Management of Commercial Banking
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Lecture 37
Management of Lending Activities - 7

So in the previous session we discussed about the different financial ratios, what the commercial banks always look at, whenever they go for assessment of any kind of business loan applications.

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In today's session we will discussing about certain other things like apart from the historical analysis of the financial ratios of that particular business unit the industry comparison also is very much required. That means if this particular company is operating within an industry then where this company stands against that particular industry affairs. Whether it is above this industry performance or below the industry performance that also give you the idea, that whether this particular company is financially doing well or not.

That is basically another issue what the lenders always try to analysis this is number one. Then apart from the financial statements like your balance sheet and profit loss account or income expenditure account there are some other contingent liabilities. The contingent liabilities may happen, may not happen because that may not happen immediately that may happen in the future. But that is not reflected in the balance sheet.

So if that is not reflected in balance sheet but if the lenders will not analyze that particular liabilities also, then also their calculations will mislead or may be the calculation will not give the better idea whether really this company is doing well or not in terms of the financial performance. So because of that the contingent liabilities also should be discussed should be analyzed whenever the loan assessment is made.

Then obviously, we have another type of cash flow statement financial statement that is called the cash flow statement. And we have to also look at whether this particular companies what is the condition that how the particular money is flowing. And whether this, in terms of the cash flow also the financial shape of the particular company is in a good shape.

And by that the banks or any lending institutions will be ready to provide them the loans. So these are the three things what we are going to cover in today's session like industry comparison, contingent liabilities and analysis of the cash flow statement of the customers, customers in the sense here we are refereeing to any kind of company or the business units.

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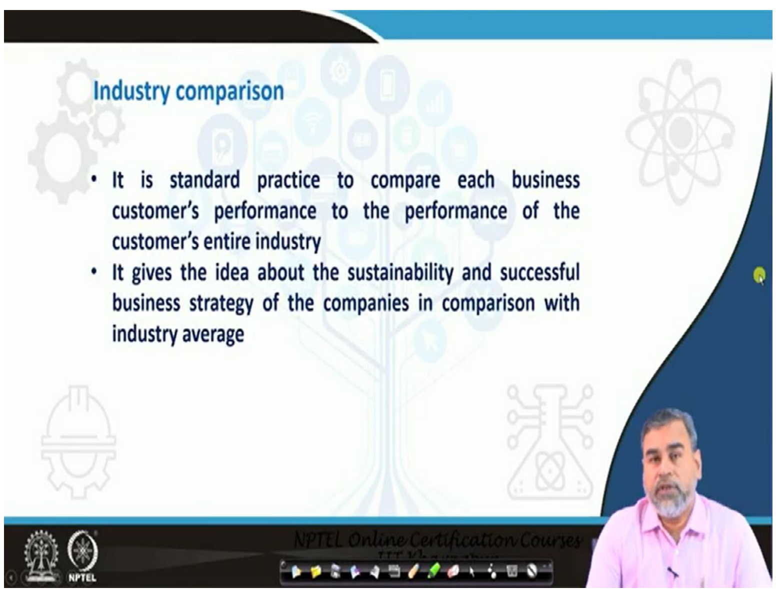

Let us see that whenever you go for the industry comparison it is a standard practice, it is a standard practice to compare each business customer performance to the performance of the customer's entire industry. So it gives the idea about the sustainability and successful business strategy of the companies in comparison with the industry average.

That means if there are 10 firms which working in industry and 10 firm's profitability ratio is very quiet, in on an average if they are maintaining a healthy profitability ratio and the particular business unit which asking for the loan their profitability ratio is below that particular industry average, then it is also to be matter of investigation that why this is happening.

Either the company is not able to compete in the market or their business strategy is not good enough to expand their business to generate more revenue in comparison to the other units in that particular industry or there is some kind of problem which is happening with respect to that particular company because of that the profit is not sustainable in comparison to the other companies which are operating within that industry.

So that also gives the idea to the lenders that whether this particular company is a good company which is working under that particular industry or not. If the countries, may be with the company's condition is not better of income comparison to the industry average, than again may be it is not good for the banks to lend them further whenever they required any kind of loans. That is why industry average is very much important.

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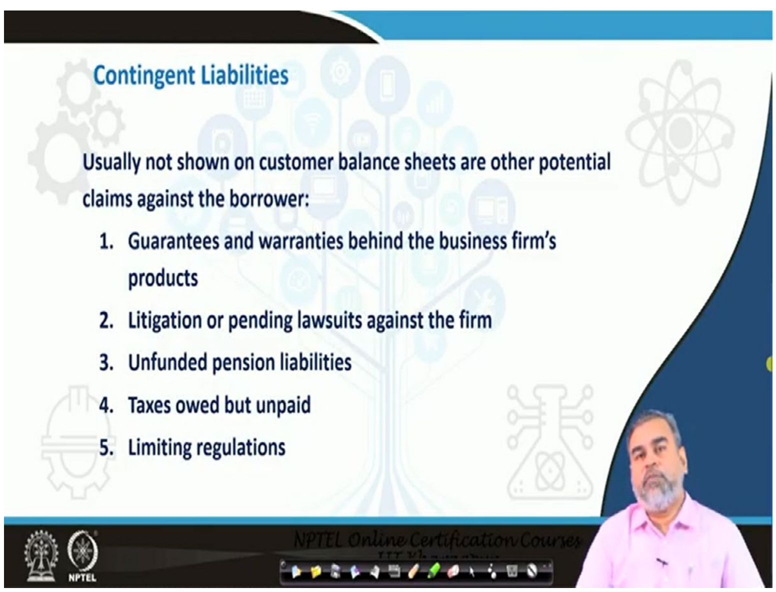

Then other thing is that contingent liabilities, what do you mean by this contingent liabilities. The contingent liabilities are not shown to the customer balance sheet, these are basically other potential claims against the borrower. So there are other issues like the company has entered into such kind of guaranty or warranties behind this business firm's products.

Whenever the company sales the product they provide the warranty and guaranties, so if something will happen to that product then company has to bear that expense against that. So in that particular point of time that particular expenses has not realized now but that expenses may happen in the future which may disturb the financial condition or financial position of this particular firm.

So the bank also will look at or may be go for the investigation that what kind of warranty or guaranty policies what the business firms are doing. And what is the success and the probability that the particular money will be paid in terms of guaranties and warranties to that particular type of products. Then we have litigation and pending lawsuits against the firm.

There may be some kind of problems what the company has already faced and there are some kind of legal kind of claims or legal kind of issues which are already involved with respect to that company. And this particular case is going on or the legal issue is still going on, but it is not yet materialized but there are huge amount of cost what the company is bearing against that particular legal expenses.

So the legal expense which is not basically very much deterministic in nature or the company is not aware about is how much cost they are going to bear against this legal expenses. And the banks also should be very much aware about this things and they can go for a thorough analysis of that legal expenditure what the company is going to be in covering in the future.

Then you have unfunded pension liabilities. Most of the companies have the pension liabilities which is not reflected in the balance sheet. So the money what basically they are paying in terms of the pension because there are less return what we generate from that. And there may be some kind of misbalance between the money what they are able to generate in terms of the payment of or utilizing the funds whatever they have to provide the pension.

And the cost what they are incurring against this particular pension. The taxes what they have already have but they have not paid it, already you know that there are many companies which have huge amount of tax, which are unpaid. And may be the current financial condition is good or it is supposed to be good or it is shown as good financial condition. But without disclosing this tax liability what the company has.

So we have to also understand that how much the tax liability the company has beforehand or in the past and after you adjust those tax liability with respect to the profits and all these things what the company generating now. Then what is the real financial condition of that particular company whether the company is able to repay the loan or will be ready to repay the loan or not that also has to be understood form that prospective.

Then there are some regulations which also control the firms business in terms of various activities. So what kind of business the firm is doing and whether there is any kind of limiting regulations which are imposed against that particular product. And whether the firm is able to fulfil all kind of conditions or they are satisfying all conditions with respect to this or not. So all those things also has to be thoroughly checked whenever the loan assessment of that particular company is made. So these are the major things which is comes under the contingent liabilities.

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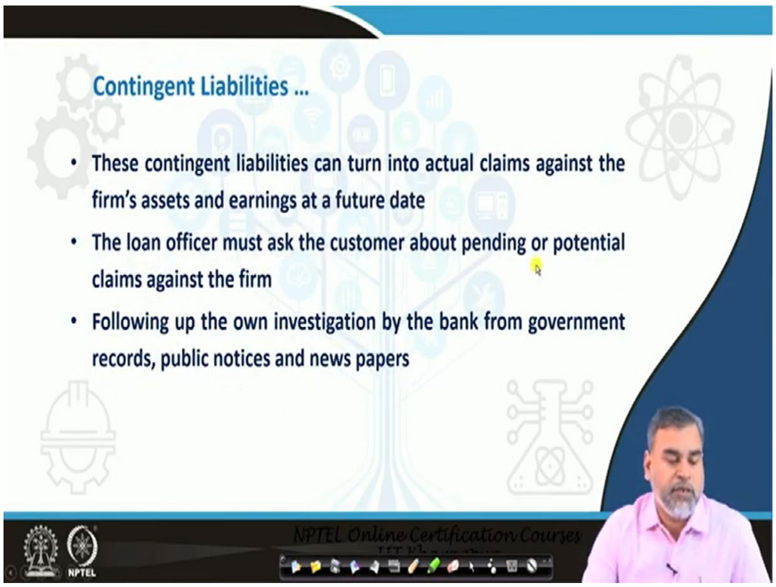

So let us see that there are some other issues which is related to that. The contingent liabilities can turn into actual claims against the firm assets and earnings at a future date. Already we have discussed that this particular items are not consider in the balance sheet or it is not utilized now or it is not realized now, but there is a possibility that this is kind of liability of this particular company may come in the future.

And if the company does not fulfill certain kind of conditions are there basically divert, the differing any kind of regulatory norms what the government or other regulatory have imposed. So whenever the assessment is done by the loan officer this would ask the customer about the pending or potential claims against the firm.

For the documentation has to be checked with respect to the potential liability what the company is or company may get in the future even that liability is not existing now. So that also to be analyzed because that is why the lender should be very careful because that is not a public domain, the data is available or in the balance sheet data that is reflected.

So because of that the contingent liabilities are sometimes is ignored by the many of the lending institutions and that creates a problem in the future. So to avoid that particular confusion what basically we do or the loan officers basically do. They go for the thorough analysis of those things apart from the financial analysis they do for the companies.

So they should follow up the own investigation for that by the bank from the government records, public notices, newspapers, there are whatever apart from the information what they get it from the different companies directly. They should also analyzes the other kind of resource or other kind of sources whatever data they get, so they can do their own assessment or their own investigation and they can assess that whether really the company is good enough to be given the loan or not in terms of the contingent liabilities.

And which is totally apart from the financial condition of the company because sometime the financial condition will be deteriorate if those kind of claims will comes into the picture. And those claims are not consider beforehand by the banks and accordingly the bank have measured that the company is able to repay the loan.

But in the end what basically the bank can observe that the loans cannot be repaid because the financial condition of the company is not good. And the liabilities which were supposed to be created in the future they have been created. So in that context the own investigation of the lenders is very much required whenever the loan assessment is made in terms of the contingent liabilities.

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Then we have other issues like environmental liabilities, so whenever we go for giving the loan that what kind of business the company is doing. Then whether the proper environmental clearance is there for that particular business or not. Whether the particular product what the company is doing or any kind of hazardous activities what is created through that particular production or may be for that particular business.

So whether really is it debarred by the environmental laws, whether the law has debarred those kind of business or any kind of business the company is doing which is not as per the regularity norms or they have not complied often this environmental rules and regulations.

So because of that if that thing is not there sometimes that incurs a huge amount of the cost or at the time also sometimes the business can be stopped by the regulatory bodies. So the banks are very much thorough about assessing those kind of facts with respect to the environments, environmental laws and all these things. Because that basically is a huge amount always the customer can bear and end of the day the loan will not be repaid.

Possible lender liability of environmental damage as per the regulation that already we have discussed. And lenders environmental risk assessment program that is why in many of the countries the lenders has an environmental risk assessment program through that they can assess that how much environmental risk the company is exposed to. And if this particular company is exposed to different level of environmental risk then how much cost the company may bear.

If they will not fulfil this regulations regulatory norms what this environmental regulatory committee has imposed upon them. So because of that most of the cases the lending institutions have the credit assessment program or environmental risk assessment team which basically always asks that how much environmental risk is involved with respect to that particular company.

And against that how much the financial condition is going to be deteriorated by that they can go for a quantifiable assessment of that particular loan by adjusting this particular kind of money or the loss what this company is going to incur or the expenditure what the company is going to incur against this particular environmental problem. So that is basically another liability that this can be a part of the contingent liabilities what the company always has and the lenders always try to analyze that issue also.

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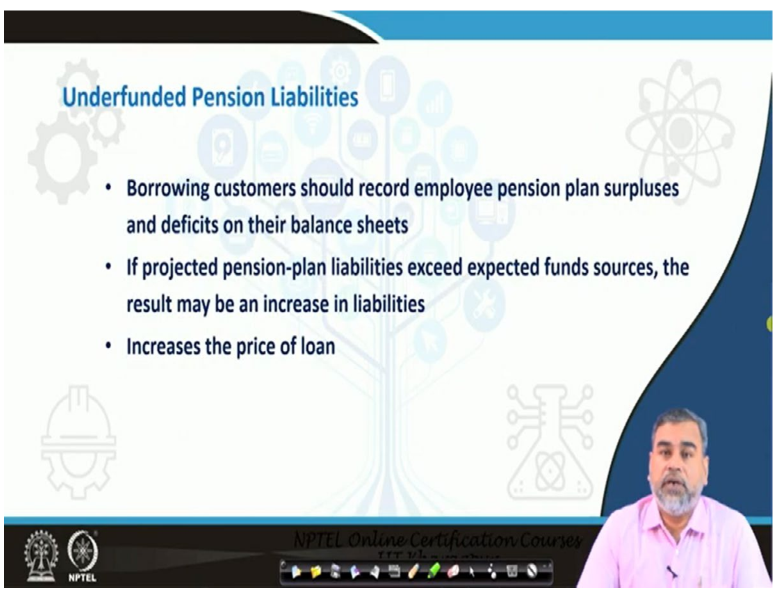

Apart from this already I told you that is underfunded pension liability. What you mean by this that the borrowing customers should imply should record the employ pension plan surpluses and deficits on their balance sheet. So whenever the particular company has a pension plan then how much surpluses they have or how much deficits they have in terms of that particular pension plan or pension account that also they have to show they have to provide.

Because most of the cases it has been observed that if there is a gap between the money which is created of that particular fund and the money which is disbursed or paid against that particular fund. So that particular point of time continuously there is a loss the company can incur over the time which is again a problematic thing or may be a problem from them to repay this particular loan in the future to the lenders.

So if the projected pension plan liabilities exceeds this expected funds resources, the result may be an increase in the liabilities. So another thing is, if the bank feels that this particular company has certain kind of problem with respect to this unfunded pension liability or that is going to be increasing over the period of time, maybe that will be reflected through the price of the loans. So whenever the banks avenue they are ready to provide the loan to them because if they satisfy some other conditions whatever the bank always look for then what basically they try to do?

They basically try to do that if there is a possibility of this particular liability then they will incur or they will basically increase the price of this particular loan or the interest rate of this particular loan will be higher than the existing interest rates whatever they have for other type of clients, other type of customers. So these are the things which comes under again a part of the contingent liability what you can say.

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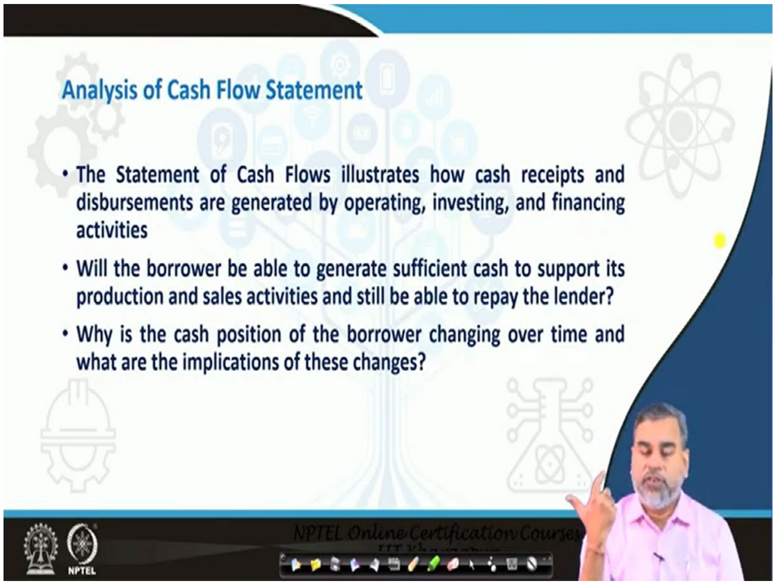

Then we can come to the other type of assessment what the commercial banks do, whenever they assess the loans that is basically the cash flow statement. What basically exactly the cash flow statement is – The cash flow statement basically examines how the cash receipts and disbursements are generally, are generated by operating, investing and financing activities.

So wherever you talk about that there are 3 major activities what the business units always have, like operating activity, investment activity and the financing activity, these are the 3 major activities. So whenever you go for the cash flow statement analysis what basically the banks try to measure from this? Will the borrower be able to generate sufficient cash to support its production and sense activities and still be able to repay the lender?

Whether they have enough cash available with them to carry out their business, to carry out their production and sales activities and still they are also in a position to repay the lender whatever loans they have taken to carry out this particular business. And other thing also this cash flow statement analysis try to answer, why is the cash position of the borrower changing over the time?

Why it is changing over the time and what are the implications of this particular changes? If the cash positions of the borrower is changing frequently over the time or it is highly volatile, then what kind of signal it gives to the market? Or whether it is good or bad that also has to be always checked upon by the lending bodies or lending organizations whenever they go for the assessment of the loans.

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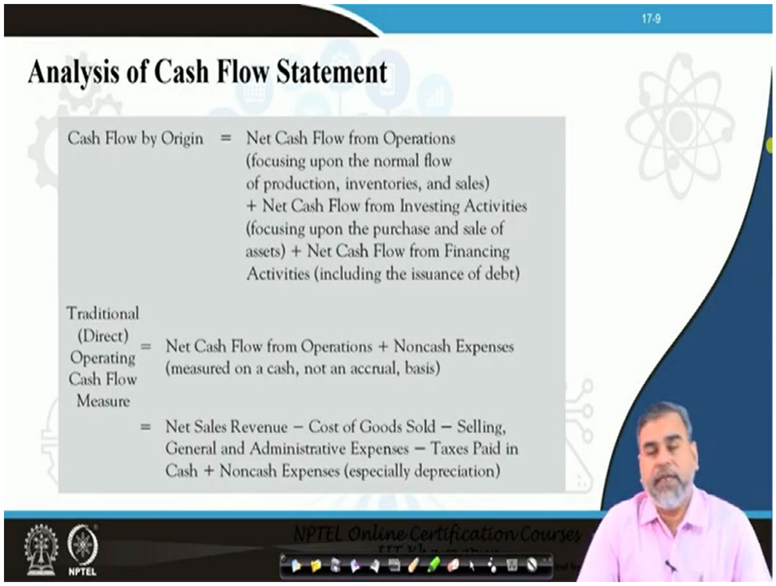

So whenever you go for the analysis of the cash flow statement already we have discussed there are 3 types of cash flow statements we always come across, one is your cash flow from the operating activities, cash flow from the investment activities and cash flow from the financing activities. So if you see in general, what is the cash flow of a company?

It is nothing but the cash flow from the operations mostly which is derived from the normal flow of the production, inventories and sales whatever the company has, plus the net cash flow from the investment activities which is nothing but purchase and sale of the assets what the company is doing or within that particular period.

And the net cash flow from the financing activities that is nothing but the debt and equity. How the financing activities are done in terms of the different financial capitals like debt and equity? And how much the investments are made in terms of the fixed assets? And as well as the other short term assets? And how much cash flow they are able to generate from the operations or the operating activities of the particular firm?

So from the operating cash flow whenever you talk about this is nothing but the net cash flow from operations plus non-cash expenses. So it is how basically it is calculated? It is basically net sales revenue, sales revenue - the cost of the goods sold - selling general and administrative expenses - taxes paid in cash + the non-cash expenses that is basically nothing but the depreciation. So if you consider all these indicators, all these variables then you can calculate the operating cash flow measure of that particular company.

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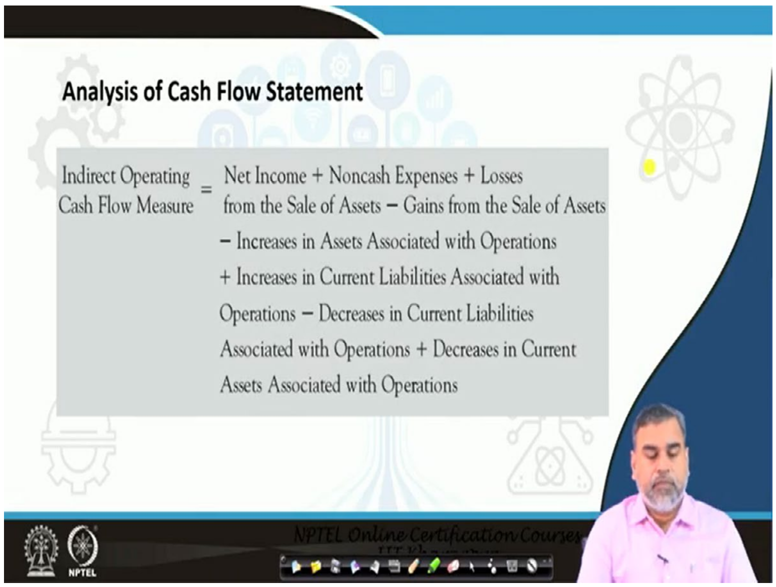

And other way also the operating cash flow can be calculated that is basically or we called the indirect operating cash flow measure. Here what we consider? We consider net income plus non-cash expenses which is nothing but the depreciation plus loses from the sales of the assets. There is a possibility that we can also incur the loss in terms of the sales and the gains - minus the gains from the sales of the assets - the increase in the asset associated with the operations + increase in the current liabilities associated with operations - decrease in the current liabilities + decrease in the current asset associated with the operations.

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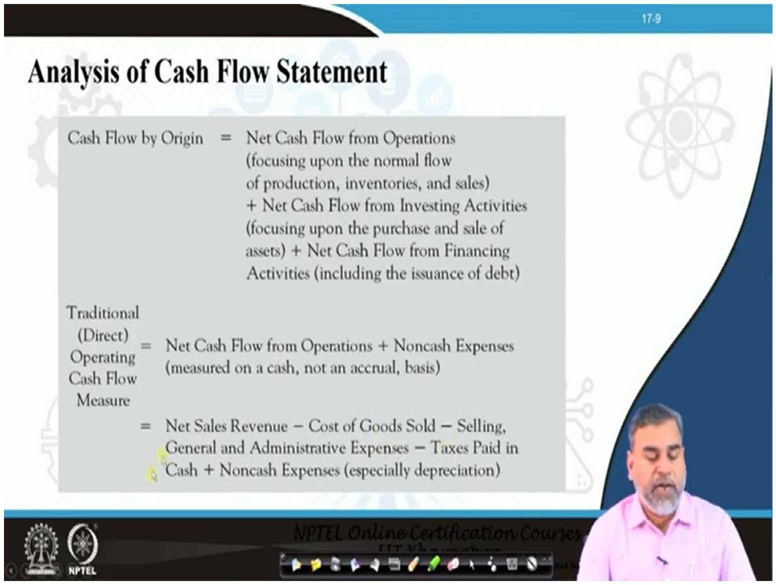

So there are many ways basically indirect or direct way the operating cash flow calculated but this is the way the popular operating cash flow is calculated that is the revenue - cost of the good sold - selling general and administrative expenses - tax paid + the depreciation which is nothing but the non-cash expenses.

So this is the way the operating cash flow of the company is measured, so the operating cash flow is in the good shape that means the company is able to generate a reasonable amount of or the adequate amount of capital, adequate amount of cash which is able to increase this or may be able to make this particular firm operable in the future or the operating efficiency of the firm is relatively high.

So in that context that is very much important because that shows the day to day operations of that particular company that whether the company is able to cope up with the business in the market or not? So if they are able to cope up in the market in the business of that particular product what they are selling, then how basically they are good enough or efficient enough to increase their profit form that particular operational activities.

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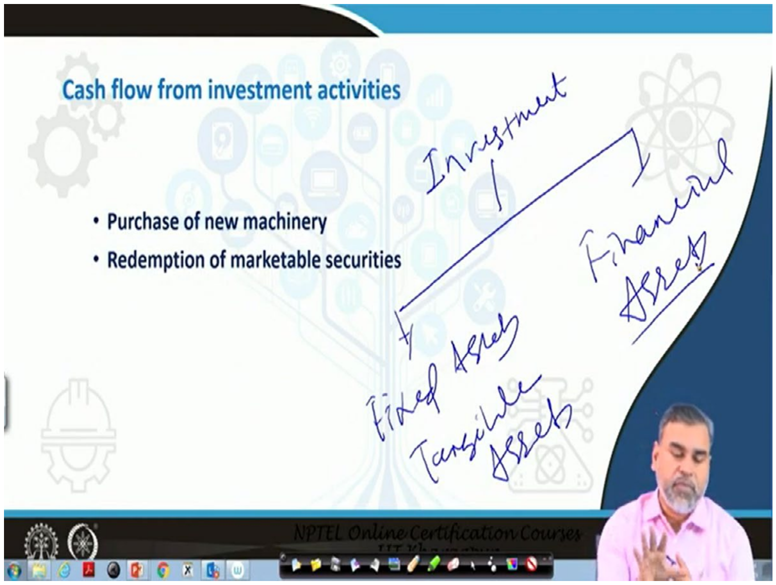

Then we can have the cash flow from the investment activities. Already we know that the investment activities includes mostly the purchase of the new machines or the raw materials and all these things. And the redemption of the marketable securities. Little bit if you expand it how basically it goes on? It goes on in this way, that whenever you talk about the investment activities, the investment activities is basically is done into two ways or two types of assets we can consider.

One is your fixed assets or tangible assets what you can say, much broader. And another one is the financial assets. So the investment activities or the flow what we use it for the investment activities that comes from the fixed assets or the tangible assets what the company is holding or it can come from the financial assets activities. So, whenever you talk about these two, what basically what we can observe that how much the new machinery or land this company has purchased or company is able to purchase.

That means they have spent some money in the fixed asset and it takes some time to generate the revenue out of use of that particular fixed assets. And another one is, that how this particular company has invested their financial capital? The financial capital already you know that the debt and equity instruments mostly and there are some risk free instruments which are variable in the market.

So how the company is able to utilize their fund in the financial market to extract the maximum return with a given amount of the risk. So whether the company is wise enough to utilize that particular financial capital whatever they have to generate the extra revenue from this particular system by taking the different positions in the market at the different time.

So in that context what basically we have to see that which assets should be redeemed and which assets should be added to the system and what kind of assets should be always consider for investments which are alternative asset which are available, because there are many financial assets which are available in the system.

So whenever you talk about the many financial assets then which assets should be chosen then whether this particular asset is really going to solve the purpose of that or objective of that particular bank or not. So all kind of considerations has to be always looked upon or should be analyzed by the lender.

Whenever they are going for analyzing the investment activities of this or cash flow activities with respect to investment by this particular customer who is nothing but a company or a business unit. So in that context it can give a fair idea that really the company is investing in the market or not? And whether the investment is fruitful or not? And whether the company is able to generate extra amount of return from that particular investment or not?

Whether it is covering of the cost what they have incurred to generate that particular capital or not? So all kind of questions has to be answered though this activities which is nothing but the investment activities. And how the cash flows are generated out of this, and those cash flow analysis will help the banks to understand that how this particular investment activities of this particular company is going on.

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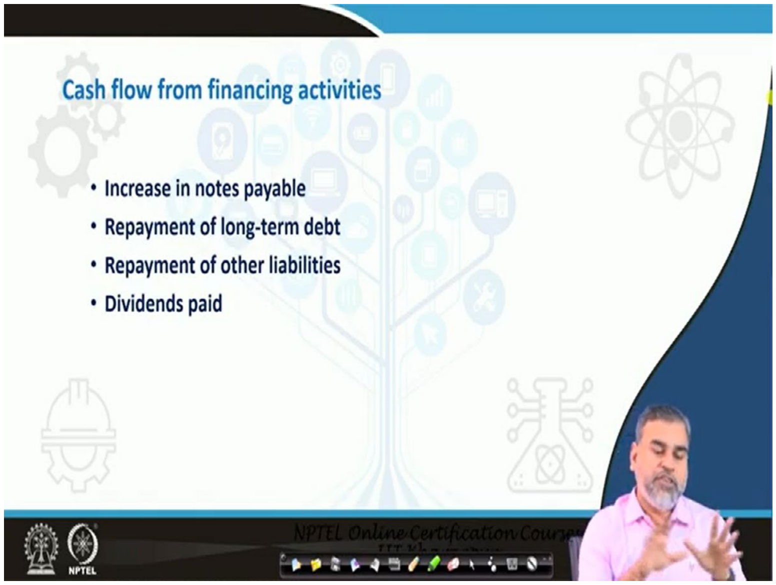

So this is about your investment activities, then we can see about the financing activities. Because you see without money or without capital there is no investment, so we have to understand that whenever this investments are made by the companies then how the financing activities are made by that. And how the financing activities are basically or how the company is able to generate this particular cash or particular capital from the market.

So first of all you know that there are short term and long term capital what the particular business unit want to carry out their investments. So the long term capital and short term capital whenever we talk about that is either in terms of debt or in terms of equity or in terms of the return earnings whatever they have. And as well as we can see that whether the particular company is paying the dividend regular or in the market or not to the shareholders.

So first of all, how much repayment the company has made in terms of the long term debt. So if the repayments they are making regularly in terms of the long term debt, then it also good for them to raise the capital or it is maybe advisable for them to raise the capital because they are able to generate the revenue in such a way by that they are fulfilling this requirements whatever they are already have, their obligations are basically unheard in the beginning.

And they have some short term liabilities like they have commercial paper, they have certificate of deposits, they have some short term working capital loans and whether those kind of things are basically happening in a systematic basis and in a systematic time manner or not. So if this things are done then what basically we can say that the company's financing activities is running smoothly and the condition of the financing activities of this particular company is good.

So in that context the bank maybe or the lender maybe ready to provide the loan if they want in the future. And another one the dividends paid whether the company is paying the dividend or not, that is also a part of the cash flow with respect to the financing activities. If the company is paying the cash, then how the dividend they are paying, they are paying the cash dividend or the stock dividend? This is the first question.

Second question comes that whether how much dividend they are paying? And if they are paying a certain amount of dividend whether the dividend is stable or not, or dividend is changing frequently over the time. So most of the cases we observe that, we people consider that dividend payments are steady or they are stable. Why it is stable? Because dividend also has another kind of implication that it gives a signal to the market.

If the company has started paying dividend and all of sudden stops paying dividend it is also problem because the stock price was decline. If the company has paid high dividend before and after that it has declined the dividend payout ratio, then again the company will be in problem. So that is why, the company basically decides a particular level of dividend payment which they can sustain it or they can always maintain that particular amount over the period of time.

So because of that the dividends we always in our language we call it the dividends are sticky in nature, the payout ratio is sticky in the sense the company does not frequently sense that. But gain the lender will look at whether really company is changing or not? If they are changing, then why they are changing? Number one.

Number two, how much dividend they are paying? Whether the dividend payments whatever they are fix that is realistic that whether really they are able to pay that amount of dividend in the market or not? So all kinds of considerations the lender always look at whenever they think about or they analyze about the dividend payout ratio of the companies.

So the financing activities gives the overall idea that really they cash flow what the company is able to generate that is good enough to utilize or maybe to overcome whatever liabilities they have in the future in terms of the different kind of failure or different kind of unforeseen situations which may arise to the company or that particular point of time. So these are the different cash flow activities that also the commercial banks should always analyze before disbursing the loans.

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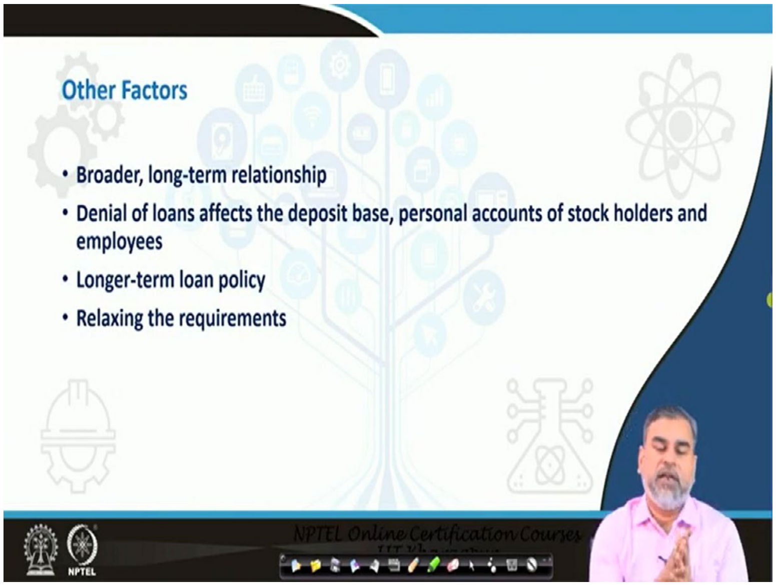

Apart from these, there are some other factors also, the loan officer look at. First of all, maybe in some cases we have observed everything is good, maybe there are some ratios which are not in the line. There are some indicators not in the line, but still sometimes the loan officer use their judgment to provide the loan because it has many implications. What is the implications?

First of all, the relationship, so if they have a longer relationship with that company beforehand then all of sudden they do not want to dealing that relationship, number one. Number two, another thing is if the company is not getting the loan from that articular lender then obviously it may affect the company's deposit base, because the deposit account which is maintained in that particular unit particular bank by this business units that may get be withdrawn or maybe stop.

The personal accounts of the stakeholders of that company may be getting affected and also the employee's accounts in that particular bank may be getting affected. Maybe this particular company will compel all those kinds of stakeholders to open not to open the account in that bank in other bank where they can get the regular salary and other kind of incentives what they are supposed to get.

So in that due process what happens, that the particular commercial bank also may use their deposit base. Or the deposit base is basically sensed or deposit base is adversely affected then it have also the adverse impact in all type of business activities what the commercial banks are doing. And another thing is whenever you talk about the commercial banks always should have a long term loan policy.

And in the long term loan policy they should design in such a way that they should consider all those considerations which are relatively behavioral considerations but still those behavioral considerations always has to be looked upon whenever this kind of lending activities take place by the commercial banks.

So whenever they provide this sometimes also the commercial banks relax certain criteria, relax certain requirements because they want to expand that particular business. Because that is the source of revenue of the particular bank that is the major asset base of the commercial bank.

So there are some conditions are not satisfied then if this conditions are not that much severe serious conditions than the commercial banks loan officers can use their discretion by relaxing those conditions and requirements and providing the loans to those business units. So apart from this there are other behavioral other kind of crucial factors also has to be looked upon whenever the assessment is made by the lenders for this business.

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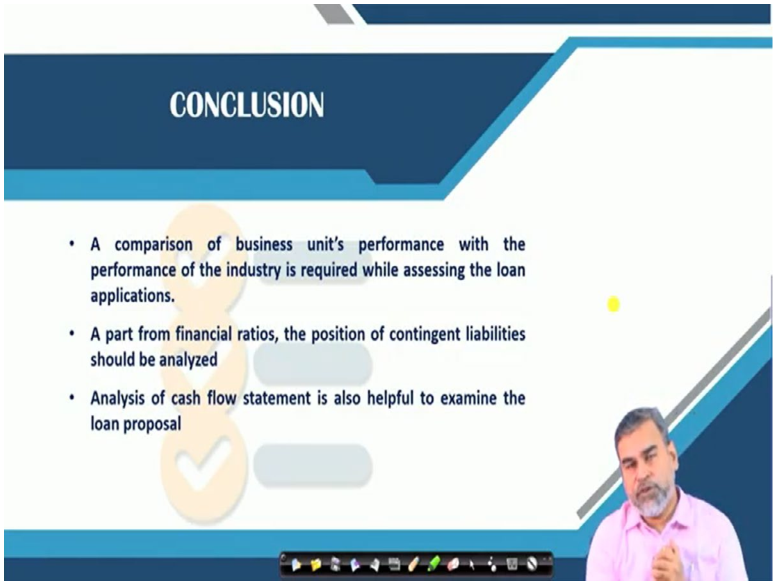

So looking at the conclusion what we have discussed today a comparison of the business unit's performance with the performance of the industry is required while assessing the loan applications. Apart from financial ratios, the position of contingent liabilities should be analyzed. And analysis of cash flow statement is also helpful to examine the loan proposal which gives that how much cash is the company is able to generate to fulfill the short term and long term requirements of that particular business units over the time. So these are the issue which always the commercial banks will look at.

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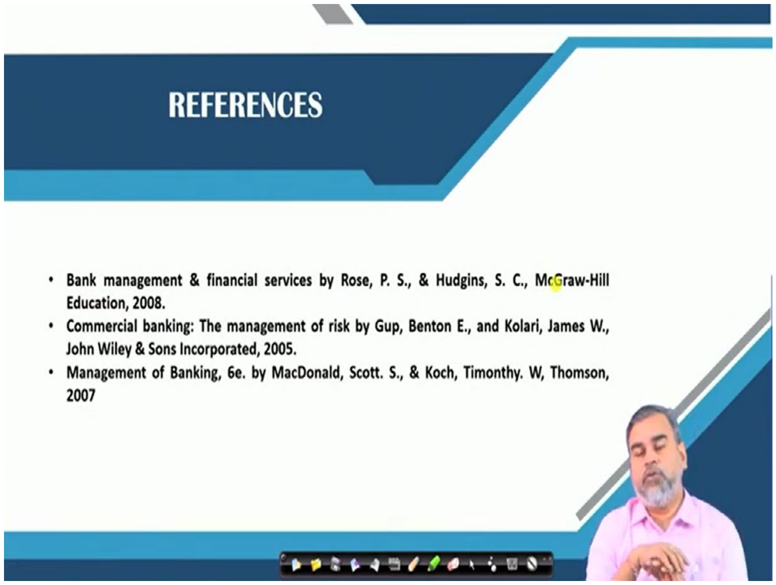

And these are the reference what basically you can go through for further detail analysis. Thank you.