

DP03

Principles of Lending

9 APRIL 2003

1. Time allowed : Three (3) hours
2. Total number of questions : Four (4) questions
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**.
7. Blank pages are provided at the end of the question paper for rough work.

ANSWER ALL FOUR (4) QUESTIONS

1. (a) Suggest how bank marketing officers may systematically develop a prospect list to source new customers. [10]

 (b) Outline and explain the principles of good lending. [10]
(Total:20 marks)

2. (a) List the most likely causes of problem loans in financial institutions. [15]

 (b) Under what circumstances can a lender avoid taking legal action as a means of loan recovery? [5]
(Total:20 marks)

3. A loan life cycle commences from business development to credit analysis, followed by annual monitoring if the request is approved. Under difficult conditions, the loan may become delinquent and the loan life cycle may extend to remedial management.

 From the above, explain in detail the various activities that are associated with each stage of the loan life cycle. You may use a diagram to support your answer.
(Total:25 marks)

4. Pattana Oil Sdn Bhd ("Pattana Oil") operates a crude oil refinery plant in Port Dickson. Pattana Oil has been experiencing losses since financial year (FY) 2000, which has severely affected its capital. As a result, the company was recapitalised by issue of new shares in FY 2001. Many oil refineries are also suffering losses due to lower refining margins caused by the increase in crude oil prices. The following are the financial statements of Pattana Oil:

BALANCE SHEET AS AT 31 DECEMBER

Item	2000 RM'000	2001 RM'000
Cash	479	553
Trade debtors	2,727	1,900
Due from related company	1,176	999
Stocks	707	1,592
Other current assets	755	590
Due from other companies	0	299
Total current assets	5,844	5,933
Land	2	2
Other fixed assets	3,692	3,633
Buildings	4,130	4,173
Machinery and equipment	5,040	5,326
Motor vehicles	276	311
Gross fixed assets	13,140	13,445
Less: Accumulated depreciation	6,847	7,799
Total fixed assets (Net)	6,293	5,646
Investments	0	38
Deferred charges	231	201
Other assets	322	200
TOTAL ASSETS	12,690	12,018
Overdraft	7,070	2,356
Loans due within one year	4,430	0
Trade creditors	1,106	793
Due to related company	1,549	1,477
Accrued liabilities	418	229
Total current liabilities	14,573	4,855
Loan due after one year	3,198	0
Deferred income	8	7
Other liabilities	222	246
Total liabilities	18,001	5,108
Paid-up capital	1,344	14,975
Revenue reserve	(6,655)	(8,065)
TOTAL LIABILITIES AND NETWORTH	12,690	12,018

PROFIT AND LOSS STATEMENT FOR THE YEAR ENDED 31 DECEMBER

Item	2000 RM'000	2001 RM'000
Turnover	50,907	48,549
Less: Cost of goods sold	49,106	46,291
Gross profit	1,801	2,258
Less: General & administration expense	2,908	1,744
Less: Depreciation	1,095	939
Operating profit/(loss)	(2,202)	(425)
Less: Interest expense	835	948
Less: Foreign exchange loss	0	194
Add: Other income	194	155
Profit before tax	(2,843)	(1,412)
Less: Taxation	1,342	(3)
NET PROFIT AFTER TAX	(4,185)	(1,409)

- (a) Compute the following credit evaluation ratios for Pattana Oil and give a short comment on the performance of Pattana Oil using the ratios that you have calculated:

Item	2000	2001
(i) Current ratio		
(ii) Quick ratio		
(iii) Total network		
(iv) Return on equity		
(v) Gross profit margin		
(vi) Gearing (Total liabilities/Total network)		
(vii) Total assets		
(viii) Return on assets		
(ix) Assets turnover ratio		
(x) Inventory days on hand (INVDOH)		

[15]

- (b) List any **five** key risks in bank financing to oil refineries. [5]
- (c) It is common in loan documentation for a bank to specify every event that constitutes an "event of default" that will trigger loan recall and repayment.

State **three** such "events of default" and suggest what options are available to a bank when such an event occurs. [10]

- (d) Explain the difference, using an illustration, between a fixed rate loan and a floating rate loan. [5]

(Total:35 marks)

OUTLINE ANSWERS

Question 1

- Candidates were able to suggest how to develop a prospect list for new customers.
- Some candidates were not able to explain the principles of good lending as they confused it with 5Cs of bank lending.

1. (a) Marketing officers often develop a prospect list using the following approaches:
- referrals from existing customers
 - dormant/under-utilised accounts
 - senior management networking referrals
 - own market research from trade journals, newspapers
 - networking with Chambers of Commerce, MIDA and other investment bodies
 - existing customers' competitors and suppliers list
 - news clippings
 - published materials, e.g. trade magazines, business journals
 - professionals such as accounting firms legal firms, valuers, etc.
 - directories in building, trade directories and industrial estates
 - smokes taking
- (b) Itemised answers are as follows, but students are expected to explain them:
- reflects national policy
 - beneficial purpose to the client
 - diversified lending
 - should be short term and on demand
 - account to be profitable
 - repayment sources to be well defined
 - lending should be priced correctly to reflect risk and return
 - collateral and guarantees to mitigate against risk
 - should fit in with credit policy of the bank, e.g. in some banks, lending for gambling activities is prohibited, etc.
 - loans should be well structured

Question 2

Candidates gave good answers in listing the likely causes of problem loans in financial institutions and were also able to list the circumstances under which a lender can avoid taking legal action as a means of recovery.

2. (a) Likely causes are:
- failure to know your borrower and his business
 - failure to obtain accurate and timely and sufficient information in the credit evaluation process stage
 - failure to know the degree of realisability of the collateral taken and failure to obtain a valid security interest-documentation
 - failure to supervise utilisation of loan proceeds
 - procrastination in taking action on problem loans, e.g. the lender is slow in the negotiation process
 - neglect of details – all information, including terms and conditions, in an offer letter and details in a loan agreement must be clearly understood and properly documented
 - inadequate assessment of the management of depth of the borrower
 - accepting appraisal of collateral based on development value
 - breach of basic lending principles
 - lure of short-term deposits and other business trade-offs
 - lack of adequate follow-up procedures after loan disbursement
 - failure to recognise early symptoms of a deteriorating credit
 - excessive gearing and mismatch in cashflow for debt repayment

- poor management quality
 - ignorant of the impact of an adverse economic cycle
 - excessive reliance on collateral without placing emphasis on cashflow as prime sources of repayment
 - gaps in credit training
- (b) When the borrower is not in severe financial distress and the chances of a debt rescheduling may resolve the problem. Furthermore the business is still viable and there is sufficient collateral and management commitment to resolve the temporary default.

Question 3

Most candidates did well in this question and were able to illustrate their answers with a proper diagram of a loan life cycle.

3. Refer to page 44, Bank Lending Assessment & Management Text, section 4.1 for a complete answer

Question 4

- Some candidates expressed the current and quick ratio as percentage, which, although uncommon, is acceptable.
- For calculations on return on equity (ROE), where the net profit is a loss, candidates did not express the answer as a “negative return”.
- Candidates should also note the assets turnover ratio should be “sales to total assets” and not the other way round.

4. (a)

	2000	2001
(i) Current ratio	0.4:1	1.22:1
(ii) Quick ratio	0.35:1	0.89:1
(iii) Total networth (TNW)	(5,311)	6,910
(iv) Return on equity (ROE)	-ve return	-ve return
(v) Gross profit margin	3.5%	4.65%
(vi) Gearing (TL/TNW)	-ve	0.74%
(vii) Total assets	12,690	12,018
(viii) Return on assets (ROA)	-ve return	-ve return
(ix) Assets turnover ratio (ATO)	4.0x	4.03x
(x) Stock turnover ratio (INVDOH)	5.06 days	12 days

Comments

Pattana Oil has improved substantially in year 2001 as evidenced by a significant improvement in its liquidity position, with current ratio at 1.22:1 compared to 0.4:1 a year ago. Likewise, quick ratio is stronger at 0.89:1 (2000 @ 0.35:1). Profit margin has also improved and ATO better at 4.03x. However, stock holding has increased to 12 days despite a lower turnover, but is still acceptable.

- (b) Risks in financing oil refineries (choose any **five**):
- supply risks
 - demand risks
 - fire risks
 - interest rate risks
 - market risks

- quality risks
- efficiency and productivity risks

(c) Events of Defaults (choose any **three**):

- failure to pay principal or interest when due
- failure to perform covenants and conditions in loan agreement
- cross default
- liquidation, cessation of business or winding up petition
- material adverse change

Options available:

- overlook the default
- temporary waiver
- renegotiate with borrower
- accelerate the loan

(d) Fixed rate loans are those loans where the interest rate is fixed for a period of time and regardless of market rates movement, is still constant during the agreed period. Floating rates are those loans priced at a margin above the variable cost of funds. Examples are 6% fixed rate for 3 years versus a floating rate of 1.0% above BLR.