COMMERCIAL BANK LENDING: BEYOND THE CONVENTIONAL CRITERIA

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Abstract

This paper takes a critical look at the various criteria by commercial banks in granting credit facilities to their customers that beyond this conventional criteria, there is every need for banks to develop a conservative credit practices rooted in strong cultures which will promote lending, communicate priority clearly with a conclusion that the standards and cultures developed must be observed strictly from the top to the bottom especially now that most of our banks are going through distress and outright liquidation.

Introduction

Commercial banking is a service industry which is organized to make money for shareholders by providing banking services and supplying financial needs for people engaged in business or residing in the area in which the bank is located. A bank is an institution whose principal operation is aimed at the accumulation of temporarily idle money for the purpose of lending.

Banks (commercial) are concerned with bringing together in a common fund or pool the temporarily idle money by the general public - money which in the absence of banks would presumably be hoarded by the individual owners. It is money lodged by individual owners that are made available to needy customers in form of loans and advances. It is therefore important on the part of the banks to formulate appropriate lending policy so as to attain the desired level of profit.

The concept of this lending policy involves conscious application of those credit policies to determine their level of finances at any particular period of time and the judicious application of these funds in form of lending to ensure the survival of banks operating in our economy.

According to Adekanye (1983) the idea of lending centres essentially on measures and policies adopted by banks on lending taking into cognizance of the government monetary policies and the environmental forces in which the banks operate in order to maximize profit which is one of their main objectives. Lending policies as stated by Nnanna (2001) involve decisions to ascertain the trend of lending as dictated by the market situation and the Central Bank guidelines.

Essentially, one of the cardinal principles of classical financial policy of commercial banks is to ensure effective lending. Lending is considered effective if it successfully reconciles the banker's obligation of maximum profitability to the shareholders and maximum liquidity to the depositors.

According to Nnanna (2001), bank lending has been considered very crucial in enhancing output growth in Nigeria because of the relative underdevelopment of the domestic capital market and the rapacity of direct foreign investment in the non-oil sector of the economy. Consequently, over the years bank lending per se has been expected to play a significant role in determining the rate of expansion or contraction of private sector investment and output growth.

It should be noted at this introductory stage that most business failures and banks losing their customers and their ultimate liquidation as witnessed in some banks in recent time was due to lack of implementation of good lending policy as occasionally dictated by the Central Bank of Nigeria via its monetary policy circulars.

It should be noted that the most important assets item in the balance sheet of commercial banks are loans and advances. These items are important for some good reasons because the size of its activities in this field (loans and advances) can make a very significant impact on the level of economic activities. The loans and advances of commercial banks attract the attention of the management of these banks, as they are prime sources of profit.

It has been argued by economists such as Kaslyyap and Stem (1999), that banks make money and hence profit by making loans and advances not by sitting on securities that offer returns close to the rate banks pay on deposits. The paradox of the Nigerian situation is that it actually pays the banks to lend out money to sundry borrowers and make enough profits to stay afloat.

The aim of this paper essentially is to highlight some salient yet very important issues, which have to be nurtured and emphasized as a credit/lending culture/policy by commercial banks operating in this country (Nigeria) in addition to the laid down criteria set out by various banks and Central Bank as the regulatory body.

Commercial Bank Lending and Borrowing Decisions

The rapidity with which loans can be negotiated and their low transaction cost has made bank borrowing a popular source of finance. Loans given out by commercial banks ranges from overdraft to term loans of up to ten years.

The framework of a classical commercial environment in which the bank operates this can be divided into banking and economic environment.

Banking environment relates to the ability of the banker to understand and appreciate the objective of his bank. The objective of any commercial organization of which banking is one, is to maximize profit which might be impossible if the bank does not understand, appreciate and watch its source and use of funds. This constitutes its cost and revenue, centres and are useful management control instruments. Effective lending and borrowing decision will be difficult to achieve unless the banker is aware of who his competitors and collaborators are. For instance, the bank may find it necessary to form a consortium to execute a big profit. The bank may be short of particular case. An understanding of the various components and instrument of financial system will enable the bank identity the sources and the outlets. Very critical and crucial to this environment (banking) is the Central Bank in terms of its position as the director, controller and regulator of the entire system. The credit guidelines or directives from the Central Bank can only be ignored at the cost of ineffective lending and borrowing decisions by commercial banks even though there is deregulation in virtually all sectors of economy in this country.

The following are the highlights of the 2004 credit policy guidelines of the Central B Nigeria as shown in the table below:

Sectoral Allocation of Credit (%)

SECTOR	PERCENTAGE ALLOCATION
(A) Higher priority sector	75%
1. Agricultural production	18%
2. Manufacturing and Agro-Allied	42%
3. Non oil export	10%
4. Solid minerals	5%
(B) Others, low priority	25%
Total	100%

Source: CBN Credit Guidelines on Sectoral Lending 2004.

Talking about the economic environment according to Barry (1982) the issue here includes the resource profile in the economy, the government polices for developing or tapping the resources, the main economic sectors and economic indicators or policy at any particular time and the short-term economic or monetary techniques are all very important. This means that the bank to be realistic in its lending and borrowing decisions must study and understand the natural resources in the economy, the country's economic policies as indicated in the national development plans, budget speeches and the Central Bank's regulations and guidelines are all critical issues.

The table below summarises the important categories of bank lending and borrowing. Bank lending is a major part of a bank's assets and is listed at the left side and bank borrowing comprise a bank liabilities and are listed at the right side.

Table 2

Lending	Borrowing
1. Cash and reserve accounts in other bankers	1. Deposit account
- Loans to other banks	- Checking accounts
- Commercial and Individual loans	- Savings accounts
- Agricultural loans	- Time deposits
- Loans to brokers and dealers.	2. Borrowing from other banks.
2. Investment	3. Borrowing from foreigners.
- Nigerian Treasury bills	
- State and local government securities,	
- Corporate bonds.	

Criteria For Loan Decisions

The following are seven key considerations in lending decisions from the commercial bank's point of view. These are:

> What is the character of the borrower? Is he likely to be really concerned about default and can he give up to date information on a deteriorating financial situation of himself or company for which he represents?

> Is the loan profitable? As De Gregorio and Guidoth (1992) put it, the focus is not only on the expansion of domestic credit as a monetary financial deepening per se but also to investigate the profitability and efficiency in the utilization of the loan.

> Is there adequate security for the loan? The rule is that there should be adequate security for every loan given.

> If the loan is secured on the profit of the enterprise how profitable is the business? How risky is the business and could management cope in a down turn situation?

> How capable is the bank in monitoring the progress of the business especially if there is deterioration? Are special skills required for monitoring such business and what are the costs?

> If the business gets into trouble how quickly could assets be sold and how variable are the second hand value of the assets?

> What clauses of covenants should be put into the loan agreement to limit management's ability to change the business? What accounting ratio would predict financial distress and allow the bank an option to withdraw the loan?

The above postulations are very necessary and have to be adequately and satisfactorily answered by bank before granting credit to its customer.

As can be seen one might simply say that the prime problem for the lender is the probability of default. The chance that a borrower will be unable or will refuse to pay the principal term. The banker will wish to know how he can limit his losses if the borrower's position deteriorates. The bank could always recall the loan before the value of the business became less than the outstanding values of the loan. Alternatively, if the customer monitored his own financial position frequently, he could inform the bank when the value of the business is declining to a critical point close to the value of the loan.

Data Required For Lending

The data required for lending depends upon many features of the borrower's position. If he can after adequate security have a little margin to spare. The margin is required because the bank does not wish to monitor the value daily or even weekly. The higher the cost of obtaining a valuation for the security the greater the margin of security required.

Generally, borrowing from banks is generally controlled by interest rate and interest rate alone. The modus operandi was to push up the margin of the cost of bank's funds via high interest rates. If it becomes necessary on the part of the banker to assess the loans given out and the assets offered as collateral for the loans the question then, is how does the bank evaluate the company's assets?

According to Ade and Wole (1982), a prerequisite will be to establish the profitability of the company and also investigate the cash flow forecast on the assumption that general economic and industry conditions may deteriorate. This earnings and cash flow fore cast for a period of years will be required under different sets of assumptions about the economy and the market. The banker would a!so wish to know how the company reacts if the condition deteriorates, how expenses would be reduced or, in the last resort, what the value would be in the event of liquidation.

How far into future should a bank demand forecasts of costs, revenues and net cash flows? Clearly, the answer will depend upon the operating life of the assets and the length of the loan. The bank will try to ensure that the outstanding loan is always less than the remaining value of the investment otherwise it will have to impose conditions on how the firm spends any cash How thrown up by investments.

Having verified the above, the lender will also need satisfactory answers 10 the following questions before giving out loans. These questions are:

- Can the loan be secured by marketable assets whose value can be monitored easily and cheaply?
- Does the value of the security provide an adequate margin above the value of the loan to allow for fluctuations in the value of the security?
- What are the cash flow forecasts for the specific investments and for the firm as a whole?
- How far mighty those cash flows deteriorate under different sets of assumptions about the future course of the economy and the industry?
- What are alternative uses of the assets and what would be their value under those economic and industry condition which could lead to liquidation.
- What repayment schedule will keep pace with the declining value of those assets which may be regarded as security for the loan?
- What covenants are feasible which would provide the bank with an option to recall the loan or if necessary liquidate the company?

It is important to appreciate that when a company's financial position deteriorates, there may be serious conflict of interest between banker and the borrower as the borrower may find it difficult to honour his loan repayment obligation.

Beyond The Lending Criteria

There are many of our commercial banks today that are convinced that their policies and controls are adequate including those that are currently on the list of problem banks. A good/sound lending practice should go beyond the conventional criteria/systems and controls put in place by the banks. In as much as the strict observance of the criteria is good, efforts should be made by the banks to develop an enduring and guiding credit culture to put them on a prudent course.

Four broad categories of credit culture - commitment, enforcement of correct behaviour, communication and lines of business management are advocated here.

Commitment

Without commitment on the part of management to credit quality according to McKinley (1990) the best policies and controls will eventually breakdown from the pressure offenders intent on the deal and a management willing to bend, stretch or break policy to meet profit goals. Exemptions will becomes the rule, and Senders will regard policy and credit administration as an impediment to their mission. Without commitment, there is no discipline and without discipline, the best set out criteria, policies and controls are ineffective.

Correct Behaviour Enforcement

There is every need for banks operating in this country to reinforce strictly the behaviour management says it wants in terms of credit especially during this political dispensation where anything can go "big" politicians could fraudulently get some of these banks to finance their political ambitions all in the name of loans. Loans which are never repaid especially when they lose out in an election. This certainly has a very serious negative consequence on the operations of the lender. Borrowers should be severely penalized for poor credit performance and handsomely rewarded for good performance. Banks must constantly alert borrowers and communicate promptly regarding which behaviour is highly valued and rewarded. These signals according to McKinley (1990) make up a "hidden policy" which will always prevail over written policies.

Communication

The bank's basic lending policies and priorities should be well understood by the borrowers of these funds and this should be communicated to them promptly. The bank's credit culture based on certain values and priorities to which the bank is committed to, has to be understood by both the staff and customers of the bank. The bank that communicates effectively is focused and consistent and its credit performance is dependable.

Lines of Business Management

Lines of business to which credit facilities can be granted should be carefully selected to assure that risk is acceptable. The growth of lines of business to which credit is given should be controlled.

The pressure to enhance profit may lead companies into riskier lines of business like in Nigeria where virtually everybody is into oil business where returns appear most attractive but the risk of losses are also high compared to credit facility granted companies engaged in real estate construction where the risk is less but with longer recovery period. There is need for the banks to weigh the sides before coming out with defined lines of business to grant credit.

Conclusion

Commercial banks are profit motivated companies. Their decision to grant credit facilities to customers should take into consideration expected returns from their earning, assets and the cost of funds and other implicit costs. Therefore, it is important for the banks in addition to the conventional criteria for lending, should develop conservative credit practices which are the most dependable bedrock on which to build for them to stay afloat and survive in face to the dwindling economy.

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