credit worthiness.

The score allocated to any application is the sum of the appropriate weight given by thevalue that the Included characteristic take for that application.

CREDIT RATING :

On the other hand is based more on the experience And judgment of the Credit officerand you financial indicators as key.

The objective of scoring uses a retail lending approach to Credit screening /decision making and is recommended for smaller ticket size loan where adequate reliable financial dataabout the borrowers is not available.

Credit Rating on the other hand is more appropriate tool for larger, mid segment orcorporate loans which have relevant financial data bussines plans that provide the basis forfurther Credit analysis and information.

SIDBI has developed software for Credit Appraisal called the Credit Appraisal and Rating tool(CART). With this software, loan proposal can be appraised on any electronic platform. This will also generate the Rating of the proposal so as to decide on the pricing.

Criteria for Credit Appraisal

- income of applicants and co application
- age of applicants
- education qualification
- profession
- Experience
- Tax history
- Assets of applicants and their financing pattern
- Recurring liabilities
- Additional sources of income

THE 3 METHOD USED TO ARRIVE AT ELIGIBILITY:

1.INSTALLMENT TO INCOME RATIO (IIR)

The ratio is generally expressed as a percentage. This percentage the portion of the customers monthly Installment on the home loan taken. Usually banks use 33.33 per cent to 40 per cent ratio. This is because it is has been observed that under normal circumstances, a person can pay an Installment up to 33.33 to 40 per cent of his salary toward a loan.

2. FIXED OBLIGATION TO INCOME RATIO(FOIR)

This ratio signifies the important of the regularity in the repayment of previous loans. In this calculationthe bank considers the Installments of all other loan already availed of the customer and still due including the home loan applied for. In other words this ratio Includes all the fixed obligation that the borrower is supposed to pay regularly on a monthly basis to any bank.

3. LOAN TO CASH RATIO (LOCR)

This ratio is used by banks to calculate the loan amount that an applicants is eligible to pay on the basisof the total cost of the property. This ratio set the upper limit or the maximum loan that a person is eligible for irrespective of the loan eligibility under any other Criteria.

- PREPARATION OF CLP

There are following step of clp.

STEP 1.SUBMISSION OF LOAN APPLICATION,:

The financial institution require that an entrepreneur seeking financing assistance should furnish detail information about the project in a prescribed from the borrower sub its an application from that seeks comprehensive information about the project.

STEP II. INITIAL PROCESSING OF LOAN APPLICATION :

When the application is received an officer of the institution reviews it to ascertain whether it is completefor processing on the basic of the flash report it is decided whether the project justifies a detailed appraisalor not.

STEP III: APPRAISAL OF THE PROPOSE PROJECT.

The detailed appraisal of the project covers the marketing, technical, financial, management and economic aspects. The Appraisal memorandum is normally prepared within two months after site inspection. Based on that a decisions is taken whether the project will be accepted or not.

STEP IV:ISSUE OF THE LETTER OF SANCTION.

If the project is accepted, a financial letter of sanction is issues to the borrower. This communicates to theborrower is assistance sanctioned and the term and condition relating thereto.

STEP V :ACCEPTANCE OF THE TERMS AND CONDITION BY BORROWING UNIT.

On received the letter of sanction from the financial institution the borrower unit convenes its board Meeting at which the term and condition associated with the letter of sanction are accepted and an appropriate resolution is passed to that effect. The acceptance of the term and condition has to be conveyto the financial institution within stipulated period.

STEP VI:EXECUTION OF LOAN AGREEMENT.

The financial institution after receiving the letter of acceptance from the borrower sends the draft of theagreement to the borrower to be executed by the authorized person and properly stamped as per the India stamp act 1899.

STEP VII:DISBURESMENT OF LAON.

Periodically, the borrower is required to submit information on the physical progress of the project, financial status of the project, and fulfilment of the pre disbursement condition.

STEP VII:CREATION OF SECURITY.

The term loans and the deferred payment guarantee assistance provide by the financial institution are secure through the first page mortgage, by way deposit of title deeds of immovable properties and hypothecation of movable properties.

STEP IX:MONITORING.

Monitoring of the project is done at the implementation stage as well as the operational stage. During theimplementation stage, the project is monitored through.

- Periodic site visits
- Audited account of the company
- Progress reports submitted by the nominee director.
- Discussion with promoters, Bankers, suppliers, Crediors, and other connect with the project.

The most important aspects of Monitoring of course is the recovery OD dues represented by interest andprincipal repayment. This is a worthy but elusive goal.

ASSESSMENT OF CREDIT FACTOR RISK.

There are following principals of assessment of credit factor risk.

- PRINCIPAL 1. BOARD OF DIRECTOR :

The board of director should have responsibility for approving and Periodically reviewing the Credit riskand significant Credit risk policies of the bank . The strategy should reflect the bank for risk and the level of probability the bank expect to achieve for incurring various Credit risk.

- PRINCIPAL II. SENIOR MANAGEMENT :

Senior management should have responsibility for implementation the Credit risk strategy approved by the board of director and for developing policies and procedure for identifying measuring, Monitoring and controlling Credit risk. Such policies and procedure should address Credit risk in all of the bank Activities and at both the individual Credit and portfolio level.

- PRINCIPAL III. PRODUCTS AND ACTIVITIES :

Banks should identify and manager Credit risk inherent an all products and Activities. Banks should ensure that the risk of products and Activities new in them are subject I adequate procedure and control before being introduced or under taken and approved in advance by the director of its appropriate committee.

- PRINCIPAL VI. CREDIT GRANTING CRITERIA:

Banks must operate under sound well defined Credit GRANTING Criteria. These Criteria should include a through understanding of the borrower or counterparty as well as purpose and structure of the Credit and its sources of the payment.

- PRINCIPAL V. CLEARLY ESTABLISHED PROCESS :

Banks should have a CLEARLY ESTABLISHED process in place for approving new Credit as the extension ofexisting Credit.

Analysis of credit INFORMATION

INTRODUCTION:

CREDIT ANALYSIS IS THE METHOD BY WHICH ONE CALCULATES THE CREDITWORTHINESS OF A BUSINESS OR ORGANIZATION. IN OTHER WORDS, IT IS THE EVALUATION OF THE ABILITY OF A COMPANY TO HONOR ITS FINANCIAL OBLIGATIONS. THE AUDITED FINANCIAL STATEMENTS OF A LARGE COMPANY MIGHT BE ANALYZED WHEN IT ISSUES OR HAS ISSUED BONDS.

DEFINITION:

CREDIT ANALYSIS EVALUATES THE RISKINESS OF DEBT INSTRUMENTS ISSUED BY COMPANIES OR ENTITIES TO MEASURE THE ENTITY'S ABILITY TO MEET ITS OBLIGATIONS. THE CREDIT ANALYSIS SEEKS TO IDENTIFY THE APPROPRIATE LEVEL OF DEFAULT RISK ASSOCIATED WITH INVESTING IN THAT PARTICULAR ENTITY.

THE THREE FACTORS THAT LENDERS USE TO QUANTIFY CREDIT RISK INCLUDE THE PROBABILITY OF DEFAULT, LOSS GIVEN DEFAULT, AND EXPOSURE AT DEFAULT THE AIM OF THE CREDIT ANALYSIS IS TO DETERMINE THE CORRECT LEVEL OF DEFAULT RISK ASSOCIATED WITH INVESTING IN THAT PARTICULAR ENTITY.

TO JUDGE A COMPANY'S ABILITY TO PAY ITS DEBT, BANKS, BOND INVESTORS, AND ANALYSTS CONDUCT CREDIT ANALYSIS ON THE COMPANY. USING FINANCIAL RATIOS, CASH FLOW ANALYSIS, TREND ANALYSIS, AND FINANCIAL PROJECTIONS, AN ANALYST CAN EVALUATE A FIRM'S ABILITY TO PAY ITS OBLIGATIONS. A REVIEW OF CREDIT SCORES AND ANY COLLATERAL IS ALSO USED TO CALCULATE THE CREDITWORTHINESS OF A BUSINESS.

THE OUTCOME OF THE CREDIT ANALYSIS WILL DETERMINE WHAT RISK RATING TO ASSIGN THE DEBT ISSUER OR BORROWER. THE RISK RATING, IN TURN, DETERMINES WHETHER TO EXTEND CREDIT OR LOAN MONEY TO THE BORROWING ENTITY AND, IF SO, THE AMOUNT TO LEND.

EXAMPLE

CREDIT ANALYSIS EXAMPLE

AN EXAMPLE OF A FINANCIAL RATIO USED IN CREDIT ANALYSIS IS THE DEBT SERVICE COVERAGE RATIO (DSCR). THE DSCR IS A MEASURE OF THE LEVEL OF CASH FLOW AVAILABLE TO PAY CURRENT DEBT OBLIGATIONS, SUCH AS INTEREST, PRINCIPAL, AND LEASE PAYMENTS. A DEBT SERVICE COVERAGE RATIO BELOW 1 INDICATE A CASG FLOW

<u>Financial factors</u>

Introduction

Financial factors consist of revenue ,expenditure,operating position,debts structure,unfunded liabilities,and the condition of Capital plant.

Definition

"A factor is an intermediary agent that provides cash or financing to companies by purchasing their account receivable".

Types of Financial Factors

• Account receivable

• Net income

• Working capital

• Sales activity

• Fixed assets

• Operating environment

Financial Factors in education

• Government

• Contribution

• Student enrollment

• Student support

• Facilities

• Programming renewal

• Income generating strartegies

Factors influence financial decisions

• Financial decisions are influenced by the nature of the business

• Size of business

• Legal form of arganization

• Business cycle

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NON FINANCIAL FACTORS

Definition

Non-financial factors including **quality of services**, the flexibility of a company, utilization of resources, and market orientation are regarded as significant determinants that enhance the profitability-based performance of a service company or a hotel.

Non-Financial Factors

Following are these Non-Financial factors.

- Quality of service
- Flexibility of a company
- Utilization of resources
- Market orientation
- Managerial Ownership
- Government Ownership
- Independent Board of Commissioner

Quality of service

Credit management is **extending payment terms to customers and all of them pay their invoices on time**, within the terms and conditions.

Flexibility of a company

Flexibility in the workplace means **being able to quickly adapt to new circumstances as they arise**. An employee who is flexible can change their plans to navigate or overcome unanticipated obstacles.

Utilization of resources

Resource utilization is **a KPI that measures performance and effort over an amount of available time (or capacity)**. Optimal resource utilization allows project managers to foresee resource availability across multiple categories.

Market orientation

Market orientation is **an approach to business that prioritizes identifying the needs and desires of consumers and creating products**

WHAT IS FINANCIAL STATEMENT ANALYSIS?

"FINANCIAL STATEMENT ANALYSIS A PROCESS OF ANALZING COMPANY FINANCIAL STATEMEANT FOR DECISION MAKING PROCESS .FINANCIAL STATEMENT ANALYSIS IS USED BY INTERNAL AND EXTERNAL STAKEHOLDER TO EVALUTE BUSINESS PERFORMANCE AND VALUE" .

EXTERNAL SHAREHOLDER USE IT TO UNDERSTAND OVERALL HEALTH OF AN ORGANIZATION AS WELL AS TO EVALUTE FINANCAIL PERFORMANCE AND BUSINESS VALUE. **INTERNAL SHAREHOLDER** USE IT AS A MONITORING TOOL FOR MANAGING THE FINANACE .

THE FINANCIAL STATEMENT OF THE COMPANY RECORD IMPORTANAT FINANCIAL DATA ON EVERY ASPECT OF THE BUSINESS ACTIVITIES .AS SUCH THEY CAN BE EVALUATED ON THE BASIS OF PAST CURRENT AND PROJECTED PERFORMANCE..

OBJECTIVE OF FINANCIAL STATEMENT ANALYSIS

- To know the current position of the company.
- For future decision making.
- Minimize the chances of fraud.
- Provide information for economic decision.
- Provide information about finanacial position ,performance of an interprise, and changing in financial position .

TECHNIQUES OF FINANCIALSTATEMENT ANALYSIS

Several techniques are commonly used as part of financial statement analysis. Three of the most important techniques include **Horizontal analysis**, **Vertical analysis**, and **Ratio analysis**.

- ***Horizontal analysis*** is used in the review of a company's financial statements over multiple periods.
- ***Vertical analysis*** is a method of financial statement analysis in which each line item is listed as a percentage of the base figure within the statement .
- ***Ratio analysis*** compares line-item data from a company's financial statements to reveal insights regarding profitability, liquidity, operational efficiency, and solvency. Ratio analysis can mark how a company is performing over time, while comparing a company to another within the same industry or sector.

TYPES OF FINANCIAL STATEMANT ANALYSIS

There are four types of financial statement analysis:

- BALANCE SHEET
- INCOME STATEMENT
- CASH FLOW STATEMENT
- STATEMENT OF SHAREHOLDERS 'S EQUITY

BALANCE SHEET provides detailed information about a compPany's assets liabilities and shareholders equity.
INCOME STATEMENT is a report that shows how much revenue a company earned over a specific time period .
CASH FLOW STATEMENT report a company,s inflow and outflow of cash.
STATEMENT OF SHAREHOLDERS 'S EQUITY details about the change within the equity section of the balance sheet over a designated period of time .

Explain Various principles and forms of lending?

Lending:

Lending *refers to the process when an entity or individual person gives away its recourses to another entity or individual persons as per predefined mutual terms.*

OR

Lending is the process of giving money by a resource surplus entity/person to resource deficit person/entity on commercial terms or non-commercial terms based on mutual understanding.

Principles of lending:

- *Liquidity*
- *Safety*
- *Diversity*
- *Stability*
- *Profitability*

Liquidity:

Liquidity is an important principle of bank lending. Bank lend for short periods only because they lend public money which can be withdrawn at any time by depositors. They, therefore, advance loans on the security of such assets which are easily marketable and convertible into cash at a short notice.

A bank chooses such securities in its investment portfolio which possess sufficient liquidity. It is essential because if the bank needs cash to meet the urgent requirements of its customers, it should be in a position to sell some of the securities at a very short notice without disturbing their market prices much. There are certain securities such as central, state and local government bonds which are easily saleable without affecting their market prices.

Safety:

The safety of funds lent is another principle of lending. Safety means that the borrower should be able to repay the loan and interest in time at regular intervals without default. The repayment of the loan depends upon the nature of security, the character of the borrower, his capacity to repay and his financial standing.

Like other investment bank investments involves risk but the degree of risk varies with the type of the securities of the central govt. are safer than those of the state govt. and local bodies.

Diversity:

In choosing its investment portfolio, a commercial bank should follow the principle of diversity. It should not invest its surplus funds in a particular type of security but in different types of securities. It should choose *the shares and debentures of different types of industries situated in different regions of the country. The same principle should be followed in the case of state governments and local bodies.*

The principle of diversity also applies to the advancing of loans to varied types of firms, industries, businesses and trades. A bank should follow the maxim: "Do not keep all eggs in one ko basket."

Stability:

Another important principle of a bank's investment policy should be to invest in those stocks and securities which possess a high degree of stability in their prices. The bank cannot afford any loss on the value of its securities. It should, therefore, invest it funds in the shares of reputed companies where the possibility of decline in their prices is remote.

Government bonds and debentures of companies carry fixed rates of interest. Their value changes with changes in the market rate of interest. But the bank is forced to liquidate a portion of them to meet its requirements of cash in cash of financial crisis. Otherwise, they run to their full term of 10 years or more and changes in the market rate of interest do not affect them much. Thus bank investments in debentures and bonds are more stable than in the shares of companies.

Profitability:

This should be the chief principle of investment. A bank should only invest if it earn sufficient profit from it. It should, therefore, invest in such securities which was sure a fair and stable return on the funds invested. The earning capacity of securities and shares depends upon the interest rate and the dividend rate and the tax benefits they carry.

It is largely the government securities of the centre, state and local bodies that largely carry the exemption of their interest from taxes. The bank should invest more in such securities rather than in the shares of new companies which also carry tax exemption. This is because shares of new companies are not safe investments.

Forms of lending

- *Cash Finance (Cash Credit)*
- *Overdraft*
- *Loans (Term Finance)*
- *Purchase and Discounting of Bills*
- *Hire-purchase and Leasing Finance*

Cash finance (cash credit):

A Cash Credit is a very common form of borrowing by commercial and industrial concerns, and it is made available either against pledge or hypothecation of Good. In cash finance, a borrower is allowed to borrow money upto a certain limit, either at once or as and when required. The borrower prefer this form of lending due to the Facility of paying markup or service charges only on the amount he actually utilizes.

Overdraft:

The overdraft allows the account holder to continue withdrawing money even when the account has no funds in it or has insufficient funds to cover the amount of the withdrawal. Basically, an overdraft means that the bank allows customers to borrow a set amount of money.

Loan (term finance):

A term loan provides borrowers with a lump sum of cash upfront in exchange for specific borrowing terms. Borrowers agree to pay their lenders a fixed amount over a certain repayment schedule with

Hire purchase and leasing finance:

Sometimes an intending purchaser has no money sufficient to purchase a certain Transport vehicle, machinery, computers or Other durable consumer goods. Therefore, banks provide finance to hire Purchase or lease the needed goods.

Purchase and discounting of bills:

The banker advances money on the security of Bills of exchange after deducting a certain

Percentage, technically known as 'discount', from the face value of the bill.

- *Documentary bills of exchange*
- *Clean bills of exchange*
- *Demand bills of exchange*
- *Usance bills of exchange*

When discounting, the banks deduct amount at mentioned discount rate and balance is paid to the Party.

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DETERMINATION OF COLLATERAL RESOURCES

WHAT IS COLLATERAL?

Collateral is an asset or property that an individual or entity offers to a lender as security for a loan. It is used as a way to obtain a loan, acting as a protection against potential loss for the lender should the borrower default in his payments. In such an event, the collateral becomes the property of the lender to compensate for the unreturned borrowed money.

For example, if a person wants to take out a loan from the bank, he may use his car or the title of a piece of property as collateral. If he fails to repay the loan, the collateral may be seized by the bank based on the two parties' agreement. If the borrower has finished paying back his loan, then the collateral is returned to his possession.

Types of Collateral

In order to be able to take out a loan successfully, every business owner or individual should know the different types of collateral that can be used when borrowing.

1. Real estate

The most common type of collateral used by borrowers is real estate, such as one's home or a parcel of land. Such properties come with a high value and low depreciation. However, it can also be risky because if the property is sequestered due to a default, it cannot any longer be taken back.

2. Cash secured loan

Cash is another common type of collateral because it works very simply. An individual can take a loan from the bank where he maintains active accounts, and in the event of a default, the bank can liquidate his accounts in order to recoup the borrowed money.

3. Inventory financing

This involves inventory that serves as the collateral for a loan. Should a default happen, the items listed in the inventory can be sold by the lender to recoup its loss.

4. Invoice collateral

Invoices are one of the types of collateral used by small businesses, wherein invoices to customers of the business that are still outstanding – unpaid – are used as collateral.

5. Blanket liens

This involves the use of a lien, which is a legal claim allowing a lender to dispose of the assets of a business that is in default on a loan.

BORROWING WITHOUT COLLATERAL

Not all loans require collateral, especially if the borrower doesn't have any property to offer. In such a case, there are several ways to borrow money, including:

1. Unsecured loans

From the name itself, unsecured loans don't give the lender any form of assurance or protection that the money will be returned. However, they usually involve relatively smaller amounts than what might be loaned against collateral. Examples of unsecured loans include credit card debts.

2. Online loans

With the advancement of technology, there are many more ways to get a loan. In fact, people can now obtain online loans that don't require collateral and are often approved quickly. After filling out an application form, the lender will let the applicant know if he or she is approved, how much the loan amount is, the interest rate, and how the payments are supposed to be made.

3. Using a co-maker or co-signer

These types of loans don't require property for collateral. Instead, another individual besides the borrower co-signs the loan. If the borrower defaults, the co-signer is obliged to pay the loan. Lenders prefer co-signers with a higher credit rating than the borrower. A co-signed loan is often one way an individual without established credit can begin to establish a credit history.

COLLATERAL VS. SECURITY

Collateral and security are two terms that often confuse people who think the terms are completely synonymous. In fact, the two concepts are different. The differences are explained below:

- Collateral is any property or asset that is given by a borrower to a lender in order to secure a loan. It serves as an assurance that the lender will not suffer a significant loss. Securities, on the other hand, refer specifically to financial

assets (such as stock shares) that are used as collateral. Using securities when taking out a loan is called securities-based lending.
- Collateral can be the title of a parcel of land, a car, or a house and lot, while securities are things such as bonds, futures, swaps, options, and stocks.
- Collateral, or at least the ownership title to it, stays with the lender throughout the time the borrower is paying the loan. Securities, on the other hand, allow the borrower to benefit from both the loan and the securities portfolio even while the loan is still being paid back because the securities portfolio remains under the borrower's control. However, the lender assumes a greater risk because the value of the securities may fluctuate substantially.

ADDITIONAL RESOURCES

Thank you for reading CFI's explanation of collateral. To keep advancing your career, the additional CFI resources below will be useful:

- Loan Covenant
- Senior and Subordinated Debt
- Short Term Loan
- Top Banks in the USA

. MODES OF CREATING CHANGES ON SECURITIES

COMMERCIAL VS. BANK CREDIT

It will be seen that the most important function of a commercial bank is the creation of credit money—a function which overshadows all other banking functions.

Credit creation or money creation refers to the power of the banks to expand or contract demand deposits through the process of more loans, advances and investments.

Some writers express the view that a bank could never lend more than the amount deposited by the depositors; this may be partially true.

But it is also true that whatever is lent out by a bank may come back by way of new deposits, which may be lent out again and so on, a deposit becoming a loan which again returns to the bank as a deposit and becomes the basis for a new loan and so on.

A commercial bank, therefore, has been aptly described as a 'factory of credit', which is able to multiply loans and investments and hence deposits. With a little cash at the disposal they are able to create additional purchasing power to a considerable degree. It is in this sense that banks create credit. An increase in bank credit will, therefore, mean multiplication of bank deposits.

There are mainly two ways of creating credit money by a commercial bank:
(a) By giving a loan, and

(b) By purchase of securities.

(a) By giving a loan:
Let us assume an isolated community having no foreign trade relations and only one bank where everybody keeps an account; further no cash circulates and transactions are settled by cheques. Bankers know that all the currency that depositors withdraw soon returns to the bank. They also know that all depositors will not withdraw all deposits at the same time. From experience

they have learnt that if they just keep about 20% of their total demand deposits in cash reserves, they will have enough to meet all demands for cash.

Suppose an ordinary borrower goes to the bank for a loan of Rs. 1,000. After being convinced of the solvency of the borrower and the safety of the loan in his hands, the bank will advance a loan of Rs. 1,000 not by handing over cash or gold to the borrower, but by opening an account in his name. If the borrower, already has an account, he will be allowed an overdraft to the extent of Rs. 1,000.

Thus, the most usual method of making a loan is merely to credit the account of the borrower with Rs. 1,000. The borrower will then draw cheques on the bank while making purchases. Those who receive the cheques deposit them with the banks in their own accounts. Therefore, a bank loan of Rs. 1,000 has resulted in deposits of Rs. 1,000. The point to be noted and understand is that loans are made by creating a deposit.

When a person deposits Rs. 1,000 with a bank, the bank does not keep the entire cash but only a certain percentage (say 20%) of it to meet the day-to-day cash obligations. Thus, the bank keeps Rs. 200 and lends to another person B, Rs. 800 by opening a credit account in his name. Again, keeping 20% to meet B's obligations, the bank advances the rest Rs. 640 to C ; further keeping 20% to meet C's obligations the bank advances Rs. 512 to D and so on, till Rs. 1,000 are completely exhausted.

Thus, an original deposit of Rs. 1,000 leads to additional deposits of Rs. 800 plus Rs. 640 plus Rs. 512 plus Rs. 409, plus Rs. 328 and so on. By adding up all the deposits we get total Rs. 5,000. It is clear, therefore, that the total amount of credit creation will be the reverse of the cash reserve ratio. Here cash reserve ratio has been assumed to be 20% or 1/2, therefore, the credit is Rs. 5,000 i.e., live times the original deposit of Rs. 1,000. Although, we have assumed one bank, yet the credit creation will take place when there are many banks.

It is clear that the main limitation on credit creation is the reserve ratio of cash to credit. Therefore, the amount of credit that a system of banking can create depends upon the reserve ratio. The banks can multiply a given amount of cash to many times of credit. If the public would demand no cash, credit would go on expanding indefinitely. But the reserve ratio is a sort of leakage from the Stream of credit creation.

We can, thus, think of a credit creation multiplier. The higher the reserve ratio, the smaller is the credit creation multiplier. In our example above, with an original deposit of Rs. 1,000 the bank was in a position to create credit of Rs. 5,000. The credit creation multiplier is obviously 5(Rs 5,000/Rs,1,000)

(b) By purchase of securities:

Making loan is not the only way in which deposits can be created. Sometimes, banks buy securities at the Stock Exchange and also buy real assets. When the bank does so, it does not pay the sellers in cash, rather it credits the amount of the price of the security or assets to the accounts of the sellers. The bank, therefore, creates a deposit with it.

It does not matter whether the seller of securities or property is a customer of the purchasing bank or not, as the seller is bound to deposit the cheques he receives in one of the banks. The purchase of security by any banker is bound to increase the deposits either of his own bank or of some other bank, in any case, the deposits of the banking system as a whole.