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Article

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Banks' Performance Enhancement: A Framework for Valid Documentation of Credits

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Abstract

Credit is the business and recovery is the core issue of banks. Documentation of transactions is indispensable to effect complete and timely recovery of banks' credits. The valid credit documentation, that ensures recovery, has fostering impact on the performance of banks. This research study is based on critical review of literature and a framework for the valid documentation of credits has been developed to enhance the performance of banks.

Keywords: Credit, Valid Documentation, Framework, Typification, Dyadic Peculiarities.

1. Introduction

The study focuses on commercial banks (the term commercial bank includes the Islamic banks). The conventional commercial banks lend money in shape of short, medium and long term loans on interest, whereas, Islamic banks invest their money in shape of ijara, musharaka, morabaha, equity finance, and salam, etc. but generically both of them emanate credit. There are three means to finance credits i. e. deposits, owner's equity and reinvestment of profits. The deposits with no special instructions, give immense power to banks to lever, therefore, the banks are at liberty to advance loans quite liberally. The loans, in fact, are major source of income for a bank. Banks retain small premiums (i.e. difference between interest revenue and interest expense) and buildup their profitability and assume a lot of credit risk associated with the credit activity. Credit risk means the possibility that bank will suffer a loss because some borrowers do not follow lenders' repayment terms for different reasons (Driga, 2004). Credit risk and liquidity management is a huge issue for all banks (Mounira, 2008). All the transactions of the banks are necessarily sufficiently documented to minimize the credit risk. Concept of documentation is taken from Islam and Husein (2009) very rightly argues that Shariah advises for better documentation in business transactions. The concept of documentation is also deeply rooted in Anglo-Saxon Laws, inter alia, others. Very purpose of the documentation is to create evidence of every action in transaction. Documentation of the

credit transactions should suffice the establishment and enforceability of a claim of a bank at law to effectuate the recovery of credits.

Before embarking on the documentation of credits we have to engineer the credit process. Credit process starts with a proposal of a loan made to a bank by any person. Credit proposal passes through phases of investigation, assessment, approval, and disbursement conjoining the subsequent process of recovery. Generic flow of credit process is given below in Figure 1.

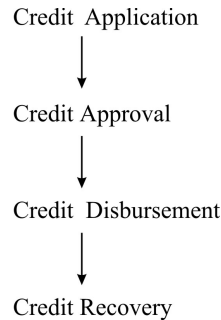


Figure 1: Generic Flow of Credit Process

Figure 1 depicts a general credit process irrespective of loan size, nature, tenure, conditions, country or bank, whatsoever. The natural flow of loans conjoins the recovery process (i. e. immediate process subsequent to that of credit is recovery). Effectuation of full and timely recovery, to large extent, depends on valid documentation of credit transactions. Firm's leverage before default negatively affects ultimate recoveries (Khieu et al., 2011).

The banks have clear cut propensity to document every step in every transaction to create evidence and the buzz words of the domain that “bank deals in documents” also endorse the idea. The tenet of documentation in credit process is, in fact, adolescence of the idea of documentation in banks. Credit documentation is a tie that binds a bank with loanee and establishes the claim of a bank against him. Therefore, it is something extra-ordinary to take care but unfortunately very few research studies addressed the issue hence a lot has to be done in this area of research.

The credits are the source of income for banks and are major contributory factor towards performance. Recovery of every rupee of a loan is of utmost importance because one stuck up loan can eat up premiums of many loans. The credits, which are poorly documented, not properly documented, non-documented, insufficiently documented, fraudulently documented or fictitiously documented, not only put banks into problem but also, give tough time to the economy of a country in ultimate. The transactions of the credit, inter alia, affect the performance of a bank copiously. The credits, while translated into recovery figures, speak for a bank and it can be visualized that what they will speak for a bank on the basis of invalid or fragile documentation. Clearly, there are more chances of default in case of invalid and/or fragile documentation and due to default bank has to register a direct decline of its profits (Driga, 2004).

Default on loans is a known and existent phenomenon behind every financial crisis and it has origins in tempt to default. People get loans from banks liberally, invest in so called

businesses emphatically and report the failure with countenance. They also manage to escape the liabilities and banks suffer as a result. This loss is ultimately adjusted in national savings which discourage the savers at grass root level. Default on loans is not a region, industry or country specific problem but is a contagion common the world over. All the nations (developed, developing and under developed) are suffering from this contagion equally. The default thrives with fragility of credit documentation; therefore the severity of default is more deleterious in the fragile countries. The willful defaults take place, if there are flaws, weakness or lacunas in documentation of credits due to fragile legal environment.

Common dimensions of bank performance are service quality, operating efficiency and profitability (Manandhar et al., 2011). The profitability of a bank is adversely affected by defaults. Provisions for bad and doubtful debts are directly subtracted from the revenues of good loans. Valid, flawless and expressly binding credit documentation reduces the tendency of willful default and enhances the performance of banks. The performance of a bank has linear relationship with the credit and recovery process. The general flow of the loans and recovery towards performance is given in Figure 2.

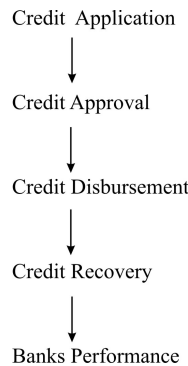


Figure 2: General Flow of Credits and Recovery towards Performance

Figure 2 clearly indicates that banks' performance is dependent on recovery of credits. Asari et al. (2011) rightly argued that banks are unable to profit from credits in default. The study relating to validity of credit documentation (i.e a medium to abstain defaults) has direct relevance to the performance of a bank.

There is no clear-cut routine to measure the performance of a bank, traditionally; financial ratios are the method often used to evaluate banks' performance (Yeh, 1996). Conventional set of profitability, liquidity, efficiency and solvency ratios are based on figures and do not take the qualitative aspects (like quality of credit documentation) into account. Sometimes the performance is measured by duration gap and dollar gap between interest sensitive asset and interest sensitive liability, i.e. yet another quantitative tool (Rose, 2005 and Gup et al., 2005). The study in hand is unique in the sense that it concerns the base on which the figures are built. Forthcoming part of the study consists of literature review, development of the framework for credit documentation and conclusion.

2. Literature Review:

There surpassed a lot of research in the domain of banking and it is virtually impossible to comprehend the literature but still the researchers are confident to at least have reviewed the studies critical to the issue in hand. The banking is considered as social relations and has conceptual roots in the idea of the house banking or relationship banking that establishes behavior pattern of long term relations (Elsas et al., 1998). The relations of a bank and a customer are expressly written in black and white and in order to sustain success the parties need to keep a judicious balance (Probst et al., 2005). The relational documents have distinguished peculiarities. The credit agreements must be quite clear (Chovancova, 2006) and according to the laws of the land. The documentation of banking transactions complements the legal system of a country. Smooth functioning of the legal system, in fact, requires all the institutions to complement (Lu et al. 2008). The argument of Santikian (2009) that the borrowers are ultimate head of a bank can only be weighed if the ties of the banks and the borrowers are strong. Although every year the bank loans increase as compared to previous year but still the growth rates are not satisfactory (Tanbir et al., 2009). Measurement of the relationship aspect in the banking sector is essential due to the sensitivity of assets and liabilities (Afzal et al., 2009) particularly, the degree of the strength of the tie between loanee and the bank. There are arguments for and against the weak and strong legal systems and in this context Yao (2009) argue that weak legal systems and under developed financial markets sometimes augment the economic development.

Globalization, dispersal and anonymity of the shareholding of listed banking and financial institution facilitate the contagion of default (Jehlen, 2010). There exists systemic risk or the threat of contagion in banks (Simpson 2010). In the well functioning legal environment, banks lend to SMEs (i.e. at grass roots level) but, on the other hand, to large enterprises and government (Haselmann, 2010). While granting and documenting the credits, the particularities of the activity and the sectors are taken into account (Sbarcea, 2010). Legal creditor protection, bank ownership and bank size are important determinants of the composition of very portfolio of credits (Haas, 2010).

Corruption is also associated with bad loans. Loan defaults are low in faster growing economies (Goel et al., 2011) because they have well functioning legal systems and well documented economies. The fragile documentation system of banking drags the economy towards financial crisis. Financial crisis and decline in output occur in a sequence and complement each other (Serwa, 2011). Global integration of financial sector contributes to the propagation of financial shocks from one economy to another through the banking channels (Chava et al., 2011), in other words, the weak legal system for banking of one country has implications for other countries as well. Some of the banks have already shown seriousness towards the issue and have started appointing chief credit risk officers who report directly to the board rather than CEO and impact is conspicuous in returns (Schmid et al., 2012).

Banking organizations now estimate credit risk through internal rating approaches (Bastos, 2010) and record the processes in black and white. The businessmen become uncontrollable greedy and willfully defaulter and government have to announce bailout packages in USA (Paul, 2009) where there is reportedly world's best legal system. It is the question of documentation that abstains default if it is taken care of in letter and spirit. Currently the laws do not cover all emerging issues particularly relating to era of e-

banking, knowledge management and information technology (Azmi, 2010). Future research must be done for understanding interconnections between profitability, risk, liquidity, capital and competition (Wilson et al., 2010). There are, now, systems under which banks develop internal methodologies to quantify the creditworthiness of their clients (Antao et al. 2011). Properly secured loans have higher recoveries (Khieu et al., 2011).

3. Developing the Framework for Credit Documentation:

We find nominal research on the relationship of credit documentation with performance of banks. Active research is available on all other aspects of banks but area of credit documentation is not sufficiently explored. Because of its immense importance, we take an initiative to study this particular aspect of banking. To reach a proposition of framework for credit documentation, it is appropriate to take closer view of logical typification and peculiarities of credit process documents and credit contractual documents.

3.1 Typification of Documents:

Documentation in banks can be mainly categorized into three: general banking documents, credit related documents, and foreign exchange related documents. Focus of the study is only on role of credit documents in performance of banks. The credit documents can further be distinguished as below:

- credit application related documents
- o customer identity related documents,
- o credit proposal related documents
- credit approval documents,
- credit transaction recording documents
- credit transaction documents
- o credit contractual documents
- o collateral security documents

The typification of documents can be visualized in a pictogram as Figure 3 below for understanding the issue more clearly.

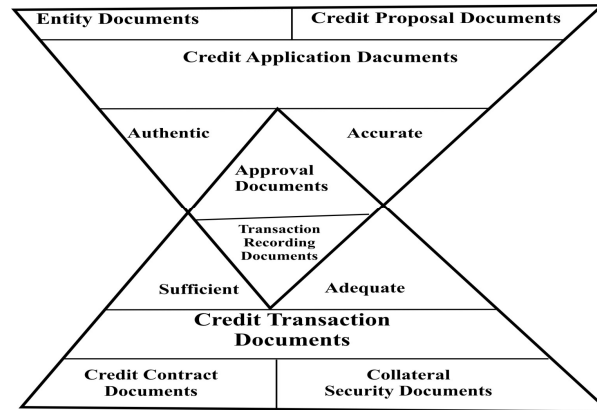


Figure 3: Typification of Credit Documents

When a bank evaluates a customer, its evaluation pertains to two aspects of the customer, first is capacity of the customer viz-a-viz amount of the loan and second is willingness of the customer to repay the loan. The first is quantitative therefore judged in figures and the second one is qualitative so is judged subjectively. Before entering into any transaction with any person a bank is supposed to be very clear about following:

- Entity (What is the entity of client? Is it individual, company, partnership or anything else?).
- Assets (What is/are the asset(s) to be financed?).
- Security (What are the securities in exact offered by the client to secure the loans?).
- Business (What are the means of the client to repay the loan and survive in business?).

First category of documentation pertains to the identity of the customer and the proposal of loan and necessarily means to verify actual existence of customer through valid documents (the documents provided by the customer). Second is approval related documents like tentative offer and acceptance, memorandum of approval of credit by competent authority, and the actual sanction conveyance etc. (the internal documentation of banks). Third type of the documents includes transaction documents. Transaction documents are the documents which actually bind the customer and record facts and figures in contractual form. These documents can be invoked in the court of law to force the customer to behave. The lacunas in these documents simply mean temptation for the customer to default. If the transaction documentation is proper then bank is safe as for as its establishment of claim is concerned. Forth type of the documents is the collateral security documents. Collateral securities can also be of many types. Common types of securities are mortgage of property, pledge of stocks, charge on assets, hypothecation of stocks, lien on deposits, and/or guarantees etc. These documents provide the bank a right to recover the dues through foreclosure of these securities. There are certain criteria, standards, prerequisites, features and legal requirements (hereinafter collectively referred as “peculiarities”) for validity of documents of credit. Logical pairs of peculiarities along with natural flow of credit transactions have been discussed in section 4.2 below.

3.2 Dyadic Peculiarities of Credit Documentation:

Credit documentation necessitates few dyadic peculiarities that must be prevailing concurrently while processing credit. These peculiarities are presented in tabular form in Figure 4 in a summarized manner.

Process Documents	Rationality	Plausibility
	Timeliness	Appropriateness
	Execution	Specificity
	Generalizeability	Uniformity
	Sequentiality	Clarity
	Secured	Legibility
Contractual Documents	Just and Parity	Flexibility
	Validity	Enforceability
	Invocation	Exit

Figure 4: Dyadic Peculiarities of Credit Documents

Figure 4 depicts that within the credit documents there are two major types i. e. process documents and contractual documents. They necessitate different peculiarities which are mentioned there against in the figure. The peculiarities identified are not sequential but simultaneous and concurrent. Figure 5 below also contain peculiarities that are different in nature and are the foremost and concerned with credit environment as a whole.

Process Documents	<ul style="list-style-type: none"> ● Safe Custody ● Compatible to Technological Agility
Contractual Documents	

Figure 5: Foremost Peculiarities of Credit Environment

Safe custody and compatibility to technological agility are, in fact, full fledge environment and should be prevalent all the times in credit processing. All the peculiarities are mutually inclusive and concurrently applicable simultaneously. The peculiarities have been identified on the basis of observation of credit processing, recovery effectuation and court proceeding of banks' credits in the environment of Pakistan.

3.3 The Conjoint:

In the Figures 1-5 we discussed the credit processing, credit documentation, peculiarities and bank performance in bifurcated form and exclusively. But in real life, this is not the case; these constituents of banking process are mutually inclusive, concurrent and simultaneous, therefore, it is necessary to develop a conjoint of all the constituents. The

conjoint of these figures will depict a real life scenario. Figure 6 is the conjoint of the Figures 1-5 that provides a framework for credit documentation in banks.

Framework for Credit Documentation in Banks

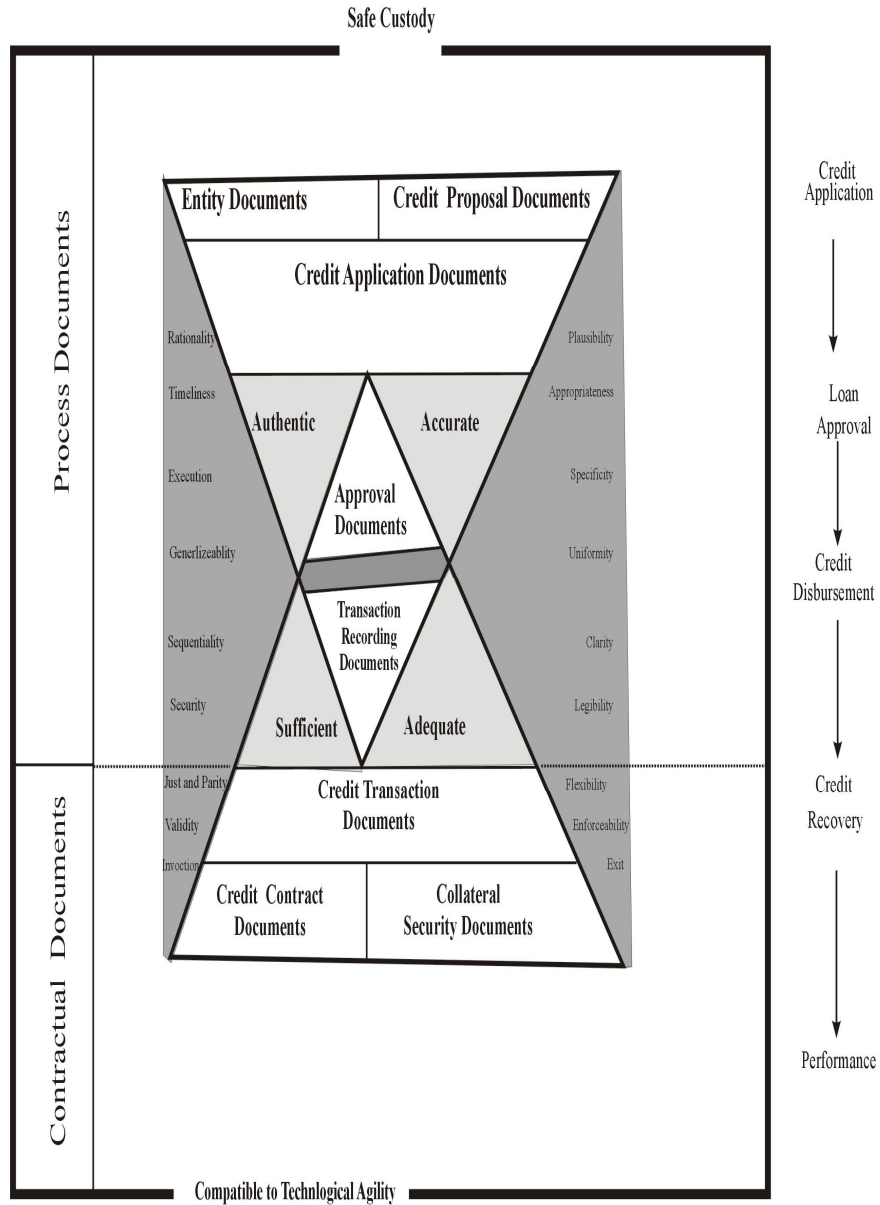


Figure 6: Framework for Valid Documentation of Banks' Credits

The framework consists of the five figures developed in foregoing sections namely loan process, performance of banks, typification of documents, dyadic peculiarities and the foremost peculiarities of credit environment. The framework consists of wide range of

constructs already established. Here the focus is not on the development of constructs or to assign/reassign new roles or properties to these settled constructs but on their relevance to particular documentation & processes, prevalence, simultaneity, concurrency and sequentiality. An intelligent shuffle of constructs within these dimensions suffices to outset the documentation parameters that warrant the enhancement of the performance of a bank. The framework given as Figure 6 is an intuitive framework, constructed on the basis of literature review and observation of peculiarities from real-life processes, to develop the thinking of research in the area of credit documentation that underlies the base of the financial figures in a bank.

4. Conclusion

The framework proposes the outset of documentation that will enhance the performance of the bank through creating deterrence to tempt a default (i.e. deterrence on likely hood of default). It is established that the documentation of credit plays vital role in performance of the banks. The constituents of credit process, typification of documentation, peculiarities of credit documentation and credit environment need to be taken as research objects for augmentation of performance of banks. The framework explains the credit process in unique manner and indicates certain new dimensions for research in the context of financial performance of banks. It also has practical implications and has the capacity to serve as a tool for a bank to judge its credit documentation by juxtaposition.

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