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Guidelines for Specifying Credit Terms

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[These guidelines attempt to provide an exhaustive list of the general principles which should be observed by lenders when they fix the terms on which they can provide credit. These include interest, maturity schedules, recovery mechanisms and security requirements, as well as principles for the evaluation of the applicant and his loan application, and the implications of using non-price criteria for allocation of credit. These are couched in terms of the lender's business and the type of relationship he seeks to establish with his customers.]

1. Interest and other fees collected from borrowers should reflect the lender's:
 - a) administrative costs,
 - b) cost of capital,
 - c) risk premium--bad loan losses, and any extraordinary collection expenses excluded from administrative costs above;
 - d) revenues in the form of subsidies or grants as an offset to costs;
 - e) exposure to loss in real loan portfolio value from inflation.

2. The principal amount of a loan should:
 - a) not exceed the incremental investment costs of the undertaking being financed, which may include
 - i) working capital requirements,
 - ii) additions to fixed assets,
 - iii) pre-operating expenses--e. g., development costs, training, trial operations;
 - b) not finance the borrower's profit, but rather be limited to some portion of his costs;
 - c) be fixed at a level which requires equity participation in the loan-supported investment. Too liberal loan support may jeopardize the borrower's commitment to the success of the investment.

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- d) not exceed, after the collection of interest, the borrowers' debt capacity.
3. Loan maturities should:
- a) be scheduled to ensure that principal and interest are recovered during the economic life of the asset or project financed. (Economic life refers to the period in which the use of the asset would be financially remunerative to the owner, assuming a reasonable degree of adversity.)
 - b) be consistent with the constraints imposed on the lender by his capital structure, including the term structure of his liabilities.
4. Debt servicing obligations should:
- a) be established with adequate provision for probable adversity;
 - b) be consistent in timing and in size with the pattern of uncommitted cash flow generated by the undertaking being financed, or the total uncommitted cash flow available to the borrower. (Borrower's uncommitted cash flow refers to the funds available after meeting costs of production, working capital and other expenditures required for normal growth, consumption requirements, the servicing of other debt, and other uses of funds which the borrower considers or could reasonably be expected to consider more important than servicing the proposed loan.)
5. Repayment or collection mechanisms should be efficient in:
- a) ensuring loan recovery;
 - b) being administratively feasible for the lender and the borrower, or for any third party transferring funds to the lender on behalf of the borrower;
 - c) generating responses to situations of greater than expected adversity.
6. Security or collateral requirements:
- a) should diminish the lender's risk;
 - b) should restrict the borrower's access to credit from other sources where repayment obligations to such other sources could impair the borrower's ability to repay the lender taking collateral;
 - c) should be administratively feasible in the sense of
 - i) being economic to administer,
 - ii) permitting realization in the event of non-payment;
 - d) are not a panacea, and may not always be in the lender's best interest.

7. The lender's analysis of the borrower's proposition and situation should:
 - a) focus on the undertaking as a whole, or the borrower's entire financial position, except where the borrower's situation or the undertaking as a whole have no material bearing on the probability of ensuring timely recovery of amounts due for repayment;
 - b) include considerations of those types of adversity which may reasonably be expected to occur over the life of the loan. In agricultural and agroindustrial financing, reasonably expected adversity frequently includes:
 - i) natural elements such as drought, floods, fire, predators, death of the borrower, livestock mortality;
 - ii) institutional elements such as the ability of suppliers to have materials available on time, the ability of the marketing system to absorb output and remain sufficiently solvent to meet its obligations on time, price changes, theft, government intervention;
 - iii) managerial skills of the borrower in relation to the technologies and activities financed by credit;
 - iv) personal elements such as experience with credit, health, attitude, approach to social and familial obligations, political status or vulnerability.
 - c) evaluate the borrower's character and intent with respect to the fulfillment of his obligation to repay the loan.

8. The lender's credit decision criteria and procedural matters should:
 - a) promote efficient credit administration;
 - b) be consistent with long run institutional goals, such as lender survival and expansion;
 - c) not subject the lender to political influence sufficient to overwhelm financial logic;
 - d) ensure that the borrower retains a sufficient share of the gains from the loan-supported investment so that he has a commitment to ensuring the success of the investment;
 - e) be consistent with realistic aspirations of the borrower;
 - f) be conducive to the establishment of a mutually beneficial business relationship between borrower and lender.

[A Note for teaching a course in credit at the Economic Development Institute, World Bank, Washington, D. C. Copyright © 1978, International Bank for Reconstruction and Development.]