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LOAN MANAGEMENT AND RISK PRACTICES IN BANKS

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ABSTRACT

The loss arising from the borrower default by delaying or not making repayments of interest or principal promised transactions affects largely banking sector. Currently, Banks experiences high levels of non-performing loans. This trend threatens viability and sustainability of banks and hinders the achievement of their business goals. The contribution of this paper is based on adding knowledge to the loan management in banks with respect to risk management. The Survey was done in commercial banks in Karnataka state, India. The findings shows that there is mismanagement of Loan practices in banks starting after receiving loans applications, screening the applicants, granting and doing follow up. The authors urged that, Banks should go as far as checking the loan criteria combined together to ensure timely repayment and hence be able to manage risk.

KEYWORDS: *Loan management, Risk management, Non-performing Assets,*

INTRODUCTION

Though it is well understood that risk taking is an integral part of banking business but in today's liberalized scenario, banking is much more risky business. Thus risk management and loan portfolio management has emerged as defining attributes. Credit risk or the risk of loan defaults is the most threatening risk for the banking sector, which can question the existence of the organization. The issue of Bank Loans has received extensive theoretical and empirical investigation but despite the problem loans being such an important factor impinging on the health of banks, identification and analysis of their determining factors have been paid little attention (Davis, 1992; Ghosh, 2007). Banks should manage Loans because of limited capacity to absorb losses and this losses, can be covered only by using returns generated by other profitable loans or by bank capital (Boffey& Robson, 1995). Loans management process makes simple and ensures the granted loans to be recovered in exact time and if not, a good collateral can be used in replacement of the loan. Credit worthiness of the borrower should be assessed by the bank, loan monitoring is required until when the borrower has finished repaying. Borrower's identification characteristics are important because of enabling easily assessment and collections, determine the most cost-effective type of customer outreach, and initiate repayment plans before a borrower's financial situation worsens (Focardi, 2009). Thus, Loan monitoring is essential mechanism to be put in place in order to reduce the frequency and /or intensity of a loss that occurs.

REVIEW OF LITERATURE

Various researches have been conducted research on the bank loans management in context of repaying the loans, and also looking at the loan policies. The financial viability of any credit institution depends absolutely on selecting applicants who have a high probability of repayment and rejecting those who have a high probability of default Ssewagudde, (2000). The Banks framework of Loans management starts by creating policies and principles that have been put in places by the board of directors on how to manage Loans. Maness &Zietlow, 2005, explained that a credit policy has four major pillars which include; credit standards, credit terms, credit limits and collection procedures. Developing Loans standards refers to the minimum standards a customer has to fulfill before he or she can be extended Loans. These standards should be set while looking at the customers character (i.e. morals, integrity, trustworthiness and management quality, capital, capacity (i.e. its ability to repay debts when due), conditions (the general economy, the borrower's environment and the reasons for the loan request), and collateral (the asset which is given as a security to back up the loan). Maness &Zietlow, 2005, opined that any decision on whether to grant a loan and how much credit to give is taken based on four steps; developing credit standards, gathering necessary information about the customer, applying credit standards, and setting limits. Credit terms- This is the credit period stipulating how long from the invoice the customer has to pay, and the cash discount (if any). This refers to the conditions under which banks advances credit to its customers. Credit period refers to the period of time in which the credit is granted. The length of the credit period is influenced by Collateral value, Credit risk, the size of the account and market competition.

Loans collection procedures have to be implemented in a good manner. When the borrower delays to repay or defaults, the bank will automatically look for other means to meet up with this financial loophole. The banks have to use efforts while collecting loans also have to make sure the collections of the amount owed as close to the loans terms as possible also must always try to preserve customer goodwill when doing so (Maness & Zietlow, 2005).

NEED AND IMPORTANCE OF THE STUDY

As banking stress persists due to failure in managing loans, financial analyst and banking practitioner's needs advanced knowledge regarding the effective practices to be used in granting loans to customers and the importance of bank loans policies and risk management. The ideas of this paper would provide useful insights into the effective way of managing loans to effective risk management.

OBJECTIVES OF THE STUDY

1. To study banking loan management practices
2. To explore challenges facing banks loans management
3. To offer suggestions on loan management in banks.

RESEARCH METHODOLOGY

The paper is based on empirical data from 10 commercial banks (5 public and 5 private) operating in Karnataka state in India, 150 bank employees in loan department filled the questionnaires. The questionnaires was structured in Likert-type scale. The analysis was also done with the help of SPSS (20).

LOAN MANAGEMENT

Loan risk management process ensures the granted loans to easier its recovery. Loan management is an essential mechanism to reduce the frequency and /or intensity of a loss that might occur in banks.

Hypothesis 1: There is significant relationship between loan management and effectiveness of risk management in banks

Table 1. Relationship between loan management and risk management effectiveness

	Value	df	Asymp. Sig. (2-sided)
Pearson Chi-Square	12.343[a]	9	.019
Likelihood Ratio	10.806	9	.289
Linear-by-Linear Association	1.802	1	.179
N of Valid Cases	50		

a. 13 cells (81.3%) have expected count less than 5. The minimum expected count is .12.

Table above shows the statistical values for judging the significance relationship between effectiveness of Loans management and risk management. The calculated value of chi square for 9 degree of freedom at 5% level of significance is 12.343 and the significance p-value is 0.019. Thus, it is clear from the above analysis that, there is significance relationship between loan management and risk management effectiveness in banks have relationship.

Table 2. Loans management practices in banks

	N	Mean		Std. Deviation
	Statistic	Statistic	Std. Error	Statistic
The loan and recovery department monitor performance of the bank loans	50	4.5400	.09566	.67643
Bank maintains provision and supervision of loan interest	50	3.8600	.09902	.70015
Bank diversifies its loan exposure to different groups of loan borrowers	50	4.5600	.09107	.64397
Bank measures its loan portfolio in terms of payment arrears	50	4.5200	.09143	.64650
The bank have a clear understanding of borrower's business skills and condition before giving loans	50	4.4200	.09076	.64175
The bank conduct financial analysis for each settlement period to monitor changes in loan borrower's condition	50	4.4600	.09566	.67643

Source: Field Survey

The table above shows the loan management practices in banks. The mean scores above 4.0 were considered effective practices. The analysis reveals that, The loan and recovery team monitor performance of the bank loans with the mean score 4.540, Bank diversifies its loan exposure to different groups of loan borrowers with the mean score 4.560, Bank measures its loan portfolio in terms of payment arrears with the mean score 4.520, The bank have a clear understanding of borrower's business skills and condition before giving loans with the mean score 4.420 and The bank conduct financial analysis for each settlement period to monitor changes in loan borrower's condition with the mean score 4.460. The less effective practices were, Bank maintains provision and supervision of loan interest with the mean score 3.860, Bank regularly monitor performance of loans with the mean score 3.980. The mean scores were considered almost the same, there is effective loan management practices in banks.

Hypothesis 2: There is no significance difference regarding effectiveness of loan department in monitoring performance of loans in banks

Table 3: The significance on loans performance monitoring

	Test Value = 5					
	t	df	Sig. (2-tailed)	Mean Difference	95% Confidence Interval of the Difference	
					Lower	Upper
Loan department effectively monitor performance of the loans	-4.809	49	.000	-.46000	-.6522	-.2678

The p value, denoted by "Sig. (2-tailed)" is .00, if the population mean is exactly 5, then there's only a 0% chance of finding the result. The null hypothesis is rejected since ($p < .05$). There is no significant difference regarding effectiveness of loan department in monitoring loans performance in banks. Banks have established effective loan department which oversee the process of granting loans and manage defaults level for maintaining banks profit. The management ensures bank comply with credit regulations for easier monitoring the performance of loans.

Hypothesis 3: There is no significance difference regarding diversification of loan exposure to different groups of loan borrowers

Table 4: Bank diversification of Loan exposure

	Test Value = 5					
	t	df	Sig. (2-tailed)	Mean Difference	95% Confidence Interval of the Difference	
					Lower	Upper
Bank diversifies its loan exposure to different groups of loan borrowers	-4.831	49	.000	-.44000	-.6230	-.2570

The p value, denoted by "Sig. (2-tailed)" is .00, t value is -4.83. The null hypothesis is rejected p < .05. We thus conclude that there is no significant difference on diversification of loan exposure to different groups of loan borrowers in banks. Banks have been using different methods to manage risk especially ones caused by borrowers default, one of those is diversification of loan exposure. It is seen that, banks have effective methods of diversification to different groups of loan borrowers which enables banks to minimize risk of defaults to some loan defaulters.

Hypothesis 4: There is no significance difference regarding understanding of borrowers business skills in banks

Table 5: Bank effective screening

	Test Value = 5					
	t	df	Sig. (2-tailed)	Mean Difference	95% Confidence Interval of the Difference	
					Lower	Upper
The bank have effective screening to understanding borrower's business skills before giving loans	-6.391	49	.000	-.58000	-.7624	-.3976

The p value, denoted by "Sig. (2-tailed)" is .00, the t value is -6.391. The null hypothesis is rejected since p < .05. We thus conclude that there is no significant difference on understanding of borrower's business skills in banks. This means that, banks have adequate procedures that leads to effective understanding of loan borrower's skills before giving loans. Loan screening helps banks to determine the eligible borrowers to grant loans. Banks have been conducting such kind of programs to ensure timely repayment of loans to minimize risk.

CHALLENGES ENCOUNTERED DURING LOAN MANAGEMENT IN THE BANK

The major challenges facing banks in loan management are: 1- Not at all (weighted-1). 2- to a small extent (weighted-2), 3- to a moderate extent (weighted-3), 4- to a large extent (weighted-4), 5- to a very large extent (weighted-5).

Table 6. Loan management challenges

	1	2	3	4	5	WAS	Ranks
Diversion of loans	0	0	5	19	27	1.50	1
Inappropriate loan screening	0	3	5	6	17	0.87	2
Improper credit ratings	0	1	6	5	11	0.63	4
Inadequate loan appraisals procedures	0	0	3	4	13	0.60	5
Inadequate loan monitoring process	0	0	5	8	12	0.71	3

Source: Primary data

In Table 6, we find that, Diversion of loan takes first rank as a most challenging banks in managing loans, followed by inappropriate loan screening, then, inadequate loan monitoring process and lastly, inadequate loan appraisal procedures. Moral hazard problem contributes largely to the occurrence of loan management challenges. In order for banks to minimize these challenges, loans policy should be well established in banks and effective loan screening should be done to minimize the number of loan defaulters.

CONCLUSION

The implementation of loan management starts right from the time the banks conduct assessment of customer loans application. All banks are always concerned about the credit worthiness of the loaning customer and this information is valued differently by the different banks but the sole goal being "to be sure that the customer willrepay the loan". Loan policy is essential to ensure repayment of interest and loans. Loan monitoring and control efforts should be emphasized, which essentially aims at accelerating collections from slow payers and reducing bad debt losses. There should be a mutual understanding between the bank and the loan's customer.

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