

DP03

Principles of Lending

11 OCTOBER 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. In every lending decision, credit officers refer to a principle of lending known as the 5 Cs of credit.
- (a) What is the relevance of this principle in a loan evaluation process? [5]
- (b) Explain with details, the 5 Cs of credit. [15]
(Total:20 marks)

2. Explain, using a diagram, the **four** stages of a loan-life cycle. Your answer should also include the purpose and functions at each stage.
(Total:25 marks)

3. Loans default eventually leads to non-performing loans (NPLs). NPLs erode into the profitability of banks as well as endanger their shareholders' funds. To this end, banks have set up Risk Management Departments to monitor credit quality and to take early preventive actions to control NPLs.

One of the methodologies of monitoring credit quality is to be able to identify early warning signals, commonly known as red flags, or the symptoms of a weakening credit. Identify and describe examples of red flags in the following **three** categories:

- (a) Account operations [8]
- (b) Business operations [9]
- (c) Environment [8]
(Total:25 marks)

4. (a) Asia Paper Bag Sdn Bhd has since 1990 operated as a manufacturer of plastic carrier bags supplying them on a contract-manufacturing basis to well-known supermarket chains, fast-food outlets, pharmacies and department stores. Lately, Asia Paper Bag Sdn Bhd exports customised plastic carrier bags to Marks n Spencer and Boots Pharmacy in the United Kingdom.

During the Asian financial crisis, Asia Paper Bag Sdn Bhd had difficulties in meeting its term loan repayment, and had to restructure the term loan last year. The term loan was restructured by way of a debt moratorium of **24** months on the principal and an extension of the maturity period from **five** years to **eight** years.

Currently, Asia Paper Bag Sdn Bhd's turnover is about RM3million per month with an average net profit margin of 7%. Lately, with the increase in world oil prices, raw materials for plastic bag production have increased by over 5% to USD1,200 per tonne. Asia Paper Bag Sdn Bhd's capacity utilisation is still low at only 40%, after it expanded rapidly pre-crisis. Asia Paper Bag Sdn Bhd's production capacity increased from 200,000tonnes per annum to 350,000tonnes per annum during the pre-crisis period. This was when the company borrowed a term loan of RM10million to finance the machinery. The raw materials, PE resins, are purchased mainly from Singapore and Thailand, whilst only 15% is sourced domestically.

From the case study above, answer the following questions:

- (i) List the qualitative risks of Asia Paper Bag Sdn Bhd in relation to bank lending. [10]
- (ii) List and explain the appropriate financial ratios to analyse the financial performance (profitability) of Asia Paper Bag Sdn Bhd. [10]
- (iii) State the motives for using ratio analysis as a credit evaluation tool. [5]
- (b) Outline the key issues in support of a debt restructuring. [5]
(Total:30 marks)

OUTLINE ANSWERS

Question 1

The question on the 5 Cs of credit was the best attempted question. Almost all the candidates managed to pass this question. The concept was generally well understood by most students.

1. (a) The principle of the 5 Cs of credit is to establish the creditworthiness of a borrower. The concept if correctly applied seeks to evaluate the key criteria of repayment ability, by analysing the stream of cash flows, the character of financial discipline, the financial health of the borrower and other qualitative factors.

(b) The 5Cs of credit are:

Character

The character of the borrower indicates two things: the ability to pay versus the willingness to pay. The ability to pay refers to the 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 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.

Conditions

Condition refers to the macroeconomic environment. For example, if the loan is needed for setting up a retail business in a particular area, then the lender must make a study of the economic conditions (the degree of propensity to spend by residents in that 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.

It is widely practiced that different weightings or emphasis are allocated to these factors. Generally, the percentages are:

- Character 30 percent
- Capacity 30 percent
- Capital 20 percent
- Conditions 10 percent
- Collateral 10 percent

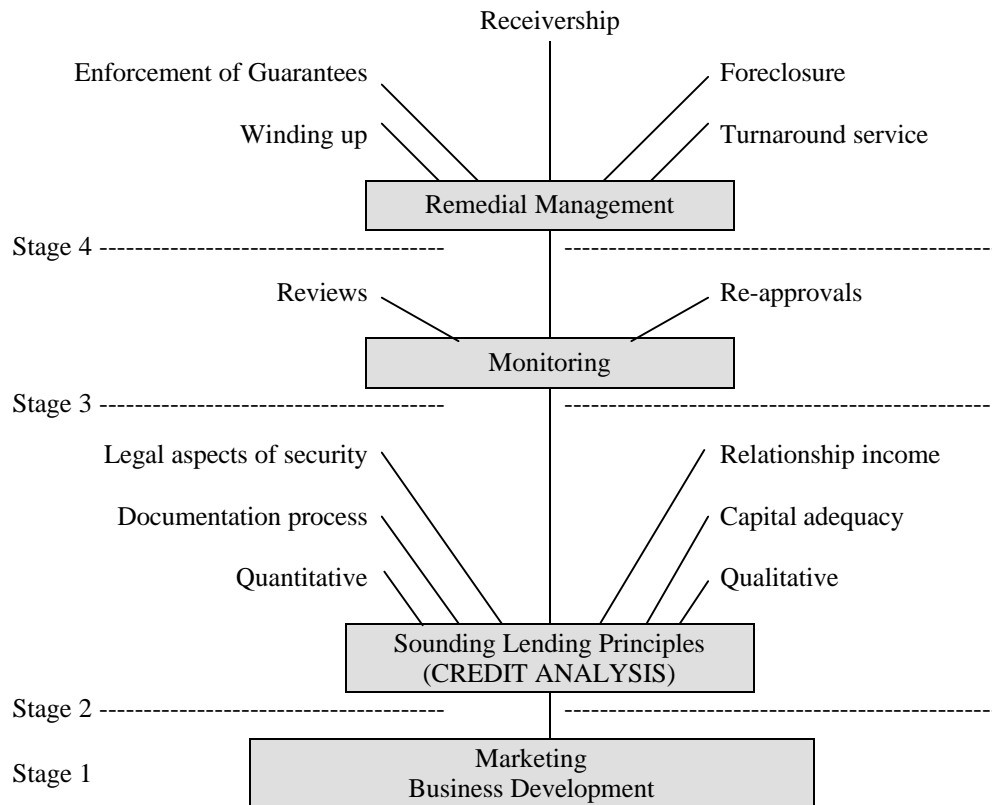
Question 2

A poorly answered question was on the four stages of a loan life-cycle. Only a handful of candidates were able to draw the loan life-cycle diagram and provide satisfactory explanation. Some candidates were completely confused and ended up drawing the product life-cycle instead.

2. The Life Cycle comprises four stages. They are:

- Stage 1 Business Development
- Stage 2 Credit Evaluation
- Stage 3 Loan Administration
- Stage 4 Loan Recovery

The Lending Process Tree



We would expect a loan to be repaid in the normal course of its life. If this happens, Stage 3 forms the completion of the loan cycle. However, in certain cases, loan repayment has to be pursued through the legal process. This is Stage 4 of the loan cycle.

The following section outlines the activities within each cycle.

There are four main stages in a lending process. The credit officer will first market for potential business opportunities (Stage 1 – Marketing). Having identified the potential borrowers, he will then do a credit analysis. To be effective, he must know what the sound lending principles are (Stage 2 – Credit Analysis). Once the loan has been approved, monitoring is necessary (Stage 3 – Loan Administration). If the borrower fails to fulfil his obligations, the credit officer will have to study the possible remedial action needed to be adopted, i.e. the remedial management (STAGE 4 – LOAN RECOVERY).

Stage 1: Business Development and Marketing

Through the selling cycle, lenders initiate the lending process.

Stage 2: Sound Lending Principles/Credit Analysis

- (a) **Quantitative**
Be able to read and analyse the financial statement (e.g. cash flows and ratios of a company).
- (b) **Qualitative**
Be able to understand the environment and trend of business.
- (c) **Documentation Process**
Be able to execute proper documentation on the collateral held.
- (d) **Legal aspect of security**
Be able to understand the procedures involved in taking debentures or a lien on fixed deposits and how to perfect a legal charge.
- (e) **Relationship Income**
Be able to analyse the profitability of the business.
- (f) **Capital Adequacy**
Be able to maintain a minimum of 8 percent ratio of equity capital to total risk-weighted loan assets.

Stage 3: Monitoring

A review is to be carried out on a yearly basis. Upon re-approval, should there be changes to certain terms and conditions, an Offer Letter will be sent to the borrower for his acceptance of the renewed facility.

Stage 4: Remedial Management

- (a) Winding up – winding-up action taken on the company.
- (b) Enforcement of guarantees – to take legal action against the guarantors.
- (c) Receivership – to appoint receivers and managers.
- (d) Foreclosure – eventual recovery by auctioning a landed property.
- (e) Turnaround service – to generate cash flows by salvaging the company.

Question 3

Candidates were required to identify and describe examples of red flags in account operations, business operations and the environment. A few candidates managed to obtain above 80% of the allocated marks for this question.

3. Three red flags are:

Account Operations	Business Operations	Environment
1. Persistent delay in servicing interest.	1. One-person management.	1. Increasing legislation - government implemented more stringent rules and regulations.
2. Failure to adhere to principal repayment schedule.	2. No management succession.	2. Changing demand or trend - unable to adapt to the changes in demand and trend.
3. Cheques issued with insufficient funds.	3. Frequent changes of auditors, to lesser known audit firm resulting in lower standard of reporting system.	3. Changes in entry barriers - lower entry barriers will result in a more competitive environment.
4. Failure to comply with covenants, e.g. financial covenants.	4. No proper accounting records - unable to produce tract record when necessary; and - few management tools.	4. Overall changes in marketing and global competition - emphasis on production efficiency.
5. Lateness in submitting audited accounts.	5. Methods of stock valuation - manipulate financial results by adopting different stock valuation methods to reflect untrue profits.	5. Changes in consumer pattern, demand and taste.
6. Communication difficulties - deteriorating banker-customer relationship; and - poor management communication.	6. Increasing asset conversion cycle - either the stock turnover is slow or the collection period has been lengthened.	6. Changes in technology, resulting in rapid product obsolescence and decay in life-cycle.
	7. Reducing profit trend.	
	8. Increasing gearing - engage into heavier borrowings; - highly leverage, thinly capitalised.	
	9. Increasing bad debts - perhaps due to longer collection period.	

Question 4

The first part of the question was a case study. Many candidates were unable to list the qualitative risks applicable in this case. However, many candidates were able to list and explain the appropriate financial ratios relevant to the case. Some candidates, however, simply quoted formulas, which were not applicable to the case. The second part, part (b), required candidates to outline the key issues in support of a debt restructuring. Despite the past two years of economic and financial crisis, students were unable to learn something from the environment, outside their textbook, and therefore did poorly for this question.

4. (a) (i) Qualitative Risks include:
- raw materials supply risk
 - production quality risk
 - competition risk
 - cost escalation risk
 - environmental risk

- (ii) The ratios to be discussed are:
- Return on sales (ROS)
 - Return on equity (ROE)
 - Return on Assets (ROA)
 - Assets Turnover ratio (ATO)

Students should explain these ratios, indicating the formulae and a brief explanation of what it attempts to measure.

- (iii) The motives for using ratio analysis are:
- to exploit the relationships between ratios and real life situations for predictive analysis.
 - to carry out industry cross-section performance.
 - to qualify and quantify the borrower's performance.

- (b) Key issues to support a debt restructuring are:
- business viability
 - sustainable debt levels
 - sustainable cash flows
 - commitment to honour debt obligations
 - reliable and capable management