

DP03

Principles of Lending

10 MAY 2000

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**.

ANSWER ALL FOUR (4) QUESTIONS

1. The **three** processes in commercial lending are:
- (a) Loan Approval Process [9]
 - (b) Loan Monitoring Process [9]
 - (c) Loan Termination Process [7]

Briefly describe these **three** processes.

(Total:25 marks)

2. Siam Plastic Moulding Company is an original equipment manufacturer (OEM). It manufactures OEM parts for the domestic automobile industry. It buys raw materials from Japan and manufactures the finished products at its plant in Shah Alam Industrial Park. The plant capacity is running at almost maximum levels and given the economic recovery, the company plans to increase its capacity by another 200,000metric tonnes. Lately, the company is looking at the export market for its products, which received many enquiries via its e-commerce website.

The company employs **2,000** workers on **two** shifts and currently does its payroll manually. Workers are paid in cash at the premises each month. The company's accountant is complaining of the inefficient method of administering payroll and hopes for a more effective solution.

You are required to identify the suitable banking products and services that you can market to Siam Plastic Moulding Company. In your answer, you should briefly describe the features and applications of these banking products and services.

(Total:25 marks)

3. (a) State **ten** possible causes of problem loans. [10]
- (b) Explain with examples, how loan recovery is carried out by the bank under:
- (i) negotiated workout [6]
 - (ii) liquidation of collateral [6]
 - (iii) judgement under legal process. [3]

(Total:25 marks)

4. As a credit officer, describe how you would analyse the financial statements of a company, to assess its suitability for credit accommodation.

In your answer, you are required to construct a simple (single period) pro-forma Balance Sheet and Profit and Loss Statement and illustrate the calculations of the ratios used with a brief explanation of how the ratios can be used for credit assessment.

(Total:25 marks)

OUTLINE ANSWERS

Question 1

The answers received were average and lacked sufficient depth in describing the processes in lending activities. A few students lost marks when they only answered the 5Cs and omitted issues covering the amount of loan, interest rates, covenants and, other terms and conditions in the approval stage.

1. Essentially the answer should cover a discussion of the issues outlined below:

(a) **Loan Approval Process**

Approval Criteria

- (i) Value of client relationship
 - Is this an existing customer or a new customer?
 - What is his/her background?
 - Is this the right type of client?
 - Am I interested in offering the loan?
- (ii) Financial statement benchmarks
Ask for financial statement to check on the company's past and present performances.
- (iii) Strategic factors
 - What is the strategic plan for such a loan?
 - What direction is the business heading for?
- (iv) Quality of management
 - How strong is the management?
 - Is there any successor (if necessary)?
- (v) Risk exposure
The risk exposure of the financial institution, such as:
 - Is the risk too high?
 - Is the loan amount too large?
- (vi) Industry and economic outlook
What is the expected outlook for the industry in particular, or for the economy as a whole for this year and the coming year?
- (vii) Other factors
 - How is the customer's reputation in the market?
 - Is there any technical agreement?

If the answers are mostly unfavourable, the loan officer should reject the loan application without unnecessary delay.

If the loan officer decides to accept the application, he must work out the following:

- Amount of loan – the commitment.
- Interest rate – how much to charge?
- Security – negotiate for collateral.
- Loan covenants – control mechanisms in the credit.
- Other conditions.

Examples:

- Request for injection of capital; or
- Dividend restriction, i.e. shall not declare dividends without the consent of the lender; or
- Other conditions.

When all these requirements have been met and approval has been obtained from the loan committee, an offer letter will be issued for acceptance by the applicant. Once the customer accepts it, the drawdown will begin when all conditions precedent to the drawdown have been met and the loan monitoring process will start.

(b) **Loan Monitoring Process**

(i) Variables

- Timing of interest and principal repayments – to ensure that, on due-date the interest and principal sum have been serviced accordingly without default.
- Value of assets held as security – from time to time (or when necessary), a revaluation on the assets is required. This ensures that the value of these assets will remain stable and does not fall below the security cover level.
- Compliance with covenants – to ensure that the company has understood and complied with the rules in the loan agreement. Default arises when non-compliance occurs.

(ii) Loan Classification

- Current – when payment (principal plus interest) is always prompt and up-to-date, such a loan account is considered as current.
- Special mentioned – always delayed by one or two months. The borrower has the ability to pay but slightly reluctant to pay.
- Substandard – loans that have been poorly designed or granted unwisely. However, such loans have not turned into doubtful loans yet.
- Doubtful – possibility of non-recovery.
- Loss – loans that are confirmed non-recoverable.

(iii) Loan Restructuring Decisions

When a loan is classified under “Loan Classification” items (point 2 and 5), there may be a need to restructure the loan. Restructuring may involve a change in the payment terms.

(c) **Loan Termination Process**

(i) Accounting for loan

After restructuring the loan, the loan officer will try to terminate the loan, either by:

- completing repayment; or
- writing-off part or whole of the interest and principal amount.

(ii) Relationship with client

After the loan has been settled, the lender will choose either to:

- continue, e.g. roll-over the loan; or
- discontinue and close the account.

Question 2

The question on recommending the correct loan products and services to the case was the weakest attempted question. Only a few candidates passed this particular question. Some candidates went totally off-course by providing a marketing plan.

2. An abbreviated answer is presented in a tabular form below. Candidates however are expected to elaborate further.

	Products and Services	Features and Applications
(i)	Payroll management	Part of a cash management product which banks are offering to generate fee-based income.

(continued)	Products and Services	Features and Applications
(ii)	Letter of credit facilities	Both sight and issuance LCs depending on sellers terms. Need for importation of raw materials.
(iii)	Bankers Acceptances' (BAs) and Trust Receipts (TRs)	Bridge facilities for completion of asset conversion cycle before cash is received from sales.
(iv)	Term loans	For fixed asset financing as company appears to need machinery purchase.
(v)	Overdraft or Revolving Credit	To meet short-term operation needs and to bridge working capital shortfall. For payment of salaries and overheads costs.
(vi)	Local bills discounting	Can be used for domestic sales financing.
(vii)	Shipping guarantees	For customs guarantee to clear goods in the event documents of trade are not available or delayed.
(viii)	Foreign exchange line	To hedge payments for importation and also for subsequent export proceeds denominated in foreign currencies.

Under today's cross-selling concept, the bank may also offer housing loans, credit cards, ATM cards, savings accounts and current accounts to the companies 2,000 employees.

Furthermore, if these employees are also foreign workers, remittance services will be in demand as well.

Likewise, for candidates from finance companies, they may include products such as industrial hire-purchase, leasing and term loans.

Merchant banking specialised products such as NIF, RCIFs may however be unsuitable as an answer to this question.

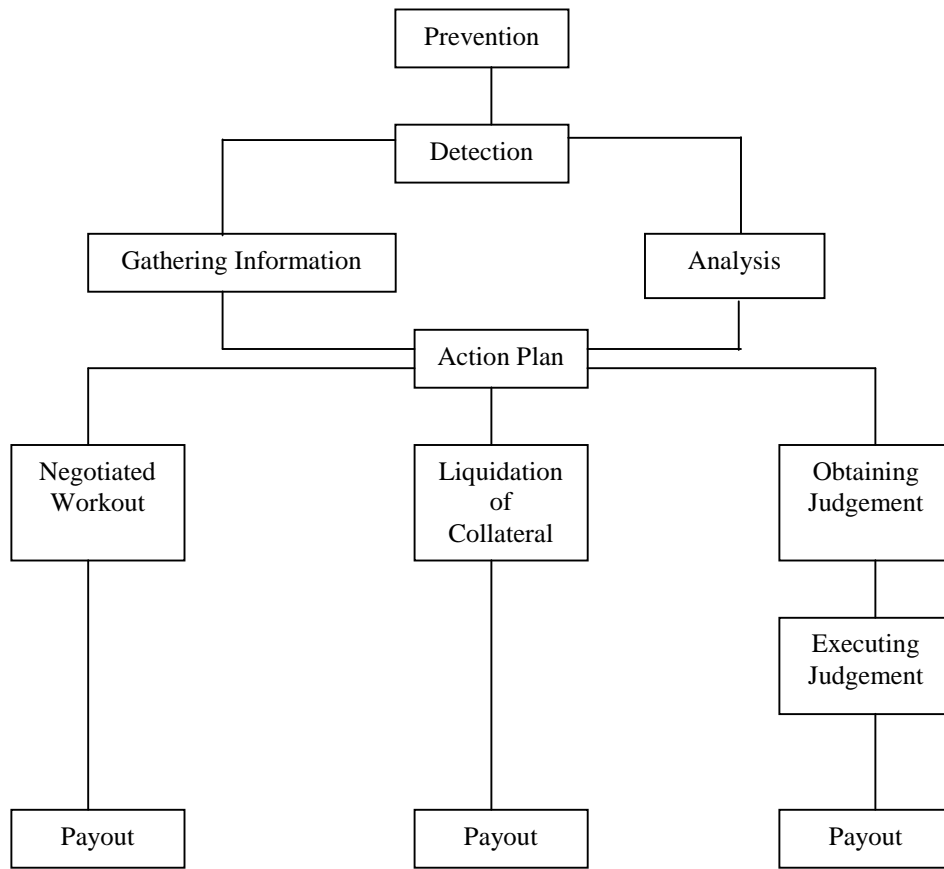
Question 3

The question on causes of problem loans and loan recovery was generally well-answered. Most candidates had a sound understanding of the topic, which led to them scoring above 60% of the allocated marks for this particular question.

3. (a) The answer should revolve around the factors contributing to the causes of distressed loans. The factors are listed below: *(Select any **ten** causes)*
- (i) Failure to know the borrower and understand his/her business.
 - Lender performing a "remote control analysis" without visiting the borrower in recommending a credit.
 - Failure to understand the business cycle.
 - Failure to verify information from the borrower.
 - Failure to know the background of the borrower, including his/her present credit standing and legal status.
 - (ii) Failure to obtain sufficient information prior to making the initial loan decision, may cause insufficient/improper credit analysis and failure to identify weaknesses/risks in the loan.
 - (iii) Failure to know the degree of realisability of the collateral taken and failure to obtain a valid security interest-documentation.

- (iv) Failure to supervise utilisation of loan process.
 - Purpose of the drawing utilised not in accordance with the purpose stated in the loan agreement.
 - Non-compliance of the pre-drawdown conditions. However, the lender nevertheless proceeds to release the facility.
- (v) Lack of adequate follow-up procedures.
 - Failure to conduct internal review.
 - Internal review system is inadequate.
 - Lack of staff to handle the monitoring process.
- (vi) Failure to recognise early symptoms and adverse signals or “red flags”.
- (vii) Procrastination in taking action on problem loans, e.g. the lender is slow in the negotiation process.
- (viii) Over generosity
Failure to understand the lending rationale. The lender has recommended a wrong credit structure either by giving excess requirements or unmatched loan product or tenure.
- (ix) Neglect of details
In order to protect the bank’s interest all information, including terms and conditions in an offer letter and details in a loan agreement, must be clearly understood and properly documented.
- (x) Inadequate assessment of the management’s depth of the borrower.
- (xi) Accepting appraisal of collateral based on development value. The lender fails to request for a value based on the “as-is-value” basis, and accepts a value based on future development. This is only a potential value upon occurrence of future events and, thus, cannot be used as the value of a security.
- (xii) Breach of basic lending principles.
- (xiii) Ignorance of the impact of an economic cycle.
- (xiv) Lure of short-term deposits and other business trade-offs, such as corporate finance work in the case of merchant banks.
- (xv) Too “collateral oriented” rather than “cash flow oriented”. Failure to recognise the importance of sources of repayment.
- (xvi) Gaps in credit training. The lender’s knowledge and skills have not been updated after a certain duration. It may not be sufficient to use old techniques to solve new problems.

(b) The framework of a typical recovery process is illustrated as follows:



In committing a loan, the banker's main objective is to obtain full payout (principal sum and interest element). However, if the payout fails to follow the normal course of repayment, then it will be collected through the legal process whereby:

- (i) the main objective is still to obtain full recovery plus the interest portion; and
- (ii) to maximise the recovery rate with minimal costs in the shortest possible time when (i) becomes unattainable.

Under a **negotiated workout**, the bank may elect to restructure the loan by revising the repayment terms and maturity to be in line with the company's reduced cash flow position. Other variations may include a concession interest rate period, or a grace period on the principal repayment. Under certain circumstances, the lender may even accept a haircut on principal in exchange for cash settlement outright. The current methodology is also to include a computation of debt restructuring losses calculated from the future repayment cash flows discounted to present value using present interest rates level.

Liquidation of collateral would entail immediate realisation of pledged security which may include fixed deposits, quoted shares or landed properties. Given that loan agreements would accord the right of liquidation of collateral, banks may uplift fixed deposits or give the appropriate notices and dispose quoted shares to generate cash for loan set-off. Landed properties may be sold by private treaty or public auction.

In the case of an evasive and uncooperative borrower, the lender may elect to file court action for enforcement of debt. The common routes available are bankruptcy proceedings for individual borrowers and winding up petition for companies. In some cases, banks may apply for garnishment order if they discover that the defaulter or guarantor have monies stashed away and not using it to repay their debt obligations.

Question 4

Candidates excelled in the question where they were required to present a financial statement, evaluate the financial strengths and creditworthiness and provide brief explanations to ratio analysis. Most of the candidates passed this question with above average marks, with the exception of a few candidates who answered poorly.

4. Coverage of the financial statement analysis should include:

- (i) Liquidity position analysis, i.e. current and quick ratio.
- (ii) Financial performance, i.e. profitability analysis covering Return on Equity, Return on Asset, Return on Sales, Asset Turnover, Gross Profit Margins and Net Profit Margins.
- (iii) Solvency position as to gearing and asset conversion where appropriate.

Candidates are expected to show calculations followed by an overall analysis statement as to the company's creditworthiness (using their own set of numbers presented in the Balance Sheet and Profit and Loss Accounts).

Descriptions and explanations as to each ratio used are expected as completeness of the answer.