

DP03

Principles of Lending

8 MAY 2002

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. The concept of bank lending is premised on an understanding of the risk-return principle. Discuss with illustration, the principle of risk-return. (Total:20 marks)

2. (a) List the 5Cs of credit and explain their relevance in a bank's assessment of borrower creditworthiness. [15]
 (b) Suggest **five** ways of prospecting for potential customers. [5]
 (Total:20 marks)

3. Outline the framework of credit evaluation in commercial lending. Illustrate your answer with a diagram. (Total:20 marks)

4. (a) The following is a balance sheet of a borrower in financial distress. The bank has decided to seek recovery by way of liquidation of the assets of the borrower.

**ABSTRACT OF AUDITED BALANCE SHEET
(NET BOOK VALUE IN RM)**

Fixed Assets :	
Motor vehicles	100,000
Machinery	2,000,000
Current Assets :	
Stocks	4,000,000
Debtors	3,000,000
Cash	100,000
Loan to be recovered	5,000,000

Assumptions:

- Recovery rate for motor vehicles at 70%
- Recovery rate for machinery at 40%
- Recovery rate for stocks at 50%
- Recovery rate for debtors at 70%
- Company withdraws all cash when in distress
- Liquidation and legal fees assumed at 1% of liquidated sum

With the assumptions stated above, you are required to compute a liquidation statement of the borrower to show the realisable value of each asset item, followed by the rate of recovery. [20]

- (b) Briefly explain how a bank can achieve a diversified loan portfolio. [5]
- (c) List **five** terms and conditions found commonly in a typical loan agreement. [5]
- (d) Suggest a checklist for credit officers when interviewing a loan prospect. [10]
 (Total:40 marks)

OUTLINE ANSWER

Question 1

Candidates were unable to fully explain several key theories on risk-return, and omitted to discuss “loan diversification” and “products & location” as means to spread the risks. Few used the diagrams on risk-return to explain the general theory.

1. Students should discuss the general rule of high risk-high return. The argument of commercial banking risks taking and venture capital risks taking should be used as example. The answer is expected to elaborate on the concept of risks diversification to achieve lower risks but maintaining same level of return, or higher return but maintaining the same risks. Answers are extensively discussed on pages 8 to 12 in Bank Lending-Assessment & Management text published by IBBM.

Question 2

Questions on these concepts were well answered. Many candidates were able to list the 5Cs of credit and explain the 5Cs in relevance to assessment of borrowers’ creditworthiness. Candidates were also able list the 5 ways of prospecting for new customers.

2. (a) The 5 Cs are Character, Capacity, Capital, Conditions and Collateral. Please refer to page 86 of Bank Lending-Assessment & Management text for further elaboration.
- (b) Ways of prospecting for potential customers (any **five**):
 - from customers referral
 - from under-utilised accounts
 - from senior management network
 - from commercial organisations
 - competitors of customers
 - suppliers of customers
 - news clippings
 - from professionals, e.g. lawyers, accountants.

Question 3

Candidates who prepared well, scored in this question while ill-prepared candidates gave irrelevant answers and did not discuss the repayment ability.

3. Candidates should explain the basic criteria of repayment ability and the other aspects of credit risks evaluation. Reference should include credit checking, bank statements and conduct of account, and business visits to verify information as part of the credit decision making process. Full answers may be drawn from para 4.2 page 47 of Bank Lending-Assessment & Management text.

Question 4

Most candidates were able to answer satisfactorily all parts of this question.

4. (a) Liquidation Statement in RM
[book value of assets x % recovery rate]

Motor vehicles	70,000
Machinery	800,000
Stocks	2,000,000
Debtors	2,100,000
Cash	0
Total Liquidated Value	4,970,000
Less 1% legal and fees	49,700
Net Recovery Amount	4,920,300
Rate of recovery [4,920,300/5,000,000]	0.98 to the dollar

- (b) A bank can achieve a diversified loan portfolio by:
- by lending to a portfolio of various industry sectors
 - by geographical spread in loans commitment
 - by lending in various financial products.
- (c) Terms and conditions found commonly in a typical loan agreement (the list is not exhaustive but most likely will have the following, choose any **five**):
- purpose
 - amount and currency
 - repayment conditions
 - interest rates
 - prepayment clause
 - fees, costs, and expenses
 - conditions precedent
 - representations and warranties
 - covenants
 - events of default
 - governing laws.
- (d) Checklist for credit officers when interviewing a loan prospect:
- loan amount and purpose
 - proposed primary repayment and sources
 - secondary sources of repayment
 - details of security and coverage
 - details of operations
 - past financial statements
 - character reference of borrower
 - current credit reports and references
 - worst case scenario
 - guarantors
 - strengths and weaknesses of management
 - level of approval required.