MKey anagement of Commercial Banking

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Lecture 31

Management of Lending Activities 1

Good morning. So, after the discussion on the different issues related to the commercial banking like, how the commercial banks function and how the asset liabilities of the commercial banks are managed, particularly to manage the interest rate risk or the concepts of dollar gap, duration gap and as well as the use of the derivatives and other kinds of instruments to manage the interest rate risk in the market.

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We can start the discussion on the measure we can say that item, what the commercial banks always hold that is the Lending Activities. If you remember whenever, we are talking about the assets and liabilities of the commercial bank. So, from the asset side the major asset the commercial bank holds that basically is the bank lendings or we can say that loans and advances.

So, in this particular session will start the discussion on how the lending activities are managed by the commercial banks and what are those different ways the lending activities are managed by that the profit and as well as the other objectives of the commercial banks is maintained. So, this is basically today’s discussion.

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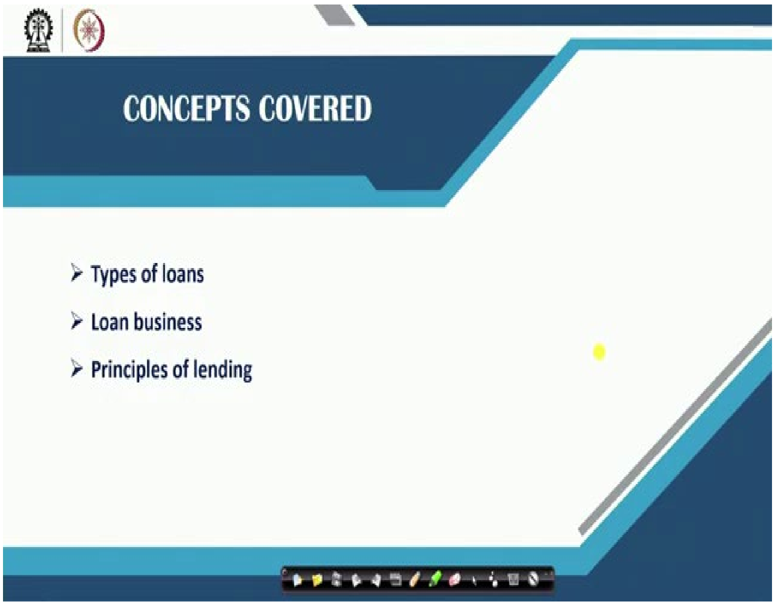

So, in todays session will be covering up the three different issues. One is, what those different types of loans are or the lending activities the commercial banks do, this is number one. And number two is that whenever, you talk about the loan business if you assume that the lending is an activity which all the commercial banks do to maximize the income or the profit.

Then how that particular business condition is there and what are those factors which affect the commercial banks loan business and as well as we have to also see that whenever, the commercial banks provide the loans or the advances then what are those basic principles they always follow or they always keeping the mind whenever the loans are provided.

So, these are the three basic concepts what we are going to discuss in todays session. So, let us see that what exactly the types of the loans the commercial banks provide.

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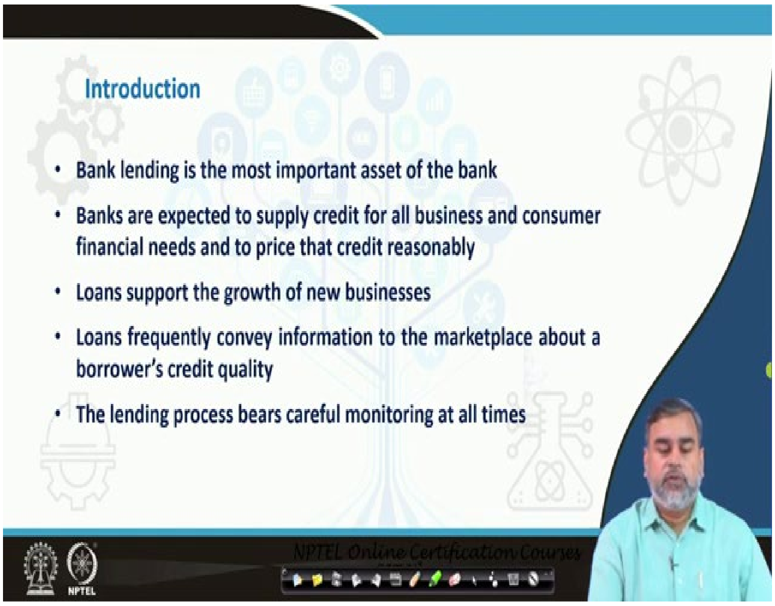

So, before that already you know that the bank lending is one of the most important assets of the commercial bank or from the asset side the proportion of the total assets if you consider the lending has the maximum percentage that basically you can say.

And another thing is banks are always expected to supply the credit for all the business and consumers financial needs and always they try to price that particular asset in such a way by that the business units or the consumers are not filling the burden in that way and in the same time the profit of the commercial banks is managed properly.

So, that is why the banks are always expected to price those assets reasonably by that the profit or the return of that particular loans can be managed and as well as the lender is or maybe the borrower are basically not free though fit. And, another thing that the basic objective of the bank lending is to provide the support for the growth of the new business.

Whenever, any new business any kind of organization or any kind of individual started, so the commercial banks always provide the loans for them or the basic objective of the commercial banks also to expand this particular activities in the commercial sector or the corporate sector.

And, another thing you see that whenever, we are talking about the loans it basically convey the information to the market place about the borrowers credit quality. For example, whenever, any company starts the business all of you know that, the business starts with a particular owners equity or whatever their money they have, we can say that private equity or any kind of capital whatever they have in the beginning.

And if that particular amount of money is not sufficient enough to carry out the business in the future then they always rely upon the different sources and this different sources maybe include the VC funds, the venture capital funds, it also include the investments like equity market or raising the fund from the equity market. But, as well as one of the major sources of the fund is bank capital or we can say that bank borrowings.

So, whenever we talk about the bank for borrowings that it basically people have more trust on those particular aspect our particular kind of resource if the particular organization is using the reasonable amount of high bank borrowings in financing activities then it basically provides that the credit quality of that particular borrower or the borrower's ability to repay this particular loan or whether the borrower is financially sound or not.

So, in that context, it gives a good signal to the investor and as well as other market participants to understand the borrower's ability to pay or whether the borrowers credit worthiness is existing or not that kind of information we get whenever the banks provide more loans to the particular organization. But, one thing is that whenever the banks provide the loan in today's context if you observe that we are facing a bigger problem in terms of the non-performing assets.

So, what is non-performing asset that already all of you know, that non-performing asset is basically a particular asset which does not pay any kind of interest or any kind of principle amount over a reasonable period of time and whenever, we are talking about with reference to India, we can say that the period is basically 3 months. So, if and as already all of you know, that non-performing asset has a very clear cut adverse impact on the total profitability of the commercial banks.

So, to avoid this kind of problem or we can say that to understand that or to always ensure that the particular asset which are basically created by the banks through this lending activities should not be consider as the non-performing asset, (out) or we can say that this particular asset always should generate certain kind of principle and as well as the interest whatever is he involved in that periodical basis by that the profit of the organization or the bank will not be affected.

So, therefore the lending process we can say careful monitoring of all the times. So, whenever the banks provide the loan always bank, monitor that particular lending activities regularly by that, this kind of adverse situation will not arise in the future. So, these are the basic notions or basic concept which are related to the lending activities.

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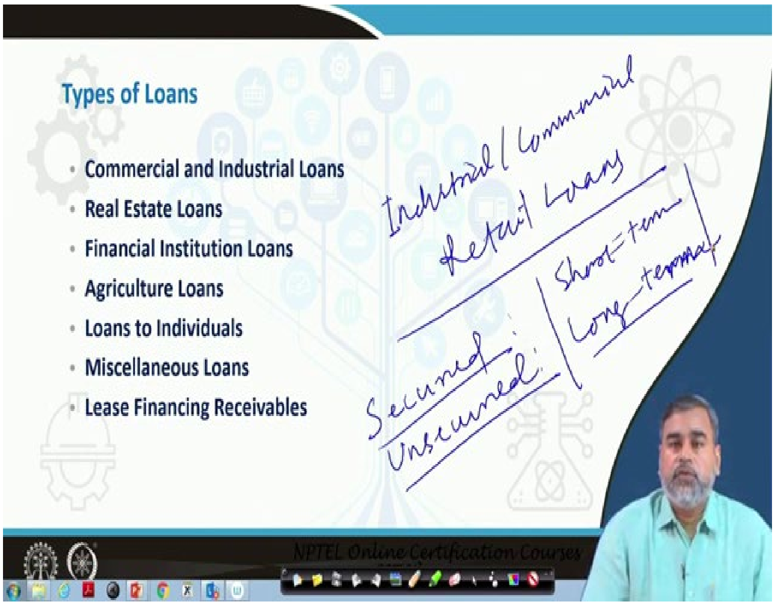

Then, we are coming back to the different type of loans what the commercial banks provide. But if you see broadly what happens that people basically divided into two way, one is industrial loans, industrial or the commercial loans and another we can define it the retail loans.

And out of all those loans some of the loans are given for the different activities like some loans are given to the real estate market, but we can name it the real estate loans, some of the banks provide the loans to another banks or other financial institutions that is why you consider it the financial institution loans. And also most of the cases generally loans are provided for the development of the priority sector and out of them the most important sector is agriculture sector.

And, that is why we can sub-categorize that particular loan as the agricultural loans, loans to the individuals and also the lease financing receivables also consider as a loan. There are different type of loan personal loan, miscellaneous education loan there are different miscellaneous loans also exists. So, on the basis of the use of that particular loan, the loans are also categorized or the banks provide the loans in that way.

But, one thing you remember whenever, we give the loan some of the loans are secured loans and some of the loans are unsecured loans. So, whenever you talk about the secured loan and unsecured loan, the secured loans are basically those loans which are backed by any kind of mortgages or any kind of collaterals but whenever you talk about the unsecured loan, these loans are not basically backed by the collaterals.

And this loans basically are given by the bank by expecting that this particular borrower will repay the loan in the regular basis and he has enough potential or his ability to generate cash flow is quite high. So, because of that it will be, we can say that convenient for him to repay that loan in the periodical basis.

So, in this context, what we can say that broadly whether, it is industry loan or whether it is retail loan or what kind of loaned it is. So, on the basis of the characteristics, the loans also can be defined in these two ways. One is secured and another one the unsecured and the secured loans are backed by any kind of collaterals and unsecured loans are not.

So, this is the way the different type of loans are provided to the different customers on the basis of the different objectives. Some people also define the loan as short-term loans on the basis of the term to maturity, short-term loans and the long-term loans or the term loans what we call it.

So, the short-term and long-term loans already by definition or by name, you know that the particular short-term loans the term to maturity period is very short, generally we can go up to 1 year and some cases people consider the 3 years loans are also considered as a short-term loan. But whenever, you talk or the long-term loan or the term loans in particular, which is popularly known as, so their maturity period is reasonably high or we can say that more than 3 years, it can be 10 years, 15 years, 20 years like that.

So, these are basically considered as the term loans. So, the loans can be defined on the basis of the purpose. The loans can be defined on the basis of their characteristics, like whether it is backed by the asset or not backed by the asset or it also can be categorized as on the basis of the term to maturity like weather is the short-term loan or it is a long-term loan.

So, this is the way the different types of loans which are offered by the commercial banks to the different entities over the period of time to fulfil certain objectives and as well as to increase their asset quality, or we can say that maximize their revenue.

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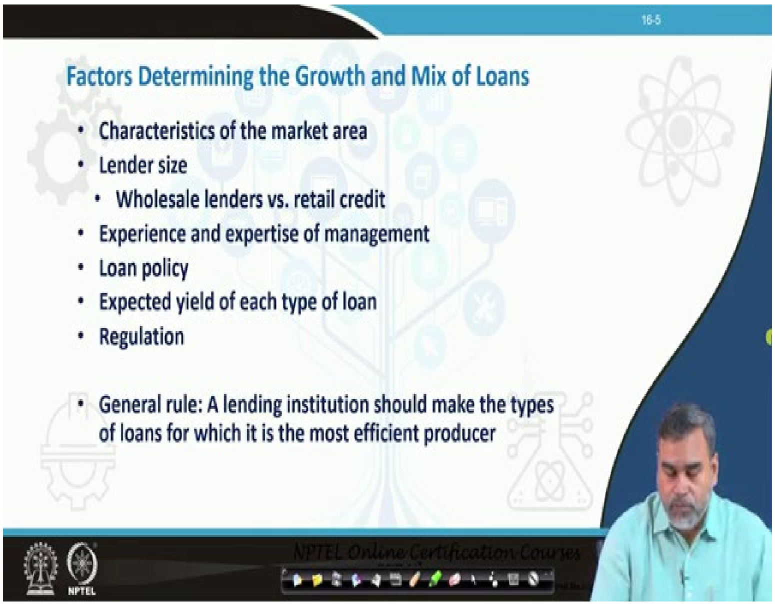

Whenever, you talk about the different type of loans like real estate loans, you have the consumer loans, you have the house loans, you have the other kind of short-term and long-term loans, what we have discussed just now. How the banks basically maintain, how basically banks maintain their mix?

Because it is not that the banks provide only one type of loans to the different customers. So, on the basis of the requirements of the demand from the customer side there is a proper mix they always maintained within this particular organization. Then, what are those factors which are responsible for the growth and mix of that particular loan?

First of all, the most important factor is that market. So, in that particular market because, you know that the particular banks are operating in the different conditions, like some of the banks are operated in the metropolitan cities, some of the banks are operating in the rural areas, some of the banks also operating semi-urban areas like that.

And as well as also depending upon the locality the demand of different type of loans since, some of the locality the demand for house loans or more and for some of the locality the commercial, small-scale commercial establishment loans are more. So, like that on the basis of the requirements of that particular market the banks portfolio also changes, particular the loan portfolio changes.

So, the first and foremost important factor is that in which market area the bank is operating and what are the characteristics of that particular market this is number one, number two is the lender sizes. Whatever banks are available in that particular region, whether the particular bank is a wholesale lender, it is a big bank or it is a small bank which can only provide the loans up to particular limit.

We can say that the retail loans only they can provide, they may not be eligible to provide the loan to different bigger commercial establishments or for the corporates for their investments. So, depending upon the land of size also the type of loans differ. So, that is why, we can categorize them as wholesale lenders and the retail credits or little lenders what we can say, then another one is experience and expertise of the banks management.

So, some of the banks are quite experienced to manage the portfolio in such a way that the total return can be maximized with a given amount of risk and that portfolio may not be that much diversified because, over the period of time maybe the banks have gained that kind of ability if the loans are given in to this particular kind of domain then maybe the return will be maximized and as well as the objective of this particular bank can be fulfilled.

So, and some cases the banks which does not have much experience maybe expertise in terms of managing that portfolio, they go by a basic principle of diversification and they want to diversify their particular own portfolio in such a way that in overall risk of that particular portfolio can be minimized.

So, that is why experience and expertise in management is another reason, which affect the mix of that particular different type of loans in the commercial bank. Then the most important thing is loan policy and the loan policies are basically formulated by the top executives or the top, we can say that layer people in the particular bank, particular in the director's level.

And on the basis of the loan policy they basically decide that, how this loans will be dispersed in the different kind of reason or different kind of purpose. So, in that particular context if the loan policy is more biased towards or maybe the particular committee feels that in this bank is eligible or the bank is convenient for this bank to provide more loans to the industrial sector not to the retail sector or it may be, because of housing loan because of the vehicle loan not to the personal loan or other kind of loans.

Then, that also will have the impact on the growth and mix of that particular loans or the portfolio of the total loans of that particular commercial bank. So, the loan policy is quite important and what is the objective of that policy and what is the goal on the basis of the objective and goal the composition of the different kind of assets or different kind of loan what basically the commercial banks provide that change.

And, another most important factor is the expected yield of each type of loan. Obviously some of the loan rates or the price of the loans are not same across the different type of loans what the commercial banks provide.

So, if the price of the loan is not same accordingly, we can say that the demand for loans also will change and as well as from the banking perspective how much return or the yield the particular loan can generate in the future that also is a very crucial factor of the portfolio choice or the asset allocation of the loan portfolio of the commercial bank.

Then, obviously the regulation, because as you know that we will discuss these things further but regulation has a lot of impact on the lending activities with certain objectives. Because most of the cases the bank loans are being converted into non-performing assets and the non-performing high level of non-performing asset has an adverse impact on the profitability and as well as the whole economic condition become unstable.

Because all of you know that the bank is the payment gateway for all type of transactions which are happening in a particular economy. So, in that particular context the regulatory bodies over the period of time from time to time, they device certain policies, certain kind of regulations by that the banking sectors lending activities can be managed in such a way by that the total profit or the objective of that particular thing will not be changed.

So, if you see that from a general thumb rule prospective, a general rule prospective the lending institutions should always make the types of loans for which it is the most efficient producer. So, they have the expertise on different type of loans but they always inclined towards that kind of loan which gives them more return and as well as it will be, they are the most efficient producer of that particular type of loan in that particular point of time.

So because of that this is another rule basically we can formulate, a general rule we can always say that lending institutions always decide the different type of loans on the basis of their efficiency towards that particular type of loans in that particular segment. So, these are the different factors which effect the growth and mix of the loans or we can say that the composition of the loan portfolio of a particular commercial bank.

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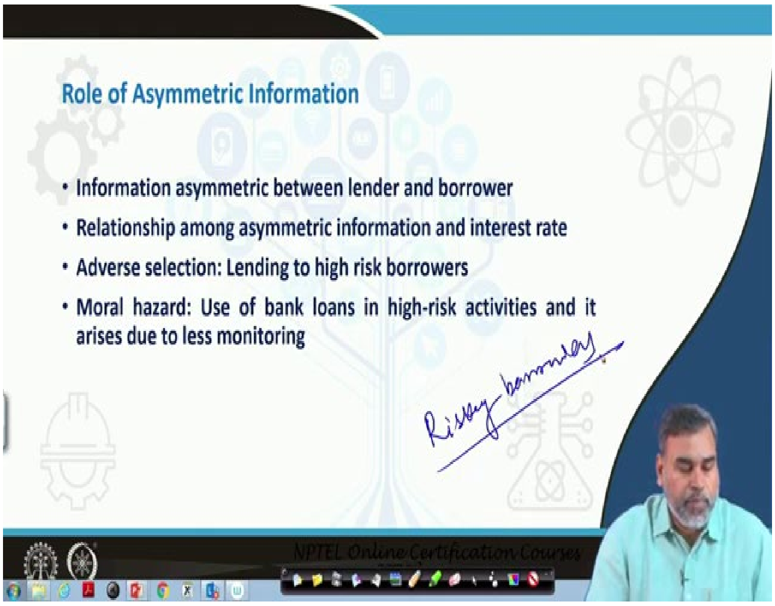

Then, we have you see that whenever, the commercial banks provide the loan, the asymmetric information plays a very significant role. So, in the area of finance and banking if you see that already you know or you might have aware about these things there is always information gap between buyers and sellers. Whatever information the seller has the same information may not be buyer is having.

So, in that particular context what happens that the transaction cost increases or the price increases, so to avoid that particular kind of discrepancy between the information between the buyers and sellers the market mechanism or we can say that the regulators and other bodies always try to reduce that particular gap by the different kind of policy measures and as well as kind of mandatory regulations they impose on that particular aspect.

So, here in the same line, if you see there is always asymmetric information between the lender and the borrower, lender here is the bank borrower is basically can be a company or it can be an individual. So, whenever you talk about this, if you see that if there is asymmetric information then the interest rate increases, because whenever the banks provide the loan he or she whatever loan somebody is taking, bank always needs the information from them in the accurate basis, to assess that particular loan or for pricing of that particular loan.

So, if the bank feels that the information what the bank is getting that is not accurate or all the informations are not basically given by this particular borrower to the bank then what happens that, in that particular point of time bank increases the interest rate. So, the bank will increase the interest rate in the cost of financing of that particular fund increases.

So, again that we have an adverse impact on that organizations profitability because the cost is increasing. So, because of that always we can establish a relationship between asymmetric information and the interest rate fluctuations. So, if it is more asymmetric, the lender and borrower gap is quite large then interest rate will increase. If the interest rate will increase then what will happen that the demand for loans will go down.

And why the demand for loans will go down? Because it may not be possible by the banks always to judge that whatever informations the particular investor or particular kind of borrower is giving that is the information, most information they have shared with them. Maybe, if they have any kind of feeling that there is a gap between the information then the bank always charge the high interest rate.

And that high interest rate may be profitable for the banks, but it is not profitable for the organization who is taking that particular loan. In that particular point of time the demand for loans may go down and which ultimately affect the profitability of the commercial banks. Then obviously, whenever the interest rate increases due to the information gap then the demand for the loans will decline.

If the demand for loans will decline only few borrower will be there who wants to take the loan from the bank. So, we are defying them the risky borrowers. So, this risky borrowers basically what, they may not be complying all kind of information or all kinds of details what the commercial banks need.

But if the bank will relax that criteria then what happens with that high interest rate also, some of the banks are ready to take the loan or some of the organizations are ready to take the loan from them, further which can create the problem because they may not be able to repay the loan and automatically that loan will be converted into non-performing assets.

So that is why, if you are selecting somebody which is adversely or this particular person is not deserve to get that particular loan 100 percent. Then, what happen that it will create an adverse selection problem. If the adverse selection problem is there, then ultimately there will be problem with the moral hazard.

So, what do you mean by moral hazard in this context? The moral hazard is use of the bank loans in high-risk activities and it is arises due to the less monitoring. Sometimes what happens is that whenever the banks have given the loan and how the loan is utilized by somebody it is not basically known to the bank from the beginning, but the particular person has taken the loan for a particular reason.

But what generally people sometimes observe even if the particular organization or particular individual has taken the loan for some particular objective. But, still they do not maintain that objective and they try to use that particular money to generate the profit in the market, the extra profit in the market.

So, in that particular point of time what happens that, if there is a failure then obviously the bank will collapse. But why we call it the moral hazard? Because, there is nothing against this legal aspects of this particular business, but the banks are basically using that instrument is the high-risk activities and obviously, if it is invested in the high-risk activities, there is a probability of high return.

And also there is a probability of loss. So, if really the bank incurs the loss then that basically creates the problem among this for the banks as a whole because, they may not be able to maintain their objectives in terms of profitability and liquidity. So, because of that the moral hazard is another issue what the banks always look at whenever the loans are given or with a condition that the particular interest payment and the principle will be repaid in a particular point of time over the period of time in the periodical basis.

So, these are the different things which arise due to the information asymmetric in the market and the banks are basically always try to reduce that information asymmetric, between the lender and borrower but still if the bank feels that there is information asymmetry, then the cost of loans increases.

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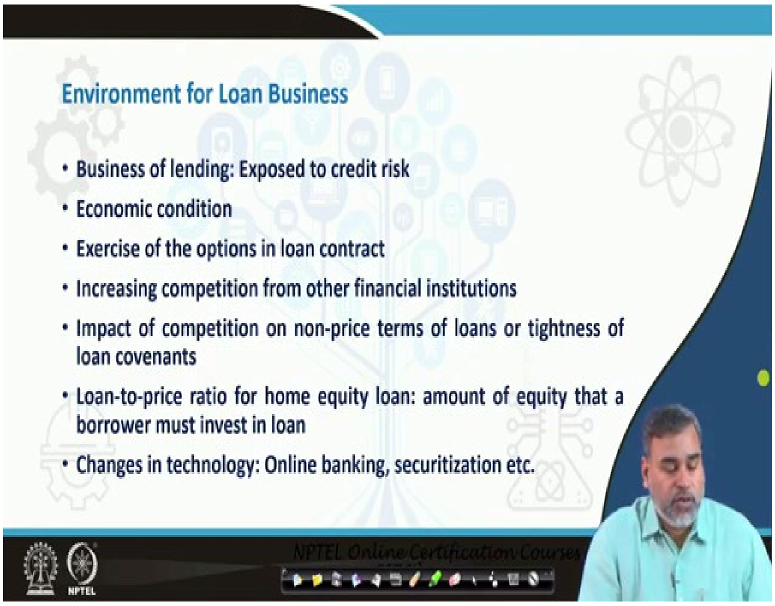

Then, we have the business, whenever you talk about. There are different type of loan business or the talk about the business, loan business market. So, always the business of lending is exposed to credit risk, obviously whenever they have given the loan they are exposed to more credit risk.

They are also getting affected by the economic conditions, because the particular borrower also has affected by the economic condition. If the borrower will go for exercising the call option or the put option whatever, if they are holding any kind of contract or any kind of loan which has some kind of call option or the put option, then also the business of the particular lending activities gets affected.

And there is now, in todays context there is a huge competition from the other non-banking financial organizations. Then also the tightness of the loan covenants, the loan covenants is basically that the where it is not related the mortgage but it is basically related to certain kind of covenants like, if the bank has given the loan then so-and-so organizations cannot invest in this kind of market or they have to provide this information before they go and invest in that particular market.

So, there are certain kind of conditions the bank put in the beginning which basically affect the banks business in the larger extend, then automatically the profit also gets affected by that. So, loans to price ratio is basically kind of example for the home equity loan. So, here the amount of equity that a borrower must invest in the loan that was, if the amount of equity the borrower has invested more, then what you can say that, this particular loan is a better loan.

Because investor has put their own money instead of borrowing that money from the broker or the bank itself. Then, another thing is that the loan business is under todays context is getting affected by the technology like we have online banking, we have securitization and all so, that also affect the loan business and the information gap day by day is reducing.

So, because of that the loan business is a different kind of set of business what we always observe that which is going to affect this particular system as a whole and the loan business sector is getting affected due to the some of the external or exogenous factors just now, whatever we have discussed.

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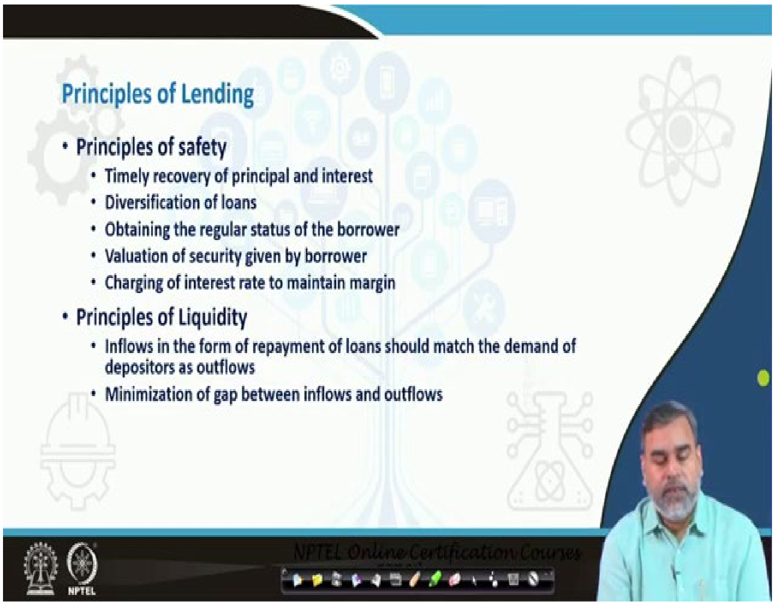

Then, whenever the banks provide lending they follow certain principles. Certain principles also have to be kept in the mind whenever the loans are given to the banks. The first one is the principles of safety. Principles of safety in the sense, there is a timely recovery of principle and interest the banks would get back that.

The loans portfolio should be adequately diversified and there should be a kind of proper monitoring by that, you should obtain the regular status of the borrower, how the borrower is functioning and whether the net asset value of the borrowers is increasing or the other regular cash flow is already happening in that, for that particular borrower.

So, the those kind of regular status of the borrower has to be obtained and the valuation of security given by the borrower, if the borrower has taken the loan with the collateral then what kind of collateral the particular borrower has given and how the particular collaterals value is increasing or decreasing in the market. So, that is why the valuation of security is very much important whenever we provide the lending.

Then, the charging of interest rate to maintain the margin that is another reason, if whenever, we are maintaining the margin of the broker on behalf of the broker we invest on behalf of us broker invest in the market. So, in that particular point of time we have to ensure that, that how this particular margin is maintained and as well as whenever, there is any kind of changes in the market whether this particular margin is sustainable or not.

So, these are the different concentrations in terms of the principles of safety then we have the principles of liquidity already again and again we are discussing liquidity is very important particularly after the emergence of the Basel 3 the importance of the liquidity has further increased. So, we talk about liquidity, we are talking about the liquidity within the bank not the external liquidity.

So, the in terms of internal liquidity, if you see that the inflows in the form of repayment of the loans should match the demand for depositors as outflows. So, that means what do you mean by the liquidity? Liquidity is nothing but, to fulfil the demand for the customers or the depositors, but what basically we have seen that most of the cases the loans are long term, deposits are short term. So, therefore there is a mismatch between the assets and liabilities.

So, to avoid that, we have to ensure that how the inflows in the form of repayment of the loans that means whether the loan repayment is happening regularly or not and if the loan repayment is happening then the demand for depositors as outflows can be honoured or there is a balance can be maintained, between these two.

So, this is basically the objective of the principles of liquidity is to minimize the gap between the inflows and outputs or the outflows. So, the inflows and outflows what is happening with respect to the bank, whenever there is a huge gap between them and that basically creates the problem for the commercial banks to manage their assets and liabilities. So, if really we are going to minimize that, then that kind of situation will not arise and the bank can easily maintain that.

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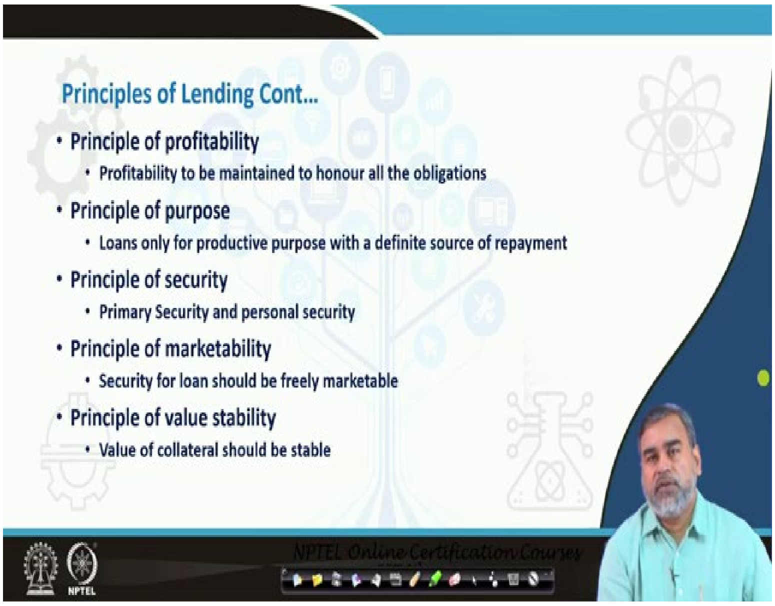

Then, we have the principles of lending in terms of profitability, the profitability has to be maintained and the loan should be sanctioned only on the basis of certain productive use productive purpose and obviously, there is a guarantee that, the definite source of repayment is existing in that particular purpose.

Then, another one is that the different kind of assets which are used are security or the collateral out of them some of the assets are primary security. For example, somebody has taken a vehicle loan. So, the car is the primary security and there are some personal security which is related to the guarantee and all other kind of aspects which is reasonably very low in nature.

But, mostly the primary securities are dominating in the market. Then another one is the principle of marketability, marketability means whatever securities you have given to the bank or collaterals whatever, you have given to the bank the value of that particular collateral should not fluctuate much and it should be easily marketable if there is a requirement.

So, if the bank is going to really liquidated then whatever, securities you have given the bank will be able to sell that particular securities in the market to get back the money by that your loss or banks loss can be avoided.

And also we have to ensure that, the value of the collateral should be stable, stable in the sense we are not answering that, there will be no fluctuations, but, the fluctuations should not be so high or it cannot be so low, by that the particular total revenue generation from that activities will be largely affected.

So, in this context the principle of value of the stability is also quite important in terms of the fluctuations of the price and other things of this particular lending activity. So, these are about the different kind of process or different kind of principles what the commercial banks should follow whenever they are providing the loans to the different customers.

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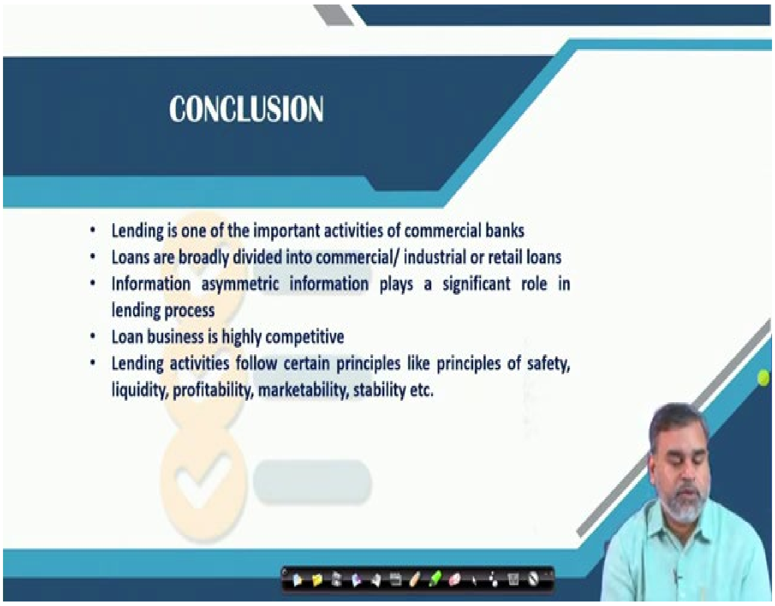

Coming to the conclusion, what we find that lending is one of the most important activities of the commercial bank. Loans can be commercial, it can be industrial, it can be secured can be unsecured. Information asymmetric plays a significant role in the lending process between the borrower and the lender.

Loan business is highly competitive, lending activity follows certain principles like, principles of safety liquidity, profitability, marketability, stability, etc. By that the profit and liquidity of the banks can be properly manage and as well as the other type of risk can be reduced by proper diversification of the different type of portfolio.

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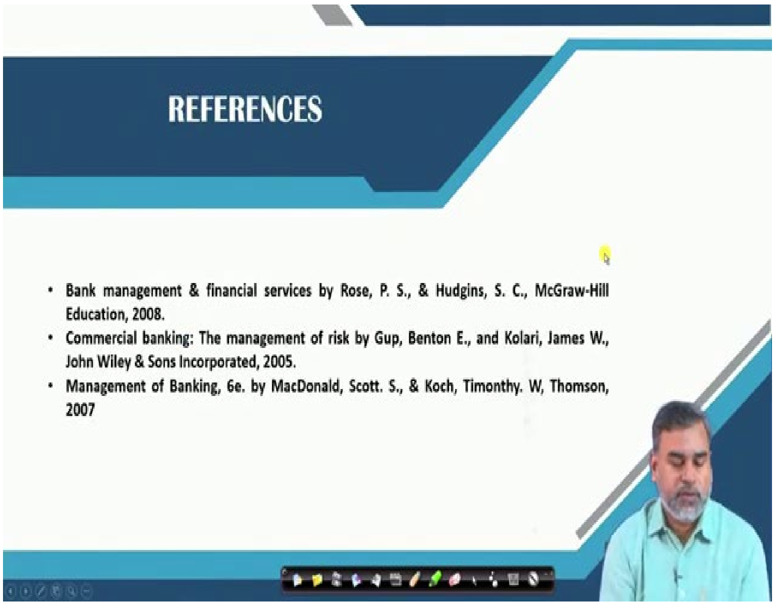

So, these are the different references you can go through in detail and thank you.