Commercial Banking

CHAPTER - 2

Commercial Bank

The term **commercial bank** refers to a financial institution that accepts deposits, offers checking account services, makes various loans, and offers basic financial products like certificates of deposit (CDs) and savings accounts to individuals and small businesses.

" A **commercial bank** in a financial intermediary which collects credit from lenders in the form of deposits and lends in the form of loans"

- Professor Hart

Structure of Commercial Bank in Bangladesh

Types of Commercial Bank

- Nationalized Commercial Bank
- Govt. owned development finance Institution
- Private Commercial Bank
- Foreign Commercial Bank

Objectives of Commercial Bank

- Profit Maximization
- Collect Savings
- Bringing Solvency
- Build up Capital
- Create Propensity of Savings
- Enhancing Supply of Money
- Assist the Govt.
- Expedite Investments

Functions of Commercial Bank

Primary Functions

- Accepting Deposits
- Advancing Loans
- Credit Creation

Secondary Functions

- Agency Functions
- General Utility Functions

Modern Function

Principles of Commercial Bank

- Liquidity
- Profitability
- Loan & Investment
- Solvency
- Savings
- Services
- Secrecy
- Efficiency
- Location

Services of Commercial Bank

- Advancing of Loans
- Cheque
- Overdrafts
- Foreign currency exchange
- Consultancy
- Bank guarantee
- Credit & Debit cards
- ATM services
- Discounting of bill of exchange
- Online banking
- Mobile banking
- Remittance of funds
- Accepting deposit

Loan

A loan is a sum of money that one or more individuals or companies borrow from banks or other financial institutions so as to financially manage planned or unplanned events. In doing so, the borrower incurs a debt, which he has to pay back with interest and within a given period of time.

“Loan is an amount of money that is borrowed, often from a bank, and has to be paid back, usually together with an extra amount of money that you have to pay as a charge for borrowing.”

-Cambridge Dictionary

Features of Loan

- Parties
- Maturity
- Amount of loan
- Mode of loan
- Nature of distribution
- Security
- Interest

Types of Loan

Secured and Unsecured Loans

- **Secured loan** is one that is backed by some form of collateral(stocks, bonds, and personal property).
- **Unsecured loan** means that the borrower does not have to offer any asset as collateral.

Open-End and Closed-End Loans

- **Open-ended loan**, an individual has the freedom to borrow over and over.(Credit cards)
- **Closed-end loans**, individuals are not allowed to borrow again until they have repaid the loan. (mortgage, auto loans, and student loans.)

Good/Ideal Loan

Good debt is an investment that will grow in value or generate long-term income. Taking out student loans to pay for a college education is the perfect example of good debt. First of all, student loans typically have a very low interest rate compared to other types of debt. Secondly, a college education increases your value as an employee and raises your potential future income. Home loan ,auto loan, business loan also good example of good debt.

The loan installments are being paid regularly and in accordance with the repayment schedule as specified in the loan agreement.

Willingness to repay + Ability to repay = Good/Ideal Loan

Bad Debt/Problem Loan

The loans which can't easily be recovered from borrowers are called **Problem Loan.** When the loans can't be repaid according to the terms of the initial agreement or in an otherwise acceptable manner, it will be called problem loans.

It refers those which the borrowers do not return as well as they are not interest to repay or unable to repay. Example- Credit cards, Personal loan etc.

Unwillingness to repay + Ability to repay = Problem Loan

Unwillingness to repay + Inability to repay = Problem Loan

Willingness to repay + Inability to repay = Problem Loan

Causes of Problem Loans

External Causes

- High interest rate
- Recession
- Fire
- Flood

Internal Causes

- Lack of managerial, operational, financial control.
- Loss of market share

Lender Causes

- Improper loan structuring
- An inadequate or expensive loan amount
- Insufficient collateral
- Poor documentation

Handling of Problem Loans

- **Usual procedure**
- ✓ Issue of demand notice
- ✓ Legal notice
- ✓ Special notice
- ✓ Personal communication
- ✓ Loan recovery camp
- ✓ Interest exemption
- **Legal procedure**

Precaution of Bank Before Loans & Advances

- Ability to repay
- Purpose
- Business volume
- Amount of loan
- Period of loan
- Safety & security
- Liquidity
- Earning power of the customer
- Check the asset

Lending Policy

Lending Policy is a program and direction of the credit organization's activities in the field of providing loans to enterprises and private individuals.

- The lending policy of the bank is determined based on macroeconomic external and microeconomic internal factors.
- The main objective of the lending policy of the bank is to obtain maximum profit with a minimum level of risk.

“**Lending Policy** is a set of guidelines and criteria developed by a bank and used by its employees to determine whether an applicant for a loan should be granted or refused the loan.”

- Collins Dictionary

Principles of Lending Policies

- Safety
- Profit
- Liquidity
- Security
- Source of loan
- Considering aspects of investment
- Amount of loan

Elements of Lending Policy

- Statements of Lending
- Lines of Responsibility & Authority
- Required Documents
- Policies & Procedures
- Upper Limit to Loans
- Lending Authority
- Operating Procedure
- Guidelines
- Quality Standards

Security

A security is a tradable financial asset. Securities are fungible and tradable financial instruments used to raise capital in public and private markets.

Securities are broadly categorized into: debt securities (banknotes, bonds, and debentures), equity securities(common stocks).

"Security is an asset pledged to guaranty the repayment of a loan, satisfaction of an obligation, or in compliance of an agreement."

-Business Dictionary

Features of Security

- Marketability
- Stability of price
- Durability
- Easy storability
- Documentation
- Acceptability
- Transportability
- Cost consideration
- Ownership

Mortgage

A **mortgage** is a debt instrument, secured by the collateral of specified real estate property, that the borrower is obliged to pay back with a predetermined set of payments.

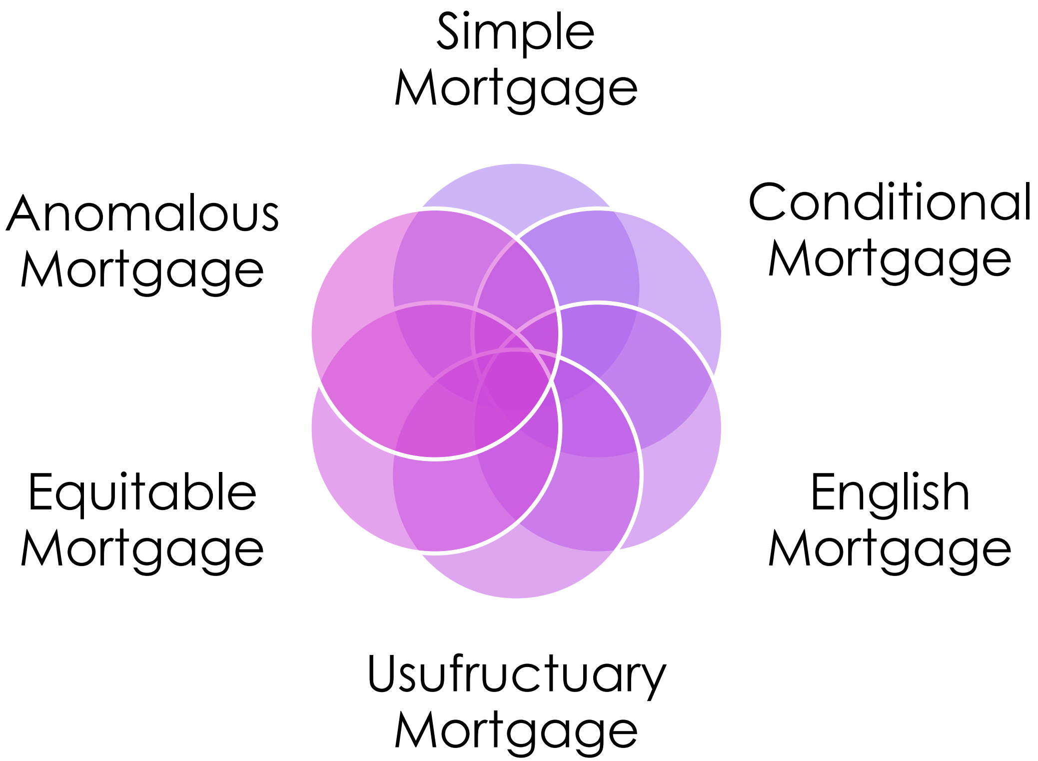
A mortgage is a loan in which property or real estate is used as collateral. Mortgage is the transfer of an interest in specific immovable property for the purpose of securing the payment of money advanced or to be advanced by way of loan, and existing or future debt or the performance of an engagement which may give rise to a pecuniary liability.

Mortgages are also known as **"liens against property"** or **"claims on property."**

Characteristics of Mortgage

- Properties
- Co-owners
- Transfer of interest
- Security
- Transferable
- Re-convincible

Types of Mortgage



Pledge

A **pledge** is a bailment that conveys possessory title to property owned by a debtor (the *pledgor*) to a creditor (the *pledgee*) to secure repayment for some debt or obligation and to the mutual benefit of both parties. The term is also used to denote the property which constitutes the security. The pledge is a type of security interest.

The pledgee has the right of selling the pledge if the pledgor fails to make payment at the stipulated time.

"Pledge is a bailment of goods, as a security, for payment of a debt, or performance of a promise, against some advances."

- Satish B. Mathur

Hypothecation

Hypothecation occurs when an asset is pledged as collateral to secure a loan. The owner of the asset does not give up title, possession, or ownership rights, such as income generated by the asset. However, the lender can seize the asset if the terms of the agreement are not met.

A rental property, for example, may undergo hypothecation as collateral against a mortgage issued by a bank. While the property remains collateral, the bank has no claim on rental income that comes in; however, if the landlord defaults on the loan, the bank may seize the property.

"Hypothecation is charge against property for an amount of debt where neither ownership nor possession is passed to the creditor"

- Hart

Collateral

The term collateral refers to an asset that a lender accepts as security for a loan. Collateral may take the form of real estate or other kinds of assets, depending on the purpose of the loan. The collateral acts as a form of protection for the lender.

That is, if the borrower default on their loan payments, the lender can seize the collateral and sell it to recoup some or all of its losses.

“In lending agreements, **collateral** is a borrower's pledge of specific property to a lender, to secure repayment of a loan.”

- Wikipedia

Credit Creation

Credit creation is the expansion of deposits. It is an activity which has enabled the bank to manufacture money.

Credit Creation is a process, where the bank create deposits by providing loan.

Process of Credit Creation

- Creation of credit through providing loan
- Creation of credit from deposit

Credit Creation = Main Credit/CRR

= 50,000/10%

= 5,00,000

Liability	Tk	Asset	Tk
Deposits:		Assets:	
Rafi 50,000		Cash reserve 10% 5,000	
Sohel 45,000		4,500	
Niloy 40,500		4,050	
Rakib 36,450	1,71,950	3,645	17,195
		Loan:	
		Rafi 45,000	
		Sohel 40,500	
		Niloy 36,450	
		Rakib 32,805	1,54,755
	1,71,950		1,71,950

Process of Credit Creation

- Credit creation by discounting bill
- Creation of credit through sanctioning bank over draft
- Creation of credit through investment

Limitations of Credit Creation

- Insufficient Cash Fund
- Credit demand in Market
- Security of Loan
- Willingness to borrower
- Savings Tendency
- Cash Reserve Ratio
- Effect of Bad Debt
- Credit Control Policy of Central Bank

E-Banking or Internet Banking

E-Banking is a blanket term used to indicate a process through which a customer is allowed to carry out, personal or commercial banking transactions using electronic and telecommunication network.

E-banking is also called as **"Virtual Banking"** or **"Online Banking".**

"Electronic banking is a form of banking in which funds are transferred through an exchange of electronic signals rather than through an exchange of cash, checks, or other types of paper documents."

-Encyclopedia

It covers facilities such as – fund transfer, checking account statements, utility bill payments, opening of bank account, locating nearest ATM, obtain information on financial products and services, applying for loans, etc. using a personal computer, smartphone, laptop or personal digital assistant.

Advantages Of E-Banking

- Provide quick & accurate services
- Access anywhere
- Low cost banking service
- Saving time
- Secrecy & safety of accounts
- Decrease paper work
- Increases efficiency
- Any time cash facility
- Increase customer satisfaction
- Receiving quick & correct information

Disadvantages Of E-Banking

- High start-up cost
- Security concern
- Training & maintenance
- Transaction problems
- Lack of personal contact

E-Banking Risks

- Transactional or Operational Risk
- Credit Risk
- Liquidity or Interest Rate Risk
- Reputation Risk
- Legal/Compliance Risk
- Safety Risk
- Strategic Risk

Risks associated with e-banking

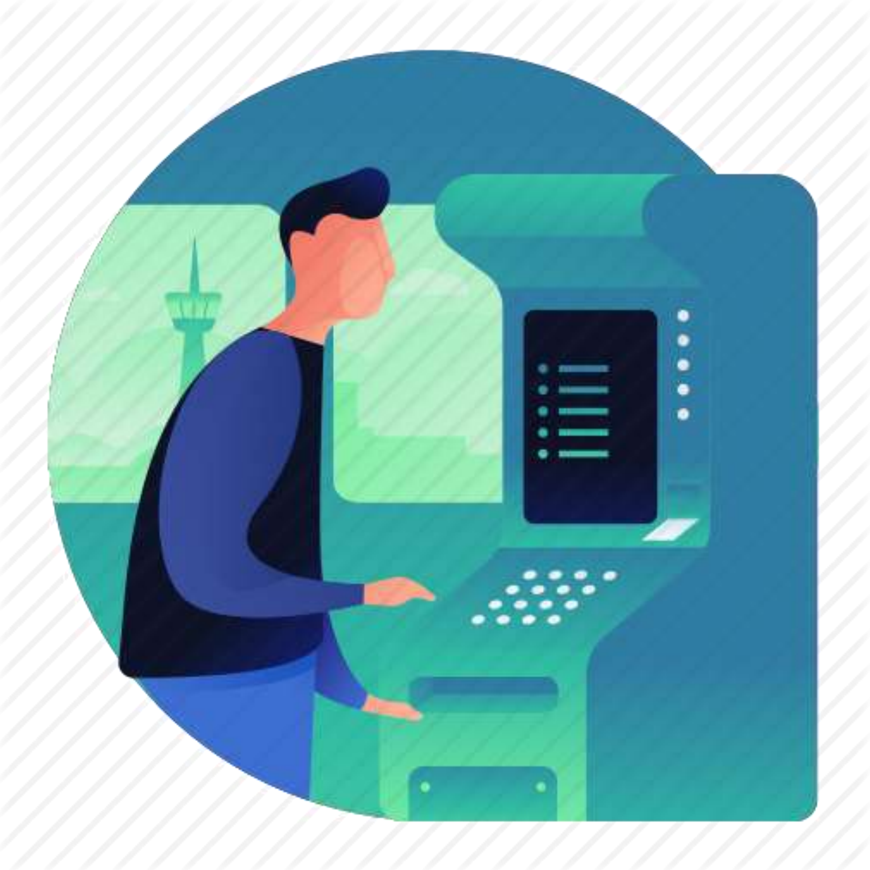
- Transactional risks – inaccurate processing of transactions.
- Credit risk – risk regarding whether an obligation will be settled or not.
- Liquidity/interest rate risk – Banks' inability to meet the required obligations.
- Reputation risk – Risk of getting significant negative public opinion.
- Compliance risk – Violation of rules or regulations.
- Safety – E banking is exposed to risks of hacking and frauds.

Services of E-Banking

- Automated Teller Machine(ATM)
- Debit Card
- Credit Card
- Smart Card
- Point of Sale(POS)
- Cheque Truncation
- Home Banking
- Tele Banking
- Mobile Banking
- SMS Banking

Advantages Of using Bank ATM

- Quick cash withdrawal
- Account balance inquiry
- Anyone can have bank card
- Details of recent transaction
- Deposit cash
- Request for new cheque book
- Transfer funds between accounts within the same bank
- Pay utility bill



Benefits Of using Bank ATM Cards

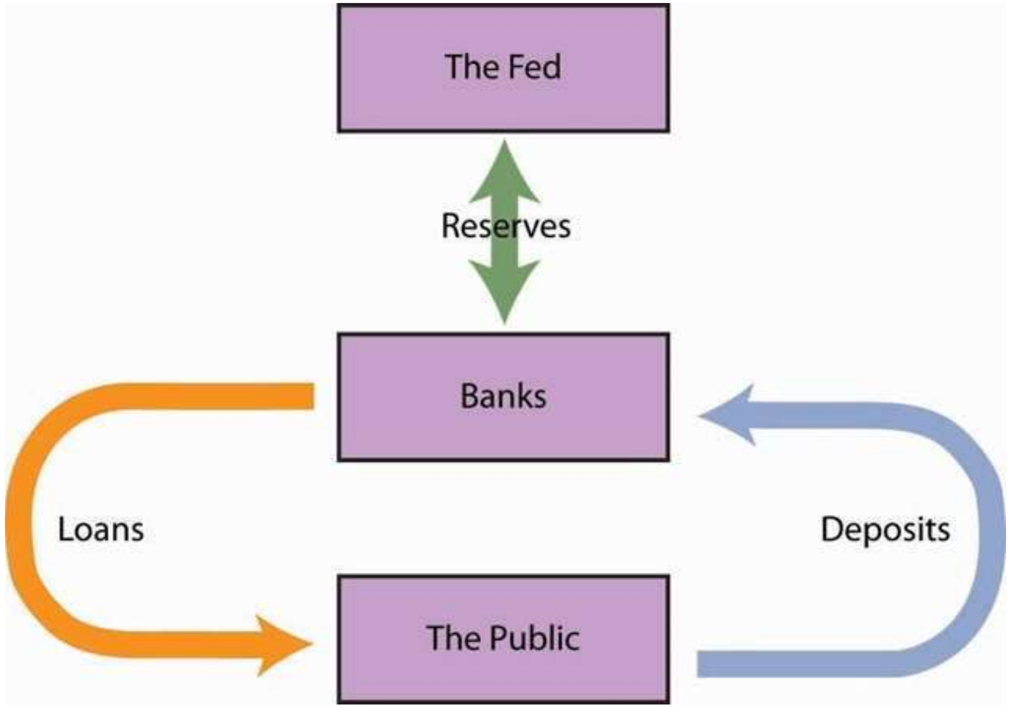
- Save time
- 24*7 Banking
- Withdraw cash when overseas
- Universally accepted
- Security & safety
- Save your account from being dormant

Balance Sheet of a Bank

Liabilities	Assets
1) Capital a) Authorized capital b) Issued capital c) Subscribed capital d) Paid-up-capital 2) Reserved fund 3) Deposits 4) Borrowing from other banks 5) Bills payable 6) Acceptance & endorsement 7) Contingent liabilities 8) Profit & loss account 9) Bills for collection	1) Cash a)Cash on hand b)Cash with central bank & other banks 2) Money at call & short notice 3) Bills discounted 4) Bills for collection 5) Investments 6) Loans & advances 7) Acceptance & endorsement 8) Fixed assets

How Do Banks Make Money?

- Loans
- Credit Cards
- Public Deposits
- Debt Issuance
- Service Fees



Financial Measurements

1. Profitability Performance:

a)Return on Asset(ROA) = *Net Income / Total Assets*

b)Return on Equity(ROE) = Net Income / Average Shareholders' Equity

c)Cost to Income Ratio(C/I)= Net Cost / Net Income

2. Liquidity Performance:

a)Liquid assets to deposit-borrowing ratio= Liquid Asset / Customer Deposit & Short Term Borrowed Funds

b)Net loans to total asset ratio= Net Loans / Total Assets

c)Net loans to deposit & borrowing= Net Loans / Total Deposits & Short Term Borrowings

3. Asset Credit Quality:

a)Loan loss reserve to gross loans= Loan Loss Reserve / Gross Loans

Evaluating a Bank's Performance

Determining Long-Range Objectives

Maximizing the Value of the Firm

Profitability Ratio
(ROA,ROE,NIM,NIMPLL,EPS etc.)

Measuring Risk in Banking & Financial Services

Impact of Commercial Banks in Economic Development

- Trade development
- Agricultural development
- Industrial development
- Capital formation
- Development of foreign trade
- Transfer of money
- Increase in savings
- Increase in employment
- Credit creation
- Increase in investment

Corporate Social Responsibility(CSR)

Corporate Social Responsibility is a management concept whereby companies integrate social and environmental concerns in their business operations and interactions with their stakeholders.

Corporate social responsibility (CSR) is a company's commitment to manage the social, environmental and economic effects of its operations responsibly and in line with public expectations.

"Corporate social responsibility (CSR) is a business approach that contributes to sustainable development by delivering economic, social & environmental benefits for all stakeholders"

-Financial times

The Expectation from Nationalized Bank

- Social welfare
- Reducing regional imbalance
- Priority sector lending
- Developing banking habits

Role of Private Commercial Banks in Economic Development

- Capital formation
- Mobilizing of savings
- Availability of funds
- Self sufficiency
- Development of agriculture & industrial sector
- Expansion of market
- Research & development
- Modern facilities
- Regional development
- Socio-economic development

When Banks Required Disclosing Customer's Information

- Disclose of information required by law
  1. Under income tax act
  2. Under the company acts
  3. Disclose to police
  4. Under the foreign exchange regulation act
- Disclose permitted by the banker's practices
  1. With express or implied consent of the customer
  2. To protect his own interest
  3. Banker reference
  4. Duty to public to disclose