COURSE GUIDE

ENT 210
START-UP FUNDING

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INTRODUCTION

ENT 210: Bank Lending and Administration II is a two credit course for students offering B. Sc. Entrepreneurship and Business Management in the School of Management Science.

The course will consist of fifteen (15) units, that is, three (3) modules of five (5) units for each module. The material has been developed to suit undergraduate students in Entrepreneurship and Business Management at the National Open University of Nigeria (NOUN) by using an approach that treats fundamental areas of risk management.

A student who successfully completes the course will surely be in a better position to manage risk exposures of organizations in both private and public organizations.

The course guide tells you briefly what the course is about, what course materials you will be using and how you can work your way through these materials. It suggests some general guidelines for the amount of time you are likely to spend on each unit of the course in order to complete it successfully. It also gives you some guidance on your tutor-marked assignments. Detailed information on tutor-marked assignment is found in the separate assignment file which will be available in due course.

WHAT YOU WILL LEARN IN THIS COURSE

This course will introduce you to some fundamental aspects of Rationale for Credit Administration, Procedure for Credit Administration, Credit Investigation, Decision Criteria in Credit Administration, Criteria for Lending Decisions, Loan Workout Situations, Responsibilities of Loan Workout Personnel, Responsibilities of Bank Lending Officer, Analysis of Financial Statement, Horizontal and Vertical Analysis of Financial Statement, Ratio Analysis of Financial Statement, Asset and Liability Management in Banks, Investment Securities of Banks, and Investment in Loans By Banks.

COURSE AIMS

The course aims, among others, are to give you an understanding of the intricacies of risk management and how to apply such knowledge in managing risk exposures in both private and public enterprises.

The Course will help you to appreciate Rationale for Credit Administration, Procedure for Credit Administration, Credit Investigation, Decision Criteria in Credit Administration, Criteria for Lending Decisions, Loan Workout Situations, Responsibilities of Loan Workout Personnel, Responsibilities of Bank Lending Officer, Analysis of Financial Statement, Horizontal and Vertical Analysis of Financial Statements, Ratio Analysis of Financial Statement, Asset and Liability Management in Banks, Investment Securities of Banks, and Investment in Loans By Banks.

The aims of the course will be achieved by:

- Identifying and explaining Rationale for Credit Administration;
- Explaining the Procedure for Credit Administration;
- Identifying and explaining Credit Investigation;
  Highlighting and discussing Decision Criteria Credit Administration;
- Explaining Loan Workout Situations;
  Listing and Discussing Responsibilities of Loan Workout Personnel;
  Listing and Discussing Responsibilities of Bank Lending Officer;
- Presenting Analysis of Financial Statements;
  Presenting Horizontal and Vertical Analysis of Financial Statements;
- Presenting Ratio Analysis of Financial Statements;
- Discussing Asset and Liability Management in Banks;
- Analyzing Investment in Securities by the Banks; and
- Analyzing Investment in Loans by the Banks.

COURSE OBJECTIVES

By the end of this course, you should be able to:

- Identify and explain Rationale for Credit Administration;
- Explain the Procedure for Credit Administration;
- Identify and explain Credit Investigation;
- Highlight and discuss Decision Criteria Credit Administration;
- Explain Loan Workout Situations;
- List and Discuss Responsibilities of Loan Workout Personnel;
- List and Discuss Responsibilities of Bank Lending Officer;
- Present Analyze of Financial Statements;
  Present Horizontal and Vertical Analysis of Financial Statements;
- Present Ratio Analysis of Financial Statements;
- Discuss Asset and Liability Management in Banks;
- Analyze Investment in Securities by the Banks; and
- Analyze Investment in Loans by the Banks.

WORKING THROUGH THIS COURSE

To complete this course, you are required to read all study units, attempt all the tutor-marked assignments and study the principles and practice of lending and credit administration in this material provided by the National Open University of Nigeria (NOUN). You will also need to undertake practical exercises for which you need access to a personal computer running Windows 95.

Each unit contains self-assessment exercises, and at certain points during the course, you will be expected to submit assignments. At the end of the course is a final examination. The course should take you about a total of 17 weeks to complete. Below are the components of the course, what you have to do, and how you should allocate your time to each unit in order to complete the course successfully on time.

COURSE MATERIALS

Major components of the course are:

- Course Guide
- Study Units
- Textbooks
- Assignment file

STUDY UNITS

The study units in this course are as follows:

Module 1

Unit 1 Rationale for Credit Administration
Unit 2 Procedure for Credit Administration
Unit 3 Credit Investigation
Unit 4 Decision Criteria in Credit Administration
Unit 5 Criteria for Lending Decisions

Module 2

Unit 1 Loan Workout Situations
Unit 2 Responsibilities of Loan Workout Personnel
Unit 3 Responsibilities of Bank Lending Officer
Unit 4 Analysis of Financial Statement
Unit 5 Horizontal and Vertical Analysis of Financial Statement

Module 3

Unit 1 Ratio Analysis of Financial Statement
Unit 2 Asset and Liability Management in Banks
Unit 3 Investment Securities of Banks
Unit 4 Investment in Loans by Banks

ASSIGNMENT FILE

In this course, you will find all the details of the work you must submit to your tutor for marking. The marks you obtain for these assignments will count towards the final mark you obtain for this course. Further information on assignments will be found in the assignment file itself and later in the section on assessment in this course guide. There are 15 tutor-marked assignments in this course; the student should attempt all the 15.

PRESENTATION SCHEDULE

The presentation schedule included in your course materials gives you the important dates for this year for the completion of tutor-marked assignments (TMAs) and attending tutorials. Remember, you are required to submit all your assignments by the due date. You should guard against falling behind in your work.

ASSESSMENTS

There are two aspects to the assessment of the course: first are the tutor-marked assignments; and second is a written examination.
In tackling the assignments, you are expected to apply information, knowledge and techniques gathered during the course. The assignments must be submitted to your tutor for formal assessment in accordance with the deadlines stated in the ***Presentation Schedule*** and the ***Assignment File***. The work you submit to your tutor will count for 30% of your total course mark.

At the end of the course, you will need to sit for a final written examination of 'three hours' duration. This examination will also count for 70% of your total course mark.

TUTOR-MARKED ASSIGNMENT (TMAs)

There are fifteen tutor-marked assignments in this course and you are advised to attempt all. Aside from the course material provided, you are advised to read and research widely using other references (under further reading) which will give you a broader viewpoint and may

provide a deeper understanding of the subject. Ensure all completed assignments are submitted on schedule before set deadlines. If for any reasons, you cannot complete your work on time, contact your tutor before the assignment is due to discuss the possibility of an extension. Unless in exceptional circumstances, extensions may not be granted after the due date for the submission of the assignments.

FINAL EXAMINATION AND GRADING

The final examination for this course will be of 'three hours' duration and have a value of 70% of the total course grade. All areas of the course will be assessed and the examination will consist of questions, which reflect the type of self-testing, practice exercises and tutor-marked problems you have previously encountered. All areas of the course will be assessed.

Utilise the time between the conclusion of the last study unit and sitting for the examination to revise the entire course. You may find it useful to review your self-assessment tests, tutor-marked assignments and comments on them before the examination.

COURSE MARKING SCHEME

The work you submit will count for 30% of your total course mark. At the end of the course, you will be required to sit for a final examination, which will also count for 70% of your total mark. The table below shows how the actual course marking is broken down.

Table 1 Course Marking Scheme

ASSESSMENT	**MARKS**
Assignment 6 (TMAs)	4 assignments, best 3 will be used for the Continuous Assessment
Final Examination	70% of overall course marks
Total	**100% of course marks**

ASSIGNMENT FILE

Unit	Title of work	Weeks activity	Assessment (end of unit)
1	Rationale for Credit Administration	1	
2	Procedure for Credit	1	
3	Credit Investigation	1	
4	Decision Criteria in Credit	1	
5	Criteria for Lending Decisions	1	
6	Loan Workout Situations	1	
7	Responsibilities of Loan Workout	1	
8	Responsibilities of Bank Lending	1	
9	Analysis of Financial Statement	1	
10	Horizontal and Vertical Analysis of Financial Statement	1	
11	Ratio Analysis of Financial	1	
12	Asset and Liability Management in	1	
13	Investment Securities of Banks	1	
14	Investment in Loans by Banks	1	
15		1	
	Revision		
	Total	**15**	

TUTORS AND TUTORIALS

There are 15 hours of tutorials provided in support of this course. You will be notified of the dates, times and location of these tutorials, together with the names and phone numbers of your tutor, as soon as you are allocated a tutorial group.

Your tutor will mark and comment on your assignments, keep a close watch on your progress and on any difficulties you might encounter as they would provide assistance to you during the course. You must submit your tutor-marked assignments to your tutor well before the due date (at least two working days are required). They will be marked by your tutor and returned to you as soon as possible. Do not hesitate to contact your tutor by telephone, e-mail, or discussion group if you need help.

The following might be circumstances in which you would find help necessary, when:

- you do not understand any part of the study units or the assigned readings.
- you have difficulty with the self-tests or exercises.
- you have a question or problem with an assignment with your tutor's comment on an assignment or with the grading of an assignment.

You should try your possible best to attend the tutorials. This is the only chance to have face-to-face contact with your tutor and to ask questions which are answered instantly. You can raise any problem encountered in the course of your study. To gain the maximum benefit from course tutorials, prepare a question list before attending them. You will learn a lot from participations in discussions.

SUMMARY

ENT 210: Bank Lending and Administration II intends to expose the undergraduate students to the fundamentals of credit investigation and workouts management by commercial and other banks in the process of their financial intermediation in the economy. Upon completing the course, you will be equipped with the necessary knowledge required to produce a good research work.

We hope you enjoy your acquaintances with the National Open University of Nigeria (NOUN). We wish you every success in the Future.

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MODULE 1

UNIT 1 RATIONALE FOR CREDIT ADMINISTRATION

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2.0 Objectives
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 3.1 Rational for Credit Administration
 3.2 Reasons for Credit Administration
4.0 Conclusion
5.0 Summary
6.0 Tutor-Marked Assignment
7.0 References/Further Reading

1.0 INTRODUCTION

In the first stanza of this course, you have been introduced to the objectives of lending and credit administration. This initial study unit of this second stanza of the course serves more or less the same purpose. This is because lending refers to credit facilities being offered by commercial banks to business entities in the economy. Lending of funds to bank customers involves the use of the depositors' money for credit facilities. Therefore, the recoveries of funds from loans and advances granted out to customers must be managed to safe guide bank liquidity position. This implies that recoveries of funds under credit facilities to customers should be managed effectively in order to secure the interest of the depositors. Therefore, this study unit is used to discuss the rationale for instituting relevant steps towards effective management of bank credits.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- discuss the rationale for credit administration
- list and explain factors influencing credit administration

3.0 MAIN CONTENT

3.1 Rationale for Credit Administration

You will recall that the major operational business of commercial banks revolves around financial intermediation. In carrying out this business the banks would source for funds from various members of the public. The funds of the customers are held in safekeeping of the banks and

therefore, such funds must be made available to the depositors whenever they demand for them.

This implies that banks must strive to ensure that the funds are available for payments to the depositors on periodic basis for their needs and commitments. In the process of performing the other aspect of financial intermediation, the commercial banks usually keep the interest in uppermost consideration so as to discharge their delicate function efficiently.
In the process of lending depositors' funds to customers, the banks normally ensure that their recoveries from loans and advances granted out to customers must be managed in such a manner that their operations would not run into murky waters. In performing such function of lending funds to customers the banks usually take necessary steps to protect the interest of the depositors.

While trying to maintain a delicate balance between recovery of loans and advances and periodic payments to the depositors, the banks usually institute appropriate measures to safeguard their position with regards profitability and survival. Based on this discussion, it is possible to identify the basic reasons for the management of lending and credits by the banks, which are critical to their operations.
The rationale for effective management of credits by the banks revolves around reasons such as the following:

- Safeguarding the funds of the depositors;
- Generating enough funds to meet depositors' demands;
- Ensuring their profitable operations;
- Protecting the interest of their shareholders;
- Ensuring efficient administration of lending and credits;
- Ensuring positive capital base for their operations;
- Protecting the values of the shares in the capital market;
- Properly aid the growth of industrial undertakings; and
- Creating conducive environment for economic development.

You will observe from above that the need for the commercial banks to manage their loans and advances effectively cannot be over-emphasized. The subsequent discussion in this study unit is devoted to the objectives of lending and credit administration.

SELF-ASSESSMENT EXERCISE 1

Mention the reasons which inform credit administration by commercial banks.

3.2 Factors Influencing Credit Administration

1. Liquidity of the Bank

One of the factors influencing credit administration is the bank liquid position in terms of meeting the regular demands of the depositors. This is the uppermost objective in bank lending because banks only make use of depositors' money for business. And since such depositors are entitled to their funds as often as they so desire, banks lend money for a short time in most cases.

This is informed by the fact that the banks only lend money which is generated mainly from the deposits which can be withdrawn at any time by the depositors. Basically, therefore, banks advance loans from the deposits on the consideration that their collection will be effected on periodic basis. Furthermore, the major consideration in government securities is that the investment in treasury bills and certificate is secured and they can be easily marketable and convertible into cash at a short notice.

2. Prompt Repayment of Loans

Another issue in credit administration is to ensure that the funds committed into loans and advances are promptly repaid by the beneficiaries. Banks always ensure that the depositors' money is safe in the sense that the borrower should be able to repay the principal amount and the interest charges involved in loans.

The administration of credit facilities by the banks is managed in such a manner that the funds are repaid at agreed regular intervals without defaults. The repayment of loans by the beneficiaries depends on their capacity to generate enough funds from their projects, besides the fact that their character which are normally evaluated before loan approval.

In essence, the banks lend funds to the customers based on the financial standing of their business in terms of regularity of cash inflows with which to repay the loans. The
banks also take into consideration a less risky business for loans to ensure the safety of the funds and their prompt recovery from the borrowers.

In the case of new business ventures, the banks would also grant loans for those enterprises whose owners command good character and have adequate capacity to repay the loans. The new business venture should have sound financial projections in relation to the technical feasibility and economic viability of the project for which the loan is granted.

3. Balanced Loan Portfolio

Another factor in credit administration is the need to ensure that there is a balanced portfolio in terms of the composition of loans and credits being granted to customers.

This means that in the process of granting loans and credits to customers, the banks consider the composition of the loan portfolio so as to maintain balanced diversity of the assets. This is view of the fact that the spread goes a long way to guarantee the safety of the banks funds. This is important for the banks' profitable operations and liquidity so as to protect the interest of the depositors as well as that of the shareholders.

It implies that the loans and credits being granted to customers are not concentrated in a particular sector but in diverse sectors of the economy. This is in conformity with the policy of the apex bank in terms of extending loans to various productive industries and businesses for balanced growth and development of the economy.

The spread of the loan portfolio to various productive sectors of the economy is also imperative towards minimizing risks that are always associated with lending of funds. In this regards, commercial banks take appropriate measures to spread the risks of investment in loan and advances portfolio by considering various trades and industries.

4. Constant Stream of Cash Inflows

Another issue in credit administration is the need to guarantee constant stream of cash inflows from loans and advances for the banks' liquidity. Therefore, commercial banks will only grant loans and advances to customers whose business ventures have the potential of earning enough funds with which to repay the principal amounts and the interest charges.

In order to ensure constant inflows of funds from loans and advances, the banks normally put in place some administrative measures towards assessing that such credits are the types that would generate stable incomes with which to repay the funds.

For effective management of lending and credits, customers' loan applications are normally scrutinized by appropriate loan officers and committees in charge of credit facilities so as to choose those ventures that are capable of generating constant income with which to service the loan and make repayment on regular basis.

It is the responsibility of the credit officers and the committee to also evaluate new projects using their technical feasibility and economic

viability reports to determine the nature of cash inflows in terms of their nature of earnings. Such assessment will be used for the selection of the projects that can generate enough funds for repaying loans and credit facilities.

In the case of existing business, the usual practice is for the bank to request for financial reports of the business which incorporate relevant data for five years. This will be used in evaluating the regularity of generation of earnings. And the assessment is used to determine the stability of income from the business for the repayment of loan facility.

5. Adequate Returns from Credit Facilities

The other issue in credit administration is the need to generate adequate earnings from credit facilities, which are very important to the operations of commercial banks. Loans and advances are usually granted to customers with the intention of earning some income for the banks. The income from lending facilities comes mainly from the interest charges being made from loans advances being granted to customers by the banks.

The rate of interest being charged on loans and advances by the banks is normally determined in consideration to the prevailing interest rate and the ruling bank rate sanctioned by the apex bank in the economy. Such bank rate is called the monetary policy rate in the country, as determined by Central Bank of Nigeria.

The interest rate being charged on loans by the commercial banks is normally determined in relation to the bank rate being charged by the apex bank, the former being higher than the later. In addition, the banks incorporate some other charges as may be determined by the lending officers or the credit committee.

6. Effective Supervision of Credit

There is also an issue in loan and credit administration that involves the need to ensure effective supervision of lending by the banks. In order to ensure that lending operations are proper supervised, the banks normally set administrative policies on loan supervision. In this regards, administrative policies are established on supervision of credit facilities, their recovery drives, and personal visits by bank officials to the loan beneficiaries.

The relevant supervision policies are normally established in relation to the past strategies and those methods being used by the other banks in the industry. In order to ensure effective loan supervision, these policies are used: supervisory teams, reports and evaluation, time line for periodic reviews of loan recoveries, loan recovery visits, procedures for

compliance with banking regulations, appropriate pricing of loans and credits, and loan recovery methods.

7. Efficient Management of Credit Risk

Another major issue in loan and credit administration is the need to ensure efficient management of risks associated with loans and advances. In this regard, administrative measures are established by the banks for management of the credit risk in respect of grave problems which can arise from loan recovery by the bank.

The banks do formulate administrative measures for the management of credit risks by assigning responsibilities for;

- branch managers in preventing credit risks;
- senior officers in credit risk management;
- loan officers in recommending only loans with minimal risks;
- credit committee for assessing and handling credit risks;
- effective supervision to minimize defaults in loan repayment;
- managing accounts of loan beneficiaries;
- constant visits to loan beneficiaries; and
- actions necessary in managing difficult loan beneficiaries.

The objective is to eliminate or minimize the hazards and perils that loans and advances can present to the operations of banks. The measures for controlling loans and advances in order to manage their risks may differ from one bank to another.

SELF-ASSESSMENT EXERCISE 2

Mention the responsibilities involved in minimizing credit risks in commercial banks.

8. Effective Management of Difficult Facility

There is also an important issue in loan and credit administration which borders on the need to ensure effective management of difficult loan beneficiary. Administrative policies are normally formulated for managing difficult loan beneficiaries.

Banks formulate administrative policies and assign them to relevant bank officials for managing problem loans. These policies are used to specify the necessary actions to be taken by relevant bank officials to handle loan beneficiaries that are proving difficult and problematic.

Examples of such administrative measures for managing difficult beneficiaries of loan facilities include the following:

- Committee' s actions for the recovery of difficult loans;
- Mutual discussion with the beneficiary of the loan;

- Planned contact for assessment of beneficiary's premises;
- Threat of legal action against the beneficiaries
- Offer of restructuring of beneficiaries' operations;
- Threat of sale of securities for the loan; and
- Representation to beneficiaries on plan to take over their business operations.

SELF-ASSESSMENT EXERCISE 3

What are the necessary administrative measures for managing problem credit facilities?

4.0 CONCLUSION

You have learnt from this study unit that there are basic reasons which inform the need for the commercial banks to adopt appropriate measures in ensuring effective credit administration. Such reasons translate into the need to ensure effective management of loans and credits which are being granted by the banks to the customers. Furthermore, there are factors which influence credit administration by commercial banks. Such factors include operational liquidity, prompt repayment of loans, earning reasonable revenue from loans, ensuring balanced loan portfolio, effective management of credit risk, and handling difficult loan and credit beneficiaries, among others. All these reasons are meant to facilitate the profitable operations and survival of the banks.

5.0 SUMMARY

In this study unit, topics covered include the following:

- Rational for Lending and Credit Administration
- Factors Influencing Credit Administration

In the next study unit, you will be taken through the discussion on credit administration.

6.0 TUTOR-MARKED ASSIGNMENT

Mention and explain the factors influencing credit administration by commercial banks.

7.0 REFERENCES/FURTHER READING

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UNIT 2 PROCEDURE FOR CREDIT ADMINISTRATION

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7.0 References/Further Reading

1.0 INTRODUCTION

You would recall that, in the preceding study unit, the reasons for effective management of bank credits are identified and discussed. The basic purpose for managing the funds under loans and advances effectively is informed by the fact that lending of funds to bank customers involves the use of the depositors' money. Therefore, the necessary procedure must be instituted to ensure that recoveries of funds under loans and advances are managed in order to protect the interest of the depositors. This is critical in ensuring that the profitable operations and survival of the banks are not compromised. Therefore, this study unit is used to identify and discuss the necessary steps involved in effective management of credits being granted to the customers by commercial banks.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- discuss credit administration
- mention and explain steps for credit administration

3.0 MAIN CONTENT

3.1 Credit Administration

Basically, the back business of commercial banks revolves around financial intermediation activities. Therefore, they source for funds from the members of the public, corporate organizations and other institutions through various forms of deposit accounts. Such funds are then used for the purpose of lending and credit facilities.

Depositors are entitled to the funds whenever they so desired. The banks are invariably under legal obligations to honour the demands of the depositors. The banks therefore, are constantly under obligation to evolve ways of maintaining delicate balance between the recoveries of funds loaned out and the demands of the depositors.

Hence, the issue of credit administration comes into play. In essence, the funds which are loaned out to customers have to be managed in such a manner that such funds can be available from the customers whenever they are needed to meet the demand of the depositors.

The fragile balancing of demands for funds by depositors and recoveries of loans and advances from customers is predicted on the necessity for the commercial banks to survive in business and generate reasonable returns for the shareholders. It implies that lending and credits should be managed in such a way that generating funds from loan repayments is tailored towards meeting periodic demands of the depositors.

In order to manage loans and credits effectively for adequately meeting the demands on the deposit accounts of customers, there are operational modalities normally put in place by the banks for administering loans and advances right from inception to the time when they totally liquidated. Such modalities of managing loans and advances are identified and discussed below.

3.2 Procedure for Credit Administration

There are some fundamental steps that should be taken for managing credit facilities by commercial banks in order to safeguard their investment and the expected returns. The steps involved in credit administration are identified and discussed below.

1. Loan Budget and Composition

It is an ideal practice for commercial banks to determine the amount of funds which will be devoted for loans and advances in a given period of time taking into consideration the requirements of the regulatory agency. Hence the banks determines total amount of loans and advances for a particular period, maximum amount for a single case, and average amount of lending to be made per case.

In terms of composition of loans and advances that will be granted to customers, the banks consider issues such as types of loan and advances, sectors, sub-sectors and industry mix, investment or equity participation, and productivity sector favoured by the government.

2. Loan Committee and Authorisation

It is also a common practice for commercial banks to institute a loan and advances committee to deal with major credit decisions. There are some responsibilities which the loan committee is expected to perform.

Such responsibilities or duties of the loan committee may, among others, include the following:

- To review major new loans;
- Review major loan renewals;
- Ascertain the reasons for renewal;
- Assess delinquent loans & determine the cause of delinquency;
- Ensure compliance with established lending policy;
- Ensure full documentation of loans before disbursement; and
- Ensure consistency in the treatment of loan customers.

The responsibilities of a loan committee as stated above may not be exhaustive and therefore, individual bank may include other duties for the committee to discharge.

SELF-ASSESSMENT EXERCISE 1

Mention the responsibilities of a loan committee of the commercial bank?

3. Periodicity and Loan Grading System

In terms of periodicity, the duration of loan composition is very critical. Therefore, the basic considerations are call loans, short-term working capital loan, intermediate-term investment loan, and long-term investment loan.

A typical grading system for loans and advances is as presented below, which indicates classification of loans in terms of their likely performance. The classification is as follows:

Figure 2.1: Grading of Loans and Advances

Grade	Classification
A	**Top Grade Loan:-** Loans that are secured and repayable as at when due by the beneficiaries; because of the performance of the companies based on market fundamentals.
B	**Good Loans:-** Loans that are expected to perform without fear of defaults by the companies as a result of their (beneficiaries') credibility.
C	**Marginal Loans:-** Loans that are being taken for the speculative purposes such as the funds for use in purchasing shares and stock. Their repayment is subject to performance of the capital market.

D **Doubtful Loans:-** Loans for which their repayment by the beneficiaries is uncertain due to the fact that such funds will be used for restructuring and re-engineering of failing corporate giants.

E **Likely Bad Loans:-** Loans for which their repayment by the beneficiaries is practically uncertain because the companies or business entities for which the funds are secured are technically insolvent.

The above grading will be used to allocate funds accordingly in terms of the magnitude of money that will be assigned to each grade out of the total funds being earmarked by the bank for lending facilities.

4. Evaluating Credit Worthiness & Securities

There is issue of the evaluation of the creditworthiness of the customer that is prospecting for loan facility. Factors that are taken into consideration, among others, include the following.

- Financial Statements
- Other Required Information
- Personal interview
- Credit investigation
- Information on Operations; personnel, financial, market, etc.

The other important contemplation is the concern of collateral security which is very critical for loan consideration. In this regard, the critical issues to consider are as follows:

- Criteria of acceptable security;
- Listing of acceptable security;
- Allowable margins to be made; and
- Qualifications of becoming guarantors.

The discussion above implies that the issue of securities is just as important as the consideration of the creditworthiness of the customer in loan and credit administration.

SELF-ASSESSMENT EXERCISE 2

Mention the areas for which data are required for assessing the credit worthiness of a
customer.

5. Expected Revenue from Loan

The expected revenue from any loan facility to the bank is referred to as the pricing of the loan, which is the lending cost plus the profit inherent in the facility. It is expressed formula wise as:

Lending Cost = Cost of fund + Cost of lending operation + Liquidity of the advance + Risk.

The rate of interest in relation to the cost of the fund to the bank definitely partly determines the amount of profit that can be earned from a loan facility. The interest chargeable on loan is normally considered in relation the bank rate of the apex bank; the former being above the latter.

The interest rates being charged on loans by the banks may depend on factors, which are in the following areas:

- The bank's cost of funds;
- The riskiness of the borrower;
- Compensating balances & fees;
- Interest rates charged by competitors;
- The ruling bank rate in the economy; and
- Other banking relationships with the borrower

SELF-ASSESSMENT EXERCISE 3

Mention the factors that influence the rate interest being charged for bank loan.

6. Assessment of Credit Risk & Compensating Balance

It is always a practice for the bank to assess the risk involved in the loan being granted to a customer. This calls for determining the risk average in relation to previous loans that are similar to the loan under consideration, the types of risk involved, and the insurable risk that should be insured by the bank.

It is always necessary for the bank to retain some funds in the loan account of the customer which is regarded as the compensating balance. This is considered in line with the bank's right of offsetting deposit balance for an outstanding loan and the method of computation of compensating balance.

7. Loan Approval, Documentation & Accounting Record

The process of the loan approval refers to the necessary considerations which are taken cognizance of towards the final decision on loan request. Such considerations include the following issues:

- Sanctioning limits of various types of loans;
- Delegation of Authority;
- Uniform Presentation Format & Standards;
- Descriptions of the client;

- Assessment of management;
- Pricing Policy;
- Purpose of the loan request;
- Repayment schedule & source of repayment;
- Secondary sources of repayment including collateral values & guarantors;
- History of past borrowing with the bank;
- Required monitoring steps;
- Timing of submissions of financial statement;
- The loan Decision; and
- Loan officer's comments including consistency with policy.

More considerations can be included in the above list for effective loan approval process. The documentation starts from the time that the customer applies for the loan. Therefore, the documents to be kept bank include application form filled by the customer, evidence of security, loan agreement, credit reports, referee forms, and financial statements, among others.

The necessary considerations for the accounting records include recording procedure to be followed, loan and project profiles to be maintained, statements to be provided by the customer, and loan recovery recording, among other accounting records to be maintained by the bank.

SELF-ASSESSMENT EXERCISE 4

Mention the necessary considerations normally taken into cognizance towards final decision on loan request.

8. Collection Procedure & Handling Problem loans

In terms of collection procedure, there are critical considerations which include repayment schedule as prepared by loan officers, remainders & circular letters to be sent out on periodic basis, constant personal visits by the credit officers, and collection the principal payment and interest charges on the loan necessarily through cheques.

The procedures for managing problem loan problems and their beneficiaries involved the following considerations:

- Criteria to be used for identifying problem loans;
- Methods to be used for identification problem loans;
- Steps to be taken in managing the loans and their beneficiaries; and
- The issue of setting up loan reserves for managing such risk

4.0 CONCLUSION

You have learnt from this study unit that it is necessary for commercial banks to institute appropriate measures that would guarantee the effective management of their loans and credits. Such measures are critical towards ensuring that funds are allocate for classes of loans to be granted to the customers, appropriate documents are secured for assessing credit worthiness of customers, and the risks involved in the credits are understood. The other considerations include pricing of the loans towards making profits, assessing and securing securities for the loans, appropriate compensating balances are maintained for loans, documentation is effected, and necessary ways of managing problem loans are instituted, among others.

5.0 SUMMARY

In this study unit, topics covered include the following:

- Credit Administration
- Procedure for Credit Administration

In the next study unit, you will be taken through the discussion on credit analysis in lending decisions.

6.0 TUTOR-MARKED ASSIGNMENT

Mention and discuss the necessary steps credit administration in commercial banks.

7.0 REFERENCES/FURTHER READING

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UNIT 3 CREDIT INVESTIGATION

CONTENTS

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1.0 INTRODUCTION

You would recall that, in the preceding study unit, we discussed the issue of credit administration. You have observed from such analysis that it is important for the banks to institute appropriate measures for ensure effective credit administration. In line with such administrative measures, the credit officials of the bank often ensure that there is appropriate investigation of any loan request before a concrete decision is taken. Therefore, the discussion in this study unit is focused on the relevant methods being used by the commercial banks in credit investigation regarding decisions on credit facility.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- list and discuss the issues involved in appraisal of credit request
- mention and explain the considerations involved in credit analysis
- discuss the assessment of past performance of loan applicant
- explain the technique used for assessing creditworthiness of customers.

3.0 MAIN CONTENT

3.1 Appraisal of Credit Request

The commercial banks, at the instance of loan OR credit request from a customer, have to engage in initial evaluation of the application in relation to relevant areas, which constitute part of the lending procedure.

Such evaluation is very critical because it provides the basis for the engagement in credit analysis of the request.

The relevant issues to be considered in the initial evaluation are identified and discussed below.

1. Purpose of the Loan

The bank will be interested in determining the purpose of the loan so that the funds from the loan would not be used for illegal business activities or unproductive project. Therefore, the bank would assess that the reason for the loan is not related to;

- speculative business;
- illegal business transaction;
- fruitless venture;
- self aggrandizement;
- failed venture;
- money laundering;
- dealing in arms or weapons;
- political agendas, etc

Once the loan request is not connected to any of the above subject or business, the request will be qualified for consideration by the bank.

2. Amount of the Loan

It is also the practice for the commercial banks to take into consideration the amount funds that a customer is prospecting for. The amount of funds that is incorporated in a customer's loan request will be assessed by a commercial bank in relation to:

- available funds for lending;
- the liquid position of the bank;
- regulation of the apex bank;
- amount of loan already committed to the industry;
- pace of loan recovery;
- trend in volume of withdrawals;
- pattern of deposits; and
- quality of deposit accounts.

The assessment of the amount in relation to the above issues will make the bank either to grant the whole amount or decrease it.

3. Reason for the Loan

The banks will also be interested in determining the main reason which informs the customer's request for loan. The reason for the loan will enable the bank to classify the request in relation to broad-based categorization as shown below.

- Real estate loans:- short-term loans for construction and land development and longer-term loans for the purchase of farmland, homes, apartments, commercial structures, and foreign properties.
- Financial institution loans:- loans to other banks, insurance companies, finance companies, and other financial institutions.
- Agricultural loans:- loans to finance farm and ranch operations, mainly to assist in planting and harvesting crops and to support the feeding and care of livestock.
- Commercial and industrial loans: to businesses to cover expenditures on inventories, paying taxes, and meeting payrolls.
- Loans to individuals:- credit to finance the purchase of automobiles, appliances, and other consumer goods, equity lines for home improvements, and other personal expenses
- Lease financing:- to corporate firms on equipment or vehicles.

The categorization of the loan request will enable the bank to determine the appropriate amount to grant for the demand.

4. Sources of Payment

The means of repayment will also be considered by the banks in assessing any loan request by the customer. This consideration is related to the cash inflows from the business, which will be used by the beneficiary to meet the periodic repayments of the principal amount and the interest charges to the bank.

5. Ability of the Beneficiary to Repay

This issue will be assessed in relation to the capital and assets of the business for which the loan is being requested. This is based on the fact that the capital base of the business determines its ability to carry out its operations efficiently.

In the case of a new project, the financial projections for a period of five years will be assessed to determine the ability of the business to generate enough income to meet its cost of operation and meeting the loan repayment.

6. Risk Inherent in the Loan

The loan request will also be assessed in relation to the risks inherent in the facility in the event that it is granted. These credit risks include:

- default in repayment;
- delays in repayment;
- diversion of the funds;
- failure of the project;
- mismanagement of the funds; and
- total loss of the funds.

Once most of these risks are perceived to the inherent in the loan request, the bank officials may not advance further on the analysis of the request. Nevertheless, if the bank is satisfied with above elements of assessment, it will proceed to credit analysis, which is the next area of discussion below.

SELF-ASSESSMENT EXERCISE 1

Mention and explain the considerations for initial analysis of loan request.

3.2 Credit Analysis

The credit analysis is based on the popular considerations such as the character of the applicant, capacity of the customer to repay the loan, capital in relation to contribution of the customer to the project funding, collateral security being offered by the customer for the loan, condition of the economy, cash generation from the project for repayment, and lastly control of the bank over the loan facility.

All these considerations are discussed below.

1. Character

This consideration is the personal integrity of the customer requesting for the loan, which is relation to his business dealings with the bank and other banks. The bank officers or loan officers would take steps to determine the character of the customer to ensure that they are convinced that the customer has a well-defined purpose for requesting bank credit and a serious intention to repay the funds appropriately.

2. Capacity

This involves the authorization of the person making the request to make a demand for loan facility, which is normally defined by virtue of his position. Therefore, the bank always takes steps to ensure that the customer requesting credit has the authority to do so. The bank will also consider the approval of the board of directors and the legal standing of the person to sign a binding loan agreement on behalf of his firm. This customer characteristic is known as the *capacity* to borrow money.

3. Collateral

The bank will also assess the borrower's security in terms of whether or not it possesses adequate networth. The assessment also applies to the quality of the assets in providing adequate collateral support for the loan. The bank officials will be interested in evaluating the assets of the firm particularly in relation to such considerations as the age, condition, and degree of specialization for the firm's operations.

4. Conditions:

This has to do with the assessment of the economic conditions and the industry in which the firm operates. The bank officials or credit analysts are to consider the recent trends in the borrower's line of work or industry and the dynamics of the changing economic conditions might impact on the usage of the funds and the repayment. To assess industry and economic conditions, most banks maintain files of information-newspaper clippings, magazine articles, and research reports-on the industries represented by their major borrowing customers.

5. Capital

This refers to the contribution of the customer’s business to the financing of the project for which the loan request is desired. This is important because in the absence of any appreciable contribution or the capital base of the business, the customer will not feel that the firm has any stake in the scheme of things. Therefore, the project may be allowed to fail and the bank will lose its funds.

6. Cash Inflows

The expected cash inflows from the business or the project that may affect the repayment of the loan will be evaluated by the bank. There are three main sources of income from a business to repay the funds of the loans.

The main sources being used to generate cash from operations by business entities include the following:

- The cash flows generated from sales or turnover of the business;
- the sale or liquidation of operating assets of the business; or
- funds to be raised by way of issuance of debt or equity securities.

The net cash inflows is the net profits from the operations of the business, indicative of total revenue less all expenses, and combined with non-cash expenses such as the amount of depreciation of capital assets.

The other of looking at the cash inflows is that the net cash inflows is the net profits plus non-cash expenses plus additions to accounts payable less additions to inventories and accounts receivable.

This latter view on the concept of cash flow is of importance to the bank. This is because it helps to focus the attention of bank officials or loan officials on those areas of the customer's business that reflect the quality and experience of its management, and above all the strength of the market the business serves.

7. Control

The issue of control is focused on such consideration as to the assessment of the effect of any changes in government rules and regulations on business. Furthermore, the consideration is on the possible adverse effect on the borrower's ability to repay the funds on the loan. The other issue in the control consideration is relating the loan request to the bank's and the regulatory authorities' standards for loan quality.

SELF-ASSESSMENT EXERCISE 2

Mention and explain the considerations for credit analysis in loan request.

3.3 Assessment of past Performance of Loan Applicant

This involves assessing the performance of the business of the customer who is prospecting for a loan facility. The relevant information for such assessment involves the data which are embedded in the financial statements of the business operations in the past five years.

The relevant financial statements are the income statement and the balance sheet. A simple approach to the assessment involves the use of financial ratios. The important ratios are identified below.

1. Current Ratio

The current ratio refers to relating the total value of the current assets to the total of the current Liabilities. The quotient obtainable from the calculation is indicative of the ability of the business to meet its current financial obligations.

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

The ideal ratio from the calculation is 2:1 but it all depends on the type of business, many thriving companies continue to operate successfully despite having negative ratio.

2. Acid Test Ratio or Quick Ratio

The ratio relates the total of the current assets minus the value inventories to the total value of the current liabilities. The quotient obtainable from the calculation is indicative of the ability of the business to meet its current financial obligations with available cash and bank balances, debtors and the marketable securities, which can easily be converted into cash.

$$\text{Acid Test or Quick Ratio} = \frac{\text{Current Assets - Inventories}}{\text{Current Liabilities}}$$

The ideal ratio is 1:1 for thriving companies. The ratio is of fundamental importance when assessing the ability of the firm to survive.

3. Debtors Collection Period

The ratio relates the value of sales to debtors or accounts receivables of the business. The ratio measures the efficiency of the business in controlling debts collection. This is in relation to the average length of time that money is owed by debtors.

Debtors Collection Period = Debtors x 360
Sales

Since the ratio measures the efficiency in debt collection, the ideal collection period is five weeks, which is a good average for thriving or successful companies.

4. Inventory Turnover Ratio

The ratio measures the relationship between the cost of sales and the inventory in the current assets. This measures the speed at which a company sells its stocks. The rate is bound to affect the profitability of the business.

Inventory Turnover Ratio = Average Stockholding x 360
Cost of Goods Sold

The ratio is very relevant because it assesses the ability of the business to generate cash inflows with meet the current commitments of the business.

5. Interest Coverage Ratio

This measure relates the earnings before interest and taxes of the business to the total interest payments on fixed interest debt obligations. This measures the ability of the business to generate enough earnings to cover the fixed interest debt obligations.

Interest Coverage Ratio = Earnings before Interest and Taxes
Interest Payments

The ratio is an important consideration because without enough earnings, a business will not be able to service its debts and make loan repayment.

6. Leverage Ratio

The ratio relates the total debt obligations of the business to the networth. This measures the volume of debt obligations that has been used in financing the business compared to the owners funds.

Leverage Ratio = Total Debt
Networth

The ratio is important to the business because it assesses the degree to which the borrowed funds have been utilized to generate income for the business owners' funds in the business as measured by the networth.

7. Return on Total Assets

This measures the volume of earnings which has been generated from the operating assets of the business. The ratio measures the ability of the business to use the available assets to generate earnings for the business.

Return on Total Assets = Earnings before Taxes
Total Assets

The ratio measures the efficiency of the managers in the utilization of the available to generate reasonable volume of earnings. Hence the ratio measures the efficient management of the assets in the operations of the business.

8. Fixed Assets Turnover

The ratio relates the total volume of sales to the total fixed assets available for the business operations. This measures the efficient utilization of the available fixed assets to generate reasonable level of sales or turnover for the business.

Fixed Assets Turnover = Total Sales
Fixed Assets

This also measures the efficiency of the managers in utilizing the available fixed assets to generate adequate level of sales in the process of business operations.

SELF-ASSESSMENT EXERCISE 3

Mention and show how to calculate relevant financial ratios considered for creditworthiness of customer in loan request.

3.4 Technique for Assessing Creditworthiness of Customers

The use of the data in the income statement and the balance sheet is not considered weighty enough to assess the creditworthiness of the customer. Therefore, the commercial banks normally make use of an assessment technique called CAMPARI, an acronym from other relevant considerations in loan assessment.

Such considerations for assessing the creditworthiness of customers seeking for loan facilities are as follows.

- **Character:** – this is a review of the management of the business, the products of the company, and the past performance of the business for which a loan is being requested.

- **Ability:** – this refers to the ability of the business to generate enough income from cash inflows with which to repay the loan facility.
- **Margin:** – this refers to the profit or reward of engaging in the lending facility which will determine the bank's consideration in committing funds.
- **Purpose:** – this relates to the reason which informs the customer's request which should not be connected with abnormal business operations such as speculative business, illegal business transaction, fruitless venture, self aggrandizement, failed venture, money laundering, dealing in arms or weapons, etc.
- **Amount:** – this refers to the value or amount of funds that is being requested by the customer, which will be considered in relations to issues such as available funds for lending, the liquid position of the bank, regulation of the apex bank, amount of loan already committed to loan, pace of loan recovery, trend in volume of withdrawals, etc.
- **Repayment:** – this refers to the possibility of the repayment schedule being appropriate to the bank's liquidity management plan. More so, the bank will also consider the past performance of the business in relation of its ability to meet periodic repayments of the funds in relation to the liquidity plan of the bank.
- **Insurance:** – this refers to the issue of collateral security which is available to secure the loan by the customer. This is very important to the bank because in the event of defaults or inability to repay the loan the bank will use the collateral security for generate funds to settle the loan.

The analysis above indicates that it represents a broad-based evaluation of the loan request compared to the earlier consideration in this unit. These considerations are important in terms attributes which coalesce to form the basis of the lending decision.

Among these considerations, there are five attributes that are linked to the accounts and finances of the prospective borrowers. The remaining two considerations are character and margin, which are related to the customer and the bank's profit contemplation.
In the case of character, the issues are management of the business, which represents subjective assessment, and the others in the areas of the products of the company, and the past performance of the business, the latter which can be specifically quantified from the balance sheet data.

The banks will therefore, be interested in seeing financial information for the past five years before lending any money to the customer. These are the balance sheet and the income statement of the business which incorporates the past data relating to five years consecutively.

SELF-ASSESSMENT EXERCISE 4

What are the issues to be considered in technique used for assessing the creditworthiness of the customers?

4.0 CONCLUSION

You have learnt from this study unit that there are numerous considerations which are normally taken into cognizance by commercial banks in evaluating and analyzing loan request for credit facilities from customer before taking decisions on such facilities. This is important for the commercial banks because they are interested in ensuring that funds committed into credit facilities as well as loans would not go down the drain. The relevant considerations are in categorizations such as: analysis of the credit request; credit analysis; assessment of the past performance of the customer; and the technique that commercial banks used in assessing creditworthiness of the customers requesting for credit facilities.

5.0 SUMMARY

In this study unit, topics covered include the following:

- Analysis of Loan Request
- Credit Analysis
- Assessment of Past Performance of Loan Applicant
- Technique for Assessing Creditworthiness of Customers

In the next study unit, you will be taken through the discussion on decision criteria in credit administration.

6.0 TUTOR-MARKED ASSIGNMENT

Identify and discuss the relevant technique for assessing the creditworthiness of customers requesting for credit facilities.

7.0 REFERENCES/FURTHER READING

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UNIT 4 DECISION CRITERIA IN CREDIT ADMINISTRATION

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1.0 INTRODUCTION

You would recall that, in the preceding study unit, we discussed the issue of credit investigation. The issue of credit investigation presupposes that certain decisions should be taken by the bank. Such decisions include establishing credit policy which stands as general guide for credit administration generally. Appropriate decisions would also affect criteria to be adopted in managing credit facilities. Furthermore, such decisions would also incorporate considerations in assigning responsibilities to appropriate hands in handling the credit administration generally. Therefore, such considerations for assigning responsibilities in credit administration are identified and discussed in this study unit.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- list and discuss important elements of credit policy
- explain decision on responsibility in credit administration
- discuss the responsibility of the relation managers
- explain the role of analytical team in credit administration
- discuss decision regarding authority on credit approval
- identify and explain issues involved in structuring of loans
- mention ways of handling problem loans.

3.0 MAIN CONTENT

3.1 Establishing Credit Policy

It is always the normal practice by commercial banks to consider the issue of establishing appropriate policy for the management of credit facilities which constitute an integral aspect of bank asset portfolio.

The important elements of a good bank credit policy in general terms are outlined as follows.

i) A clear mission statement for the bank's loan portfolio in terms of types, maturities, sizes, and quality of loans.
ii) Specification of the lending authority given to each loan officer and loan committee, if there is any in a given bank.
iii) Determination of the maximum amount and types of loan that each person and committee can approve and what signatures are required.
iv) Lines of responsibility in making assignments and reporting information within the credit department.
v) Requisite operating procedures for soliciting, reviewing, evaluating, and making decisions on customer loan applications.
vi) Required documentation that is to accompany each loan application and what must be kept in the bank's credit files such as required financial statements, security agreements, etc.
vii) Lines of authority within the bank, detailing who is responsible for maintaining and reviewing the bank's credit records.
viii) Guidelines for taking, evaluating, and perfecting collateral security for loan.
ix) A presentation of policies and procedures for setting loan interest rates and other fees and the terms for repayment of loans.
x) Statement of quality standards and relevant criteria applicable to granting of all loans.
xi) Statement of the preferred upper limit for total loans outstanding in terms of the maximum ratio of total loans to total assets allowed.
xii) A description of the bank's principal trade area, from which most loans should come.
xiii) A discussion of the preferred procedures for detecting, analyzing, and working out problem loan situations.

SELF-ASSESSMENT EXERCISE 1

What are the important elements of a good bank credit policy in general terms?

3.2 Decision on Responsibility in Credit Administration

3.2.1 Relationship Managers

In credit administration, some responsibilities are assigned to relationship or business managers such as those relating to small and medium enterprises customers. Such responsibilities are assigned on the basis of a certain number of customers in respect of and volume of credit facilities granted.

The relationship managers are under obligation to be reporting to regional managers. These relationship managers are granted the required authority to approve loans within their discretionary limits. Therefore, any loans outside of their authority are referred to a credit manager for consideration and approval.

There is always a considerable variation between the banks in terms of the discretion limits assigned to relationship managers in terms of the amount of loan facility that they can approval for customers. In the case of loan request that is above such discretion, in which they have no discretion to approve credit exposures at all, relationship managers must always seek approval from their credit managers for such facilities.

The discretion levels can be granted to senior managers on individual basis, not necessarily on the basis of group responsibility, and such authorities also vary according to the level of security offered against a loan. The implication is that some decisions regarding loans to small businesses are made at the relationship manager level and do not require higher levels for the approval.

In some scenarios, the approval process required by credit managers can be relatively automated in the face of internet facilities being deployed by a number of the commercial banks. In this regards, the credit managers complete an assessment and electronically transmitted to the regional office or the head office for approval.

The length of the assessment varies between banks depending on some critical considerations such as the complexity and size of the loan request.

Generally, the assessments may cover a range of considerations which are highlighted below. Such considerations include:

- Remarks on assessment of loan request;
- Business plans of the applicant;
- Financial statements of the applicant's business;
- Statement on cash flows from the business;

- Industry analysis in which the applicant operates; and
- Assessment on management of the applicant's business.

In many commercial banks, there is a degree of standardisation in terms of the assessment forms being used for credit investigation. The use of standard templates is to reduce information requirements and also reduce the time to make decisions. Some banks may require narratives of varying lengths.

Decisions are also made regarding the fact that approval from a risk management or credit approval team is necessary or required for all credit facilities before their approval.

3.2.2 Analytical Team

Some commercial banks do also have an analytical team comprising a dedicated team of financial experts who analyze the financial information and potentially non-financial information being provided by loan applicants.

The analytical teams are designated to provide analysis of credits to relationship managers and credit teams to facilitate the assessment and monitoring of risk and credit worthiness of customers.

The analytical team is required to consider critical areas for the credit analysis which include four key areas such as outline below.

- Liquidity,
- Profitability,
- Gearing, and
- Operational performance.

The required analysis is usually carried out and completed prior to the consideration and acceptance of the loan facility. The analysis may be required to continue during the loan term. This means that the analysis of the loan also takes place during the tenure of the loan when the beneficiary is making use of the facility.

The relationship managers are supposed to work with the analytical team. They are also to be communicating the decisions which their banks make in response to applications from borrowers based on the work of the analytical team.

The communication of the result of the analysis and the decision of the bank does not indicate the end of the relationship. Therefore, in instances where applications are declined, the relationship managers are expected to typically work with the customers to explain why their

application is declined and to investigate options, where appropriate, for modifying their application.

The relationship managers are expected to explain that some applications fail because of their lack of good quality information incorporated in them and provided to the banks for consideration. The decision is that while banks do not generally see it as their responsibility to provide professional advice to the customers, the relationship managers will endeavour to point out to the customers the next line of action.

Hence, on the basis of the report of the analytical team, the nature of the advice required will vary between customers. In this regard, some may need assistance with the preparation of budgets and financial statements. On the other hand, others may need assistance with business plans while others require marketing or business development advice.

3.2.3 Credit Approval

Another important area of decision is the approval of loan facility. In this regard, in some commercial banks, the credit managers may have considerably greater delegated authority than the relationship managers.

In granting lending limits to individuals rather than positions by banks, factors such as experience and skill of the individual are perceived as being critical to good decision-making. In general terms, the level of delegation may fall as the element of risk in a loan facility increases, and distinctions are made between new and existing customers.
In some cases, the level of delegated authority in respect of new customers can be lower than that for existing customers. This is because the new customers are not tested and trusted as compared with the old customers. Moreover, delegation levels vary between well secured and unsecured borrowers.

3.2.4 Structuring and Documenting Loans

Decision in this area of responsibility concerns significantly the following considerations.

1. Structuring a Loan

This involves issues such as those highlighted below.

i) Drafting a loan agreement that meets the borrower's need for funds with a comfortable repayment schedule.
ii) Anticipating and accommodating of a customer who may request more or less funds than requested, over a longer or shorter period.

iii) Imposing certain restrictions (covenants) on the borrower's activities to protect the banks when these activities could threaten the recovery of bank funds.

iv) Specifying the process of recovering the bank's funds - when and where the bank can take action to get its funds returned.

2. Loan Review

This involves issues such as those highlighted below.

i) Reviewing all types of loans on a periodic basis - every 30, 60, or 90 days on the largest loans, along with a random sample of smaller loans.

ii) Detailed the loan review process carefully to include:

   a) The record of borrower payments, to ensure that the customer is not falling behind the planned repayment schedule.
   b) The quality and condition of any collateral security pledged for the loan facility.
   c) The completeness of loan documentation, to make sure the bank has access to any collateral pledged and possesses the full legal authority to take action against the borrower in the courts if necessary.
   d) An evaluation of whether the borrower's financial condition and forecasts have changed, which may have increased or decreased the borrower's need for bank credit.
   e) An assessment of whether the loan conforms to the bank's lending policies and to the standards applied to its loan portfolio by examiners from the regulatory agencies.

iii) Reviewing most frequently the largest loans, because default on these credit agreements could seriously affect the bank's own financial condition.

iv) Conducting more frequent reviews of troubled loans, with the frequency of review increasing as the problems surrounding any particular loan increase.

v) Accelerating the loan review schedule if the economy slows down or if the industries in which the bank has made a substantial portion of its loans develop significant problems.

SELF-ASSESSMENT EXERCISE 2

Mention the issues involved in loan review and structuring of loans.

3.3 Handling Problem Loan Situations

3.3.1 Common features of Problem Loans

There are some peculiar features which can be associated with problem loans regarding funny behavior of the beneficiaries of credit facilities. Such characteristics are as identified below.

i) Unusual delays in receiving promised financial reports and payments or in communicating with bank personnel.
ii) Sudden changes in methods used by the loan beneficiary to charge depreciation, make pension plan contributions, value inventories, account for taxes, or recognize income.
iii) In business loans, restructuring outstanding debt or eliminating dividends, or experiencing a change in the customer's credit rating.
iv) Unfavorable changes in the price of the borrowing firm or the beneficiary's stock in the capital market.
v) Losses in net earnings in one or more years, especially as measured by returns on the borrower's assets (ROA), or equity capital (ROE), or earnings before interest and taxes (EBIT).
vi) Unfavorable changes in the borrower's capital structure (equity/debt ratio), liquidity (current ratio), or activity levels (e.g., the ratio of sales to inventory).
vii) Deviations of actual sales or cash flow from those projected when the loan was requested.
viii) Sudden and unexplained changes in deposit balances maintained by the customer who is a loan beneficiary.

3.3.2 Procedure for Handling Problem Loan

i) Always keep the goal of loan workouts firmly in mind, which is to maximize the bank's chances for the full recovery of its funds.
ii) There should be rapid detection and reporting of any problems with a loan because delay often worsens a problem loan situation.
iii) Keep the loan workout responsibility separate from the lending function to avoid possible conflicts of interest for the officer in charge of loans.
iv) The workout specialists of the bank should always confer with the troubled customer quickly on possible options; such as cutting expenses, increasing cash flow, and improving management control.
v) Prepare for the contact by embarking on a preliminary analysis of the problem; taking cognizance of its possible causes and any special workout problems.
vi) Develop a preliminary plan of action after determining the bank's risk exposure and the adequacy of the loan documents; such as

any claims against the customer's collateral other than that held by the bank.

vii) Estimate the quantum of resources that are available for the collection of the troubled loan; including the estimated liquidation values of assets and deposits.

viii) Loan workout personnel should conduct some tax and litigation search to determine if the borrower has other unpaid obligations.

ix) In the case of corporate borrowers, bank loan personnel must evaluate the quality, competence, and integrity of current management and visit the site to assess the borrower's property and operations.

x) Bank workout professionals must consider all reasonable alternatives relevant for cleaning up the troubled loan; including making a new, temporary agreement or helping the customer strengthen cash flows.

Making a new and temporary agreement arises when the loan problems seem to be short-lived in nature. The alternative option of finding ways to improve customer's cash-flow position in its operations is also very critical; hence it can be combined with the former strategy.
Available ways of improving cash-flows include reducing expenses or entering new markets or to infuse new capital into the business. There are other possibilities that include finding additional collateral, securing endorsements or guarantees, reorganizing, merging or liquidating the firm, or filing a bankruptcy petition.

SELF-ASSESSMENT EXERCISE 3

Identify the viable ways of dealing with problem loan situation.

4.0 CONCLUSION

You have learnt from this study unit that there are relevant considerations in terms decisions on credit administration, which are critical in ensuring the intended objective in lending such as securing the interest of the bank. Such decision criteria are in the areas of establishing the credit policy, assigning responsibilities in credit administration, the use of relationship managers and analytical team. Some other decisions are also necessary, and these are granting authority for loan approval, structuring of loan facilities, and the applicable procedure for handling problem loan situations.

5.0 SUMMARY

In this study unit, topics covered include the following:

- Establishing Credit Policy
- Decision on Responsibility in Credit Administration
- Relationship Managers
- Analytical Team
- Credit Approval
- Structuring and Documenting Loans
- Handling Problem Loan Situations
- Common features of Problem Loans
- Procedure for Handling Problem Loan

In the next study unit, you will be taken through the discussion on criteria for lending decisions.

6.0 TUTOR-MARKED ASSIGNMENT

Mention the relevant ways through which the banks can deal with problem loan situations.

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UNIT 5 CRITERIA FOR LENDING DECISIONS

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1.0 INTRODUCTION

You would recall that, in the preceding study unit, we discussed the issue of decision criteria on credit administration. The issue under discussion in this unit is an appendage of the preceding discussion. This is because criteria on lending decision are critical in credit administration. There are some critical issues that are involved in lending decisions out of which the operational position of a prospective loan beneficiary is of paramount consideration. Therefore, such critical issues relating to lending decisions are identified and discussed in this study unit.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- list and discuss critical issues in lending decision
- mention and explain factors affecting portfolio allocation
- discuss the relationship between collateral security and pricing
- explain monitoring and relationship management in lending

3.0 MAIN CONTENT

3.1 Critical Issues in Lending Decision

There are some critical issues that are taken into cognizance in the process of taking decisions on lending. Such factors are normally applied in assigning the risk grade that is assigned to each loan account. This is diagrammatically portrayed by Figure 5.1 below.
Risk grading of any loan account is primarily focused on the probability of default by the beneficiary. It implies that such risk refers to the likelihood of the beneficiary having insufficient cash flow to meet debt obligations. The quality of collateral security offered is also an important part of decision making. Basically, therefore, collateral security is particularly relevant in the context of probable loss arising from default.

1. Management Capability
One important factor that affects the ability of the beneficiary firm to repay loan is the management capability of the business. Therefore, the commercial banks normally emphasize the importance of the management capability of the business applying for loan facility.

Such management capability is in turn influenced by the following variables.
i) **Experience**
The argument is that the more experienced the management of a given business entity, the more favourably a bank will look upon the proposition. Therefore, in general terms, a young, inexperienced management team potentially presents greater risk than a management team is made of older and more experienced managers.
ii) **Continuity**
In relation to key person risk in management team, a bank will be interested in knowing that the existing management will continue to function for the duration of the loan term. For instance, an owner who is also the manager of a give business entity that is approaching retirement age may be of concern to the bank.

This arises if there is no succession plan that might have instituted or has been undertaken to ensure that the business will continue as a going concern subsequent to the retirement of the owner manager.

2. Individual Characteristics
The commercial banks will be interested in the individuals who are applying for loan facilities. Therefore, the banks will consider the following issues.

i) Credit and Account History

The commercial banks normal consider individual's characteristics to assess whether such can be used to indicate the possibility or chance of default or funds being used for inappropriate or illegal activities by the beneficiaries. The relevant applicant characteristics could include, but may not be limited to, credit ratings of the individuals, the performance of his account in the past and his personal behaviour.

ii) Key Person Risk

In any business entity, there are some employees around which the operations of the entity revolve. This is due to their personal skills, business connections, and key positions they occupy in the entity.
Therefore, the importance of such persons to their organisations is another potential consideration. Basically, key person risk tends to be more of an issue where the individual has specialist skills and or is critical to the relationship with clients.
In most cases, the issue of ethnicity and gender are not critical characteristics that are taken into account in lending decisions. Hence, such factors are not relevant in the consideration of individual characteristics.

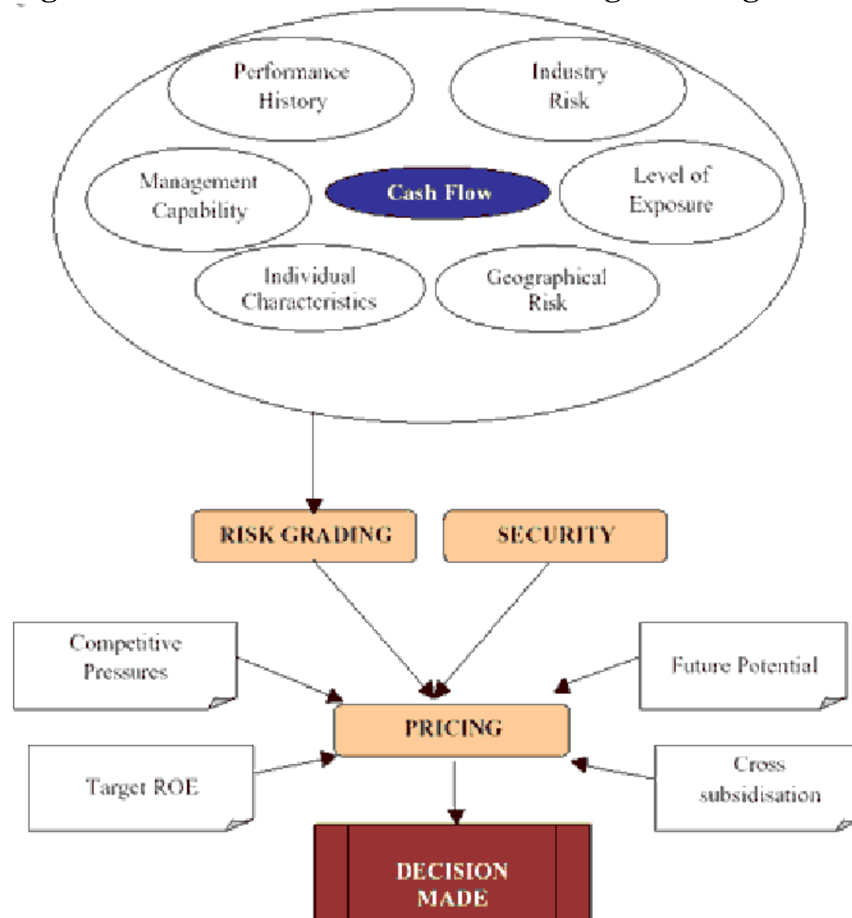
3. Performance History

This consideration has to do with past performance of the entity that is prospecting for a loan facility. Therefore, the banks give favourable consideration to those business entities with good track records, and strong financial performance. Such financial performance is normally reflected in income statement and balance sheet of a firm.

The size of the business entity, as an entity-specific characteristic, may not counter as a factor for consideration. Track record and financial performance counter more than the size of an entity.

Nevertheless, if the small size of an entity is a reflection of a lack of track record, experience or capital, this could affect the price, or availability of loan finance with which to run the operations of the business..

Figure 5.1: Critical Factors Influencing Lending Decisions



Source: Fraser, D. R., Gup, B. E. and Kolari, J. W. (1995). Commercial Banking: The Management of Risk, Minneapolis/St Andrew: Western Publishing Company, p.75.

4. Geographical Risk

The geographical location of the business entity seeking for a loan facility can also be one of the factors considered as part of a loan application. The essence of this factor can be explained as follows.

i) Location Specific Risk

The location of a business is considered in relation to the fact that some banks can limit their exposure to residential property in certain areas for those that would prefer landed property as collateral security. Basically, the value and marketability of residential property differs substantially between urban centres and small rural areas.

The implication of this is that the quality of collateral security in relation to landed or residential property in small rural areas would definitely be considerably less than the landed property that is in urban centre.

ii) Geographically Specific Risks

Basically, there are risks that are associated with a geographical area such as low population bases, flood-prone area or earthquake fault-line area. All these considerations may be taken into account if any of such risk can impact on the entity applying for the loan.

In spite of all these considerations, the commercial banks are predisposed to neglect such considerations on decisions on loan facility. Therefore, there may there is no material difference in pricing between regions. Hence, the policies regarding requirements on security of business operations and by implication, the safety of funds loaned out to customers, are generally the same irrespective of location.

5. Level of Exposure

The level of exposure of the funds of the banks depends on the size of the beneficiary company, the geographical area where the company operates, the industry in which the company operates and its type of business in form of goods and services it produces.

Therefore, the commercial banks, offering large amount of loans, may put more time and resource into understanding the nature of the business benefiting from the loan facility and associated risks. This is because the size of the loan directly impacts the exposure the bank faces.

6. Industry Risks

There are some risks associated with the various industries in the economy. Such elements of risk are of varying degrees according to the sectors like the agriculture sector, property sector, service sector, manufacturing sector, mining sector, and petroleum and gas sector.

Basically, most of the commercial banks refer to the agricultural sector as the most risky which is closely followed by the property development as a high-risk sector in the economy. In the scale of consideration, the petroleum and gas sector is the most lucrative industry in the economy, and therefore, most preferred by the commercial banks.

In identifying high risk sectors, the commercial banks normally indicate that loan terms and conditions might be more stringent. The hurdle for approving a loan facility for companies in these sectors is, therefore, set at a higher level.

The number of high risk sectors in the consideration of the banks, nevertheless, varies considerably. The extent to which the list applies to any one sector also depends on the market position and strategy of that bank.

Some other sectors in advanced economies can be identified particularly in medium and small enterprises, and these include the following.

i) Firms operating in the social sector, e.g., rest homes, schools, churches, non-government organizations, community based organizations, etc. The banks may reckon that it is harder to close down this type of entities.
ii) Firms with low margins and/or high failure rate, e.g., logging companies, contracting companies, small service stations, small transport companies, small cafes and country pubs, etc.
iii) Firms of specialist nature in operations such as mining of minerals where the banks do not have the specialist personnel or expertise in its operations to understand the risks involved.
iv) Firms involved in a range of other sectors which include information technology and fishing because their peculiar nature of operations.
v) Firms operating in prohibited sectors such as those operating cafes for people of easy virtues and those dispensing prohibited drugs like marijuana and cocaine, etc.
vi) Firms that engage in dubious operations that come up with dubious propositions.

In most cases, some commercial banks normally formulate guidelines that specifically prohibited lending to certain industries, which are classified as high risk. In general, such banks would indicate that each case would be evaluated on its merits.

Those that are regarded as higher risk may usually translate into higher margins for some businesses such as the small and medium enterprises in their operations. Therefore, this scenario in some most cases means a decline of loan facilities to such entities.
The commercial banks do not also lend to dubious propositions for loan facilities. Such propositions might be regarded by the commercial banks as having some connection to money laundering, arms and weapons, or political agendas. Therefore, the baks would not lend funds for such undertakings.

SELF -SSESSMENT EXERCISE 1

Mention and explain the critical issues involved in lending decisions.

3.2 Decisions on Portfolio Allocations

3.2.1 Sectors of the Economy

The commercial banks normally have policy on allocation of funds to various sector of the economy as required by the apex bank. This is regardless of the fact that some sectors are considered risky by the banks as discussed in the preceding section.

Therefore, the banks would place limits on the extent of lending to business entities on the bases of certain criteria or factors such as sector, industry, geographic location, urban areas, rural areas, agriculture, mining, transport, information technology, nature of products, etc.
Some banks may not have restrictions on the maximum proportion of the total loan portfolio by value that can be allocated to certain industries particularly the petroleum and ICT sectors of the economy. Therefore, the volume of lending to such industries may be greater that other sectors' allocations.
There are factors that appear to contribute to the lack of any portfolio limitations and these include the following.

- The fact that in lending to petroleum and ICT sectors, banks are lending to lucrative sectors which would help them in diversifying their risk.
- In aggregate, the value of lending to such sectors is a relatively small proportion of the total loan book, but very profitable.
- The issue of default by such companies may not arise because they operate in fast moving industries.
- Lending to some industries such as commercial agriculture and mining companies which may be owned by large corporate entities may have considerable ramifications for regional economies and by extension, the national economy.

3.2.2 Available Information

Quality of information being made available particularly by the small and medium enterprises may impact on the decision to approve or decline a loan application, and potentially will affect the pricing and the magnitude of facility granted.

The quality of information required by commercial banks normally centre on the following areas.

- History of business, if already in existence.
- Past/projected financial statements (preferably audited).
- Production and cash budgets.
- Cash flow forecasts.
- Information/background on key individuals.

- The supply arrangements.
- Market and customer base.
- Details of trade terms.
- Capital assets of the business.
- Business plans or strategy for operations.
- Industry analysis.
- Information on bank accounts for reference checks.

There is the concern by commercial banks that the quality of information being supplied by customers varies enormously despite the availability of prepared forms for such information. Generally, the information required for loan decisions concern comprehensive financial statements, forecasts, strategies and business plans. Other pieces of information are those that may be necessary with which to take decision on loan facility.

Some banks may make use of the relationship managers to work with the customers to get information, and in some instances will direct them to seek professional advice from accountants, financial advisors or various agencies, whose expertise and professional experience will be of tremendous value in supplying the necessary information.

3.2.3 Grading of Loans

Risk grading and security are two important factors that determine pricing of loans and the allocation of funds. The assignment of entities to a risk grade is made in relation to the probability of default, that is, ability of borrower to meet debt obligations. The security issue is a major consideration in the determination of loss on default because the collateral security serves as a safety valve.

The allocation of funds for loan facility is largely affected by both the probability of default and probable or expected loss on default. Such factors also have a major bearing on the pricing of the loan. Some commercial banks do combine the security quality indicator with the risk assessment grade to generate a single risk grade.
The grading system that has been used for analysis in Study Unit 2 is replicated herein for more understanding in this analysis. See Figure 5.2 below.

Figure 5.2: Grading and Classification of Loan Facilities

Grade	Classification of Loan
A	**Top Grade Loan:-**

These are loans that are secured and repayable as at when due by the beneficiaries; because of the performance of the companies based on market fundamentals.

B **Good Loans:-**

These are loans that are expected to perform without fear of defaults by the companies as a result of their (beneficiaries') credibility.

C **Marginal Loans:-**

These are loans that are being taken for the speculative purposes such as the funds for use in purchasing shares and stock. Their repayment is subject to performance of the capital market.

D **Doubtful Loans:-**

These are loans for which their repayment by the beneficiaries is uncertain due to the fact that such funds will be used for restructuring and re-engineering of failing corporate giants.

E **Likely Bad Loans:-**

These are loans for which their repayment by the beneficiaries is practically uncertain because the companies or business entities for which the funds are secured are technically insolvent.

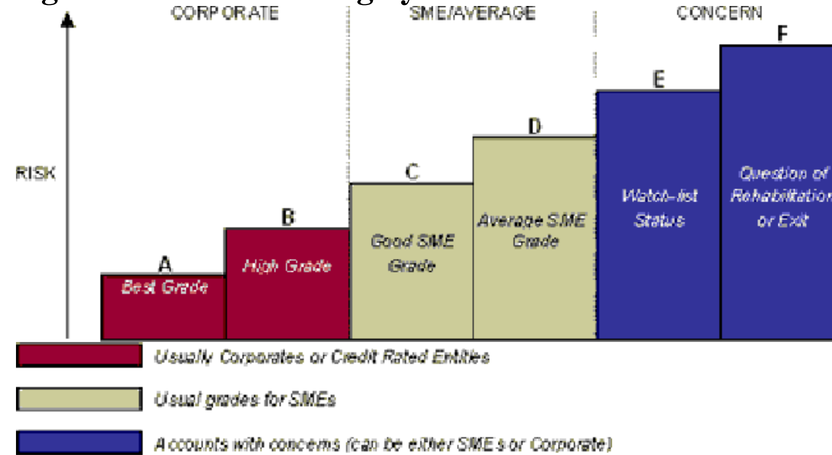
The above grading of loans and advances is based on the elements of risk inherent in them and also on the security issues in respect of the facilities. This approach requires that consideration be given to credit scoring by the credit managers. Nevertheless, various commercial banks may have different techniques for assessing risk.

3.2.4 Risk Grading

Some banks do assign risk grades to each beneficiary of a loan facility borrower on their books. The concepts, purpose and application of the grading systems may be comparable for all of the banks using them. The systems may be applicable to all customers, not just selected ones.

The diagram in Figure 5.3 below is used to illustrate in a general approach the concept of the risk grading systems that can be used by the banks. The actual number of grades employed by each bank varies. Some of the banks could have more than six grades, with more categories being used for small and medium enterprises and the loan accounts that may be considered higher risk accounts.

Figure 5.3: Risk Grading System for Loan Accounts



Source: Fraser, D. R., Gup, B. E. and Kolari, J. W. (1995). Commercial Banking: The

Management of Risk, Minneapolis/St Andrew: Western Publishing Company, p.67.

Taking the case of companies, higher grades are generally assigned to larger corporate organizations or blue chip entities. In related terms, it is feasible that very high quality small and medium enterprises could be assigned a higher grade.

For the categories of Grade A or B, the following characteristics are discernible in relation to the corporate entities concerned:

- strong and sustainable cash flow;
- very strong and accountable management;
- good reporting and information systems; and
- credit ratings/proven debt servicing record.

For the categories of Grade C, the following characteristics are discernible in relation to the corporate entities concerned:

- good cash flow/strong business;
- strong management capability;
- good debt servicing history (if available); and
- good account history (if available).

For the categories of Grade D, the following characteristics are discernible in relation to the corporate entities concerned:

- adequate but not exceptional financial performance;
- reasonable management capability;
- good debt servicing history (if available); and
- good account history (if available).

For the categories of Grade E, the following characteristics are discernible in relation to the corporate entities concerned:

- Breach of financial covenants.
- Poor financial performance.
- Poor industry performance.
- Account conduct, e.g., excessive use of overdraft facility.
- Pressure on entity from third parties.
- High level of gearing in operations.
- Exception reviews that can produce exception reports when a borrower's activity is unusual, such as exceeding overdraft limits, defaulting on payments.

Exception reviews are normally based on quarterly behavioural assessments. Automated behavioural systems are frequently used by commercial banks to monitor account activity on a regular basis usually quarterly as has been pointed out.

In most cases an existing borrower can be downgraded to an "E" grade, and the implication is that there is cause for concern over the account or the performance of the loan facility. Nevertheless, such a downgrade may only be taken as a precautionary measure.

The overall implication for the entity being downgraded is in relation to the following considerations:

- The account is placed under the control of the relationship manager, unless the account is overly complex or exposure level is sufficient to require credit management involvement.
- Account review or monitoring is undertaken more frequently.
- Discussions would be undertaken with the beneficiary in order for him to understand the issues involved, and necessarily, finding some strategies for improvement.

A situation arises when a borrower, in respect of which there are serious concerns over his loan account, will be assigned an "F" grade. The usual causes of this downgrade are similar to those issues raised in "E" grade, but they tend to be more serious in nature. For the accounts which are downgraded to an "F" category, the bank takes the following actions:

- The account is transferred to the credit management team.
- The customer is interviewed to ascertain reasons for default, and to find ways to avoid an exit strategy being employed.
- In the case of rehabilitation a strategy is developed between the customer and the bank.
- Detailed budgets, forecasts and cash flows would be required from the customer, along with ongoing management accounts and variance reports.
- The level of monitoring is intensified.

- Interest on loans could be suspended to assist the borrower in the short term.
- Professional advice may be required to assist the borrower.
- Investigating accountants may be called in by the bank with which to assess the reality of the situation faced by the borrower.
- In the case of an exit strategy that might be agreed upon, there would be asset sales, receivership or liquidation.

The above actions by the banks on the weak accounts of loan beneficiaries are imperative so that they would guide against their funds which have been invested in such loan facilities.

3.2.5 Collateral Security

There would be notable differences between the types of collateral security that will be accepted by the various commercial banks. The banks are very much concerned about the recovery of their funds in the case of defaults.

There are some important points about the issue of collateral security. Such considerations are as highlighted below.

Residential property constitutes a predominant form of security for loans being granted to small and medium enterprises. Most of the banks favour lending against property such as commercial and residential buildings because, in the case of loan repayment default, it can be easily sold in order to realise value and does not depreciate in value.

The preference for property as collateral security is demonstrated by the fact that the operations of small and medium enterprises can easily fail and such business entities are in most cases personalized by their owners or are mainly family business.

The commercial banks may have policies that favour the acceptance of other forms of collateral security. Nevertheless, the proportion of loans for small and medium enterprises with property as collateral security is normally very high.

Some commercial may have regulations which may specify that lending over residential property is the most cost effective option for loans being given to small and medium enterprises. The price will often be determined without regard for the credit grading assigned. The margins in housing property-backed loans are regarded as being very reasonable.
The small and medium enterprises may be made to pay some premium on the loan facilities granted to them in the event that such lending facilities are not in the form of home mortgages. Debtors and stock are

not normally favoured as collateral security. In the event that debtors and stock are accepted as collateral security, the policy is that they are usually heavily discounted.

Some commercial banks are not favourably disposed towards lending on the basis of debentures. This is because when it comes to executing a debenture, it is reckoned that there are costs that will be involved in realising value. The problems inherent in debentures include collecting payments from debtors, selling stock, competing claims against the residual value of the entity and the value realised from company assets may be lower than their book value.

There are still some loan facilities which can be granted without any collateral backing particularly in the case of small and medium enterprises but they are negligible. In such instances, guarantors are being demanded too sign up for the security of the funds so that their repayments can be assured.

In respect of the very small proportion of loans for small and medium enterprises that are unsecured, a number of characteristics must be present, and they are as highlighted below:

- Very strong cash flow position
- Profitable trading history
- Good relationship with bank
- Strong managerial capacity
- Quality financial information
- Strong financial position
- Guaranteed future sales
- Good viability assessments
- Personal guarantees and covenants.

The usual practice is for the banks to assign security quality indicator to a borrower offering collateral security, which is based on the value of the security in relation to the value of the loan. The indicator for collateral security is influential in setting loan terms such amount of loan, duration, and interest charges, etc.

SELF-ASSESSMENT EXERCISE 2

Mention and explain the factors that influence decision on portfolio allocation in lending.

3.3 Relationship Between Collateral Security and Pricing 1. Cash Flow Consideration

The usual practice is that commercial banks normally require adequate levels of cash flow and security to ensure that the risk of default and loss on default is considerably minimized.

All considered, there seems to be an element of trade-off between security and cash flow. Ideally, while all banks would prefer strength in both cash flow and asset backing, there is particularly an exception in the case of the loans to the small and medium enterprises. While the requirement for security is strong in one dimension, it tends to lower the extent to which reliance is placed on the cash flow.

In cases where a loan application is granted and be secured against a landed property such as a house which has value twice the value of the loan, the emphasis on cash flow can be lessened. Nevertheless, in practical situation there is no bank that will lend if there is poor cash flow in operations of a business entity applying for the loan facility.
In related terms, all commercial banks make it as a policy to lend at lower levels of security provided that the cash flow position of the beneficiary business is particularly strong. There will be assurance that the repayment will be made as at when due at the instance of strong cash inflows from operations.

There may be variations among the banks in terms of the definition, number and allocation of the lending grades, but comparable risk characteristics are normally utilized. Furthermore, all the banks are bound to place heavy reliance on having reasonable sources of loan repayment.

2. Interest Rate Charges

The commercial banks normally base their pricing or interest rate charges primarily on risk grade, which is adjusted by the level and quality of collateral security being pledged in respect of the facility. The risk grades used by the banks, as pointed out earlier, are normally correlated to statistical data available to the banks, which is used to estimate the probability of default and likely loss on default.
Nevertheless, due to bank-customer relationship and competitive reasons, it is quite feasible that two companies or corporate entities in the same risk grade with equivalent facilities and collateral security may pay different interest rates. By the same token or consideration, two corporate entities with different risk grades may pay the same rate of interest.

There could be some variation regarding interest rates and margins with respect to the nature of business and peculiar loans generally and with respect to loan type and nature of security. Therefore, the variation can arise because of the consideration for the promotion of small and medium enterprises and peculiar regulation of the apex bank on loans and advances for favoured sectors of the economy.

The various commercial banks may use different methodologies for pricing which are consistent with their business strategies. In general terms, interest charges are combinations of fees and margins in terms of the interest rate charges. In related terms:

- fees are normally charged to cover the costs incurred by the banks for establishing and servicing loan facilities; and
- margins are normally charged by the banks to provide a commensurate return based on the risk inherent in the loan and the cost of capital faced by banks.

The cost of capital reflects the cost of financing the banks' deposit liabilities. In respect of small businesses, the banks may likely charge a uniform rate of interest with little or no variation in interest rate between micro-business customers).

A number of banks use a matrix in terms of methodology, by setting out risk and security, as well as customer need or product type to ascertain an appropriate base for interest charges. And then adjustments are made to reflect the relative risk of the business entity. This may increase or decrease the base pricing. The relationship managers or credit managers may be granted some discretion to change interest charges as necessary.
There may be consideration by the banks that the risk-reward relationship in respect of the small and medium enterprises is attractive for loan facilities due to the following reasons.

- The profitability of the small and medium enterprise sector is perceived to be higher than personal banking.
- Lending to the small and medium enterprises may be regarded as the most profitable sector for the banks.
- The small and medium enterprise market may have a higher risk of default, but it has a lower loss on default, and therefore, it is normally priced accordingly.

In terms of lending generally to the small and medium enterprises, the factors considered for charging interest rates include; inherent risk element, competitive pressures, target return on equity, future potential, level of patronage of products, and government regulations.

i) Competitive Pressures

These constitute a potent influence on margins. This can affect the margins of the banks and therefore, tends to erode the risk-return relationship, notwithstanding the profitability of lending to the small and medium enterprise sector. The banks may consider the fact that the industry is highly volatile but they tend to be unwilling to lose a customer primarily due to price.

ii) Target Return on Equity

This factor is a high level consideration in setting interest charges. Nevertheless, other factors are more important on a case-by-case basis. The target margins are normally used to ensure the desired level of profitability is achieved by the bank. Nevertheless, banks tend to match rates or negotiate charges to win new business, or more importantly to attempt to retain business under threat from competing banks.

iii) Future Potential Earnings

The future earning potential of businesses is a consideration when banks price facilities in terms of charging interest on loans. For a small and medium enterprise with good growth prospects, a bank may provide loans at discounted rates or margins, in order to secure a long-term profitable customer. This is considered to be beneficial for both the business and the bank; the SME can access the funds at very competitive rates to enable its growth, and the bank secures a profitable client.

iv) Level of Cross Subsidization

This factor is also important in charging interest on loan facility. The consideration encompasses the fees received from the customer from other accounts held within the bank. Certain banks have more sophisticated pricing models that are based on the overall relationship profitability, rather than individual product profitability.

v) Government Regulation

This factor is also very important in charging interest on loan facilities for the small and medium enterprises. The commercial banks are normally under pressure to charge interest rates that are in line with the regulation from the apex bank regarding the appropriate rate to charge for loans for SMEs.

SELF-ASSESSMENT EXERCISE 3

List and explain the factors that influence charging of interest rate on lending to small
and medium enterprises.

3.4 Monitoring and Relationship Management

It is always necessary that once the decision has been made by the credit manager to approve a loan, the bank will maintain an ongoing relationship with the customer. This is important towards securing the interest of the bank and profitable use of the funds. Such responsibility involves monitoring and maintaining constant relationship with the loan beneficiaries.

1. Monitoring of Loan Accounts

The nature and frequency of ongoing monitoring of the behavior of the loan beneficiary depends on a number of factors such as identified and explained below:

i) Account Conduct

This is in the areas of overdraft usage, cash inflows and outflows, number of transactions. In the event of unusual conduct, a bank may monitor an account more closely.

ii) Risk Level

This is in reference to the small and medium enterprise itself, the industry and the economy in general. Basically, the consideration is that the higher the risk assessments, the higher the level of monitoring.

iii) Borrower Preferences

The borrower may dictate the form and frequency of contact with the bank officials or relationship manager. In this regard, some borrowers may prefer a lot of contact, whereas others desire as little as few contacts or the number of possible contacts.

iv) Borrower Needs

The contacts may be based on the need for further facilities and or facility restructuring such loan workout between the borrower and the bank. This has the potential of having tremendous impact on the level of monitoring required by bank officials.

In the event that the account does not exhibit any signs of adverse trends or exceptional trends, it will only be subjected to an annual review. Normally, the annual review focuses on considerations such as follows:

- movements in balance sheet items;
- cash flow position of the business;
- analysis of audited financial reports;
- assessment of the business trends; and
- mutual discussions with the borrower.

Many commercial banks may desire to install and utilise an automated behavioural system that can identify when account conduct changes for the worse. This is considered useful in providing early warning of

impending cash flow or profitability problems. Accordingly, a relationship manager can tell up to three months ahead if an account may be having issues. In a situation where such systems are in place, many accounts will only be reviewed when exceptions occur.

In the event that an account gets into considerable difficulty, then the banks will follow procedures along the lines outlined in the risk grading as discussed earlier in this Study Unit. Monitoring may then occur as frequently as once a month for such problem account.

In a situation when a customer is downgraded below a certain level as a result of the bank becoming concerned with the adverse trends affecting the customer, the account may be transferred to a credit or asset management team. This team is normally expected to work with the customer to determine a strategy for rehabilitation, or if rehabilitation is not considered feasible, then an exit strategy will be formulated by the bank and normally executed with minimum delay.

2. Relationship Management

In a situation where the use of relationship managers is considered ideal in the case of dealing particularly with the small and medium enterprises, the banks will place more resources at the customer interface level in order to make the relationship effective. This may call for the use of increasing number of employees in each branch of the bank.

The number of customers which will be assigned to individual relationship managers will have to be determined in order to make their work effective. The use of relationship management is particularly important in dealing with customers in the small and medium enterprise sector of the economy.

Basically, the relationship managers are specialists with specialize knowledge in specific areas within the bank operations. These individuals would have a greater understanding of the risks and technical aspects of particular industries or markets and services. Such specialist areas include international trade, insurance, payment services, investments, property finance, as well as specific industry sub-sectors.

SELF-ASSESSMENT EXERCISE 4

Identify and explain the considerations in monitoring of loan facilities.

4.0 CONCLUSION

You have learnt from this study unit that there are critical issues which are considered in lending decisions. These issues such as management capability, individual characteristics, performance history, geographical risk, level of exposure, and industry risks are essential towards ensuring that the funds of the bank are not lost in the process of lending. Some factors are normally taken into consideration is portfolio allocation. Such factors which include sectors of the economy, available information, risk grading and security, risk grading, and collateral security are important in safeguarding the funds of the bank. The commercial banks normally charges interest on loans and advances based on factors such as competitive pressures, return on equity, and government regulation, among others. Monitoring and relationship management are critical towards keeping the loan beneficiaries on their toes towards regular repayment of loans granted them.

5.0 SUMMARY

In this study unit, topics covered include the following:

- Critical Issues in Lending Decision
- Decisions on Portfolio Allocations
- Sectors of The Economy
- Available Information
- Grading of Loans
- Risk Grading
- Collateral Security
- Relationship between Collateral Security and Pricing
- Monitoring and Relationship Management

In the next study unit, you will be taken through discussion on loan workout situations.

6.0 TUTOR-MARKED ASSIGNMENT

Mention and discuss the relevant considerations by the banks in lending decisions.

7.0 REFERENCES/FURTHER READING

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UNIT 1 LOAN WORKOUT SITUATIONS

CONTENTS

1.0 Introduction
2.0 Objectives
3.0 Main Content
3.1 Framework for Loan Workout Programme
3.2 Nature of Loan Workout Arrangements
3.3 Critical Considerations in Loan Workout Situations
3.4 Loan Workout Options
4.0 Conclusion
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1.0 INTRODUCTION

You would recall that, in the preceding study unit, we discussed the criteria for lending decisions in terms of the necessary which must be put in place to avoid unfavourable situations that may affect the interest of the banks. In spite of such measures, some loan beneficiaries may still default while some accounts can become distressed. All this requires some workout situations whereby the banks will have to arrange for loan restructuring and the use of other workout options. Therefore, the discussion in this study unit is focused on identifying and explaining such loan workout options that are available for handling distressed loan facilities.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- discuss the framework for loan workout programme
- explain the nature of loan workout arrangements
- list and discuss critical considerations in loan workout situations
- identify and explain loan workout options.

3.0 MAIN CONTENT

3.1 Framework For Loan Workout Programme

The normal practice is that for any organizational function to succeed the management has to institute an operational structure towards it effective implementation.

A bank's structure for management practices of renewing and restructuring loans is normally recommended to be appropriate for the complexity and nature of its lending activity. Furthermore, the operations in restructuring and renewal should be consistent with safe and sound lending practices and relevant regulatory reporting requirements.

In general terms, the framework for loan renewal and restructuring should be formulated to take into consideration some specific requirements. Therefore, the framework should tackle the following:

1. Management infrastructure to identify, control, and manage the volume and complexity of the workout activity
2. Documentation standards to verify the borrower's financial condition and collateral values.
3. Adequacy of management information systems and internal controls to identify and track loan performance and risk, including concentration risk
4. Management's responsibility to ensure that the regulatory reports of the bank are consistent with regulatory reporting requirements and supervisory guidance
5. Formulation of appropriate and effective loan collection procedures.
6. Adherence to statutory, regulatory and internal lending limits.
7. Collateral administration to ensure proper lien perfection of the bank's collateral interests for both real and personal property.
8. The use of continuous credit review, which should be instituted by the bank so as to keep abreast of beneficiary repayment.

SELF-ASSESSMENT EXERCISE 1

What are the specific requirements to be considered in establishing a framework for a loan workout programme?

3.2 Nature of Loan Workout Arrangements

Loan workouts can take many forms, including a renewal or extension of loan terms, extension of additional credit, or a restructuring with or without concessions by the bank.

A renewal or restructuring of loan is normally designed with the intent of improving the borrower's prospects for repayment of principal and interest and be consistent with sound banking, supervisory, and accounting practices.

Banks normally consider loan workouts after analyzing a borrower's repayment capacity, evaluating the support provided by guarantors, and assessing the value of the collateral pledged on the debt. Loan workout arrangements are normally designed to help ensure that the bank maximizes its recovery potential.

Furthermore, the renewed or restructured loans to borrowers who have the ability to repay their debts under reasonable modified terms are not normally made subject to adverse classification. This is because the value of the underlying collateral might have declined to an amount that is less than the loan balance.

While banks may enter into restructurings with borrowers that result in an adverse classification, a bank will not be criticized for engaging in loan workout arrangements so long as management has an appropriate workout policy.

The considerations are that:

- such a prudent workout policy is the type that establishes appropriate loan terms and amortization schedules;
- it also permits the bank to modify the workout plan if sustained repayment performance is not demonstrated or if collateral values do not stabilize;
- a well-conceived and prudent workout plan for an individual credit should be the type that analyzes the current financial information on the borrower or guarantor; and
- it should also supports the ultimate collection of principal and interest charges on the loan facility.

The essential elements of a workout plan that a bank normally adopts include:

i) updated and comprehensive financial information on the borrower, the project for the funds, and any guarantor;
ii) current valuations of the collateral supporting the loan and the workout plan;
iii) analysis and determination of appropriate loan structure (e.g., term and amortization schedule), curtailment, covenants, or re-margining requirements;
iv) appropriate legal documentation for any changes to loan terms;
v) an analysis of the borrower's debt service that reflects a realistic projection of the borrower's and guarantor's expenses;
vi) the ability to monitor the ongoing performance of the borrower and guarantor under the terms of the workout;
vii) an internal loan grading system that accurately and consistently reflects the risk in the workout arrangement; and
viii) it covers estimated credit losses in the restructured loan.

The restructuring of a loan or any other debt instrument should be undertaken in ways as to achieve the following:

- Improve the likelihood that the credit will be repaid in full under the modified terms in accordance with a reasonable repayment schedule.
- All restructured loans should be evaluated to determine whether the loan should be reported as adverse.
- A restructured loan is considered adverse when the bank, for economic or legal reasons related to a borrower's financial difficulties, grants a concession to the borrower in modifying or renewing a loan that will not be considered.

For this determination, the bank would have assessed whether the borrower is experiencing financial difficulties.

In other situations, modification of various loan terms and other workout possibilities might provide the means for the investors and lender to salvage more of their investment and minimize their respective losses. The workout might include an interest rate reduction, amortization schedule adjustment and, in rare cases, a forbearance or principal reduction.

SELF-ASSESSMENT EXERCISE 2

Mention the essential elements of a workout plan that a bank normally adopts.

3.3 Critical Considerations in Loan Workout

SITUATIONS 1. Evaluating Guarantees

The support provided by guarantees for loan facilities is a consideration in determining the credit classification for a workout. The presence of a guarantee from a financially responsible guarantor may improve the prospects for repayment of the debt obligation.

The guarantee may be sufficient to preclude classification or reduce the severity of classification. The attributes of a financially responsible guarantor include the following:

- The guarantor has both the financial capacity and willingness to provide support for the credit through ongoing payments or curtailments.
- The guarantee is adequate to provide support for repayment of the indebtedness, in whole or in part, during the remaining loan term.

- The guarantee is written and legally enforceable which can be appropriated by the bank for recovering of the loans.

Therefore, the banks should have sufficient information on the guarantor's global financial condition, income, liquidity, cash flow, contingent liabilities, and other relevant factors (including credit ratings, when available) to demonstrate the guarantor's financial capacity to fulfill the obligation.

This assessment by the banks includes consideration of the total number and amount of guarantees currently extended by a guarantor in order to assess whether the guarantor has the financial capacity to fulfill the contingent claims that exist.

The banks should also consider whether a guarantor has demonstrated its willingness to fulfill all current and previous obligations, has sufficient economic incentive, and has a significant investment in the project.

Another important consideration will be to assess whether previously required performance under guarantees has been voluntary or it results from legal or other actions by the bank to enforce the guarantee.

2. Assessing Values of Collateral

The collateral serves as the primary sources of loan repayment decline. Nevertheless, the importance of the collateral's value as a secondary repayment source increases in analyzing credit risk and developing an appropriate workout plan.

The bank should take appropriate steps for reviewing current collateral valuations. This involves an appraisal or evaluation towards ensuring that their assumptions and conclusions are reasonable.
Further, the bank should have policies and procedures that dictate when collateral valuations should be updated as part of its ongoing credit review, as market conditions change, or a borrower's financial condition deteriorates.

In the event that project loans are involved in a workout situation, a new or updated appraisal or evaluation, as appropriate, should address current project plans and market conditions that were considered in the development of the workout plan.

For the consideration in a workout for a project loans, the assessment should include whether there has been material deterioration in the following factors:

- the performance of the project;
- conditions for the geographic market and property type;
- variances between actual conditions and original appraisal assumptions;
- changes in project specifications;
- loss of a significant lease or a take-out commitment; and
- increases in pre-sales fallout.

A new appraisal may not be necessary in instances where an internal evaluation by the bank appropriately updates the original appraisal assumptions to reflect current market conditions and provides an estimate of the collateral's fair value for impairment analysis.

The market value in a collateral valuation and the fair value in an impairment analysis are based on similar valuation concepts. Nevertheless, the market valuation may differ from the collateral's fair value for regulatory reporting purposes.

For instance, differences may result if the market value and the fair value estimates are determined as of different dates or the fair value estimate reflects different assumptions than those in the market valuation. Such situations may occur as a result of changes in market conditions and property use.

The documentation on the collateral's market value should demonstrate a full understanding of the property's current and other relevant risk factors affecting value. The banks should use the market value conclusion and not the fair value that corresponds to the workout plan and the loan commitment. The bank may intend to work with the borrower to get a project to stabilized occupancy.

In such consideration, the bank can consider the stabilized market value in its collateral assessment for credit risk grading after reviewing the reasonableness of the appraisal's assumptions and conclusions. Conversely, if the bank intends to foreclose, then it should use the fair value of the property in its current condition in its collateral assessment.

3. Loan Performance Assessment

The main approach to loan performance is based upon an assessment as to whether the borrower is contractually current on all principal and interest payments. In many cases, this perspective is sufficient for a particular credit relationship and accurately portrays the status of the loan.

In the case of project loan, the development project may stall for any number of reasons and management fails to evaluate the collectibility of the loan, interest income will continue to be recognized from the initial interest reserve and capitalized into the loan balance even though the project is not generating sufficient cash flows to repay the principal.

In such cases, the loan will be contractually current due to the interest payments being funded from the reserve, but the repayment of principal may be in jeopardy, especially when expected leases or sales have not occurred as projected and property values have dropped below the market value reported in the original collateral valuation. In these situations, adverse classification of the loan may be appropriate.

4. Classification of Renewals of Maturing Loans

Loans to commercial borrowers can have short maturities, including short-term working capital loans to businesses, and personal loans, among others. Many borrowers whose loans mature in the midst of an economic crisis have difficulty obtaining short-term financing or adequate sources of long-term credit due to deterioration in collateral values despite their current ability to service the debt.

In such cases, the banks may determine that the most appropriate and prudent course is to restructure or renew loans to existing borrowers who have demonstrated an ability to pay their debts, but who may not be in a position, at the time of the loan's maturity, to obtain long-term financing.

Restructured workout loans typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. The assessment of each credit should, therefore, be based upon the fundamental characteristics affecting the collectibility of the particular credit.

In general, renewals or restructurings of maturing loans to commercial borrowers who have the ability to repay on reasonable terms will not be subject to adverse classification, but should be identified in the bank's internal credit grading system and may warrant close monitoring.
Nevertheless, adverse classification of a restructured loan would be appropriate, in the event that after the restructuring, well-defined weaknesses exist that jeopardize the orderly repayment of the loan in accordance with reasonable modified terms.

5. Classification of Restructured Loans with Charge-off

A situation may arise that based on consideration of all relevant factors, an assessment may indicate that a credit has well-defined weaknesses that jeopardize collection in full and may result in a partial charge-off as part of a restructuring.

When well-defined weaknesses exist, and a partial charge-off has been taken, the remaining recorded balance for the restructured loan generally should be classified as being substandard. A more severe classification than substandard for the remaining recorded balance would be appropriate if the loss exposure cannot be reasonably determined.
The above situations may occur where significant risk exposures are perceived, such as a borrower's bankruptcy or a loan collateralized by a property subject to environmental hazards. A restructuring may involve a multiple note structure in which, for example, a troubled loan is restructured into two notes.

The banks may separate a portion of the current outstanding debt into a new legally enforceable note (that is, the first note) that is reasonably assured of repayment and performance according to prudently modified terms. This note may be placed back on accrual status in certain situations. In returning the loan to accrual status, sustained historical payment performance for a reasonable time prior to the restructuring may be taken into account.

The portion of the loan that is not reasonably assured of repayment (that is, the second note) should be adversely classified and charged-off as appropriate. In contrast, the loan should remain or be placed on non-accrual status if the bank lender does not split the loan into separate notes, but internally recognizes a partial charge-off. A partial charge-off would indicate that the bank does not expect full repayment of the amounts contractually due.

6. Loan Restructuring and Interest Accrual

In the case of a restructured loan that is not already in non-accrual status before the restructuring, the bank needs to consider whether the loan should be placed in non-accrual status to ensure that income is not materially overstated.

In related terms, a loan that has been restructured so as to be reasonably assured of repayment and of performance according to prudent modified terms need not be maintained in non-accrual status. This is based on the assumption that the restructuring and any charge-off taken on the loan are supported by a current, well-documented credit assessment of the

borrower’s financial condition and prospects for repayment under the revised terms.

The assessment of accrual status should include consideration of the borrower’s sustained historical repayment performance for a reasonable period prior to the date on which the loan is returned to accrual status. A sustained period of repayment performance generally would be a minimum of six months and would involve payments of cash or cash equivalents.

A restructuring should improve the collectibility of the loan in accordance with a reasonable repayment schedule and does not relieve the bank from the responsibility to promptly charge off all identified losses.

SELF-ASSESSMENT EXERCISE 3

What are the critical considerations in loan workout situations?

3.4 Loan Workout Options

There are various options available loan workouts. The options below are normally applied to different situations. It is not all workout options that are available to all borrowers or all situations. Therefore, the bank normally determines which type is best applicable to a specific loan workout situation.

1. Loan Restructuring

A restructuring or renewal of loan is normally designed to improve the borrower’s prospects for repayment of principal and interest and be consistent with sound banking, supervisory, and accounting practices.

A restructuring of loan is, in most cases, made for borrowers who have the ability to repay their debts under reasonable modified terms.

The option is normally granted by the bank on the basis of the likelihood that the credit will be repaid in full under the modified terms in accordance with a reasonable repayment schedule.

2. Forbearance Plan

This is a forbearance plan that occurs when the bank agrees to suspend all or part of a monthly payment for a specified time period. The repayment automatically resumes immediately after the lull period.

3. Repayment Plan

The repayment plan is the plan that is designed to take care of accumulated payments. Therefore, the borrower is under obligation to be

making payment more than one full payment per month until the account is brought to current position.

4. Loan Modification

The loan modification arises when the original terms of the promissory note are changed. The loan modification may be arranged to include an adjustment of the interest rate, a capitalization of the past due amount, and some combination of all of these.

5. Sale of Property

This implies that the property may be sold prior to foreclosure sale and the proceeds used to pay off the delinquent loan. In some cases, the sale price or the amount realized may not be enough to pay off all of the debt.

If the sale is approved and carried out it becomes a “Short Sale”. This implies that a short sale arises when the net proceeds from the sale of the property are less than the payoff of the required amount of the mortgage.

6. Deed-in-Lieu of Foreclosure

In some circumstances the bank may allow the borrower to transfer the property to the lender without going through the foreclosure process. This is usually regarded as a “last resort” option, and this may follow other options such as an attempt to sell the property.

7. Loan Extension

In a maturing loan situation, when no other financing seems to be available, it may be possible for the borrower to negotiate for extension of the existing loan normally for a fee. The fee is normally paid on the basis of the period of extension.

In relation to the extension quest, the borrower would take steps to approach the bank some months before the loan matures, with evidence of the borrower’s unsuccessful refinance efforts and a specific proposal for the extension. As part of the proposed extension, the borrower might also request other modifications such as an interest rate reduction, if appropriate.

4.0 CONCLUSION

You have learnt from this study unit that there are situations in lending that call for loan workouts. Therefore, commercial banks normally put a framework in place for managing loan workouts. The workout involves determining the best options for use in handling distressed loan facilities so as to save the interest of the banks. Generally, there are some options that are available for handling loan workouts. Nevertheless, the options

adopted for handling specific problem loans depend on the nature of problems arising from the facilities in terms of the behavior of the borrowers and the loan accounts.

5.0 SUMMARY

In this study unit, topics covered include the following:

- Framework for Loan Workout Programme
- Nature of Loan Workout Arrangements
- Critical Considerations in Loan Workout Situations
- Loan Workout Options

In the next study unit, you will be taken through the discussion on

6.0 TUTOR-MARKED ASSIGNMENT

Mention and explain the various options available for loan workout by the banks.

7.0 REFERENCES/FURTHER READING

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UNIT 2 RESPONSIBILITIES OF LOAN WORKOUT PERSONNEL

CONTENTS

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  3.3 Responsibilities of Loan Workout Officers
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    3.3.2 Relationship Operations Responsibilities of Loan Workout Officers 4.0 Conclusion
5.0 Summary
6.0 Tutor-marked Assignment
7.0 References/Further Reading

1.0 INTRODUCTION

You would recall that, in the preceding study unit, we discussed the intricacies of loan workout. You would also recall that such workout arises when the bank observes that the loan accounts of beneficiaries are not measuring up to date in terms of repayment lodgments and the expected frequency of payments of principals and their interest charges. This study unit is a continuation of such discussions because it is used to discuss the role of the risk and loan workout officers of the banks generally.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- mention the reasons for loan workout arrangement
- identify the responsibilities of bank risk officers
- list the management responsibilities of loan workout officers
- list the relationship responsibilities of loan workout officers

3.0 MAIN CONTENT

3.1 Reasons for Loan Workout Arrangement

Before the discussion of the role of loan workout officers there is need for us to review and discuss the loan workout situations in the banking system generally. This discussion herein is based on the previous analysis of the preceding study unit.

From the previous discussion, you have observed that loan workouts arise when the loan accounts and indeed the beneficiaries of loan facilities are not behavior according to the agreed terms on such credit facilities.

Therefore, the loan workout situations can take many forms, which include a renewal or extension of loan terms, extension of additional credit, or a restructuring with or without concessions by the bank.
The process of renewal or restructuring of loan is normally designed with the intent of improving the borrower's prospects for repayment of principal and interest and be consistent with sound banking, supervisory, and accounting practices.

Generally, banks normally consider loan workouts after:

- analyzing a borrower's repayment capacity;
- evaluating the support provided by guarantors; and
- assessing the value of the collateral pledged on the debt.

Hence loan workout arrangements are normally designed to help ensure that the bank maximizes its recovery potential. Basically, the renewed or restructured loans to borrowers who have the ability to repay their debts under reasonable modified terms are not normally made subject to adverse classification.

This is because the value of the underlying collateral might have declined to an amount that is less than the loan balance. A bank will only engage in loan workout with borrowers that results in an adverse classification arrangements so long as management has an appropriate workout policy.

The reasons for the establishment of appropriate loan workout policy by the banks are such that they cannot be neglected considering the fact that loan beneficiaries are bound to default in repayment schedule. Therefore, the reasons for loan workout arrangement include the following:

i) A prudent workout policy is the type that establishes appropriate loan terms and amortization schedules;
ii) It also permits the bank to modify the workout plan if sustained repayment performance is not demonstrated or if collateral values do not stabilize;
iii) A well-conceived and prudent workout plan for an individual credit should be the type that analyzes the current financial information on the borrower or guarantor;
iv) It should also supports the ultimate collection of principal and interest charges on the loan facility; and
v) It is needed for sustained relationship between the loan beneficiaries and the bank.
vi) Improve the likelihood that the credit will be repaid in full under the modified terms in accordance with a reasonable repayment schedule.
vii) All restructured loans are normally designed to assess whether the loan should be reported as adverse resulting from repayment difficulties.
viii) A restructured loan that is considered adverse for economic or legal bottlenecks aggravating the borrower's financial difficulties needs urgent consideration.
ix) Loan workout would invariably lead to granting of concession to the borrower in modifying or renewing a loan that will not be considered.
x) The paramount trust of loan workout is to protect the interest of the banks as lenders whose funds ultimately belong to the depositors.

For an effective loan workout plan, the banks are bound to consider appropriate ingredients which are normally incorporated in the workout framework. Therefore, the important elements of a workout plan that a bank normally adopts include the following:

- Updated and comprehensive financial information on the borrower, the project for the funds, and any guarantor;
- Current valuations of the collateral supporting the loan and the workout plan;
- Analysis and determination of appropriate loan structure (e.g., term and amortization schedule), curtailment, covenants, or re-margining requirements;
- Appropriate legal documentation for any changes to loan terms;
- An analysis of the borrower's debt service that reflects a realistic projection of the borrower's and guarantor's expenses;
- The ability to monitor the ongoing performance of the borrower and guarantor under the terms of the workout;

- An internal loan grading system that accurately and consistently reflects the risk in the workout arrangement; and
- It covers estimated credit losses in the restructured loan.

The essence of loan workout policy framework therefore, is the fact that the bank would have assessed that the borrowers can and may be invariably be experiencing financial difficulties, which will hamstring the repayment of their facilities.

In such situations, modification of various loan terms and other workout possibilities might provide the means for the investors and lender to salvage more of their investment and minimize their respective losses. The workout might include an interest rate reduction, amortization schedule adjustment and, in rare cases, a forbearance or principal reduction.

SELF-ASSESSMENT EXERCISE 1

What are the reasons which can necessitate the establishment of loan workout arrangement?

3.2 Responsibilities of Bank Risk Officers

The bank risk officer has some responsibilities to perform in risk management in bank operations towards enhancing the security of the bank's funds and its interest generally. Such bank officers work in tandem with the loan workout officers of the banks to guide the borrowers in the management of adverse situations in relation to their credit facilities.

Therefore, the risk officer of the bank has the following responsibilities in relation to the management of risks inherent in bank lending.

1. Plans, identifies, mitigates, and monitors risks in lending function of the bank.
2. Plans and initiates strategies for portfolio development and recovery of loans.
3. Conducts market surveys and identifies new and viable markets for lending business.
4. Initiates plans for recruitment, training and development of Credit Officers in accordance with the loans portfolio development and makes recommendations to the management.
5. Reviews lending policies and procedures on a regular basis and submits appropriate improvement plans and strategies.
6. Coordinates all loan recovery activities and ensures prompt recovery of the outstanding loan facilities.

7. Monitors and controls the performance of all loans, and overdrafts taken by both corporate and individuals including the staff loans.
8. Monitors and controls the appraisal performance of credit and recovery personnel and makes recommendations to the human resources manager.
9. Compiles, disseminates and monitors implementation of lending policies, procedures and Central Bank regulations, particularly those regarding classification and recovery of outstanding portfolio.
10. Ensures that proper securities are taken on loan facilities and appropriately registered in accordance with the applicable regulations and bank's policies as well as procedure.

SELF-ASSESSMENT EXERCISE 2

What are the responsibilities of bank risk officers in management of loan facilities?

3.3 Responsibilities of Loan Workout Officers

The loan workout officers of the banks have strategic role to play in the management of loan facilities. Such role which is embedded in some responsibilities is imperative towards effective management of loan facilities being granted to customers.

The role of the loan workout officers cannot be discounted in the face of incessant defaults in repayment by the beneficiaries in both corporate and personal loan facilities. This is because the overall reason for the use of loan workout officers is for enhancing the security of the bank's funds.

The loan workout officers are also to work in tandem with the risk officers of the banks to guide the bank in the management of adverse situations in relation to the credit facilities. Both risk officers and workout officers have onerous responsibilities in safeguarding the profitable operations of the bank.
Generally, therefore, the responsibilities of the loan workout officers, which are classified into management and relationship categories are as stated below:

3.3.1 Management Operations Responsibilities of Loan Workout Officers

i) Develop guidelines with which to provide support to the corporate lending staff and the bank management in addressing problem loans.
ii) The loan workout officer is to institute viable strategies for the reduction of past due loans and charged-off amounts.
iii) In addition, the loan workout officer provides analysis and advice concerning problem loans being addressed by corporate, retail or business banking relationship managers.
iv) The officer also ensures appropriate documentation for the various problem loan facilities for appropriate decisions by the bank management.
v) The officer will participate in reviewing, at least on a quarterly basis, workout action plans with relationship managers or loan officers, and provide guardian, as necessary.
vi) The loan workout officer documents workout strategies and collateral position periodically as required on adverse loans.
vii) Develops liquidation strategies for various collateral securities and makes such available to the bank management for necessary action.
viii) Develops the required contingency plans, strategies and resource contacts needed to sell loans, whenever the need arises, to expeditiously reduce the level of difficult loans.
ix) Prepares regularly scheduled action plans, specific reserve worksheets, and ad hoc reports for management review in a timely and accurate manner.
x) Develops and implements a system of loan review that would identify nonperforming loans at an early stage so that remedial action can be taken at appropriate time.

3.3.2 Relationship Operations Responsibilities of Loan Workout Officers

i) Help in assigning a portfolio of loans to different sectors of the economy, the level of which will be reviewed from time to time.
ii) The officer is also to assign problem credits by assessing the financial position of the obligors and collateral values.
iii) The officer determines the appropriate strategic direction for handling difficult loans, set the relevant timelines for workout and then executes the strategy to achieve the desired results.
iv) Ensures that all actions to be taken on loan workouts are being done in line with requirements lending authority, policy requirements and applicable laws.

v) The loan workout officer develops contacts with appropriate external resources to assist in managing the bank's level of problem credits down to an acceptable level.
vi) The officer provides individual workout attention on both large and small problem loan facilities as assigned by the management.
vii) Executes agreed upon workout strategies and corresponding timelines while utilizing and coordinating with the allied bank staff on smaller, non-complex business purpose credits.
viii) Ensures that negotiated loan restructuring adheres to all bank policies and regulations, including credit and non-credit authority levels.

SELF-ASSESSMENT EXERCISE 3

Mention the relationship operations responsibilities of a loan workout officer in a bank system.

4.0 CONCLUSION

You have learnt from this study unit that there are specific responsibilities which are expected to be discharged by some loan workout personnel in bank system. These responsibilities of the loan workout officers are critical for effective management of any workout situations. The loan workout officers normally perform the role in tandem with the laid down framework for managing loan workout situations of the banks as well as the regulations of the regulatory agencies. In performing their roles, the loan workout officers have to work in conjunction with other bank personnel such as lending officers and risk management officers.

5.0 SUMMARY

In this study unit, topics covered include the following:

- Reasons for Loan Workout Arrangement
- Responsibilities of Bank Risk Officers
- Responsibilities of Loan Workout Officers
- Management Operations Responsibilities of Loan Workout Officers
- Relationship Operations Responsibilities of Loan Workout Officers

In the next study unit, you will be taken through the discussion on the responsibilities of bank lending officer.

6.0 TUTOR-MARKED ASSIGNMENT

What are the management operations responsibilities of a loan workout officer in a bank system?

7.0 REFERENCES/FURTHER READING

Fraser, D. R., Gup, B. E. and Kolari, J. W. (1995). Commercial Banking: The Management of Risk, Minneapolis/St Andrew: Western Publishing Company.

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UNIT 3 RESPONSIBILITIES OF BANK LENDING OFFICER

CONTENTS

1.0 Introduction
2.0 Objectives
3.0 Main Content
  3.1 Management Responsibilities of Bank Lending Officer
  3.2 Credit Responsibilities of Banking Lending Officer
  3.3 Main Responsibilities of Bank Credit Manager
4.0 Conclusion
5.0 Summary
6.0 Tutor-marked Assignment
7.0 References/Further Reading

1.0 INTRODUCTION

You would recall that, in the preceding study unit, we discussed the responsibilities of the personnel in charge of loan workouts in terms of their duties in restructuring problem loan facilities. Their function is complementary to the responsibilities of the bank lending officers. Therefore, it is important that you should be exposed to such responsibilities of lending officers of the commercial bank. Hence, the discussion in this study unit is focused on identifying such responsibilities and those of loan recovery officers.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- list the management responsibilities of a bank lending officer
- mention the credit responsibilities of a bank lending officer
- identify the responsibilities of a bank credit manager
- list the responsibilities of a loan recovery officer.

3.0 MAIN CONTENT

3.1 Management Responsibilities of Bank Lending Officer

The lending officer of a bank is the person employed and saddled with responsibility to manage the credit function and make decisions concerning lending portfolio, credit limits, acceptable levels of risk, interest charges on loans and terms of repayment by the beneficiary companies and individuals.

The lending officers of commercial banks have some specific responsibilities to discharge in the management of lending operations. Therefore, a bank lending officer:

1. Assists management in preparing appropriate procedures portraying clearly the necessary steps that should be involved in lending process
2. Keeps abreast of all current developments in both corporate and personal loan obligations so as to anticipate borrowers' requests.
3. Provides relevant information to the management on the different types of loans being offered, the interest charges, and documentation collected for making loan facilities.
4. Maintains appropriate records on borrowers' accounts or approved loans in terms of documentation on: documents submitted by the borrowers, loan accounts records, amount of loans granted, interest charges, maturity dates on loans, collateral securities pledged for loans, etc.
5. Secures all loan documents in fireproof cabinets while ensuring that all such documents are filed according to laid procedures.
6. Ensures that the staff under the lending department is given adequate training in loan underwriting skills and techniques.
7. Makes suggestions on periodic basis to the management on necessary areas of changes to the lending policies and procedures.
8. Carries out periodic evaluation on the performance of loan facilities and makes appropriate recommendations on ways for improvement in collection, monitoring and supervision.
9. Maintains the required authority-responsibility structure of the credit department in order to meet the set goals and objectives;
10. Promotes cordial relationship with all the loan beneficiaries of the bank so as to encourage them in seeking for advice, information, counseling in managing their operations.

SELF-ASSESSMENT EXERCISE 1

What are the management responsibilities of a bank lending officer?

3.2 Credit Responsibilities of Banking Lending Officer

The lending officers of commercial banks have some responsibilities to discharge in the credit operations. Therefore, a bank lending officer:

1. Interviews loan applicant, collect the necessary documents from the customers to make the loan decisions, and properly secure the collaterals being pledged for loan facilities, before approving the loans.

2. Makes loan decisions in timely manner and divulge such information to the loan applicants appropriately.
3. Grants loans on the basis of the laid down policies, procedures and in compliance with extant regulations from the apex bank.
4. Provides financial counseling to loan beneficiaries on the prudent use of their funds so that repayment will not be problematic.
5. Refers all borrower requests for loan extension, refinance, restructuring or any other changes to the original loan terms to the management.
6. Makes counteroffer to customers that are creditworthy but cannot qualify for the loan they may have requested for
7. Monitors credit granting and ensuring customer compliance with lending agreement in order to safeguard the interest of the bank.
8. Working on customers' loan accounts to keep abreast of their performance and detect any discrepancies in their repayment schedules.
9. Negotiates documentation and repayment terms with loan beneficiaries in order to ensure that transactions and the bank's funds are properly secured.
10. Enforces lending policy and assures adherence to the accepted standards in terms of loan repayment, payment of interest charges, and regular lodgment of funds in dedicated loan accounts.

SELF-ASSESSMENT EXERCISE 2

Mention the credit responsibilities of a bank lending officer.

3.3 Main Responsibilities of Bank Credit Manager

Some commercial banks may have credit managers whose status supersedes that of the lending officer. In this regard, the position of the lending officer is subordinate to the credit manager, and therefore, the former will have to be reporting to the latter in terms of authority-responsibility relationship.

The main functions of the credit managers are as identified below.

1. The chief function of the credit manager involves planning, coordination and control of lending operations.
2. The credit manager monitors and reports on the implementation of loan policies and procedures.
3. The credit manager Analyses portfolio performance on monthly basis and submits recommendations to the management.
4. Ensures that loans accounts in all branches are balanced and, where necessary, some corrective actions are taken to check any deviations from the laid down regulations.

5. The credit manager compiles periodic returns on lending business which are made available for management decisions.
6. The credit manager compiles summary of key information and date on each loan to be submitted to the management for monitoring and supervisory decisions.
7. The credit manager prepares and sends all terms of offer on each loan cleared by the Head Office to loan beneficiaries for further action.
8. The credit manager follows up all loans approved by Head Office with occasional site inspection.
9. The credit manager files and maintains all records and information on lending operations of the bank.
10. The credit manager regularly inspects the credit departments in branches of the banks with the intent of keeping the loan officers on their toes.
11. The credit manager performs other duties that may be assigned to them from time to time by the Head Office.

SELF-ASSESSMENT EXERCISE 3

What are the responsibilities of a bank credit manager?

4.0 CONCLUSION

You have learnt from this study unit that there are specific responsibilities which are being played by various bank lending officials towards making lending facilities effective and efficient. In this regards bank lending officials such as the lending officers have roles to play in terms of their management, credit and risk responsibilities in lending function of the banks. There are other bank officials such as the credit managers and the loan officers at the various branches of commercial banks that are charged with some responsibilities towards the effective management of the lending function of the commercial banks.

5.0 SUMMARY

In this study unit, topics covered include the following:

- Management Responsibilities of Bank Lending Officer
- Credit Responsibilities of Banking Lending Officer
- Main Responsibilities of Bank Credit Manager

In the next study unit, you will be taken through the discussion on

6.0 TUTOR-MARKED ASSIGNMENT

Identify the management and credit responsibilities of the bank lending officers.

7.0 REFERENCES/FURTHER READING

Fraser, D. R., Gup, B. E. and Kolari, J. W. (1995). Commercial Banking: The Management of Risk, Minneapolis/St Andrew: Western Publishing Company.

Jessup, P. F. (1980). Modern Bank Management, New York: West Publishing Company.

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UNIT 4 ANALYSIS OF FINANCIAL STATEMENT

CONTENTS

1.0 Introduction
2.0 Objectives
3.0 Main Content
  3.1 Statement of Sources and Applications of Funds
  3.2 Fund Flow Statement
4.0 Conclusion
5.0 Summary
6.0 Tutor-marked Assignment
7.0 References/Further Reading

1.0 INTRODUCTION

You would recall that, in the preceding study unit, we discussed the issue on the responsibilities of a bank lending officers. The lending officers as part of the management team of any bank need some tools with which to perform such responsibilities effectively. A fundamental tool is provided by the analysis of the financial statements of the bank. Therefore, the discussion in this study unit is focused on the intricacies of analyzing financial statements of business entities which can be adopted in the analysis of the financial statements of banks. For the purpose of this analysis, the financial statements of a trading company have been used.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- explain the sources and application of funds
- discuss the fund flow statement

3.0 MAIN CONTENT

3.1 Statement of Sources and Applications of Funds

The statement of sources and application of funds fundamentally indicates movement of available funds to the company. Sources of funds indicate the ways and means through which a company raises funds for operation. On the other hand, application refers to the uses to which the funds raised are put in the course of operations.

The analysis of the sources and application of funds can be used to assess changes in the working capital of the firm. This is important for

planning purposes because the banks depend mainly on the funds from the depositors.

Therefore, in lending such funds they have to analyze their sources in order to separate the long-terms funds from the short term funds in terms of their placement by the depositors.

For the purpose of this analysis, the financial statements of a trading company have been used. The basic format for the preparation of Sources and Application of Funds is presented below:

Sources of Funds	Application of Funds
i. Gains or funds from operation	i. Losses from operation
ii. Increase in Trade Credits	ii. Reduction in Trade Credits
iii. Reduction in Stock	iii. Increase in Stock
iv. Reduction in Debtors	iv. Increase in Debtors
v. Sale of Fixed Assets	v. Purchase of Fixed Assets
vi. Increase in Instalment Credits	vi. Decrease in Instalment Credits
vii. Increase in Lease Finance	vii. Decrease in Lease Finance
viii. Increase in Loans	viii. Decrease in Loans
ix. Increase in Share Capital	ix. Decrease in Share Capital
x. Deferred Tax Payment	x. Payment of Tax
xi. Receipt of Dividends	xi. Payment of Dividends
xii. Reduction in Cash Balances	xii. Increase in Cash Balances
xiii. Increase in Overdraft	xiii. Decrease in Overdraft

In discussing some items in the above format, it is indicative that gains from operations refer to amount of funds generated by the company in the course of running the business while losses incurred represent some form of expenditure by the company.

When trade credits just like the installment credits, are offered to a company, they bring in some funds for operational use. Repayment of such obligations calls for the utilization of funds.

Whenever goods (the stock) are sold out some funds are generated for use in the business operation. Expenditure is incurred whenever goods are purchased by the business. This is also applicable to trade debtors because decrease is indicative of payment to, or funds received by, the company while increase in trade debtors means depleting the quantum of funds available for company's operations.
A public offer for subscription and rights issue of shares are meant to, and normally bring, additional funds for a company's use in operations. The pertinent issue is how can share capital decrease.

This is applicable in the event of share reconstruction, which implies decrease in the value of a company's share (not the market price of the share) and consequently a decrease in share capital of the company.

In the case of cash balances, a company normally desires to maintain a certain cash level in business as has been demonstrated in the preparation of cash budget in chapter one and chapter nine of this text. Depletion in such cash balances implies availability of additional funds for use in operations. An increase in cash balances on the other hand implies depriving the business some quantum of funds, which is channeled into cash reserves.

An example of the preparation of sources and uses (application) of funds is set forth below in Figure 9.1.

Figure 9.1: Balance Sheet of Ozohu Incorporated

		2007 (N'000)		2008 (N'000)
Share capital		250		200
Retained Earnings		356		330
Shareholders' Funds (Equity)		606		530
Long-term Loans		30		80
Capital Employed		636		610
Fixed Assets:				
Freehold Property @ Cost		380		320
Plant and Equipment	275		240	
Less: Depreciation	145	130	120	120
Motor Vehicles	135		120	
Less: Depreciation	85	50	60	60
Total Fixed Assets		560		500
Current Assets:				
Stocks		160	70	
Debtors		120	65	
Cash at bank		-	125	
Total Current Assets		280	260	
Less: Current Liabilities				
Creditors	125		150	
Bank Overdraft	79	76	-	110
		N636		N610

Source: Araga, A. S. (2009). Practical Business Finance, First Edition, Abuja: Premier Educational Institute, p.126.

The above information can be used to prepare the Sources and Uses of Funds for the Company. It is necessary, as prelude to the presentation of sources and application of funds, for calculation to be carried out to determine the differences in the figures given for both years regarding the items of balance sheet. For the solution, the calculations are as shown below:

Figure 9.2 Calculation of Differences between 2007 and 2008 Figures

	2008 (N'000)	2007 (N'000)	Difference (N'000)
Share capital	250	200	50 (+)
Retained Earnings	356	330	26 (+)
Long-term Loans	30	80	50 (-)
Freehold Property @ Cost	380	320	60 (-)
Plant and Equipment	275	240	35 (-)
Depreciation	145	120	25 (+)
Motor Vehicles	135	120	15 (-)
Depreciation	85	60	25 (+)
Stocks	160	70	90 (-)
Debtors	120	65	55 (-)
Cash at Bank	-	125	125 (+)
Creditors	125	150	25 (-)
Bank Overdraft	79	-	79 (+)

Source: Araga, A. S. (2009). Practical Business Finance, First Edition, Abuja: Premier Educational Institute, p.126.

From above calculations, the plus signs are indicative of sources of funds while the minus signs imply sues or application of funds in the course of the company's operations.

The presentation of the sources and application of funds from the calculations is as given below:

Sources of Funds	(N'000)	**Application** of Funds	(N'000)
Increase in share capital	50	Decrease in loan	50
Increase in retained earnings	26	Increase in property	60
Increase in depreciation(P&M)	25	Increase in P &M	35
Increase in depreciation (Veh)	25	Increase in M. Vehicles	15
Reduction in Bank balances	125	Increase in Stock	90
Increase in Bank Overdraft	79	Increase in Debtors	55
		Decrease in Creditors	25
	N330		N330

The result of above calculation is indicative of the fact that the amount of funds sourced in the course of the company's operations is just enough to cover the uses to which funds or cash is required during the financial year.

SELF-ASSESSMENT EXERCISE 1

Differentiate between source of funds and application of funds in a company's operations.

3.2 Cash Flow Statement

This type of analysis of financial information regarding the balance sheet items is designed to portray how the magnitude of the funds sourced has been expended in terms of all the necessary items of operations covered under application of funds.

Figure 9.3: Cash Flow Statement for the year ended December 2008

	N'000	N'000
Sources of Funds		
Decrease in Bank Balance	125	
Shares (increase)	50	
Retained Earnings (increase)	26	
Depreciation (Plant & Machinery)	25	
Depreciation (Motor Vehicle)	25	
Overdraft (increase)	79	330
Application of Funds	**N'000**	**N'000**
Long-term Loan (decrease)	50	
Freehold Property (increase)	60	
Plant and Machinery (increase)	35	
Motor Vehicles (increase)	15	
Stock (increase)	90	
Debtors (increase)	55	
Creditors (decrease)	25	330

Source: Araga, A. S. (2009). Practical Business Finance, First Edition, Abuja: Premier Educational Institute, p.127.

The above presentation shows that the amount of funds sourced in the course of the company's operation is just enough to cover the uses to which funds or cash is required during the year.

SELF-ASSESSMENT EXERCISE 2

Give the major reason which informs the preparation of Fund Flow Statement.

4.0 CONCLUSION

You have learnt from this study unit that the statement of sources and application of funds, which are obtained from balance sheet and income statement, is prepared to depict the movement of available funds to the company. While sources of funds indicate the ways and means through which a company raises funds for operation the application refers to the uses to which the funds raised are put in the course of operations. This analysis coupled with the statement of funds flow can be used to assess changes in the working capital of the firm.

5.0 SUMMARY

In this study unit, topics covered include the following:

- Statement of Sources and Applications of Funds
- Fund Flow Statement

In the next study unit, you will be taken through the discussion on horizontal and vertical analysis of financial statement.

6.0 TUTOR-MARKED ASSIGNMENT

Lambete Incorporated: Balance Sheet

	2007	2008
	(N'000)	(N'000)
Share capital	550	450
Retained Earnings	456	530
Long-term Loans	70	90
Fixed Assets:		
Freehold Property @ Cost	380	320
Plant and Equipment	275	240
Motor Vehicles	135	120
Total Fixed Assets	560	500
Current Assets:		
Stocks	160	70
Debtors	120	65
Cash at bank	-	125
Current Liabilities:		
Creditors	125	150
Bank Overdraft	79	-

Required: to prepare the Sources and Uses of Funds for the Company using the above information.

7.0 REFERENCES/FURTHER READING

Fraser, D. R., Gup, B. E. and Kolari, J. W. (1995). Commercial Banking: The Management of Risk, Minneapolis/St Andrew: Western Publishing Company.

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UNIT 5 HORIZONTAL AND VERTICAL ANALYSIS OF FINANCIAL STATEMENT

CONTENTS

1.0 Introduction
2.0 Objectives
3.0 Main Content
 3.1 Horizontal Analysis of Financial Statement
 3.2 Vertical Analysis of Financial Statement
4.0 Conclusion
5.0 Summary
6.0 Tutor-marked Assignment
7.0 References/Further Reading

1.0 INTRODUCTION

You would recall that, in the preceding study unit, we discussed the issue of the analysis of the financial statements of the bank. In the study unit we focused on the determination of the sources and application of funds as well as fund flow statement. Therefore, the discussion in this study unit is based on the horizontal and vertical analyses of financial statements. Such discussion is meant to complement the earlier analysis of financial statements. For the purpose of this analysis just like the earlier analysis, the financial statements of a trading company have been used.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- discuss the horizontal analysis of financial statement
- explain the vertical analysis of financial statement

3.0 MAIN CONTENT

3.1 Horizontal Analysis of Financial Statement

This analysis involves the comparison of the current year's figures with those of the previous year. The horizontal analysis, therefore, shows the percentage changes from the preceding year to the current year.

Major movements within the revenue statement have occurred in such areas as sales, gross profit, payment of interest, provision for doubtful debts, net profit, taxation and dividends. The information below is used to demonstrate the horizontal analysis and presented together with the vertical analysis of financial statement.

Figure 10.1: Abuja Products Limited

Income Statement for the years ended 31 Dec 2005 and 2006

		2006		2005
		(N'000)		(N'000)
Sales		4,500		3,600
Less: Cost of sales				
Opening stock	200		160	
Purchases	1,850		1,670	
Goods Av. For Sales	2,050		1,830	
Less: Closing Stock	250	1,800	200	1,630
Gross Profit		2,700		1,970
Less: Expenses				
Directors' salaries	148		127	
Wages and salaries	915		836	
Advertising&Printing	275		223	
Postages & Sundries	61		57	
Discount (net)	18		-	
Rent and rate	31		26	
Light and heating	42		60	
Motor expenses	95		90	
Telephone & Insur.	25		26	
Repairs and renewals	49		45	
Interest payments	74		50	
Depreciation	180		170	
Audit/Account'cy fees	19		18	
Provision(D'tful debts)	18	1,950	2	1,730

Net Profit	750	240
Less: Taxation	200	60
Net profit after tax	550	180
Proposed dividend	150	60
Reserves	400	120
Profit and loss brought forward	300	180
Reserves carried forward	700	300

Figure 10.2: Abuja Products Limited
Balance Sheets as at 31 December 2005 and 2006

		2006		2005
		(N'000)		(N'000)
Fixed Assets		1,114		322
Current Assets				
Stock	250		200	
Debtors	434		476	
Cash in hand	22	706	20	696
Less: Current Liabs.				
Creditors	126		101	
Taxation	200		60	
Dividend	150		60	
Bank Draft	350	828	285	506
Net Cur. Assets (Liabs)		(122)	190	190
Net Total Assets		992		512
Share Capital				
Ordinary Shares		200		200
Reserves (P & L Acc't)		700		300
Equity		900		500
Long-term Loans		92		12
Capital Employed		992		512

The data as presented above are used for the both horizontal and vertical analyses below. The figures (10.1 and 10.2) below are for balance sheet and income statement of a company. Both horizontal and vertical analyses are presented together (as shown below) after the discussion on vertical analysis. Therefore, the next line of discussion is on the vertical analysis.

SELF-ASSESSMENT EXERCISE 1

What does the horizontal analysis of financial statement involve?

3.2 Vertical Analysis of Financial Statement

In vertical analysis, unlike the horizontal analysis, each item in income statement is expressed as a percentage of the total sales. In the same vein, each item in the balance sheet is expressed as a percentage of the total capital employed.

The presentation below is on the horizontal and vertical analyses of the income statement and balance sheet provided above on the operations of the Abuja Products Limited.

Figure 10.3: Abuja Products Limited
Income Statement for the years ended 31 Dec 2005 and 2006

	2006 (N'000)	2005 (N'000)	Horizontal Analysis %change	Vertical Analysis 2006(%)	2005(%)
Sales	4,500	3,600	+ 25.0	100	100
Cost of sales:					
Opening stock	200	160	+ 25.0	4.4	4.4
Purchases	1,850	1,670	+ 10.8	41.1	46.4
Goods Av. For Sales	2,050	1,830	+12.0	45.5	50.8
Less: Closing Stock	250	200	+ 25.0	5.5	5.5
	1,800	1,630	+ 10.4	40.0	45.3
Gross Profit	2,700	1,970	+ 37.1	60.0	54.7
Less: Expenses					
Directors' salaries	148	127	+ 16.5	3.3	3.5
Wages and salaries	915	836	+ 9.4	20.3	23.2
Advertising&Printing	275	223	+ 23.3	6.1	6.2
Postages & Sundries	61	57	+ 7.3	1.4	1.6
Discount (net)	18	-	+ 0.0	0.4	-
Rent and rate	31	26	+ 19.2	0.7	0.7
Light and heating	42	60	- 30.0	0.9	1.7
Motor expenses	95	90	+ 5.6	2.1	2.5
Telephone & Insur.	25	26	- 3.8	0.5	0.7
Repairs and renewals	49	45	+ 8.9	1.1	1.2
Interest payments	74	50	+ 48.0	1.7	1.4
Depreciation	180	170	+ 5.9	4.0	4.7
Audit/Account'cy fees	19	18	+ 5.6	0.4	0.5
Provision(D'tful debts)	18	2	+800.0	0.4	0.1
	1,950	1,730	+ 12.7	43.3	48.0
Net Profit	750	240	+212.5	16.7	6.7
Less: Taxation	200	60	+233.3	4.4	1.7
Net profit after tax	550	180	+2,065.6	12.3	5.0
Proposed dividend	150	60	+150.0	3.3	1.7
Reserves	400	120	+233.3	9.0	3.3
P & L b/f	300	180	66.7	6.6	5.0
Reserves c/f	700	300	+133.3	15.6	8.3

Source: Araga, A. S. (2009). Practical Business Finance, First Edition, Abuja: Premier Educational Institute, p.130.

Figure 10.4: Abuja Products Limited

Balance Sheets as at 31 December 2005 and 2006

	2006 (N'000)	2005 (N'000)	Horizontal Analysis % change	Vertical Analysis 2006(%)	2005(%)
Fixed Assets	1,114	322	+ 246.0	112.3	62.9
Current Assets					
Stock	250	200	+ 25.0	25.2	39.0
Debtors	434	476	- 8.8	43.8	93.0
Cash in hand	22	20	+10.0	2.2	3.9
	706	696	+ 1.4	71.2	135.9
Less: Current Liabs.					
Creditors	126	101	+26.7	12.9	19.7
Taxation	200	60	+233.3	20.2	11.7
Dividend	150	60	+150.0	15.1	11.7
Bank Draft	350	285	+ 22.8	35.3	55.7
	828	506	+ 63.6	83.5	98.8
Net Cur.Assets(Liabs)	(122)	(190)	-164.2	(12.3)	37.1
Net Total Assets	992	512	+93.7	100.0	100.0
Share Capital					
Ordinary Shares	200	200	-	20.2	39.1
Reserves(P & L Acc't)	700	300	+133.3	70.5	58.6
Equity	900	500	+ 80.0	90.7	97.7
Long-term Loans	92	12	+666.7	9.3	2.3
Capital Employed	992	512	+ 93.7	100.0	100.0

Source: Araga, A. S. (2009). Practical Business Finance, First Edition, Abuja: Premier Educational Institute, p.131.

The net total assets have the same percentages with the capital employed for both years since total net liabilities and total net assets must be equal in a given balance sheet.

Therefore, expressing other items of the balance sheet as a percentage in relation to the capital employed implies that such items are indirectly being expressed in percentages in relation to the net total assets employed for the operations of the company in the given financial years.

SELF-ASSESSMENT EXERCISE 2

What does the horizontal analysis of financial statement involve?

4.0 CONCLUSION

You have learnt from this study unit that horizontal analysis of financial statements analysis involves the comparison of the current year's figures with those of the previous year while vertical analysis, unlike the horizontal analysis, each item in income statement is expressed as a percentage of the total sales. This means that each item in the balance sheet is expressed as a percentage of the total capital employed. Both analyses, therefore, show some changes between one year and the preceding year to the current year. The two analyses are very useful in complementing the analysis on the sources and application of funds and the fund flow statement as discussed in the previous study unit.

5.0 SUMMARY

In this study unit, topics covered include the following:

- Horizontal Analysis of Financial Statement
- Vertical Analysis of Financial Statement

In the next study unit, you will be taken through the discussion on the ratio analysis of financial statement.

6.0 TUTOR-MARKED ASSIGNMENT

Lambete Incorporated: Balance Sheet

	2007	2008
	(N'000)	(N'000)
Share capital	550	450
Retained Earnings	456	530
Long-term Loans	70	90
Fixed Assets:		
Freehold Property @ Cost	380	320
Plant and Equipment	275	240
Motor Vehicles	135	120
Total Fixed Assets	560	500
Current Assets:		
Stocks	160	70
Debtors	120	65
Cash at bank	-	125
Current Liabilities:		
Creditors	125	150
Bank Overdraft	79	-

Required: to prepare both the horizontal and vertical analysis of the Company.

7.0 REFERENCES/FURTHER READING

Fraser, D. R., Gup, B. E. and Kolari, J. W. (1995). Commercial Banking: The Management of Risk, Minneapolis/St Andrew: Western Publishing Company.

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UNIT 1 RATIO ANALYSIS OF FINANCIAL STATEMENT

CONTENTS

1.0 Introduction
2.0 Objectives
3.0 Main Content
 3.1 Operating Ratios
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1.0 INTRODUCTION

You would recall that, in the preceding study unit, we discussed the issue of the horizontal and vertical analysis of the financial statements of a company. In the study unit we focused on the determination of the differences in the result of the two years of operations for the selected company. The discussion in this study unit is based on ratio analysis of both the balance sheet and the income statement of the selected company. Such discussion is meant to complement the earlier analysis of financial statements. Again, for the purpose of this analysis just like the earlier analysis, the financial statements of a trading company have been used.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- list and discuss the various ratios in operating ratios
- mention and explain the ratios involved in financial ratios
- mention and discuss the ratios involved in investment ratios

3.0 MAIN CONTENT

3.1 Ratio Analysis of Financial Statement

The ratio analysis is the device normally employed to assess the specific aspects of the financial representation of the business operations. The approach involves the use of mathematical formulations with which are regarded as ratios to assess specific aspects of the financial picture provided for the company’s operations.

There are three categories of ratios that are discussed in this analysis. Such categories of ratios include operating ratios, financial ratios and investment ratios. The operating ratios are extracted primarily from the trading and profit and loss accounts (otherwise known as income statements) as well as the working capital section of the balance sheet. The financial ratios are also extracted exclusively from the balance sheet of the business. Therefore, the ratios are employed to assess the liquidity, solvency and financial structure of the business. The investment ratios are calculated to assess the profitability of the business in relation to the interest of the shareholders. They are also used by potential investors when assessing the shares and dividends of publicly quoted companies.

The calculation of ratios in this study unit is based on the financial information presented and used for the Abuja Products Limited. The summary of the ratios, their calculations demonstrated in the subsequent section of this study unit are presented below.

SELF-ASSESSMENT EXERCISE 1

Mention and explain the three main categories of ratios that can be calculated from financial statements.

Figure 11.1: Abuja Products Limited

Summary of Operating, Financial and Investment Ratios

	2006	2005	Trend (A = Adverse) (F = Favourable)
Operating Ratios:			
Gross Profit Margin	60%	54.7%	F
Net Profit Margin	16.7%	6.7%	F
Mark-up	150%	120.9%	F
Returned on Capital Emp.	83.1%	56.7%	F
Fixed Assets Turnover	4:1	11.2:1	A
Rate of Stock Turnover	45.6 days	40.3 days	A
Debtors' Collection Period	35.2 days	48.3 days	F
Creditors' Payment Period	26 days	22.6 days	F
Cash Operating Cycle	54.8 days	66 days	F
Financial Ratios:			
Working Capital Ratio	0.85:1	1:4.1	A
Acid Test Ratio	0.6:1	1:1	A
Gearing Ratio	9:3%	2.3%	-
Investment Ratios:			
Earnings Per Share	137k	45k	F
Price/Earnings Ratio	3	8	A
Dividend Yield	9:1%	4:05%	-
Dividend Cover	3.7	3	F

Source: Araga, A. S. (2009). Practical Business Finance, First Edition, Abuja: Premier Educational Institute, p.133.

The summary of the various ratios as presented above portrays a fundamental contrast between the operating ratios and the financial ratios; clearing indicative of the fact that the increased profits of the company are gained at the cost of a weakened working capital position.

This can be appreciated when it is considered that whilst the net profit margin increases from 6.7% to 16.7%, the acid test ratio declined from 1:1 to 0.6:1. Furthermore, the decline in the price/earnings ratio appears to reflect stock market anxieties that the company is over-trading – expanding its turnover and profits – without sufficient working capital to meet its debts as they fall due.

The calculations and analysis of the relevant ratios as summarized above are as follows:

3.1 Operating Ratios:

1. **Gross Profit Margin** $= \frac{\text{Gross profit}}{\text{Sales}} \times 100$

1986: $\frac{2.700}{4,500} \times 100 = 60\%$

1985: $\frac{1970}{3,600} \times 100 = 54.7\%$

The result shows the proportion of the sales revenue which resulted in a gross profit to the company. It is affected by various factors including changing price levels and altered sales mix.
The margin might be reduced by companies that wish to increase their share of a particular market. For the company, the position strengthened in 1986 as compared with 1985.

2. **Net Profit Margin** $= \frac{\text{Net profit}}{\text{Sales}} \times 100$

1986: $\frac{750}{4,500} \times 100 = 16.7\%$

1985: $\frac{240}{3,600} \times 100 = 6.$

The net profit margin shows the efficiency with which expenses are controlled, and it is clear that 1986 was a far better year than 1985 in this respect.

Nevertheless, the figure can become distorted by factors such as the company imposing rigid ‘wage freezes’ on employees’ pay, or by drastic although temporary cut-backs in overhead, which may be storing up trouble for future years.

3. Markup = $\frac{\text{Gross profit}}{\text{Cost of goods sold}} \times 100$

1985 $\frac{2,700}{1,800} \times 100 = 150\%$.

1985 $\frac{1,970}{1,630} \times 100 = 120.9\%$

This is directly linked to the gross profit margin. Therefore, the mark up indicates the pricing policy of the business, as it shows the percentage addition made to cost price to arrive at selling prices.
In 1986, every N 100 of goods brought by the firm was being sold at an average of N250 Similarly priced goods brought in 1985 being sold at just over N220.

4 Return on Capital Employed

(ROCE) = $\frac{\text{Net profit before interest and tax}}{\text{Average capital employed}} \times 100$

1986: $\frac{750+74}{992} \times 100 = 83.1\%$

1985: $\frac{240+50}{512} \times 100 = 56.7\%$

Despite the fact that the ROCE percentages are reduced, the returns are still high, and the revised formulae do little to change the original comment on the figures.

5. Fixed Assets Turnover = $\frac{\text{sales}}{\text{Fixed assets (net Value)}}$

1986: $\frac{4,500}{1,114} = 4.0:1$

1985: $\frac{3,600}{} = 11.2:1$

The fixed assets turnover ratio measures the sales generated by each N1 of fixed assets: N 11.20 in 1985 but only N 4 in 1986. The purchase of the supermarket referred to in the notes to the accounts appears to have been completed in the latter part of 1986, which would seem to indicate that the sharp decline in the ratio is only temporary.

When the 1987 accounts are available analysts would expect to see a reversal of the downward trend as the sales from the new premises would be recorded for the full year.

6. Rate of Stock Turnover (' stock turn') $= \frac{\text{Average stockholding} \times 365}{\text{Cost of goods sold}}$

1986 $\frac{2(200 + 250)}{1,800} \times 365 = 45.6$ days

1985 $\frac{2(160 + 200)}{1,630} \times 365 = 40.3$ days

Assuming a company can increase the speed at which it sells its stocks, then it can generate more profit in the process, provided that the increase in turnover is not obtained by simply slashing the gross profit margin.

In 1985, the business took an average of 40.3 days to sell its stock, but this had increased to 45.6 days in 1986. The drawback of this calculation is that accurate average stock figures need to be used.

Nevertheless, those appearing in the balance sheets are likely to be at an unrealistically low level owing to the fact that most business choose the end of their financial year so that it coincides with their period of least activity.

7. Debtors Collection Period $= \frac{\text{Debtors}}{\text{Sales}} \times 365$

1986: $\frac{434}{4,500} \times 365 = 26$ days

1985: 101 $\times 365 = 22.6$ days

$\frac{135}{1,630}$

The efficiency of the business's credit control department is measured here by calculating the average length of time that money is owed by debtors.

The department was more efficient in 1986 than 1985, and a collection period of five weeks is considered to be very good average.

8. Creditors Payment Period = $\frac{\text{Creditors}}{\text{Cost of goods sold}} \times 365$

1986: $\frac{128}{1,800} \times 365 = 26$ days

1985: $\frac{101}{1,630} \times 365 = 22.6$ days

In 1986, creditors were paid, on average, twenty days after the suppliers were made. This appears to indicate that attractive discount terms were being offered in return for payment within one calendar month of the invoice date.

If no such discount were available then the company might delay payment for obvious reasons; thus taking advantage of the interest – free credit provided by its suppliers. Nevertheless, great care should be taken not to alienate suppliers through undue delays in the settling debts.

9. Cash Operating Cycle:

	1986 (days)	1985 (days)
Stock turn	45.6	40.3
Debtors' collection period	35.2	48.3
	80.8	88.6
Less: Creditors' payment period	26.0	22.6
	54.8	66.0

In using the result of the three previous ratios, it is possible to assess the period of time which elapses between the payments for stock received and the collection of cash from customers in respect of the sale of that stock. The shorter the length of time between the initial outlay and the ultimate receipt of cash, the less working capital needs to be financed by the company.

There are ways of speeding up' the cycle which include selling stock faster by reducing margin or increasing advertising, tightening up the collection of debtors balances, and delaying payments to creditors.

SELF-ASSESSMENT EXERCISE 2

What are the ratios involved in the measurement of efficiency of the operations of a company.

3.2 Financial Ratios

These are extracted exclusively from the balance sheet, and concentrate on the liquidity, solvency and financial structure of the business.

1. Working capital ratio = Current assets / Current liabilities

(Or current ratio)

1986: $\frac{706}{828}$ =0.85:1

1985: $\frac{696}{506}$ =1.4:1

The working capital ratio measures the overall adequacy of the working capital as indicated by the quotient of the calculation. The ideal' ratio is often quoted as 2:1 but this depends upon the type of business, and many thriving companies continue successfully, despite having a negative ratio.

Nevertheless, it is apparent that the firms' position has deteriorated markedly in the year, which is of concern if the company is having, or is likely to have, difficulty in meeting its debts as they fall due. This aspect is further explored by the acid test ratio as calculated below.

2. Acid test ratio = Current Assets - Stock / Current Liabilities

(Or 'quick assets' or liquidity ratio)

1986: $\frac{456}{828}$ = 0.6:1

1985: $\frac{496}{506}$ = 1.0:1

It is of obvious importance that a company should be able to meet its debts as they fall due. 'Quick assets' are those which can converted quickly into cash as the need arises, and stocks and work-in –progress are excluded as being, generally, slow-moving assets.

The 'ideal' ratio is 1:1, as recorded in 1985 for the firm. By 1986, the company has only 60k of quickly realizable assets to meet each 1 of its current liabilities which indicates that it might be unable to withstand a crisis whereby the majority of its creditors demand payment at about the same time.

Financial analysts consider the acid test to be of fundamental importance when assessing the ability of a business to survive; a fact which must cause great anxiety to this company.

3. Gearing ratio = $\frac{\text{Fixed return funding}}{\text{Total long-term capital}} \times 100$

1986: $\frac{92}{992} \times 100 = 9.3\%$

1985: $\frac{12}{512} \times 100 = 2.3\%$

The calculations show that the company is low geared in both of the years under review. The directors may feel that this them scope for further borrowing so as to alleviate their liquidity problems with reference to acid test ratio.

It is instructive to note, however, that there are other ways of calculating a company's gearing; for example the level of bank borrowing is sometimes included in the numerator. For the company this will increase the gearing levels to the following percentages:

1986: $\frac{92 + 350}{992} \times 100 = 44.6\%$

1985: $\frac{12 + 285}{512} \times 100 = 58\%$

The analyst will use the formula which he feels gives him the greatest insight into the position and trends of the company; there are no hard and fast rules as to the composition of the gearing calculations.

The first formula showed that long - term borrowing has increased in 1986 as compared to 1985, whilst the second formula shows that when the overdraft is included in the definition of long-term borrowing the proportion of borrowing to total capital actually decrease in 1986.

3.3 Investment Ratios

These are used primarily by potential investors when assessing the shares and dividends of publicly listed companies. For the purpose of calculating ratios 2 and 3 below it is assumed that the firm's current stock market price is 412 k (1985 370k).

1. Earnings per share (EPS)

$$= \frac{\text{Net profit before extraordinary items} - (\text{Tax} + \text{pref divs})}{\text{Number of Ordinary shares in issue}}$$

1986: $\frac{(750-200)}{400} = 137k$

1985: $\frac{12 + 285}{512} = 45k$

There were neither extraordinary items nor preference dividends in either of the two years, the formula thus becoming 'net profit after tax' divided by the number of ordinary shares in issue. The progress made in 1986 reflects the increased profitability obtained despite a weakening in the liquidity position.

2. Price/Earning Ratio

$$= \frac{\text{Stock market price}}{\text{EPS}}$$

1986: $\frac{412k}{137k} = 3$

1985: $\frac{370k}{45k} = 8$

The price/earning ratio as would be expected is a reflection of the way in which the stock market views the prospects of a particular company. The higher the price/earning ratio, the more optimistic are investors' views concerning future profits and dividends.

The decline in the company's performance possibly indicates the concern that the company has over reached itself with the acquisition of a new line of business, and that the liquidity problems might force the company to cut back its operations.

3. Dividend Yield = $\frac{\text{Dividend per share}}{\text{Market price per share}} \times 100$

1986: $\frac{(150/400)}{₦4.12} \times 100 = 9.1\%$

1985: $\frac{60/400)}{₦3.70} \times 100 = 4.05\%$

This measure the actual rate of return obtained by way of dividends, assuming that the shares are purchased at the current stock market price. Nevertheless, the yield from the company's operations has doubled in 1986 this indicates the higher risk which associated with the investment, due to factors explained previously.

4. Dividend Cover = $\frac{\text{Profit available for dividend}}{\text{Dividend}}$

1986: $\frac{550}{150} = 3.7$ times

1985 $\frac{180}{60} = 3$ times

This reveals the proportion which the dividend bears to profit available for dividend, thus giving an indication as to how secure future dividend payments may be. From the whole analysis, profit does not equal liquidity and whilst the firm's profits are three times greater than the proposed dividend payments, the poor state of the company's liquid resources may well jeopardize future dividends payment.

SELF-ASSESSMENT EXERCISE 3

Mention the other relevant ratios that can be calculated from the financial statements of a company.

4.0 CONCLUSION

You have learnt from this study unit that ratio analysis is a tool employed to assess the specific aspects of the financial statements of business operations. Three categories of ratios include operating ratios, financial ratios and investment ratios. The operating ratios are extracted primarily from the income statement and the working capital section of the balance sheet. The financial ratios are extracted from the balance sheet for assessing the liquidity, solvency and financial structure of the business. The investment ratios are calculated primarily to assess the profitability of the business as well as for assessing the shares and dividends of publicly quoted companies by potential investors.

5.0 SUMMARY

In this study unit, topics covered include the following:

- Operating Ratios
- Financial Ratios
- Investment Ratios

In the next study unit, you will be taken through the discussion on the asset and liability management in a banking operations.

6.0 TUTOR-MARKED ASSIGNMENT

Lambete Incorporated: Balance Sheet

	2007 (N'000)	2008 (N'000)
Share capital	550	450
Retained Earnings	456	530
Long-term Loans	70	90
Fixed Assets:		
Freehold Property @ Cost	380	320
Plant and Equipment	275	240
Motor Vehicles	135	120
Total Fixed Assets	560	500
Current Assets:		
Stocks	160	70
Debtors	120	65
Cash at bank	-	125
Current Liabilities:		
Creditors	125	150
Bank Overdraft	79	-

Required: to prepare the relevant ratios from above information for the company.

7.0 REFERENCES/FURTHER READING

Fraser, D. R., Gup, B. E. and Kolari, J. W. (1995). Commercial Banking: The Management of Risk, Minneapolis/St Andrew: Western Publishing Company.

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UNIT 2 ASSET AND LIABILITY MANAGEMENT IN BANKS

CONTENTS

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3.0 Main Content
 3.1 Issues in Asset and Liability Management in Banks
 3.2 Focus of Asset and Liability Management in Banks
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  3.2.3 Management of Foreign Exchange Risk
4.0 Conclusion
5.0 Summary
6.0 Tutor-marked Assignment
7.0 References/Further Reading

1.0 INTRODUCTION

You would recall that, in the preceding study unit, we discussed the issue of ratio analysis of financial statement. This analysis does not suffice it that there is effective management of asset and liability of the banks. Therefore, there arises the important need for the banks to adopt viable measures in managing their assets and liabilities in such a manner that their operations would be profitable. Therefore, the discussion in this study unit is focused on the intricacies of asset and liability management of banks.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- list and discuss the issues involved in asset & liability in banks
- discuss the management of liquidity risk
- analyze the management of interest rate risk
- explain the management of foreign exchange risk

3.0 MAIN CONTENT

3.1 Issues in Asset and Liability Management in Banks

The management of asset and liability of the banks is very paramount in their operations. The assets of the banks particularly the liquidity assets, in most cases, are largely the funds which have been committed in lending, marketable securities, and long-term investments.

Therefore, the management of such funds must be synchronized with the management of the liabilities of the banks. This is because the funds that are embedded in loans, credit facilities, and long-term investments come from the depositors. This brings to the fore the critical issues in asset and liability management of banks.

1. **Liquidity Management**

The main concern in liquidity management as regards the asset and liability management is the funding liquidity risk embedded in operations of the banks. The funding of long-term loans and other securitised assets with short term liabilities possesses a grave challenge to the banks.

Banks are in the business of ensuring that funds involved in the lending facilities are available with which to meet their customers' requirements. Poor management of these loan facilities and other investments result in liquidity, interest rate and currency mismatches which is the concerned of the bank operators.

In general terms, failure to manage asset and liability of banks effectively can have dire consequences on the liquidity of any bank. In recognition of this grave implication, it is necessary for the banks to put a workable framework in place to manage liquidity risk. This involves two critical aspects:

- Managing liquidity in the recognition that all the operations of any bank; and
- Managing liquidity as the panacea of resolving the usual crisis that confronts the commercial banks.

There are appropriate guidelines that banks need to consider in effective liquidity management. Such principles are as identifies below.

- Diversify sources and term of funding – concentration and contagion were the killers in the recent crisis.
- Identify, measure, monitor and control – it is still surprising that many banks do not fully understand the composition of their balance sheet to a sufficient level of detail to allow for management of the risks.
- Understand the interaction between liquidity and other risks – e.g. basis risk – the flow on impact of an event in one area can be devastating to others.
- Establish both tactical and strategic liquidity management platforms – keep a focus on both the forest and the trees.
- Establish detailed contingency plans and stress test under multiple scenarios regularly.

2. Mismatch Management and Performance Measurement

For practical purposes, a bank needs to decide whether it wants to take a relatively cursory approach to asset and liability management risks. The other consideration is whether a bank is prepared to take a more definite approach and target higher long - term earnings which translates into profitable operations.

While the choice is that of the banks a bank normally realise that there is the need for right level of skills and resources to be instituted and committed to support the function. In the face of dynamic nature of banking industry, failure to do this can result in a poorly managed operation which can arise from volatility in core earnings, economic instability, and unpredictable business cycle.

The mismatch position of the asset and liabilities normally results in the interest rate and liquidity risk for the banks. There are various techniques that banks can use to examine the mismatch in a bank's balance sheet and it can be a difficult process if not supported with adequate systems.

Depending on systems and analytical support that a bank uses in the asset and liability management process, the usual analysis is designed to identify:

- static and dynamic mismatch;
- sensitivity of net interest income; and
- market value under multiple scenarios such as high stress.

The general practice is that majority of the banks normally set net interest income limits as a main measure of performance while the more advanced banks also use market or economic value as a secondary measure.

The use of interest income limits has become the industry benchmark simulation tool because;

- it is relatively easy to understand and implement;
- it's a single period measure that does not require many assumptions, and
- it is easy for investors to understand because it is linked to reported financial results.

Nevertheless, the approach is limited as it does not provide a full view of the risks of operations of a bank or reflect fully the economic impact of interest rate movements. Market value or economic value simulations on the other hand, offer a more complete assessment of the risk confronting banks in their operations.

3. Funds Transfer Pricing

The funds transfer pricing system is a fundamental asset and liability management tool in the banking system. The system creates the ability of the bank to immunize its operations from risk.

Therefore, it provides the basis for operational transparency and profitability. The process of funds transfer pricing is normally designed to identify interest margins and remove interest rate and funding or liquidity risk.

The system of funds transfer pricing, from operational perspective, effectively locks in the margin on loans and deposits by assigning a transfer rate that reflects the repricing and cash flow profile of each balance sheet item. This is because it is applied to both assets and liabilities.

The system in the asset and liability management is used to isolate the bank's business performance into discrete portfolios that can be assigned individualised metrics. Therefore, it facilitates the centralisation and management of interest rate mismatches. In addition, it also effectively allocates responsibilities between the bank's business units and the treasury department.

In a sophisticated banking system, the funds transfer pricing mechanism can also be used as a tool to assist with management of the balance sheet structure with its rates adjusted to either encourage or discourage product and customer flows. The inherent advantage is that it can lead to greater understanding of a bank's competitive advantage and assisting with asset allocation.

The funds transfer pricing rates are normally structured to include both interest rate and funding liquidity risks with the derived transfer yield curve constructed to include appropriate premiums.
Such premiums can be used to capture all elements associated with the banks funding cost in terms of the cost of items such as:

- holding liquidity reserves,
- optionality costs;
- term funding programme costs; and
- items such as operational risk.

SELF-ASSESSMENT EXERCISE 1

Mention and explain the critical issues involved in asset and liability management in banks.

3.2 Focus of Asset and Liability Management

3.2.1 Management of Liquidity Risk

Liquidity risk refers to the risk arising from the use of short term liabilities to finance long term assets. The implication is that such mismatch between asset and liability makes the liability subject to rollover or refinancing risk invariably.

There are some approaches which are amenable for measuring liquidity risk. These measures for determining liquidity risk embedded in bank operations include the use of relevant ratios such as:

- loan to asset ratio;
- loan to core deposit ratio;
- purchased funds to total assets;
- loan losses to net loan;
- large liabilities to earning assets; and
- growth in core deposits to growth in assets.

There are various situations that can precipitate liquidity risk. Such causes of liquidity risk include the following:

i) Funding risk

This arises from unanticipated withdrawals by the customers coupled with non-renewal of deposits. For example, the recent fuel subsidy removal precipitated massive withdrawals of funds by customers from the banking system with which to meet the sudden rise in transportation cost.

ii) Time risk

This arises because of the need to compensate for non-receipt of expected inflow of performing assets, and hence turning it into non-performing assets.

iii) Call risk

This arises from crystallization of contingency liabilities and thus making the bank unable to undertake profitable business opportunities when desirable.

There are signs from banking operations that normally indicate that a particular bank is experiencing liquidity crises. Such symptoms of liquidity risk include the following:

- Offering high rate of interest on deposits by the bank;
- Delayed payment of matured proceeds by the bank;
- Delayed disbursement to borrowers arising from committed lines of credit;
- Deteriorating asset quality of the bank;
- Large amount of contingent liabilities; and
- net deposit drain

There are some viable ways through which the liquidity risk can be effectively managed. Therefore, in order to effective manage liquidity risk the bank can make use of the following strategies.

- Calculation of cumulative surplus or deficit of funds at selective maturity dates.
- Cash flows to be placed in different time buckets (e.g., Next day, 2-7 days, 8-14 days, 15-28) based on the behavior of assets, liabilities and off-balance sheet items.
- Variance analysis on periodic basis such as monthly, quarterly, and half-yearly.
- Impact of prepayment of loans, premature closure of deposits and exercise of put and call options after specified time.
- Difference in cash inflows and cash outflows in each time band.

SELF-ASSESSMENT EXERCISE 2

Mention the strategies involved in managing liquidity risk.

3.2.2 Management of Interest Rate Risk

The interest rate risk arises from frequent fluctuations in interest rate regime as determined by the apex bank.

The measurement of the interest rate risk involves the use of the following strategies:

- **Maturity gap analysis:-** by measuring interest rate sensitivity of earnings;
- **Duration:-** by measuring interest rate sensitivity of capital;
- The use of **Simulation** through computer modeling of the bank's interest rate sensitivity based on certain assumptions; and
- The use of **Value at Risk:-** the maximum potential loss in market value or income over a given time horizon, under normal market conditions, at a given level of certainty.

In order to prepare the gap analysis, the steps involved include the following.

i) Consideration of balance sheet and off-balance sheet position on the day of analysis.
ii) Determination of the number of time buckets.
iii) Determination of duration or length of each time bucket. and iii) Slotting every asset, liability and off-balance item into corresponding time bucket.
iv) Computation of each gap between an asset and a liability.
v) Computation of the cumulative gap.
vi) Determination of cumulative gap as:

- a percentage of total assets,

- a percentage of earning assets, and
- a percentage of equity.

The gap quotient may either be positive or negative. Nevertheless, the quotient of the gap could be zero, meaning the maturing assets would be enough to settle maturing liabilities.

In other to alter the gap the considerations to be used by the bank include asset restructuring, liability restructuring, growth, and shrink, and off-balance sheet hedge.

SELF-ASSESSMENT EXERCISE 3

What are the steps involved in preparing gap analysis?

3.2.3 Management of Foreign Exchange Risk

The foreign exchange risk arises as a result of fluctuation in the foreign exchange values of various currencies occasioned by the dictates of market forces of demand and supply.

The foreign exchange risk is associated with foreign exchange transactions in terms of cash flow exposure. This implies that at the instance of any variation in the exchange rate regime, the profits involved are altered.

In order to manage the foreign exchange risk, certain measures are involved in the framework to be adopted by banks. These measures to be incorporated in the framework include the following:

- Setting up appropriate limits involving open position and gaps;
- Clear-cut and well defined position of responsibility between front, middle and back office;
- Value at risk approach to risk associated with exposures;
- Interest rate sensitivity analysis; and
- Maturity and position analysis.

The techniques for management of foreign exchange risk can be categorized into internal and external techniques. In the case of the internal techniques for managing foreign exchange exposures, the banks can make use of Netting, Matching, Leading and Lagging, Pricing Policy – Transfer Pricing, and Asset Liability Management in area of Derivatives.

In the case of the external techniques for managing foreign exchange exposures, the banks can make use of Forward Contracts, Swaps, Options, and Futures. The use of derivatives in consideration of asset-liability relationship for managing foreign exchange exposures involves the use of hedging or speculation.

In this regard, the bank may purchase a one year Treasury contract in the Future Market. Alternatively, the bank can purchase a Call Option or Treasury Future.In order to reduce medium and long term exposures, banks may have interest rate Swap in which case, it swaps a portion of variable interest payment stream for fixed rate interest payment stream. The bank may lose the profit potential in a situation whereby the interest rises. Therefore, banks can also enter into Floor Contract with an intermediary and retain potential for profit n case interest rate rises.

4.0 CONCLUSION

You have learnt from this study unit that effective management of asset and liability in a banking system is very strategic to the operations of commercial banks. the management of the assets and liabilities are neceassry because the funds being sued by the banks and embedded in investments are from the depositors. Therefore, the funds must be made available in form of liquidity towards meeting the demands of the depositors. Furthermore, the banks have the responsibility to institute appropriate measures in managing their assets and liabilities in order to manage effectively the various risks involved in their operations.

5.0 SUMMARY

In this study unit, topics covered include the following:

- Issues in Asset and Liability Management in Banks
- Focus of Asset and Liability Management in Banks
- Management of Liquidity Risk
- Management of Interest Rate Risk
- Management of Foreign Exchange Risk

In the next study unit, you will be taken through the discussion on the analysis of financial statement.

6.0 TUTOR-MARKED ASSIGNMENT

Identify and explain the issues involved in the asset and liability management of a banking system.

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UNIT 3 INVESTMENT SECURITIES OF BANKS

CONTENTS

1.0 Introduction
2.0 Objectives
3.0 Main Content
 3.1 Marketable Securities Held By Banks
 3.2 Investment In Equity And Leasing
4.0 Conclusion
5.0 Summary
6.0 Tutor-marked Assignment
7.0 References/Further Reading

1.0 INTRODUCTION

You would recall that, in the preceding study unit, we discussed the issue of asset and liability management in banking operations. In most cases, the assets of the commercial banks are embedded in the loans and advances which the bank grants to the corporate bodies, the government, and individuals. In this study unit, therefore, the various assets of the banks that embedded in lending are identified and discussed.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- identify and explain marketable securities held by banks
- differentiate between investment in equity and investment in leasing

3.0 MAIN CONTENT

3.1 Marketable Securities held by Banks

The securities that are normally held by the banks in the course of their operations are identified and discussed below.

1. Bill of Exchange
Bill of Exchange is a financial contract acknowledging a debt which is separate and distinct from the transaction going rise to the debt.

The seller of the products who holds the bill can negotiate it before maturity date usually to a bank for a discounted value which is lower than the face value of the bill. This is also known as trade bill.
The Bill is therefore held by the bank for only a short time for about ninety days before recovering the funds invested in it from the designated bank.

2. Letter Of Credit
This is a form of bill of exchange known as bank bill which is issued by a bank as an interaction on the bill of exchange. The letter of credit is issued by the financial institution in place of the bill of exchange indicating its wiliness to accept the bill of exchange up to a certain amount of a specific period of time on behalf give buyer.

It is a form of lending because which is based on the fact that it may mature and the bank is expected to pay for the importer for payment to the exporter. The payment is therefore paid by the bank within a short time before recovering the funds invested in it from the designated bank.

3. Promissory Note
It is a negotiable instrument acknowledging a debt obligation in trade transaction. It is normally issued by the debtor to a creditor indicating announcement to pay the amount involved at a specified date. This can be issued by the acceptance house guarantying payment at a specified date.

This can also be negotiated by the seller to a commercial bank for a discounted value for cash before the maturity date. The Note is therefore held by the bank for only a short time for about ninety days before recovering the funds invested in it from the designated bank.

4. Factoring
It involves the selling of debts to a factor which can be a bank such as an investment banker for immediate cash. This usage depends on the continued widespread use of trade credit. The instrument which can be an invoice is therefore held by the bank for only a short time for about ninety days before recovering the funds invested in it from the designated bank.

SELF-ASSESSMENT EXERCISE 1

List and explain the forms of marketable securities in which commercial banks can invest.

5. Government Securities

These are mainly the Treasury Bill and Treasury Certificates which are normally issued by the Central Bank of Nigeria on behalf of the government on periodic basis. The subscription by banks to these securities is compulsory, and therefore, all commercial banks in the country must subscribe to them whenever they are floated by the apex bank.

The banks hold these securities for a period of time ranging from sixty days, ninety days to one hundred and eighty days. The maturity period may even extend beyond one hundred and eighty days. The period of the maturity of these securities is normally determined by the apex bank.
The Central Bank purchases the securities back from the commercial banks after the maturity period while paying the designated interest charges and the face value of these securities.

SELF-ASSESSMENT EXERCISE 2

What are the two forms of government securities to which commercial banks must subscribe whenever they are floated by the apex bank.

3.2 Investment in Equity and Leasing

1. Equity Investment

The holder such as the bank is a part owner of the company. An investment banker as and the commercial banks do invest in the equity of a company particularly the blue chip firm. The banks will be entitled to the part of dividends of the firms on periodic basis. In order to ensure the efficient management of such firms the banks as part owners would appoint some of the directors for the firms. These non-executive directors will serve as the eyes and ears of the banks in the operations of the firms.

2. Leasing Financing

Leasing gives the possessor of the property called the lessee to use and control ill throughout the rental period while paying only rental charges to the owner called lessor.

The effect of leasing on the operations of the company is that annual or move frequent rental payments are made by the company over the term of the lease rather than one large initial payment for the outright purchase of the property.

The commercial banks do engage in lease financing by purchasing some items of machinery, equipment and motor vehicles and lease them to manufacturing companies, service firms, and transporters, among others. The leasing may take the form of financial lease or operating lease

depending on the terms of agreement that would secure the interest of the banks.

SELF-ASSESSMENT EXERCISE 3

Differentiate between investment in equity and investment in leasing by banks.

4.0 CONCLUSION

You have learnt from this study unit that they are some marketable securities that available for investment of their funds by the banks. Such securities include those that are available for dealing in the open market operation. These securities for dealing in the open market operation include the government securities which are held for period of time that falls within one year.

5.0 SUMMARY

In this study unit, topics covered include the following:

- Marketable Securities Held By Banks
- Investment In Equity And Leasing

In the next study unit, you will be taken through the discussion on the analysis of financial statement.

6.0 TUTOR-MARKED ASSIGNMENT

Identify and explain the various marketable securities available for investment by the banks.

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UNIT 4 INVESTMENT IN LOANS BY BANKS

CONTENTS

1.0 Introduction
2.0 Objectives
3.0 Main Content
 3.1 Term Loan
 3.2 Mortgage Loan
 3.3 Real Estate Loans
 3.4 Bond Instrument
 3.5 Working Capital Loans
 3.6 Installment Loans
4.0 Conclusion
5.0 Summary
6.0 Tutor-marked Assignment
7.0 References/Further Reading

1.0 INTRODUCTION

You would recall that, in the preceding study unit, we discussed the issue of investment in securities by the banks. Such investments take the form of marketable securities, equity and security and government securities. In this study unit, therefore, the various assets of the banks that embedded in loans and credits are identified and discussed.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- discuss term loan
- explain mortgage loan
- analyze real estate loans
- discuss the bond instrument
- explain working capital loans
- discuss the installment loans.

3.0 MAIN CONTENT

3.1 Term Loan

This is the loan facility that is granted by the commercial banks for a period of more than one year. In other words, term loan is an intermediate-term credit which is a commercial an industrial loan with maturity of more than one year. It is also regarded as a loan facility that

is granted on the basis of revolving credit or standby on which the original maturity of the facility is in more than one year.

The term loan can be granted as a facility for the general use of the business entities such as acquisition of land, purchase of building, and purchase of equipment. In comparison with installment loan, the loan agreement in term loan is not elaborate and does not involve similar obligations and restrictions.

Furthermore, the interest charges on term loan are much less that the interest involved in installment loans, and the installment loans may be restricted for the purchase of specific items of equipment or machinery for the operations of the business entity which is granted the facility.

The term loans from the banks are more flexible than the bond issue because they can be liquidated before their maturity date without the lender subjecting the borrowers to payment of penalty fees.
The term loans generally are associated with shorter maturity dates as compared with bond issue coupled with the less interest rate than what is obtainable with the interest payment for the bonds.

There is no abnormal cost for the arrangement of term loans from the banks when compared to the bond issue that requires special arrangement and the payment of heavy costs, appointment of trustees, and writing of special covenants.

In addition, there is no need to consider the issue of registration and its associated costs, underwriting and selling by issuing houses, which are compulsory in the case of the issuance of bonds by corporate entities.

SELF-ASSESSMENT EXERCISE 1

Explain the term loans being granted to firms by the banks.

3.2 Mortgage Loan

Mortgage is a kind of loan for which land or any other specific asset is offered as collateral security for the repayment of the funds involved in the credit facility. This is also applicable to real estate loans for which the building structures put up by the beneficiaries are automatically pledged as their collateral securities.

Therefore, it is a kind of loan stock that has a fixed charge on the company's specific assets. Document of title to the assets, which usually consist of land and trading, will be in the hands of the mortgage holders or their representative.

In the case of default, the receiver manager will sell and use the proceeds to pay the bank in the case of lands. In the case of other assets the bank can sell them for the repayment of the mortgage loan.

SELF-ASSESSMENT EXERCISE 2

Explain the nature of mortgage loan being granted to firms by the banks.

3.3 Real Estate Loans

The real estate loans are credit facilities which are normally granted for the purchase or construction of building structures. Such loan facilities are granted on the basis of the fact that the real estates in terms of the landed property involved constitute the collateral security. Therefore, the real estate loans are more or less mortgage loans.

The real estate loans are like the mortgage loans because they are associated with specific collateral securities such as the building structures for which the loan funds are used to construct by the beneficiaries. Therefore, the bank that grants the loans automatic has a legal lien over the building structures constructed with the funds by the customers.

It suffices it to say that the real-estate loan facility can indeed assume the trappings of a mortgage loan. It means that all the features of the mortgage loan are also applicable to all real estate loans.

3.4 Bond Instrument

This instrument is issued and held by the firm for over a long period of time, the repayment of which is after a maturity period. The whole amount will be held until after maturity when it is repayable. The bank that subscribes to bond will only be receiving the interest charges on periodic basis.

In essence, bond is a loan instrument issued by a company with promise to pay back the fund borrowed after a specific number of years. The interest accruing on bond is normally paid to the holder at regular basis, say, semi-annually over the life of the debt

It is normally due for payment after 10 to 20 years when the face value (principal amount borrowed) is paid back to the holder. The bond can be sold before the maturity date of the holder at the prevailing market price determined by the forces of demand of supply.

The bond attracts the appointment of a trustee and institutions of a contractual discount called in debenture which will be used by the trustee to oversee the declinator of the beneficial of a bond. Different types of bond include sinking fund bond, convertible bond, collateral trust bond-secured by specific collateral security, and income bond-interest on the bond payable debtors.

A debenture is the type of bond which is issued by large, well known industrial company. These loan instruments do not have any collateral backing they enjoy in fixed or floating charge on the assets of the corporate body. It attracts annual payment of interest to the holders.

SELF-ASSESSMENT EXERCISE 3

Explain the nature of bond as a form of investment by the banks.

3.5 Working Capital Loans

The working capital loan is a short-term loan which is normally obtained by a firm to finance its day-to-day operations. The loan is normally a facility for a comparably small amount. It is not normally used for long-term operational purposes. In most cases, the funds from working capital loan are normally for immediate needs of the firm, such as meeting payroll and accounts payable. This can be granted by a firm on short-term or installment basis.

In essence, the working capital loan is a kind of loan that is normally granted by a bank to a well established firm to finance the daily operations of a business entity. There are indicators that are normally monitored by entrepreneurs and executive officers of large companies with which to know the indicators indicating the need for working capital loans from a bank or other alternative credit financing firms.

Normally, business entities need the working capital loans when they are having liquidity crisis within their operations such as inability to meet additional funding to settle short-term obligations or to expand their operations. Under these circumstances and many others, a working capital loan is really a necessity towards the survival of the operations of many a business such as a small business startup and established business.

3.6 Installment Loans

The installment loan involves a sum of money advanced by a bank to a customer for repayment over a fixed time period in equal amounts. In return for the loan, the borrower agrees on a repayment plan, which

involves an amount that typically remains the same throughout the life of the loan. The interest charges on an installment loan are normally factored into future repayments.

In another perspective, installment loan can be described as the type of loan that is granted on the understanding that there will be periodic payments. Such amount of payment is based on a specified period of time which can be longer or shorter depending on the term of agreement between the bank and the customer. The cost of the installment loan depends on the interest rate and the terms involved generally.

The terms of repayment of installment loans are normally expressed in months. The common periods of repayment include 36, 48, 60 or 72 months. There are a wide variety of terms, ranging from short term, medium term to long term. For instance, mortgages are installment loans with longer terms such as 180 or 360 months of repayment. It implies that some installment loans may be structured for payment over a period of years.

Installment loans are normally repaid by the beneficiary on a monthly basis with some exceptions. The monthly repayments for an installment loan are usually the same in each month. Nevertheless, the monthly repayment can change if the loan has a variable rate. The total repayment amount of an installment loan normally includes the principal and the interest charges.

It is the banks that determine the monthly payment amount by calculating the total amount of interest due over the duration of the loan and add the figure together with the principal amount of the loan. The bank then divides that total figure into equally sized monthly payments.
There might be some fluctuations in the monthly payment due to the fact that years and months have uneven numbers of days so the interest on a loan does not usually end up being a round figure. Therefore, it implies that monthly payments are not always exactly the same. Such variations in monthly payments, however, usually amount to some insignificant figure.

4.0 CONCLUSION

You have learnt from this study unit that there are other areas through which the banks can invest their funds. Such areas include the various loans and credit facilities being granted by the banks to corporate bodies. Among these lending facilities include some short-term loans while others relate to long-term investment facilities which include equity investment and lease finance of machinery, equipment and motor vehicles.

5.0 SUMMARY

In this last study unit of the course material, the topics covered include the following:

- Term Loan
- Mortgage Loan
- Real Estate Loans
- Bond Instrument
- Working Capital Loans
- Installment Loans

6.0 TUTOR-MARKED ASSIGNMENT

Mention and explain the main types of loans and credits in which the banks invest their funds.

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