

Chapter 7 – Principles of Lending

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Learning Objectives

What you should achieve after completing this chapter:

- Know the true meaning of credit;
- Understand the key credit principles in making appropriate credit decisions;
- Apply the fundamental risk management principles;
- Appreciate the basic credit factors;
- Gain knowledge of the overall credit process; and
- Understand the scope of credit evaluation.

1. Introduction

In lending, lenders have to conduct a credit analysis. This means that lenders have to take both macro and micro perspective of the lending proposition. The macro view will involve understanding the business, industry and economic environments while the micro view will require assessing the borrower's creditworthiness based on the lender's lending guidelines and procedures.

A credit analysis is an objective appraisal of the critical issues surrounding a credit application before making the decision to lend. Although it is ideal to have a fool-proof appraisal, in reality credit analysis involves the ability to make a credit decision in an environment of uncertainty and incomplete information. This is caused by the credit officer's difficulty in obtaining timely, relevant and accurate information. Credit officers do face an asymmetrical information problem whereby borrowers have access to critical credit information, which credit officers may not be aware of and which the borrowers may intentionally hold back, particularly if the information has an adverse effect on their creditworthiness. Furthermore, we are operating in a dynamic environment that can cause current information to become obsolete very quickly.

Information required for the credit analysis can be obtained from various sources such as from the borrowers themselves, trade associations, government agencies, publications like magazines, newspapers and trade journals, internet and lenders' databases.

Further lead information can be obtained from credit bureaus such as the Central Credit Information System (CCRIS), Financial Information System (FIS) Companies Commission of Malaysia (CCM), CTOS and BASIS. Besides, blacklist information can be obtained from the "Biro Maklumat Cek" (BMC) and the lenders own database.

Generally, lenders have to assess the reliability of the information sources. The more objective a source is, the more reliable it tends to be. It is particularly important to verify information provided by borrowers to prevent any fraud.

Hence, the ability to make good credit decisions depends on the ability to logically analyse a complex, often hazy situation and reach a clear, practical solution.

The major purposes of credit analysis are to:

- examine the nature of the borrower's business in the context of its industry;
- identify and quantify the business risks in lending situations;
- analyse cash flow to estimate future sources and uses of cash to make conclusions with respect to the likelihood of repayment as per the proposed and agreed terms; and

- make recommendations as to the proper type and structure of loan facility in the light of the perceived financing needs and risks.

The end result is to enable the lenders to maximise risk-return.

In analysing the credit, lenders must resist any outside pressure to influence the credit decision. Lenders must also insist on being given sufficient time and information to assess the credit proposal so that a proper evaluation is done.

In assessing a credit proposal, credit officers should be guided by the following guidelines:

- Do not be rushed into reaching a credit decision;
- Where the credit is marginal or complex, ask for a neutral third party's opinion that may be able to provide new insights that could have been missed out.
- Attempt to obtain the necessary information for the credit analysis instead of forming baseless assumptions to make up for the lack of information; and
- Be able to distinguish between facts, estimates and opinions when forming a judgement.

Two critical issues are:

- Credit analysis is not an academic exercise; the goal is to provide sufficient information so as to make “a calculated credit risk” decision, not produce a report. However, this should not be an excuse for any poorly written report.
- The specific tools used in credit analysis vary with the situation, but the goal and logic are constant.

2. What is Credit?

Broadly speaking, credit is the measure of the ability of an individual or business enterprise or government authority to obtain present value in the form of money or guarantees while deferring payment to a definite future time.

2.1 Credit involves risk taking

The process of credit effectively involves risk taking. Credit officers must be mentally prepared to take risks. No credit is guaranteed to be risk free. As an analogy, a soccer player cannot tell the coach that he wants to play the game but also wants a guarantee against injury. No coach will be able to provide such a guarantee. However, how frequently a player gets injured depends on what kind of player he is. An aggressive player who bulldozes his way through the game all the time will certainly face injuries more often than a player who evaluates his chances of winning the ball before committing himself.

2.2 Credit revolves around the concept of risk management

Hence, it is clear that credit revolves around the concept of risk management that effectively requires credit officers to:

- identify risks that can cause the credit to be vulnerable, and then
- mitigate the identified risks, meaning that some measures have been taken either by the borrower or imposed by the lender to ensure that the risks are under control.

No risk can be mitigated unless it is first identified. Risks in credit may not be eliminated but must be mitigated. If any of the vulnerable risks cannot be adequately mitigated, then the credit proposal may have to be turned down. Hence, credit officers must view the process of risk identification as a necessary step for risk management and not as an end to the credit decision resulting in a rejection of the credit application. Lastly, risk management does not mean risk avoidance or risk aggression.

3. The Credit Process Cycle

3.1 Origination

Origination is the starting point of a credit process. Here, the lenders identify the following:

- (a) Target credit markets;
- (b) Priority sectors;
- (c) Products on a portfolio basis; and
- (d) Key individual/business customers.

The risks, assets (loans) and acceptance criteria (RAAC), can be set based on minimum sales, profitability, net worth, and account profitability to the lender for business credit.

For consumer credit, it can be based on age, minimum loan amount, high net worth individuals, industries in which the individual is employed, employment years in present job, payment history, income per annum, capping deductions as a percentage to income, i.e. debt to income ratio, etc.

A big challenge for consumer credit is to generate sufficient applications across all consumer loan products the lender offers to meet all of its objectives in terms of volume, loan outstandings, loan quality and profitability.

Based on the above, initial contact with a prospective customer is made. A preliminary analysis of the customer's requirement is studied and related to the acceptance criteria. Once the evaluation is completed, a credit memorandum is submitted to the appropriate credit approval authority within the lender's approval framework. At the same time, the viability of the relationship is assessed.

3.2 Approval

Consistency and sound decision making are essential for the success of the credit process. The approver analyses the contents of the credit memorandum, credit investigation report, and other data to reach a decision consistent with the lender's definition of acceptable credit risk.

Consequently, the marketing effort results in approval, modification or rejection. If it is modified, it then goes back to the origination stage. Rejection terminates the relationship.

If approved, then a letter of offer and other relevant inhouse documents are prepared. These documents will usually be in the lender's standard format containing the lender's standard clauses and modified to include or delete certain clauses where necessary. At this stage, the potential customer may accept or decline the offer. If accepted, the process continues to the next stage, i.e. administration.

3.3 Administration

Security documentation is perfected in this stage. If the collateral offered is land, then a panel solicitor will be appointed to perfect the documents. For clean facilities, documentation would be simple and can be completed by the lender himself. The objective is to prepare for the facility to be drawn down. It is advisable for another person (not the marketing person) to do an independent check. This will serve as a check and balance to ensure all conditions precedent are complied with, thereby, reducing the risk of overlooking any required document, and also not compromising on late submission. Also, to overcome any abuse in favour of self interest.

Therefore, the final approval for draw down must be endorsed by credit administration and never by the marketing section.

3.4 Monitoring

Once a facility is disbursed, then starts the collection effort. Besides collection, tracking of conditions antecedent is also done at this stage. Some examples are renewal of fire insurance, computation of drawing power, payment of sinking fund, etc. The annual renewal for business credit is a big exercise. The borrower's risk profile is revisited together with any need for additional financing or any need to pare down the facilities. Audited or management financial statements will be called for to do an evaluation. Utilisation of credit facilities will be reviewed together with account profitability. The end result is to see if the lender wishes to continue or to phase out the relationship.

For programmed consumer credit such as housing or vehicle loans, an annual review is redundant.

3.5 Control

Measures to ensure facilities are operated continuously for the intended purpose are done. Red flags if any are also looked out for. If problems are detected, then remedial management either by way of rescheduling or restructuring will be done to prevent the account from turning non-performing.

Only as a last resort are legal remedies undertaken, by enforcing the collateral, suing principal borrower and guarantors if any.

However for credits, which are repaid in accordance with the agreed terms, the relationship will be terminated in due course. Any collateral offered as security will be discharged accordingly.

4. The Credit Officer's Role

4.1 Takes calculated risks

Lenders are to effectively take calculated and not aggressive risks. They must be reminded that no risk means low or negligible return to the lending institution where a large proportion of the income is generated from loan assets. Credit officers are recruited and trained to generate such income through taking calculated credit risks. They are successful to the degree that they perform proper and effective credit analysis to maximise risk-return.

4.2 Makes informed judgements

No amount of credit analysis can relieve the credit officer from making his own credit judgement. They must be responsible for their own credit recommendations. However, they must make informed rather than uninformed judgements. Informed judgements require credit officers to:

- understand the business entity's comparative market position, the pressures of competition, the industry's risk and reward structure, the barriers to entry, the degree of technological change, etc;
- use the experience they have gained on the job as well as with their respective customers;
- tap the experience of the lending specialist or senior credit officers through a consultative process, especially for new or junior credit officers; and
- perform the required quantitative and qualitative analysis of factual information on the customers. This will usually be made on standard forms designed by each financial institution.

The credit officers are often in the best position to make a judgement on their borrowers in view of the following reasons:

- They have access to more information about the customers than anyone else;
- They visit the borrowers' place of business and are able to personally assess areas that may not be reflected in the financials;
- They are in conversation with their borrowers more often than anyone else and would be kept current on happenings in their borrowers' businesses; and
- They monitor the day-to-day utilisation of the credit lines and would have up-to-date knowledge of the conduct of the account.

It is important for credit officers to realise that their bosses need their judgement before making an appropriate credit decision.

5. Fundamental Credit Principles

As every credit extension involves risks, credit officers must adhere to fundamental credit principles so that the lender's loan portfolio can be protected. It is absolutely necessary that credit officers understand these principles to make good loan decisions. The key credit principles are as follows:

5.1 Comply with credit parameters

Credit officers must comply with both external and internal parameters. This is to ensure that the business of lending is carried out within the country's legal framework and the respective lenders' policy guides.

5.1.1 External parameters:

Malaysian laws require that lending institutions not engage in any illegal lending activity and at all times be mindful of the provisions as set out in the various legislation such as the Companies Act 1965, the Banking and Financial Institutions Act 1989, and the National Land Code 1965 and the BNM Directives.

5.1.2 Internal parameters

The lenders' set of credit policies, procedures together with their internal circulars must be complied with at all times. Consistently applying them will help build a strong credit culture within the lenders' organisations.

5.2 Engage in credit that is within the lenders' respective financial resources

In layman's terminology, this principle is to ensure that lenders do not swallow a deal too big for their stomach. It can "choke" lenders to death or cause uncomfortable "indigestion" if it turns out to be non-performing. Bank Negara Malaysia monitors this by limiting the amount of exposure extended by a bank to a single borrower or a group of borrowers. This is to ensure that lenders will not collapse due to one non-performing loan.

The Bank for International Settlement sets the minimum capital requirements. Bank Negara Malaysia then monitors the position of each lender to ensure that it is adequately capitalised. Indicators such as the Loan-Deposit Ratio and the Capital Adequacy Ratio can assess the lenders' financial resources.

5.3 Lenders should only extend credit within their competence

Lenders should not extend credit to businesses that they do not have any competence in. We are not talking about the competence of an individual credit officer but the competence of the lender as an organisation. For example, a lender should not be engaging in property development financing if the organisation has no competence within the real estate market. The lender can acquire competence through headhunting or identifying credit officers with initiative and giving them the opportunity to develop the skill.

5.4 Lenders' primary business is to lend profitably

Lenders at times need to be reminded that they are in the business of lending. It is only when they lend, will they generate income. However, the amount of income they generate depends largely on the spread (the difference between the lending rate and the lender's cost of funds), which must be sufficient to cover the following:

- **Operating costs:** One of the major components is staff salary. Hence, it is important for staff to recognise their cost to the lenders and do their best to obtain the best possible spread for the lenders. Other major cost components are administration and general expenses, and establishment expenses (such as rental and depreciation).
- **Possible loan losses:** Lenders should try to earn an extra bit from each deal to cover for possible losses due to non-performing loans.
- **Reasonable return to the lenders' shareholders:** With the concept of Capital Adequacy Ratio, shareholders have to provide sufficient capital to support the loan assets. Hence, credit officers must ensure that they are earning a reasonable rate of return on behalf of the shareholders.

5.5 Lenders must be mindful of the risk-return concept

Effectively, there can be two categories of investors in a business. The owners are the equity investors while the lenders are the debt investors. Technically, equity investors are taking higher risks than debt investors, as they are the residual owners of the business. This means that they rank after the debt investors in terms of distribution of earnings and assets.

Equity investors will not get any dividend unless the debt investors are paid their interest. In the event of liquidation, debt investors will be repaid first. Equity investors are prepared to take higher risks because they have the potential (not guaranteed) of unlimited return. As for debt investors, the returns will always be fixed as stated in the loan document or offer letter.

This would imply that there is a limit which lenders can stretch their risk taking. Lenders will need to assess whether the shareholders are sufficiently committed in their business. Otherwise, they may find themselves "effectively" taking equity risks without realising it even though, technically, lenders are providing debt financing. It is not economically logical to take effective equity risks for a fixed return. In short, lenders should not take more risks than the owners of the business.

Today's credit decisions must be based on maximisation of risk-return to the lenders. However, there often seems to be a trade-off often between security and profitability. The more securities that lenders insist on, the

lower the spread the borrower is willing to put up with. Obtaining security is quite a common practice as it represents an easy way to mitigate credit risks.

Of concern to lenders is that the growing competitive environment in the banking and finance industry has caused a narrowing of spreads that may not commensurate with the risks. Under such scenarios, loan pricing may become an issue of a credit policy rather than a credit decision. Setting minimum spreads for each risk group of borrowers will help define the boundaries of what is acceptable to the lenders. This also provides consistency in loan pricing.

5.6 Quality of credit is more important than exploiting new opportunities

Credit officers have to ensure that the quality of the credit extended remains good. This is more critical than extending new credit. Every ringgit of bad debts recovered contributes a ringgit to the lender's profitability, whereas the lender may have to extend new credit of RM50-RM100 a year to earn a dollar of net profit.

5.7 Every loan should have two ways out that are mutually exclusive and identified from the beginning

Business viability with sufficient cash flow generated to service the borrowing obligations will always be the first way out. However, in a dynamic economy, businesses do face uncertainties that may unexpectedly impair the borrower's ability to repay. For consumer loans, the individual borrower's monthly income will be the first way out. Risk of unemployment may impair repayment.

This will result in a need to have a second way out that can be in the form of collateral or an awareness that the borrower has sufficient unencumbered assets that can be liquidated to honour the obligations, or third party guarantees.

5.8 The purpose of the loan should contain its repayment basis

To the lender, the best type of loan is where the source of repayment is contained in the purpose of the loan. This means that the loan extended to the borrower will generate the required cash flow to repay the loan. This is applicable to business loans.

5.9 Understanding the business cycle is critical

For business loans, credit officers cannot effectively identify the operating risks affecting the business' viability without understanding the business cycle. The business' needs cannot be established as well. Hence, it will

not be possible to appropriately structure the credit facilities to meet the borrower's needs. It is imperative that credit officers understand the business cycle with risk identification and need matching dependent on it.

5.10 Assessing a company's management competence is vital

Extending credit to a business borrower with management competency will always have a higher chance of success. Management is always the ace behind any business. It is like the conductor of an orchestra. As such, credit officers cannot just assess the business' financial position and performance and neglect assessing its management competence. One common mistake made by many credit officers is that they tend to assume management competence based on the number of years a person has in the industry. It is important to note that experience may not necessarily add to competence. However, strong financials also reflects competent management and vice versa.

In conclusion, risk increases when the above principles are violated. Therefore, adherence at all times is vital.

6. Fundamental Credit Risk Management Principles

There are some fundamental principles in credit risk management that credit officers must know and uphold. These principles are:

6.1 Principle of "proportionate stake"

Lenders must ensure that business owners must be sufficiently committed. In other words, owners have something significant to lose if their business were to fail. This will ensure that they will do their utmost best to ensure the business succeeds.

For the same reason, a margin of contribution is stipulated for consumer loans too. In other words, the margin of financing will be less than 100%.

6.2 Principle of "*pari passu*"

Pari passu means equal footing in Latin. This implies that a lender must ensure that its collateral arrangement position for the same borrower relative to other lenders is not worse off. Lenders that are not financially strong often compromise on this principle. Hence, they have no choice but to adopt a more aggressive position as they may not be able to lend otherwise. If this principle is to be compromised (for instance, in order to woo an established borrower with good financial standing with the view to establish a relationship), it should be for a limited period only. A lender should always work towards a *pari passu* position. However, a lender should also be mindful of the type of borrowing in deciding whether it is less than *pari passu*. For instance, if all lenders are initially unsecured on

trade finance facilities extended to a borrower and subsequently one of the lenders is secured by a legal charge over a factory financed by the lender, the other lenders should not over-react and claim that their position is less than *pari passu*.

6.3 Principle of “protection”

This principle does not suggest that credit must always be secured. The manner of protection depends on the credit predication.

- If the credit has been predicated on the need for collateral in addition to business viability, then the lender must ensure that the loan or facility extended is protected by sufficient coverage and quality of the collateral.
- If the credit has been predicated strictly on the borrower’s financial strength without the need for collateral, then the borrower’s meaningful unencumbered assets must protect the loan or facility extended. This does not provide the lender with a priority claim over the unencumbered assets. However, it will provide the lender with a fair chance of recovery should the need arise. This credit predication does not preclude the lender from having collateral if one is successfully negotiated for.

6.4 Principle of “control”

This principle concerns proper structuring of facilities to ensure that the lender is in the driver’s seat. A lot of businesses get into trouble because money in the business is being directed to an unintended purpose. Hence, the structure must give the lender the control such that when the facility is drawn down, it will be directed to the purpose originally intended for when the credit officers have sought approval from their management for the loan.

In the case of consumer credit, disbursements for the intended purpose can be controlled closely as in housing loan, vehicle loan, etc.

6.5 Principle of “well-spread lending portfolio”

Lenders must ensure that there is no high concentration of loans directed to a particular industry or type of lending business such as share margin financing. This is to avoid any “indigestion” should that industry face or experience any downturn.

6.6 Principle of “good first way out”

Credit officers must always identify repayment sources. Thereafter, there should also be an assessment of the reliability of each repayment source. The assessment normally involves an analysis of qualitative operating

risks affecting a business' ability to generate cash flow, and quantitative cash flow projection. For consumer credit reliability, this would be the individual's monthly income.

6.7 Principle of “appropriate tenor of financing”

Generally, the longer the tenor of financing, the higher the risk to the lender. However, credit officers should not just consider the risk aspect and ignore the borrower's need aspect. It is pointless for a lender to structure a short tenor and expect the borrower to meet the repayment obligations knowing full well that the borrower requires a longer tenor. This is tantamount to the lender lending with an expectation that the borrower will default.

6.8 Principle of “reflective of national policy”

Lenders should try to feel the “heartbeat” of the government in the area of economic policy and go with the flow. It is important to be able to identify the priority sectors that enjoy direct governmental support. Such sectors normally have higher chances of success. Most financial institutions continually identify and review the list of industries that they want to concentrate on and those they would like their credit officers to avoid. However, it is important to understand non-priority sectors are not equivalent to sunset sectors. They could be matured sectors that are flying on auto pilot and do not require any incentive from the government to uphold them.

For consumer loans, the government may impose quotas to meet for housing loans, especially for low cost homes. In this respect, lenders should be mindful too of the government's social agenda.

7. Summary and Conclusion

Lenders are in the business of making loans, and it is the credit officer's responsibility to understand clearly defined credit standards. Towards this end, they must clearly understand the credit process cycle, fundamental credit principles and risk management principles, so that standards become more meaningful.

Practice Questions

1. What is credit?
2. What are the major purposes of credit analysis?
3. Explain the essential steps in a credit process cycle and state the objective of each step.
4. Name four fundamental credit principles and examine the implications to the lenders.
5. Name the three components of cost that must be covered by the spread.
6. What does the principle of proportionate stake mean to lenders? Suggest how lenders can ensure that this risk management principle is adhered to.
7. In the principle of *pari passu*, give examples of how lenders can end up in applying the principle.
8. “The principle of protection means that the lenders must ensure at all times that their credit is protected by sufficient quality collateral”. Discuss the statement.
9. Discuss this statement: “In every credit, we should try not to reveal too much risks, otherwise management must be doubtful of our competence”.
10. What are the consequences of violating credit principles?