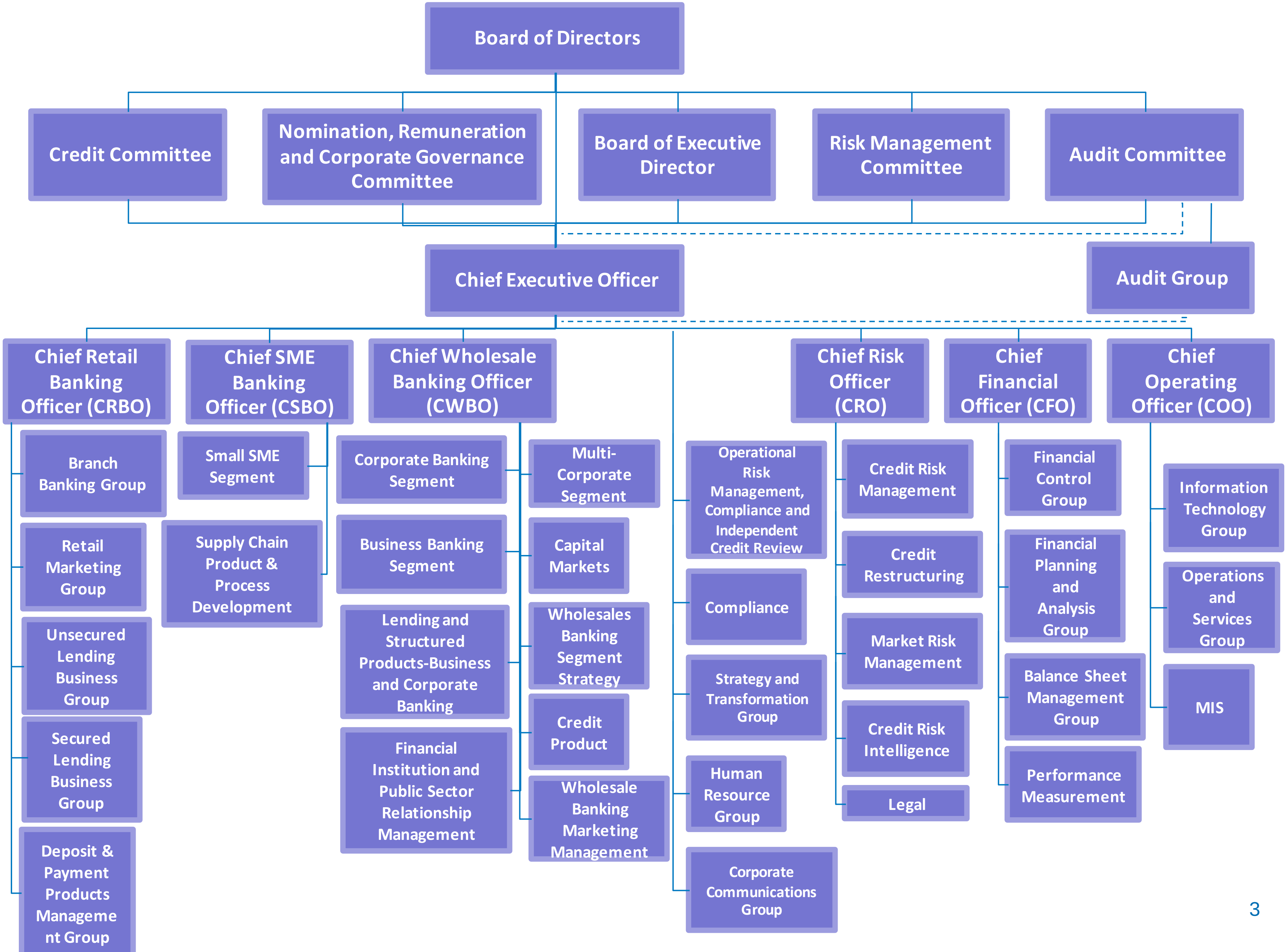
EE431: Lecture 6.1 (Spring 2012)

Banking 101,

Understand Bank's Products (1)

Banking 101 | Knowing Organization Structure


Board of Directors
Credit Committee
Nomination, Remuneration and Corporate Governance Committee
Board of Executive Director
Risk Management Committee
Audit Committee
Chief Executive Officer
Audit Group
Chief Retail Banking Officer (CRBO)
Chief SME Banking Officer (CSBO)
Chief Wholesale Banking Officer (CWBO)
Chief Risk Officer (CRO)
Chief Financial Officer (CFO)
Chief Operating Officer (COO)
Branch Banking Group
Retail Marketing Group
Unsecured Lending Business Group
Secured Lending Business Group
Deposit & Payment Products Manageme nt Group
Small SME Segment
Supply Chain Product & Process Development
Corporate Banking Segment
Business Banking Segment
Lending and Structured Products-Business and Corporate Banking
Financial Institution and Public Sector Relationship Management
Multi-Corporate Segment
Capital Markets
Wholesales Banking Segment Strategy
Credit Product
Wholesale Banking Marketing Management
Operational Risk Management, Compliance and Independent Credit Review
Compliance
Strategy and Transformation Group
Human Resource Group
Corporate Communications Group
Credit Risk Management
Credit Restructuring
Market Risk Management
Credit Risk Intelligence
Legal
Financial Control Group
Financial Planning and Analysis Group
Balance Sheet Management Group
Performance Measurement
Information Technology Group
Operations and Services Group
MIS

Banking 101 | Credit Products: Introduction

How banks' credit products help businesses?

- **Increase return on shareholders' equity**
  - Role of Leverage (more risk-taking)
- **Cost management**
- **Liquidity**

How banks' credit products help businesses? (1)

<u>Assume</u> Stock price = 1 Baht/share
Sales = 2,000 Baht
Cost of goods sold = 90%
Interest = 10%

case1

Asset	Equity
100	100

- 100 shares
- No borrowing

Net profit = 2,000 – 2,000*(90%) = 200
Earning per share = 200/100 = 2 Baht

case2

Asset	Liability
100	25
	Equity
	75

- 75 shares
- Borrow 25 Baht

Gross profit = 2,000 – 2,000*(90%) = 200
Net profit = 200 – 25*(10%) = 197.50
Earning per share = 197.5/75 = 2.63 Baht

More leverage, more return
And more risk …

How banks' credit products help businesses? (2)

Cost management

- Banks are major and straightforward sources of funds (beside trade credit & own equity), especially for those with no access to capital markets (SMEs).
- Banks can provide 'suitable' type of credit for businesses.

  Such as loan for importer, loan for exporter, working capital (for buying raw materials & day-to-day operations to fill orders).

Liquidity

- Some products provides 'borrowing optionality' so businesses can borrow when they want to, hence less need to hoard cash (which hurts profitability).

General types of credits

- **For working capital**
  - Provide liquidity for short term gong concerns for businesses.
  - Cyclical & self-liquidating loan, e.g. a firm uses O/D to buy raw materials then sell its goods and O/D is automatically repaid.
- **For investment**
  - To buy long-term assets or to finance long term projects
  - Syndicated loans for really big corporates.
- **For guarantee**
  - Banks don’t *de facto* lend, rather just provide ‘guarantee’ and in return are compensated by fees.
  - E.g., letter of guarantee, standby L/C.

Banking 101

Some Important Credit Products

How banks compute interest: Amortized Rate

n = 10

i = 5%

Amortize Loan

year	Principal Beginning of Year	Interest Expense	Principal Reduction	Installment	Principal End of Year
1	10,000	500	795	1,295	9,205
2	9,205	460	835	1,295	8,370
3	8,370	419	877	1,295	7,494
4	7,494	375	920	1,295	6,573
5	6,573	329	966	1,295	5,607
6	5,607	280	1,015	1,295	4,592
7	4,592	230	1,065	1,295	3,527
8	3,527	176	1,119	1,295	2,408
9	2,408	120	1,175	1,295	1,233
10	1,233	62	1,233	1,295	-
	Total	**2,950**	**10,000**		

Typically, mortgage loan & business loan.

How banks compute interest: Flat Rate

n = 10

i = 5%

Flat Loan

year	Principal Beginning of Year	Interest Expense	Principal Reduction	Installment	Principal End of Year
1	10,000	500	-	500	10,000
2	10,000	500	-	500	10,000
3	10,000	500	-	500	10,000
4	10,000	500	-	500	10,000
5	10,000	500	-	500	10,000
6	10,000	500	-	500	10,000
7	10,000	500	-	500	10,000
8	10,000	500	-	500	10,000
9	10,000	500	-	500	10,000
10	10,000	500	10,000	500	-
Total		5,000	10,000		

Typically, automobile loans & personal loans…

Effective rate of flat rate is twice larger than that of amortized rate. Day Light Robbery for unknowns.

Typography of Loan

➢ Loan:

- Has specific maturity date. (3 months, 5 years, etc.)
- Has non-compounding interest calculation.
- Can be either 1) short-term revolving or 2) long-term non-revolving (term loan).
- Term loan will have specific draw-out expiry date (a.k.a blackout period).
- Repayment is in form of fixed installment.
- If it is not drawn in time, the line is cancelled.
- If it is repaid before contract time (a.k.a. prepayment), clients must compensate banks with extra fee.

➢ Do banks have foreign currency loan?

- Yes. Same structure as THB loan, with FX risk.

Overdraft (O/D) (1)

➢ What is O/D?

- Overdraft is provided when businesses make payments from their business *current account* exceeding the available cash balance. An overdraft facility enables businesses to obtain short-term funding that is recurrent (‘revolving’). Short-term maturity (less than a year).

➢ How O/D works ?

- Based on current account (a.k.a. checking account).
- Credit profile appraised by banks.
- Draw out borrowing by writing checks.
- Contract will be reappraised by banks annually up to credit profile & utilization rate.

➢ How to compute interest?

- Daily interest on end-of-day outstanding.
- Repayment from account inflow (deposit).
- Monthly amortized (principal reduction).

Overdraft (O/D) (2)

- **How much O/D is limited?**
  - BOT limits THB 30 mil. For each obligor.
- **What happens if businesses abuse O/D (wrong purpose)?**
  - Banks can’t really track the use of funds of clients.
  - O/D is designed to be ‘Working Capital’ (procurement of raw materials & day-to-day operations). Short term nature.
  - Should it be more or less expensive vis-à-vis normal loans ?

Syndicated Loan

- **What is syndication?**
  - Loan mutually provided by multiple banks (pooled loan).
  - ‘Lead Manager’ is the main bank that syndicates the deal
  - Subject to same clause & condition of contract and collateral.
- **Why syndicate?**
  - Big ticket (huge size). Few billion baht and beyond.
  - Too concentrated on one bank’s portfolio…hence risk-sharing
  - Collude among banks, avoid pricing war.
  - One unified contract. Less headache for borrower.
  - One contact point. The ‘Lead Manager’ bank.

Bill Discount

➢ What is bill discount ?

- Businesses sell IOUs (received from trade partners or debtors) to a bank at discount.
- Credit risk transferred to a bank (discount as risk premium).
- Instantly provide liquidity to businesses (get cash now…)

➢ How many type of bills?

- Bills of exchange (B/E) – smaller amount, short tenor
- Promissory note (P/N) – bigger amount, long tenor
- Checks

Bank's Guarantee

- **Not per se lending from a bank.**
- **Contingent liabilities for banks in case buyers of guarantee defaults.**
- **Examples**
  - Letter of Guarantee (e.g., electricity & LPG gas lot purchases)
  - Stand-By L/C (required by foreign banks of business's trade partner)
  - L/C, Domestic L/C (bank's guarantee that sellers will be paid).
  - Aval on bills (guarantee on bills)