

DP03

Principles of Lending

10 OCTOBER 2001

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. A blank page is provided at the end of the question paper for rough work.

ANSWER ALL FOUR (4) QUESTIONS

1. Develop a framework for evaluating creditworthiness of borrowers. The framework should be structured around the 5Cs of credit. (Total:20 marks)

2. (a) List the main components of a marketing plan for promotion of banking products and services. [5]
(b) Briefly describe each of these components in (a) above. [15]
(Total:20 marks)

3. (a) List the symptoms of a weakening credit. [15]
(b) (i) What are the likely causes of problem loans? [7]
(ii) What should credit officers do to minimise problem loans? [8]
(Total:30 marks)

4. Interglobal Blaster Sdn Bhd (Interglobal) is a company specialised in the geotechnical infrastructure engineering business. Interglobal's operations include underground drilling of sewage connection tunnels, maintenance of wastewater treatment plants, building of dams and infrastructure tunnelling.

Lately, Interglobal was awarded two contracts by the KL Metropolitan Authority (KLMA), to carry out tunnelling works for underground wastewater collection from city road drainage and commercial building wastewater discharge. The contracts are valued at RM150million and completion period is over 36 months from date of award.

To fulfil this contract, Interglobal needs to purchase specialised micro-tunnelling equipment from Germany. This equipment allows for tunnelling to be done on public roads without excessive disruption to traffic flow. The approximate cost is DM5million and purchase is only on sight terms against letters of credit. KLMA also requires performance bonds and advance payment bonds to be issued to them.

The following are financial statements of Interglobal:

BALANCE SHEET AS AT 31 DECEMBER

Item	1999 RM'000	2000 RM'000
Cash	50,334	56,847
Trade debtors	26,247	82,185
Intercompany	10,594	4,013
Income receivable	23,000	0
Advance payment receivables	3,424	3,451
Interest receivables	89,611	328
Stocks	20,569	28,584
Work in progress	74,463	106,484
Other current assets	38,847	34,636
Total Current Assets	337,089	316,528
Land	44,275	44,275
Other depreciable fixed assets	159,530	169,656
Less: Depreciation	105,785	127,803
Total Fixed Assets	98,020	86,128
Other non-current assets	305,006	268,813
TOTAL ASSETS	740,115	671,469
Overdraft	5,651	6,529
Accounts payable	65,259	148,777
Accrued liabilities	58,500	33,983
Interest payable	43,707	1,565
Total Current Liabilities	173,117	190,854
Long-term debts	584,438	293,208
Total Liabilities	757,555	484,062
<u>Networth</u>		
Issued capital	100,000	175,000
Retained earnings	(117,440)	12,407
Networth	(17,440)	187,407
TOTAL LIABILITIES & NETWORTH	740,115	671,469

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31 DECEMBER

Item	1999 RM'000	2000 RM'000
Turnover	173,787	120,780
Gross profit	29,700	13,518
Operating expenses	17,465	18,729
Operating profit	12,235	(5,211)
Interest income	50,567	14,426
Earnings before interest and tax	62,802	9,215
Interest expense	51,791	3,966
Profit before tax	11,011	5,249
Tax	3,709	0
Profit after tax	7,302	5,249
Extraordinary item	0	124,598
NET PROFIT	7,302	129,847

Answer all questions below relating to the above case:

- (a) List **two** key credit risks associated with Interglobal. [5]
- (b) Suggest **two** banking products suitable for financing of Interglobal's business. [5]
- (c) Why would KLMA require a performance bond from Interglobal? [5]
- (d) Fill in the blanks in respect the following financial ratios:

Ratio	1999	2000
Working capital		
Current ratio		
Gearing		
Stock in days (Asset Conversion Cycle)		
Receivables in days (Asset Conversion Cycle)		

[10]

- (e) What is a cashflow statement and why is it necessary in analysing loan repayment? [5]
(Total:30 marks)

- END OF QUESTION PAPER -

OUTLINE ANSWER

Question 1

This question on evaluating creditworthiness of borrowers was well answered by most candidates.

1. Candidates' answers should be centred on the principles of the 5Cs, i.e. Character, Capacity, Capital, Conditions, and Collateral. Full details are found under Section 6.3, page 86 of "Bank Lending-Assessment & Management" by Howard Choo.

Question 2

This question on marketing plan for promotion of banking products and services was not well answered. Some candidates mistook the marketing plan for business development sources.

2. The main components of a marketing plan are:
 - identify customers' needs and requirements
 - identify customers' expectations
 - communication plan
 - delivery and implementation plan
 - financial impact

Question 3

This question on weakening credit and problem loans was well answered by most candidates.

3. (a) Symptoms of a weakening credit are categorised into three types, i.e. from account operations, business operations, and external environment. Full details are found in section 12.3, page 167 of "Bank Lending-Assessment & Management" by Howard Choo.
- (b) (i) Possible causes of problem loans are:
 - failure to know the customers and their business;
 - failure to obtain sufficient credit information prior to making the approval;
 - failure to supervise loan disbursement for the intended purpose;
 - lack of loan supervision;
 - failure to recognise 'red flags';
 - breach of sound lending principles; and
 - ignorance on impact of economic cycle.
- (ii) To minimise problem loans, officers must comply with the lending criteria of the 5Cs in making loans, followed by the methodology of loan review and supervision. They, at the same time, must have loan surveillance systems to detect any 'red flags' and respond quickly to loans downgraded arising from delayed payments or qualitative downgrading. Any problem loans should be dealt with quickly at its early stage.

Question 4

Most candidates were able to compute the required ratios. The remaining part of this question on ratio analysis and interpretation of financial statements in credit analysis was generally well answered.

4. (a) Performance risk and Payment risk.
- (b) Performance bond, advance payment bond, short-term loans, project finance loans, letters of credit, trusts receipts.

(c) As financial compensation should, Interglobal fails to perform according to the terms of the contract.

(d)

Ratios	1999	2000
Working capital	163,972,000	125,674,000
Current ratio	1.95	1.66
Gearing	(43.4)	2.58
Stock in days (ACC)	43	86
Receivables in days (ACC)	55	248

(e) Cash flow statements represent an analysis of the stream of future earnings against operating costs and debt repayment. The analyses will indicate the debt service capability and the cumulative cash flows before and after the financial obligations are made.

Cash flow statements will allow for scenario testing as part of credit analysis.