Literature Review:

The Impact of Lending Procedures and Asset Management to the Sustainability of Community Banks

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2009
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Introduction

Community Banks are micro financial institutions that provide financial services for the community who are living in the urban areas which are not taken care of by the big financial institutions. Studies on this kind of institutions are still limited especially in developing countries. The total amount of funds involved in community banks is not as big as the total value of funds that are operated by the big financial institutions but this group cannot be neglected because it is providing support to the low level income community.

This paper attempts to review the theoretical literature on the banking lending procedures and asset management and study their relationship to the sustainability of the micro financial institutions. This paper further will elaborate literatures relating to lending procedures, assets management, and the sustainability of firms.

Lending procedures

Ralston and Wright (2003) has conducted a study to examine the sound lending procedures in retail financial institutions that involve the identifying of high risk applicants, modifying loan conditions such as security requirements, and monitoring payments post-loan approval. For managers of credit unions, this procedure is complicated by the need to achieve the balance between the institution’s social objective of improving loan accessibility so that members can attain lifestyle goals and the possibility of reducing the institution’s viability through loan default. The results of the survey of Australian credit unions, in which 70 per cent of respondents reported experiencing some bankruptcy-related default on personal loans,
indicates that managers do not impose stringent lending conditions on high-risk borrowers. However, social and viability objectives could be better balanced through careful loan monitoring and timely arrears practices.

Wei-Shong and Kuo-Chung (2006) have conducted a study on the internal performance measures of bank lending: a value-added approach. In credit unions, there is a conflict in the relation between the lending procedures and the social-viability objectives. The purpose of the study was to solve problems of overdue loans and bad debts. The research establishes the internal performance measures to monitor and enhance the operational qualities of the employees in the lending department. The research utilizes the value-added approach to analyze the lending production process and derive the internal performance measures to add value to lending activities. The study found that compared to final measures (data envelopment analysis, benchmark, and productivity measures), the internal performance measures proposed in this research would be more effective for evaluating the job performance of employees in lending activities. A comprehensive analytical framework that will improve the accuracy of analyzing a borrower’s capacity and condition has also been constructed in this research.

Recently bankers have come to realize that banking operations, especially corporate lending, affect and are affected by the natural environment and that consequently the banks might have an important role to play in helping to raise environmental standards. Although the environment presents significant risks to banks, in particular environmental credit risk, it also perhaps presents profitable opportunities. Stricter environmental regulations have forced companies to invest in environmentally friendly technologies and pollution control measures and in turn generated
lending opportunities for bankers. This article examines the lending policies of a sample of
UK banks with respect to the environment, focusing on issues of environmental risk
management, market segmentation and the exploitation of marketing opportunities. The
research found that
while the banks are placing considerable emphasis on environmental risk management in their
corporate lending operations, there is little evidence of them harnessing the opportunities
presented by the “greening” of industry. (Thompson, 1998)

Asset Management
Liquidity is the ability of a bank to fund increases in assets and meet obligations as they
become due, without incurring unacceptable losses. The fundamental role of banks in the
maturity transformation of short-term deposits into long-term loans makes banks inherently
vulnerable to liquidity risk, both of an institution-specific nature and that which affects
markets as a whole. Virtually every financial transaction or commitment has implications for
a bank's liquidity. Effective liquidity risk management helps ensure a bank's ability to meet
cash flow obligations, which are uncertain as they are affected by external events and other
agents' behaviour. Liquidity risk management is of paramount importance because a liquidity
shortfall at a single institution can have system-wide repercussions. Financial market
developments in the past decade have increased the complexity of liquidity risk and its
management. (Bank for International Settlements, 2008)

Effective credit risk assessment and loan accounting practices should be performed in a
systematic way and in accordance with established policies and procedures. To be able to
prudently value loans and to determine appropriate loan loss provisions, it is particularly
important that banks have a system in place to reliably classify loans on the basis of credit
risk. Larger loans should be classified on the basis of a credit risk grading system. Other, smaller loans, may be classified on the basis of either a credit risk grading system or payment delinquency status. Both accounting frameworks and Basel II recognize credit grading systems as tools in accurately assessing the full range of credit risk. Further, Basel II and accounting frameworks both recognize that all credit classifications, not only those reflecting severe credit deterioration, should be considered in assessing probability of default and loan impairment. (Bank for International Settlements, 2005)

Rottke and Gentgen (2006) have conducted a research on workout management of non-performing loans: a formal model based on transaction cost economics. The purpose of the research was to examine the German banking sector which recently has been facing high real estate loan default rates. The design and methodology used in this study was based on the transaction characteristic of the transaction cost economies to work out the real estate loans. In their research, they found:

Following the assumptions of the transaction cost economics, the specificity of the investment of the workout manager (and also the bank) is crucial for the decision of integrating or disintegrating the workout of real estate loans. The degree of specificity required to perform the workout tasks depends on the status of underlying credit engagement and the characteristics of the collateral (the real estate). The formal analysis shows that the bank and the workout manager both under-invest in integration and disintegration scenarios. However, if the degree of specificity of the investments is equal, non-integration is superior to integration. Forward integration is superior to non-integration, if the bank’s investment is more specific than the workout manager’s investment.
Acharya, Kagan, and Lingam (2008) in their research on online banking applications and community bank performance aims to examine the impact of online banking intensity on the financial performance of community banks. The design, methodology and approach of this study estimates online banking intensity and bank performance indices using a combination of primary and secondary data. Online banking intensity is specified as a latent construct and estimated using web feature data collected from bank websites. An empirical profit function of a nonstandard Fourier flexible form is estimated using bank’s financial data to derive a theoretically consistent performance measure. The actual impact of online banking on performance is measured by regressing the profit efficiency index against a number of correlates including online banking intensity measure. The findings of the studies indicate that the increasing use of internet as an additional channel of marketing banking services has significantly improved the financial performance of community banks.

**Sustainability**

Setthasakko (2007) in his case study: Determinants of corporate sustainability: Thai frozen seafood processors have aimed to gain a clearer understanding of key determinants that drive corporate sustainability and barriers that hinder its development. The study employs semi-structured interviews with top and middle managers and did site observations at two frozen seafood processing companies in Thailand. The study reveals that the government, the local communities, and the top leadership management are the three primary factors influencing company integration of environmental and social responsibility into corporate strategies and practices. Interestingly, international buyers do not take the environmental and social impact generated by their suppliers into purchasing decisions. For them, quality, safety and prices are the main factors influencing their purchasing (Setthasakko, 2007) He concluded that adopting
a system perspective to the organization with an emphasis on integrating environmental and social responsibility into corporate strategies and practices is a key to creating corporate sustainability.

Aras and Crowther (2008) in their article Governance and sustainability want to show that corporate governance is fundamental to the continuing operation of any corporation; hence much attention has been paid to the procedures of such governance. Similarly sustainability is fundamental to the continuing operation of any corporation, and is arguably the fashionable concept of the moment. While it is clear what is generally meant by corporate governance it is much less clear what is meant by sustainability and the paper starts by investigating this concept. The methodology and design used in this study are two such fundamental concepts. However it would seem that there should be a relationship between the two, although little work has been undertaken on exploring this relationship. The central part of this paper is therefore based upon an exploration of the relationship between governance and sustainability, by investigating the FTSE100 companies and their corporate governance policies. This analysis found some strengths and hence cause for optimism, some weaknesses and hence cause for concern. Areas where further work is needed are identified.

CONCLUSION

Based on the literature review of the above mentioned variables, it can be seen that ample of research topics can be developed from the six related articles. Former studies are mostly conducted in developed countries except the one in Thailand. Research publications about community banks are limited in the ASEAN countries. Indonesia as one of ASEAN countries has a significant amount of community banks which are called BPRs. Lending procedures and sustainability will be an interested research topic. The literature shows that studying those two
variables plus including loan quality (assets management) as an intermediary variable will provide new paradigms in the banking industry.

The summary of the studies are as follows:

<table>
<thead>
<tr>
<th>Author</th>
<th>Variable</th>
<th>Finding</th>
<th>Future Research</th>
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<tbody>
<tr>
<td>Raiston, W., &amp; Wright</td>
<td>Lending procedure, Viability-social objectives</td>
<td>Difficult to balance satisfying of social objectives and financial viability</td>
<td>The same topic in other countries</td>
</tr>
<tr>
<td>Wei-Shong, L.P., &amp; Kuo-Chung, M.A., (2006)</td>
<td>Performance measures, Activities of lending process</td>
<td>Internal performance measures proposed are more effective for evaluating the job performance</td>
<td>Extent NPL to asset management</td>
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<tr>
<td>Thompson (1998)</td>
<td>Lending Procedures, Environment</td>
<td>banks are placing considerable emphasis on environmental risk management in their corporate lending operations</td>
<td>Green lending Procedures, Lending procedures and CSR</td>
</tr>
<tr>
<td>Rottke, N.B., &amp; Gentgen, J., (2008)</td>
<td>NPL, Work out management</td>
<td>• Low servicing NPL should be organized externally &lt;br&gt;• High collateral NPL managed internally &lt;br&gt;• Low collateral NPL should be through external third party</td>
<td>Data from other countries, Extent the industry not only for real estate</td>
</tr>
<tr>
<td>Acharya, Kagan, and Lingam (2008)</td>
<td>On line banking application, Community bank performance</td>
<td>Study results indicate that the increasing use of internet as an additional channel of marketing banking services has significantly improved the financial performance of community banks</td>
<td>Community bank in developed countries</td>
</tr>
<tr>
<td>Setthasakko, W., (2007)</td>
<td>Government, Local Communities, Customers:</td>
<td>The study reveals that the government, local communities, and top</td>
<td>Introduce other corporate governance variable</td>
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<td>International buyer</td>
<td>management leadership are the three primary factors influencing company integration of environmental and social responsibility into corporate strategies and practices.</td>
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<td>Top Management leadership</td>
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<td>Barriers to corporate sustainability</td>
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Reference


