# IMPACT OF LENDING DECISION ON ORGANIZATION PERFORMANCE: A STUDY OF SELECTED FINANCIAL INSTITUTIONS IN SRI LANKA

## Velnampy.T & Pratheepkanth.P

Professor/ Dean, Faculty of Management Studies & Commerce, University of
Department of Accounting, University of Jaffna, Sri Lanka

## Abstract

The Study seeks to assess the effect of Lending Decisions and performance of Financial Institution in Sri Lanka. Researcher's results put forward that Lending Decisions tend to be positively associated with Financial Institution's performance. The results have implications for risk managers, regulators and monetary policy makers. Notably, they underline the crucial relevance of commercial property prices as a macro prudential variable that warrants close scrutiny by the authorities. There are some interesting differences in the response of small and large Financial Institution, with in particular Lending Decisions movements having a smaller effect on the loan quality and provisions for small Institution than for large Institution. Furthermore, this is steady with large Financial Institution being more willing to take risk, perhaps as a consequence of enjoying higher protection by the safety net. Generally, and particularly in combination with the macro results in Zorny (2008), these results highlight the vital relevance of Lending Decisions as an important driver of Financial Institution performance that warrants close study by the system.

Key Words:- Lending Decisions, Performance, Financial Institution

## Introduction

The financial institution lending profits have been strongly affected in frequent occasions by asset price fluctuations, at time culminating in instituting crisis. First, Commercial property loans are important component of financial institution assets. Second, institutions' exposure to the Commercial real estate sector usually tends to be even larger owning to the wide spread use of Commercial property as collateral for other types of loans. Third, and most importantly, Commercial property loans are often the most volatile component of financial institutions portfolios. There fore, encouraged to extend extra loans to the Commerciasector. sector. Reserve effects are observed when Commercial property prices fall..

450 ←

It is well-known that bank lending and Financial Institution performance have been strongly affected on frequent occasions by asset price fluctuations, at times culminating in banking crises. Among various key assets, commercial real estate is of special interest, not only because commercial property loans are an important component of bank assets, but also because of the widespread use of commercial property as collateral of other types of loans. Whereas there is a fairly extensive literature on the relation between financial Institution lending and commercial property prices at a macro level (see recent work and a literature survey in a companion paper by Davis and Zhu (2004)), there is much less extant work on the impact of commercial property prices on the lending decisions, risk and profitability of individual financial Institution.

In many countries loan quantum and credit facilities of up to 90% of the collateral value were common for investments in real estate properties. This flood of liquidity led to a sharp price application in the asset markets, inflated collateral value and prompted further credit expansion as asset price climbed.

Whereas there is a fairly extensive research literature on the relation between financial institution lending and Commercial property prices at a macro level, there is more limited body of work on the impact of Commercial property prices on lending decisions, risk and profitability of individual institutions. Evidence of a clear and consistent link to institution performance would prudential indicator, as well as being relevant to the monetary transmission process.

## Literature Review

There are strong financial and economic linkages between Commercial property cycles and credit cycles, among which the most influential in terms of theoretical development is the "financial accelerator" mechanism proposed by Beranke et al (1994) and Kiyotaki and Moore (1997). In their models, credit market imperfections exist because borrowers have informational advantage over lenders regarding the true value of the underlying projects. To avoid the potential adverse selection problem (before the loan is extended) and moral hazard (after lending takes place), the lender will require the borrowers to provide collateral assets. The price of institution loans (the risk premium) then largely depends on the value and quality (in terms of liquidity, price volatility etc) of collateral. This argument applies both to normal industrial and Commercial loans and to loans to develop property perse.

## The Impact of Commercial Property Price Cycle on Banks

Despite the important linkage between the two cycles, most empirical work in this area has so far been related to residential property prices. For example, country specific studies reveal strong evidence of dynamic interactions between house prices and bank lending in Hong Kong (Gerlach and Peng 2005), the Netherlands (de Greef de Hoas (2000) and Rouwendal and Alessie (2002) and the US Quigley (1999). There are also few studies

based on asset prices that include a mix of residential and Commercial property prices (generally with a much higher weight on residential property). Work by Goodhart (1995) explains credit conditions with asset prices, while Borio et al (1994) explain asset prices with credit conditions, and both find significant results. Hofmann (2000) employs a victor – error correction model and again finds a strong dynamic interdependence between bank credit and property prices, with the latter being the causal element.

One exception is Davis and Zhu (2004), who developed a reduced – from theoretical model and tested it on macro for industrialized countries. Their model suggests that bank lending is closely related to Commercial property pries, and their interaction can develop cycles given plausible assumptions, cross country empirical analysis based on a sample of 17 developed economics confirmed the model's predictions. An investigation of determinants of Commercial property prices shows particularly strong links of credit to Commercial property in the countries that have experienced banking crises linked to property losses in 19985-95. Further studies of dynamic interactions suggested, as in Hoffmann (2001), that property prices are rather "autonomous" in that tend 'cause' credit expansion, rather than being driven by excessive bank lending.

## Micro - Based Studies of Financial Institution Performance

The previous study is based, Cavallo and Majnoni (2001), Leaven and MAJNONI (2003) AND Bikker & Metzemakers (2004), all o f which analysis data base similar to researcher using institutions scope. A common focus of the three papers is the relationship between banks' provisioning for loan losses and banks' pre- provision income after controlling for bank specific macro – economic and institutional features. They all find generally – positive link from banks' profitability to provisioning, as I s desirable to "provision for bad loans in good times". At he same time provisioning, decisions are also associated with economic growth, financial Institution's lending behaviour and banks capital strength. Real GDP growth has a significantly negative effect, implying there is a deterioration of banks loan quality during economic downturns. Banks with higher loan to asset ratios tend to be involved in higher credit risk and therefore their loan loss provisions are higher. The effect real loan growth rate of the bank is mixed.

Cavallo and Majnoni (2001) and Leaven and Majnoni (2003) find a significant a negative effect, which supports the hypothesis that lending booms are associated with imprudent lending practice. By contrast, Bikker and Metzemkers (2004) find a positive effect of loan growth on provisioning, which seems to be consistent with the view of Borio et al (2001) and Lowe (2002) that credit risk is built up during a boom, but is interpreted by Bikker and Metzemakers as prudential provisioning by banks that are conscious of risk. They also find that provisions raise when the capital ration id low, suggesting that the two are substitutable buffers against potential losses.

In terms of lending per se, Bikker and Hu (2002) seek to distinguish between supply

demand factors in order to assess whether the instituting system itself has a procyclical pattern of behaviour. In particular, in line with the so-called bank lending channel of monitory transmission, they seek to investigate whether a separate supply channel can be distinguished, based for example on constrains on bank capital. This follows the extensive literature on the US credit crush of the early 1990s which was thought to be partly linked to such supply constrains. Demand side factors include were macro variables such GDP, unemployment, inflation, share prices and real M3. Supply side factors were the interest differential, banks deposits, capital and reserves and financial institutions profits. Demand side factors were dominant on the supply side. Whereas capital was not significant, profit margins were significant and indicate a role for the bank lending channel.

## Objectives

The following objectives were undertaken for the study.

1. To examine the role of Commercial property prices in financial institution lending decision in respect of loan volume growth and the pricing of loans as proxied by the net interest margin.

2. To examine the impact of macro variables and Commercial property pries on the financial institution performance.

## Hypotheses Development

The following hypotheses are formulated for the purpose of this study.

H1: Commercial property prices have a positive effect on loan growth

H2: Commercial property prices have negative effect on the net interest margin.

H3: Loan to asset has positive effect on loan growth.

H4: Equity to asset has negative effect on the loan growth.

## Research Methodology

Research methodologies of the present study were outlined below.

## Sample

This research study covers 05 samples of financial institutions in Sri Lanka. There are

DFCC Bank

LOLC Group company

LB Finance PLC

HDFC Bank

Central Finance Company PLC

→ 453

## Mode of Study

Real loan growth rate = $\dfrac{\text{Current loan} - \text{Previous loan}}{\text{Previous loan}} \times 100$

Return on assets $= \dfrac{\text{Profit before tax}}{\text{Total assets}}$

Loan to asset Ratio $= \dfrac{\text{Total loan}}{\text{Total asset}} \times 100$

Equity to asset ratio $= \dfrac{\text{Equity}}{\text{Total asset}} \times 100$

Net interest margin in loan growth $= \dfrac{\text{Net interest income}}{\text{Total income}} \times 100$

Commercial property

Loan ratio $= \dfrac{\text{Commercial property loan}}{\text{Total loan}} \times 100$

Growth rate of commercial

Property $= \dfrac{\text{Current property loan} - \text{previous property loan}}{\text{Previous property loan}} \times 100$

## Findings and Analysis

### Correlation

### Loan growth rate Vs Loan to asset ratio

The relationship between the Average real loan growth rate and Average loan to asset ratio can be shown in the following table.

**Correlations**

| | | Average real loan growth rate | Average loan to asset ratio |
|---|---|---|---|
| Average real loan growth rate | Pearson Correlation | 1 | .817** |
| | Sig. (2-tailed) | | .004 |
| | N | 10 | 10 |
| Average loan to asset ratio | Pearson Correlation | .817** | 1 |
| | Sig. (2-tailed) | .004 | |
| | N | 10 | 10 |

**. Correlation is significant at the 0.01 level (2-tailed).

The above table shows the positive & strong relationship between the Average real loan growth rate and Average loan to asset ratio.

## Loan growth rate Vs Commercial property loan ratio

The relationship between the Average real loan growth rate and Average Commercial property loan can be shown in the following table.

**Correlations**

| | | Average real loan growth rate | Average commercial property loan ratio |
|---|---|---|---|
| Average real loan growth rate | Pearson Correlation | 1 | .797** |
| | Sig. (2-tailed) | | .006 |
| | N | 10 | 10 |
| Average commercial property loan ratio | Pearson Correlation | .797** | 1 |
| | Sig. (2-tailed) | .006 | |
| | N | 10 | 10 |

**.  Correlation is significant at the 0.01 level (2-tailed).

The above table shows the positive & strong relationship between the Average real loan growth rate and Average Commercial property loan ratio.

## Loan growth rate Vs Equity to asset ratio

The relationship between the Average real loan growth rate and Average equity to asset ratio can be shown in the following table.

**Correlations**

| | | Average real loan growth rate | Average equity to asset ratio |
|---|---|---|---|
| Average real loan growth rate | Pearson Correlation | 1 | -.719* |
| | Sig. (2-tailed) | | .019 |
| | N | 10 | 10 |
| Average equity to asset ratio | Pearson Correlation | -.719* | 1 |
| | Sig. (2-tailed) | .019 | |
| | N | 10 | 10 |

*.  Correlation is significant at the 0.05 level (2-tailed).

The above table shows the negative & strong relationship between the Average real loan growth rate and Average equity to asset ratio.

## Net interest margin Vs Return on asset

The relationship between the Average net interest margin and Average return on asset can be shown in the following table.

**Correlations**

| | | Average net interest margin | Average return on asset |
|---|---|---|---|
| Average net interest margin | Pearson Correlation | 1 | -.637* |
| | Sig. (2-tailed) | | .048 |
| | N | 10 | 10 |
| Average return on asset | Pearson Correlation | -.637* | 1 |
| | Sig. (2-tailed) | .048 | |
| | N | 10 | 10 |

*. Correlation is significant at the 0.05 level (2-tailed).

The above table shows the negative & moderate relationship between the Average net interest margin and Average return on asset.

## Net interest margin Vs Average growth rate of real CPP

The relationship between the Average net interest margin and Average growth rate of real CPP can be shown in the following table.

**Correlations**

| | | Average net interest margin | Average growth rate of CPP |
|---|---|---|---|
| Average net interest margin | Pearson Correlation | 1 | -.784** |
| | Sig. (2-tailed) | | .007 |
| | N | 10 | 10 |
| Average growth rate of CPP | Pearson Correlation | -.784** | 1 |
| | Sig. (2-tailed) | .007 | |
| | N | 10 | 10 |

**. Correlation is significant at the 0.01 level (2-tailed).

The above table shows the negative & strong relationship between the Average net interest margin and Average growth rate of CPP.

## Regression Analysis

This analysis is used to find out the value of independent variable based on the value of independent variables. It is used to estimate of Y while X is increased by one.

Real loan growth rate and equity to asset ratio, loan to asset ratio and commercial property loan.

## Model Summary

| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate |
|---|---|---|---|---|
| 1 | .942[a] | .887 | .830 | 3.07085 |

a. Predictors: (Constant), Average equity to asset ratio, Average loan to asset ratio, Average commercial property loan ratio

$R^2$ is the measure of proportion of the variance (88.7%) of dependent variable. 11.3% is not dependent.

ANOVA result for real loan growth rate and equity to asset ratio, loan to asset ratio and commercial property loan

The mean value is 147.589, the difference between the variable. Since, P value (0.003) is less than 0.05 of Average real loan growth rate on Average loan to asset ratio, equity to asset ratio and commercial property loan ratio, therefore variance has significant on real loan growth rate at 5% confident level.

Coefficient result for real loan growth rate and equity to asset ratio, loan to asset ratio and commercial property loan

## Coefficients[a]

| Model | Unstandardized Coefficients | | Standardized Coefficients | t | Sig. |
|---|---|---|---|---|---|
| | B | Std. Error | Beta | | |
| (Constant) | -31.467 | 16.763 | | -1.877 | .110 |
| Average loan to asset ratio | .398 | .113 | .593 | 3.535 | .012 |
| Average commercial property loan ratio | 1.251 | .483 | 1.155 | 2.588 | .041 |
| Average equity to asset ratio | .191 | .121 | .720 | 1.584 | .164 |

a. Dependent Variable: Average real loan growth rate

Average real loan growth rate = -31.467+ (0.398*Average loan to asset ratio) + (1.251*Average commercial property loan ratio) + (0.191*Average equity to asset ratio)

Since, the Average loan-to-asset ratio P value (0.012) and the variable is less than 0.05 statistically significant at 5% confidence level. Therefore, Average commercial property loan ratio P value (0.041) and the variable is less than 0.05 statistically significant at 5%

457

confidence level. But, Average equity to asset ratio P value (0.164) and the variable isn't less than 0.05 statistically no significant in this variable.

## Results and Discussion

Real loan growth rate is correlated with loan to asset ratio positively. That is correlation between two variables is 0.797. R square is 0.667. The means that only 66.7% of variance of real loan growth is accounted for by loan to asset ratio.

The correlation between real loan growth rate and commercial property loan ratio is 0.817. So the above two variables are correlated strong positively. The R square is 0.635 that only 63.5% of variance of real loan growth rate is accounted for by commercial property loan ratio.

When real loan growth rate is correlated with equity to asset ratio, the correlation is -0.719 and R square is 0.517. This means that the real loan growth and equity to asset ratio are correlated negatively.

Net interest margin is correlated with return on asset ratio negatively. The correlation between above two variables is -0.637. R square is 0.406.

The correlation between net interest margin and growth rate of real CPP is -0.784 So, the above two variables are correlated negatively. R square is 0.615.

## Hypothesis Testing

Data analyses are found to supportive in order to examine the hypothesis. This research has been carried and based on the following hypothesis.

**H1: Commercial property prices have a positive effect on loan growth.**

The commercial property price variable is significant in all three variables. Higher commercial property prices encourage institutions to lend more, and the risk premium shrinks when property prices rise.

Loan growth rate is correlated with the commercial property price is strong positively. The correlations between above to variables are 0.817. This hypothesis is accepted

**H2: Real growth rate of CPP have negative effect on the net interest margin.**

Net interest margin is correlated with the real growth rate of CPP is negatively. The correlations between above two variables are -0.784. This hypothesis is accepted.

**H3: Loan to asset ratio has a positive effect on loan growth.**

Real loan growth rate is correlated with the loan to asset ratio is positively. The correlations between above two variables are 0.797. This hypothesis is accepted.

**H4: Equity to asset has negative effect on the loan growth.**

The real loan growth is correlated with the equity to asset ratio is negatively. The correlations between above two variables are -0.719. This hypothesis is accepted.

### Directions for the future Researchers

This research only covered the financial institution in Sri Lanka. But this financial is not same as other country financial institution. That is affection of accounting policy/administrative policy and available resources may differ among other country. The financial institutions have different types of size (small, moderate, and large). That provides to differ from lending decision. Hence, findings of this research may not be applied to all. This research only considered, the limited period of 05 financial institutions in Sri Lanka.

ৎৰৎ