Credit Management

Credit management by commercial banks is a part of banking activities of normal course where banks constitute as a largest group of financial intermediaries. There are two core activities of commercial banks one to accept deposits and second to give loans and advances. The deposits are liabilities for any bank as these are required to be paid back to customers either on demand or on completion of a term.

Whereas credit and advances made by banks are their financial Assets. But banks' credit has to be productive and must contribute to the generation of the borrower's income and also towards increasing the rate of growth of the economy as a whole.

Banks mobilize deposits to contribute to gross national product through their different kind of deposit schemes. About 60% of these funds are deployed as bank credit in various sectors of economy.

Thus deposit mobilization and credit dispensation are the two most important functions of commercial banks. In a way, these banks are the trustees of the savings and idle funds of the society. How efficiently they are able to discharge this responsibility depends largely upon the quality of their credit portfolio.

Credit Management refers to the process of providing credit, recovering credit on the due date and also formulating a credit policy for a company or organization. Credit Management is one of the techniques in order to manage the bad debts of the company in an efficient manner. Usually the credit period consist of the 15 days to 60 days and in some case even 90 days. Firm's credit policy is decided based on the investment a firm does in account receivable.

Advantages of Credit Management

- Increase in cash conversion or cash inflow.
- Low bad debts.
- Increase in profitability.
- Increase in liquidity.
- Helps to increase production level and lower the cost.
- Builds Credit Rating and brand reputation.
- Efficient management of working capital.

Principles of Credit Management

Credit management plays a vital role in the banking sector. As we all know bank is one of the major sources of lending capital. So, Banks follow the following principles for lending capital:

Liquidity

Liquidity plays a major role when a bank is into lending money. Usually, banks give money for short duration of time. This is because the money they lend is public money. This money can be withdrawn by the depositor at any point of time.

So, to avoid this chaos, banks lend loans after the loan seeker produces enough security of assets which can be easily marketable and transformable to cash in a short period of time. A bank is in possession to take over these produced assets if the borrower fails to repay the loan amount after some interval of time as decided

Safety

The second most important function of lending is safety, safety of funds lent. Safety means that the borrower should be in a position to repay the loan and interest at regular durations of time without any fail. The repayment of the loan relies on the nature of security and the potential of the borrower to repay the loan.

Unlike all other investments, bank investments are risk-prone. The intensity of risk differs according to the type of security. Securities of the central government are safer when compared to the securities of the state governments and local bodies. Similarly, the securities of state government and local bodies are much safer when compared to the securities of industrial concerns.

This variation is due to the fact that the resources acquired by the central government are much higher as compared to resourced held by the state and local governments. It is also higher than the industrial concerns.

Diversity

While selecting an investment portfolio, a commercial bank should abide by the principle of diversity. It should never invest its total funds in a specific type of securities; it should prefer investing in different types of securities.

It should select the shares and debentures of various industries located in different parts of the country. In case of state governments and local governing bodies, same principle should be abided to. Diversification basically targets at reducing risk of the investment portfolio of a bank.

The principle of diversity is applicable to the advancing of loans to different types of firms, industries, factories, businesses and markets. A bank should abide by the maxim that is “Do not keep all eggs in one basket.” It should distribute its risks by lending loans to different trades and companies in different parts of the country.

Stability

Another essential principle of a bank’s investment policy is stability. A bank should prefer investing in those stocks and securities which hold a high degree of stability in their costs. Any bank cannot incur any loss on the rate of its securities. So it should always invest funds in the shares of branded companies where the probability of decline in their rate is less.

Government contracts and debentures of industries carry fixed costs of interest. Their cost varies with variation in the market rate of interest. But the bank is bound to liquidate a part of them to satisfy its needs of cash whenever stuck by a financial crisis.

Profitability

This should be the chief principle of investment. A bank should only invest if it earns sufficient profits from it. Thus, it should, invest in securities that have a fair and stable return on the funds invested. The procuring capacity of securities and shares relies on the interest rate and the dividend rate and the tax benefits they hold.

Broadly, it is the securities of government branches like the government at the center, state and local bodies that hugely carry the exception of their interest from taxes. A bank should prefer investing in these types of securities instead of investing in the shares of new companies which also carry tax exception. This is due to the fact that shares of new companies are not considered as safe investments.

Objectives of Credit Management

Managing Risk

All lenders must reduce their risk of loan loss. Credit risk management is the most difficult potential loan loss to prevent. Borrowers with consistently poor credit reports or excellent credit scores allow lenders to make easier approval and rejection decisions. However, prospective borrowers with a mix of on-time payments and late payments create credit risk management challenges for lenders.

Procedures

Lenders design lending pricing, policies and procedures for employees to achieve credit-risk objectives. Based on borrower credit scores, procedures advise bank employees how to process and price loan applications to reduce credit risks. Banks often instruct lending staff to approve or reject applicants based on their credit scores. For example, lender procedures may give loan officers permission to approve loans at higher than market interest rates for borrowers with credit problems that increase loan risk.

Credit Risk and Customer Satisfaction

Balancing credit risk and superior customer service often requires approving applications while changing loan terms, such as increasing down payments or interest rates, to manage risk and increase loan security. Since banks do not want to appear to be restrictive, increasing interest rates or down payments can achieve credit risk management objectives, while maintaining customer satisfaction. Balancing credit risk objectives and customer loan approvals, adjusted for increased risk, can achieve reasonable risk and customer satisfaction.

Fiduciary Responsibility

Lenders have a fiduciary responsibility to stockholders (banks) and members (credit unions) to make the safest operational, financial and risk decisions at all times. Conservative credit risk management is critical to exercising appropriate fiduciary responsibility. Adhering to conservative credit risk policies better protects loan portfolios and satisfies stockholders, management and customers, while proving to federal or state regulators that the lender is exercising effective fiduciary responsibility.

Credit Risk Equals Financial Risk

Just as banks must avoid financial risk with their investments and cash security measures, they must establish credit risk policies that minimize loan losses. Credit risk can impact both the lending and the financial areas of banks and credit unions. Loan losses occur at every bank; however, mismanaged credit risk can lead to excessive loan problems, inevitably damaging the financial condition of financial institutions. Properly managing credit risk, along with improving the earnings of the loan portfolio, can prevent excessive financial damage.