

Trust between Branch Managers and Loan Officers of Indian Banks

Shyam Bhati*

The lending climate for banks in emerging economies like India is very different from those in western countries. Banks in India undertake many additional risks when they lend. There are a number of impediments for banks in India for recovering their loans. Some of these impediments have been put in place due to the government policies. The instrument based quantitative methods have limitations in evaluating the lending risk because instrument based methods use variables which cannot be accurately described and measured by banks in emerging economies. A social risk evaluation is therefore more appropriate for risk evaluation and reduction by banks in India. This study focuses on one specific aspect of lending relationship - the relationship between branch manager and loan officer of bank branches in India. A social risk evaluation approach is used to describe this relationship. A framework based on trust theory is developed which help in understanding and reducing the lending risk by Indian banks.

Field of Research: Banking

1. Introduction

Bank lending is a risky activity. Banks undertake risk when they grant a loan - the risk that the borrower may not honour their debt commitments according to the terms and conditions of the loan contracts. The probability of default on the loan to the borrower depends on the quality of risk evaluation by the bank. To deal with risk, banks have created methods of risk evaluation. The two main approaches to credit risk evaluation by banks are - the instrumental or quantitative approach and the qualitative approach. The quantitative approach relies on formal rules and variables that help in assessing the clients' solvency and the probability of default of a loan. Borrower's characteristics such as age, income, activity, previous record are related to the probability of default. The problem with instrumental approach is that the variables used to construct quantitative models are based on the information that could be subjective. The second problem is that quantitative methods are based on accounting data and information. In a business situation the entrepreneurs use many other inputs such as past experience, training, goodwill and relationships which contribute to business profits. Additional risk is created for banks when the state intervenes in the regulation of credit activities by banks. The example of lending to Small Scale Industries in India is considered below to illustrate this intervention by the state. According to a report by Reserve Bank of India (2005) public sector banks in India have to observe the government guidelines and policies on credit to SSI sector as given below. While some of the policy initiatives of Government of India help in reducing the credit risk for the banks whereas others help in increasing the credit risk for banks.

1. SSI sector is included as one of the groups in the priority sector to which defined percentage of lending is to be targeted by banks. By specifying the quantum of credit the Government has diluted the norms the bank could use in assessing the quality of credit. This increases the credit risk for banks.
2. The Credit Guarantee Fund was established to refund a part of defaulted loan to the bank against fees paid by the banks to the fund. To the extent that the bank obtains its amount in default from CGF, the credit risk of the bank is reduced. But the provision of Guarantee Fund also induces a moral hazard problem. The availability of CG Fund reduces the incentive for the bank to assess

* Dr. Shyam Bhati, School of Accounting and Finance, University of Wollongong, Wollongong, E-mail. sbhati@uow.edu.au

and monitor its loans properly. The borrowers are inclined to undertake risky business activities because they rely on Credit Guarantee Fund to pay for the amount in default.

Similarly, Credit Linked Subsidy provided by the Government results in reducing the quality of credit assessment, which in turn increases the risk for the bank.

4. Opening of specialised SSI branches helps in providing speedy credit to SSI units. The provision of specialised staff in these branches helps in reducing the credit risk for the bank. But these branches are required to fulfil lending targets set by Head Office of the bank and the Government. In order to achieve the targets, the branches are forced to dilute their assessment criteria resulting in risky loans, increase in bad debts and credit risk for the bank.
5. The Government has initiated measures to provide increased lending powers to regional and branch managers for speedy credit decisions. In addition, a policy of sensitisation of branch managers has been introduced. This policy in political parlance means putting pressures on the branch managers to conform to the government policies, external administrative and political pressures from government agencies, local politicians and administration. These pressures lead to the dilution of credit norms and increase the credit risk for the bank. (Reserve Bank of India, 2005)

The net increase in credit risk is evidenced by the large number of non-performing assets of the banks in India, particularly in public sector banks. The reduced profitability of public sector banks as compared to private sector banks and foreign owned banks in India can also be explained due to the increased credit risk for public sector banks, arising due to the government credit norms.

The lenders do not have the same level of legal protection in India as the lenders in the western countries have. The financial law is not very developed. In addition, the enforcement of financial contracts through the legal system is very time-consuming, costly and cumbersome. According to the study by the World Bank Group (2006), ease of contract enforcing is critical to encourage business relationships, generate confidence in business transactions and in the event of default, enforcing threat points in contracts. According to this study, India rates poorly on the all the indices of investor protection through the legal system. The banks in India face additional risk due to lack of legal protection in enforcing contracts, as compared to western banks.

Many additional variables play a significant part in the risk evaluation process for banks in India as compared to western banks, the effect of which cannot be easily quantified. A bank trying to use a conventional instrumental method of risk evaluation will need to define, quantify and measure these variables to a great degree of accuracy. The accuracy of the bank's risk evaluation process will depend on the quality and reliability of this risk measurement. Therefore the conventional instrumental based methods of risk evaluation have limited use for banks in India.

Ferrary (2003) has analysed the decision making of granting credit in banks using a social risk evaluation process. Using the example of French social networks, Ferrary (2003) argued that banks can reduce their credit risk by participating in these networks. Banks, through social networks can improve the quality of risk evaluation by developing personal relationships and trust with the borrowers. Ferrary (2003) examined the trust relationship between a loan officer (financial counsellor) and a borrower. In addition to a loan officer, a branch manager of the bank branch play a crucial role in managing the credit function at the branch level which includes taking credit decision and risk evaluation. The relationship between a branch manager and a loan officer therefore determine the quality of risk evaluation that a bank will achieve in its credit assessment, evaluation and risk management. This paper focuses on the relationship between a branch manager and a loan officer of bank branches in India. The purpose of the paper is to study the role played by both of them in lending relationship and to identify the factors that help in developing trust between them. In Section 2 of this paper, the nature of relationship between a branch manager and a loan officer is described. Section 3 summarises the current literature on trust in banking. A framework of trust between branch managers and loan officers of Indian bank is described in Section 4. In Section 5, various trust factors used in the trust framework are described in detail. The conclusions are summarised in Section 6 of this paper.

2. Nature of relationship between a branch manager and a loan officer

A branch manager of a bank branch is the leader and chief executive at the local level. They are responsible for the profitable operations of the branch. The Branch Managers approve loan request within their delegated authority. This approval is done based on the evaluation of loan applications by loan officers. Sometimes a branch manager may delegate the lending authority to a loan officer for temporary period. When a branch manager delegates this authority to a loan officer they take a considerable risk. If the loan officer does not use the delegated authority in accordance with the bank's policies and procedures, the branch manager may be held accountable for any mistakes committed by the loan officer. When a loan officer assumes the authority of a branch manager on delegation, they also undertake a risk. If the loans are not approved according to the bank's policies and procedures, the branch manager may refuse to confirm the actions of the loan officer. In such an event, the loan officer may be held personally accountable for any lapse of judgment. Neither a branch manager will delegate their authority to a loan officer nor the loan officer, will assume the delegated authority of the branch managers unless there is a trust between the branch manager and the loan officer. The trust between the two becomes a very important part of the relationship.

The agency theory (Jensen and Macklin, 1976) has been used in the finance literature to describe economic relationships. The agency theory has limitations in describing the relationship between a branch manager and a loan officer of a bank branch because this relationship has different dimensions from a simple principal-agent relation. One, the branch manager is a superior officer whereas the loan officer is a subordinate officer. Therefore the relationship between a branch manager and a loan officer has elements of superior subordinate relationship. Both the branch manager and the loan officer operate in a risky environment. Sometimes they may act independently, while at other times the branch manager may delegate authority to the loan officer. When a branch manager delegates his or her authority to a loan officer, the relationship between the two will involve issues relating to the delegation of authority (principal–agent relationship). Both the branch manager and the loan officer are accountable to the Head Office of the bank and senior management for their decisions. Both work as agents of the bank, which is the common principal. The bank is a hierarchical organisation and both these functionaries interact with other employees of the bank in a group while performing their individual responsibilities towards the bank. Therefore the relationship between the branch manager and the loan officer is more complex than a principal agent relationship as observed in the finance literature. The nature of their relationship however put them in a risky situation when trust becomes important.

3. Trust in Banking

The literature on lending relationships that includes trust focuses on lending relationship between a bank and the borrowing customer. Lehmann et al (2001) provide an empirical analysis of a bank lending to small and medium-sized firm in Germany. Their study provides evidence that the availability and terms of loans are not only influenced by firm characteristics and credit risk variables but also by social interaction between a loan officer and a firm manager. This social interaction may indicate mutual trust as advantageous to both borrower and the bank. Petersen and Rajan (1994) show that the bilateral credit relationship between a bank and a customer is considered as enduring when both parties have dealt with each other for some time and expect to continue to do so in future. Sjorgen (1994) has provided a theoretical framework to study the merits of lending relationship using neo-institutional theory. Their study provides a framework for change of perspective from neoclassical interest in the quantitative, strictly economic aspect of the capital market to those of a qualitative, organisational and social nature of the relationships. The studies of Lehmann et al (2001), Mayer (1988) and Burghoff (2000) suggest that the continuing relationship between the bank and the borrowing customer is beneficial to the bank and the customer alike and the quantitative variables used by banks in their credit evaluation process are not enough in credit risk management. Banks have to look into social interaction between the bank and the borrower in order to reduce the credit risk for banks. Ferrary (2003) has used the notion of social capital, social networks and trust to define this framework for analysing lending activities. By analysing the process involved in the financing of Parisian Breweries in 1980s, Ferrary (2003) has shown that

information gathered through social networks allows better risk evaluation than an instrumental evaluation used by banks. The present study focuses on trust relationship between a branch manager and a loan officer of bank branch in India. This relationship is important from the perspective of the bank because these actors have a continuous input into the credit management of the bank and play more important part in lending activity than customers.

4. Framework of Trust between Branch Managers and Loan Officers

The theoretical model of Mayer et. al (1995) is modified to develop the present framework of trust between a branch manager and a loan officer of bank branches. This framework is described in Figure 1.

The key concepts of the framework are as follows:

1. A Branch Manager and a Loan Officer develop a trusting relationship due to credit risk caused by the external environment. The parties involved have propensity to trust and develop trust due to the risky situation they are involved in.
2. Trust is based on a number of key factors – similarity, benevolence, behavioural integrity, behavioural consistency, communication, ability and culture. Culture is identified as an important aspect of trust in Indian context.
3. The risk caused by external environment leads to development of trust and trust leads to risk taking in relationship. The higher the trust in a relationship the more is the assumption of perceived risk.

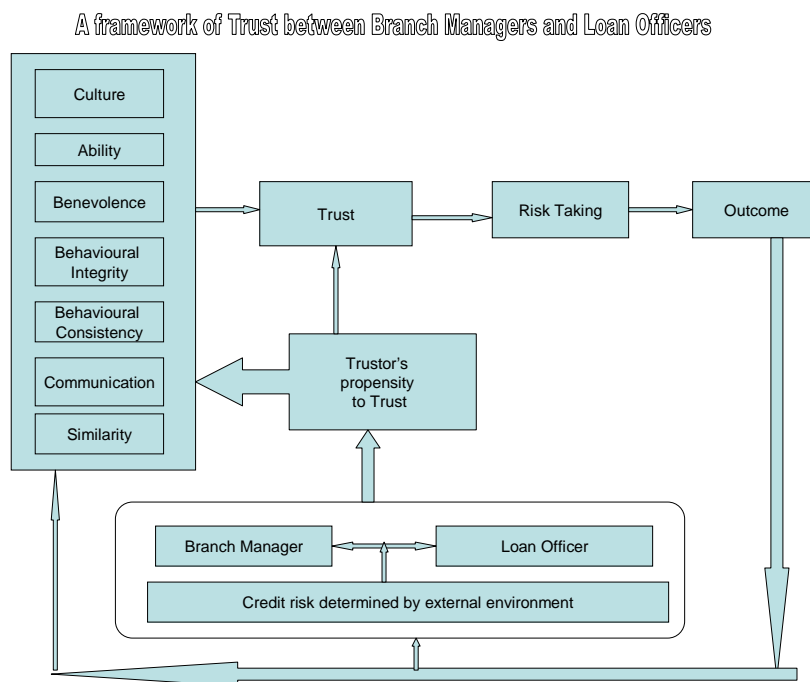


Fig. 1: A framework of Trust between Branch Managers and Loan Officers of Indian Banks

Risk

The first key concept of the framework is the assumption of risk. Shemwell, Cronin and Bullard (1994) have found that the trusting relationship helps in reducing the level of perceived risk in a relationship. The definition of risk developed by Sitkin and Pablo (1992) is used here. According to them risk is the extent to which there is uncertainty about whether potentially significant or disappointing outcomes of decision will be realised. In their opinion risk exists due to outcome uncertainty, outcome expectation and outcome potential. It is however necessary to differentiate, between the risk due to external environment to which actors in a trusting relationship are exposed as compared to the risk arising due to a trust relationship. In a lending situation, both the branch manager and the loan officer are exposed to

risk from external parties when they loan to customers. This risk from external parties occurs irrespective of whether there is a trusting relationship between a branch manager and a loan officer. The previous frameworks of trust do not incorporate this element of risk, which is specific only to lending situations. The present framework on trust considers this financial risk as an important part of the trust.

5. Trust Factors

5.1 Similarity

Creed and Miles (1996) have discussed the impact of similarity on willingness to trust. Individuals are willing to trust other individuals who exhibit characteristics similar to their own. In the present context, a branch manager of a bank branch will be very willing to trust a loan officer whom he or she perceives to have similar characteristics as his or her own. Similarity can exist in a number of ways- such as similarity of race, religion, culture, language or personal characteristics such as approach to work.

5.2 Ability

Ability or competence is an essential characteristic for the development of trust in a lending situation. Lending involves taking risk. Assumption of risk without the competence of trusted person can increase the risk. Skills related to the job performance are essential components of the ability. Butler and Cantrell (1984) found that the competence of subordinates was a determining factor of the level of trust that would be placed in individual. In the context of a branch manager- loan officer relationship, ability would mean knowledge and competence on how the loan function is performed. A loan officer would be required to have knowledge about the various policies and procedures of the bank, analytical techniques, legal knowledge, knowledge about people, place, customers etc. For a branch manager, ability includes ability to take decisions, resolve conflicts and handle unforeseen situations.

5.3 Benevolence

Mayer et. al (1995) have defined the benevolence as the extent to which a trusted want to do good to the trustee. According to Mayer (1995) benevolence is an integral part of trust. For the purpose of this study, the definition of benevolence provided by Velez (2000) in regard to the action of managers in protecting the interest of subordinates, not exploiting the subordinates to further their own interest and remaining considerate and sensitive to the need of their subordinate is more appropriate and will be used because the relationship between a branch manager and a loan officer is also a subordinate-supervisor relationship

5.4 Behavioural Integrity

Ring and Van den (1992) and Shaw (1997) suggest that a person gains trust from others by explaining honestly and acting with integrity. A person who is consistently incompetent and dishonest will not be trusted. Integrity and honesty are considered here as integral part of the relationship and factor determining trust.

5.5 Behavioural consistency

Velez (2000) defines behavioural consistency as the reliability or predictability of another's behaviour. Behavioural consistency is achieved by gathering information and predicting the trustee's behaviour accurately. In a supervisor-subordinate relationship both parties over time look for common patterns in behaviour. This information is used to make specific prediction about future behaviour and estimate the amount of risk they are willing to take within their predictions. Behavioural consistency has shown to be related to an employee's perception of managerial trustworthiness and important in a branch manager-loan officer relationship.

5.6 Communication

Communication is vital to the creation and maintenance of trust. When a supervisor provides accurate information to employees, explain decisions clearly to them and is open to feedback or any other communication, in that case employees are most likely to trust the supervisor. The honesty and clear communication is very important to a branch manager-loan officer trust which is also a supervisor-subordinate trust

5.7 Culture

Culture is an important determinant of trusting relationship in Indian context. However the cultural aspects are not limited to India alone. Each country has its own culture which finds its place in the business practice. While the culture is different in different countries, cultural influences the relationships between people. Ferrary (2003) and Lehmann (2001) have suggested that trust in banking relationship depends on the context and culture of players involved in trusting relationship. The way the actors develop their relationship, change with change in context and culture. Culture, according to these authors, is an important factor in trust in lending relationship. In his study of South Indian IT clusters. Tuaebe (2004), found that culture is an essential part of social networks and that in the context of India, economic relationships should be looked into using not just economic and geographical factors but cultural factors as well. In their case study, Siehl and Singh(2004) conclude that in Indian context, given the great diversity, it is important to get a good grasp of culture – company cultures as well as national culture and subcultures. According to them an effective leader in India has to take into account the cultural differences due to diversity in religion, caste, language before putting together a team. It is indicative of the value that is attached to knowing culture in the Indian context. The next issue is about the components of culture that are vital in the development of trust?

Tuaebe (2004) regard caste and ethnicity as essential part of Indian culture. Siehl and Singh (2004) regard language and religion also as essential parts of Indian culture. Rishi (2002) found that values of affiliation, personal concern, dependence and personal warmth of nurturant leadership can create climate of trust and understanding between people in business in India. Their results strongly support culture led leadership styles in India. It is therefore necessary that culture is incorporated as a determining factor in any trust relationship involving a branch manager and a loan officer of Indian bank because business conditions in India are considerably different from those in the West.

5.8 Roles within the relationship

The relationship between two individuals depends on the relative status of the two individuals and not many studies focus on the trust relation between two individuals when their relative status differs. In a Branch Manager- Loan Officer relationship, the relative status of two individuals will have a bearing on the trust as each one of them, perceive it to be. In the cultural setting of India, this dimension of relative status will have lot of influence on the Branch Manager-Loan Officer relationship because of values and beliefs associated with relative status and the power situation between the two. The loan officer is a subordinate and as a subordinate his or her behaviour in trust relationship will be very different from that of the branch manager. Subordinates in Indian context have to demonstrate great degree of loyalty, values of affiliation and respect towards the superior- branch manager in this case. It is also expected that the branch manager as a superior will have a nurturing attitude towards the loan officer. Communication between the two is also expected to be at a different level compared to their western counterparts. Indian cultural values, norms and conditions such as caste and ethnicity could influence the way in which communication is done between a branch manager and a loan officer. Velez (2000) in her study have found that correlates of trust depend on the direction of the trust. Variables that relate to trust from a subordinate to supervisor will differ from the variables of trust from a supervisor to subordinate trust. In the present context the correlates of trust from a Branch manager to Loan Officer could be different than from the correlates of trust in case of a Loan officer to Branch manager trust.

The relationship between a branch manager and a loan officer is a very specific relationship. Although many times the two parties may volunteer for the particular relationship, it is likely that both of them are thrown into the relationship involuntarily. The loan officer will not have a choice in selecting a branch manager but a branch manager sometimes may have the choice to select their loan officer. Many times the Head office of the bank appoints a loan officer without consulting a branch manager. In such an event, it will be interesting to observe the stages of trust relationship between the two because these players do not volunteer for trust relationship but are forced into the relationship.

6 Conclusions

The present paper focuses on the trust relationship between a branch manager and a loan officer of bank branch in India. This trust relationship is important because the environment in which a branch manager and a loan officer of Indian bank works, is very different and risky as compared to those of western banks. The quantitative risk based frameworks used in evaluating banks in the west are inadequate to explain this relationship. This study suggests a social risk evaluation approach to describe this relationship. This study also identifies various factors of trust relevant to trust relationship between a branch manager and a loan officer. It is suggested that culture is a very important factor in the development of trusting relationship in Indian context. It is predicted that a trusting relationship between the branch managers and the loan officers in India should help in improving lending performance of Indian bank branches.

References

- Burghoff, H.P., 2000, "Credit and information in universal banking", *Schmalenbach Business Review*, 52, p. 282-309
- Butler J.K. 1991, "Towards understanding and measure conditions of trust. Evolution of a condition of trust inventory", *Journal of Management*, 17, p. 643-663
- Butler, J.K. and Cantrell, R.S., 1984, "A behavioural decision theory approach to frame working dyadic trust in superior and subordinates", *Psychological Reports*, 55, p. 19-28
- Creed W.D. and Miles, B.E., 1996, "Trust in organisations: A conceptual framework linking organisational forms, managerial philosophies and the opportunity cost of control". In R.M.Kramer and T.R.Taylor (ed) "Trust in organisations: Frontiers of theory of research", pp. 16-38, Sage Publications.
- Ferrary, Michael, 2003, "Trust and social capital in the regulation of lending activities", *The Journal of Socio-economics*, 31, p. 673-695.
- Jensen, M.C. and Macklin, W.H., 1976, "The theory of firm managerial behaviour, agency costs and ownership structure." *Journal of Financial Economics*, October, p.287-310.
- Lehman, Eric and Doris Neurgerger, 2001, "Do lending relationships matter? Evidence from bank survey data in Germany", *Journal of Economic Behaviour and Organisation*, 45, p. 339-359
- Mayer R.C., Davis, J.H., and Schoorman, F.D., 1995, "An integrative Framework of organisation trust", *Academy of Management Review*, 20, p. 709.
- Mayer, C., 1988, "New Issues in corporate finance", *European Economic Review*, 32, p. 1167-1188
- Petersen M.A. and R.C.Rajan, 1994, "The benefits of lending relationships, Evidence from Small Business data", *Journal of Finance*, 49, p. 3-37
- Reserve Bank of India, 2005, "Report of Internal working group to review guidelines on credit flow to SME Sector", Central Office, Rural Planning and Credit Department, Mumbai.
- Ring P.S. and Vandevan, 1992, "Structuring cooperative relationship between organisations", *Strategic Management Journal*, 13, p. 483-498
- Rishi, Parul, 2002, "Leading J.F.M. through nurturance: an Indian Scenario", *International Forestry Review*, 4(2), p. 143-147

Shaw, R.B. 1997, "Trust in balance: Building successful organisations on results of integrity and concern", San Francisco, C.A. Jossey Bass Publishers.

Shemwell, D.J. Jr, Cronin, J.J.. Jr and Bullard, W.R., 1994. "Relational exchanges in services. An empirical investigation of ongoing customer service-provider relationship". *International Journal of Service Industry management*, 5(3), p. 57-68

Singh, Kokil and Caren Siehl, 2004, "Leading across cultures: India", *The Thunderbird Case Series*, Garvin School of International Management.

Sitkin, S.B. and Pablo, A.L., 1992, "Reconceptualising the determinants of risk behaviour" *Academy of Management Review*, 17(1), p. 9-30.

Sjorgen, H. 1994, "Long term financial contracts in the bank oriented financial system", *Scandanavian Journal of Management*, 10, p. 315-330

Tauebe, Florian Arun, 2004, "Culture, innovation and economic development; The case of South Indian ICT Clusters in Innovation, learning and technological dynamisms of developing countries". Ed. S. Mani and Henry Romijin, *United Nations University Press*, Tokyo, p. 202-228

The World Bank Group, 2006, "Doing business: Benchmarking business regulations", <http://www.doingbusiness.org/Exploreeconomies/Default.aspx?economyid=89>. Accessed 05/09/2006

Valez, P., 2000, "Interpersonal trust between Supervisor and Subordinate", *Doctoral dissertation*, University of California.