Management of Commercial Banking
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Lecture 32
Management of Lending Activities 2

In the previous class, we started the discussion on the Management of Lending Activities. There we have seen that, the banks provide the different type of loans and the loans can be categorized on the basis of their purpose or on the basis of the terms to maturity or on the basis of the secured or unsecured, which is basically nothing but generally basis of the characteristics.

And as well as we have seen that the commercial banks should follow certain principles, while providing the loans to the different entities.

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And todays discussion or todays session we will discuss about certain other issues related to that, because already we said that, the lending activities of the banks are highly regulated, why it is regulated? Because, the lending activities is a risky business of the commercial bank and that particular business is also highly competitive.

And as well as the varieties of the loans which are existing in the market that is also another factor which is creating the complexity in managing this loan portfolio of the commercial banks. So, and again already if you know that, the commercial banks are the backbone of the financial system or which is very much required for the economic growth process.

So, keeping all these things in the mind, the lending activities of the banks should be highly regulated or there is a probability that maybe, the market can be failure or there is the competition, due to the competition, due to the different asymmetric information there is a probability of the failure. To avoid that particular failure the regulation is very much important for the lending activities of the commercial bank.

And already we said that because of that whenever we are providing any kind of lending every commercial banks follows a particular loan policy and that loan policy has to be made in such a way that, the objective of the commercial banks is properly maintained. Will see that, how this loan policy of the commercial banks are made.

Then the proper lending process, whatever lending process the commercial banks follow and how this lending process basically works in the system. So, these are the three different issues or different concepts, what basically will be discussing in the todays session.

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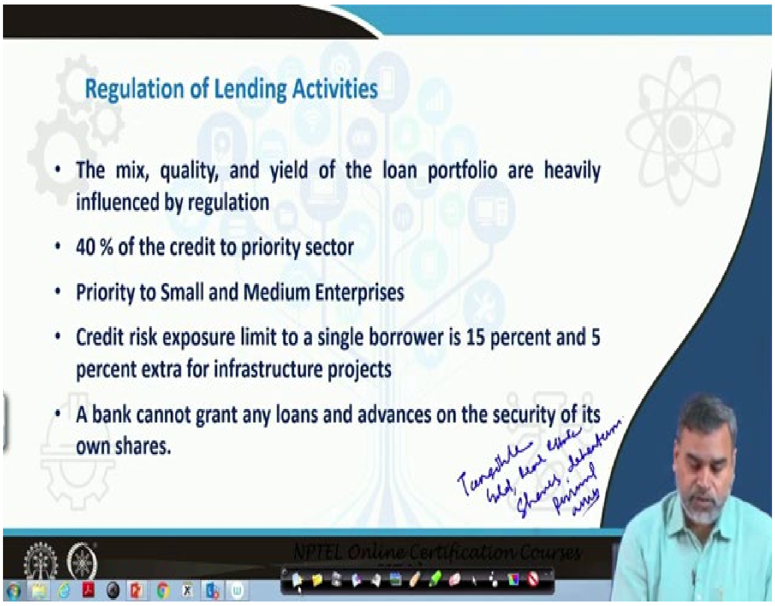

If you see that whenever, you talk about the lending activities regulations or how the regulation basically plays a role or what kind of regulations are related to the lending activities of the commercial banks, you see that whenever you talk about the regulation the mix, the quality, the yield of the loan portfolio are heavily influenced by the regulation.

Because the commercial banks are not completely free to use their money or to use that particular deposits whatever they have for different kind of loan activities. So, they have certain kind of restrictions and the restrictions are made by the regulator with certain objectives to help the society at a large to make this particular banking sector more stable or to avoid any kind of market failure and all these things.

So, out of all kind of regulations if you see that the 40 percent if you talk about the India, the Reserve Bank of India has put a cap that at least 40 percent of the total bank credit or the bank lending should be given to the priority sector and the priority sector includes the agricultural sector, the small and medium enterprises, the cottage industry all kinds of things.

Where, the small-scale industries are being boosted with certain kind of incentives or the banks are basically bound to provide the loans to them and out of the total loans what they are, they can provide out of them the 40 percent should be disbursed to the priority sectors. And, in todays context if you see the more priorities are given to the small and medium enterprises for the development of the industry.

Then another regulation if you see on the basis of the Basel norms, the commercial banks basically always try to maintain their exposure, particular the credit risk exposure and here according to that the credit risk exposure limit to a single borrower is 15 percent, single borrower for any kind of purpose is 15 percent.

But, if it is infrastructure projects, then the 5 percent extra can be given or maximum it can go up to 20 percent. So, the entity which is taking the loan, that if you calculate the credit risk exposure towards that particular loan, it should be 15 percent for any kind of business loans, what the commercial banks are giving, but if the loans are giving to the infrastructure projects, then this particular exposure can be enhanced to 15+ 5 that is 20 percent.

And, there are many regulations also are made on the basis of the do's and don'ts with respect to the governance structure. So, in this context if you talk about the Indian commercial banks, the bank cannot grant any loans or advances on the security of its own sets. Because the loans can be given against any kind of collateral and the collaterals can be anything.

The collaterals can be any kind of tangible assets like gold, real estate etc or it can be also given against the financial assets like shares, debentures etc or also the loan can be given also against other kind of assets like your personal assets. So, here whenever talk about this, these are the assets which can be kept as collateral.

But, according to the regulation a bank cannot give the loan to another kind of individual or another kind of organization against this shares and that share basically is nothing but, the share of that particular bank. So, if they are holding the share of that particular bank, then from that bank the loan cannot be disbursed against that.

So, that is basically another regulation what the Reserve Bank of India has put whenever we talked about the regulations of the lending activities.

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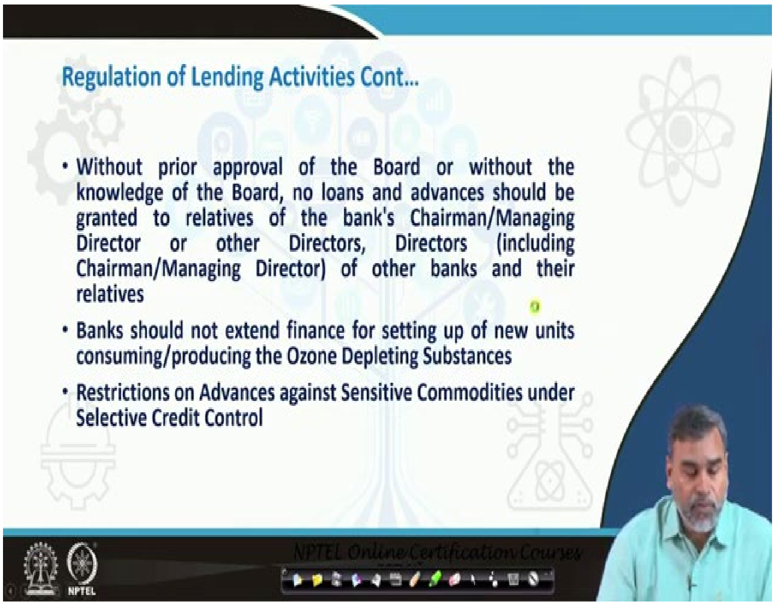

Another measure regulation if you see without prior approval of the board, board means the board of that particular bank or without the knowledge of the board, no loans and advances should be granted to the relatives of the banks chairman or managing director or other directors of other bank and their relatives.

So, at any point of time the loans cannot be given that means it is basically related to the governance issues that without the knowledge of the board any kind of loan cannot be given to any relatives of the managers of the chairmans or maybe board of directors or anybody and if any kind of loan will be given to them, then the prior approval or at least the information to the board has to be sought by that particular commercial bank.

And another very important regulation what the banks have made in todays context or the Reserve Bank of India has made, the banks should not extend the finance for setting of new units, which is consuming or producing the ozone depleting substances. It is related to the environmental issues. So to avoid any kind of environmental pollution or to create any kind of hazardous situation any kind of company, who is doing this kind of business.

So, the banks are not allowed to extend the loans to them who are basically establishing or forming or founding any business which is creating the hazards to environment as a whole so that is why, this particular banks cannot finance them. And also there are restrictions and advances against the selective commodities under Selective Credit Control, what does it mean?

what do you mean with the Selective Credit Control? The Selective Credit Control, the Reserve Bank of India does to regulate the price or to avoid any kind of unfair practices in that particular segment. For example, if somebody is holding a particular commodity then, obviously what will happen that there will be scarcity which will be created in the market.

So, when the market price will increase that holder basically will use that particular product and they can generate a supernormal profit out of this. So, to avoid this kind of thing the financing activities or the credit activities extending the credit towards that kind of business or that kind of sector is completely prohibited.

And mostly those sectors are cottons you can say that most of the basic necessity goods like sugar, like different kind of pulses. So, whenever we talk about those kind of agricultural products and all so there is a possibility of the hoarding.

So, if there is a possibility of the hoarding then to avoid that hoarding the banks are debarred or banks are not allowed to extend the loans to the different kind of business units, who are producing this kind of products to avoid any kind of price fluctuations in the market. So, that is why there are restriction and advances in loans against this kind of commodities.

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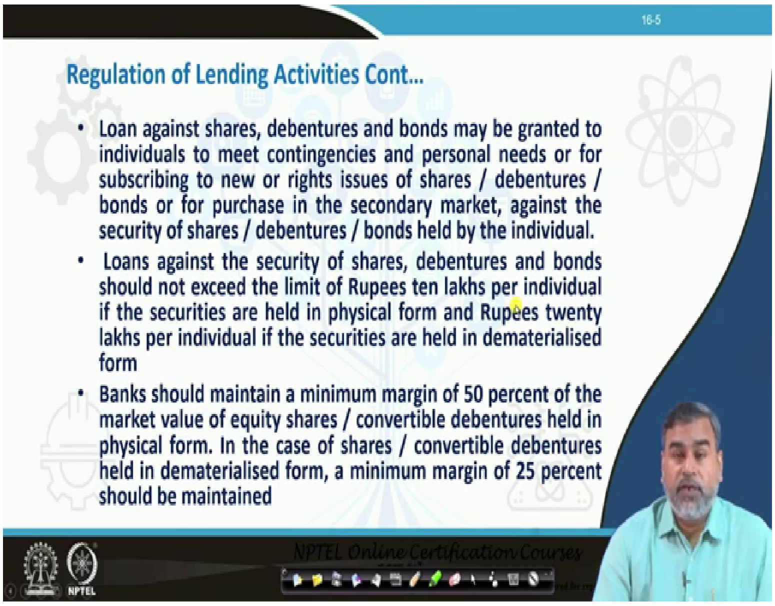

Then another thing is that the loans against shares, debentures and bonds may be granted to individuals to meet the contingencies and personal needs or for subscribing to a new or the right issues of the shares or for purchase in the secondary market against the security of the shares and debentures held by the individuals.

So that means the loan can be given if somebody has invested or somebody is going to invest by using that particular money or somebody has already invested and again further they want to invest or any kind of personal needs. For any kind of thing the loan against shares and debentures can be given.

So, the shares and debentures and bonds can be used as a collateral for this kind of reasons further if they want to invest in those kind of assets or if they want money for some specific reason or they can go and invest it in the secondary market to extract some more revenue out of this.

But, one thing is the loans against the security of the shares, debentures and bonds should not exceed the limit of rupees 10 lakh per individual. If the securities are held in the physical form and it should not exceed rupees 25 lakhs, if the securities are held in the dematerialized form, if all the securities finance and securities, whatever you have what you are going to use is as collateral, if that is in the physical form, then the bank can give maximum 10 lakhs rupees loan against that.

But, if it is in the dematerialized form, then the loan amount can go up to 25 lakhs. And, another thing also the banks always should maintain a minimum margin of the 50 percent of the market value of equity shares or the convertible debentures held in the physical form. In the case of shares and convertible debentures held in the dematerialized form a minimum margin of 25 percent should be maintained. Then, what do you mean by the margin?

The margin is nothing but, for example, somebody wants to take a loan of 1 lakh rupees. So, he has to provide a collateral, whose value should be 125000 rupees, if the bank wants to maintain a margin of 25 percent. So, 1 lakh rupees 25 percent is 25000. So, if you want to take a loan of 1 lakh then you have to provide the collateral to the bank with the value of 125000.

So, in this context if you are using your assets or the financial assets or the collateral then if it is in the physical form then the collateral value or the margin value should be 50 percent and if we can dematerialize form the margin the particular value should be 25 percent. So, that is another regulation what the Reserve Bank of India has made in terms of lending activities.

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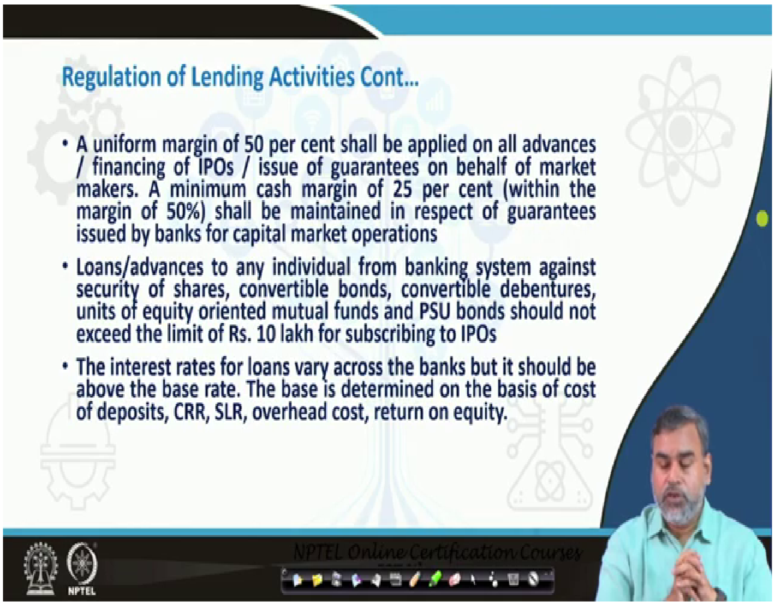

A uniform margin of the 50 percent shall be applied on all advances or financing of IPOs issue of guarantees on behalf of the market makers and minimum cash margin of 25 percent shall be maintained in respect of guarantees issued by the banks for the capital market operations.

Whenever, you talk about the individual form of the banking system the loans and advances to any individual from banking system against security of the shares, convertible bonds, convertible debentures units of equity of the mutual funds PSU bonds should not exceed the limit of the 10 lakhs for subscribing the IPO.

If somebody wants to subscribe the IPO and for that they want a loan then for any kind of assets if they are using, they can use any of the assets can be collateral but the maximum loan can be given for that is 10 lakhs rupees. And another regulation also commercial banks always get from the central bank or the Reserve Bank of India in particular with respect to India.

The interest rates, which was highly regulated particularly in the 90s before liberalization it was completely regulated it was decided by the Reserve Bank of India then up to 94-95 it was also regulated to some extent but in todays context if you see that, the interest rates are completely deregulated and it is interest rate is a driven by the market forces. The Reserve Bank of India only can change the policy rates and the policy rates includes the repo rate, reverse repo rate etc.

And accordingly the loan rates and other rates are completely determined by the respective banks and that particular rate also varies from one particular loan to another type of loan depending upon the nature of the loan and depending upon the risk involved in that particular loan.

So, one thing is the Reserve Bank of India has given a guideline that the particular loan rates should be more than the base rate. So, whenever talk about the base rate the bank can charge an extra premium over and above the base rate but the base rate should be maintained for any kind of loan what the commercial banks are giving.

So, whenever talk about the base rate then what kind of and how this base rate is determined. What kind of guidelines are given? Mostly the Reserve Bank has given the guideline. The base rate should be determined on the basis of the cost of the deposits the CRR and SLR and the overhead cost what the bank basically is getting and also the return on equity.

So, this is basically a part of the pricing of the loans that will discuss further in elaborate way but these are the factors will be under consideration whenever the interest rates for particular loans are determined by the respective commercial banks. Whenever, they provide the loans as per the Reserve Bank of India guidelines.

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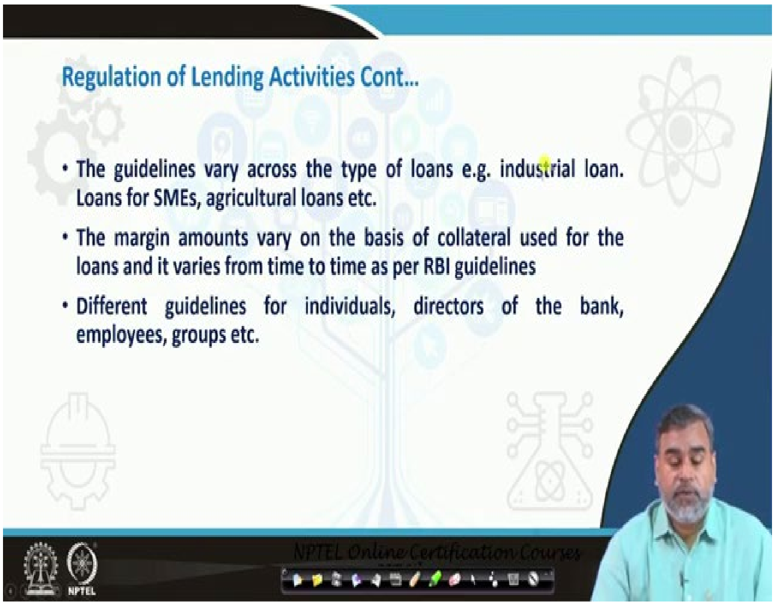

And another thing is already told you the guidelines vary across any kind of guideline, what the Reserve Bank of India gives for the different type of lending activities the guidelines may not be same for all type of loans. The guidelines vary across the type of loan like, it can be industrial loan, it can be a loan for SMEs, it can be agricultural loans and all kinds of things.

For different kind of loans Reserve Bank of India has the guidelines. For any kind of collateral, what you are using for the loans for that also different type of guidelines the Reserve Bank of India has, for detailed you can go through the master circulars of the Reserve Bank of India against these lending activities.

You can get the clear knowledge about that how the different kind of collaterals are used for what kind of margins are involved for different kind of collaterals and how the restrictions are imposed on the basis of the nature of the loan and all these things are basically already you can get it from those Reserve Bank of India circulars, master circulars from period to period they revised that and the provide the information accordingly.

The margin amounts vary on the basis of collateral used for the loans and it varies from time to time as per the RBI guidelines and different guidelines for individuals and directors of the bank employees groups etc. So, different restrictions, different kind of impositions of the different kind of rules regulations and all these things they always vary on the basis of the different kind of stakeholders of that particular bank, which includes maybe a common individuals, it may be the directors of the bank, it may be employees of the bank or it may be group loan.

If somebody wanted to take a group loan there are also this kind of the guidelines are different. So this is the overview of the guidelines or the regulations always the banks face whenever they go for the lending activities in the banking sector.

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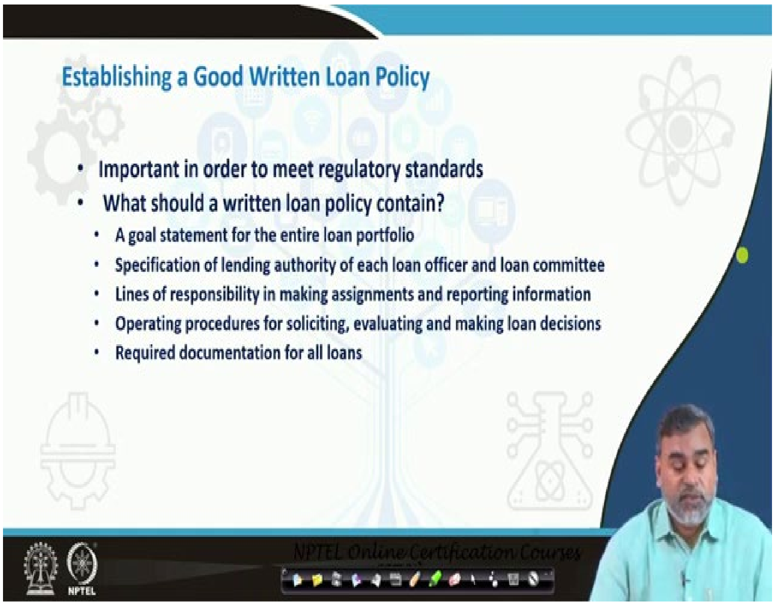

Whenever, talked about the loan policy, how can establish a good rating loan policy? So, if you see first of all, the first and foremost important thing is this should maintain the regulatory standards. Whatever, regulatory norms the central bank has, the commercial bank has to fulfil all those regulatory standards to carry out this lending activities, that is particular system.

Then, what are those components of the loan policy, first of all a goal statement for the entire loan portfolio, what is the goal of that particular loan portfolio of the commercial bank? That has to be clearly mentioned in the beginning that is why the loan policy is always made by the top management or the higher level people because, they must notify that what kind of objective they have or what kind of goal they have.

Specification of the lending authority of each loan officer and loan committee or to how much loan somebody can sanction and who is basically reviewing authority? And, which are the particular loan committee, who is going to access or who is going to assess all kinds of loans what basically the commercial banks are giving.

And on the basis of the different type of loans the authority or the power has been given to the different entities to whom basically the power should be given up to what limit, so that also has to be specified in the beginning. Lines of responsibility in making assignments and reporting information because while providing the loan they need lot of information about the borrowers.

So, whose responsibility is this? Who will assign this responsibility? And this whatever information, what kind of information is required? That all kinds of details has to be maintained. Operating procedure for evaluation and making the loan decision, there is a proper procedure has to be designed that how much scores should particular individual or particular organisation should get to get that particular loan.

For that proper kind of parameters are to be designed and required documentation for all the loans and once all kinds of details are there then a proper documentation has to be made to assess that how this particular whether the loan should be given or not and under what condition the loan and should be given or under what condition loan should not be given. So, this is basically another point what they have to mention.

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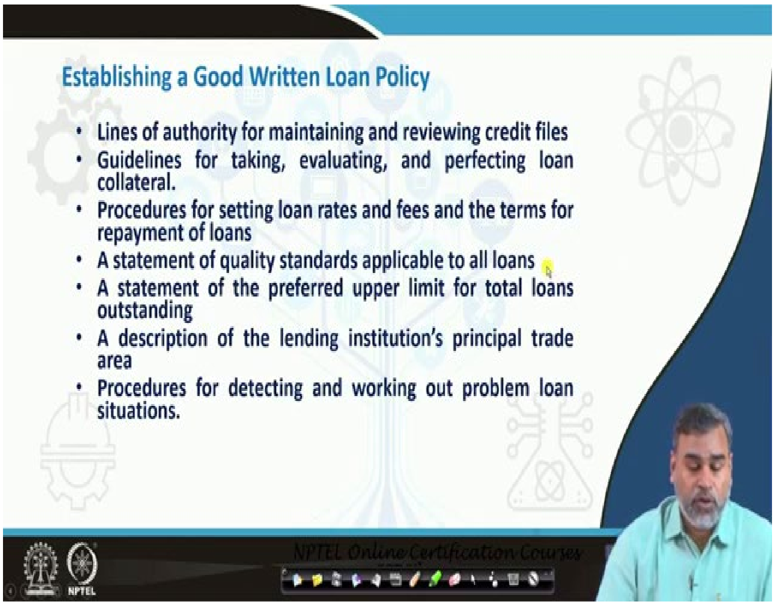

Then, the lines of authority for maintaining and reviewing the credit files over the period of time they should maintain that because loan is relatively long term in nature, because if it is a term loan the no loan continue for a reasonable period of time then whenever, the loan will continue for a reasonable period of time then the regular maintenance and driving of the credit files is required.

Guidelines for taking evaluating and perfecting the loan collateral, whatever, collaterals the particular bank is taking against that particular loan then how to evaluate those collaterals and is there any kind of merits, demerits against that particular collateral or the value of the collateral is going to increase or going to decline.

So, all kinds of details has to be always analysed from the beginning then procedures for setting loan rates, once everything is done on the basis of the different type of loans that what are those different type of interest rates will be fixed for that particular loan, what kind of fees will be imposed on them and the terms for the repayment of the loans, how the loan will be repaid. Whether, it is in what period, it is monthly, quarterly, yearly?

On what basis the loan will be repaid all kind of details has to be fixed and which will vary as per the different type of loans what the banks provide. Statement of quality standards applicable to all loans statement of the preferred upper limit of the total loans outstanding. Generally, how much loan upper limit of the total loan, outstanding what the bank can maintain or the bank can accommodate that has to be mentioned in the beginning.

A description of the lending institutions principle trade area because there are many ways this particular lending activities can be made but for that particular bank, what kind of loans is basically preferable or they have the expertise to the business on that particular area. Then procedures they have to detect in terms of the loan situations, working out the problem if there is any problem then how the particular problem can be tackled.

And what are the difference steps we have to follow to tackle that problem, to recover that particular loan that also has to be mentioned. So, all kinds of details has to be documented in the top management to make a proper loan policy and after that maybe the all those over the period of time the particular bank can follow that loan policy to provide the loan to the different kind of customers.

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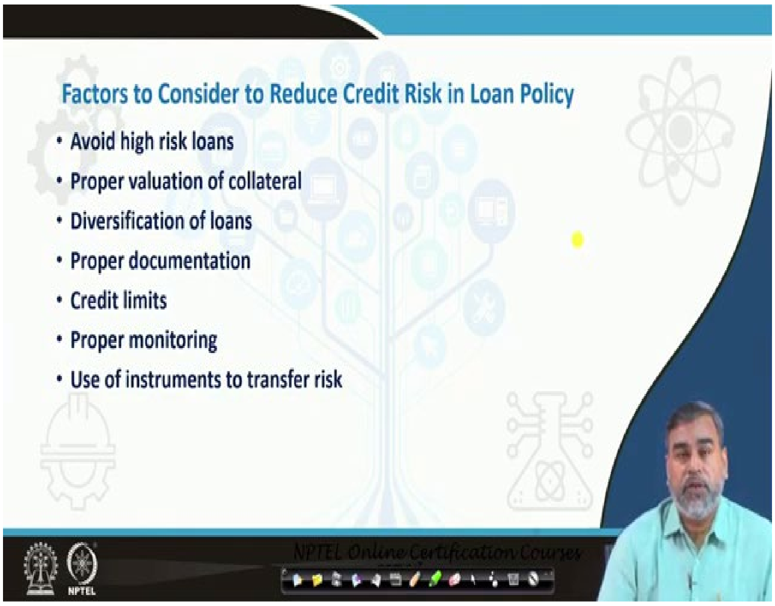

So, whenever the loans are given the most important thing is the bank has to always keep in the mind that how the risk can be minimized but the most important risk the ones what the banks face that is a credit risk. So, first of all avoid the high risky loans, particular business unit whose is doing the risky business, the proper rate of cash flow in the future may be positive may be negative.

Go for a proper valuation of the collateral, what kind of collateral you are using that has to be properly valued. Diversify the loans instead of giving the one type of loans the loans should be properly diversified. The documentation should be properly done with all kinds of legal documents by that if any kind of situation arrives, then the operational risk can be or the legal risk and nullified out of that.

Credit limits for the different type of customer different kind of loans has to be imposed, it should be regularly monitored and if it is necessary the different kind of other instruments particularly the derivatives instruments can be used to transfer the risk. The, for the transferring the risk, we can use many instruments to reduce the credit risk by that the total credit risk of the commercial bank can be minimized.

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So, if you talk about the lending process, how the lending process goes find out a prospective loan customer, evaluate the customers character and the sincerity of the purpose. Make the site visits, evaluate the customer's credit record. You have many kind of sources through which the information also can be sought like credit information bureau and all. Then evaluate the customer's financial condition, whether the customer is able to repay the loan in the future or not.

Assess the possible loan collateral, what kind of collateral the particular customer can provide. Then signing the loan agreement after everything is clear you can sign the loan agreement, monitoring the compliance with the loan agreement and the other customer service in its, you regularly monitor this compliance with the loan agreement and other customer service needs.

And finally the loan can be disbursed and by that whether, the loan can be disbursed at a time if the loan is a vehicle loan or other kind of loan. So, if it is a term loan, which basically has a periodic cash flow then accordingly your monitoring will relatively better because you can stop this payment in the beginning or maybe in the middle of this particular disbursement of that particular total loan on the basis of the credit quality of that particular customer.

So, these are the different steps, general steps what we follow. Whether the loans can be a personal loan or it can be we can say that house loan or an industrial loan or anything else.

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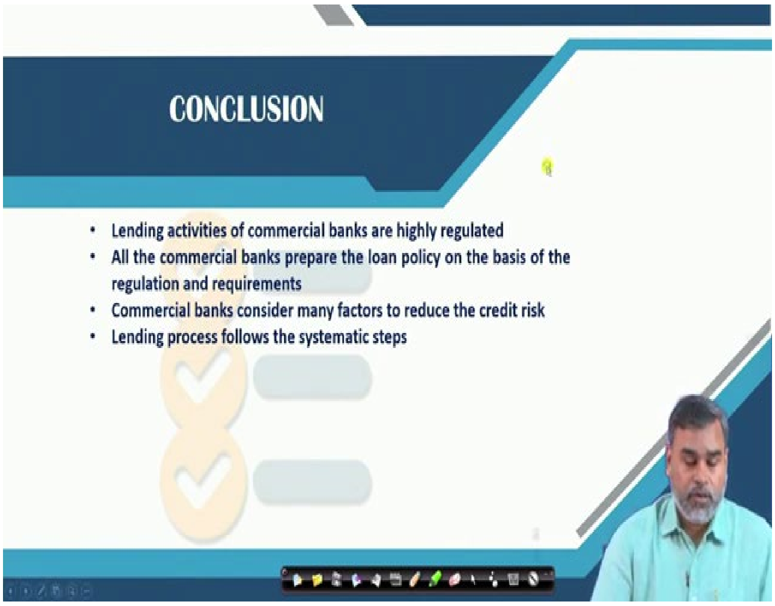

So, this is the conclusion what we get from the todays discussion, that the lending activities of the commercial banks are highly regulated. All the commercial banks prefer a loan policy on the basis of the regulation and the requirements of that particular bank and commercial banks consider many factors like diversification, like providing less loan to the high-risky business, transferring the risk or going for a proper loan policy.

All kinds of things to reduce the credit risk, which is the most important risk in the loan business. And, whenever you go for a lending process, the lending process basically follows a systematic steps, from identifying the customer to loan disbursement in between all kinds of assessment and all kinds of legal documentation and all these things always is a part of this particular process or particular steps.

And all the steps have to be considered while providing these particular loans or completing these lending activities of the commercial banks. So, these are about the overall learning process of the commercial bank, what for the different type of loans what they follow.

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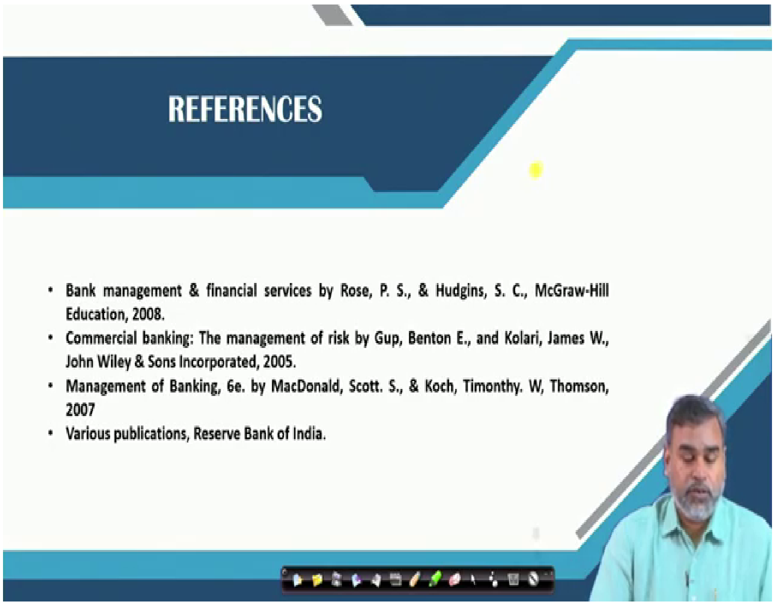

So, these are the references you can go through for the detail discussion on these particular points what we discussed today. Thank you.