**INSTITUTE OF BANKERS IN MALAWI**

**ADVANCED DIPLOMA**

**CREDIT RISK SSESSMENT 2**

**NOVEMBER 2014 EXAMINATIONS**

**SUGGESTED SOLUTIONS**

**SECTION A 60 Marks**

**QUESTION 1**

Certain elements or characteristics must be present in the security in order for the lending banker to place reliance on it. These are:

1. **Ownership**:-

Ownership must be determined without difficulties. When taken, the bank must be able to obtain indisputable title to the asset pledged as security.

1. **Value:**-

Value of the security should be easy to determine with little or no expenses

1. **Control:-**

The bank should be in a position to maintain effective control over the asset(s) held as security with little or no expenses

1. **Realization:-**

When a debtor defaults and the only source or repayment is through security realization, that security must be easy and fairly quick to realize with no or minimum of expenses.

**QUESTION 2**

1. Characteristics of guarantees:

There are three parties involved: principal creditor (bank), principal debtor, and the third party (the guarantor).

1. Three major disadvantages of guarantees:

* Value largely hinges on guarantor’s financial standing
* In rare circumstances, protracted litigation might result when attempts are made towards realization
* Bank may, in cases where debtor has several debts outstanding, lose its buffer if called upon to surrender securities by debtor.

**QUESTION 3**

1. Matching period of repayment to purpose is essential because if not matched….:

* It might result into creating a negative effect on the repayment ability
* It might also affect customer’s liquidity
* It will have a negative impact on customer’s cash flow
* It might impact negatively on the business’ solvency and gearing
* It might create difficult financial position when interest rates increase
* It might deplete W/C

1. Hard-core O/Ds potentially toxic debts: how and why?

* Do not meet fundamental principle of a fully fluctuating facility
* Balances remain almost at same level wherein total deposits almost equal total debits
* Quite often balances exceed level of O/D facility agreed upon as a result of inability to accommodate interest charges

It would follow therefore that if unable to meet/service interest, fluctuate, remain within the agreed limit e.t.c, hardcore debts are indeed toxic!

**QUESTION 4**

1. Bank’s internal factors that affect credit risk

* The credit policy
* Credit management and control systems
* Employees of the bank
* Products and markets

1. High interest rates for long term exposures due to:

* The principle that the longer the time the higher the risk
* The uncertainties that the future holds which can adversely affect the performance of the business and consequently it ability to repay
* Fast changes that are taking place in the environment and customer’s industry make it difficult to predict with certainty the future impact.

**SECTION B 40 Marks**

**QUESTION 5**

* A floating charge does not prevent the company from dealing, in the ordinary course of business, with assets which are subject of the charge. Unknown to the bank a company in financial difficulties may well sell its stocks and collect money from its debtors to pay off pressing demands of its unsecured creditors
* By law, certain classes of creditors are preferentially treated in the event a Receiver is appointed or when a company is being wound up. These preferential creditors have priority over the holder of a floating charge
* Certain unsecured creditors may obtain priority over the bank e.g. landlord or judgment creditor if sale of the assets subject to the charge is completed prior to charge crystallization
* If company goes into liquidation within 12 months of creating the charge, it may become an invalid charge unless it can be proved that the company was solvent immediately after or before creation of the charge
* Creditor who obtains a fixed charge subsequent to the bank’s floating charge may have priority of claim of the assets on the floating charge unless the charge claims he was not aware of the restrictions in the floating charge from crating any charge ranking in priority to it
* Supplier may obtain priority if goods in possession of the debtor company sold on credit are still owed

The flipside of the discussion is weak and proceeds thus:

* unlike a fixed charge, the floating charge remains dormant until the company ceases to be a going concern or when charge intervenes
* charge does not prevent charger from dealing with the charged assets in the ordinary course of business, thus allowing the debtor to carry on with business operations.

**QUESTION 6**

Characteristics of a good credit proposal can be appropriately presented in a generic form

With the following taken into account:

* credit proposal must be well structured, logical and systematically presented, to enable a proper decision to be made
* proposal must be factually correct and representative of the real situation
* proposal should be technically correct and complete
* proposal must meet the requirements of the credit policy of the bank
* Proposal must be concise, to the point, and must not reflect unnecessary information.

**QUESTION 7**

1. Under the Safety principle, 3 factors that can influence decision to lend are:

* Willingness of customer to repay
* Ability of customer to repay
* Availability of acceptable collateral

1. Willingness and ability to repay:- crucial factors to consider:

* Are cash flow projections correct and realistic?
* Does the account history reveal positive indicators?
* Is amount under request OK?
* What are the sources of repayment?
* Reliability and capability of borrower to repay OK?
* Take-home pay adequate to service facility?
* What about customer’s net worth?
* What about management risk - High, Medium or Low

**QUESTION 8**

The model focuses on 5 forces, (namely Competitor Rivalry, Threats of New Entrants, Threat of Suppliers of Substitute Products, Supplier and Buyer Power) that operate in the competitive environment of a business.

* Rivalry between businesses in the same industry: assess the extent with which a business fares in the market place. The position the borrowing customer holds and its future outlook play a crucial role in the decision. The higher/intense the level of competition the higher the risk of survival and by extension, the higher the lending risk
* Threat of New Entrants into the industry of the borrower customer: bank need to establish the level of appetite that exists dormantly in the minds of potential new entrants and the impact this might have on the borrower business in the event of entry into the industry of these potential entrants.
* Buyer Power: the more diverse the customer base the less likely that any one of them will exert pressure on the business of borrower customer for unreasonable discounts or other terms. Point to consider is, how diverse the customer base is.
* Supplier