

**TOPIC: DIFFERENT PRINCIPLES OF SOUND LENDING**

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## **Different Principles of Sound Lending**

Following are the different principles of sound lending, highlighting their significance and practical implications.

### **1. Creditworthiness Assessment**

The foundation of sound lending lies in evaluating the creditworthiness of potential borrowers. Creditworthiness refers to the ability and willingness of a borrower to repay the borrowed amount. Lenders utilize various financial and non-financial factors to assess creditworthiness, including credit history, income stability, employment status, debt-to-income ratio, and the purpose of the loan.

A thorough assessment helps lenders gauge the risk associated with the borrower and make informed decisions regarding loan approval, interest rates, and repayment terms.

### **2. Principle of Adequate Collateral**

Collateral serves as a safety net for lenders in case a borrower defaults on their loan obligations. Sound lending involves ensuring that the value of the collateral pledged by the borrower is sufficient to cover the outstanding debt in case of default.

This principle helps mitigate the risk of financial loss for lenders and encourages borrowers to take their repayment obligations seriously.

### **3. Interest Rate Determination**

Interest rates play a pivotal role in lending transactions. Lenders must set interest rates that are not only competitive but also reflective of the risk involved.

**The riskier the borrower**, the higher the interest rate is likely to be.

**Sound lending principles** dictate that interest rates should be fair and transparent, ensuring that borrowers understand the cost of borrowing and can make informed decisions.

### **4. Liquidity**

The second important golden rule of the grant loan is liquidity. Liquidity means the possibility of converting loans into cash without loss of time and money.

Needless to say, the funds with the bank out of which he lends money are payable on demand or short notice.

As such a bank cannot effort to block its funds for a long time. **Hence**, the bank should lend only to short-term requirements like working capital. The bank cannot and should not lend for long-term requirements, like fixed capital.

## 5. Return or Profitability

It is another important principle. The funds of the bank should be invested to earn the highest return, so that it may pay a reasonable rate of interest to its customers on their deposits, reasonably good salaries to its employees, and a good return to its shareholders.

**However**, a bank should not sacrifice either safety or liquidity to earn a high rate of interest. Of course, if safety and liquidity in a particular case are equal, the banker should lend its funds to a person who offers a higher rate of interest.

## 6. Diversification

One should not put all his eggs in one basket is a proverb that very clearly explains this principle. A bank should not invest all its funds in one industry. In case that industry fails, the banker will not be able to recover his loans.

**Hence**, the bank may also fail. According to the principle of diversification, the bank should diversify its investments in different industries and should give loans to different borrowers in one industry.

It is less probable that all the borrowers and industries will fail at one and at the same time.

## 7. Object of Loan

A banker should thoroughly examine the object for which his client is taking loans. This will enable the bank to assess the safety and liquidity of its investment. A banker should not grant loans for unproductive purposes or to buy fixed assets.

The bank may grant loans to meet working capital requirements.

**However**, after the nationalization of banks, the banks have started granting loans to meet loan term requirements. As per prudent banking policy, it is not desirable because of term lending by banks a large number of banks had failed in Germany.

## 8. Safety and Security

The most important golden rule for granting loans is the safety of funds. The main reason for this is that the very existence of the bank is dependent upon the loans granted by him. In case the bank does not get back the loans granted by it, it might fail. A bank cannot and must not sacrifice the safety of its fund to get a higher rate of interest.

A banker should grant secured loans only. In case the borrower fails to return the loan, the banker may recover his loan after realizing the securing. In the case of unsecured loans, the

chances of bad debts will be very high. However, the bank may have to relax the condition of security in order to comply with the economic policy of the government.

## **9. Loan Diversification**

Diversification is a key risk management strategy in lending. Lenders should avoid concentrating their loan portfolio on a single sector or industry. **Instead**, they should diversify their lending across various sectors and borrowers to reduce the impact of economic fluctuations on their portfolio. This principle helps maintain stability in the face of unforeseen challenges that may affect specific industries or regions.

## **10. Loan Repayment Structure**

The repayment structure of a loan is designed to align with the borrower's cash flow and financial capacity. Sound lending involves tailoring repayment schedules to match the borrower's income stream, ensuring that they can comfortably meet their repayment obligations.

**Flexible repayment options**, such as grace periods and step-up or step-down repayment plans, may be considered to accommodate borrowers' changing financial circumstances.

## **11. Transparency and Disclosure**

Transparent communication is crucial in lending transactions. Lenders are bound by sound lending principles to provide borrowers with clear and comprehensive information about the terms and conditions of the loan.

This includes details about interest rates, fees, repayment schedules, and potential penalties. Transparency helps borrowers understand their financial commitments and prevents any potential misunderstandings.

## **12. Sustainability Assessment:**

Lending decisions have broader economic and social implications. Sound lending principles extend to evaluating the sustainability of the projects or activities for which borrowers are seeking financing. Lenders may assess the environmental, social, and governance (ESG) impact of projects to ensure that the borrowed funds are being used responsibly and contribute positively to the overall well-being of society.

### **13. Margin Money**

In the case of secured loans, the bank should carefully examine and value the security. There should be a sufficient margin between the number of loans and the value of the security. If an adequate margin is not maintained, the loan might become unsecured in case the borrower fails to pay the interest and return the loan.

The amount of the loan should not exceed 60 to 70% of the value of the security. If the value of the security is falling, the bank should demand further security without delay.

In case a person fails to do so, the loan might become unsecured and the bank has to suffer a loss on account of bad debt.

### **14. National Interest**

Banks were nationalized in India to have social control over them. As such, they are required to invest a certain percentage of loans and advances in priority sectors, viz, agriculture, small scale, and tiny sector, and export-oriented industries, etc. Again, the Reserve Bank also gives directives in this respect to the scheduled banks from time to time.

The banks are under obligation to comply with those directives.

### **15. The Character of the Borrower**

Last, but not least, the bank should carefully examine the character of the borrower. principles of sound lending Character implies honesty, integrity, creditworthiness, and the capacity of the borrower to return the loan. In case a person fails to verify the character of the borrower, the loans and advances might become bad debts for the bank.

### **16. Stress Testing**

Stress testing is a risk management practice that involves assessing how a lending portfolio would perform under adverse economic scenarios. By subjecting their portfolios to hypothetical stressors like economic recessions or interest rate hikes, lenders can identify vulnerabilities and develop contingency plans. Sound lending institutions regularly conduct stress tests to ensure their resilience in the face of unexpected challenges.

## **17. Regulatory Compliance**

The financial industry is heavily regulated to maintain stability and protect both lenders and borrowers. Sound lending principles encompass strict adherence to regulatory requirements and guidelines. Lenders must ensure that their lending practices align with legal frameworks governing interest rates, consumer protection, anti-money laundering, and other relevant aspects of lending.

## **18. Continuous Monitoring and Review**

Sound lending is an ongoing process that extends beyond loan origination. Lenders should establish mechanisms for continuous monitoring and review of the borrower's financial health and adherence to repayment schedules. Proactive monitoring allows lenders to identify early signs of distress and take appropriate actions to prevent defaults or minimize losses.

## **19. Risk Management**

Risk is an inherent part of lending. Sound lending principles emphasize the importance of robust risk management strategies. Lenders must identify, assess, and manage various risks, including credit risk, market risk, liquidity risk, and operational risk. Adequate risk management practices help lenders maintain stability and ensure their ability to fulfill their obligations even during challenging times.

## **20. Ethical Lending Practices**

Ethics and integrity are integral to sound lending. Lenders are expected to uphold ethical standards and treat borrowers with fairness, respect, and dignity. This includes avoiding predatory lending practices, such as excessive interest rates or hidden fees, which can exploit vulnerable borrowers. Ethical lending practices contribute to the overall reputation and credibility of the financial institution.

## **21. Borrower Education and Support**

Empowering borrowers with financial education and support is a vital principle of sound lending. Lenders should not only provide funds but also educate borrowers about responsible borrowing practices, budgeting, and managing debt. Offering guidance and resources can help borrowers make well-informed decisions and improve their financial literacy.

Additionally, providing a supportive environment for borrowers facing financial difficulties can lead to better outcomes for both parties, as it increases the likelihood of successful repayment and long-term financial stability.