Psychology of Lending and Borrowing

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Basic Banking Principle

Asset = Liability + Owner's Equity

Deposit

Capita

(-)

LOANS (+)

General Accounts Management Cycle

1. Prospecting and Solicitation
2. Loan Packaging and Credit Evaluation
3. Loan Approval
4. Documentation for Loan Release
5. Loan Administration and Management
6. Remedial Accounts Management
7. Foreclosure and Litigation
8. ROPA or NPA management and Asset Recovery
9. Cash conversion of recovered asset

THE PSYCHOLOGY OF LENDING

Lending is an essential (if not the most important) aspect/segment of banking. While the other aspects of banking are similarly critically important, lending is the main activity that brings-in and generate the operating income of the bank.

Consider this equation: A = L + O E (ASSET = Liabilities + Owners' Equity)

Liabilities are typically the deposits entrusted by the clients to the banks, while the Owners' Equity is the Capital of the Bank Owners. Both these however, are EXPENSES incurred by the banks. And the only way these expenses could be converted to EARNING ASSETS, is via LENDING (or LOANS). Thus, lending becomes a NECESSARY ACTIVITY of the banks.

However, lending, as a main source of income, should be done with prudence. Here are some critical points in lending:

1) Maximizing profits and minimizing risks.

This involves a correct loan pricing by charging a higher rate for a higher risk account and vice versa.

2) Use of correct credit risk assessment and underwriting technique.

This involves proper and correct cash flow analysis in evaluating and assessing loan applications.

3) Mentality shift from purely 'Collateral Based Lending' to ' Cash Flow Based/Evaluated' Lending.

This involves a shift of mentality and approach in over reliance in the submitted collateral value as the sole and main basis for granting the loan. Rather, cash flow evaluation and correct credit underwriting technique should be looked at as the main reason for granting the loan.

4) Correct use of Credit Rating Tools.

Credit rating tools are designed to guide the bank on the level of risks involved in a particular loan account. And when applied to the total loan portfolio, the resultant risk rating indicator should enable the bank in its proper portfolio management, and eventual provision for losses. Thus, a PROPERLY crafted and internally tested credit rating tool is a must for all bank.

5) Cautious Observance of Regulatory Rules, without losing the target market/clients.

This involves creative loan packaging techniques to balance regulatory risks vis-a-vis loan opportunities.

6) Proper loan portfolio diversification.

Loan portfolio should be properly diversified. Over concentration in just one or two loan products should be avoided. As the saying goes...... ‘never put all your eggs in just one basket.’

7) Manage Past Due Level and maintain it in its lowest possible level.

How?

a) Decide quickly on the resolution of problematic past due accounts. Don’t dribble them. Foreclose immediately if warranted, and if restructuring isn’t an option already or it isn’t feasible anymore. Don’t keep these problematic accounts sleeping long in the books of the bank.

b) While cleaning up and resolving problematic accounts, continuously book quality accounts simultaneously.

Be guided by the mathematical formula in managing past due ratio:

$$\text{Past Due Ratio (PDR)} = \frac{\text{Total Past Due Accounts}}{\text{Total Loan Portfolio}}$$

The rule in interpreting this equational ratio is by understanding the direct relationship between the numerator (the variable above the equation) and the denominator (the variable below the equation). And since lower ratio is desired, as it connotes better accounts quality, the rule therefore is:

Continuously bringing down the past due accounts and simultaneously increasing the loan portfolio. In other words, problematic past due loans should be reduced and minimized while increasing continuously the production and booking of quality loan accounts.

8) Maintain a high level of CAR (Capital Adequacy Ratio).

Don’t be contended by just being in the border of the acceptable 10% CAR level. If possible, strive to be much higher than the BSP required 10% CAR.

9) Dispose ROPAs. Do not keep them in the books of the bank for an unreasonable longer period of time.

Rule: ROPAs that are 5years and above in the books of the banks should be given priority for sale and/or disposal. Remember the rule........5years old and above ROPAs are required 100% provision for losses. This scenario appears ironic. While the banks supposedly have assets, as these ROPAs are duly registered in their names and are duly reflected and recognised in their respective books, they are penalised 100% for keeping them for 5years.

10) Keep and maintain an effective and efficient organizational structure while ensuring a check and balance set-up.

Banks must follow the suggested structure of BSP under its Circular 855 (i.e. front-middle and back set up).

11) Maintain an ideal number of accounts effectively assigned to each account officer.

The number of loan accounts assigned to these account officers to manage, should be within their actual ability to personally visit all assigned accounts at least 2x a year.

12) Source deposit funds at the lowest possible cost.

Remember, deposit funds are expense items in our books. And these funds must be utilized for lending. The higher the difference between the loan lending rate and deposit sourcing rate, the bigger the gross income, and vice-versa.

13) Tap and utilize external funding sources, like BSP Rediscounting window, ALF, IGLF, etc., for lending to loan clients. The higher the spread from these externally borrowed funds, the bigger the gross income.

Finally, let’s reiterate again the lending principle:

Lending, as a basic banking function is UNAVOIDABLY a risk taking activity.

For every peso lent out, a bank exposes itself to the chance of losing the principal and profits, or even incurring unexpected expenses in safeguarding or recovering the investment.

Thus, the bank analyzes the risk of lending to a party, with the end view of predicting possible failure in advance. If the identified risks are great and uncontrollable, the bank denies the loan.

On the other hand, if the risks are minimal and acceptable as well as they can be calculated, a prudent bank approves the loan but sets up a monitoring system to always check whether the borrower maintains its sound financial position.