

DAF II · COURSE UNIT: BANKING OPERATIONS

CREDIT MANAGEMENT

Diploma in Accounting and Finance

SEMESTER ONE · AY 2026/2027

By the end of this topic, students should be able to:

- 01** Define credit management and explain its objectives in banking.
- 02** State and explain the main principles of sound lending.
- 03** Apply the 5 Cs of credit when assessing a borrower's creditworthiness.
- 04** Distinguish between the different types of credit facilities.
- 05** Explain the concept of Non-Performing Loans and outline basic recovery methods.

What is Credit Management?

Credit management refers to the systematic process by which a bank plans, organises, controls and monitors the extension of credit (loans and advances) to customers, with the aim of maximising returns while keeping the risk of default within acceptable limits.



It covers the entire credit cycle; from receiving a loan application to final recovery or closure of the account.



In simple terms, credit management helps a bank lend money safely and profitably while protecting the interests of depositors.

Objectives of Credit Management

To ensure that funds lent out are recovered in full, together with interest, within the agreed period.

To comply with regulatory requirements set by the central bank and other supervisory bodies.

To maintain a high-quality loan portfolio and minimise the level of non-performing loans.

To protect depositors' funds, since loans are largely financed from customer deposits.

To achieve an optimal balance between profitability and risk.

To support prudent growth of the loan book in line with the bank's strategic objectives.

Principles of Sound Lending

1. Safety

The primary concern is that the loan will be repaid. The bank must be satisfied that the borrower has both the ability and the willingness to repay. Safety of depositors' funds comes first.

2. Liquidity

Loans should be repayable within a reasonable period so that the bank can convert them into cash when needed to meet deposit withdrawals. Short-term loans are generally more liquid than long-term loans.

3. Profitability

Lending must generate adequate interest and fee income to cover the cost of funds, operating expenses and the risk of possible losses, while contributing to the bank's profit.

Principles of Sound Lending

4. Purpose

Funds should be used for productive and legitimate purposes (e.g., business expansion, working capital, asset purchase). Speculative or illegal use of funds must be avoided.

5. Security (Collateral)

Wherever possible, loans should be backed by adequate security (assets pledged by the borrower). Security acts as a secondary source of repayment if the primary cash flow fails.

6. Diversification (Risk Spread)

Banks should avoid concentrating loans in one borrower, industry or geographic area. Spreading risk reduces the impact of any single default.

Types of Loans

Term Loans

Medium- to long-term loans for purchase of fixed assets (machinery, buildings, vehicles). Repayable in instalments over a fixed period.

Working Capital Facilities

Cash Credit / Overdraft – Short-term revolving facilities to finance day-to-day operations (inventory, receivables). Interest is charged on the utilised amount.

Overdrafts

Short-term facility allowing a customer to withdraw beyond account balance.

Retail Loans

Personal loans, vehicle loans, education loans and credit cards granted to individuals.

Mortgage Loans

Long-term finance for purchase or construction of property.

What is Credit Appraisal?

Credit appraisal is the process of evaluating a loan application to determine the creditworthiness of a borrower — that is, the borrower's capacity and willingness to repay the facility as agreed. It is the single most important stage in the credit process, since most credit losses can be traced back to inadequate appraisal.



Key purpose

To ensure that only creditworthy borrowers receive facilities and that the risk of default is properly assessed before funds are released.



Outcome of good appraisal

A high-quality loan portfolio, lower non-performing loans, and protection of depositors' funds.

The 5 Cs of Credit

1. Character

Refers to the borrower's integrity, honesty and willingness to repay. Banks examine past repayment history, credit bureau reports (e.g., CIBIL score), references and reputation of the management or individual.

2. Capacity

Measures the ability to generate sufficient cash flow to service the debt. Key indicators include income stability, debt-service coverage ratio (DSCR), and cash-flow projections. Capacity is often considered the most important quantitative factor.

3. Capital

Represents the borrower's own financial stake (equity or net worth). A higher capital contribution shows commitment and provides a cushion against losses. Banks prefer borrowers who have "skin in the game".

The 5 Cs of Credit

4. Collateral

Assets pledged as security for the loan. Primary security is the asset being financed; collateral security is additional cover. Collateral reduces the bank's loss if the borrower defaults.

5. Conditions

External factors that may affect repayment — economic conditions, industry outlook, interest rates, regulatory environment and competition. Banks assess whether the loan remains viable under different scenarios.

Management of Non-Performing Loans (NPLs)

A Non-Performing Loan is a loan or advance where the borrower has failed to pay interest or principal for a specified period (generally 90 days or more). NPLs stop generating income for the bank and require provisioning, which affects profitability.

Common Causes of NPLs

- Poor credit appraisal and inadequate assessment of the borrower; The bank approves a loan without properly checking the borrower's ability and willingness to repay so uncreditworthy borrowers get credit they can't pay back.
- Inadequate monitoring after disbursement; Once the money is released, the bank fails to follow up and early warning signs about possible default go unnoticed by the bank
- Poor business management or diversion of loan funds; Even a sound/good loan can fail if the borrower runs the business badly (weak planning, high costs, poor record-keeping) or uses the money for something other than the agreed purpose, such as personal spending or unrelated ventures..
- Economic downturn or industry-specific problems; External factors beyond the borrower's control can hurt repayment: recession, inflation, currency depreciation, high interest rates, droughts, price collapses, or regulatory changes affecting a particular sector. Sales and incomes fall, and borrowers who were previously performing begin to default.
- Students can identify other factors

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Methods of Recovery

- **Reminders and follow-up;** The bank contacts the borrower through calls, SMS, letters, and visits to remind them of overdue payments and find out why they're late.
- **Restructuring / rescheduling;** If the borrower is willing but struggling, the bank changes the loan terms to make repayment manageable. This may include extending the loan period, lowering installments, granting a grace period, or adjusting the interest rate.
- **Compromise / One-time settlement;** The bank agrees to accept a reduced amount (for example, waiving part of the interest or penalties) as full and final payment, usually in a single lump sum.
- **Enforcement of security;** Where the loan is backed by collateral, the bank takes control of it and sells it to recover the outstanding balance.
- **Legal action;** When other methods fail, the bank sues the borrower or guarantors to obtain a court judgment.
- **Write-off (last resort);** When recovery is judged unlikely, the loan is removed from the bank's balance sheet after full provisioning. This is an accounting action, not forgiveness: the bank can still pursue the borrower and recover later, and any recoveries are recorded as income.

S U M M A R Y

Credit management is a core banking function that ensures funds are lent safely, productively and profitably.

Strong credit management protects depositors, supports bank profitability and contributes to the overall health of the financial system.