Chapter 10 ▶ Lending Policy

OBJECTIVES

At the end of this chapter, you should be able to:
1. explain lending process in detail;
2. describe the three main principles in lending;
3. identify the relevant elements of lending policy; and
4. identify factors influencing lending policy.

▶ INTRODUCTION

Lending is one of the key activities of any commercial bank. Loan assets constitute a large portion of banks assets while interest income derived from customer loans makes up a large part of bank income. Since lending is a key activity, every bank must have its own clear, accurate and documented lending policy.

Lending policy of a bank should make reference to a set of comprehensive criteria so that they can provide guidelines for new as well as existing credit officers. When formulating lending policy, all internal and external factors that may influence the lending policy must be accounted for. Last but not least, lending policy must be aligned to the three main principles in lending, i.e. the principles of payment, objective and protection.

10.1 THE IMPORTANCE OF LENDING ACTIVITIES

THINK

Most of us have borrowed from a banking institution, or even a non-bank institution before. What would happen to you, the society and the country if the financial institutions did not provide such facility?

The importance of lending activities of banks can be viewed from several angles:

(a) Firstly, lending activities represent one key contributor to the achievement of banking objectives. They fulfil the valid credit needs of the society. A loan that satisfies "valid credit needs" means a loan with a purpose that is both legal and relevant to the society. For example:

(i) Lending to serve the purpose of smuggling drug or other illegal goods cannot be considered to be fulfilling "valid credit needs".

(ii) Provide agricultural lending in non-agricultural area or granting a loan to send someone to the moon is not considered as fulfilling "valid credit needs".

Commercial banks must provide loans or credit facilities to their respective local communities for the economic growth and stability of these communities.

(b) Secondly, loans are important intermediaries that shape and maintain the relationship between a bank and its deposit customers. Customers are more attracted to banks that provide loans to their deposit customers.

Usually, banks are more willing to provide loans to their existing deposit account holders instead of new customers. When granting a loan to a new loan customer without any deposit account, a bank will usually request that the customer open a deposit account with the bank first.

(c) Thirdly, the return of loans is higher than any other investments of a bank. This is in consistent with risk-return trade off, as loans are the riskiest bank assets. Such high risk is attributed to credit risk and liquidity risk.

10.2 THE PROCESS OF LENDING

Before we discuss the main principles in lending, let's look at the lending process first. Figure 10.1 illustrates the lending process of banks in general.

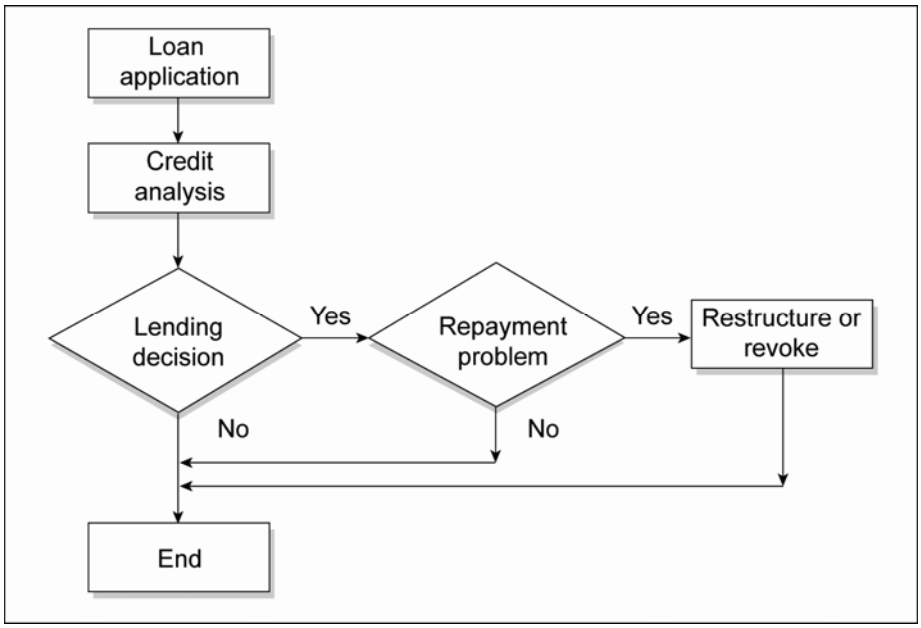


Figure 10.1: Lending process

Lending activities begin with a written loan application, i.e. the applicant completes the application form supplied by the bank. The application is then sent to the credit department for credit analysis to determine the applicant's credit-worthiness. After the credit analysis is done, the credit department will put forward a proposal to the management for the final decision.

In Malaysia, the credit process involves two levels, i.e. branch level and area level or head office level. The power to approve loans at branch level rests with the branch managers. A branch manager's power to approve loan applications is subject to the size of the branch. For example, a branch manger may be granted the power to approve any loan applications not exceeding RM50,000 per loan. Any loan exceeding RM50,000 will be sent to the area office or the credit department at head office after preliminary credit analysis is performed at the branch. The area or head office will then conduct a detailed analysis and make the final decision on the loan application.

YOUR IDEA

Most of us have the experience of applying for a car loan, housing loan or education loan from a financial institution. What process took place when you made your application? Outline the process that you have experienced and compare it with the one discussed earlier. What conclusion can you draw from the comparison?

If you have not applied for any loan from any financial institution so far, obtain the information on loan application process from your friends who have experienced loan application before.

10.3 THE PRINCPLES OF LENDING

A bank lends to a customer based on the credit information of the customer and his business. Unfortunately banks are always faced with the problem of asymmetric information since banks always have less knowledge than the customers of the customers' future performance.

Loan applications usually provide information that shows low credit risk and conceal information that proves their high credit risk. The problem of asymmetric information is more common when dealing with small-scale businesses compared to large-scale businesses because public information on small-scale businesses is very limited.

Asymmetric information can cause two problems in lending, i.e. adverse selection and moral hazard.

(a) **Adverse Selection**
Adverse selection comes into play before any loan is granted. It involves a bank's knowledge, or the lack of it, of the businesses of its loan applicants. Due to incomplete information and knowledge, a bank may make incorrect credit decisions at this stage and suffer from losses subsequently. For example, if, for lack of the relevant knowledge, a bank procures low quality customers and ends up charging high interest rates, the bank may risk turning away high quality borrowers and may also have to deal with large numbers of non-performing loans.

(b) **Moral Hazard**
Moral hazard happens after a loan is granted. It is attributed to the change in attitude and behaviour of a borrower after the loan is granted. Again,

banks may be ignorant of those changes. For example, without the bank's knowledge, a borrower's appetite for risk may have increased from moderate to high after he obtained the loan. Changes like this spell potential problems for the bank.

In order to make sound and founded loan decisions, bank officers should use the three main principles in lending, i.e. the principle of purpose, the principle of payment and the principle of protection.

10.3.1 Principle of Purpose

Loans are used for various purposes. Loans can be used, amongst others, as working capital, for purchase of a fixed asset and for investment in securities. Credit officers of a bank must ensure that the purposes of loans are consistent with the lending policy of the bank in order to avoid confusion and other problems among customers. Loans without any real and concrete purpose are bound to be problematic.

'If I manage to get the loan, I will use it to expand my business through franchise. I am certain that I will be able to repay the RM600 loan in six months…'

A lot of people have the opinion that there is a close relationship between the purpose of a loan and its repayment; if we do not know the true purpose of a loan, we tend to be unclear about its repayment too. Otherwise conversely, if the purpose of a loan can be identified clearly, so can the source of repayment. For example, if a loan is for the purchase of raw material for a business, the proceeds from the eventual sale of goods will be identified as the source of loan repayment.

The purpose of loans becomes even more important when bank credit is difficult to obtain. For example, during the financial crisis in 1997–1998, commercial banks in Malaysia decelerated the growth rate of credit because of the pressure from Bank Negara Malaysia which required them, and other financial institutions, to give lending priority to manufacturing and agricultural sectors. Non-productive lending such as lending to the real estate sector was halted, and loans for the purchase of real estate shares were not to be granted. In such situation, the purpose of loans became crucial as banks wanted to ensure that the loans would not have high risk and the potential of becoming non-performing loans (NPL) like non-productive loans and speculative loans.

How do we know the purpose of a loan? The purpose of a loan is usually stated in the loan application form. The real purpose can usually be discovered by

interviewing the applicant and through credit analysis on the application. The credit officer must have the ability to uncover from the applicant the real purpose of the loan by asking specific and relevant questions.

10.3.2 Principle of Payment

Loan repayment is likened to the blood flow in our bodies. Just imagine if the blood flow stops because of any reason that is beyond our control. To ensure uninterrupted repayments from customers, a bank must set systematic and realistic repayment schedules for its customers. When repayment becomes a problem, the credit officer may have to review the borrower and revise the repayment schedule in order to protect the interest of the bank.

A sound loan should be collectible via the disposal of the borrower's asset or from the income stream or business profits of the borrower, and not from forced sale of any of the collateral. Disposal of borrower's asset means the sale of asset purchased with the bank loan concerned. For example, if a loan was granted to finance the purchase of stocks, the borrower should use the proceeds from the eventual sales of these stocks as loan repayments.

If repayment is by instalments, the instalment amount and the date of final payment must be determined at the time the loan is approved. Repayment schedule must be set so that the repayment process can be monitored and repayment problems, if any, can be detected and resolved without undue delay.

10.3.3 Principle of Protection

A bank must protect its own interest when approving loans since the credit-worthiness of any borrower may change in future. Due to uncertainties, a borrower who is credit-worthy when the loan is approved may become a credit-unworthy customer subsequently. Negative factors that emerge in the future may affect a borrower's loan repayment capacity. A bank can protect its interest by requiring its customers to provide collateral for their loans. Collateral only acts as the second line of defence for purpose of loan protection. The first line of defence is cash flow from the borrower's business or project.

Banks' interest can also be protected by positive as well as negative terms and conditions in the loan agreements. Positive terms and conditions include periodic submission by the borrower of the relevant audited financial statements, maintenance of financial ratios and notification to bank by the borrower of any internal or external development that may affect the borrower's position. Negative terms and conditions include restriction on dividend payment, prohibition in selling or leasing any asset of the borrower without the bank's permission, and restriction on the borrower's operation capacity. These terms and

conditions are to ensure that the borrower's liquidity will remain intact for loan repayment purpose.

Banks must observe all three principles in lending when making credit decisions. Should any of the three principles be neglected or violated, the resultant credit decision may be incorrect. For example, a bank may neglect the principle of payment on the basis that the collateral offered by the borrower is sufficiently attractive and that the purpose of the loan is consistent with the bank's lending policy. The credit decision made based on two principles only is likely to lead to non-performing loan problem because the repayment of the loan should not be dependent on disposal of collateral.

YOUR IDEA

Encik Ali, a petty trader, comes to your bank to apply for a loan to expand his business. How will you use the principle of purpose, principle of payment and principle of protection to evaluate Encik Ali's loan application? Outline a simple mind map to show the relationships among the three principles.

Test your comprehension level by answering the questions below.

Exercise 10.1

1. What is the relationship between the principle of purpose and the principle of payment in ensuring the soundness of a bank's credit decisions?

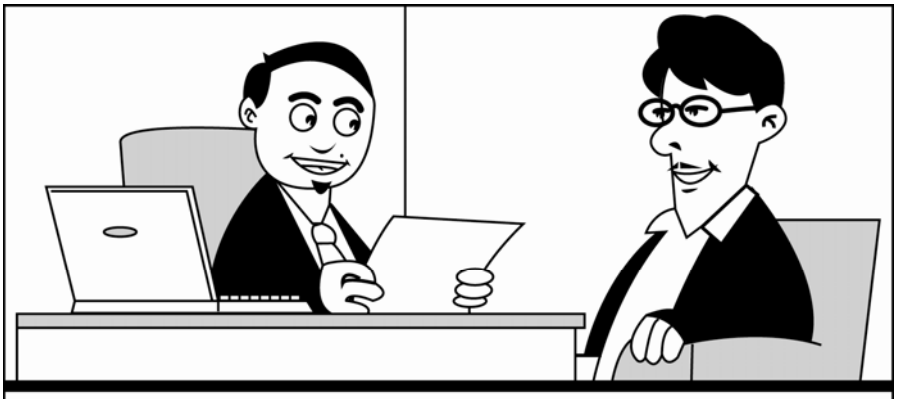
2. Why is it important for a credit officer to consider all the three main principles in lending simultaneously?

BREAK

10.4 DOCUMENTED LENDING POLICY

A bank's lending policy usually symbolises the bank's lending philosophy and concept. It encompasses the standards, guidelines and restrictions that guide the process of making credit decisions. Lending policy should be documented as it is

an official guide for all credit officers. Lending policy of a bank is even more important to the new credit officers still adapting to a new environment.



"We have a very flexible lending policy. You just need to pay by 10.00 am on the 20th of every month. Should you pay at 10.30 am, you will be charged an additional amount of RM100 only...."

Documented lending policies are required for the following purposes:

- setting directions including that pertaining to bank fund utilisation;
- controlling the composition and size of loan portfolio; and
- determining which or what loans should be granted.

Documented lending policy can also be used to evaluate the performance of credit officers or loan officers. For example, the competence of a loan officer can be measured by the officer's compliance with the lending policies.

A bank without any documented lending policy is faced with two dangers:

- Decision making pertaining to loans tend to be done by a certain cluster only. This will hold up the decision making process and hinder the development of loan officers; and

- It will result in non-standardised loan philosophies and practices, cause confusion and inconsistent and erratic credit decisions forthwith.

According to Behrens (1985), the following elements must be incorporated into any comprehensive lending policy:

(a) The objectives of lending
(b) Authority lines
(c) Credit criteria

(d) Procedures and controls
(e) Staff loans
(f) Criteria for handling non-performing loans (NPL)
(g) Criteria for auctions
(h) Compliance procedures
(i) Procedures on periodic review of credit policy

(a) **The Objectives of Lending**
Most lending institutions have the following lending objectives:

(i) Growth: Of assets, loans and capital.

(ii) Profitability: Expressed in Ringgit, or in percentage as the return on equity or return on assets.

(iii) Quality of portfolio: Keep non-performing loans (NPLs) and losses at a certain ratio; limit loan concentration.

(iv) Customer service: Guidelines on effective and efficient customer service.

(v) Social service: Guidelines on corporate social responsibilities and involvement in the society.

(vi) Compliance of rules: All lending institutions are required by the regulatory body to incorporate compliance policy into their general policy statements.

(b) **Authority Lines**
(i) Endorse the responsibilities of the board of directors.

(ii) Establish the authorities and functions of the loan committee or discount committee,

(iii) Establish the tasks and responsibilities of the chief executive officer and loan supervision officer.

(iv) Determine the tasks and responsibilities of loan officers.

(v) Determine the lending authorities of each of the loan officers by taking into account their respective ranks, experience in lending, past performance and assignments.

(c) **Credit Criteria**
(i) Determine the types of loans that are permitted and the types not permitted. Non permitted loans may include loans for illegal or speculative activities, loans granted on subordinate basis and backed by subordinate collateral, loans secured by restricted shares and loans related to brokered deposits.

(ii) Define credit factors that have to be considered when making credit decisions.

(iii) Determine the criteria for unsecured loans.

(iv) List all acceptable types of collateral and the margins of finance based on each type of collateral.

(v) Ascertain the types of deposit relationship required from borrowers.

(vi) Construct guidelines on acceptable maturity tenures based on loan types and objectives.

(vii) Determine the extent of credit investigation for each type of loan application.

(viii) Set the criteria for loan renewal or extension.

(ix) Define the bank's stance on lending deemed outside the bank's ordinary course of business.

(d) **Procedures and Controls**

(i) Detail all the information and documentation required to be kept in credit files, and the frequency of updating this information.

(ii) Define the standards for loan supervision including the frequency of visit to borrower's business premises, the frequency of credit file review and the monitoring of repayments.

(iii) Set the procedures for the reporting of potential problems to the management.

(e) **Staff Loans**

(i) No special treatment for internal people.

(ii) Ascertain the procedures for approving this type of loans.

(iii) Determine the credit limits and other terms and conditions.

(f) **Criteria for Handling Non-performing Loans (NPL)**

(i) Determine who should be responsible for the handling of non-performing loans (NPL).

(ii) Set the guidelines for legal action proceedings.

(iii) Define the procedures for periodic status reporting to the management.

(g) **Criteria for Auctions**

(i) Identify situations that may warrant foreclosure or auction action.

(ii) Establish accounting procedures for auctions.

(iii) Define guidelines and procedures for follow-up and collection of auction proceeds.

(h) **Procedures for Rules Compliance**
   (i) Intention statements on compliance of laws and rules must be made known to staff and customers.
   (ii) Establish guidelines for staff training.

(i) **Procedures on Periodic Review of Credit Policy**
   (i) Annual review may be sufficient.

YOUR IDEA

ABC Bank is reviewing its documented lending policy. As an experienced credit officer, you are assigned to review the policy and make the necessary recommendations to the bank. What are the main components that must be incorporated in the documented lending policy of ABC Bank?

You may use the elements of documented lending policies suggested by Behrens (1985) as a guide. For additional input, you may make enquiries with the credit officers of the local commercial banks by visiting the web sites of these banks through the hyperlinks at BNM web site at http://www.bnm.gov.my.

10.5 FACTORS INFLUENCING LENDING POLICY

In order to stay in the race against competition, banks must take into account the following factors when formulating a complete set of documented lending policy:

(a) Capital Position
(b) Risk and profitability of each type of loan
(c) Stability of deposits
(d) Economic situation
(e) Bank staff's capability and experience
(f) Monetary and fiscal policies of the country
(g) Local credit requirement

(a) **Capital Position**

THINK

How do you think capital influences the lending policy of a bank, based on your understanding of capital management and capital adequacy discussed in Unit 2?

We have learned about the important role of bank capital; bank capital absorbs losses incurred by banks to ensure bank security and to safeguard the welfare of depositors. We have also discussed how capital adequacy ratio (CAR) influences the risk level of a bank.

A bank with high capital ratios, especially the CAR, can afford to bear higher risk by providing loans with longer maturity tenures and also by providing loans to non-conventional sectors. We must stress here that capital is a criterion for opening any new branches. In the branch banking system in Malaysia, the more the branches, the more loans can be granted. Moreover, the capital level of a bank is a determinant of the total amount and types of loans the bank can offer.

(b) **Risk and Profitability of Each Type of Loan**

Each type of loan has its unique profile of risk and profitability. In general, the higher the risk, the higher the expected return. Therefore, the loan portfolio of a bank is vastly dependent upon the bank's mission statement. If a bank opts for a conservative approach in its strategic management, then its loan portfolio will have a conservative risk and profitability profile.

(c) **Stability of Deposits**

Deposits are the main source of finance for customer loans and advances. Therefore, deposit stability has significant impact on lending policy. A bank's lending activities will be in jeopardy if it has unstable deposit base.

We must remember one important point, i.e. deposits are usually short-term while loans are long-term. For that reason, an unsteady supply of deposits can indeed disrupt lending activities and in turn impair bank profitability. Deposit stability becomes even more important when it is difficult to forecast or estimate the demand for loans.

(d) **Economic Situation**

Loan portfolio is very sensitive to the local economic situation, i.e. the economic situation of the area where the bank is situated. Usually, the

country's economic situation can be used as a guide to forecast local economic situation. Lending policy of a bank is usually tighter during economic recession and more liberal during economic expansion.

(e) **Bank Staff's Capability and Experience**

A lot of people have accepted the fact that the most valuable asset of any organisation is the staff. We can find the acknowledgment of this fact by the board of directors and Chief Executive Officers (CEOs) of several banks in their annual reports.

Staff's capability and experience determine a bank's competitive edge. For example, if a bank wants to be the leader in high technology loans, the banks must have staff members who have the experience and skills related to the high technology field; otherwise the bank will end up with vast number of non-performing loans (NPL). That means the focus as well as diversification of loan portfolio are limited by the capability and experience of bank staff.

(f) **Monetary and Fiscal Policies of the Country**

The government implements monetary policy or financial policy and fiscal policy that promote an environment for growth. If the government practises expansionary monetary policy and fiscal policy, banks may put in place more liberal lending policy.

For example, a reduction in statutory reserve will enable banks to have more funds for loan purposes. Otherwise, if the government practises contractionary monetary policy, banks will have to slow down their respective credit growth and be more selective in their lending activities.

(g) **Local Credit Requirement**

Bank management must consider the credit needs of their respective local communities when defining their loan portfolios. This is because the existence of a bank depends on whether the bank is able to fulfil the needs of its local society.

A bank that does not provide agricultural loans or provides minimal agricultural loans must not operate in any agricultural area. We often heard complaints about banks not providing loans for one or the other sector. These complaints may evolve into strong grounds for challenging the roles and existence of the banks in the respective local communities.

Test your comprehension level by answering the questions below.

Exercise 10.2

1. What role does lending policy play towards an effective lending activities?
2. Discuss **THREE** external factors and **TWO** internal factors that can influence the lending policy of a commercial bank. Rank the factors based on their degrees of significance, and support your answer with reasons.

SUMMARY

Sound credit or loan decisions depend on the three main principles in lending, i.e. the principle of purpose, principle of payment and principle of protection. All three principles must be considered simultaneously. Clear, accurate and documented lending policy is also crucial for accurate credit decisions. In order to develop effective lending policy, banks must consider all relevant factors comprehensively.