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“Five Basic Principles of Lending”

OR

What is the Consideration Which a Banker Has to Keep in View before Employment of its funds?

Basically there are 5 basic principles which are observed by a lender while granting credit. These are as follows

1. Safety:

Bank has not got his own money; He uses the public money to advance loans and to earn profits there from. So a banker must realize the need of safety in this procedure. A wrong decision while granting credit may be extremely dangerous for the future life of bank. The money which a banker is going to lend has been deposited by the public just because of the trust they have on the bank. If that trust is deteriorated in any sense, the bank may collapse. Therefore the banker must be very careful and must take all possible steps to ensure that loans advanced are safe in terms of the repayment and usage. In order to ensure safety, the banker observes the 3C's which have been discussed in previous question.

2. Liquidity:

As the depositor has the right that he can withdraw his money either in lump sum or in installments according to the nature of accounts so a banker must ensure that banks funds, loans and advances remain liquid. Blockage of bank funds for an extraordinary longer, time may cause difficulties in paying back the money to depositors. For this caution bank usually do not advance loans to small borrowers for the purchase of fixed assets. Because in such a case the liquidity is no more present and the borrower would not be able to repay the loan when the banker wants so.

3. Dispersal:

The dispersal principle has the same logic as that of business continuations. Business combination is made so that if one business is under a loss, profits from others will keep the businessmen firm. The banks also advance loans to variety of lines and nature of businesses. They simultaneously advance loans to housing, financing, fisheries, industry, agriculture, retail shops, construction companies etc. The logic being that if a particular industry is overtaken by depression the revenue or interest from others can compensate the bank and keep it running. The dispersal principle ensures security and reduces the risks of recovery.

4. Remuneration:

The banks not only receive interest but they are also bound to pay interest to depositors in their deposits. Further they have to pay salaries, overheads expenses, rent of premises etc. They have also to accumulate sufficient reserve to meet contingent liabilities and unexpected losses. Further, dividends to shareholders are also to be paid. All these expenditures are to be met from the only source of income i.e. interest in the loans advanced. So a banker needs a

situation in which returns and remuneration are healthy and predictable. A banker has to think on fronts first the risk of having a bad two debts in future, second the earnings or interest receivable. So in order to have sound course of business, a banker should preferably advance a loan where remuneration are high as compared to risk involved.

5. Suitability:

Suitability refers to the presumption that loans advanced must not be profitable for the banker only, but they also watch with the national development plans and programmers. The macro-effect of loans advanced to a particular sector shall also be taken into account and government priority policy regarding a particular sector should also be followed.

Conclusion:

These are the five basic principles that are observed by all bankers while granting. A loan. The observer of these principles makes the lending decision easy and opera table.