DP03

Principles of Lending

12 OCTOBER 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. (a) Outline and explain the principles of good lending. [15]

   (b) List and briefly explain the 5Cs of credit. [15]

   (Total:30 marks)

2. Bank lending management and theory is largely based on an understanding of the risk-return principle.

   Discuss, with examples, the risk-return principle. (Total:20 marks)

3. In the activities of bank lending, lenders look towards collateral as a second-way out for loan repayment. In the case of quoted shares as collateral, special characteristics apply as opposed to landed properties as collateral.

   In relation to quoted shares as collateral, answer the following questions:

   (a) What does market value of quoted shares mean and where can such values be obtained? [5]

   (b) What is the margin of advance? Illustrate your answer with a simple calculation. [5]

   (c) Should the value of collateral fall below the agreed margin, the lender will request the borrower to top-up the margin.

   Explain what the above statement means and how a top-up could be effected. [5]

   (d) What are **five** credit requirements when accepting shares as collateral? [10]

   (Total:25 marks)

4. (a) Explain the process of a loan review and state its objectives. [10]

   (b) List **five** "red flags" that are symptoms of a weakening credit for each of the following areas:

   (i) Account operations [5]

   (ii) Business operations [5]

   (iii) External factors [5]

   (Total:25 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

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1. (a) The principles of good lending should:
   - reflect national policy.
   - beneficial purpose to the client.
   - ideally be short term to reduce risks.
   - justify the risk-reward function for account profitability.
   - repayment sources to be well defined.
   - well diversified client base/to avoid concentration risk.

   (b) 5Cs of credit:
   - Character.
   - Capacity.
   - Capital.
   - Condition.
   - Collateral.

Question 2

Candidate could not elaborate on the risk-return principle.

2. The risk-return principle represents the basic concept of lending. Students should discuss the underlying theory of banks having the need to maintain a balance between risk-taking and risk-return. Current, theory includes looking at expected default frequency (EDF) and risk adjusted return on capital (RAROC). An elaborate discussion on the risk-return function is found in section 1.3, page 8 of the Bank Lending Assessment and Management textbook.

Question 3

- Candidates could not explain the basic application and guidelines related to share financing.
- Candidates should examine their own financial institution, the rules and regulations on share financing or using listed shares as collateral. With this knowledge, candidates should be able to answer the entire question without difficulties.

3. (a) Market value of quoted shares means the price of the underlying shares which is the collateral value. Quotations on the market price are found from Bursa Malaysia quotations which are displayed on price boards at stockbroking prices. They are also reported in various media, example: internet, newspapers and research homes.

   (b) Denotes the margin which banks are prepared to finance or lend money against. If a share is quoted at a price of RM5.00 per share and if the bank adopts a 50% margin of advance, then the lending limit is RM2.50 based on this margin.

(c) Top-up means reverting to the margin of advance when the margin exceeds the agreed level. This can be caused by a reduction in the market price. Top-up may be effected by cash payment to reduce the loan outstanding, adding more collateral shares or adding some other tangible collateral.

(d) Any five of the following credit requirements:
- Listed shares as opposed to private company shares.
- Good tracking volume.
- Low market beta, i.e. lower volatility shares.
- Execution of Memorandum of Deposit of Shares and power of attorney to allow banks to dispose the shares when conditions are breached.
- Shares that are not overvalued in their prices.
- Not designated counters.

Question 4

4. (a) The process of loan review includes the various activities outlined below:
- Site visit.
- Review of past year's financial results to determine performance and compliance with financial covenants and other covenants.
- Reviewing past conduct of debt repayment.
- Account profitability statement review.
- Review on risk position and pricing.
- Review completeness of documentation and update collateral value, where applicable.

Objectives are basically to determine whether credit risks position has deteriorated, improved or status quo.

(b) (i) Account operations
- Bounced cheques.
- Delay in debt servicing.
- Delay in submitting audited accounts.
- Failure to adhere to principal repayment schedule.
- Failure to comply with covenants.

(ii) Business operations
- One-person management.
- No management succession.
- Reducing profit trend.
- Increasing asset conversion cycle.
- Increasing gearing.

(iii) External factors
- Government legislation affecting business.
- Changes in barriers to entry.
- Changes in technology, taste and demand pattern
- Changes in consumer pattern, demand and taste.
- Changes in marketing and global competition.