CHAPTER - IV

CREDIT MANAGEMENT IN COMMERCIAL BANKS

Lending is considered as one of the principal functions of commercial banks not only because of their social obligation to cater to the credit needs of different sections of the community but also due to the most profitable activity of the financial institution. After having a portion of deposits in the cash reserve and highly liquid assets, a banker has to deploy the remaining funds in profitable outlets so that he may be able to pay interest on deposits, salary to the staff, meet other establishment expenses, built up reserves, and to pay dividend to the shareholders. That’s why bank loans account for a major portion of residual funds of a commercial bank.

4.1 Characteristics of Commercial Bank Credits

Some of the most important characteristics of loans in India are given below:-

1. In India, since nationalization banks have shown keen interest in making advances to the agriculture sector even then the bulk of the bank loans are provided to trade and industries. This is because of the relatively greater credit risks and inability of agriculturists to furnish good security.

2. Nearly three-fourth of bank loans in our country is provided for a period of less than one year because of the high liquidity of such loans. The short-term loans are given to finance the seasonal
needs of the businessmen for increasing the current assets and for expanding production.

3. A highly profitable firm depends less on bank loans to finance expansion or current needs because it has sufficient earnings to do so. The less profitable concerns need bank support which can help them to tide over the financial difficulties caused by the shortage of liquid funds. It suggests that bankers should be very careful while granting loans to firms and should take all protective steps to minimize their risk.

4. Another characteristic of bank borrowers is that smaller firms and young concerns depend more on bank loans to finance their needs because of their limited access to other sources of finance. As a matter of fact, bank shows less interest in making advances to such firms.

4.2 Principles of Sound Bank Lending

The most profitable business of the commercial bank is lending; but at the same time, it is highly risky. Loans are always accompanied by the credit risk arising out of the borrower's default in repaying the money. Therefore, a lending institution should manage its loan business in a profitable and safe manner. In considering a loan proposal, banker should bear in mind certain general principles of lending and should take all necessary precautions to minimize the risk associated with the grant of a loan. These principles are discussed as under:
4.2.1 Safety

The safety of fund is the most important guiding principle of a banker. They should ensure that the lending out fund is safe. Every care should be taken to ensure that a loan to a particular borrower does not involve any avoidable risk of non-payment and should always take only a calculated risk. That is why he always insists upon collateral’s margins and guarantees in addition to the personal promise of the borrower.

4.2.2 Liquidity

Liquidity signifies the readiness with which the bank can convert its assets into cash with no or insignificant loss. Since a major part of commercial bank liabilities is payable either on demand or after a short notice, the banker should ensure the liquidity of loans. Loans should be provided against the security of highly convertible assets so that in the event of borrower’s defaults in repaying, these might be readily converted into cash.

4.2.3 Diversification of Risks

Diversification implies dispersal of funds over a large number of borrowers and borrowing firms situated in different parts of the country. Banker should avoid concentrating the funds in a few customers. He should diffuse lending and offer advances to different firms belonging to different industries which are situated over different geographical areas, so that he may not be badly mauled by the failure of one industry or a few big borrowers. The maturity diversification is another important form
of diversification because banker may get certain amount of loans mature at regular intervals and are utilized to meet the demands of other customers.

4.2.4 Profitability

Commercial banks must make sufficient income to pay interest, meet establishment charges, income for future, and to pay dividends to owners. Inter-bank competition, inter-bank agreements and bank rates make the principle of profitability as most important in loan management. A banker should avoid making profit at the expense of the liquidity and safety of his capital. Within the limits of liquidity and safety, and the national policies as laid down by the government and the Central Bank, a banker should strive for accomplishing the profitability objective.

4.2.5 Purpose

It is well supposed that the purpose for the loan proposed is itself a guarantee of its repayment. Safety and liquidity of loan depends on the purpose of its use, therefore, the banker should inquire properly into the purpose for which the loan is taken. The loan utilized for productive purpose would generate additional income for the borrower to enable him to repay it.

A banker should, therefore, avoid making loans for wasteful expenditure on social functions and speculative transactions. It is well known fact that loan borrowed for a productive purpose has often been used for speculative purposes. Therefore, the lending commercial bank
should take follow-up steps to see that the end-use of loan is not for a purpose other than the one for which it was given.

4.3 Formulation of Credit Policy

A bank can not afford to lend the funds to its depositors and owners indiscriminately to meet the social obligations of diverse credit needs of different sections of the community. A clear-cut and definite credit policy which provides a direction to the use of funds controls the size and make-up of the loan portfolio, and influences the credit decisions of the bank. The banker will find it easy to reach the goals of the bank and serve the public concurrently with a systematic loan policy. A loan policy is, therefore, a necessity for a bank. In deciding the loan policies, the policy formulators must be very cautious, because the lending activity of the bank affects both the bank and public at large. They should consider all the factors which are likely to influence the loan policies, and work out their policies accordingly.

4.4 Factors Influencing Credit Policy

Some of the most important factors which must be considered while determining the loan policies of a bank are as under:

4.4.1 Capital Position

The capital position of a bank serves as a protective factor against losses for depositors and guarantees funds for the creditors. A bank with a strong capital position can assume more credit risks than one with a weak capital position.
4.4.2 Earning Requirement

Profit making is one of the principal objectives of a commercial bank. Some banks may be in a position to emphasize the importance of income, while other may lay stress on liquidity. Earnings receive a greater emphasis in the loan policy of a bank, it means that it would include securities which carry shorter maturity periods and possess relatively less risk in its investment account.

4.4.3 Deposit Variability

Banks which experienced irregular movements in their deposits will have to follow a conservative lending policy as they cannot afford to incur undue risk by extending their term-lending facilities. The banks, whose deposits have shown a rising tendency in the past, and which expect the rising trend to persist in future, can also be liberal in their loan policy.

4.4.4 Position of Local and National Economy

The banker should keep in mind the economic conditions that prevail in the area served by the bank, before formulating the lending policy. A bank operating in an area which is subject to seasonal and cyclical fluctuations and if the national economy is likely to recede in the future can ill afford to adopt a liberal policy because that would entail the hazards of illiquidity. But in a stable economy or if the economic conditions of the country are expected to improve, banks may liberalize
their lending policies and accommodate those borrowers who were hitherto refused banking facilities because of a stiff credit policy.

4.4.5 Monetary Policy

Monetary policy of the central banking authorities goes a long way in determining the lending policy of a commercial bank. The central bank influences the lending policy of banks by bringing about variation in the minimum reserve requirement and the net liquidity ratio.

4.4.6 Ability and Experience of Loan Officers

The management of a bank should consider the skill and competence of its loan officers while laying down a loan policy because loan officers of a bank can play a significant role in the execution of its loan policies.

4.4.7 Competitive Position

In formulating a loan policy, the management should have consideration for the competitive position of the bank with the other institutions operating in the area.

4.4.8 Credit Needs of the Operational Area

The credit needs of the area served by the bank would also influence its loan policy. A bank is supposed to meet the loan demands of all the local borrowers and if this cannot be done, there will be injustice by the financial institutions existing in that region.
4.5 Contents of Credit Policy

A bank must have a definite and broad-based loan policy which includes all the important dimensions of its lending business so that credit officers may not face any problem in evaluating the credit worthiness of the loan applicants and in taking credit decisions. In the following paragraphs an attempt has been made to discuss the main characteristics of a loan policy with respect to some aspects of guidelines like loan portfolio, compensation, security, maturity etc.

4.5.1 Size of Loan Account

The primary social and business excuse for the commercial banking system is its ability to supply credit to the community. A commercial bank should lend as long as it is possible to do so prudently. An intelligent loan policy must spell out clearly the amount of the total advances that a bank would sanction and a due consideration of various factors like Banking Companies Act, RBI guidelines and resource position of the bank must keep in mind while formulating bank credit policy.

4.5.2 Credit for Infrastructure

In view of the natural importance attached to infrastructural development, operational guidelines made a commercial bank free to sanction term loans for technically feasible, financially viable and bankable projects undertaken by both public and private sector undertakings.
4.5.3 Composition of Loan Portfolio

In an attempt to minimize the credit risks, the bank should clearly mention in its loan portfolio about the various broad categories of borrowers among which the bank's advances will be diffused. specifying the proportion of the loan for each such category.

4.5.4 Acceptable Security

While determining the policy regarding the security aspect of a bank loan, the government policy as well as the credit policy of the RBI should also be kept in view and the management should see to it that the security requirements do not violate statutory provisions laid by RBI and banking regulation acts.

4.5.5 Lending Criteria

In order to minimise the risk in lending, a bank should make loans only to deserving parties whose credit character, capacity and integrity are within approach. The criteria of evaluating credit character and capacity to generate income should be set forth in it in the policy statement.

4.5.6 Loan Maturity

One of the most constructive characteristics of a good loan policy is to make a loan for a period after which it may be called back in times to satisfy the liquidity needs of the bank and ensure that it is not exposed to risk. Minimum period of loans and spread over various maturities subject to roll-over would now be decided by banks and they
could invest short-term or temporary surplus of borrowers in money market instruments.

4.5.7 Compensating Balance

The compensating balance is a protective device to save the bank from the risk of default. The policy statement on the compensating balance should include a clear cut statement on the manner of computing the compensatory balance, the type of borrowers to whom the compensating requirement would apply, and the specific percentages of the loans that different borrowers would be required to hold as deposits in the bank.

4.5.8 Limitations on Lending Authority

A large-scale commercial bank, with a big credit organization consisting of a number of loan officers, should specifically determine the loan authority of different officers; otherwise there may be overlapping and duplication of efforts, resulting in considerable wastage.

4.5.9 Loan Territory

The loan policy statement of a commercial bank must include the regions or certain areas to be served by the lending operations of the bank. This will save the time and efforts of the credit department which will, in that case, know from whom to receive a loan application.
4.5.10 Consortiurn Lending

On the basis of the suggestions of the RBI, a commercial bank also do consortium fmancing, i.e., where one bank takes on the liability for a minimum number of years while the second bank steps in for the remaining tenure for the rest of the liability. The consortiurn could include more than two banks depending on the size of the project.

4.6 Evaluation of Credit Applicant

It is impossible to accomplish the overall objective of maximizing earnings of the commercial bank while keeping an adequate amount of liquidity, unless the creditworthiness of the applicants is evaluated to ensure that they conform to the standards prescribed by the bank. The credit evaluation process involve following steps.

4.6.1 Credit Informations

The credit department of a commercial bank gathers the requisite information from different sources on which customer evaluation must necessarily be based. Two important factors, i.e., cost and time, should be kept in mind while searching for credit information. Commercial bank can gather information on the creditworthiness by the interview and financial statements made by the applicant. The lending officer may also get information about the customer's repaying habits from the bank's own record, if the applicant happens to be the bank's customer. Reports on business firms, especially the larger ones, can be obtained form credit- rating agencies, bazaar reports, reports from other banks,
journals, periodicals, newspapers, income-tax statements, sales-tax returns, government gazettes, revenue and municipal records.

4.6.2 Credit Analysis

After gathering the credit information on the potential customer, the lending officer analyses it to evaluate the creditworthiness of the applicant and to determine whether he meets the requirements of prefixed norms or not. Credit analysis involves the credit investigation of a customer to determine the degree of risk associated with the loan. The capacity of the applicant to borrow and his ability and willingness to repay the debt in accordance with the terms of the loan agreement must be studied. A number of tools like ratio analysis, cash flow projections, funds-flow statement, and credit scoring have been developed with which a banker can evaluate the character, capacity, capital, collateral and conditions of an applicant.

4.6.3 Credit Decision

After determining the creditworthiness of the applicant, the lending officer has to decide whether the credit facilities should be provided to him or not. The creditworthiness of the applicant should be matched against the credit standards set out in the loan policy. If the applicant is found above or up to the standards, the loan should be made to him and if he does not satisfy the standard of acceptability he may be told of the bank’s helplessness in view of its loan policy. The applicant may be
asked to approach other existing financial institutions of the area for assistance.

4.7 Supervision of Loans

To ensure the end-use of the loan, it is necessary for the bank to keep track of the loans outstanding. It should keep in touch with the borrowers during the life of the loan. The supervision of the loan is the responsibility of more than one department of the bank. The credit department regularly obtains the financial reports of customer indebted to the bank and analyses them to assess the progress made by the customer. Usually, the outstanding loans are supervised by inspection, keeping track of the deposit balance, checking with other creditors and obtaining half-yearly and yearly financial and budgetary reports. If the reports of the performance of the borrower are found unsatisfactory, the intelligent banker can plan a sort of economic retreat which, in the long run, works to the advantage of the borrower as well as the lending commercial bank.

4.8 Organization of Bank Lending

The credit policy is usually formulated by the Board of Directors, and its implementation is carried out by the loan committee and loan specialists because in most of the banks all the directors do not attend to the day-to-day lending activities of the bank. They constitute a separate lending body, known as the credit department, to implement the loan policies which they formulate.
The credit department of a bank performs the following functions:

1. It receives loan applications.

2. It collects credit information about the applicants from different sources, conduct interviews with the applicants, and verifies the accuracy of the information given by them in the application.

3. It investigates the creditworthiness of applicants by making use of numerous tools of credit analysis.

4. After granting loan, it monitors loans by visiting the borrowers, keeping a constant watch on their deposit balances, obtaining financial and other reports and calling the attention of the borrowers to their unsatisfactory performances.

5. It maintains records of credit information and revises them constantly so that bank officers may come to know the status of their accounts.

6. It furnishes credit information to other banks and creditors who ask about it.

The organizational set-up of the loan function in a bank would depend upon a number of factors, including the size of the bank, the magnitude of the loan portfolio and its composition, and attitude of the Board of Directors, the extent of the authority delegated. In a small bank, two or three officers perform all the necessary credit functions, and the routine functions of the credit department are performed by a clerk. There is a little or no specialization and each officer involved in credit
function is responsible for securing the credit information that is necessary and for maintaining his own credit files. In the larger banks, the loan function is highly departmentalized, and there is a considerable amount of specialization of the lending activities. In such branches, there may be a good deal of specialization in lending work. For expeditious disposal on credit requests, it is desirable to delegate more powers to branch or regional managers.

Borrowers, particularly those requesting for a small amount of loan, cannot be expected to wait for a long time for credit decisions. Moreover, the personal touch or sympathetic attitude with the borrowers must be maintained, which is very necessary for the development of the banking business.