Management of Commercial Banking
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Lecture 33
Management of Lending Activities 3

So, in the previous class we discussed about the different regulations related to the lending activities of the commercial banks and as well as we also discussed that what are those different ways the credit can be reduced in practical sense. And as well as what are those lending process the commercial banks follow whenever they disburse any kind of loans to the different entities.

Today we will see that, what are those different ways the commercial banks provide the loan, what are that different forms, different kind of methods through which the loans are disburse, this is number one.

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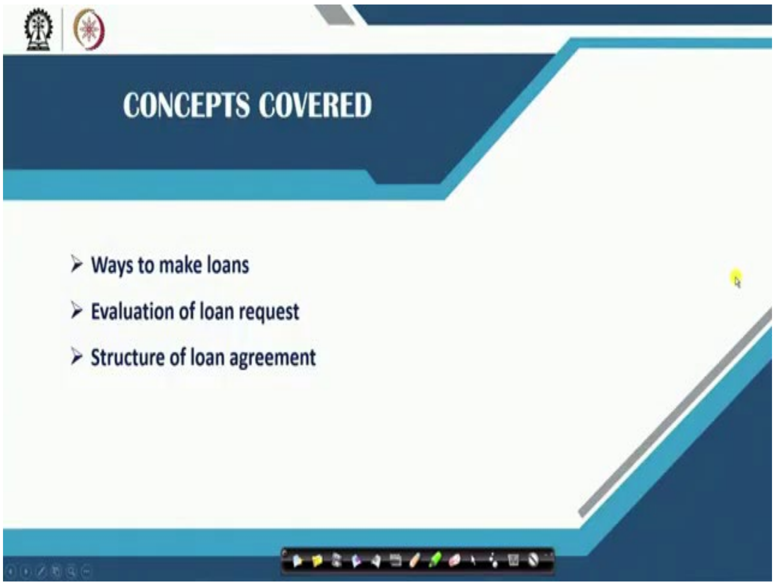

And as will as we will also see that how the loan request is evaluated. What are those factors they look at whenever they go for evaluation of the loans which is the basic step of the lending process.

Then, how the structure of the loan agreement looks like, how, the structure of the loan agreement looks like. So, these are the three different kind of issues what we are going to cover in today’s sessions. Whenever, we talk about the ways to make loans what does it mean? To whom the loans should be given? Or how the commercial bank will identify on what basis or in what is the method or what is the way the loans will be disbursed?

So, that is the fast and foremost question always we get whenever we talk about the lending business of the commercial banks.

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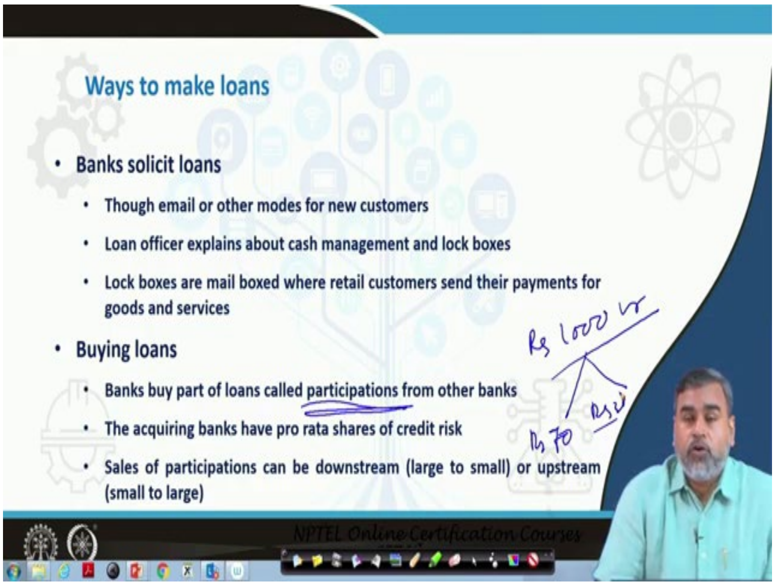

So, in this context there are many ways the commercial banks make loans. First of all you might have seen that the commercial banks can look for the perspective borrowers depending upon their data base or anybody who has the deposit base in that particular bank or they can collect the information from the various other sources through which they always try to identify that who can the prospective borrowers or credit toward borrowers who can be given the loan or to whom loan can be given, where the probability of default is relatively less.

So, the banks solicit loan is basically the bank from the bank side basically they start initiation. So, it is not initiated by the customer, it is most initiated by the banks. And the banks basically initiate that process because they feel that this particular customers credit worthiness is there and easily this particular money can be repaid back.

So, in this context they can identify that and finally this bank can contact them through the email or through other modes and for a new customers they can with the new customers may cause existing customer already as there in their data base and they know that whether how much loan they have, they are getting and how much loan are giving and all.

So, the first of all though email and other modes they identify the new customer and once they find out that particular customer the loan officer explain about the all the activities what the commercial banks are going or that particular bank is doing and as well as what kind of facilities or the incentives they will provide in terms of this particular loans.

If they can provide different types of incentives in terms of lower interest rate, in terms of different ways, basically they can attract that particular costumer or they can convince that customer, the customer should take the loan from them. That is why they explain about their cash management and the lock boxes. Lock boxes is basically a concept which is used in the banking.

Lock boxes are basically the mail boxes where the retail customer send their payments for goods and services. Whatever loans they have taken or the goods services they have taken there all the details and everything are available with them. So, the particular bank can provide or can give the idea about this to the new costumers. By that the new customers should be interested that for what kind of business, for what kind of activities the particular banks have the expertise or the bank is ready to provide the loan to them.

So, this is the one way the bank can make the loan or the bank can disburse the loan. Another kind of method is the buying loans. So, what do you mean by the buying loans? The buying loan means the banks basically buy the part of loans which is called the participations, if you see here, here the participation is important from other bank.

For example, one bank has disbursed 100 crore, 1000 crore and this 1000 crore is a quite big money for that particular banks then this particular bank can buy the part of the loans, other bank can buy the part of loans from that particular bank or the bank can divide that particular load to different other participants. By that the loan portfolio, reliability basically will be reduced, or the loan portfolio value will be reduced.

It is not the reliability of the bank but the loan portfolio value will be reduced. So, may be this can be divided into 2 banks. The one bank will be where the original bank will have the 70 crore and another bank will go for the 30 crore like that. And the acquiring banks have pro-rata shares of credit risk. The obviously depending upon the risk exposure or the amount of loans what the particular banks has.

Or bank has disbursed or have shared with another bank the credit risk also will be shared accordingly. So, if the sale of the participation can be downstream, for example the large to small. A large bank has given the loan of 1000 crore and they have shared that particular loan with some another small bank then we call it the downstream. And another case there can be off stream also, may be a small bank which have disbursed a loan which is beyond his capacity.

And after they realized that okay this much is not basically in their cup of tea. They can share that particular loan with a large bank. They can request a large bank to share that particular loan and that large bank accommodate that particular loan in their balance sheet and accordingly the credit risk will be shared and the return also will be accordingly shared.

So, in this context that is another way, the banks can also take off some kinds of loans into their loan portfolio. So, buying loans is another method through which the loans can be made.

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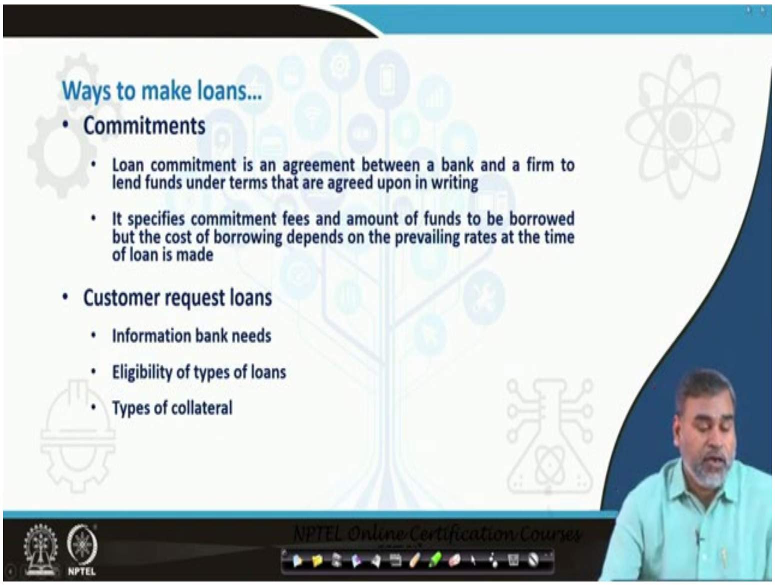

Then, we have the commitments. Loan commitment is basically an agreement, loan commitment is an agreement between a banks and the firm to lend funds under the different terms that agreed upon in writing.

So, what particular that terms and conditions or the agreement basically consisting of? It specifies the commitment fees and amount of the funds to be borrowed. But the cost of the borrowing depends upon the prevailing rates at the time of loan is made. The loan interest rate will not be fixed in the agreement. The loan interest rate will be fixed whenever the loan will be actually made.

But, the commitment fees and as well as the amount of funds what has to be borrowed, that will be mentioned in that particular agreement and this commitment fees can be given on the day basis. So, if the loan amount is let commitment fees generally varies from 0.25 percent to 0.5 percent. So, if you have a loan amount of 100 crore then your commitment fee per annum will me 100 crore multiplied by 0.0025.

So, if it is daily basis then it will be whatever money you get divide by 365 then if it is for the 40 days then 100 crore ×0.0025. Whatever money you get divided by 365 ×40. So, this much is the commitment fees what you have to pay and accordingly this particular loan will be disbursed in a particular day. So, when the loan will be disburse in a particular day then according on that particular day basis whatever prevailing interest rate in there in that particular market in that point of time, interest rate should be paid accordingly.

So, that is the way the commitments works in the particular banking system to provide the loan. Then, we have the costumer request loan, a costumer which more known or may be more fluent in the banking sector. Weather it is a business unit or individual entity the request for a loan and the problem basically was happened that which have been observed most of the cases the loans can be denied.

Then what is the possibility? Why, what is the reason that the loans are denied? The loans are denied because either the customer has not provided the information what the bank needs about that particular customer to provide that loan, that is number one. Number two, the eligibility of the types of the loans. You see, you need one type of loan but in that particular type or that type of loan you do not have the eligibility.

May be you have the eligibility for other types of loans. So, in that particular point of time the bank can deny that particular type of loan but bank can tell you that you are not eligible for this loan but you are eligible for that loan. So, the eligibility also varies on the basis of the types of loans. Somebody wants a house loan, somebody wants a vehicle loans, somebody wants a personal loan, and somebody has an educational loan.

But, depending upon the different types of loan the eligibility varies. So, whenever the eligibility varies then this customer should know that for this kind of loan, what kind of eligibility required. So, in that particular context they can fulfil that kind of criteria they again provide information to the bank by that the loans can be given. And another most important thing types of collateral.

What kind of collateral you are giving? You are giving a primary collateral like for example you are buying a house, your house is the primary collateral, you are buying a car your car is a primary collateral or you are giving some collateral which is not exactly have a fixed value. So, in that particular context we have to insure that what kind of collateral we are giving. So, against that particular collateral may be its easy for the banks to provide the loans.

Because there is a possibility that value of collateral can be used or the liquidation of the collateral can be used if there is a default. So, costumer request loan has a different kind of characteristics through which we can ensure that how the loans can be made and accordingly whether the costumer will get the loan or not.

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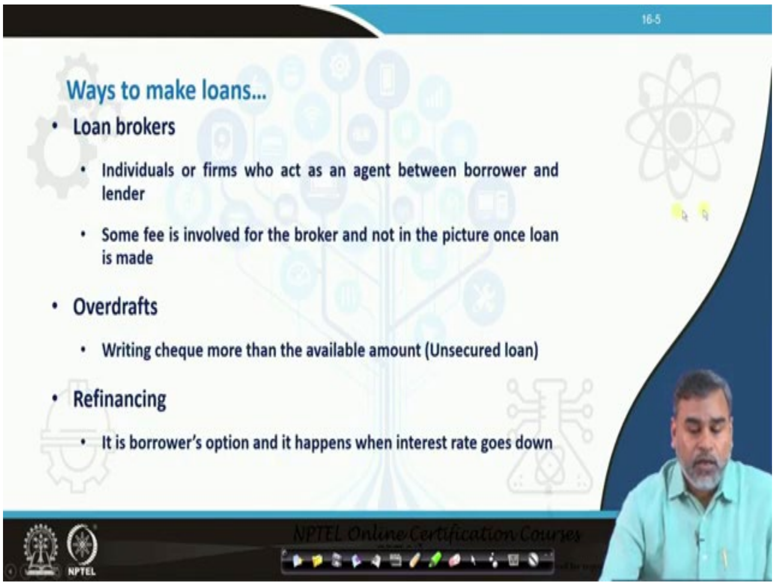

Another way also the banks provide the loans like loans brokers. That is relevant in US and in India also. So, generally instead of directly contacting banks to get a loan the individuals or firms who basically act as an agent between the borrower and the lender, they are called the loan brokers. So, the loan brokers can contact you, or the bank can also take help of the loan brokers and they charge certain fee, and they will advise the prospective borrower to prepare the documentation to provide the information what the bank need.

And accordingly the particular customer will have less information gap in terms of the disbursement or the requirement of that particular loan, what the loan document what the bank needs. So then finally what will happen that let this particular requirement is fulfilled and bank is happy with the information what this particular customer has provided then accordingly what will happen that the particular loan will take place between the different two entities.

And, but the particular broker will not be in the picture. Then finally the agreement is between you and the bank but the broker will charge some fee. There is a brokerage fee they will charge and finally they will get out of this particular picture but they have arranged this contract for you or this agreement for you. In another thing is over drafts all of you are very much aware about this word maybe comfortable with this word.

An overdraft means what? Whenever we want to use more money from the bank even if you do not have that much money in the bank. So, writing a cheque more than the available amount and in the cheque you write this much amount is not available and the bank is ready to provide that money to respective person as a loan and again start the rest of the money whatever they have provided against that they basically charge certain interest.

So, that is called the overdraft facility and the overdraft loans what the commercial banks gives, these are basically the unsecured loans. The overdrafts what the, facility what the commercial bank give, this are the unsecured loan, and that is happening with the prospective customers where the bank has the trust and the bank feels that these people will not be in defaults if the overdraft facility will be given to them.

And accordingly the loan can be or the money can be utilized for that specific purpose and finally the bank can generate certain interest out of this as an income generating source. And another ways also the loan can be made that is called the refinancing. What is refinancing? For example, somebody you have taken a loan whose interest rate is 10 percent and that is a fixed loan. Whenever after certain days you observe that, in the market the loan is available at 6 percent, then what basically how you will do?

So, instead of carry out that particular loan you can go and take another loan with a rate of 6 percent and repay that particular loan to him which was basically carrying 10 percent interest. Now your 6 percent will carry on for a particular period of time and this interest basically what you are paying as 10 percent that has converted into 6 percent. So, that is called the refinancing activity.

So, it is the borrower's option. If the borrower want they can go for the refinancing that particular loan and the refinancing generally happens when the interest rate goes down, just now what example we have taken that if the loan rate was 10 percent it has come down to 6 percent if it is floating rate no problem, it is a fixed rate then you go for another loan.

Pay off that particular money whatever you have taken to where you are paying 10 percent interest and obviously the remaining money whatever you have that will carry the 6 percent interest for you in the future. So, in this context these are different ways the commercials banks provide the loan broadly to the different customers. These are the different kind of methods or ways to make the loans by the commercial banks.

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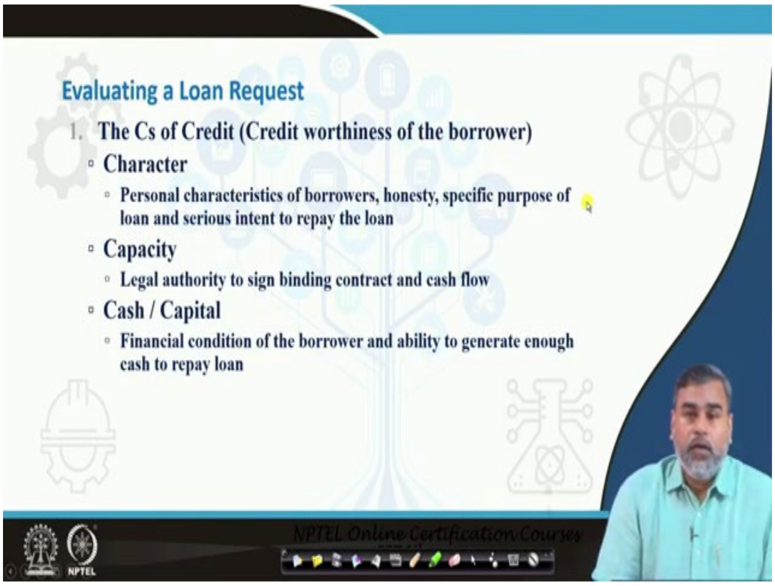

How to evaluate the loan request? Basically it is the 7 Cs or the 6 Cs of the credit popularly it is called as. Which basically tries to measure the credit worthiness of the borrower So, whenever you talk about the Cs of the credit to measure the credit worthiness of the borrower. What that Cs stands for? What do you mean by the Cs? The first one is character, personal character characteristics of the borrower age, gender, income all the socio-economic characteristics what this person has.

Dependency, cash flow all kind or information has to be gathered. Honesty difficult to measure but the banks try to measures through the different other external sources. Then specific purpose of loan for what purpose the particular person is taking the loan and his willingness to repay the loan.

Again difficult to measure but still the credit history of that particular person can tell you whether they have a serious intent to repay the loan or not. Whether this person also will take away with the money or they have real intension to repay the loan in the future whatever loan they have taken from this particular bank .

So, first C stands for this. Second C, capacity. The capacity means the legal authority to sign binding contract in the cash flow. Whether the particular person has the capacity to sign the binding the contract or not. So that is basically the second one whether they have a legal authority to sign the contract or not. Cash or the capital that means it shows the financial condition of the borrower and also they show the status or ability to generate enough cash flow to repay the loan.

So, whether the availability of the money or the cash particularly mostly it is financial factors only. The look art, analyse the financial factor of the individual. Whether the individual is good enough to repay the loan or they are able to generate that cash flow in the future to repay the loan or not. So that is basically called the capital or the cash.

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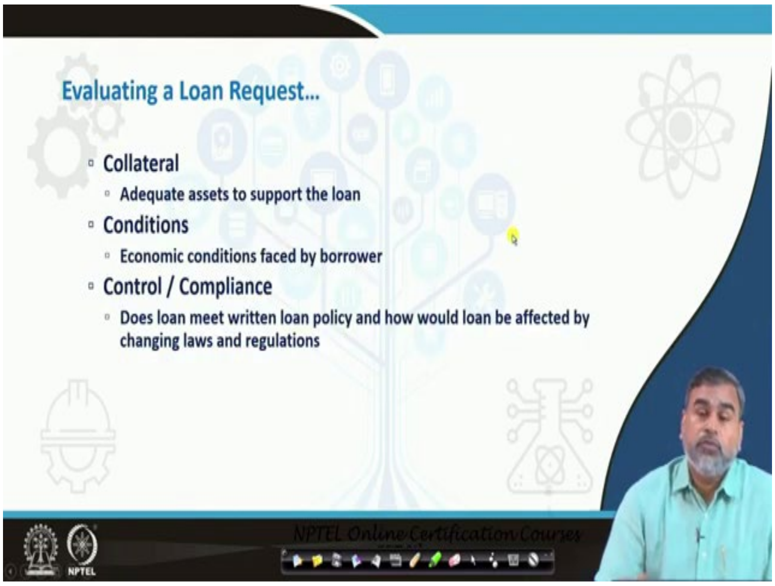

3 Cs then 4th collateral, whether this particular individual is able to provide adequate amount of assets to support this loan. Adequate amount of assets in this is adequate amount of fixed assets, variable assets whatever the borrower has. Because there is any kind of default the particular assets can be liquidated and the bank can recover these loans from that particular payoffs. Conditions, economic conditions which is not in the hand of the borrower.

Let the borrower has taken a loan which is for a particular business establishment and because of certain reasons because of slow down in the economy the product what the particular costumer or the particular entrepreneur has produced they are not sold in the market, there is a huge loss all the competition in that particular segments has gone off.

Now the profit is said, that the amount of profit goes down. In that particular point of time it is very difficult for that borrower to repay that loan. So, because of that the banks obligations also to see that how that particular business is going to be affected by the economic fluctuations. Is there any probability that the profit is going to be changed or going to be lower if there is any change in economic conditions in the market, that also has to be looked upon.

So the economic conditions faced by the borrower is another factor what the banks look at whenever they go for evaluation of the loan or if the employ if it is an individual loan then they have to look at where that person is working, in which sector whether that sector has any kind of potential to generate this much cash flow for this much type of period, this much time period or not.

So those kind of assessments the commercial banks do whenever they go for the evaluation of this loan request for the individuals. Then controller or the compliance what does it mean? Does the loan made return loan policy whatever loan policy the bank has prepared whether it is compatible with that loan policy, whether it is fulfilling all the compliances of that particular loan policy or not? And how would loan be affected by changing laws and regulations, that means if there is a change in the regulations and the laws with respect to the different kind of activities then how the loan is amount or loan disbursement is getting affected by that or how the interest rate is getting affected by that.

Particularly the legal aspects is quite important that whether under what conditions there is a possibility that the loan will be a failure. That is also another C what basically we have to look at.

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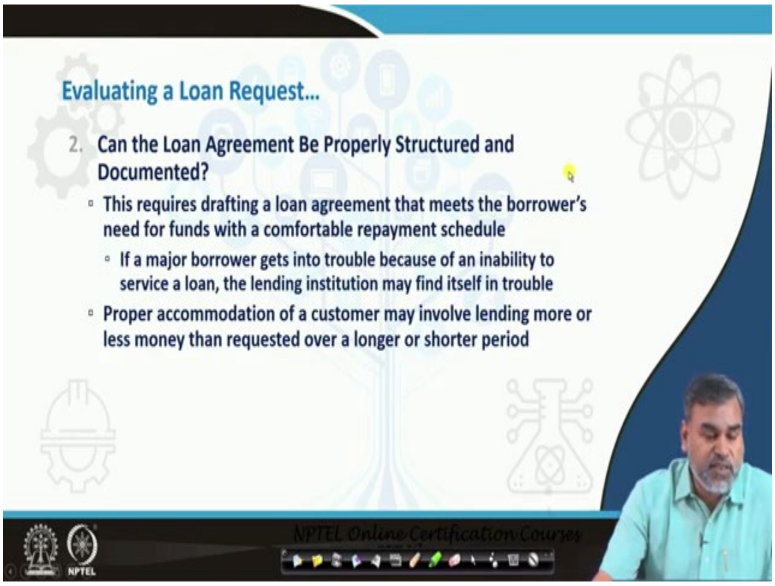

Then apart from the Cs we can also see some other things can the loan agreement can be properly structured and documented, that means this requires a drafting a loan agreement that meets the borrowers needs for the funds with a comfortable repayment schedule.

So, the loan agreement or the drafting of the loan agreement should meet the interest of the both the stake holder both the borrower and the lender. It should meet the borrowers need and it should have a comfortable repayment schedule. That means if a borrower, if a major borrower gets into trouble because of an inability to service a loan the lending institutions may find itself in trouble.

Poor accommodation of a customer may involve lending more or less money than requested over a longer and shorter period So, therefore proper drafting is required that looking at the prospective of both lender and borrower by that both the interest, both the stake holders interest can be considered while providing the loans to them.

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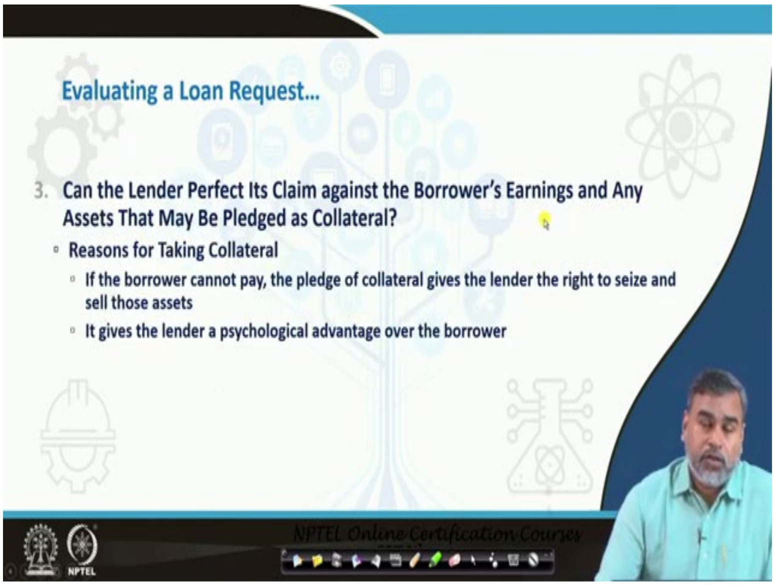

Other things basically also we look at can the lender perfect its claim against the borrower's earnings and any asset that maybe placed as collateral. So, why you are taking a collateral, if the borrower cannot pay? And the plays of the collateral give the lender the right to seize and sell those assets. It gives the lenders a psychological advantage over the borrower. If they do not repay will sell the asset and get the (loan) money back. So, this because of that the collateral are given.

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What are those different collaterals generally mostly people or the banks use? The accounts receivables can be used as a collateral if it is a company. Inventories what the companies has, real property, real property means a real estates, lands and all these things. Personal property fixed assets whatever you are individual or the business units have in their own setup.

Then guarantees, personal guarantees, so there are many more but these are the some of the collaterals they can use also the shares, debentures, they can use their golds, all kinds of assets can be used as a collaterals who has a value which has a proper value can be used as a collateral or whose values is not going to detoriate in that way in the market by that the banks will incur the loss if there is a default .

So, these are the different ways the particular loan evaluation policy goes through and the banks basically go and evaluate the loan request.

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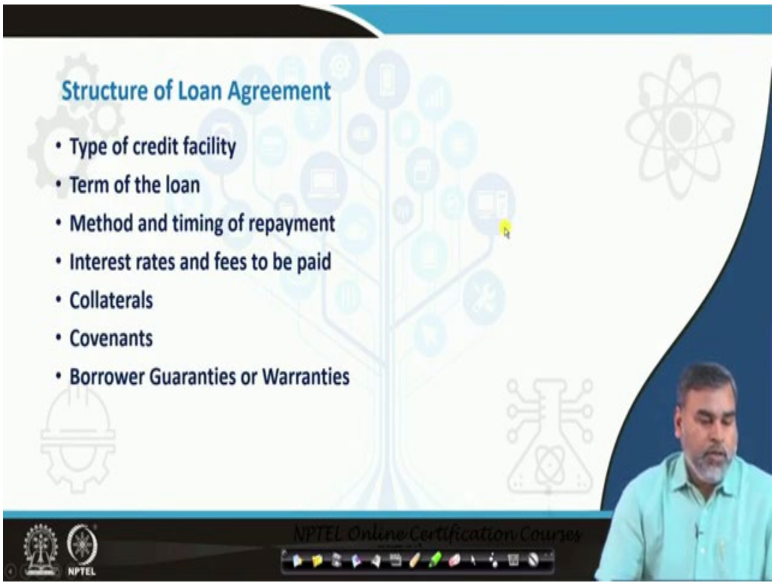

How the structure of the loan agreements look like? The types of credit facilities, what kind of loan it is? How much loan, and for what reason? Term of the loan, how many years? The method and the timing of the repayment, whether the money will be paid directly or money will be paid in the instalments basis through the bank account or it may be through the cheques and when the money will be paid, monthly, quarterly like that.

Interested rates, how much interest rate will be charged? What if the collateral will be used, is there any covenants any restrictions has been imposed on this, and the borrowers guarantee and warranties if anything has. So these are the different kind items has to be given or has to be recorded in the structure of the loan agreement by that the loan agreement can be designed in the proper way to provide the loan to the customer.

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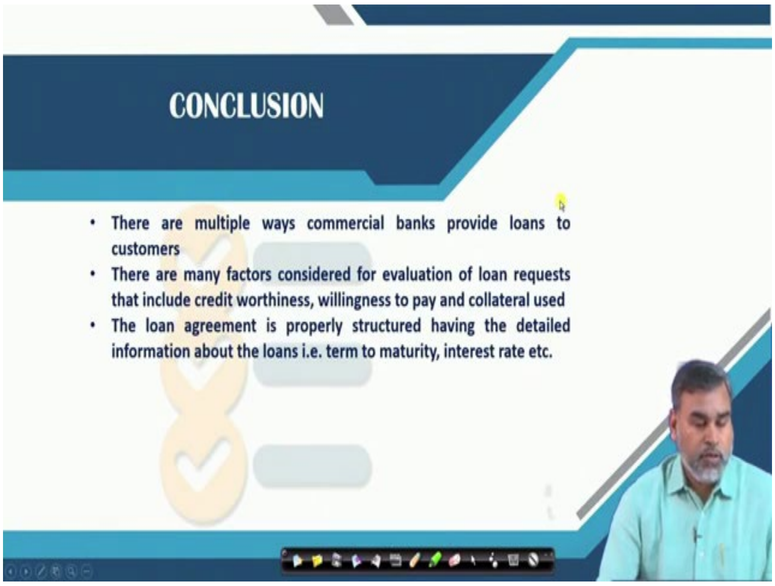

So, in the conclusion what we find there are multiple ways the commercial bank provides loans to the customers, there are many factors that are considered for evaluation of loan requests, which include credit worthiness, willingness to pay collaterals used etc. The loan agreements is properly structured having the detailed information about the loan that is term to maturity, interest rates collateral used and all these things.

So these are the basic steps or basic ways through which the particular loans are disbursed and the commercial banks are able to generate the profit out of this or return out of this. In the forthcoming classes we will discussing more about specific loans like, industrial loans, retail loans, and all these things.

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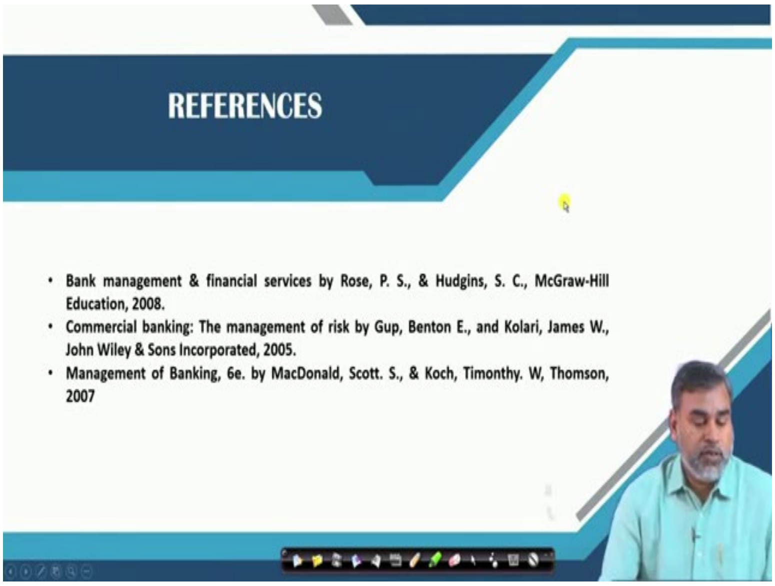

So, these are the references what you can go through for the detailed analysis. Thank you.