

مكتبة

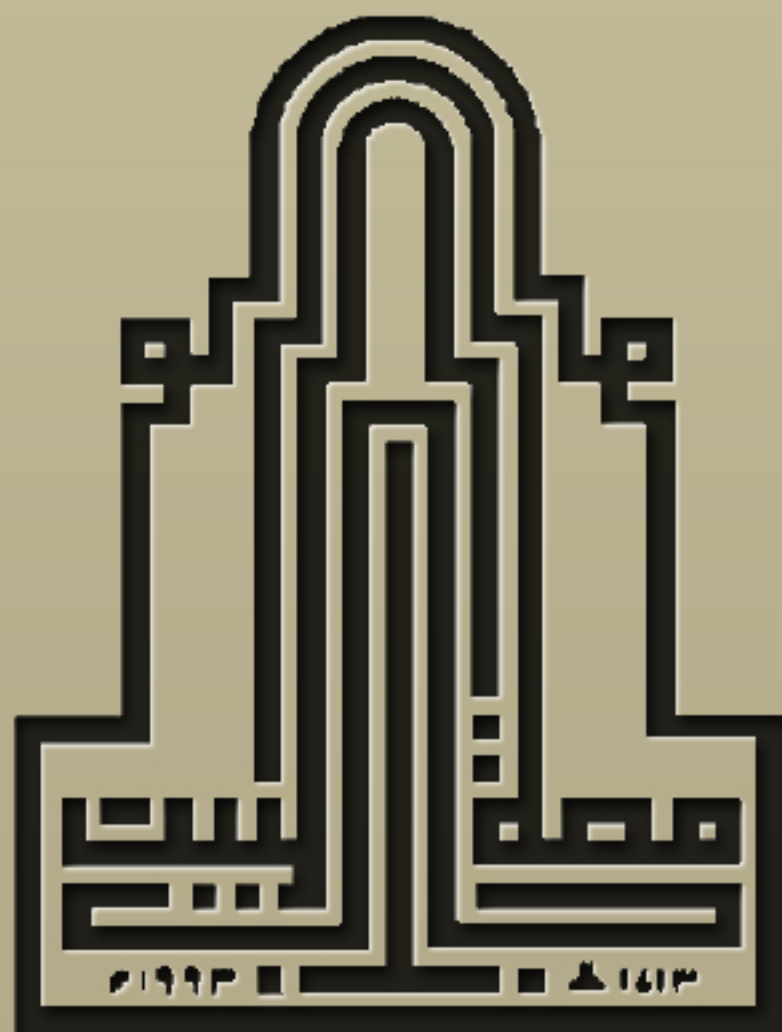
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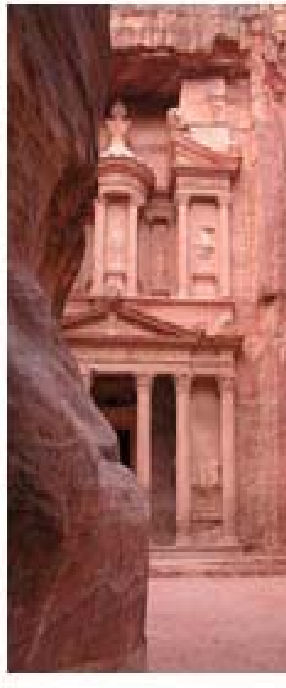
الإلكترونية

جامعة آل البيت " كلية الإقتصاد "

مجموعة طلابية تسعى لتوفير كل ما يلزم طلاب

كلية إدارة المال والاعمال من مواد وشرحات واسئلة بصورة الكترونية



<p><i>CREDIT MANAGEMENT</i> (0503414) Part (1)</p> <p><i>Sufian I. HRAZE, Lecturer</i> sufian_hraze@aabu.edu.jo First Semester 2012/2013 Department of Finance and Banking Faculty of Finance and Business Administration Al – al BAYT University</p>	
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Part 1

<p>Chapter</p> <p>1</p> <p>Bank Lending: Policies and Procedures</p> <p><i>Sufian I. HRAZE, Credit Management, (0503414), Department of Finance and Banking, AABU, 1st Semester, 2012/2013.</i></p> <p>*Part-1* * Page-2*</p>

Bank Lending: Policies and Procedures

- ☞ Why sound bank lending policies are important to banks?
- ☞ The public they serve.
- ☞ How to spot and deal with problem loans when they appear in a bank's portfolio.

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Types of Loans Made By Banks

- ☞ Bank loans are usually classified by the purpose of the loans
 - ❖ Real Estate Loans
 - ❖ Financial Institution Loans
 - ❖ Commercial and Industrial Loans
 - ❖ Agriculture Loans, or any other sector
 - ❖ Loans to Individuals
 - ❖ Miscellaneous Loans
 - ❖ Lease Financing Receivables

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Factors Determining the Mix of Bank Loans

- ☞ Characteristics of Market Area.
- ☞ Bank Size.
- ☞ Experience and Expertise of Management.
- ☞ Expected Yield of Each Type of Loan.
- ☞ Regulations.

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CAMELS Rating System

- ☞ The CAMELS is a system used by Central banks' examiners for evaluating the overall condition of a bank based upon the
 - ❖ Capital Adequacy
 - ❖ Asset Quality
 - ❖ Management Quality
 - ❖ Earnings Record
 - ❖ Liquidity Position
 - ❖ Sensitivity to Market Risk

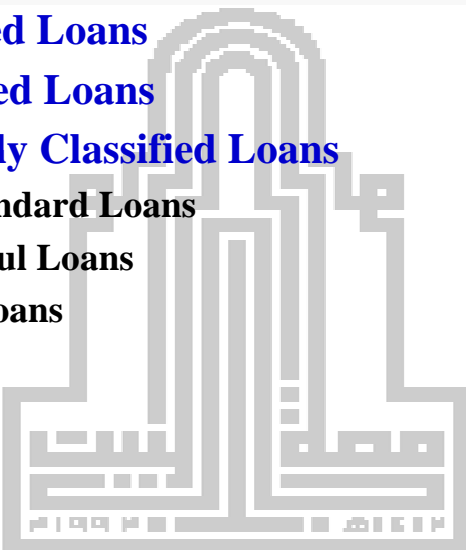
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Asset Quality

- ☞ Criticized Loans
- ☞ Scheduled Loans
- ☞ Adversely Classified Loans
 - ❖ Substandard Loans
 - ❖ Doubtful Loans
 - ❖ Loss Loans



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**CREDIT FACILITIES EXTENDED BY THE LICENCED BANKS
ACCORDING TO TYPE AND MATURITY (CONTINUED)**

ID Million	2010	2009	2008	2007	2006	مليون دينار
Total Credit	14451.4	13317.2	13044.3	11295.6	9761.9	اجمالي التسهيلات الائتمانية
Overdraft	1782.0	1599.6	1769.6	1658.6	1580.5	جاري مدين
Loans and Advances	12403.8	11418.0	10859.0	9199.8	7722.1	قروض وسلف
Due within						تستحق خلال
(3) Months	2152.7	2048.6	2904.2	1557.5	1198.1	اشهر (3)
(3-6) Months	1095.8	1062.7	985.2	876.6	775.5	اشهر (3-6)
(6-12) Months	1123.3	1107.0	1119.3	1234.6	1161.4	اشهر (6-12)
More than (12)	7067.9	6468.3	5234.8	5049.3	4129.6	اكثر من ١٢ شهر
Receivable	93.1	99.5	88.9	51.5	76.8	برسم التحصيل
Accrued	871.0	631.9	526.6	430.3	380.7	مستحقة
Discounted Bills	265.6	299.6	415.7	437.2	459.3	كمبيالات مخصومة
Due within						تستحق خلال
(3) Months	99.8	114.8	165.7	148.4	142.7	اشهر (3)
(3-6) Months	41.4	42.7	64.2	65.4	65.3	اشهر (3-6)
(6-12) Months	27.4	33.0	53.6	75.6	74.1	اشهر (6-12)
More than (12)	27.3	52.9	74.2	97.0	98.5	اكثر من ١٢ شهر
Receivable	9.3	9.9	10.2	5.9	18.9	برسم التحصيل
Accrued	60.4	46.3	47.8	44.9	59.8	مستحقة

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Regulators' Use of Market Forces

**Because the Quality of Examination
Information Decays Very Quickly
Regulators are Starting to Use Market
Forces and Private Market Discipline to
Monitor Bank Behavior**

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Bank's Written Loan Policy

- ☞ Goal Statement for Bank's Loan Portfolio**
- ☞ Specification of Lending Authority of Each Loan Officer and Committee**
- ☞ Lines of Responsibility in Making Assignments and Reporting Information**
- ☞ Operating Procedures for Reviewing, Evaluating and Making Loan Decisions**
- ☞ Required Documentation for All Loans**
- ☞ Lines of Authority for Maintaining and Reviewing Credit Files**

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...Bank's Written Loan Policy

- ☞ Guidelines for Taking and Perfecting Collateral
- ☞ Policies and Procedures for Setting Loan Interest Rate
- ☞ Statement of Quality Standards for All Loans
- ☞ Statement of Upper Limit for Total Loans Outstanding
- ☞ Description of the Bank's Principal Trade Area
- ☞ Discussion of the Preferred Procedures for Detecting, Analyzing and Working Out Problem Loans

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The Six Basic C's of Lending

- ☞ **Character:** Specific Purpose of Loan and Serious Intent to Repay Loan
- ☞ **Capacity:** Legal Authority to Sign Binding Contract
- ☞ **Cash:** Ability to Generate Enough Cash to Repay Loan
- ☞ **Collateral:** Adequate Assets to Support the Loan
- ☞ **Conditions:** Economic Conditions Faced By Borrower
- ☞ **Control:** Does Loan Meet Written Loan Policy? and How Would Loan Be Affected By Changing Laws and Regulations?


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Another Approach for Lending 5 P's

- ☞ **People.**
- ☞ **Purpose.**
- ☞ **Protection.**
- ☞ **Payment.**
- ☞ **Perspective.**



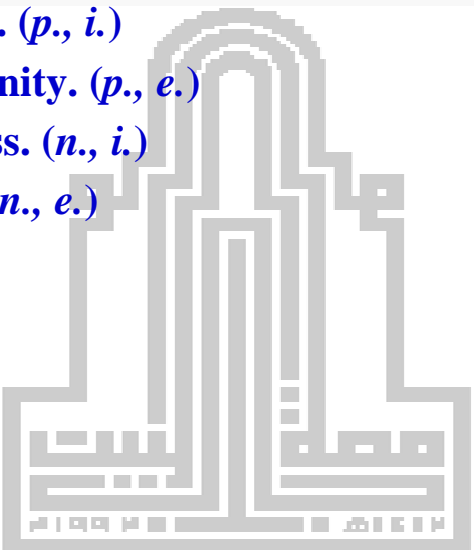
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Another Approach for Lending SOWT

- ☞ **Strength. (p., i.)**
- ☞ **Oppportunity. (p., e.)**
- ☞ **Weakness. (n., i.)**
- ☞ **Threat. (n., e.)**



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Common Types of Loan Collateral

- ☞ Accounts Receivables
- ☞ Factoring
- ☞ Inventory
- ☞ Real Property
- ☞ Personal Property
- ☞ Personal Guarantees

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Parts of a Typical Loan Agreement

- ☞ The Note
- ☞ Loan Commitment Agreement
- ☞ Collateral
- ☞ Covenants
 - ❖ Affirmative
 - ❖ Negative
- ☞ Borrower Guaranties and Warranties
- ☞ Events of Default

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Loan Review

**Examination of Outstanding Loans to
Make Sure Borrowers are Adhering to
Their Credit Agreements and the Bank
is Following Its Own Loan Policies**

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Warning Signs of Problem Loans

- ☞ **Unusual or Unexpected Delays in Receiving Financial Statements**
- ☞ **Any Sudden Changes in Accounting Methods**
- ☞ **Restructuring Debt or Eliminating Dividend Payments or Changes in Credit Rating**
- ☞ **Adverse Changes in the Price of Stock**
- ☞ **Net Earnings Losses in One or More Years**
- ☞ **Adverse Changes in Capital Structure**
- ☞ **Deviations in Actual Sales from Predictions**
- ☞ **Unexpected and Unexplained Changes in Deposits**

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Loan Workouts

**The Process of Resolving a
Troubled Loan So the Bank Can
Recover Its Funds**

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Loan Workout Process

- ☞ Goal is to Maximize Full Recovery of Funds**
- ☞ Rapid Detection and Reporting of Problems is Essential**
- ☞ Loan Workout Should Be Separate From Lending Function**
- ☞ Should Consult With Customer Quickly on Possible Options**
- ☞ Estimate Resources Available to Collect on Loan**
- ☞ Conduct Tax and Litigation Search**
- ☞ Evaluate Quality and Competence of Management**
- ☞ Consider All Reasonable Alternatives**

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Recent Trends in Loan Growth Quality

☞ Wholesale Bank

- ❖ Emphasizes lending to businesses

☞ Retail Bank

- ❖ Emphasizes lending to individuals
- ❖ Primary funding is from core deposits

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...Recent Trends in Loan Growth Quality

- ☞ Larger banks have, on average, recently reduced their dependence on loans relative to smaller banks.
- ☞ Real estate loans represent the largest single loan category for banks.
- ☞ Residential 1-4 family homes contribute the largest amount of real estate loans for banks.

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Trends in Competition for Loan Business

- ☞ **Most firms can obtain loans from many different sources**
 - ❖ Bank loans
 - ❖ Finance companies
 - ❖ Life insurance companies
 - ❖ Commercial paper
 - ❖ Junk bonds
- ☞ **Reduced regulation, financial innovation, increased consumer awareness, and new technology have made it easier to obtain loans from a variety of sources**

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...Trends in Competition for Loan Business

- ☞ **Banks still have the required expertise and experience to make them the preferred lender for many types of loans**
- ☞ **Technology advances have meant that more loans are becoming “standardized,” making it easier for market participants to offer loans in direct competition to banks**
- ☞ **Structured Note**
 - ❖ Loan that is specifically designed to meet the needs of one or a few companies but has been packaged for resale

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The Credit Process		
Business Development and Credit Analysis	Credit Execution and Administration	Credit Review
<ul style="list-style-type: none"> • Market research • Advertising, public relations • Officer call programs • Obtain formal loan request • Obtain financial statements, borrowing resolution, credit reports • Financial statement and cash flow analysis • Evaluate collateral • Line officer makes recommendation on accepting/rejecting loan 	<ul style="list-style-type: none"> • Loan committee reviews proposal/recommendation • Accept/reject decision made, terms negotiated • Loan agreement prepared with collateral documentation • Borrower signs agreement, turns over collateral, receives loan proceeds • Perfect security interest • File materials in credit file • Process loan payments, obtain periodic financial statements, call on borrower 	<ul style="list-style-type: none"> • Review loan documentation • Monitor compliance with loan agreement: Positive and negative loan covenants Delinquencies in loan payments Discuss nature of delinquency or other problems with borrower • Institute corrective action: Modify credit terms Obtain additional capital, collateral, guarantees Call loan
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...The Credit Process
<ul style="list-style-type: none"> ☞ Loan Policy- Formalizes lending guidelines that employees follow to conduct bank business ❖ Credit Philosophy <ul style="list-style-type: none"> ➤ Management's philosophy that determines how much risk the bank will take and in what form ❖ Credit Culture <ul style="list-style-type: none"> ➤ The fundamental principles that drive lending activity and how management analyzes risk
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...The Credit Process

☞ Credit Culture

- ❖ The fundamental principles that drive lending activity and how management analyzes risk
 - Values Driven
 - Focus is on credit quality
 - Current-Profit Driven
 - Focus is on short-term earnings
 - Market-Share Driven
 - Focus is on having the highest market share

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Business Development and Credit Analysis

☞ Business Development

- ❖ Market research
- ❖ Train employees:
 - On what products are available
 - What products customers are likely to need
 - How they should communicate with customers about those needs
- ❖ Advertising and Public Relations
- ❖ Officer Call Programs

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...Business Development and Credit Analysis

☞ Credit Analysis

- ❖ Evaluate a borrower's ability and willingness to repay
- ❖ Questions to address
 - What risks are inherent in the operations of the business?
 - What have managers done or failed to do in mitigating those risks?
 - How can a lender structure and control its own risks in supplying funds?

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...Business Development and Credit Analysis

☞ Six C's of Good Credit

- ❖ Character
- ❖ Capital
- ❖ Capacity
- ❖ Conditions
- ❖ Collateral
- ❖ Control

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...Business Development and Credit Analysis

☞ Six C's of Bad Credit

- ❖ Complacency.
- ❖ Carelessness.
- ❖ Communication.
- ❖ Contingencies.
- ❖ Competition.
- ❖ Crisis.

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Credit Execution and Administration

☞ Loan Decision

- ❖ Individual officer decision
- ❖ Committee
- ❖ Centralized underwriting

☞ Loan Agreement

- ❖ Formalizes the purpose of the loan
- ❖ Terms of the loan
- ❖ Repayment schedule
- ❖ Collateral required
- ❖ Any loan covenants
- ❖ States what conditions bring about a default

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...Credit Execution and Administration

☞ Documentation: Perfecting the Security Interest

❖ Perfected

- When the bank's claim is superior to that of other creditors and the borrower
 - Require the borrower to sign a security agreement that assigns the qualifying collateral to the bank
 - Bank obtains title to equipment or vehicles

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...Credit Execution and Administration

☞ Position Limits

- ❖ Maximum allowable credit exposures to any single borrower, industry, or geographic local

☞ Risk Rating Loans

- ❖ Evaluating characteristics of the borrower and loan to assess the likelihood of default and the amount of loss in the event of default

...Credit Execution and Administration

☞ **Loan Covenants**

- ❖ **Positive (Affirmative)**
 - Indicate specific provisions to which the borrower must adhere
- ❖ **Negative**
 - Indicate financial limitations and prohibited events

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Sample Loan Covenants

Negative	Affirmative
<ul style="list-style-type: none"> • Capital outlays cannot exceed \$3 million annually • Cash dividends cannot exceed 60% of periodic earnings • Total officers' salaries cannot exceed \$500,000 annually • No liens on assets beyond existing liens • No mergers, consolidations, or acquisitions without bank approval • No sale, lease, or transfer of more than 10% of existing assets • No change in senior management • No additional debt without bank approval 	<ul style="list-style-type: none"> • Borrower must maintain following financial ratios: <ul style="list-style-type: none"> Current ratio >1.0 Days receivables outstanding <50 days Inventory turnover >4.5 times Debt to total assets <70% Net worth >\$1 million Fixed charge coverage >1.3 times Cash flow from operations >dividends + current maturities of long-term debt • Certified financial statements must be provided within 60 days of end of each fiscal year • Borrower will maintain \$500,000 key man life insurance policy on company president, with bank named as beneficiary • Bank will be allowed to inspect inventory, receivables, and property periodically • Borrower must pay all taxes and government fees, unless contested in good faith, and comply with all laws • Borrower must inform bank of any litigation or claim that might materially affect its performance • Borrower must maintain all property in good condition and repair

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Credit Execution and Administration

☞ Loan Review

- ❖ Monitoring the performance of existing loans
- ❖ Handling problem loans

☞ Loan review should be kept separate from credit analysis, execution, and administration

- ❖ The loan review committee should act independent of loan officers and report directly to the CEO of the bank

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Credit Execution and Administration

☞ Problem Loans

- ❖ Often require special treatment
 - Modify terms of the loan agreement to increase the probability of full repayment
 - Modifications might include:
 - Deferring interest and principal payments
 - Lengthening maturities
 - Liquidating unnecessary assets

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Characteristics of Different Types of Loans

☞ **Commercial Real Estate Loans**

- ❖ **Typically short-term loans consisting of:**
 - **Construction and Real Estate Development Loans**
 - **Land Development Loans**
 - **Commercial Building Construction and Land Development Loans**

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...Characteristics of Different Types of Loans

☞ **Commercial Real Estate Loans**

- ❖ **Construction Loans**
 - **Interim financing on commercial, industrial, and multi-family residential property**
- ❖ **Interim Loans**
 - **Provide financing for a limited time until permanent financing is arranged**
- ❖ **Land Development Loans**
 - **Finance the construction of road and public utilities in areas where developers plan to build houses**

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...Characteristics of Different Types of Loans

☞ Commercial Real Estate Loans

- ❖ Developers typically repay loans as lots or homes are sold
- ❖ Takeout Commitment
 - An agreement whereby a different lender agrees to provide long-term financing after construction is finished

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...Characteristics of Different Types of Loans

☞ Residential Mortgage Loans

- ❖ Mortgage
 - Legal document through which a borrower gives a lender a lien on real property as collateral against a debt
- ❖ Most are amortized with monthly payments, including principal and interest

...Characteristics of Different Types of Loans

☞ Residential Mortgage Loans

❖ 1-4 Family Residential Mortgage Loans

- Holding long-term fixed-rate mortgages can create interest rate risk for banks with less potential if rates increase
- To avoid this, many mortgages now provide for:
 - Periodic adjustments in the interest rate
 - Adjustments in periodic principal payments
 - The lender sharing in any price appreciation of the underlying asset at sale
- All of these can increase cash flows to the lender when interest rates rise

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...Characteristics of Different Types of Loans

☞ The Secondary Mortgage Market

- ❖ Involves the trading of previously originated residential mortgages
 - Can be sold directly to investors or packaged into mortgage pools

☞ Home Equity Loans

❖ Second Mortgage Loans

- Typically shorter term than first mortgages
- Subordinated to first mortgage

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...Characteristics of Different Types of Loans

☞ Equity Investments in Real Estate

- ❖ Historically, commercial banks have been prevented from owning real estate except for their corporate offices or property involved in foreclosure
- ❖ Regulators want banks to engage in speculative real estate activities only through separate subsidiaries

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...Characteristics of Different Types of Loans

☞ Working Capital Requirements

- ❖ Net Working Capital
 - Current assets – current liabilities
 - For most firms, net working capital is positive, indicating that some current assets are not financed with current liabilities

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...Characteristics of Different Types of Loans

☞ Seasonal versus Permanent Working Capital Needs

- ❖ All firms need some minimum level of current assets and current liabilities
- ❖ The amount of current assets and current liabilities will vary with seasonal patterns

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Characteristics of Different Types of Loans

☞ Permanent Working Capital

- ❖ The minimum level of current assets minus the minimum level of adjusted current liabilities

➤ Adjusted Current Liabilities

- Current liabilities net of short-term bank credit and current maturities of long-term debt

☞ Seasonal Working Capital

- ❖ Difference in total current assets and adjusted current liabilities

Short-Term Commercial Loans

☞ Open Credit Lines

- ❖ Loan is seasonal if the need arises on a regular basis and if the cycle completes itself with one year
- ❖ Used to purchase raw materials and build up inventories of finished goods in anticipation of later sales
- ❖ It is self-liquidating in the sense that repayment derives from the sale of finished goods that are financed

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...Short-Term Commercial Loans

☞ Open Credit Lines

- ❖ The bank makes a certain amount of funds available to a borrower for a set period of time
 - Often used for seasonal loans
- ❖ The customer determines the timing of the actual borrowings (“takedowns”)
- ❖ Borrowings increase with inventory buildup and decline with the collection of receivables

...Short-Term Commercial Loans

☞ Open Credit Lines

- ❖ Typically require that the loan be fully repaid at least once during each year to confirm that the needs are seasonal
- ❖ Commitment Fee
 - A fee, in addition to interest, for making credit available
 - May be based on the entire credit line or on the unborrowed balance

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...Short-Term Commercial Loans

☞ Asset-Based Loans

- ❖ Loans Secured by Inventories
 - The security consists of raw materials, goods in process, and finished products.
 - The value of the inventory depends on the marketability of each component if the borrower goes out of business.
 - Banks will lend from 40 to 60 percent against raw materials that are common among businesses and finished goods that are marketable, and nothing against unfinished inventory

...Short-Term Commercial Loans

☞ Asset-Based Loans

❖ Loans Secured by Accounts Receivable

- The security consists of paper assets that presumably represent sales
- The quality of the collateral depends on the borrower's integrity in reporting actual sales and the credibility of billings

Part 1

...Short-Term Commercial Loans

☞ Asset-Based Loans

❖ Loans Secured by Accounts Receivable

- Accounts Receivable Aging Schedule
 - List of A/Rs grouped according to the month in which the invoice is dated
- Lockbox
 - Customer's mail payments go directly to a P.O. Box controlled by the bank
 - The bank processes the payments and reduces the borrower's balance but charges the borrower for handling the items

...Short-Term Commercial Loans

☞ Highly Levered Transactions

❖ Leveraged Buyout (LBO)

- Involves a group of investors, often part of the management team, buying a target company and taking it private with a minimum amount of equity and a large amount of debt
 - Target companies are generally those with undervalued physical assets
- The investors often sell specific assets or subsidiaries to pay down much of the debt quickly
 - If key assets have been undervalued, the investors may own a downsized company whose earnings prospects have improved and whose stock has increased in value
 - The investors sell the company or take it public once the market perceives its greater value.

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Part 1

...Short-Term Commercial Loans

☞ Highly Levered Transactions

❖ Arise from three types of transactions

- LBOs in which debt is substituted for privately held equity
- Leveraged recapitalizations in which borrowers use loan proceeds to pay large dividends to shareholders
- Leveraged acquisitions in which a cash purchase of another related company produces an increase in the buyer's debt structure

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Term Commercial Loans

- ☞ **Original maturity greater than 1 year**
 - ❖ **Typically finance:**
 - **Depreciable assets**
 - **Start-up costs for a new venture**
 - **Permanent increase in the level of working capital**
 - ❖ **Lenders focus more on the borrower's periodic income and cash flow rather than the balance sheet**
 - **Term loans often require collateral, but this represents a secondary source of repayment in case the borrower defaults.**

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...Term Commercial Loans

- ☞ **Balloon Payments**
 - ❖ **Most of the principal is due at maturity**
- ☞ **Bullet Payments**
 - ❖ **All of the principal is due at maturity**

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Short-Term Commercial Loans

☞ Revolving Credits

- ❖ A hybrid of short-term working capital loans and term loans
- ❖ Typically involves the commitment of funds for 1 – 5 years
- ❖ At the end of some interim period, the outstanding principal converts to a term loan
- ❖ During the interim period, the borrower determines how much credit to use
- ❖ Mandatory principal payments begin once the revolver is converted to a term loan

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Part 1

Short-Term Commercial Loans

☞ Agriculture Loans

- ❖ Proceeds are used to purchase seed, fertilizer and pesticides and to pay other production costs
 - Farmers expect to repay the debt with the crops are harvested and sold
- ❖ Long-term loans finance livestock, equipment, and land purchases
 - The primary source of repayment is cash flow from the sale of livestock and harvested crops in excess of operating expenses

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Additional Loan Types

☞ Consumer Loans

- ❖ Installment
 - Require periodic payments of principal and interest
- ❖ Credit Card
- ❖ Non-Installment
 - For special purposes
 - Example: Bridge loan for the down payment on a house that is repaid from the sale of the previous house
- ❖ The average consumer loan is relatively small and has a maturity of 1 to 4 years

Part 1

Additional Loan Types

☞ Venture Capital

- ❖ A broad term use to describe funding acquired in the earlier stages of a firm's economic life
 - Due to the high leverage and risk involved banks generally do not participate directly in venture capital deals
 - Some banks have subsidiaries that finance certain types of equity participations and venture capital deals, but their participation is limited

Additional Loan Types

☞ Venture Capital

- ❖ This type of funding is usually acquired during the period in which the company is growing faster than its ability to generate internal financing and before the company has achieved the size needed to be efficient

Part 1

Additional Loan Types

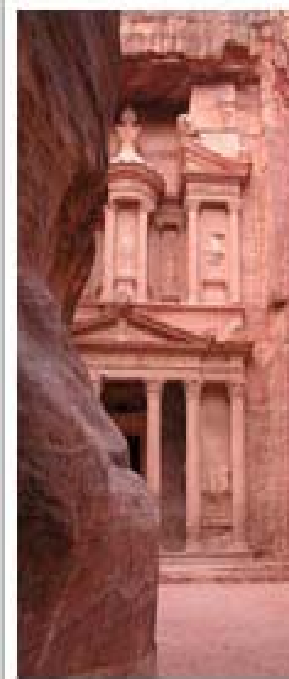
☞ Venture Capital

- ❖ Venture capital firms attempt to add value to the firm without taking majority control
 - Often, venture capital firms not only provide financing but experience, expertise, contacts, and advice when required
- ❖ Types of Venture Financing
 - Seed or Start-up Capital
 - Early stages of financing
 - Highly levered transactions in which the venture capital firm will lend money for a percentage stake in the firm
 - Rarely, if ever, do banks participate at this stage

CREDIT MANAGEMENT

**(0503414)
Part (1)**

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Part 1