Fund management in Banking and Insurance

Lecture-5

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Topic covered bank lending and loans

1. Principals of lending and loan policy
2. Loan policy and lending guidelines
3. Credit and deposit ratio
4. Targeted portfolio mix
5. Hurdle rating
6. Loan pricing
7. Collateral security
8. References

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Principals of lending

1. **Safety-**Banks need to ensure that advances are safe and money lent out by them will come back. Since the repayment of loans depends on the borrowers' capacity to pay, the banker must be satisfied before lending that the business for which money is sought is a sound one.

2. **Liquidity:-** To maintain liquidity, banks have to ensure that money lent out by them is not locked up for long time by designing the loan maturity period appropriately.

3. **Profitability:-**To remain viable, a bank must earn adequate profit on its investment. This calls for adequate margin between deposit rates and lending rates. In this respect, appropriate fixing of interest rates on both advances and deposits is critical

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4. Risk Diversification:- To mitigate risk, banks should lend to a diversified customer base. Diversification should be in terms of geographic location, nature of business etc.

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Loan policy

Based on the general principles of lending stated above, the Credit Policy Committee (CPC) of individual banks prepares the basic credit policy of the Bank, which has to be approved by the Bank's Board of Directors.

Lending guidelines:

1. **Level of credit-deposit ratio**
2. **Hurdle ratings**
3. **Loan pricing**
4. **Collateral security**

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Credit Deposit Ratio

A bank can lend out only a certain proportion of its deposits As Cash Reserve Ratio (CRR), and an additional part has to be used for making investment in prescribed securities i.e. Statutory Liquidity Ratio or SLR requirement Therefore, the CPC has to lay down the quantum of credit that can be granted by the bank as a percentage of deposits available.

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Targeted Portfolio Mix

The CPC aims at a targeted portfolio mix keeping in view both risk and return towards different sectors.

It lays down guidelines on choosing the preferred areas of lending as well as the sectors to avoid. Banks typically monitor all major sectors . They target a portfolio mix in the light of forecasts for growth and profitability for each sector.

This entails active portfolio management. It may also like to avoid certain kinds of loans keeping in mind general credit discipline, say loans for speculative purposes, unsecured loans, etc.

Hurdle Rating

There are a number of diverse risk factors associated with borrowers. Banks should have a Comprehensive risk rating system that serves as a single point indicator of diverse risk factors of a borrower. This helps taking credit decisions in a consistent manner.

A substantial degree of standardization is required in ratings across borrowers. The risk rating system should be so designed as to reveal the overall risk of lending.

For new borrowers, a bank usually lays down guidelines regarding minimum rating to be achieved by the borrower to become eligible for the loan.

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Loan pricing

Risk-return trade-off is a fundamental aspect of risk management. Borrowers with weak financial position and, hence, placed in higher risk category are provided credit facilities at a higher price (that is, at higher interest).

The higher the credit risk of a borrower the higher would be his cost of borrowing. Loan pricing is also dependent upon competition

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Collateral Security

As part of a prudent lending policy, banks usually advance loans against some security. The loan policy provides guidelines for this. In the case of term loans and working capital assets, banks take as 'primary security' the property or goods against which loans are granted.

Banks often ask for additional security or 'collateral security' in the form of both physical and financial assets to further bind the borrower. This reduces the risk for the bank.

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References

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2. Sinkey,JosephF.Jr:CommercialBanksFinancialmanagement,PrenticeHall,Delhi.
3. GeorgeE.Rejda:PrinciplesofRiskManagement&Insurance,Pearson:NewDelhi

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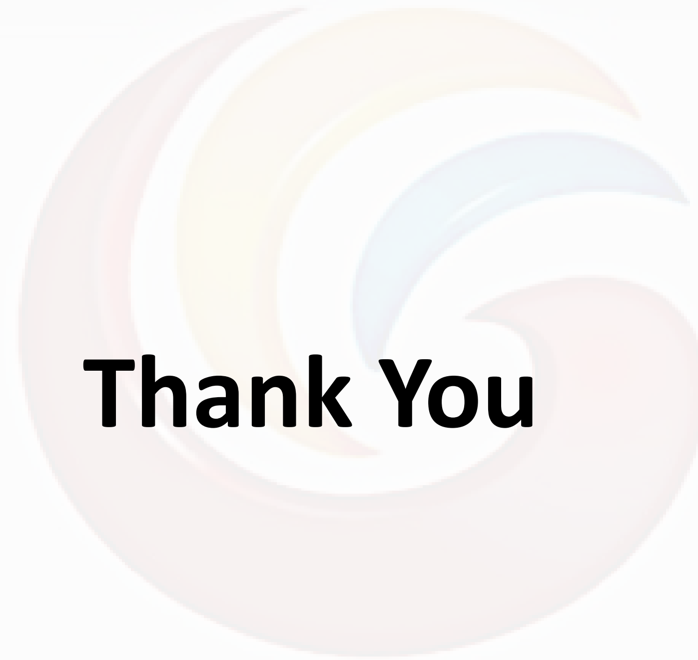

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