

**DP03**

# **Principles of Lending**

**13 APRIL 2005**

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. Outline the framework of a loan life cycle and describe the various credit activities involved. (Total:20 marks)

2. In relation to bank lending, explain the following:

(a) Principles of good lending [10]

(b) 5Cs of credit [10]  
(Total:20 marks)

3. (a) (i) Describe the features of asset conversion lending. [8]  
(ii) State **two** credit products that fall under the category of asset conversion lending. [2]  
(b) Define and explain the concept of asset protection lending. [10]  
(Total:20 marks)

4. Flex Sdn Bhd ("Flex") is a producer of medical gloves. It has a production capacity of 20million gloves per annum and operates 10 production lines.

Surgical and medical gloves are made from dipping moulds (known as formers) in latex. Thus, production lines are often known as dipping lines. This industry boomed in the 1980s as world demand for rubber gloves rose due to HIV and AIDS. The industry saw many new entrants, big and small, jumping onto the bandwagon to capitalise on the western world demand for rubber gloves. As Malaysia is a producer of latex, exports of rubber gloves in the 1980s became a big business.

During the late 1980s, the industry experienced a shake-out with many small producers going bust. The United States market also imposed stricter regulations on imports of rubber gloves. Many local producers failed to meet the quality standards and had their shipments rejected. Over 80% of the local players closed down leaving only a handful of quality producers.

Today, the world demand for rubber gloves has increased. Flex is positioned to take on more orders provided it increased its output. Thus, the Board of Flex is considering 10 new dipping lines to their present capacity.

The following are Flex's financial statements over the last three financial years:

**BALANCE SHEET AS AT 31 DECEMBER**

Item	2002 RM'000	2003 RM'000	2004 RM'000
<b>Current assets</b>			
Cash	269	361	2,460
Time deposits	305	-	-
Accounts/notes receivables – trade	3,277	3,798	5,428
Accounts/notes receivables - related companies	106	1	-
Accounts/notes receivables – others	266	437	905
	4,223	4,597	8,793
Inventory			
- Raw materials	156	331	365
- Work in process	427	193	208
- Finished goods	2,660	3,985	3,007
- Other inventory	-	171	232
Total inventory	3,243	4,680	3,812
<b>Total current assets</b>	<b>7,466</b>	<b>9,277</b>	<b>12,605</b>
<b>Non-current assets</b>			
Machinery and equipment	10,652	11,802	13,453
Furniture and fixtures	463	516	522
Gross fixed assets	11,115	12,318	13,975
Accumulated depreciation	(2,796)	(4,368)	(6,149)
Total fixed assets – net	8,319	7,950	7,826
<b>Total non-current assets</b>	<b>8,319</b>	<b>7,950</b>	<b>7,826</b>
<b>Total assets</b>	<b>15,785</b>	<b>17,227</b>	<b>20,431</b>

**BALANCE SHEET AS AT 31 DECEMBER (cont'd)**

Item	2002 RM'000	2003 RM'000	2004 RM'000
<b>Current liabilities</b>			
Overdrafts (book)	140	384	-
Bills payable	1,844	1,601	1,289
Current portion long-term debts - other unsecured	31	18	102
Accounts payable – trade	3,987	4,382	2,829
Accounts payable – related companies	2,970	2,906	77
Accounts payable – others	1,820	1,709	2,074
Amount due to Directors	4,475	4,315	3
Provision for taxation	3	12	21
<b>Total current liabilities</b>	<b>15,270</b>	<b>15,327</b>	<b>6,395</b>
<b>Non-current liabilities</b>			
Long-term debts – other unsecured	18	-	-
Deferred income tax – long-term portion	-	-	471
<b>Total non-current liabilities</b>	<b>18</b>	<b>-</b>	<b>471</b>
<b>Total liabilities</b>	<b>15,288</b>	<b>15,327</b>	<b>6,866</b>
<b>Net worth</b>			
Paid in capital	4,044	4,044	11,757
Retained earnings	(3,547)	(2,144)	1,808
<b>Total net worth</b>	<b>497</b>	<b>1,900</b>	<b>13,565</b>
<b>Total liabilities and net worth</b>	<b>15,785</b>	<b>17,227</b>	<b>20,431</b>
Working capital	(7,804)	(6,050)	6,210
Tangible net worth – actual	497	1,900	13,565

**PROFIT AND LOSS STATEMENT FOR THE YEAR ENDED 31 DECEMBER**

Item	2002 RM'000	2003 RM'000	2004 RM'000
Sales/revenue	19,074	30,097	40,499
Cost of sales/revenue	(16,167)	(24,864)	(31,608)
Gross profit	2,907	5,233	8,891
Other operating income	49	37	71
Selling expense	(183)	(636)	(835)
General and administration expenses	(759)	(944)	(1,086)
Lease/rent expense	(517)	(546)	(637)
Depreciation	(1,206)	(1,575)	(1,786)
Total operating expense	(2,665)	(3,701)	(4,344)
Net operating profit	291	1,569	4,618
Interest expense	(153)	(164)	(163)
Interest income	13	-	-
Net interest income/(expense)	(140)	(164)	(163)
Profit before tax	151	1,405	4,455
Current income tax	-	(2)	(503)
<b>Net profit</b>	<b>151</b>	<b>1,403</b>	<b>3,952</b>
Earnings before interest and tax	304	1,569	4,618
Earnings before interest, tax, depreciation and amortisation	1,510	3,144	6,404
Earnings before interest, depreciation and amortisation	1,510	3,142	5,901

- (a) (i) Compute the following financial ratios for years 2002 to 2004, based on Flex's financial statements:

Item	2002	2003	2004
(aa) Current ratio			
(bb) Quick ratio			
(cc) Working capital			
(dd) Gearing (Total liabilities/total net worth)			
(ee) Return on assets (ROA)			

[15]

- (ii) Explain the significance of ROA in terms of Flex's business performance. [5]
- (iii) Explain why gearing ratio is important in credit assessment. [5]
- (b) List the types of credit products that will meet Flex's current and future needs. [5]
- (c) (i) Identify the qualitative risks faced by Flex. [5]
- (ii) How can Flex mitigate the risks identified in (c)(i) above? [5]

(Total:40 marks)

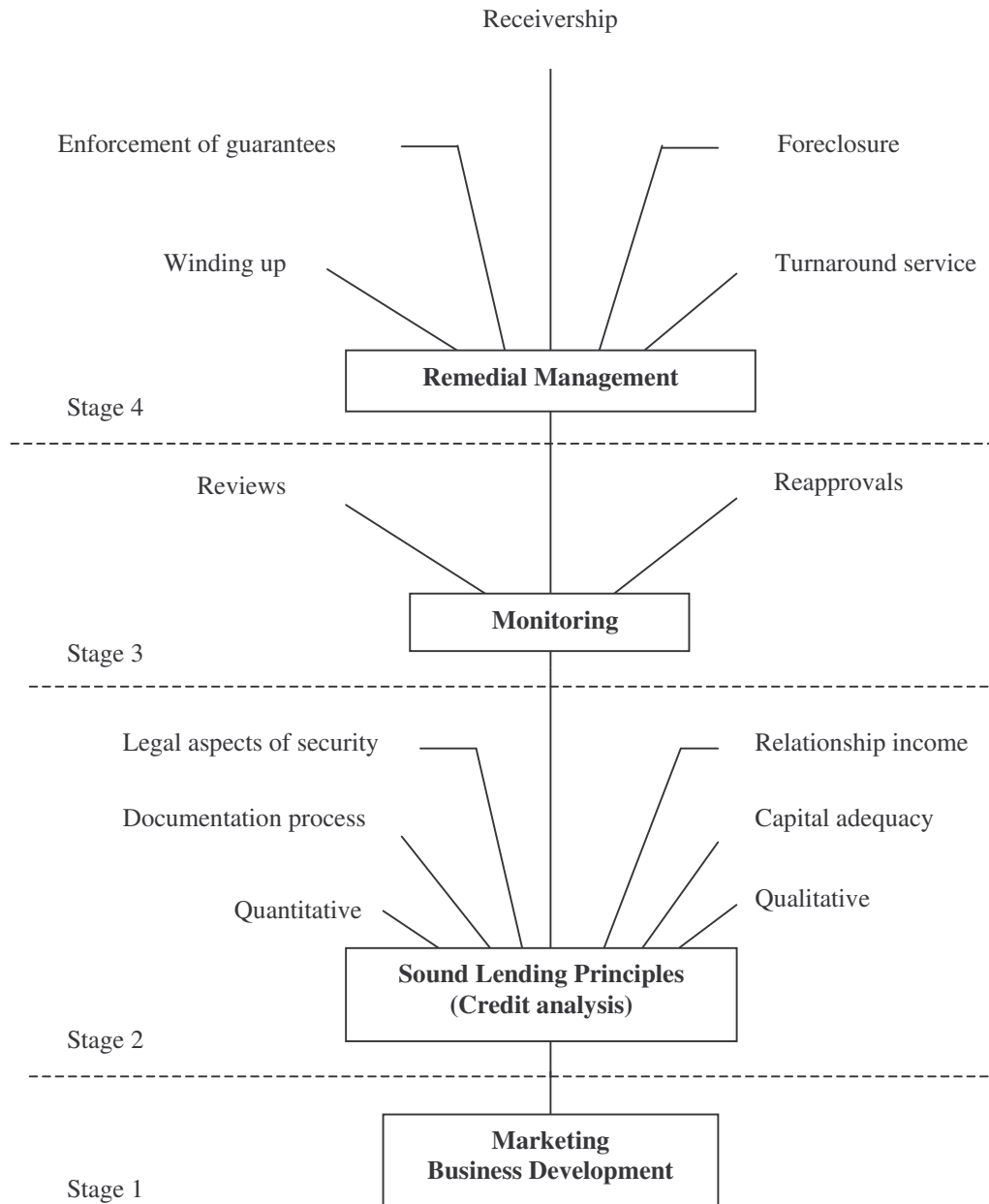
## OUTLINE ANSWERS

The comments given in the boxes below indicate the areas of weaknesses the examiners have identified and their advice to future candidates.

### Question 1

- There are no examiner's comments for this question.

1. The framework of a loan life cycle:



The credit activities involved in this framework are:

- Stage 1 : business development
- Stage 2 : credit evaluation
- Stage 3 : loan administration
- Stage 4 : loan recovery

*(Note: Students are required to explain the four stages)*

### Question 2

- There are no examiner's comments for this question.

2. (a) Principles of good lending:
- Reflect 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
  - Loans should be well-structured

*(Note : Students are required to explain the principles)*

- (b) 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 person with a good character is one who has the ability to pay and a willingness to pay. The lender should check on the borrower's character.
  - **Capacity**  
This 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**  
This represents the degree of commitment and the ability to sustain this commitment during bad times.
  - **Condition**  
This refers to the macroeconomic environment. For example, 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 reference to the degree of propensity to spend by residents of the locality.
  - **Collateral**  
This is the lender's second line of defence. If the payback is derived from cash flows, then the collateral will not be liquidated for repayment.

### Question 3

Candidates could not explain the concept of asset protection lending.

3. (a) (i) The features of asset conversion lending are:
- short-term lines
  - temporary financing
  - self-liquidating
  - payback on the borrower's ability to complete the conversion cycle
- (Note : Students are required to explain the features)*
- (ii) Any two of the following products:
- Bankers acceptances
  - Trust receipts

- Letters of credit
  - Export credit refinancing
- (b) Asset protection lending is effectively collateral-based lending. Banks lend strictly on the value of the collateral and the ease of liquidation of the collateral to cash for debt settlement. The standard form of collateral lending works on advancing up to a certain percentage value of the collateral. The commonly acceptable collaterals are fixed deposits, quoted shares and landed assets.

**Question 4**

- There are no examiner's comments for this question.

4. (a) (i)

Item	2002	2003	2004
(aa) Current ratio	0.49	0.61	1.97
(bb) Quick ratio	0.28	0.30	1.37
(cc) Working capital ( RM'000)	(7,804)	(6,050)	6,210
(dd) Gearing (total liabilities to networth)	30.76	8.07	0.51
(ee) Return on assets (ROA) (%)	0.96	8.14	19.34

- (ii) ROA measures the business efficiency in the use of capital investment primarily in Flex's plant and machinery. The ratio also measures the Flex's ability to generate revenue from each unit of asset invested. Thus the positive the ROA, the more capable Flex is in generating returns on their investments.
- (iii) Gearing ratio reflects the debt to net worth position. Debt comprises current and long-term liabilities, covering banks loans as well as other trade creditors. Generally, the higher the gearing ratio, the higher the credit risk profile of the borrower. This also means the business is trading/operating beyond its own financial ability and if cashflows declined, the company may enter into distress as it cannot meet its high debt obligations.
- (b) Types of credit products:
- Trade financing for Flex's working capital:
    - Bankers acceptance to finance purchases
    - Letter of credit discounting lines
    - Export credit refinancing to finance export sales
    - Overdraft for day to day operational needs
  - Term loans
    - Long-term loans for machinery purchase
    - Long-term loans for factory premises
  - Foreign exchange lines for hedging of foreign currency sales
- (c) (i) Risks
- Supply risk
  - Quality risk
  - Foreign exchange risk
  - Production risk
  - Market risk
- (ii) Mitigating measures
- Seek long term supply of latex contracts
  - ISO9001 and best practices
  - Enter into foreign exchange contracts with banks
  - Professional and experienced managers
  - Stay ahead with competitors' pricing and conduct research and development