Management of Commercial Banking
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Lecture 38
Management of Lending Activities - 9

Good morning. In the previous class we were discussing about the different activities related to the business loans and how the commercial banks are basically evaluate those loans and what are those factors they consider for the evaluation of the loan request given by any kind of companies or the business firms. So apart from the industrial or the business loans what we have discussed there are other type of loans also the commercial bank provide.

And among them the consumer loans are also a very prominent type of loans what always the commercial banks provide to the different individuals and the consumer loans are many types and also they use different kind of methods for pricing these consumer loans and what are those factors they consider for pricing these consumer loans. These are all those considerations we have to also understand whenever we discuss about the commercial banking activities.

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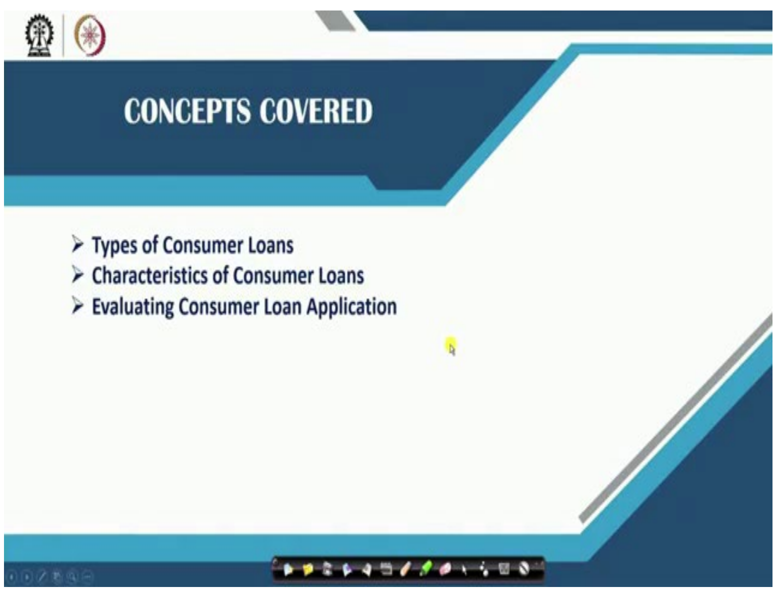

In today's discussion we will be covering of what are those different types of consumer loans the commercial banks always use or always provide and what is the characteristics of this consumer loans or what are those different features are related to consumer loans. And if you characterize these consumer loans, then what are those kind of characteristics we have to consider whenever we define that this is a particular consumer loan which is always given by the commercial banks. Then how the commercial loans' applications are evaluated. So these are the different issues or the concepts what we are going to discuss today in this particular session.

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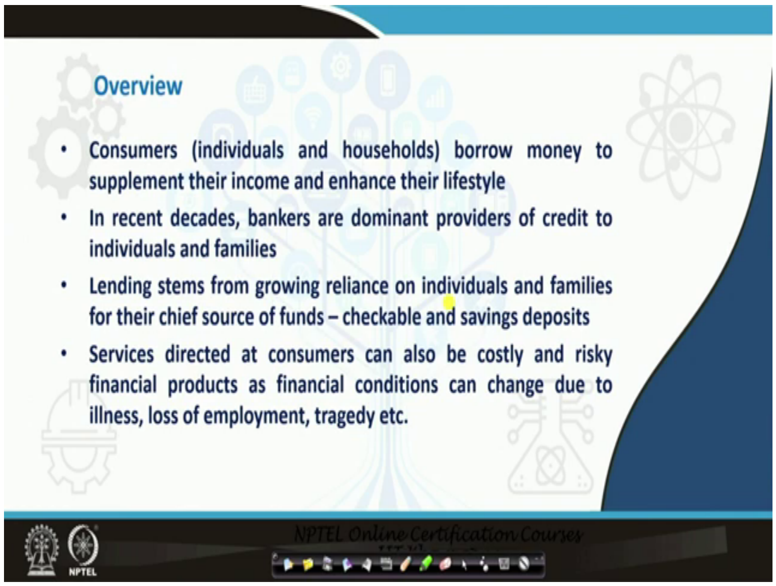

So let us see that what are those different types of consumer loans the commercial banks provide, but before that if you see that there is a huge importance of the consumer loans from the commercial banking prospective because the requirements of the individuals or the households are many and they basically borrow the money to supplement their income and enhance their lifestyle because in the current age that it is not that the income determines everything.

Or your disposable income is basically decides that what is the consumption pattern one particular consumer or particular household should have. So the consumption pattern and all those other considerations may change whenever we are talking about the different type of borrowings what the commercial banks always try to fulfill the requirement of the different borrowers.

So in this context if you see that the bankers are the dominant providers of the credit to the individuals apart from the other financial institutions which are existing. Although there are different kind of lending institutions which are existing in the system but whenever we are talking about the retail loans or the household loans consideration then always we can observe that mostly the loans are always taken by the commercial banks.

Whether it is because of the advantage of the commercial banks always enjoy or the consumers are more comfortable with getting the loans from the commercial banks instead of taking the loans from the other kind of financial entities. So here if you see that mostly the source of this particular loan are always from the savings deposits or the term deposits whatever the commercial banks are holding.

And all type of business loans and commercial loans are also given by the deposit base only but sometimes also the commercial banks lend and provide the lending activities to the business units or the industrial units. But whenever we talk about the retail loans, mostly the retail loans are always considered and taken from the savings deposits or the checkable deposits whatever the commercial banks have or the individuals always keep those kinds of deposits with the commercial bank.

But one consideration one thing you keep in the mind that whenever these particular services are given by the commercial banks, it is sometimes maybe risky because the loans which are given by the commercial banks to the entities, sometimes the loan may not be repaid back. Either the commercial banks have not assess this loan properly or because of some kind of uneven situations which can arise or because of the borrower's illness or loss of employment or any kind of tragedy. So anything can happen to that particular borrowers. So because of that the probability of default of that kind of loans also sometimes is quite high.

So considering those things that always the evaluation of those loans are very much required or the probability of default of the credit risk involved with respect to that consumer loan. So, it is very much inevitable to be considered or to be calculated before providing these loans to the different individuals. That actually we can keep in the mind always or the commercial banks always keep in the mind whenever they provide loan to the different type of consumers.

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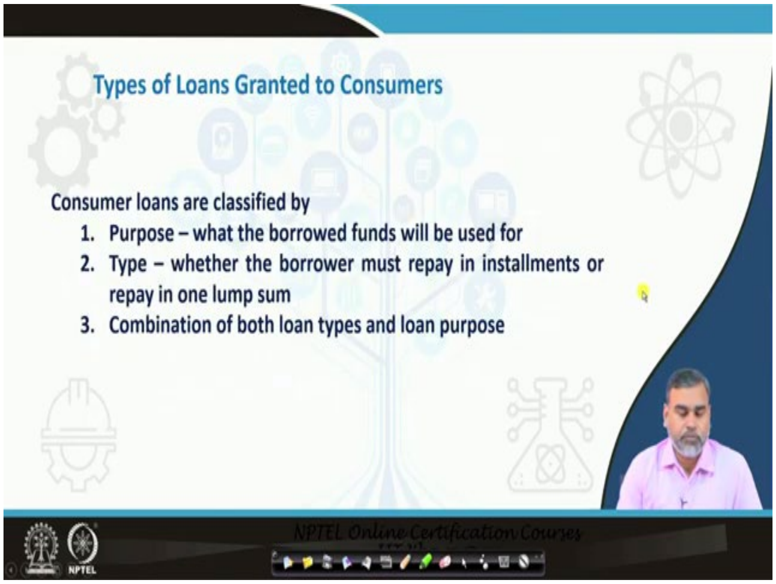

So whenever we talk about the different type of loans, the loans can be classified broadly. There are other type of loans but if you talk about the broader classification of the loans, the loans can be classified on the basis of the purpose or the objectives for what reason the borrower is basically required that particular money or how this particular money is going to be used or the borrowed funds will be used. That is number one.

That kind of classification like you have personal loan, you have the house loan, you have the vehicle loan, you have the education loan, there are different type of loans you are already might have heard about and those loans are defined on the basis of the use of that particular fund and second one is that type. Whenever we talk about the type there we basically see that whether the borrower must repay in installments or repay in the lump sum.

So that basically defines on the basis of the characteristics of that particular loan that the bank basically goes per agreement with this consumer to repay that particular loan or the principle amount as well as the interest as a lump sum amount in the end or it may be repaid with the different installments in a periodical basis.

And sometimes also loans can be classified on the basis of the combination of both the loan types and the use of that particular loan what the purpose of that particular loan. So in this context what we can say that the broader classifications of loans are basically made on the basis of the purpose and the type but we are mostly comfortable or maybe more general nature if you talk about and we are always looking at the loan classification from the use point of view or the purpose point of view.

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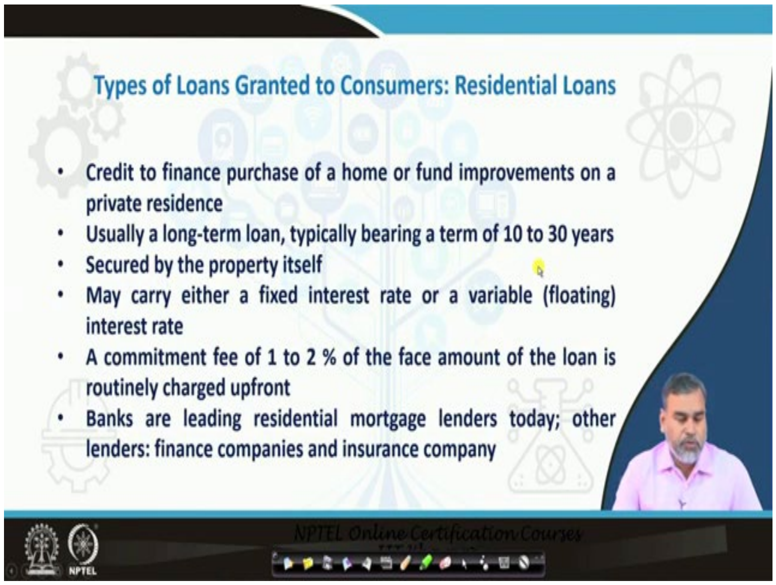

Then if you see that whenever we talk about this then again the loans can be defined in two ways, one is residential loans and the nonresidential loans. Then the residential loans are basically very long term in nature and mostly the house loans and all these things are consider as the residential loans. So this is the loan which is or the credit which is give in or the finance to purchase the home or the improvement on a private residence.

So the loans can be given only to buy the house or maybe for the renovating the house, already existing house if somebody has. So that is broadly considered as the residential loan and generally it is very long term in nature and the period can vary from 10 years to 30 years but it can mostly the on an average if you see that the house loan term to maturity is around 20 years.

So it is a mortgage based loan and the mortgage is nothing but the house itself that whatever house you are buying that particular house is considered as a mortgage. If at any point of time the particular consumer is at default or consumer is not able to repay the loan in terms of principle or the interest then the bank always has the right to use that particular asset to recover that particular loan or they can liquidate that particular asset.

And whatever proceedings they will be receiving against that particular liquidation that particular proceedings will be used as the loan recovery against that particular loan and again the loans or the interest rate which is charged against a residential loan it can be fixed or it can be floating. So it depends upon the consumer that whether the consumer wants this particular loan on the floating rate basis or the fixed rate basis.

The floating rate basis loans are basically always driven by or determined by the market forces. So depending upon the market interest rate, the rate of interest on the floating loans, the floating rate loans change what the fixed rate loan rates generally do not change on the basis of the fluctuations in the interest rates in the market.

So there is a commitment of fee of 1 to 2 percent of the face amount of the loan is always charged on upfront. Immediately that amount of money as a servicing cost or the commitment fee the consumer always pay against that particular house loan and if you see worldwide including India that banks are always leading residential mortgage lenders and although there are other lenders like some typical housing finance companies are existing.

You have HDFC and other companies which are existing in the Indian context. Then you have all the insurance companies including LIC and all who are basically operating in the Indian financial system, they are also providing the housing loans, but if you compare all those entities who are playing this role for providing consumer loans, always bank has a prominent role or bank plays a significant or special role for providing the housing loans in financial system, as a whole not only in India but also across the countries.

So in this context what basically we are trying to say that for residential loans the commercial banks play a very significant role and mostly residential loans are secured loans. That means it is backed by the assets or the mortgage and as well as it basically carries relatively lower interest rate in comparison to the other type of loans which exist in the system. That is a general characteristics of the residential or the housing loan always what we can see.

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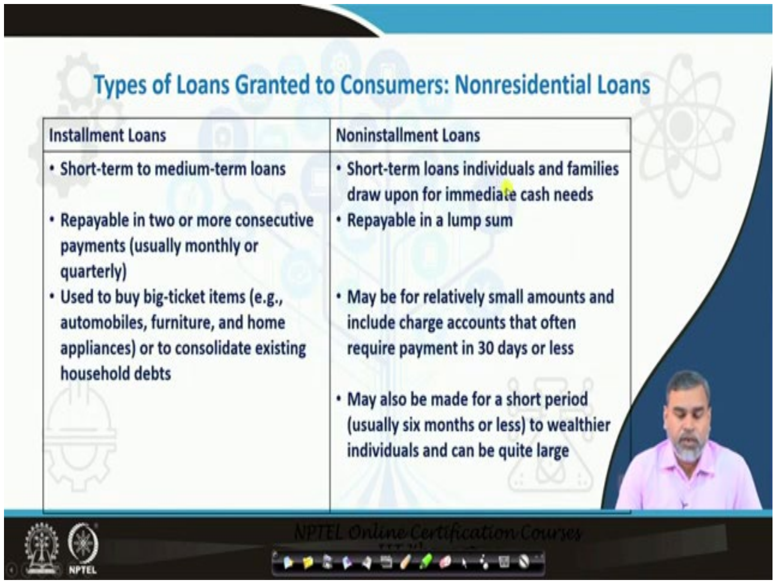

Then whenever we talk about the nonresidential loans, nonresident loans are many. The period varies from short term to medium term but again if you broadly classify them, there are some loans which are paid in the installment basis and some loans are paid in the lump sum basis. That is called the non-installment loans and the money which are repaid against the different type of installments that is called the installment loans.

So whenever you talk about the installment loans these are short term to medium term loans and generally repayable in two or more consecutive payments. It can be paid monthly, it can be paid quarterly. But mostly if you see the installment loans if it is relatively longer term in nature, the loans are basically repaid in the monthly basis. So every month some installment amount has to be paid to the commercial bank against that particular loan and that installment includes both interest and as well as the principle.

So whenever we talk about the installment loans used to buy this big items you can buy the vehicle, you can buy the high costly furniture, home appliances. You might have observed that in today's context many kind of loans are provided or financing can be provided against any kind of household commodities what we are buying. So these are coming under and the payment can be made on the installment basis not necessary that you have to pay the money immediately.

So for that we have to always take the consumer loans in terms of the different installments and sometimes also these particular loans are taken to consolidate the existing household debts. If already they have some debt, then maybe on installment basis they can take the loan from the bank to repay that particular debt and from the regular source of income this particular repayment of the loans can be made.

And for that proper assessment of that particular loan can be made before sanctioning that loan or before providing that particular loan by the commercial banks. But whenever we talk about the non-installment loans, the non-installment loans again is short term in nature and that particular loans are basically taken whenever there is immediate cash requirements by the consumers in the market.

And mostly the non-installment loans already by definition is paid in the lump sum and relatively it is small in amount in comparison to the installment loans and it include this charge accounts that often require payment of 30 days or the less and sometimes also the period can be extended.

It can be, if it is a very quite wealthy individuals the loan amount also can be relatively bigger and depending upon the financial positions the loan can be given and for a particular purpose and once that particular purpose is fulfilled then loan amount with interest has to be repaid back to the commercial bank as a lump sum amount.

But overview in a nutshell if you want to see then always we can see that non-installment loans are short term in nature and mostly the loans are always given to fulfill some very short term requirements by the individuals and the loans should be repaid back in a short span of time. So this is the way the non-residential loans classification broad classifications can be made.

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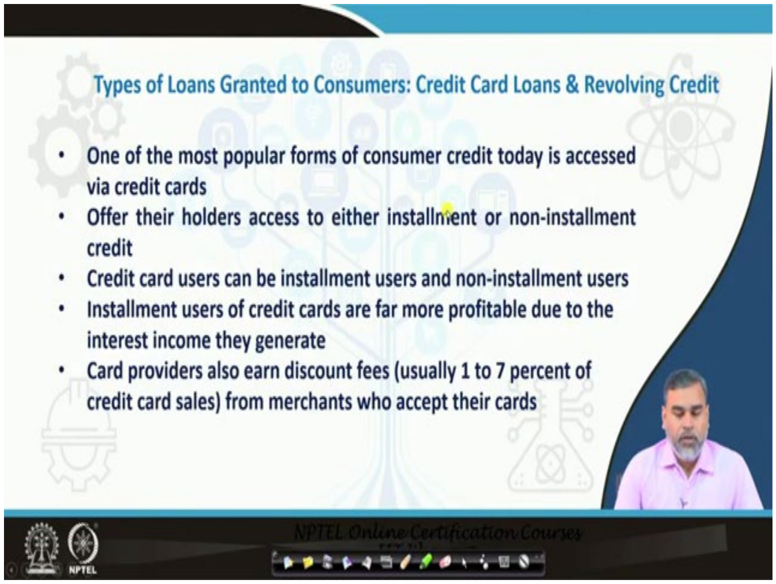

Then there are other type of loan in today's context more relevant. The relevance of the credit card loans and the revolving credit is quite important in today's scenario because most of them most of the countries, particularly developed countries they always work with a credit system and the particular use of the credit cards and all these things and after the emergence of the online transactions and all, the importance of this kind of products have gone up by many folds not only in India but also in other countries.

And here the particular loans which are taken against this credit card they can always pay either on the installment basis or the non-installment basis. So you can always, you might have known that whenever we are buying any commodities through the credit card so it is typically a loan what the bank always gives and there is a period they provide. Let 50 days period and within these 50 days the money has to be repaid back to this particular bank against that payment what the bank has made.

And the thing is in today's context if you see whenever you are buying a very high valued commodities then there is a provision of installments or you can pay in the EMI basis. That instead of putting the financial burden on the consumer as a whole even if the particular money whatever the bank has paid of 1 lakh rupees or 1 point 5 lakh rupees this can be always equally divided among 20 installments or 12 installments.

And like that the money can be paid in installment basis to make a convenience for the consumer who has used that particular credit card to buy this particular loan. So the installment users of credit card are far more profitable due to the interest they generate because even if you are paying in installment basis then against this particular installment whatever remaining amount will be there against that remaining amount some amount of interest the consumer has to pay.

But if you are paying in the lump sum basis then the bank do not charge any interest for a particular period of time and once that period crosses then this particular amount of interest has to be levied upon that money which is not repaid in that particular period. So generally the card providers always earn discount fees, usually 1 to 7 percent from the merchant who accept their cards and it may not happen in all the cases or all the countries.

But in US and other developed countries sometimes use of this particular cards get some kinds of discounts or some kind of concessions. The concession was given to use this particular credit card and the card providers get that one because of the popularity of that particular card and as well as that also creates a kind of psychological incentive to the buyer or to this particular consumer who is ready to spend more money against that particular commodities. If against this particular cash transactions what they are supposed to do to use or to buy that particular commodity from the market. So this is about the credit card loans.

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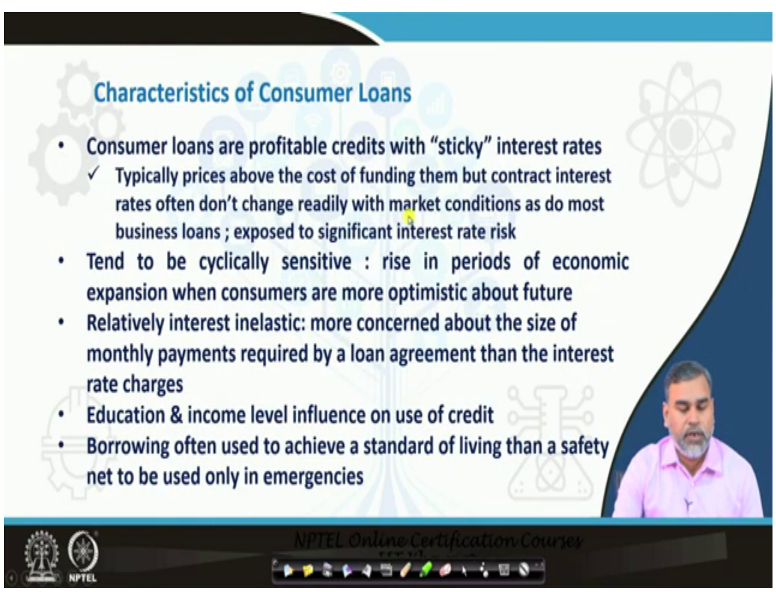

And then we have if you talk about the characteristics of the different type of loans then you can, what we have observed that the consumer loans are profitable credits with sticky interest rates. Mostly the interest rates are not very fluctuating against this consumer loans what always we have observed and typically this particular loans prices above the cost of funding them but contrast and contract interest rates often do not change readily with market conditions as do this most business loans.

So the thing is whenever there is a market condition change in the market conditions the rate of interest on the business loans or the interest rates against this business loans highly sensitive towards that but consumer loans are not that way sensitive towards this market fluctuations because of their amount and as well as the requirement of this particular loans and as well as the mortgage which is used against that loan.

Even if it is long term in nature because it is a highly secured loans sometimes also the interest rate may not that way fluctuate against that particular consumer loans but which is the case for the business loans and obviously if it is a floating rate loans then obviously we are exposed to more interest rates and depending upon this interest rate fluctuations in the market the pricing of this floating rate loans always decided for all type of residential and non-residential loans what the commercial banks have already provided.

Tend to be cyclically sensitive. Generally, the particular loan rates, the particular demand for the loans increase in the period of economic expansion but when the consumers are more optimistic about the future that the future is going to be better. The growth opportunity or the investment opportunity is going to be higher and because of that the demand for the consumer loans increases and also it depends upon the interest rate fluctuations in the market. So depending upon interest rate scenario the particular loan rates also is going to be changed.

For demand for this particular loans also is going to be changed. Relatively interest inelastic, these loans are relatively interest inelastic in comparison to the business loans and these particular loans in this context we are more concerned about the size of the monthly payment required by the loan agreement than the interest rate charges. Again we can refer to the consumer psychology that whenever we are using this mostly the consumers are not concerned about that how much interest rate.

They are mostly concerned about the absolute amount of money what they are going to pay in the monthly basis which is financial burden for them and that particular burden they always consider in the mind whenever this particular loans are demanded instead of the actual interest rate what is prevailing in the market they look at the absolute amount of the installments what they are going to pay.

So the use of the credit, the productive use of the credit depends upon the consumer's income level and education that whether the consumer is well enough to utilize that particular money properly to extract the return if they have taken the loan for some typical reasons and the particular consumer who has taken this particular loan against buying any household commodities then obviously there is no chance of the return.

So in that context the income level plays a significant role for the repayment of that particular loan and the particular consumer's education level decides that whether the loan should be demanded by the consumer or not and whether the loan should be good for this particular consumer or not. The borrowings what basically made against this consumer loan often used to achieve the standard of living than a safety net which will be used to only in the emergencies.

So mostly the loans which are taken that either to improve their standard of living, to buy the house to buy the vehicle to buy the luxury commodities and all. It is not that this particular loans are taken for the emergency, for any kind of precautionary reasons for the consumer or may face in the future which is adversely affecting their standard of life or the quality of the life. So these are the different characteristics of the consumer loans.

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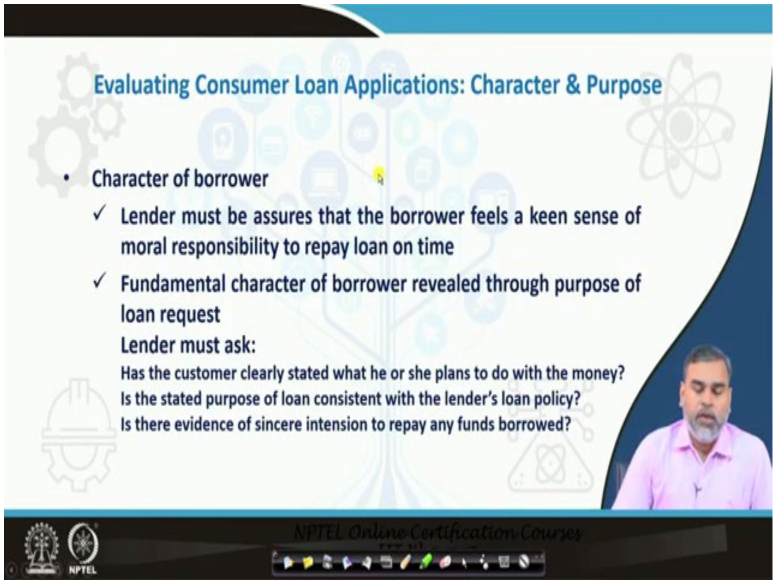

Then we can come back to the evaluation of the consumer loan applications that whenever you talk about the evaluation part, if you recall that the evaluation of the business loans in the same line that the consumer loans also are evaluated by considering the different kind of factors, different kind of variables which are really responsible for deciding that whether the loan should be given or not or the appraisal of the loans is based upon certain characteristics of the individuals and in that case we are talking about the characteristics of the funds.

But in this case we are basically talking about the characteristics of the individuals. So if you talk about the character part, the characteristics of the borrower, the banks of the lender must be assure that the borrower feel keen sense of moral responsibility to repay the loan on time which is basically nothing but the willingness to pay.

Whether the consumer is really willing to pay that particular or repay that particular loan what he is going to or he has already borrowed from the bank that is number one. And the fundamental character of the borrower reveal that how this particular, what is the loan purpose and how particular loan is going to be utilized.

So in this context the lender always ask that has this customer really stated what he or she plans to do with the money, for what purpose the loan is taken. Is the stated purpose of the loan consistent with the lender's loan policy? That means the lender is really eligible to provide that particular loan.

Or the particular conditions for the lender has put to provide that particular loan or to disburse that loan. Whether the consumer is really fulfilling their criteria or not. Then is there any evidence of sincere intension to repay. So that means whether the willingness to pay of that particular consumer is there in the future to repay that loan or not.

So all kind of things has to be analyzed in the beginning by the lender for the borrower point of view and after that they can assess that whether the loan should be given or not, and if the loan should be given then what kind of price should be charged against that particular loan. So this is basically the first thing the lenders always evaluate whenever the loan applications are made by the consumers.

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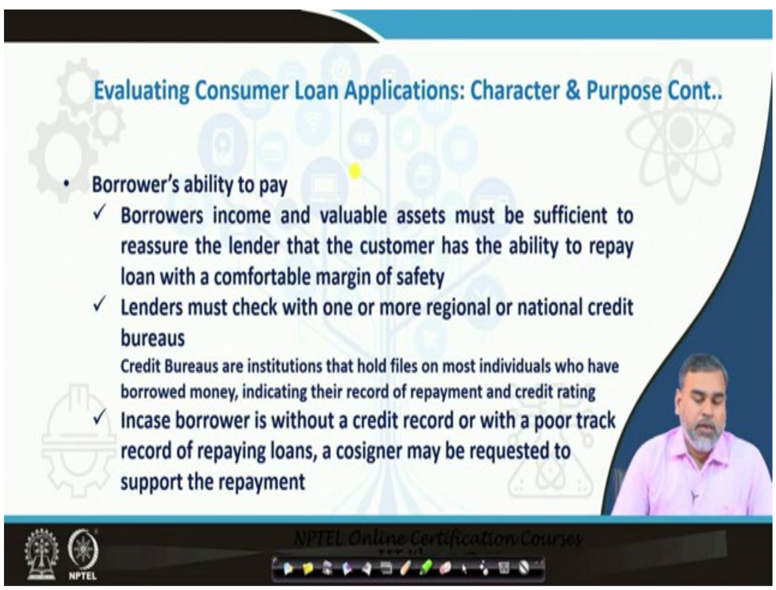

Then the next question comes the borrower's ability to pay. That means they want to assess the financial condition of the borrower and what is the future cash flow the borrower can generate. By that they will be eligible to or he will be able to repay that particular principle and as well as interest whatever the commercial banks are charging. So the borrower's income or the valuable asset must be sufficient to assure that the lender has the ability to repay with a comfortable margin of safety. That margin and safety already we have discussed.

The lenders also must check with one or more regional or the national credit bureau because the information about the different history, about the background, about the loans what already that particular consumer has taken and all these things all the details will be always assessed by the bank from the credit information bureau and accordingly they decide that whether still the credit worthiness of this consumer is there or not. That if the loan will be given to them then the loan will be disbursed.

So the credit bureaus are basically the different organizations that hold the files on most individuals who have borrowed the money, indicating their record of repayment and the credit rating that whether the particular consumer is able to or historically they have no kind of default history and they are ready to repay that particular loan in appropriate time so that kind of rating or that kind of record will be helpful for the banks to decide that whether the loans should be given or not.

Then in case the borrower is without a credit record or with a poor track record of repaying the loans, a cosigner may be requested to support the repayment. Somebody else will be the guarantor and somebody else will be there who will be ready to be a guarantor for that particular loan. If there is any kind of default against that particular loan then that person also will be responsible for that.

So in this context that we have to see that the credit worthiness of the borrower has to be evaluated very thoroughly that whether the particular person or particular individual is in the future can generate enough money or enough cash flow they can generate to repay that particular loan in a proper schedule time. By that the failure of the non-performing assets probability will be lesser for the commercial banks.

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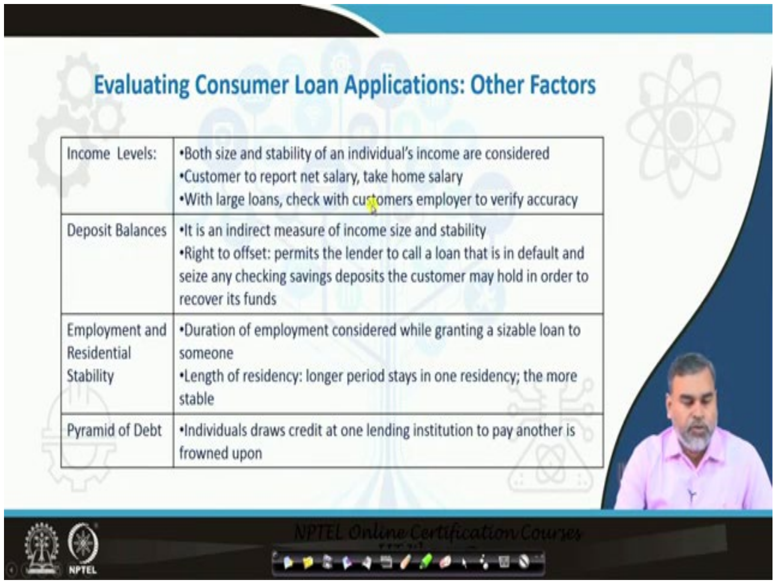

So here whenever you go for the evaluation first we look at the income levels. Both size and stability of the income level are considered. Why talk about the stability? Stability is a factor because only the absolute income is not sufficient thing. We have to see that whether the historically this much, what is the permanent component of that particular income and whether the income is not fluctuating that much. So, even if it is fluctuating whether it is in the higher side or not or it is in increasing trend or decreasing trend.

If it is increasing then it is not a bad, it is good for the banks to decide that the loans should be disbursed and if it is fluctuating then it is a risky matter for this particular bank to provide the loan. Customer to report the net salary and the take home salary what they are getting. With large loans, check with the customers employer to verify the accuracy. If somebody charging very high loan then about this particular customer about the probability of salary increase or all kinds of details can be always assessed from the employer's point of view.

They can also look at the deposit balances of this particular consumer. It is an indirect measure of income size and stability. So it permits the lender to call a loan that is in default and seize any checking deposits savings deposits customer may hold in order to recover its fund. If the deposit base is quite strong then it is easy for the banks to provide the loan. The reason is if there is any kind of default then that deposit amount of the consumer can be used to recover that particular default amount what the consumer has already made.

Employment and residential stability. Duration of employment considered while granting a sizable loans to someone. What kind of job this particular person is doing, particular individual is doing, whether the job is secured or not whether it is a public sector job or is a private sector job. What is the guarantee that the job will continue for this particular period of time? So all kind of assessment they do and longer period stays in one residency, the more the stable.

Because anyway if you are staying in your own house and you are not frequently changing your house then the credit score will be higher or the probability of getting the loans will be higher. If you are not owning a particular house or you are staying in a rented house, then you are changing your houses frequently then that shows one kind of instability about this particular consumer then it will be more risky for the commercial banks to provide the loan.

So individual pyramid of the debt which shows that the individual draw credit at one lending institution to pay another is generally happens that whenever we have enough loans to repay that loan we go for another loan. So that is why the assessment of that particular repayment are the information about that particular consumer is very much essential from the credit information below. Whether really that consumer is able to repay the loan and they do not have many loans with them.

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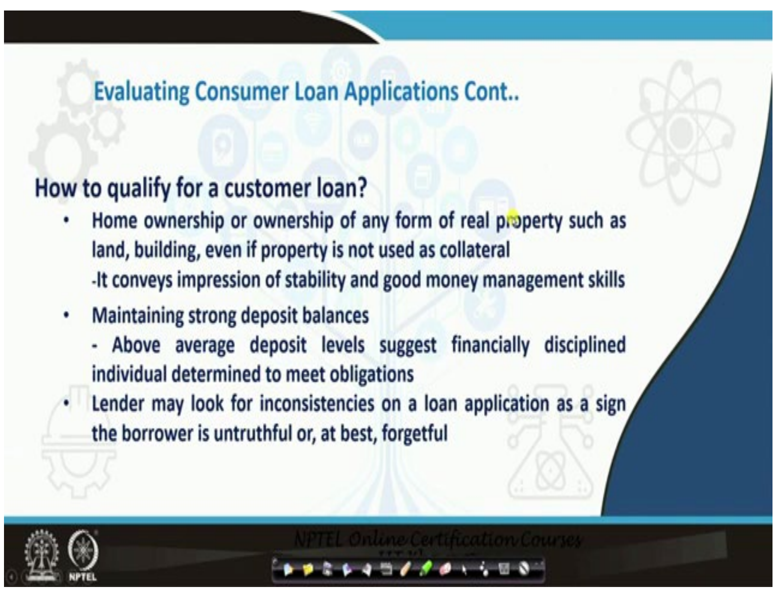

So how to qualify for a consumer loan? Home ownership or ownership of any form of real property can land building even if the property is not used as a collateral. It conveys impression of stability and good money management skills that whether really this consumer even if there is a default the consumer can repay the loan in the future by selling these particular assets.

Maintaining a strong deposit balance obviously above for deposit levels if you talk about the deposit, deposit level is high, then obviously the consumer has more financially stable and against the loans can be given. The lender may look for inconsistencies on a loan application as a sign, the borrower is untruthful or at best forgetful. So these are all the psychological or the behavioral issues what always the banks can look at whenever they go for this.

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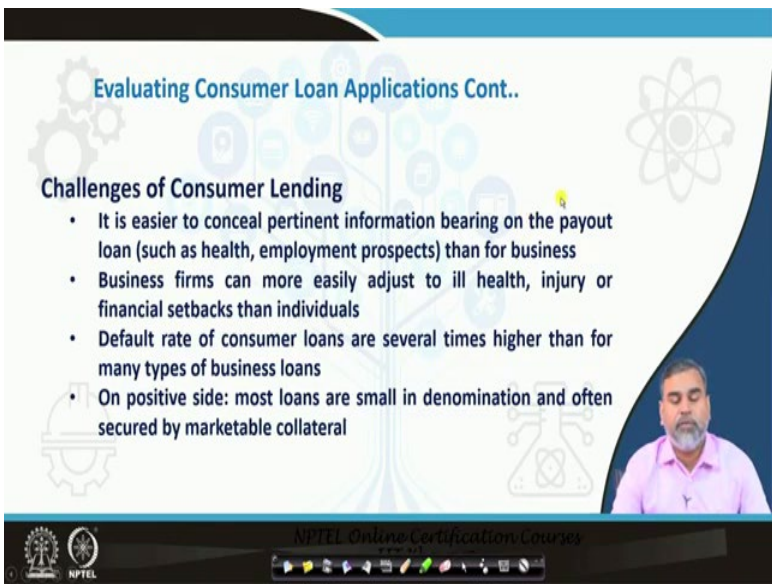

So the challenges are many for the consumer lending. It is easier to conceal pertinent information bearing on the payout loan such as health, employment prospects than the business loans. Business firms can more easily adjust to ill health, injury or financial setback than the individuals. Default rate of consumer loans are several times higher than for business loans because sometimes there may be because of some psychological or behavioral issues or because of some uneven situations there is a default against this particular loan.

But most loans are small in denomination and often secured by the marketable collateral whenever the loans are given to the consumers. So because of that this is a kind of positive side of this particular assessment that if something will happen then this particular asset can be used as a collateral and it can be liquidated and the loan can be recovered. So, these are about the different types of loans and the evaluations factors what these commercial banks always consider.

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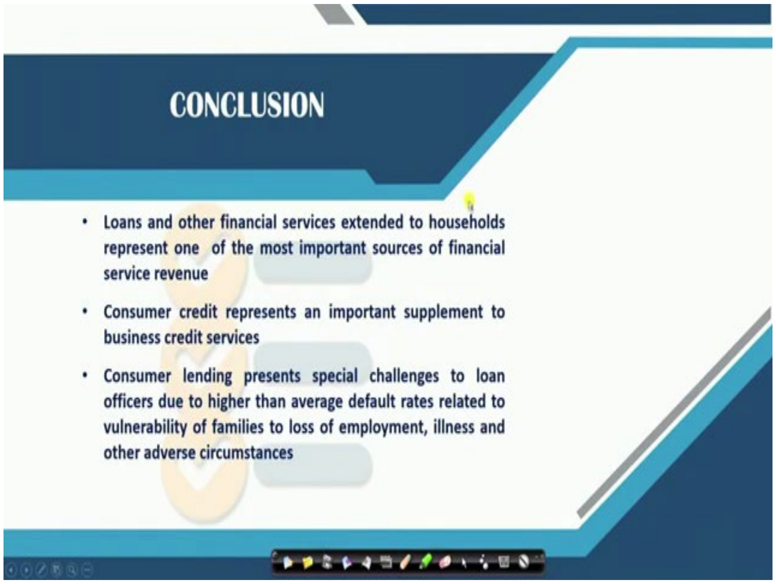

So coming to the conclusion what we have seen the loans and other financial services can be extended to the household and consumer credit represents the important supplement to the business credit services. Consumer credit presents special challenges to the loan officers due to higher than average default rates related to the volatility or maybe there are some kind of problem related to the families like loss of employment, illness or the other adverse circumstances.

In that time the default maybe relatively higher. So these are the ways basically the consumer loans are given. These are the different types or measure types of consumer loans always the commercial banks provide.

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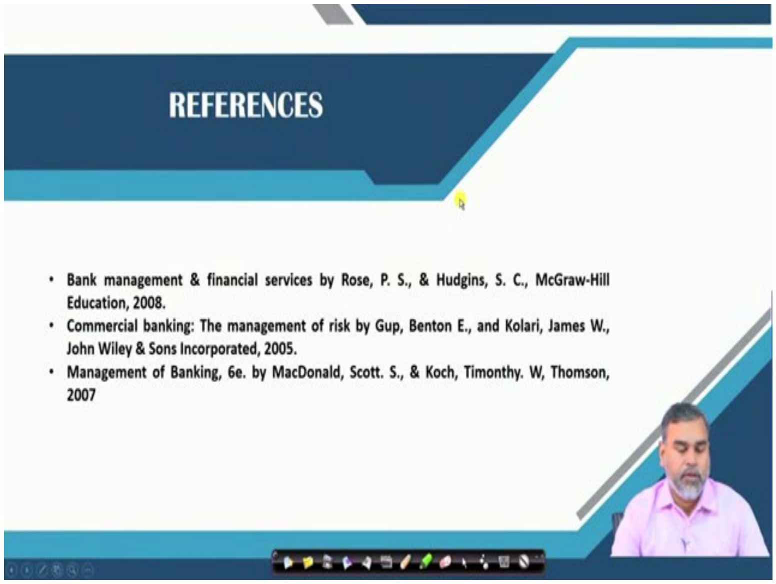

So you can go through these references for your detailed discussion, detailed knowledge about this particular issue. Thank you.