

DP03

# Principles Of Lending

12 MAY 1999

1. Time allowed : Three (3) hours
2. Total number of questions : Four (4) questions on 2 pages
3. Number of questions to be answered : All four (4) questions
4. Show details of workings, where appropriate. Silent, non programmable calculators may be used.
5. Begin each answer to a new question on a fresh page.
6. Answer **all** questions in **English**.

**ANSWER ALL FOUR (4) QUESTIONS**

- List **three** types of collateral (security for lending) and describe the methods of perfecting their legal documentation so as to facilitate enforceability. In addition, outline the respective realisation processes involved.  
(Total:20 marks)
- In Malaysia, securitisation is widely associated with Cagamas Berhad, which started in 1986. Cagamas Berhad issues bonds (called as Cagamas Bonds) to investors by securitising its housing loans purchased from commercial banks and finance companies.  
  
Explain the securitisation process. Your answer should also include the benefits of securitisation and the barriers commonly encountered.  
(Total:20 marks)
- Describe and discuss the key concepts in “asset protection lending” as compared with “cash flow lending”.  
(Total:20 marks)
- The following are financial statements of a public listed company carrying on business as a Class A contractor which recently built the Formula One Racing Track in Sepang, Selangor.

**PROFIT AND LOSS ACCOUNT  
FOR THE YEAR ENDED 31 JANUARY 1998**

Items	1998 (RMmillion)	1997 (RMmillion)
Income	416	249
Net profit before tax	19	12
<i>Less</i> : Taxation	5	3
Net profit after tax	14	9
<i>Add</i> : Unappropriated profit brought forward	17	9
Profit available for appropriation	31	18
<i>Less</i> : Dividends	3	1
Capitalisation of bonus issues	8	0
Unappropriated profit carried forward	20	17
Earnings per share (sen)	31	53

**BALANCE SHEET AS AT 31 JANUARY 1998**

Items	1998 (RMmillion)	1997 (RMmillion)
Fixed assets	48	48
Investment properties	26	24
Investment in subsidiary company	0.8	0.6
	74.8	72.6
Current assets	146	70
Current liabilities	121	81
Net current assets	25	(11)
	99.8	61.6
Represented by:		
Share capital	38	20
Share premium	29	-
Capital reserves	4	4
Unappropriated profit	21	17
Shareholders' funds	92	41
Hire-purchase creditors	3	13
Deferred taxation	4	2
Term loans	0.8	5.6
	99.8	61.6

- (a) Calculate the following ratios for financial years ending 1997 and 1998:
- (i) Current ratio [4]
  - (ii) Gearing (defined as total liabilities to shareholders' funds) [4]
  - (iii) Return on equity (pre-tax) [4]
  - (iv) Return on assets (pre-tax) [4]
  - (v) Return on sales (pre-tax) [4]
- (b) Financial analysis is an approach used by lending officers to evaluate the creditworthiness of borrowers. Describe the framework of this approach. [20]
- (Total:40 marks)

## OUTLINE ANSWERS

### Question 1

**Almost candidates did well scoring above 60% of the allocated marks. Only a few students described letters of guarantee and Assignment of Sale proceeds as a form of collateral, which is incorrect.**

**Collateral is a tangible security which upon an event of default can be liquidated. Guarantees and assignments are not capable of being liquidated.**

	<u>Types of Collateral</u>	<u>Methods of Perfecting Documentation</u>
(i)	Quoted Shares	Memorandum of Deposit/Pledge of shares with Power of Attorney to sell in open market.
(ii)	Landed Properties	By way of a land charge document under the National Land Code (with titles); for flats and condominiums without strata titles, a loan agreement cum assignment of the Sale and Purchase Agreement.
(iii)	Fixed Deposits	Memorandum of Deposit and letter of set-off.

Realisation Process

Quoted shares	-	disposal through open market
Landed properties	-	foreclosure through public auction or private treaty sale
Fixed deposits (FD)	-	upliftment of FD towards settlement.

### Question 2

**A poorly answered question.**

The securitisation process may involve five parties, namely;

- (i) the bank as originator;
- (ii) a loan purchaser e.g. Cagamas;
- (iii) a loan packager e.g. an underwriter of the securities;
- (iv) a guarantor who enhances the credit; and
- (v) investors.

When assets are securitised, the ownership of the assets and cash flows are passed on to the investors. Securitisation is a process of direct interaction which allows disintermediation to occur.

Barriers to securitisation are:

- (i) a minimum size is required;
- (ii) loan purchaser usually seeks recourse to the originator;
- (iii) loan originator expected to absorb losses should any borrowers in the securitised assets default; and
- (iv) loan purchasers may set a very high standard in terms of quality of loans making it difficult to satisfy.

### Question 3

Except for a handful of candidates who were confused on asset protection lending with asset conversion lending, all scored above 60% in this question.

Key concepts distinguishing Asset Protection Lending and Cash Flow Lending are:

#### Asset Protection Lending

- Emphasises on collateral value without reliance on future cash flow to repay debts.
- Usually short-term financing to meet long-term needs.
- Facility may continuously be rolled-over so long as collateral value is intact.
- Utilisation may not have specific purpose and funds could be used for investments in general.
- Emphasis is on collateral value and ease of realisation.

#### Cash Flow Lending

- Future stream of earnings is paramount in the credit approval process.
- Generally exceeds 1 year financing requirements.
- Facility is gradually amortised and repaid per an agreed schedule.
- Used principally for fixed asset financing or short-term bridge loan.
- Emphasis in on loan structure.

### Question 4

Some candidates answered part (b) of the question as the 5Cs of credit instead of ratio analysis and its concept thereon.

(a)		<u>1997</u>	<u>1998</u>
	(i)	Current ratio	0.86
	(ii)	Gearing	2.48
	(iii)	Return on equity (pretax)	29.3%
	(iv)	Return on assets (pretax)	20.6%
	(v)	Return on sales (pretax)	19.0%
		4.8%	4.6%

- (b) The framework for financial analysis is that of ratio analysis. Ratios are used as a predictor for tomorrow's results as well as using another company in the same industry to compare the performance. It is also used to qualify and quantify borrower's performance as in measurement of profitability, efficiency, financial position and financial adaptability.

The framework involves:-

- Common-size financial statements
- Working capital computation
- Financial performance ratios (profitability)
- Financial position ratios (gearing)
- Financial adaptability ratios (liquidity).