

DP03

Principles of Lending

8 OCTOBER 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) (i) Describe the features of asset conversion lending. [8]
- (ii) Name **two** suitable loan products that fall under the category of asset conversion lending. [2]
- (b) Based on the data below, calculate the asset conversion cycle and interpret its meaning:

Item	Year 2002 (RM'000,000)
Sales	150
Stocks	30
Trade debtors	80
Trade creditors	120
Bank loans	40

[10]
(Total:20 marks)

2. (a) Outline what would be the consequences to a bank's business if its credit policies are defined as too lenient. [10]
- (b) Sketch a flowchart of a typical credit evaluation process. [10]
(Total:20 marks)

3. Explain the 5Cs of credit in relation to bank lending. Illustrate your answer with examples. (Total:20 marks)

4. Of late, the property market has shown positive signs of a recovery. The nation's Gross Domestic Product is better than forecast, and domestic consumption is supporting economic growth.

The Sansiri Development Company (SDC) is launching a new condominium project to capture the upbeat in the property sector. In its latest project (the Alpha Condominium consisting of 150 units), SDC has projected a break-even sales level of 60% (by unit). SDC has requested for a bridging loan of RM40million. The land is part of SDC's landbank and is presently free from encumbrances.

Below are extracts of SDC's key financial ratios:

Item	2001	2002
Current ratio (:1)	2.50	2.63
Quick ratio (:1)	0.96	0.97
Gearing (times)	2.01	1.45
Long-term debt/Tangible networkh	0.37	1.25
Sales/Total assets (times)	0.28	0.15
Return on equity (%)	(13.95)	2.49
Sales growth (%)	184.8	149.1

Using the information above and from your own knowledge on bank lending, answer the following questions:

- (a) List the qualitative credit risk factors in property development financing. [10]
 - (b) Compare “bridging finance” and “end-finance” in property development financing. [10]
 - (c) Analyse and comment on SDC’s financial performance based on the key financial ratios above. [10]
 - (d) Comment on the relevance of gearing ratio as a measurement in debt service capability. [5]
 - (e) Group the above ratios under the sub-headings of liquidity, profitability and solvency. [5]
- (Total:40 marks)

OUTLINE ANSWERS

Question 1

The majority of the candidates were able to answer this question on asset conversion lending very well.

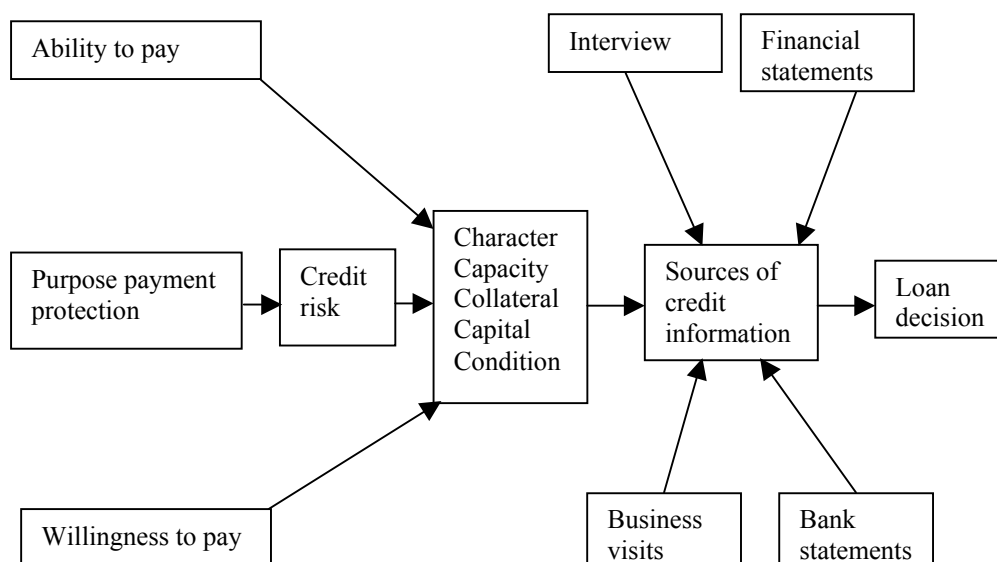
1. (a) (i) Traditional form of lending to business. Generally short-term lines, and thus functions as temporary financing. It is meant to be self-liquidating and payback is on the borrower's ability to complete its conversion cycle. Primary protection is the track record of borrower and liquidity of assets to be financed.
- (ii) Suitable loan products are letters of credit, bankers acceptances, trust receipts, bills purchase and export credit refinancing.
- (b) The ACC is calculated as INVDOH 73 days and ARDOH 195 days, thus making a total of 268 days in its conversion cycle. This is almost 9 months before the company realises its cash. The receivables are almost 6.5 months which is very unhealthy for a company cashflow.

Question 2

Candidates were able to explain the consequences of a lenient credit policy and also sketch the flowchart of a typical credit evaluation process.

2. (a) If the credit standard is too lenient, the following consequences may arise:
 - High level of non-performing loans (NPLs).
 - More efforts needed in loan recovery.
 - May lead to many poor quality customers and credits.
 - Bank may suffer losses.
 - High level of provisioning needed.
 - Credit officers may eventually lose confidence due to high level of NPLs.
 - Bank will get more customers (although such customers may be of weaker quality).

(b)



Question 3

The 5Cs of credit in bank lending is an often-examined topic and candidates had no problem in explaining the concepts and illustrating their answers with examples.

3. The 5Cs of Credit:

- **Character.** The character of the borrower indicates two things: the ability to pay vs. the willingness to pay. The ability to pay refers to borrower's financial credibility to pay. A good character is one that has the ability to pay and a willingness to pay. The lender should check on the borrower's character.
- **Capacity.** Capacity refers to the sources of repayment, i.e. the cash flow. The borrower must be able to meet with all his financial obligations on the due dates.
- **Capital.** Capital represents the degree of commitment and the ability to sustain this commitment during bad times.
- **Condition.** Condition refers to the macroeconomic environment. E.g. if the loan is for setting up a retail business in a particular area, then the lender must make a study of the economic conditions with the reference to the degree of propensity to spend by residents of the locality.
- **Collateral.** Collateral is the lender's second line of defense. If the payback is derived from cash flows, then the collateral will not be liquidated for repayment.

Candidates should illustrate each of the point above with an example.

Question 4

- While most candidates were able to answer all sections, a few were not able to distinguish between bridging finance and end-finance in property financing.
- Candidates were also able to calculate the financial ratios accurately.

4. (a) Qualitative risks in property financing:

- Demand risks, which is a function of location, pricing and quality.
- Completion risks – can the developer complete and deliver the house on time?
- Cost overrun arising from price increase in building materials.
- Financing risks.
- Interest rate risks.

(b) Bridging loans are for construction financing of the project including infrastructure whereas end-finance is for individual house buyers i.e. housing loans. Students may elaborate further as to the characteristics of end finance and/or bridging financing. E.g. in bridging loans, the release of funds is evidenced by work done into a contract account.

(c) SDC's financial performance:

- The company has turnaround as evidenced by a positive ROE in 2002 compared with a negative ROE in 2001.
- Sales declined by 20% in 2002, but the results indicate that higher sales in 2001 only translate into profits after one year.
- Gearing of the company has improved and the company has switched from short-term debts into long-term loans possibly to give better funding stability.
- It could also be that interest rates have declined and therefore financing with long-term loans makes a better financing structure.
- The company looks unlikely to face liquidity problems as judged by its strong current ratio of 2.63x in 2002. This ratio has strengthened from a year ago in 2001.
- In terms of asset utilisation, there are either many idle assets around or the pick-up rate of sales is slow. Thus, the poor showing in sales/total assets ratio of 0.15 in 2002.

(d) The gearing ratio measures the total liabilities both long term and short term, which the company owes, divided by its networth. Generally, the lower this ratio, the better. Companies with high gearing ratios have been found more likely to go into financial distress as evidenced by Altman's study. Thus, debt service capability may be impaired if a company has higher than normal gearing ratios.

- (e) Liquidity : current ratio, quick ratio
- Profitability : sales/total assets, ROE, sales growth
- Solvency : gearing, long-term debt/tangible networkth