Management of Commercial Banking
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Lecture 04
Financial Statements of Commercial Banks - 1

Good morning. So, in the previous class we discussed about the importance functions and the regulations of the commercial bank. Before, before we start the discussion on the different aspects of the managements of assets and liabilities let us understand, how the asset and liabilities of the commercial bank looks like or what are those items comes under these assets and liabilities and how the performance of the commercial banks are measured. Then after that we can move toward the risk management and the other aspects of the commercial banking.

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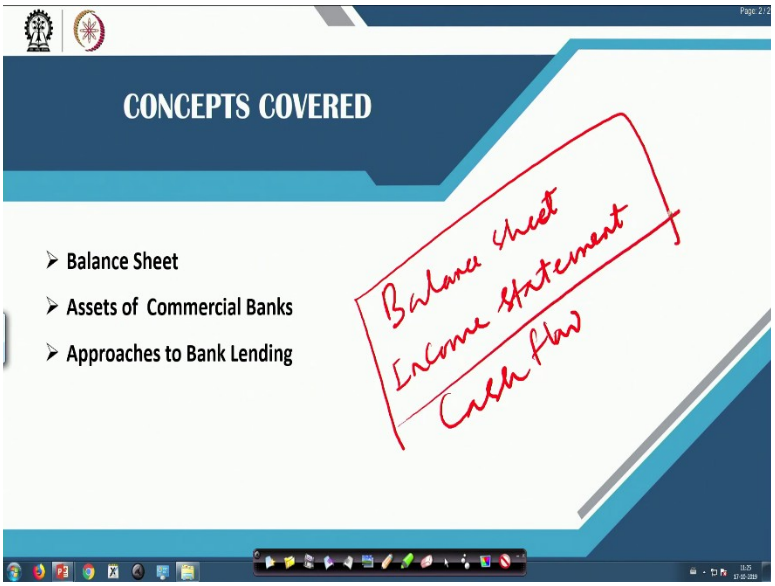

So, today I will be discussing about the financial statements of commercial bank. So, you might have the idea about the financial statements that whenever in general we talk about a financial statement, we generally always come across three things - One is your balance sheet and second one is, we come across the income statement and third thing is the cash flow. And here whenever we talk about the cash flow, the cash flows are basically derived from the different sources.

One is your operating cash flow, financing cash flow, investment cash flow and all these things. But whenever we talk about the commercial banks or we analyze the financial statements of the commercial banks, we mostly focus on the balance sheet and the income statements. So, in today's discussion particularly for this session, we will start with the balance sheet and then we can move towards the different types of assets which are comes under the balance sheet and out of them there are one of the major assets what the commercial bank has that is the bank lending.

And there are the different approaches the commercial bank follows for providing the loans or there are some theoretical philosophy involved in that. So, what exactly that approaches are or how these different approaches are used for bank lending by the commercial banks, so that is basically our next discussion. So, these are the three different motives or the three different issues what we will be discussing today.

We will define balance sheet. We will discuss about the different assets of the commercial banks, which comes under this balance sheet. And the approaches what the commercial bank follows for the lending purpose. So, these are the different concepts or different issues what basically we are going to discuss today.

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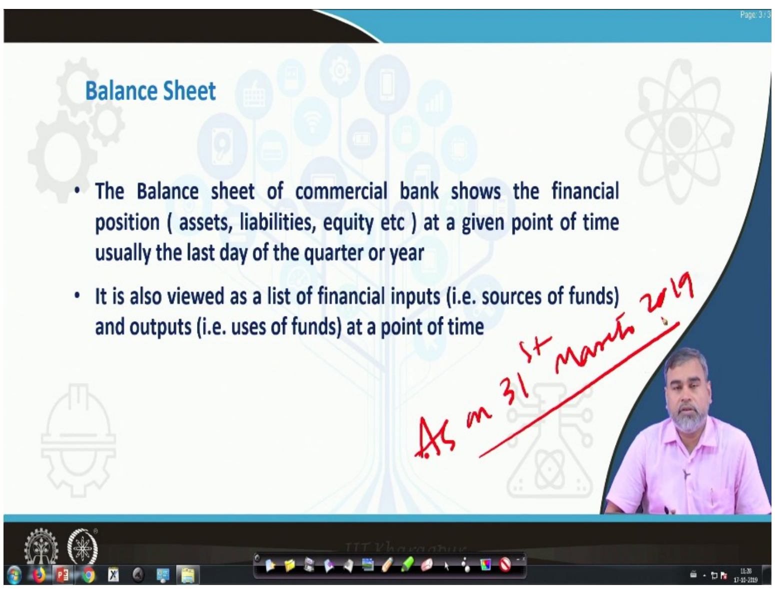

So, you must have the fair idea about the balance sheet. What exactly the balance sheet is? Whenever you talk about the balance sheet, whether it is a commercial bank or whether any other financial institution or it may be company, but whenever we discuss or we analyze the balance sheet, it basically shows the financial position of the company or financial position of bank at a given point of time usually the last day of the quarter or the year.

So, you might have heard that whenever we try to see that what is the financial condition of a particular organization, we see that, you might have seen that people generally write the “as on”, “as on 31st March, 2019”. What is the financial position of the company or financial position of the bank?

So therefore, the balance sheet basically provides the condition or the situation of the commercial bank at a particular point of time. So whenever we talk about the financial position, it talks about the assets, liabilities, the capital, all types of things which comes under the financial statements. These are reported in a balance sheet and that balance sheet gives you the idea of the financial position of the company on a particular time or a particular date.

So, sometimes also the balance sheet is viewed as a list of financial inputs that means the sources of the funds and the outputs that means the uses of the funds at a point of time. Then from where the money is coming and where the money is going and how the money is utilized? So, this is the way also the financial statements, particularly the balance sheet can be looked upon.

So, two things basically we keep in mind, one thing is the condition of company is shown at a particular point of time through the balance sheet and the balance sheet is also can be judged where the cash flow or the financial inputs and outputs or the sources induces of funds of a particular organization.

So, balance sheet basically is viewed as a list of financial inputs and outputs at a particular point of time. The point of time is very important in this particular context, because we are not basically considering what is happening to that particular bank or particular organization over a period of time.

We are basically judging this performance at a particular point of time, basically it is at a particular point of date. So, this is the basic definition of balance sheet. Then in the balance sheet we have two things, we have asset and liabilities. So in this particular session we will be discussing about the different assets of commercial bank, then we can move towards the liabilities and finally we will discuss about the income statements or the profit loss account of the commercial banks.

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So, when you talk about the assets of the commercial bank, and there are many types of assets the commercial bank has. The first one is the cash, what the commercial bank has, how much cash they are holding, there are many sources that we will discuss. Second most important aspect of the commercial bank in terms of assets are the investments or the securities what they are holding.

There are many sources of securities, holdings, there are many sources the securities can be brought into the commercial bank or can be brought in or maybe used by the commercial bank and there are many investment alternatives which are available in the financial system where the banks basically used those investment alternatives for their investment to maximize their profits or the return. And other most important asset is loans, because the loan is the liability of the customer or the clients or the individuals.

For the banks the loan is basically one asset from where the bank generates the maximum revenue because whenever the bank gives the loan, against the loan they charge certain interest. And that basically interest income is the major source of income for the commercial bank.

And there are some miscellaneous assets, miscellaneous asset includes the fixed assets, it includes the intangible assets and all these things what the commercial banks hold. So, there are four broad categories in terms of assets of the commercial bank. Then we will see that how those particular assets are defined and which are those different components which comes under the different broad classification of these assets.

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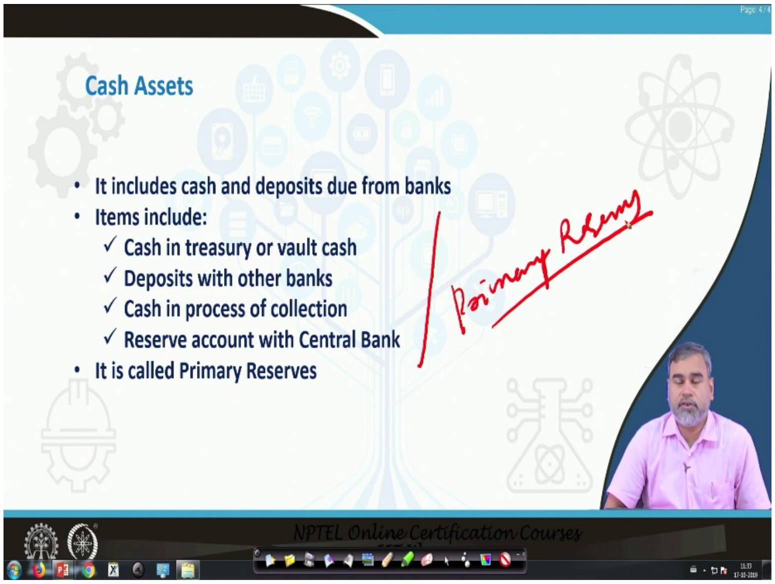

So, whenever we talk about the cash, the cash is basically what? There are some cash which is already the banks hold. So, the particular cash which includes the cash in treasury or the vault cash, already the cash is there in the commercial banks, maybe there is a surplus which is available to the commercial bank. Or the, commercial bank hold those cash for some specific purpose, so whatever cash is there that is the first part of cash asset.

Then they have a deposits with the other banks, small, the maturity period is very short, but they keep these particular deposits with other banks. And there are some cases the cash in the process of collection. The bank is not yet is not receiving that particular cash or has not received the cash immediately, already it is not there with the banks, but that is in the procession, in the process basically the collection is there, so the collection can be made in the near future for the very short span of time.

So, the process of collection also consider as an asset for this. And the commercial banks also keeps certain reserves with the central bank. So, they have some kind of deposits, they make with the central bank and against that they get certain amount of interest.

So, that is why the cash and deposit due from the banks, these are the many sources through which this particular item comes to the commercial bank and if you combine all these three, or all these four it is basically called as the primary reserves.

The primary reserves means it is the reserves which is there or which is available to all the commercial banks which are operating in the economic system or in the financial system. So, these are basically called as the primary reserve and these are highly liquid and short term in nature.

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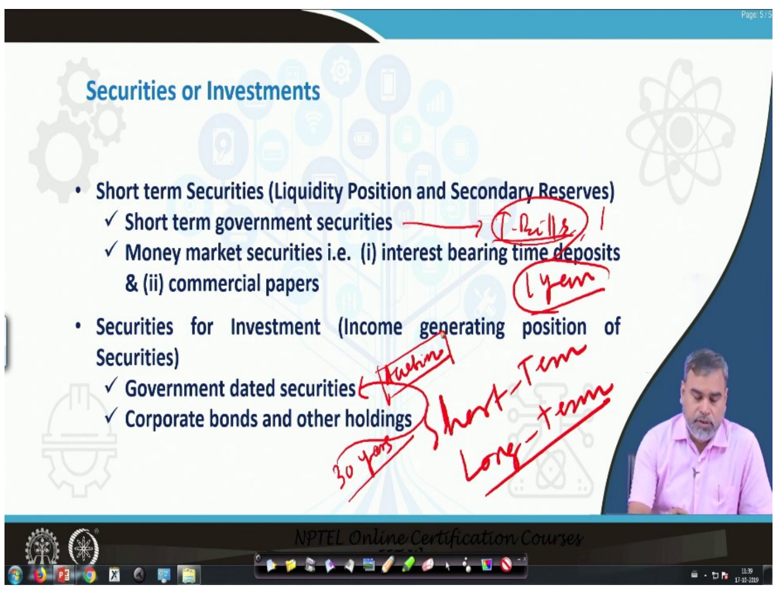

Then the second type of asset we have that is securities or the investments. You know, whenever the commercial banks invest their money, where the money is invested? Whenever they talk about the investment in different type of assets, the assets are classified into two, one is your short-term assets, and another one is the long-term assets. So, there are two different broad categories of the assets.

And the short-term asset is basically highly liquid and the long-term asset are not that much liquid. But the banks basically hold both type of asset for their investments because the requirements of the banks are different. So, to fulfill that requirements they basically keep both categories of assets into their portfolio or into their balance sheet.

So, whenever we talk about the short-term securities, the investments in the short-term securities, these are consider as the secondary reserves of the commercial banks because the primary reserves are highly liquid, these are highly short term in nature, which includes cash, the current account deposits with the Reserve Bank and all.

And then we have another type of securities which is short term securities where the bank invests their money in a very short-term instrument which are available in the system. So, these are basically consider as the secondary reserves. What are those different sources? The different sources are short term government securities. The short-term government securities particularly the treasury bills. Then we have also the instruments like, the treasury bills, which are issued by the government.

So, that is why whenever we talk about government securities, we consider the treasury bills is the one of the investment alternatives through which the commercial bank invests their money in the short-term instruments. Then we have the interest bearing time deposit which is a money market instrument. The period is very small, below one year. So, here we are referring to the maturity period of those type of asset are up to one-year time and we have the commercial papers.

The commercial papers are issued by another bank or different type of bank, so if the commercial papers are issued through which also the commercial banks invest their money or they raise their money for a short-term purpose. So, these are basically the money market securities, we have the interest-bearing time deposits, then we have the commercial papers.

Then whenever we talk about the long-term investments, the long-term investment alternatives either the commercial banks can invest their money in the government dated securities. In India we have a very developed government securities market particularly the government bond market, so there the maximum term to maturity is up to 30 years.

The 30 years is the term to maturity in the government securities market. So, because of that what basically here we can say that the banks also can invest in the dated securities whose maturity period is relatively large and they can extract some kind of return out of this by reading the yield curve in a better way. Then we have debentures or the corporate bonds these are issued by the different corporates, bank can also invest their money into that.

And these are also very long-term instruments which are available for the banks for the investments. So, we have two things, we have government dated securities and we have corporate bonds. And government dated securities are issued through the auction process. The bank basically does this or the Reserve Bank issues this particular securities through auction process and the commercial banks participate in that auction process and through that they invest in their particular securities. So, we have two types of auction.

We have a price based auction and we have a yield based auction, but whenever the first time securities come to the market, we have to use this yield based auction and generally this commercial banks always try to invest their money in this particular securities or the Reserve Bank of India sometimes control this money supply in the monetary policy process through this use of this government dated securities or by selling or buying the bonds into the open markets, which is popularly known as the open market operation.

But for commercial bank point of view this is one of the major instruments for the commercial banks basically put their money. So, government securities is one of the better alternatives for the long-term investments by the commercial banks. Then we have the corporate bonds already I have told you. These are also called the debentures and some of the assets are basically, we can say that senior and some of the assets are junior and here some of the asset are secured and some of the asset are insecured.

So, whenever we talk about the secured assets that means the assets are backed by any kind of securities. But whenever we talk about the assets which are not backed by any kind of securities these are the insecured assets or those assets, investing in those assets relatively risky. But still those are the different alternatives which are available for investments by the commercial banks, which is consider as one of the most important items in the balance sheet or the asset side of the balance sheets.

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So, this is what about the investments then we can move towards the other type of investments what the commercial banks do. Another one is commercial bank can invest also in the stock market or in the equity that is why they have a trading account. And securities purchased in this particular channel to provide the short-term profits for short term price movements. Because of the market fluctuations, because of the demand and supply purchase of the security, the particular stock issued by the, raised by this particular bank can fluctuate.

So, the commercial banks can take that advantage. Due to the short-term price fluctuations they try to extract maximum revenue or maximum return out of this and these are basically valued in the market. So, in this particular case the value of this particular asset is changing frequently on the basis of the market price of the stock of the particular bank.

So, that is why in overall what we can say, the commercial banks also invest the money in the equity market through their trading account and those particular value of those assets are changing or maybe always subject to the fluctuations of the market. So, on the basis of demand and supply the value changes or the stock price of bank changes. And the stock price of the bank changes then automatically what happens, that the value of the total assets under this category also changes.

Then we have some reverse repurchase agreement. Sometimes the central bank can pact their money with the commercial banks and against that they provide certain interest. In our context we call it the reverse repo. And these are very short term in nature, generally for the overnight and in any point of time whatever the government funds the particular commercial bank is holding, they can also sell that particular fund. And that is why these funds come from the deposits of the central bank.

And as well as already I told you about the reverse repo which is basically the money which is kept by the reserve bank of India or any other central bank with this commercial banks to park that particular money and once the money is parked with the commercial bank by the central bank then also they get certain amount of revenue out of this. So, that is why it is considered as an asset for the commercial bank.

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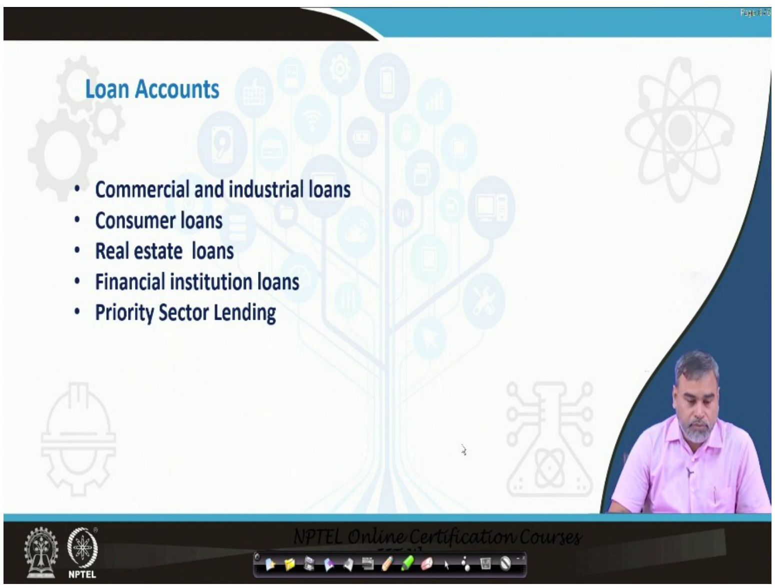

Then the most important asset or most important item in the asset side is the loan or the advances. Whatever advance the commercial banks give to the customers in different forms, so these basically is the major source of revenue. It is a major source of income for commercial banks in the market. So, whenever we talk about this there are different types of loans the commercial bank provides, the loans can be the industrial loan or the commercial loan, the loan can be also consumer loans, and loan can be given to the different companies for a particular purpose.

For example, real estate loans particularly buying the house and all these things. Then the loans also can be given to the other banks or financial institutions which are existing in the system and the loans are also given to the priority sector. Priority sector means we are talking about the rural sector like agriculture, small scale industries or small loans, which are given loan for the betterment of the society at a large.

And these loans are given with a huge discount or the interest rate against this particular loans are relatively very small in comparison to the loans given to the industry or any kind of loans given for a commercial setup or any other consumer loans like your education loan, it maybe the personal loan, or it may be any kind of vehicle loan and all these things.

So, these are different kind of loan account what the commercial banks hold and the loan is basically the major source of revenue for the commercial banks because against that they generate certain interest income and they try to maximize their revenue through this particular loan. Although there are many issues involved in this particular loan, many assets are becoming non-performing or the loans are not repaid and all these things.

But still the whole banking system realize more on these loan activities that is why the loans are considered as the most important assets for the commercial banks. So, will be discussing in detail whenever we talk about the management of loans by the commercial bank in the future session and there we will be discussing that how the loans are given, whether the loan giving procedure is same for the retail loans or and the commercial loans or the industrial loans or there are different processes or different kind of strategy the banks follow whenever they provide the different loans to the market or the loans are given for the different purposes.

So these are the things what we will be discussing in detail but these are the major type of loans what the banks have and it is consider as the asset because the banks generate the revenue through this particular loans because they extract certain kind of interest payments for that. So, this is basically about the different type of loans which are available.

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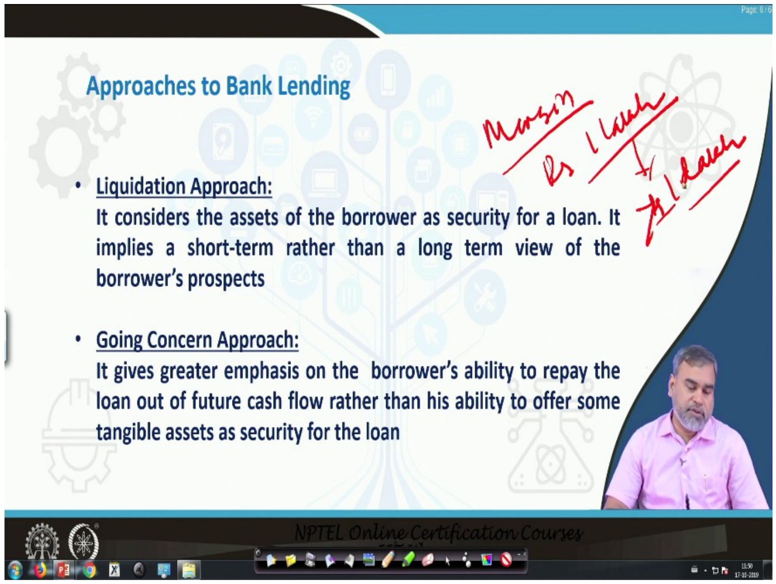

But whenever the loans are given to the commercial banks, you know, commercial banks give different type of loans, you have the housing loan, you have the industrial loan, you have the vehicle loan, you have the personal loan, you have the educational loan. There are many types of loan that are giving. But whenever whatever loan it maybe, whenever the commercial bank gives loan, the loan giving process based upon certain kind of philosophy.

Or what is the philosophy of giving these loans? And what kind of approach the commercial banks follow whenever the loans are giving to the different kind of clients? So, whenever we talk about that we can summarize that or we can say that there are two approaches the banks may follow whenever they provide loans. And what are those approaches? Then one approach they call it liquidation approach and second approach is called going concern approach.

What do you mean by this liquidation approach? The liquidation approach is whenever the commercial bank give the loan, the loans are basically always given on the basis of a collateral that means the loan should be backed by any kind of asset. So, the asset can be anything, the asset can be fixed asset or the asset can be also the stocks, bonds, etcetera, or the asset can be gold, or the asset can be land, asset can be house.

So, there are different type of assets although the margins vary across these assets. That means what do you mean by the margin? For example, whenever this is the way the margin is defined. The margin is basically what, let the bank wants to give a loan of 1 lakh, if the bank want to give a loan of 1 lakh or the you want a loan of 1 lakh, then the bank will take one particular asset as a mortgage or as a collateral against this particular loan whose value is more than 1 lakh.

More than one lakh. What is the reason? The reason is that there is a chance of depreciation or there is a chance of appreciation of that asset. But for the safer side bank always keep one particular asset whose value is more than the loan demand what the customer is making. So, that is basically margin and that margin account or the margin value varies across the different type of assets. So, if it is a gold then the margin is different, if it is a stocks or bond then margin is different, if it a certificate then margin is different, if it is a government securities then the margin is different.

So, on the basis of riskiness of that particular asset or the fluctuations of the value of that particular assets the margin amount varies. So, that is why the loans which are given these are given basically on the basis of the asset which is the customer is giving or the asset which is used as a collateral against this particular loan. So, if there is any default then the commercial bank can liquidate that asset and can get back the loan.

But mostly the India and commercial banks follow this kind of approach, so whenever any commercial bank follows a liquidation approach, so that means they always look at the short-term view of the borrower's point of view, borrower's prospects.

The long-term prospects of the borrower is not consider. How that borrower is going to perform in the future or whether really this potential of this borrower will change in future that is not basically judged by the commercial banks or that is not consider by the commercial bank. They see the current position and accordingly what kind of asset the borrower is giving, they decide on that basis, the loan is decided on that basis.

But whenever we talk about the going concern approach - So here the bank basically gives the emphasis on the ability to repay of the loan, which based upon the future cash flow of this particular customer or this particular loan instead of any kind of tangible assets. So, what does that mean?

That means that if the bank feels that this person is able to repay this particular loan in a particular period of time because he or she is able to generate the revenue periodically and that ability basically helping the banks to be convinced that, "Okay, this person is able to pay the loan in the future." So, that is why this is called the going concern approach and most developed country, US and other countries they follow this going concern approach whenever they provide the loans.

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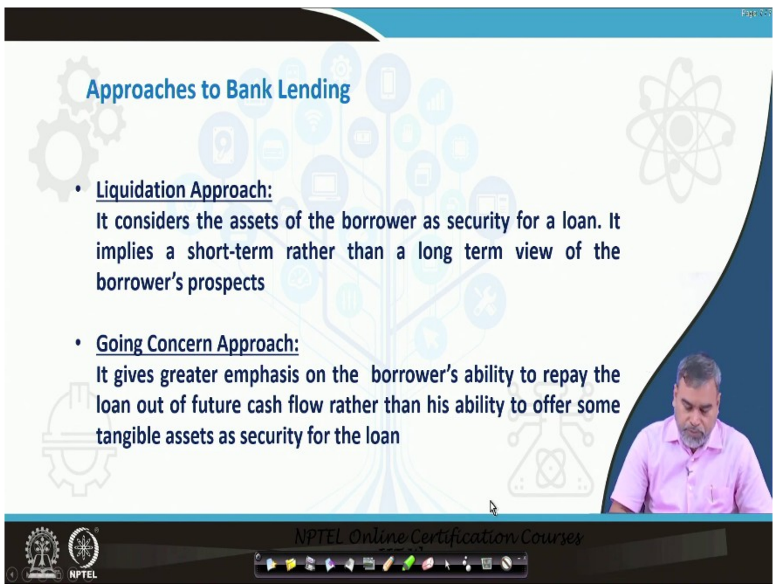

Then we have some other assets we have, we have some specific reserves also sometimes bank keep for a particular loan, it is not though general reserve what they keep against the all the loans. For some specific loans sometimes, the banks keep some reserves that is called the specific reserves and remaining reserves whatever the banks keep that is called the general reserves.

And mostly the reserves also sometimes determined by the management of the commercial bank, the taxes and government regulations. Government regulation, tax and management, these are responsible factor for these kinds of reserves what the commercial banks keep.

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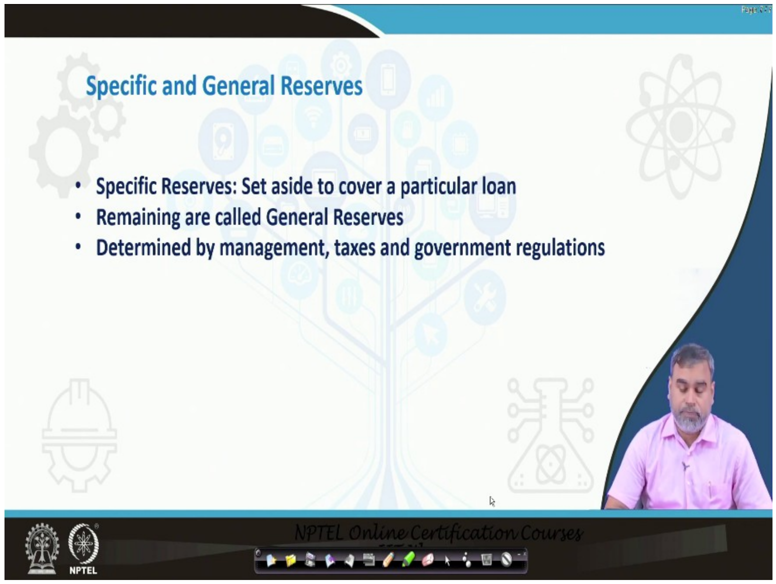

Other assets obviously they have the fixed assets, they have the building, they have the land, they have the machines, they have all kind of computers and other things these are consider as a fixed asset. They can also invest their money whether directly or indirectly in the real estate. The commercial banks do sometimes also that kind of business, so that also comes under the asset.

And another thing important in the today's context is the goodwill or the reputation of the commercial bank and the other intangibles what the commercial banks are holding. So that also affects the market value of the commercial bank. So, once the market value of the commercial bank changes, it will have a larger impact on the performance part. So, goodwill and other intangibles also consider as the important assets of the commercial banks which are relatively subjective in nature.

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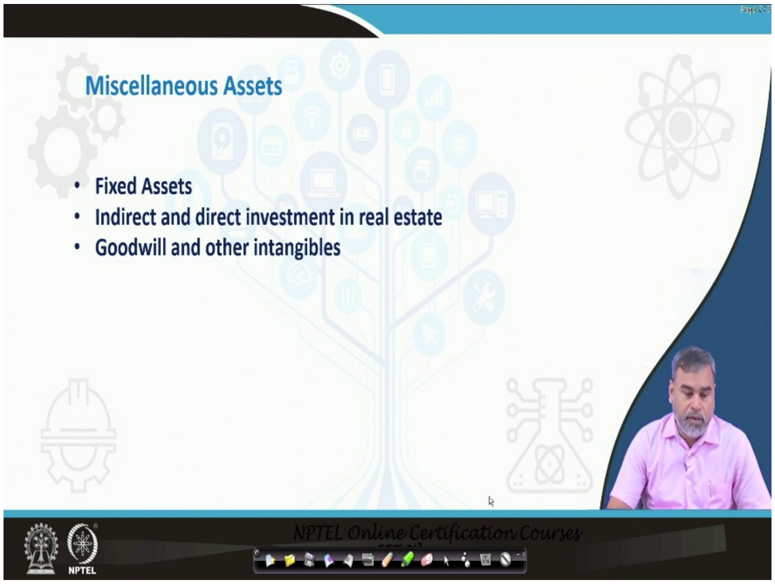

So, considering these things what basically we have discussed that the balance sheet represents the financial position of a commercial bank at a particular point of time. Loans, investment, cash, then you have the reserves, these are the major assets of the commercial banks.

And there are two approaches the commercial bank always follow, whenever they provide the loans these are the liquidation approach and the going concern approach. And liquidation approach is the short-term approach or they will look at the short-term perspective of the borrower and the going concern believes in the long-term perspective of the borrower. So, this is what, these are the issues what basically always we look at the across the globe whenever the bank's assets are analyzed.

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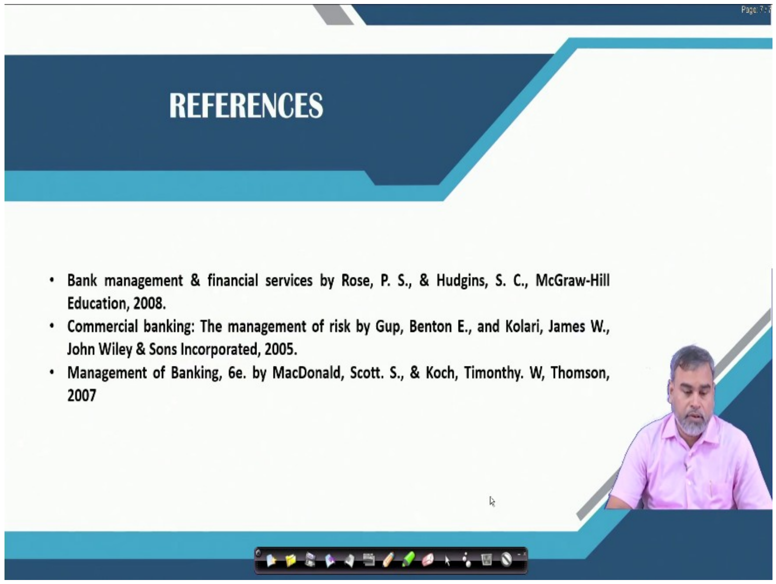

So, these are the references, you can go through further detailed discussion and thank you.