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REMEDIAL MANAGEMENT  
FOR  
PROBLEM LOANS

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A Research Topic  
Presented to Business Division  
Beirut University College

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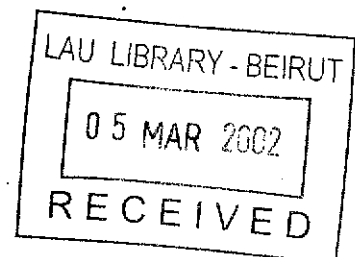
In Partial Fulfillment  
of the Requirements for the Degree  
Master of Science in Business  
Management

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By

Muhieddine Fathallah

June, 1985



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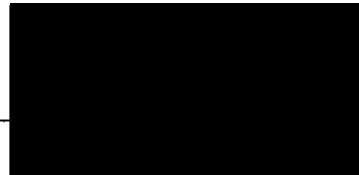
APPROVAL OF RESEARCH TOPIC

CANDIDATE: Muheiddine FATHALLAH      DATE: 17 June 1985  
DEGREE: Master of Science in Business Advisor: Dr.M.Singh  
TITLE OF RESEARCH TOPIC: Remedial Management for  
Problem Loans

The following professor nominated to serve as the advisor  
of the above candidate has approved his research topic

ADVISOR

Dr.M. Singh



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# CHAPTER

**I**

## Chapter 1

### INTRODUCTION

Credit judgment is not inherited or a divine gift, it is a development of common sense and perception. There is no trick to lending money, because it is easy to be a good credit man if you know all the facts. Getting all the facts is the problem. After that it becomes merely a matter of analysis and judgement exercised by the account officer. And no one can deny that an ounce of prevention is worth a pound of cure, especially in a lending situation.

#### STATEMENT OF THE PROBLEM

There are two basic questions to ask every borrower, first, "For what purpose is the money wanted?", and second, "How is the loan going to be paid back?". The first question is always easy to answer. There was a time when the second question was not asked as regularly as it is today, because banks put more emphasis on putting their money out than in thinking of how they were going to get it back.

Major problems are faced by lenders during the prebankruptcy petition period, when the borrower's financial problems arise and the lender is called upon to make critical judgment with a view to maximizing the revenue or minimizing the loss. This

period has been given the name of "Remedial Management", and indeed it is a most demanding business calling for rapid decisions concerning complex problems involving high risks.

Those who are charged with the responsibility of regular dealing with Remedial Management know that in the problem loan situation there are few absolute principles. Each case has many different variables and demands careful individualized financial and legal attention.

#### STATEMENT OF THE PURPOSE

Lenders can enhance their loan portfolio by being alert at the inception of credit negotiations and by consciously evaluating management balance and secondary repayment sources.

When a lender has decided to proceed with a loan, it is absolutely essential that he documents it properly and carefully in appropriate filings when necessary. And once the loan is booked, part of the loan administration technique must include proper reading and interpretation of warning signals pertinent to the borrower's business.

If, in spite of all these precautions the loan still becomes a "problem loan", the lending officer should not hesitate to acknowledge it as such. He



should move quickly to implement an appropriate "cure" from the several suggested in the research or develop whatever other remedy he deems appropriate depending upon the issues involved. If he does, his chances of loan restoration or recovery will be enhanced. At the very least, his loss will be reduced.

"During those long cold winter months of 1974, a principle crystallized in my mind that I shall never forget, it is this : A bad loan is always worse than you think it is. Think about that , can you think of one bad loan situation in which you were pleasantly surprised ?" <sup>1</sup>

#### PERFORMANCE OBJECTIVES

The purpose of this study is to achieve the following performance objectives:

1. To answer the question of why Credit Policy is needed ?

2. To introduce a risk asset process flow from market definition passing by Initiation, Documentation, and Disbursement arriving to portfolio management

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1. *Alford C. Sinclair "Bank Lending" Commercial Bank Lending, Robert Morris Associates, July 1976.*

3.To evaluate the essential steps in documenting credit transactions.

4.To present criteria for evaluation and procedures for administration of security/support arrangements for credit extension.

5.To stress on the importance of the 5C's of credit .

6.To establish a general guide follows on what actions should and what extent of action should be taken at the first hard evidence of a deteriorating loan .

7.To highlight those credits that represent an above normal credit risk by introducing a way of classification of credits.

8.To exercise viable measures to recover advances which can not be returned to their point of origin as a good credit .

9.To introduce the discriminant analysis employed by Edward I.Altman to predict Bankruptcy using various financial ratios.

10.To present a check list which should be a helpful guide to all bankers in seeking answers to the key credit questions of how to appraise management .

## DEFINITIONS OF TERMS

Assigned Account: An account, such as an accounts receivable account, which has been assigned to a bank as security for a loan by the borrower .

Attached Account: An account against which a court order has been issued, permitting disbursement of the balance ONLY with the consent of the court .

Bullion: Unminted precious metals ( gold, silver, etc.) of standard or stipulated fineness in the form of bars , ingots , nuggets , etc.

Call: To demand payment of a loan secured by collateral, because of failure on the part of a borrower to comply with the terms of the loan .

Chattel Mortgage: A mortgage on movable goods or equipments Chattel Mortgage are quite extensively used in bank financing.

Collateral: Stocks, bonds, evidences of deposits, and other marketable properties which a borrower pledges as security for a loan.

Consumer Credit: Credit extended by a bank to a borrower for the specific purpose of financing ,the purchase of a household appliance, alteration or improvement, etc. This credit is generally extended to individuals rather than to businesses.

Covenants: A contract pertaining to an undertaking, a promise, or an agreement to do, or forbear from doing, that which is of legal validity and legally enforceable.

Credit file: A portfolio where all credit information on a borrowing customer is assembled.

Credit Memo: A posting medium authorizing the credit to a specified account of a certain named account which bears the complete description of the transaction.

Credit rating: An estimate as to the credit and responsibility assigned to the borrower by credit investigating department.

Credit risk: The degree of risk calculated by the credit department that is connected with a particular request for credit.

Demand loan: A loan that has no fixed maturity date, but which is payable upon demand of the bank.

Frozen Asset: Any asset which cannot be used by its owner because of legal action.

Hypothecated Account: An account which is pledged, or assigned as collateral for a loan .

Insolvency: The inability to pay one's debts as they mature.

Loan Application: A form used by banks to record the normal request for a loan .

Mortgage: An instrument of conveyance, generally of real estate, from a borrower to the lender.

Secured loan: A loan which is secured by marketable securities or other marketable valuables.

# CHAPTER

2

## Chapter 2

### PRESENTATION AND ANALYSIS OF RESEARCH

#### PREFACE TO LENDING

In today's volatile economy, businesses are under extra pressure. Some borrowers with a good history of stability and high profitability ratios are moving toward instability and marginal profitability. The business environment promise to be different and difficult in the 1980's.

Borrowers, lenders, depositors, savers, and investors are all in the severe pains of responding to continual inflation and fluctuating interest rates, all of which are altering the environment our lives and our thinking. To make sound decisions, lenders must be aware to these changes. Inflation and the relatively depressed value of existing real capital have made it more attractive to acquire assets of another company than to build plants.

Next to the persuasive influence of the business cycle, management and its ability to adjust and prosper, to cope successfully with changes are most critical. Technology and consumer tastes aside, companies are tremendously influenced by management behavior and competence.

The decision to say yes or no reflects the lending officer's appraisal of the borrower's honesty, integrity, ability and willingness to complete the loan transaction in the manner agreed upon.

Typical questions to be answered are, what is the company's real business, and what must it do to be successful? What are its strategic thrust? Is the borrower buying successful performance today at the future's expense? What are the strategies, productwise, for keeping abreast of the times, if not ahead? Can the management continue to manage well as the business grows and becomes more complex to manage in adversity as well as prosperity?

The secret is knowing and understanding the risks and then getting protection against them. The lending officer, in determining whether the bank should bridge the borrower's paying/earnings gap, is not only making a present judgment about future willingness and ability to repay, but also about future conditions. Problems anticipation is the master key. By its nature the marketplace is mercurial. The question might be asked: How far can any lending officer, let alone, realistically forecast the future with much certainty?

All this pose challenges for lending officers:

1. In turbulent periods the need to maintain good perspective is great, where the potential for error is greater.

2. There is a need to take the long as well the short view of a credit.

3. There is a need to reconcile market practice with common sense.



4. There is a need to avoid overgenerosity in amount, terms, and conditions.

5. There is a need to recognize the importance of economic and external factors.

Each lending officer is expected to be thoroughly familiar with credit rules and policies and with banking or other regulations related to his or her area of lending activity, "when in doubt, ask. After all, good advice is a way of getting experience without going through the process." <sup>2</sup>

#### 5 C's of Credit

During the conversation with the borrower the answers obtained will help resolve some of the questions dealing with character, capacity, capital, collateral, and conditions surrounding both the borrower and the loan itself.

All information will not be collected during the initial interview and must be obtained by the credit department or the credit officer through investigations. The composition of the basic "C's of Credit" may seem elementary and could be disregarded, but if they are by-passed, a decision might be made that eventually would prove disastrous to both the borrower and the Bank .

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2. P. Henry Muller "Credit Doctrine for Lending Officers" <sup>nd</sup> 2 Edition  
Citicorp Publications 1981, pp60

Let us examine each "C"

Character:

This is the most important of all the C's. There is no substitute for character. It is a vital factor. A person's character can cause the decision to shift from "Yes" to "No". The honesty and integrity of the borrower is of primary importance. The past record of the borrower is a good criteria for his future performance when the bank is considering his current request for credit.

Capacity:

This is the management ability factor. It tells how successful a business has been in the past and will possibly be in the future. A company may have an excellent financial statement with good earnings but if management lacks the know how and determination of the financial conditions. And a company with a satisfactory but not very strong financial condition which proves to have excellent management, it can make each dollar earns its way, the end result being a profitable operation with a good return to owner.

Capital:

This is the monetary banking. The investment made by the principals represents their faiths in the company, its product, and its future. It also

indicates to the creditors the financial ability of the company. Lending institutions want to know whether the owners or creditors are supplying the capital.

#### Collateral:

Many times collateral is taken to offset a weakness in one or more of the other C's. It cannot however, be substituted for character. All of the collateral may be made available by the borrower to the bank will not make a bad loan good but it will make a good loan better. By overlooking character and capacity in favour of collateral, the banker is asking for trouble because the omission of these two factors will ultimately drain the collateral to where it could become valueless. A loan should not be made where the only source of repayment known at the time the loan is made is to be from the sale of the collateral.

#### Conditions:

The economic condition of the country and its position within the particular phase of the business cycle, together with the position of the proposed borrower's business in the industry cycle at the time of the credit request will have a lifetime bearing on the decision.

Technological conditions as well as economical conditions should also be considered. Rapid innovations in the technical field may result in economic developments, which make the credit undesirable at a future date.

## WHY CREDIT POLICY

Banks are in the business of risk taking. They are successful as long as the risks they assumed are reasonable, controlled within their financial resources and credit competence. Assets, principally loans, must be managed to help provide the liquidity to meet deposit withdrawals, cover all expenses including losses, and still earn a profit large enough to make the return to the stockholder competitive with all other investments. This objective determines policies, rules and guidelines for good risk taking.

The essence of banking is the management of liquidity. Commercial banks lend to many types of borrowers, for varying periods in different patterns, on many bases, and for a variety of reasons. Loans therefore will vary in liquidity and risk and concentrations must be limited so that no single occurrence can have a significant adverse impact. The purpose of credit policy is to guide officers in balancing the quality and quantity of the loan portfolio to achieve earnings objectives while also meeting appropriate credit needs, maintaining proper credit standards, holding risks to reasonable limits, minimizing losses, evaluating new business opportunities, adjusting to changes in the regulatory environment and providing adequate liquidity. In seeking such a balance, credit quality must always take precedence over exploitation of business

opportunities. Put simply safety of principal and assurance of repayment within the allocated time frame have priority over the profit on the transaction. You cannot charge an interest rate high enough to compensate for a loan that cannot be collected.

A primary purpose of a written credit policy is to provide a framework of standards and points of reference within which individual lending personnel can operate with confidence, relative uniformity and flexibility, while making their own decisions within delegated authority, without the necessity for constant referral to higher management. Without it there is a tendency to either concentrate all decision making in one or two people at or near the top level of management. This is likely to result in slower decisions and inability of loan officers to develop their full potential, or a dangerous diversity of lending practices and philosophies within the organization, probably leading ultimately to an inordinate number of problem loans. Stated another way, a function of loan policy is to create attitudes which lending personnel can use as a decision-making process.

In addition to establishing uniform guidelines for loan officers and satisfying the regulatory and monetary agencies, a written loan policy can aid management in defining objectives of the bank. Like any other business, a commercial bank establishes particular objectives to be met.

"A Loan policy is also a necessity for a bank if it is to attain its objectives and also serve the public .... its lending must be conducted in an orderly manner.<sup>3</sup>"

What should a credit policy include? There can be some variations based on needs of a particular organization, but at least the following areas should be covered in any comprehensive statement of credit policy:

1. legal considerations. The bank's legal lending limit and other constraints should be set forth, in order to avoid violation of banking regulations.
2. Delegation of authority. Each individual authorized to extend credit should know precisely how much and under what conditions he or she may commit the bank's funds. These authorities should be approved by written resolution of the B.O.D. at least annually and kept current at all times.
3. Types of Credit Extensions: One of the most substantive parts of a credit policy is a delineation of which types of loans are acceptable and which are not.
4. Pricing: The price to be charged for the loan

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3 *Douglas S. Clarke "Cash Cycles and Commercial Lending" Robert Morris Bulletin, June 61*

extended is very important. Relative uniformity within the same market is necessary. Without it, individuals have few guidelines for quoting rates or fees, and the variations resulting from human nature will be a source of customer dissatisfaction.

5. Market Area: Each bank should establish its proper market area, based upon other things, the size and sophistication of its organization, its ability to service its customers, and its ability to absorb risks. Given the bank's capital, defining market areas probably more important in the lending function than in any other aspect of banking.
6. Loan standards: This is a definition of the types of credit to be extended, where qualitative standards for acceptable loans are yet forth.
7. Credit granting procedures: This subject may be covered in a separate manual, and in larger banks usually is available, but should not be overlooked, as it is very much a factor in the achievement of sound loan standards. Without proper procedures, policy and standards are not likely to be achieved.

## THE LOAN PORTFOLIO

Loans made throughout the Banking system vary considerably from market to market. Some are short-term, self liquidation and seasonal others are longer term. They can be secured or unsecured. And in general all pass by the same process. (Exhibit 1)<sup>4</sup>

### Purpose of Loans

As a general rule, the purpose of every loan should be the basis of its repayment.<sup>5</sup> Short-term, seasonal liquidating loans to temporarily build current assets or to take advantage of attractive supplier terms are usually the most desirable in terms of liquidity. Loans to fund noncurrent assets carry greater risks. As liquidity diminishes, repayment must come from the revenues associated with these noncurrent assets (earn-out or sale). This extends the time frame and, therefore, adds to uncertainty of repayment.

It is desirable for the borrower as well as for the bank that each loan have a realistically defined program of repayment, agreed upon in writing at the time the loan is made. The potential borrower's cost and revenue assumptions need to be carefully treated by the lending officer.

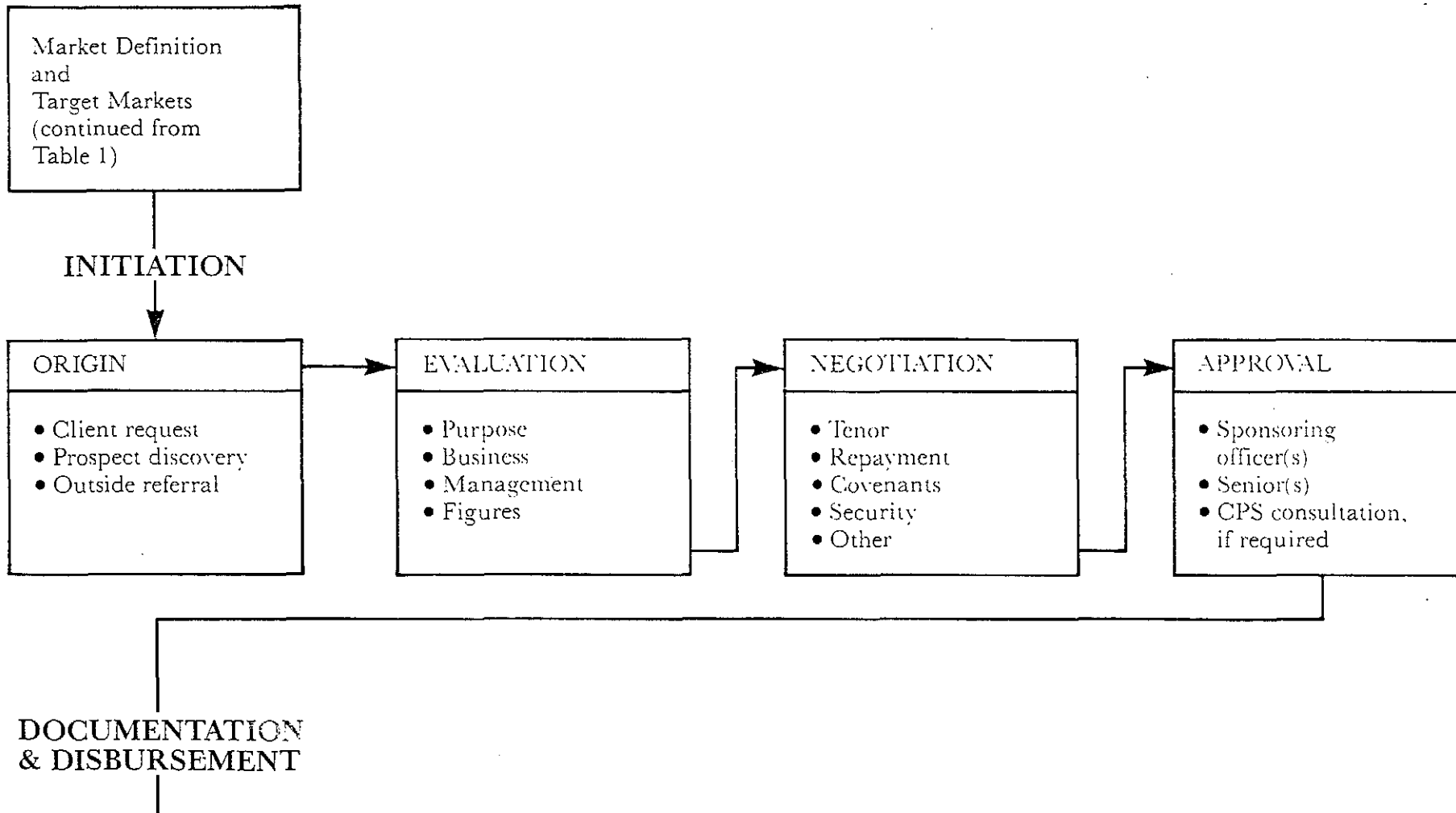
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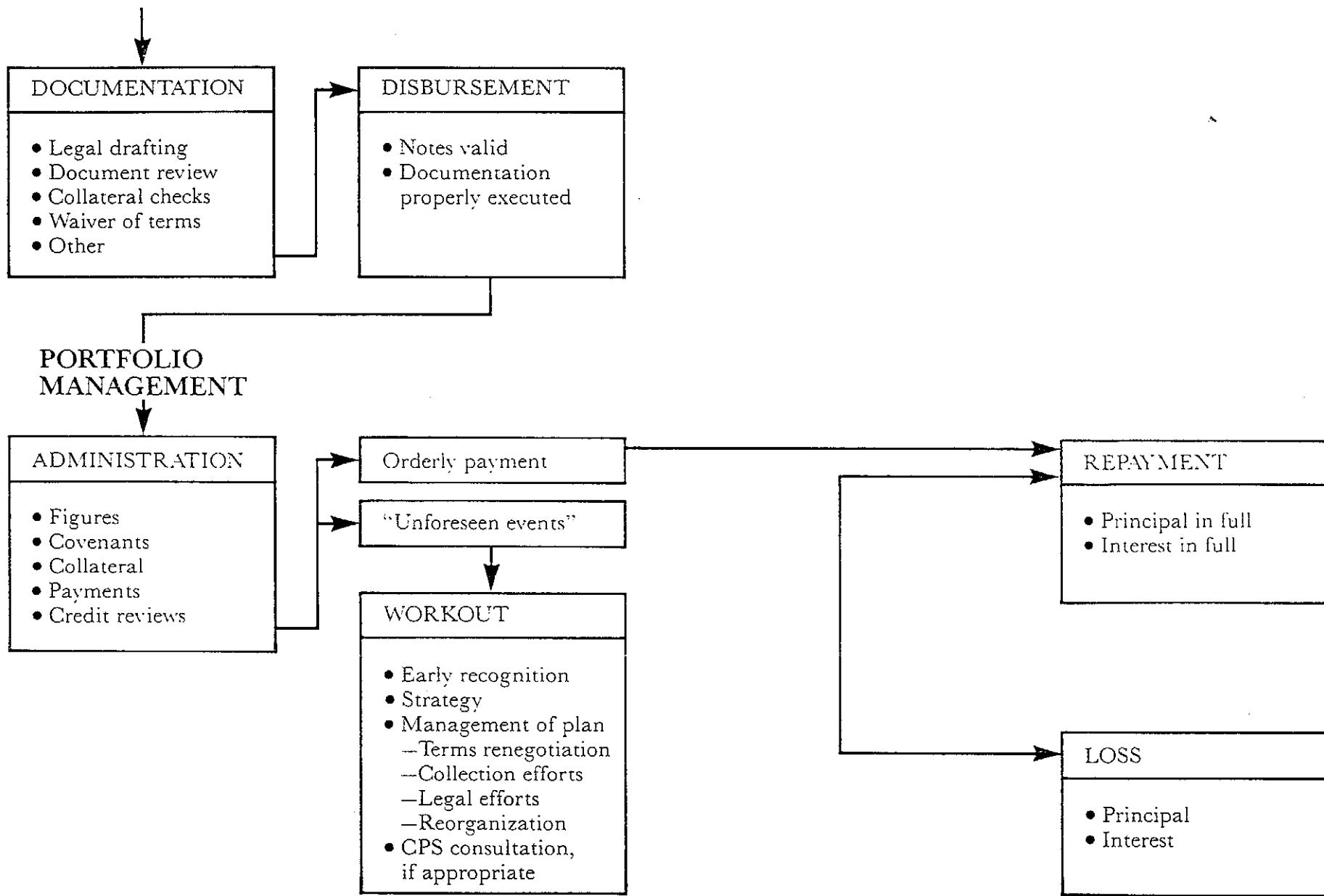
4. P. Henry Muller "Credit Doctrine for Lending Officers"<sup>nd</sup> 2  
Edition, Citicorp Publications 1981, pp 22-23

5. J. John Mathis "Offshore Lending by U.S. Commercial Banks" second  
edition 1978, pp 277-279



# RISK ASSET PROCESS FLOW





Whenever loans are made on a demand basis, they require regular and strict studying because they lack the self-policing features of time loans, which are automatically reviewed as they reach installment maturity.

### Types of Loans

The distribution of the various types of loans within the overall portfolio is a basic management decision . There are a number of factors which bear directly on the decision as to the desired levels of commercial and industrial loans , real estate loans , stability of deposits , the percentage of time versus demand deposit trends. A relatively high level of stable time deposits in contrast with a moderate volatile demand deposits , obviously encourage a bank toward long term loans.

Loans usually fall within the following categories and are considered desirable if they meet the tests of sound credit and other portfolio criteria:

1. Commercial and industrial loans, both short-term and term, secured and unsecured, must meet several criteria. When lines of credit are used to finance working capital needs, the needs should be clearly seasonal or cyclical, and loan outstanding should be self-liquidating in the normal course of business through the conversion of receivables and inventory

into cash. It is totally inappropriate for a bank to finance permanent working capital or other longterm needs under open lines of credit.

2. Export-Import trade financing, including the use of commercial letters of credit, is a traditional and attractive commercial bank activity. Documentation may be complex, so in-house experts should be consulted.

3. Real Estate loans which must be amortized and based on a thorough appraisal and analysis of the supply-demand equation for projects. Value must be realistically and carefully assessed and must be consistent with traditional standards of value. A careful margin of protection should be allowed. For reasons of diversification, geographic concentration must be avoided

4. Consumer loans which enable the borrower to satisfy needs or desires by spending money before earning it. On the other hand, commercial credit is used to generate income. In consumer lending as in other lending there is no substitute for adherence to sound business principles, good judgement and hands-on management.

5. Financial Institution lending calls for varying institutional expertise, loans to finance companies, insurance companies, and banks requires specialized knowledge.

There is no basic difference between the credit of a bank and another credit. Because it is a bank , doesn't necessarily make it better . In fact, a bank may be able to learn more about its commercial, industrial, individual, and government borrowers than it can about other banks-their management, the quality of their portfolios, large loan exposures, liquidity, foreign exchange positions, Asset/Liability management, contingent liabilities, etc. A bank balance sheet can change overnight.

There is a fine line dividing solvency and liquidity. A bank could be solvent in the sense that it may be able to liquidate over a period of time without loss, but it may, in the short run , be illiquid

Qualitative factors such as management are key. Ratio analysis suggests questions to be raised, but it is only useful up to a certain point. No matter what the ratio , a bank is only sound as the intelligence and judgment of its decisions makers-the lending officer- are included.

6.Specialized loans.Which require special knowledge. Sound credit practice suggests that lending officers utilize this knowledge where it exists, when considering loans in the following areas:

Contractors

Finance Companies

Hospital/Health Care

Nonprofit Institutions  
Information Systems & Communications  
Insurance  
Project Finance  
Public Utilities  
Real Estate

7. Project Finance. Which is a lending area requiring highly professional expertise. Ultimate repayment depends upon the success of the project. Projects usually have long development periods; they are undertaken with certain economic assumptions, particularly with respect to costs, pricing and future market conditions.

Reliance on bank credit is heavy, unless proper protection is provided, risk can run high if plans fail to develop as projected. Guarantees must be obtained for the completion, satisfactory operations and revenues of the project. If a bank feels insufficiently protected, it should not participate. Competition is the usual rationale for banks' folding on this issue.

8. Standby Letters of Credits differ from letters of credits in some risk characteristics-tenor in particular.

Since 1973 the issuance of clean credits in the form of bid, performance bonds and advance payment undertakings related to projects have assumed considerable importance.

A bid bond is an undertaking that must be submitted by a potential contractor at the time he submits his bid on a tender offer. A performance bond is an undertaking that must be submitted at the time the contract is signed. An advance payment bond is an undertaking that may be given to obtain advances against a contract.

## SECURITY/SUPPORT ANALYSIS

Do not forget that security has many shades of meaning and that in the event of bankruptcy or reorganization proceeding, access to security may be substantially deferred<sup>6</sup>

### A. Definition of security/support

1. Security: if the following conditions are satisfied, a secured credit is obtained:

1.1 The collateral must be readily marketable:

1.1.1 Time frame; an absolute time limit should not be specified, rather the limit for conversion to cash should be related to the type of asset charged. Current assets should be cash convertible within 6 months while fixed assets should be convertible within 1 year from initiating action.

1.1.2 Cash conversion value; must be sufficient to cover both principal and accrued interest. The longer the time frame, the more value must be realized because of the interest factor and executive/clerical time spent.

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<sup>6</sup> Douglas A. Hayes. "Bank Policies and Practices Requiring Collateral Securities on Commercial Loans" *Banker Magazine* (1965) pp 40-49



1.2 The bank must have legal control on a privileged or equal position with other secured creditors.

1.3 After obtaining judgment establishing the borrower's default, security can be disposed unconditionally at the sole discretion of the bank.

1.4 Where insurable, assets charged must be adequately insured against appropriate risks assigned to the Bank in amounts sufficient to liquidate the loan and accrued interest.

1.5 The Bank must be able to achieve a reasonable degree of protection against loss from fraud.

2. Support or partial security, all other documented recourse rights excluding those which satisfy all of the above criteria.

B. Reasons for obtaining security/support.

The first way out usually refers to the cash flow of the borrower while the second refers to security/support. Though it is as much against policy to extend a loan based only on the second way out as it is based only on the first way out.

The basic reasons for obtaining security/support are:

1. Minimize the risk of credit loss from non-repayment
2. Where as the borrower's cash flow to repay is dependent on the future and hence uncertain, security/support usually retains value more readily and thus provides a stronger backstop.
3. In substitution for incomplete information either deliberate or because of ignorance on the borrower's part
4. Especially in term credits the certainty of cash flow is reduced making it imperative to obtain security/support.
5. Restricts borrower's ability to use his assets to obtain more debt or disinvest.
6. To break the barrier between the owners and the corporate entity caused by limited liability
7. In the absence of specific covenants, to ensure continuing owner's commitment and availability of funds in case of losses or cost overruns.
8. To tie the cash flow and asset value of guarantors or other supporters to those of the borrower's when the latter's are weak.
9. To reduce exchange and sovereign risks.

C. Types of security/support:

1. The following can be considered as either security or support

- 1.1 Cash
- 1.2 Bullion (gold, silver, etc.)
- 1.3 Securities
- 1.4 Receivables
- 1.5 Inventory
- 1.6 Commodities
- 1.7 Fixed Assets
- 1.8 Real Estate

2. Those which can only be support of loans

- 2.1 Assignment over claims (except cash surrender value of life insurance which may serve as security.)

D. General considerations for selection of security/support

1. Basic criteria for selection:

1.1 Marketability

- a. The more favorable the general state of local economy the better marketability of security/support is.
- b. The higher the volume of the asset the more restricted potential buyers are.

c. Is security/support in different country or currency of the loan.

1.2 Perishability

1.3 Price Stability

1.4 Indentifiability

1.5 Insurability

availability of insurance to cover loss of value of security/support.

1.6 Liquidation Expenses:

- legal expenses
- executive time
- tax considerations

2. Documentation

- 2.1 Instrument of indebtedness
- 2.2 Authorization to borrow
- 2.3 Specimen signatures
- 2.4 Article of the by-laws, partnership agreement etc.
- 2.5 Loan agreement
- 2.6 Commercial register of the business
- 2.7 All forms should be approved by Bank lawyers
- 2.8 Exchange contracts, if available, for security/support in foreign currency
- 2.9 Central Bank approvals if needed

### 3. Mechanics of control & supervision

- 3.1 Periodic reviews of insurance policies
- 3.2 Periodic inspection on government records to ensure no charges registered which would affect Bank's claim

### 4. Liquidation

- 4.1 Lawyer's opinion on how to proceed
- 4.2 Court judgment where required by local law
- 4.3 Cost/benefit analysis on value to be obtained from liquidation proceeding
- 4.4 Determine ability of receiver to obtain maximum value
- 4.5 Bank approvals to proceed
- 4.6 Auction

### 5. Risk Areas

- 5.1 False reports as to title and value of collateral
- 5.2 Forgeries
- 5.3 Government actions which prevent or delay cash conversion or reduce value
- 5.4 Integrity of insurance companies
- 5.5 Accuracy of financial reporting

## RECORD & FILE REQUIREMENTS

All loans must be recorded in a credit file in enough detail to provide a single source of all documentation necessary for credit decisions: Bank, trade checks, and agency reports, summaries of other lender's experience; credit investigation and call memoranda, relevant company/industry analysis, background, management assessment, and financial information that includes balance sheet and income statements certified by an acceptable independent auditor if possible, financial statement analysis, forecasted performance and other pertinent financial data, collateral evaluation where applicable, and interim statements when appropriate. Unfavorable comments about management or others should be recorded with discretion. The file should also indicate any inquiries about the borrower with dates and names. The credit file should include a memoranda prepared by the account manager explaining the circumstances under which the loan was made, its justification, the repayment arrangement and the second way out. Significant call memoranda and memoranda of discussion germane to a credit should be kept in locked and controlled files and never removed from the Bank's premises.

### Presentation:

The evaluation of all credit proposals will be

based on a written presentation/analysis. The presentation serves not only to communicate to credit officers the information needed for arriving at a decision, but also records the approval process. Presentation/analysis will be appropriate to the complexity or simplicity of the transaction, borrower's financial situation, and degree of risk involved. While no essential elements should be omitted, brevity is a virtue.

Initial & Periodic approvals of credit facilities should be presented in standardized format. This ensures easy comparability over time, and consistency across branches, facilitating the review / approval process.

A typical credit package will consist of the following:

- A. Credit Application Form, (Exhibit 1) which will usually contain the following minimum information:
- Name of the client
  - Date
  - Amount
  - Clear and concise description of the proposed credit facilities.
  - Pricing
  - Brief description and accurate summation of previously approved facilities.
  - Purpose
  - Sources of repayment and brief comments on

other pertinent financial and economic data.

- Appraisal of management, including judgements of outside creditors, customers, and/or competitors.

- B. Basic Information Report (Exhibit 2)
- C. Accurate listing/description of collateral
- D. Background information
- E. Comparative statements of financial condition and projections, if appropriate (Exhibit 3)
- F. Credit/financial analysis memorandum, if appropriate using the following outline:
  - Purpose
  - Business Conditions
  - Management Analysis
  - Financial Analysis
  - Risk Analysis
  - Future prospects
  - Conclusion/Account Strategy
- G. Summary of proposed terms/covenants of loan agreement, if appropriate.
- H. Real Estate appraisal reports.\*
- I. Market & Bank checkings.\*



REV. 12-81

CREDIT APPROVAL

Borrower Name & Location		CA NUMBER		IN MILLIONS	
				AMOUNT	NET CHANGE
ACTIVITY	DATE	PREVIOUS CPR DATE	TOTAL FACILITIES	BANK & SUBS	
	REVISION DATE	NEXT INTERIM AT			
E & % OWNERSHIP	ADVERSE CLASSIFICATION		COUNTERPARTY RISKS		
ANNUAL _____ INTERIM _____	FACILITIES ARE WITHIN REGULATORY LIMITS			DATE PRESENTED TO BOARD OF DIRECTORS	
RELATIONSHIPS	REPORTING SENIOR CREDIT OFFICER				

UNIT/ ING OR ING UNIT (CENT)	CURRENCY AND AMT. (IN THOUSANDS)	FACILITY NUMBER	CREDIT FACILITIES BORROWER'S NAME, DESCRIPTION OF FACILITY. SHOW NET CHANGE SINCE PREVIOUS CA IN LOCAL CURRENCY. IF ADVERSELY CLASSIFIED, INDICATE CLASSIFICATION CATEGORY AND AUTHORITY.

ING UNIT	NAMES/TITLES/INITIALS	
PPROVAL		
IT	NAMES/TITLES/INITIALS	
(S TO SUBS)		
ES		
APPROVAL	SPECIALIZED INDUSTRY APPROVAL/CONSULTATION	CREDIT POLICY APPROVAL/CONSULTATION

CREDIT FACILITIES

RELATIONSHIP/BORROWER NAME & LOCATION

PAGE

ISSUING UNIT/ PROVIDING OR GUARANTEEING UNIT (DIFFERENT)	CURRENCY AND AMT. (IN THOUSANDS)	FACILITY NUMBER	CREDIT FACILITIES BORROWER'S NAME, DESCRIPTION OF FACILITY. SHOW NET CHANGE SINCE PREVIOUS CA IN LOCAL CURRENCY. IF ADVERSELY CLASSIFIED, INDICATE CLASSIFICATION CATEGORY AND AUTHORITY.

CREDIT APPROVAL REMARKS

Borrower

CA No.

Date

Remarks

## BASIC INFORMATION REPORT

BRANCHDATEDATE ACCOUNT OPENEDNAMELINE OF BUSINESSHOW OBTAINEDADDRESS

## OWNERSHIP

## MANAGEMENT AND DIRECTORS

## HISTORY

## BANKING

OPERATIONS

PRODUCTS

FACILITIES

SUPPLIERS  
AND  
TRADE  
REPUTATION

DISTRIBUTION  
AND  
SELLING  
TERMS

AFFILIATED COMPANIES AND RELATED BUSINESS

SUBSIDIARIES

ACCOUNT WITH  
B.M.

AFFILIATES

ACCOUNT WITH  
B.M.

BANK/BRANCH

BANK/BRANCH

**FINANCIAL SUMMARY**  
 HISTORICAL COST / INFLATION ADJUSTED (delete one)

COMPANY AUDITOR	AMOUNTS IN	LOCATION CURRENCY				
Audited/Unaudited						
Qualified/Unqualified						
Accounting Changes - Major/Minor						
Consolidated/Unconsolidated						
Date (Month/Day/Year)						
<b>KEY FIGURES</b>						
Sales						
Operating Profit						
Profit Pre Extraordinary Items						
Net Income						
Net worth *						
Total assets						
Working Capital						
Number of employees						
<b>ANNUAL GROWTH %</b>						
Sales						
Operating Profit						
Net Income						
Total assets						
<b>ECONOMIC ANNUAL GROWTH % (specify Index)</b>						
Industry - World :						
- National :						
GNP, etc :						
Price Index :						
<b>CASH FLOW (insert additional headings as approp.)</b>						
Gross Operating Funds Generation						
New borrowings (NET / GROSS)						
New equity						
<b>KEY RATIOS</b>						
Net Income/Sales						
Net Income/Total Assets						
Net Income/Net Worth						
Operating Profit/Sales						
Optg Profit/Assets excl. Investments						
Taxes/Profit Before Tax						
<b>Turnover Efficiency</b>	Sales/Net Fixed Assets					
	Days Receivable					
	Days Inventory (Sales/CGS/Purch basis)					
	Days Payable (Sales/CGS/Purch basis)					
	Current Ratio					
	Quick Ratio					
<b>Lever- age</b>	Total Liabilities/Net Worth *					
	Long Term Liabilities/Net Worth *					
	Interest Coverage					
<b>Investment Indicators</b>	Net Income/Net Worth *					
	Dividends/Net Income					
	% change in share price					
	% change in industry's share index					
% change in stock market index						

\* Net worth defined as :

## BALANCE SHEET

PAGE 2

NAME					
DATE (month/day/year)		KEY	AMOUNTS IN	CURRENCY	

HISTORICAL COST / INFLATION ADJUSTED ( delete one )

1	Cash						
2	Other liquid assets						
3	Receivables (Inc. bills discounted)						
4	Inventory (FIFO / LIFO / ACM)						
5							
6							
7	Prepaid expenses						
8	<b>TOTAL CURRENT ASSETS</b>						
9	Net fixed assets (Inc. capitalized leases)						
10	Equity investments - equity/cost basis						
11	Loans to subs. and affiliates						
12	Other investments						
13							
14	Goodwill						
15	Other intangibles						
16	<b>TOTAL LONG TERM ASSETS</b>						
17	<b>TOTAL ASSETS</b>						
18	Short term debt - Banks (inc. bills disc.)						
19	Trade payables						
20	Accruals						
21	Taxes currently due						
22							
23							
24	Long term debt - current portion						
25	<b>TOTAL CURRENT LIABILITIES</b>						
26	Long term senior debt						
27	Capitalized leases						
28	Long term subordinated debt						
29							
30	<b>TOTAL LONG TERM DEBT</b>						
31	Labour and pension provisions,						
32	Other deferred provisions, reserves, etc.						
33							
34							
35	<b>TOTAL DEFERRED LIABILITIES</b>						
36	<b>TOTAL LIABILITIES</b>						
37	Minority interest						
38	Deferred						
39							
40							
41	<b>TOTAL NEAR EQUITY</b>						
42	Preferred stock						
43	Common stock						
44	Capital surplus						
45	Revaluation of assets						
46	Other reserves						
47	Retained earnings						
48							
49							
50	<b>TOTAL NET WORTH</b>						
51	<b>NET WORTH AND NEAR EQUITY</b>						
52	<b>TOTAL LIABILITIES AND EQUITY</b>						
53	Contingent liabilities - guarantees						
54	- Capital commitments						
55	- Other						
56	- Total contingent liabilities						
57	Assets pledged						
58	Bills discounted (comprimes 3 and 18)						
59	Bad debt reserves deducted from line 3						
60							
61							

INCOME STATEMENT

NAME						
AMOUNTS IN :	DATE (month/day/year)					
CURRENCY	NUMBER OF MONTHS					

HISTORICAL COST / INFLATION ADJUSTED ( delete one )

	KEY	%	%	%	%	%
62	NET SALES					
63	Cost of goods sold					
64						
65	Selling, general and administrative					
66						
67						
68	Depreciation					
69	Other non cash charges					
70						
71	Lease expenses					
72	Other operating expenses					
73	OPERATING PROFIT					
74	Fixed asset disposal profits					
75	Income from associated companies					
76	Other non operating/investment income					
77	Non-operating expenses					
78						
79						
80	PROFIT BEFORE INTEREST AND TAX					
81	Interest					
82						
83	PROFIT BEFORE TAX					
84	Tax currently payable					
85	Deferred tax					
86						
87	Minority interest deducted					
88	FX translation gains/(loss)					
89	PROFIT PRE EXTRAORDINARY ITEMS					
90	Extraordinary income (expense)					
91	Extraordinary taxation					
92						
93	NET INCOME					

NET WORTH RECONCILIATION

94	OPENING NET WORTH					
95	PLUS : Net income					
96	Sale of equity					
97	Asset revaluation					
98	FX translation gains/(loss)					
99						
100						
101	TOTAL ADDITIONS					
102	LESS : Dividends					
103						
104						
105	TOTAL DEDUCTIONS					
106	ENDING NET WORTH					





## SOURCE AND APPLICATION OF FUNDS STATEMENT

PAGE 5

HISTORICAL COST / INFLATION ADJUSTED (delete one)

NAME							
AMOUNTS IN :	DATE (month/day/year)						
CURRENCY	No. of Months						

107	INTERNAL SOURCES	Operating Profit					
108		Add non-cash charges Included : Depreciation					
109							
110							
111							
112		Investment Income					
113		Other Income / (Expenses)					
114		Sub-Total					
115		Deductions :					
116		Tax Payments					
117		Interest					
118		Dividends					
119							
120							
121	Exchange adjustments Included above						
122	GROSS OPERATING FUNDS GENERATION						
123	NON-OPERATING SOURCES						
124	Sale of fixed assets						
125	Sale of investments						
126							
127	INTERNAL FUNDS GENERATION						
128	APPLICATION OF FUNDS	Increase/(Decrease) in current assets					
129		Inventory					
130		Receivables					
131		Required cash					
132							
133		(Increase)/Decrease in current liabilities					
134		Trade payables					
135		Accruals					
136							
137		CHANGE IN WORKING CAPITAL (ex. debt)					
138	Purchase of fixed assets						
139	Investments						
140	Increases in other long term assets						
141	Exchange Adjustments Included Above						
142	Extraordinary Items						
143							
144							
145	FUNDS NEEDED						
146	NET FINANCING NEED/(SURPLUS) = 145 minus 127						

147	FUNDING	Ordinary share capital					
148		Other capital increases					
149							
150		Government Grants					
151		Minorities					
152	Long term borrowings (over 1 year)						
153	Short term borrowings						
154							
155	INVEST- MENT	(Deduct): Short term debt repayment					
156		Long term debt repayment					
157		Cash + Other Liquid Assets					
158	NET FINANCING						

OPERATING / NON - OPERATING  
CASH GENERATION STATEMENT  
HISTORICAL COST / INFLATION ADJUSTED ( delete one )

PAGE 6

NAME						
AMOUNTS IN :	DATE (month/day/year)					
CURRENCY	No. of Months					

	KEY	AMOUNT	AMOUNT	AMOUNT	AMOUNT	AMOUNT
159		Operating Profit				
160		Add non-cash charges Included : Depreciation				
161						
162						
163						
164		Investment Income				
165		Other Income / (Expenses)				
166		Sub-Total				
167		Deductions :				
168		Tax Payments				
169		Interest				
170		Dividends				
171						
172						
173		Exchange adjustments included above				
174		<b>GROSS OPERATING FUNDS GENERATION</b>				
175		LESS : Operating Cash Needs				
176		Inc./ (Dec) Req. Cash				
177		Inc./ (Dec) Net Rec. (Incl. Bills Disc.)				
178		Inc./ (Dec) Inventory				
179		Inc./ (Dec) Prepaid Expenses				
180		<b>TOTAL OPERATING NEEDS</b>				
181		PLUS : Operating Cash Sources				
182		Inc./ (Dec) Accts. Payable				
183		Inc./ (Dec) Accruals				
184		<b>TOTAL OPERATING SOURCES</b>				
185		CHANGE IN WORK. CAPITAL (ex debt)				
186		Net Operating Cash Generation				
187		Less : Non-Operating Cash Needs				
188		Capital Expenditures				
189		Red. Long Term Debt				
190		Red. Short Term Debt (and Bills Dis.)				
191		Inv. and Adv. Subs. and Affil.				
192		<b>TOTAL NON-OPERATING NEEDS</b>				
193		PLUS : Non-Operating Cash Resources				
194		Sale of Equity				
195		Inc. Long Term Debt				
196		Inc. Short Term Debt (and Bills Dis.)				
197		Sale of Assets				
198		<b>TOTAL NON-OPERATING SOURCES</b>				
199		<b>NET INC./ (DEC.) IN CASH AND OTHER LIQUID ASSETS</b>				

Note : Line 185 should be equal to Line 180 minus Line 184.

Line 186 should be equal to Line 174 minus Line 180 plus Line 184.

Line 199 should be equal to the net change in Lines 1 and 2 for the period, and is the total of Line 186 minus Line 192 plus Line 198.

- J. Plant or Site visit report.\*
- K. Supplementary analyses and/or information of required to support the credit proposal.

\* Not mandatory, could be mentioned on in the credit memo.

Demonstration:

The following steps are needed in documenting credit transactions.

1. Selection of appropriate standard forms or preparations, by legal counsel, of specialized documents.
2. Review for
  - a. Appropriateness to the transactions
  - b. Adequate coverage of the risk
  - c. Completeness
3. Proper execution and registration
4. Safe keeping
5. Periodic review

Credit folders should contain an adequate history of the credit relationship, sufficient to reconstruct

credit approvals and action taken in remedial management situations.

1. A credit folder must be maintained for each borrower and guarantor.
2. All credit folders must be reviewed, culled, maintained in good order.
3. Within each credit folder, material should be subdivided under credit approvals, financial information, correspondence, and other headings as required.
4. Material not relevant to credit matters should not be filed in a credit folder.
5. Credit folders are confidential in nature and must be kept in locked and controlled files and must never be removed from the bank's premises.

#### Training

An equally important aspect of credit administration is the continual improvement in the level of expertise of the lending staff. The obvious means of achieving this goal is to provide programs which will introduce new employees to the techniques of credit analysis and lending, and will provide existing lenders with the opportunity to expand their credit skills. Most banks have a satisfactory

number of competent experienced lenders. Maintaining a steady flow of young people to replace these individual as they move to higher responsibility or toward retirement presents a continuing challeng.

## EARLY DETECTION OF WEAKENED CREDIT

"In bank lending what you dont know can hurt you"<sup>7</sup>

Since credit products are lent, not sold, it is essential to watch a credit's pressure points and to be alert . It is important to be ahead of everyone when trouble threatens, know when steps should be taken to problem credits, and be in the best deffensive position. Be aware of credit relationship, in other branches, affiliates, subsidiaries of your bank that the borrower, or related names, may have.

Credit Officers ought not to be percipitant, they should help to keep away borrowers from Financial difficulties. Borrowers should feel that our line of action is helpful to them as well as to the bank.

Deteriorating credits, as a general rule, are worse than lending officers perceive them to be at the time they are discovered. In most instances there are warning signals, and Credit Officers need to take timely steps to ensure the return of the funds we have loaned.

Highly leveraged situations are usually the most

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7. P.Henry Mueller."Credit Doctrine for Lending Officer" Citicorp Publications 1976,pp 60

vulnerable. Early identifications allows time to dig in substantively and develop facts and strategy. Being alert and taking corrective action is the responsibility of the bank. It is important to continuously monitor credits and documentation for possible difficiencies at our part.

### Inflation

Managing a business has become increasingly difficult since the early 1970's because of the unstable and uncertain environment. A major factor has been the sharp increase in world crude oil prices, which convinced everybody that resources are not limitless.

In an inflationary environment, values change rapidly and unexpectedly. Exchange rates are one aspect. Because of volatility and uncertainty introduced largely by economic policy changes, inflation muddies an understanding of the balance sheet impact. For instance, inflation adjusted numbers that get at the real profitability of a business turn fast-growth situations into slower growers. During inflationary periods, industries that are labor, energy, raw material and capital intensive often find it more difficult than others to keep their pricing abreast of increasing costs. The question should be asked: How inflation-resistant is a borrower? Can higher costs be passed on? How do they relate to profit managing and to total revenues?



A company must have a return on investment in excess of its cost of capital if it is to avoid a build up in leverage . Carried too far, leverage could jeopardize viability. Short of that, the borrower could be stealing from future business opportunities for lack of capital.

As inflation continues, it becomes harder for businesses to place fixed rate debt; This puts further pressures on companies to finance at the banks. Debt maturity profiles become necessary for borrowers to roll over debt, this could have a decapitalizing effect because of the substantially higher financing costs that may be incurred.

#### Management

One must look beyond the financials to determine if the borrower is an economically viable entity asking the right questions is the key to good decision making: What must the company do well to succeed? What is its real business? What about future planning? Can it adapt to changes? Is management making the best use of capital and other resources? Are key managerial functions such as planning, marketing, production, finance and asset controls in healthy balance? Lending officer should make a thorough appraisal of management liquidity, utilization of debt, profitability and asset-use tell much about the quality of management, unless a new management has just arrived. Don't take the borrower's word alone. Spend more time in his

office. Get to know the business and the management team completely, its integrity, personal background experience and capability, organizational structure, the decision making process, planning controls, etc... How are employees, suppliers, customers, and banks, treated?

Seek information and be fully satisfied with the ability and integrity of management. Its reputation, the viability of the company its product/market strategies and cash flow.

Be aware of a hurry-up loan that requires a fast decision. For some loans that must have a decision today the best answer is often "no". Many aspects of management may indicate trouble ahead. The following are management early signals.

- Change of key executive and/or directors.
- Change in the nature of the borrower's business, objectives, or practices.
- In ability of borrower to adjust to changes in markets and/or changes in customers wants and demands.
- Weak secondary management
- Absentee management
- Change in ownership
- Top management dominated by narrow skills having for example only financial expertise rather than a broad mixture of technical operational, strategic, marketing and financial skills.

- weak ability to plan and grow
- Vague answers to direct questions concerning recent or projected performance.
- Any major acquisition
- Unavailability of internal information such as projections, financial statements etc....
- Expression of dissatisfaction with treatment by another bank or with present auditors.
- Refusal of permission to talk with the company's auditors.
- Low morale, poor maintenance, dealing in quality and service, etc...
- Lack of adequate management controls high turnover, under or overstaffing.
- High style personal large habits by the principals of young enterprises.

### Financials

A careful financial analysis is key and the lending officer should go past and search into the substance of the credit, get to the borrower's real fundamentals and dynamics and identify what could affect them.

He should make certain that the loan has a productive purpose and verify repayment sources and terms before the loan is committed. And ask if anything could go wrong that would jeopardize repayment?

The lending officer should follow up to ensure

that the borrower uses the funds for the stated purposes, and obtain both current and past financial statements and relating supported data. Be conversant with accounting treatment, pay close attention to the basic ratios of credit, including the trend in profitability turnover and liquidity. Are there problem areas or losing operations?

Understand the borrower's continuing ability to generate cash from operations. Do you know the level of earnings in the past and how consistent they have been? Be satisfied with the borrower's financial controls.

Test the validity of all assumptions, false assumptions lead to wrong decisions.

Review capital structure and make sure that the borrower has access to all the financial resources it requires to grow and succeed. Does it have the resources to withstand major shocks?

Be precise. Aside from the thorough analysis of the credit itself. The documentation needs to be precise.

Restrict revolving or grace periods on term loans, preferably to a maximum of three years.

Restrict the tenor of term lending to a level consistent with liquidity and cash flow coverage.

Because highly leveraged situations are usually the most vulnerable, it is critical that lending officers watch out for the following:<sup>8</sup>

- Anything that grows exponentially.
- Diminishing margins of profitability regardless of how they are computed.
- Subsidiary, affiliates, divisions, plants or other business segments or product lines that are / or could be, a financial drag on the borrower's overall performance.
- The competitive cost structure.
- Decline in net income.
- Deviation from normal seasonal borrowing pattern.
- Changes in the market value of equity.
- Regulatory measures that could change the way of closing business and affect financials.
- Top-heavy fixed assets.
- Decline in sales.
- Excessive inventories
- Delay in receipt of financial statements.
- Major sale of assets.
- Build up in inventories and receivables.
- Difficulty in requiring debt overdrafts.
- High leverage, not only financial, but also operational - for example, high fixed costs.
- Decline in net working capital.
- Violation of covenants or agreements- ours and others.
- Credit refusals by other lenders.

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8. *Personal interviews with 3 Credit Officers in Banque de la Mediterranee S.A.L.*

- Slowness in trade
- Unusual increase in overdrafts
- Earnings growth with a dilution of earnings quality. Earnings can be inflated by inventory profits, allowances for doubtful accounts reduced without justification, prepaid expenses capitalized, maintenance, repair, and advertising costs deferred; changes in depreciation schedules and methods.

#### External

The business cycle with the management factor, has a primary and continuing impact on a credit. There are basic economic givens that enable a lender to anticipate the risks likely to arise when economic signals change.

Implicit in any lending arrangement is the understanding that the borrowing enterprise will continue no worse off than when the credit was approved.

Lenders have sometimes depended heavily on the prospects for future growth; They have gone too far in sophisticated cash flow techniques and perhaps accounting projections which always seem to fit perfectly when a loan proposal is presented. You never bet the farm on forecasts. Nobody knows the future in today's unstable world-with many borrowers

as only marginally profitable - it is presumptuous to think one can foresee or predict accurately the factors that will introduce themselves overtime. Few turn out to be accurate. Forecasts are more often wrong on the downside than on the upside. They assume a continuum that seldom occurs.

Again, regulatory, social, political and similar environmental conditions are as serious as the prevailing economic conditions. The impact of regulations on the affairs of companies in recent years has been substantial.

Lenders should understand thoroughly the structure and economics of the borrower's industry, its maturity, its seasonal or cyclical factors and its relative vulnerability to recession or accelerating inflation. Also Lenders should understand the borrower's competition position in the industry, the basis of competition, entry and exit barriers, cost structure and energy sensitivity. Competitive analysis should cover not only markets to which the borrower sells, but also markets in which it purchases. Supply and other factors could adversely affect borrowers under certain circumstances.

And adverse industry information, including signals includes:

- Any adverse industry information, including regulatory
- Adverse international development

- Changes reflected in the bank and trade checks
- Changing technology - foreign and domestic
- Competition from industries



## REMEDIAL MANAGEMENT

### Identification of Problems

"Some loan officers are unwilling or psychologically unable to raise the red flag when problems emerge."<sup>9</sup>

If a credit shows any one or a combination of these warning signals mentioned above, the account officer should quickly begin an in-bank investigation to determine whether or not a substantial problem exists. In gathering this information the officer should be extremely careful not to alert the borrower, outside creditors, suppliers, other banks, and so on, to his or her suspicion, so he should collect the data possible from internal sources.

The lender may have reviewed the company's financial data many times before, but he should now do so again in light of whatever information led him to suspect a problem. Any internal action which might in some way reveal new data about the company's position should be taken at this point.

If the investigation shows that a company indeed has a serious problem, the next step should be to contact the bank's attorney. It is possible for the lender to reduce legal fees involved by making certain he has conducted a thorough internal

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9. Joel B. Zweibel. "Work - Out Problem and Solutions" *The Banker's Magazine* 1977, Page 89.

investigation and has a good grasp of the situation. The lender can then present the lawyer with a concise, comprehensive written summary of the existing situation, along with a list of the questions to be answered. In addition, all loan documentation should be reviewed with the attorney for accuracy and completeness. The lender's first priority is to protect the bank's interest, and if the loan documentation appears faulty, it should be corrected at once if possible. This is essential if the loan is collateralized.

Having completed the background preparation, the account officer should reevaluate the credit on light of the new information, and prepare a written report assessing the present situation.<sup>10</sup>

#### Classification of Credits

It is the responsibility of credit officers to identify and adversely classify those credits that require special attention.

##### A. Purposes

1. To highlight those credits that represent an above - normal credit risks.
2. To evaluate the degree of risk involved.
3. To develop a strategy and/or action plan for the elimination of the weakness and/or collection of outstandings.

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10. *Credit Policy applicable in Banque de la Mediterranee S.A.L.*

B. Definitions of classifications

- I.           Uncriticized (Current): Credits that are fully current and the orderly repayment is without debt.
- IA.           Criticized: Credits with evidence of weakness in the borrower's financial conditions or credit worthiness, or which are subject to an unrealistic repayment program, or which are lacking adequate collateral, credit information or documentation. Early attention including substantive discussions with borrowers, is required to correct deficiencies.
- II            Substandard: Credits of which the normal repayment of principal and interest may be jeopardized by negative trends of a financial managerial, economic, or political nature, or by important weakness in collateral. No loss is foreseen, but a protracted work-out is a possibility. Prompt corrective action is required to strengthen the Bank's position as a lender, to reduce its exposure, and to assure that adequate remedial measures are taken by the borrowers.

III. Doubtful: repayments appear questionable on the basis of available information, and which therefore suggests a degree of eventual loss not yet determinable as to amount or timing. Vigorous action is required to minimize losses. Non-accrual of interest is normally required. The principal should be written off to the extent deemed necessary.

IV. Loss: Credits are regarded as uncollectable, but does not mean that there is no potential for eventual recovery. The Bank is expected to continue a vigorous collection effort until it is decided that no further repayment or recovery is possible.

At this point, another lending officer, usually senior to the one handling the account, should be called upon to review the facts and discuss the different strategies of action for developing an action plan. If the bank proceeds one way, how will the borrower react? In what position will the bank be? If another route is taken, what will the company management reaction be?

## Analysis of Problems

It may be prudent to move the account from the originating account officer to another who is not as close to the borrower and may be less reluctant to take any unpleasant steps necessary to protect the bank. Since the originating account officer should have both insight into the company and its management's capabilities and attitude, this is a difficult decision. Also the originating Account Officer will emerge in a better way if he is able to work through the problem himself. Here the old saying applies: "Good Judgement comes from experience - usually and experience that was a result of bad judgement."<sup>11</sup> Therefore, if the account officer has not identified too strongly with the borrower, and has been able to prepare a fresh review of the situation as it truly exists, it may be a good idea to let him remain with the account. In any event, a problem loan should have close supervision by a senior officer through the workout period.

When it becomes obvious that a borrower's situation has deteriorated to worse than IA a formal course of action must be developed.

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11. Willard Alexander. "Handling problem loans." *The Banker's Handbook* 1980, page 66

1. The account should be promptly advised to the Main Office Senior Credit Committee.
2. A specific assignment of responsibility for working out the loan should be made to a designated account officer, and as suggested earlier, to the originating account officer.
3. Immediate measures should be taken to avoid further deterioration. Virtually all of the following are considerations in the initiation of credit but must be re-examined to assure the bank ability to work out successfully.
  - a. all documentation and collateral relating to the loan should be reviewed and completed as needed. Actually, maintenance of documentation is an ongoing responsibility, but an extra review when problems arise is desirable.
  - b. Financial statements should be re-analyzed with the possibility of a liquidation in mind.
  - c. The potential preferred position of other banks and lenders should be carefully analyzed.
  - d. Tax liens and other prior liens should be determined.

- e. The personal situation of management and guarantors should be re-examined.
- f. Alternative courses of action should be considered and a workout program should be developed as such.
- g. Need for special expertise, internal or external, may be appropriate.
- h. The lending units should not operate in a vacuum and should seek guidance from any appropriate area of the bank.

- Credit Checking Department
- Legal Department
- Senior Credit Committee
- International Department
- Other Branches
- Etc....

4. Once re-analysis has been completed, a formal corrective action plan should be established with target dates. This may be done in good fashion enumerating all of the problems to be corrected in one column and then spreading out alternative courses of action and estimated time to achieve results.

Such action may involve:

- a. A retrenchment program with budgets and

forecasts closely followed by the lenders.

- b. Obtaining additional financial support from creditworthy parties, such as owners, customers, suppliers, relatives, etc..., who may have an interest in the continuance of the business.
- c. Selling collateral
- d. Obtaining new or additional collateral support for the problem loan.
- e. Renegotiating the terms and/or tenor of the existing credit facilities.
- f. Advancing additional funds, if proved to be solution for overcoming the financial problems of the borrower.
- g. Seeking the support of appropriate governmental agencies such as development banks.
- h. Takeout by another financial institutions.
- i. Sale of the business
- j. Reorganization or bankruptcy.



5. Decisions as to the most beneficial course of action must have the bank's best interest always as the prime objective.
6. It is essential that developments be closely followed and alternative measures implemented if the credit continues to deteriorate.
7. If corrective actions are not having the desired result, consideration must then be given to last-resort solutions:
  - a. Compromise settlement with the borrower.
  - b. Bankruptcy or foreclosure
  - c. Other forms of legal action, such as suing guarantors.
8. When all efforts have been made and a maximum foreseeable recovery obtained a decision may be made to abandon further collection and recovery effort. This will require the approval of a higher position from the general management of the Bank usually represented by the Senior Credit Committee.

## Recording Procedures for Problem Loans

During the process of working out problem loans, it is essential to keep adequate records, such as the following:

1. A claim record should be established for each designated problem loan by the account officer, showing the gross principal amount, the amount of any write-offs or reserves which have been made, and the net book value. Additionally, it should show the amount of interest earned not collected. The record should be kept up to date.
2. At the same time, a separate control record should be maintained to reflect the total balance of all problem loans listed in the claim record. Any changes in individual claim records should be reflected in the control record. At least quarterly, the control record should be reconciled to an independent proof of the individual claim records.
3. The monthly classified loan report should, by definition, update the status of loans being handled on a workout basis. The report should be carefully reviewed by the Senior Credit Committee.

4. Each branch should feel free to develop any additional workout plans and procedures reflecting special conditions in its area. The number of personnel committed to the effort will, of course be directly related to the volume and complexity of problem loans. Overall, the basic goal is to assure that remedial action is given thorough and prompt attention to minimize ultimate loss.

#### Remedy of Problems

One excellent way for a lender to bring a problem into proper focus is to involve the borrower in a mutual exploration of the problem. This practice has not been resorted to in the past. But in the light of today's awareness of borrowers' legal responsibilities and accountabilities to their company, lenders seem to welcome this sort of involvement.

Many times it is also appropriate to seek outside help in the form of expert qualified management consultants who can bring specific areas of expertise and objectivity to bear on an issue. Calling on their past experience in solving identical or similar situations, they can usually identify the problem areas quickly, provide suggested reasonable courses of action, and help implement those actions on a prompt, effective basis.

### Continuation of the Problem

At the appropriate time the decision must be made whether to try to keep the company in business or to permit it to liquidate. Based on what the bank knows of the existing management, product, and competition, it may be that the situation is temporary and can be overcome in time with the bank's assistance and help.

Perhaps restructuring of debt could ease the strain over the long term. There are, however certain external factors which may be beyond control of management - for instance, the economy - which must certainly be taken into consideration when deciding whether to continue or liquidate the business.

Even if the problems appear too difficult to remedy, the decision might be to continue the business as an interim basis in order to get the bank's position better established. If there are documentation gaps, and a need to refile in court, it might be wise to keep the company going for at least a time to strengthen the bank position.

It should be noted that if the bank decides to advance funds to keep the company in operation temporarily, legal advice will be needed before doing so.

Liquidation may be inevitable. However, if it would be possible to delay complete liquidation and scale the business down in order to reduce assets, the debt would be covered, and both the bank and the company could well be in better positions.

Whether from being too highly leveraged or unable to show a profit, a business that has been experiencing difficulty may have already begun a course of action which will deplete some of its assets. If it hasn't, and the decision has been made to keep the business going, temporarily or otherwise, general steps can be taken in an attempt to improve the picture.

The first measure should be to eliminate or reduce every expense possible. Begin at the top. The lender, company president, and advisers should examine the company's expenses line by line to determine those which are absolutely essential. The principals should decide how much they are willing to cut their salaries and personal expenses charged to the company. It should then be made clear to the rest of the staff that all expenses must be kept to the minimum. Naturally, any dividends payments should be stopped at once.

Next, inventory should be reduced and accounts receivable should be analyzed carefully. Methods of handling customer claims for returned and damaged merchandise should be studied. Although receivables

generally shrink in liquidation, if credits and claims have not been handled properly, it may be that the receivables were substantially overstated to begin with.

Also, problems may occur if accounts receivable have concentrations. Even if these customers are financially strong, they will frequently claim rather large credits due them. For this reason, no more than 20-25 percent of a company sales volume should be to a single customer, and even this is a high percentage.

Next, any idle equipment or plants not essential to current operations should be disposed of. The lender should look at production techniques to see if he can offer objective suggestions which might improve the product or the profit margins.

To improve the cash flow, the company's payments should be analyzed to determine which are not required by contract and could be deferred. Perhaps some of the accounts payable can be postponed. In debt of current maturity can be extended and/or subordinated to bank debt, this also could be helpful.

Finally, the lending officer should discuss with management the possibility of obtaining new equity capital from officers or other sources.

Keeping a financially fragile company in business

requires not only diligent effort on the part of lending officers, but often creativity and ingenuity as well. Although generally tried and true guidelines can be applied in most situations, each credit is different and the workout plan must be tailor-made to obtain the best results possible for all parties involved.

In most situations, lenders prefer to keep borrowers out of bankruptcy. Notwithstanding the emotional distress of the proceedings, they involve actions in federal courts and are expensive for everyone. Therefore, if the borrower and his or her creditors can cooperate in solving the problem, all parties will benefit. However, any time the lender feels that the borrower is trying to defraud the bank, conceal assets, or carry assets away, it would be wise to take legal action regardless of the debt outstanding that might otherwise be salvaged.

#### Liquidation of the Business

If liquidation appears to be the only course open to the bank, there are several alternative ways to proceed. Before the lender can act in this regard, however, the borrower must be in default on some part of the bank debt instrument, or the note would have to be due.

If liquidation is decided upon, the bank should

immediately bring in those professional resources, such as attorneys and accountants, needed to help protect its position.

Next, the lender should be certain he has all the collateral on the business he can possibly obtain. Remember, however, that although banks can take any security available for debt previously contracted, the effect that taking it can have on other creditors must be considered. For example, obtaining an inventory lien may scare trade suppliers into cutting off the source of supplies the company must have to continue functioning.

If debt is owed to officers, affiliates, or subsidiaries of the company, it may be possible to subordinate it to bank debt. Not only should the lender attempt to get the debt subordinated, but he should try to induce officers, affiliates, or subsidiaries to guarantee the bank debt, obtaining a pledge of the note to secure the guarantee. It is best to show the subordination on the face of the note, keeping the note in the bank to make certain it does not get transferred to an innocent party who might become a holder in due course.

It may be worth additional pounds to the bank to purchase senior liens from other creditors. The lender should also keep in mind that the right of offset may be applicable in liquidation; however, advice should be sought from the bank's attorney before applying it.



In some circumstances, the lender may agree to compromise the bank's debt. For example, a company may owe the bank L.L. 100,000. Complete liquidation of the assets may yield L.L. 75,000. If the officers are willing to sell personal assets yielding another L.L. 10,000, the bank may decide to accept the L.L. 85,0000 as sufficient payment of the obligation, and dismiss the remaining L.L. 15,000 owed.

A borrower who is financially embarrassed may decide to call a meeting of creditors to inform them of the existing situation. Often these meetings are hastily arranged and not carefully thought out, and little is accomplished. If a lender learns that the borrower is close to calling a meeting of creditors, he should immediately attempt to meet with the borrower, along with the attorneys from each side. Assuming the borrower will cooperate, the banker can then assist in planning a concrete, viable plan of action to present to creditors.

It may be that liquidation will take the form of an informal settlement between the company and its creditors. The assets will be sold and the proceeds distributed among the creditors based on an agreement approved by all parties involved. Liquidation can also be accomplished through a formal assignment of assets to a third party responsible for liquidating them and distributing the proceeds. The advantages to these methods, formal or informal, are speed, efficiency, and lower cost.

## Election of Bankruptcy

The borrower, however, may not wish to follow any of these paths, and may elect instead to file for voluntary bankruptcy or reorganization. If either of these paths is chosen, the situation should be followed closely by the bank's legal counsel.

In many problem loan situations, the company is not willing to voluntarily declare bankruptcy, therefore the creditors may wish to petition the court to force the business to take this step. To do this creditors may prove that an "act of bankruptcy" has been committed by the company.

Acts of bankruptcy involve certain steps taken by a business which give rights to legal action on the part of creditors. Any meeting of creditors that is called by the debtor, for instance, is considered to be an action of bankruptcy.

When creditors attempt to force involuntary bankruptcy, the company in debt has a right to contest the petition .

Whatever path is chosen to work out the company's debt problem, the lender must be careful to carry all steps to a logical conclusion. Loose ends can generate further losses or the possibility of legal action against the bank.

## Discriminant Analysis

Edward I. Altman<sup>12</sup> employed multiple discriminant Analysis to predict bankruptcy, using various financial ratios. The ratios were used to discriminate between bankrupt and nonbankrupt firms selected in his research, using data from one to five years prior to Bankruptcy. As expected, the predictive accuracy of the multiple discriminant model declined with the increase in years prior to bankruptcy; however the model was able to forecast failure quite well up to two years before bankruptcy.

First let us describe thoroughly financial ratios. They are used as comparative indicators and measures to help bankers appraise the financial condition, efficiency and profitability of a business. The analyst becomes interested in the results of the business operation as reflected in the relationships among balance sheet and operating statement items.

When the analyst concerns himself with the financial facts of a business, he asks questions about its ability to meet current obligations, the true worth of its various assets, the extent and character of its liabilities, its resource fullness and ability to earn a fair return on its investment; its ability to raise new funds when needed etc... The analyst's viewpoint and approach will differ

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12. "Financial Ratios, Discriminant Analysis and the Prediction of Corporate Bankruptcy" *Journal of Finance*, Sept. 1968

somewhat depending on his purposes. A business executive intimately familiar with his company's operations will have to undergo few formal steps to appraise its financial conditions and operating efficiency. The outside analyst, who is reviewing a business for purposes of extending credit, will wish to make certain test and apply certain standards to be able to rank, classify, and judge the merits of a company by comparing it to other companies of similar nature or to relevant averages.

It is often helpful, therefore, to relate financial data to each other, to obtain ratios, or index numbers, which express a significant comparison more useful than the raw figures themselves. For example, to compare the amount of the current assets on the balance sheet to the amount of current liabilities is more meaningful than simply to look at each amount without reference to the other, since current assets are frequently considered the major reservoir of funds for meeting current obligation, especially when the future of the firm is in jeopardy. On the other hand, it would be nonsensical to compare "other assets" with "accounts payable" and hope to obtain a significant relationship. Our basic caution must be remembered here:

Ratio analysis of financial statements must be preceded by careful thought as to the kind of insights the analyst wishes to obtain. Ratios are not ends in themselves, rather, on a selective basis they may help answer significant questions.

It is very important to call attention to the many limitations inherent in ratio analysis. The first and most obvious drawback lies in the differences found among the accounting methods used by various companies, which seriously affect the comparability of many situations., even on the same industry. Methods of recording and valuing assets, write-offs, costs, expenses, etc... vary with the customs, policies, and character of the company investigated. For example, the various methods for establishing inventory value leaves great leeway to management, just as the extent of depreciation claims can fluctuate widely. In short, the balance sheet accounts do not necessarily correspond to the value of the firm, either as a going concern or in liquidation, and liability accounts may be incomplete or understated. Thus no ones business is exactly comparable to any other.

More importantly, however, financial statements are based upon past performance and past events, and we must project our evaluation from this basis. Needless to say, for credit extension, the significance lies in which can be expected to happen. Past events are guides only to the extent they can reasonably be considered as clues to the future. Their use must be tempered by the best possible knowledge about the outlook for the business.

Where, then, lies the usefulness of ratio analysis? Within relatively rough limits ratios analysis will provide guides and clues especially in

spotting trends toward better or poorer performance, and in finding significant deviations from any average or relatively applicable standard. It is in the interpretation of such trends and deviations that the analyst will use his skills, experience to the fullest extent.

Based on the above mentioned constraints Altman, with financial ratios for a sample of companies as the dependent variables, use the discriminant analysis to predict bankruptcy. The best ratios for predictive purposes were found to be debt-to-net worth, the net operating profit margin, debt coverage and its stability, return on investment, size, and earnings stability. On the basis of this study, it appears that a handful of ratios can be used to predict the longterm credit standing of a firm. As a result of the empirical testing of financial ratios, we have a better understanding of which ratios are important in predicting certain types of events. rather than analyze a set of ratios indiscriminately, the financial analyst can concentrate on those ratios that are really important with respect to the problem at hand. These are the ratios that have underlying predictive ability.

In addition to telling us which ratios are important, empirical testing can show us how these ratios can best be combined so that the analysis is most meaningful in prediction of a future event. As a result of this work, financial ratio analysis has become more scientific and objective than ever before.

Discriminant analysis, a statistical technique, is being used increasingly by the American Banks. On the basis of a weighted overall score provided by this technique, an applicant is judged to be a "good" or a "bad" credit risk. In other words, routine credit decisions are made on the basis of a numerical score. Marginal applicants, who fall between "clear" accept or reject signals, can then be analyzed in detail by the credit analyst. In this way, a bank is able to achieve greater efficiency in its credit investigation process. It uses trained credit analysts to the best advantage.

Now let's give a brief description of discriminant analysis and its applications.

Discriminant analysis is a statistical tool that can help us decide which prospective accounts to accept or reject on the basis of certain relevant variables. For example, an account officer in analyzing the financial ratios of a certain borrower, wishes to use these ratios to classify the account as either bankrupt or nonbankrupt. Discriminant analysis is a statistical technique that allows such classification.

Basically, discriminant analysis consists of three steps:

1. Establishing mutually exclusive group classification. Each group is distinguished by a probability distribution of the characteristics.

2. Collecting data for each of the groups.
3. Deriving linear combinations of the characteristics that best discriminate between the groups. By best, we mean those discriminations that minimize the probability of misclassification.<sup>13</sup>

Let us start with an evaluation of only two characteristics of trade credit applicants: The quick, or acid-test, ratio ( $X_1$ ) and the ratio of net worth to total assets ( $X_2$ ). For purposes of experiment, we extend open-book credit to all new credit applicants for a sample period. We record the quick ratio of each account, its net worth/total assets ratio, and whether or not after a length of time it defaults in payment. If the account defaults, it is classified as a bankrupt account, if it pays in a reasonable period of time, it is classified as a nonbankrupt account. With this information, we are able to undertake a linear discriminant analysis with two independent variables. We wish to determine the predictive value of these variables for the behavior of the dependant variable, whether the account is bankrupt or nonbankrupt.

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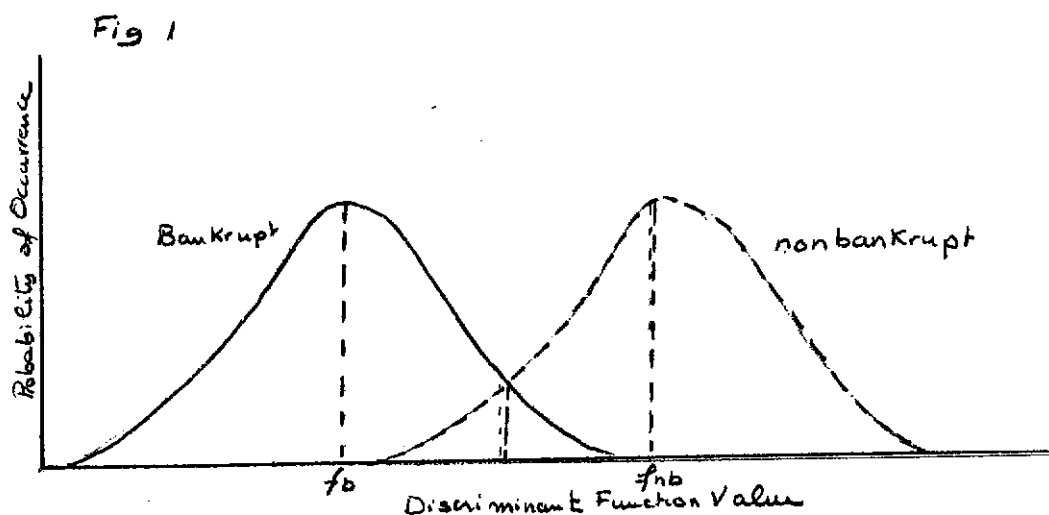
13. J. Fred Weston, Eugene F. Brigham, *Managerial Finance*, Holt-Sanders International Editions <sup>7</sup> Edition 1981, page 85.



Let's take the following formula:

$$f_i = V_1 X_1 + V_2 X_2 \quad (A)$$

where  $V_1$ ,  $V_2$  are the parameters or weights we wish to compute. Our purpose is to obtain parameter values such that the average or mean value of  $f_{nb}$  in Eq. (A) for nonbankrupt accounts will be significantly larger than the average value of  $f_b$  for bankrupt accounts. This notion is illustrated in Figure 1, where the discriminant function value is along the horizontal axis, and the probability of occurrence is along the vertical axis.



In the Figure, two universe of credit applicants are shown: bankrupt to the right, and bankrupt to the left. The average value,  $f_b$ , for bankrupt accounts is much lower than the average value,  $f_{nb}$ , for nonbankrupt accounts, but the two universe overlap, the better the ability of discriminant analysis to predict bankrupt and nonbankrupt accounts.

The coefficients  $V_1$  and  $V_2$  in Eq. (A) can be computed mathematically from the sample data by

$$V_1 = \frac{S_{zz}dx - S_{xz}dz}{S_{zz}S_{xx} - S_{xz}^2}$$

$$V_2 = \frac{S_{xx}dz - S_{xz}dx}{S_{zz}S_{xx} - S_{xz}^2}$$

Where  $S_{xx}$  and  $S_{zz}$  represent the variances of variables  $X_1$  and  $X_2$ , respectively, and  $S_{xz}$  is the covariance of variables  $X_1$  and  $X_2$ . The difference between the average of  $X_1$ 's for nonbankrupt accounts and the average of  $X_1$ 's for bankrupt accounts is represented by  $dx$ . Similarly,  $dz$  represents the difference between the average of  $X_2$ s for nonbankrupt accounts, and the average of  $X_2$ s for bankrupt accounts. When we solve for  $V_1$  and  $V_2$ , we obtain the parameters of the linear discriminant function in Eq (a). The ratio  $V_1/V_2$  determines the slope of the discriminant boundary line.

We now need to determine the minimum cut off value of the function. The idea is to refuse credit to those accounts with values of  $f$  below the values above the cut off value and extend credit to those with  $f$  values above the cut off value. Using this value for cut off purposes will minimize the prediction of nonbankrupt accounts when they are bankrupt and the prediction of bankrupt accounts when they are nonbankrupt. To determine the cut off

value in practice, we start by calculating the  $f_i$  for each account, given the parameters of Eq(A) for our example, suppose that we obtained the  $f_i$  values arranged in ascending order of magnitude, shown in table.1

Table.1												
Acc. nb.	7	10	2	3	6	12	11	4	1	8	5	9
Bankrupt or Not	B	B	B	B	B	NB	B	NB	NB	NB	NB	NB
$f_i$	.8	.9	1.3	1.4	1.6	1.7	1.8	1.9	2.1	2.1	2.3	2.4

We see that there is an area of overlap for accounts 6,12,11,and 4. We know that the cut off value must lie between 1.65 and 1.91. For simplicity, we may want to use the mid point, 1.78, as our cut off value. Given the cut off value, we are able to draw the discriminant boundary line that discriminates best between bankrupt and non bankrupt accounts. We note that two of the accounts 11 and 12, are misclassified, given this cut off value Account 11 is classified as a non bankrupt; account 12 is classified as a bankrupt when, in fact, it was non bankrupt. Rather than assign a strict out off value, it may be better to allow for misclassification and designate the area between 1.65 and 1.91 as uncertain, requiring further analysis.

In summary discriminant analysis is a flexible and practical means for evaluating new credit applicants and monitoring existing accounts. Because the information is processed on a high-speed computer, time spent on clerical work and credit analyses can be reduced. Credit analysts can concentrate on only those marginal accounts falling in an uncertain area. Discriminant analysis offers an efficient means by which a bank can meet the mounting demands on its credit department.

# CHAPTER

# 3

## Chapter 3

### CONCLUSIONS, RECOMMENDATIONS, AND SUMMARY

#### Conclusions

The work which is performed in all banks essentially accomplishes a similar result, particularly as it relates to lending. Banks move credit into areas of the economy which are growing or in other way, require the use of capital. Loans are advanced and repaid. As we have seen, very considerable of this straight forward task is required. Many of the risk and loan structuring consideration which go into lending should be studied and analyzed.

As has been pointed out, there exists a multiplicity of challenges and opportunities for banks in choosing the manner in which they administer their loan systems and procedures. These differences occur for many, many reasons. Loan systems and procedures are designed to fit existing management patterns and eventually become a part of and reflect the style of that management.

The ultimate goal of sound credit administration however, regardless of style, is a soundly managed loan portfolio. Whether a bank is large or small, workable, dependable, and responsive to changing loan market conditions.

Loan approval, loan closing, and loan collection together with many other loan procedures assure the daily operating of the bank's loan

departments. However, as business life has speeded up and grown in complexity, much faster response times are required of bank managers.

To help accomplish this, much innovation has taken place in banking in the last decade. Today loan review systems and sophisticated loan accounting and information systems provide in depth continuous reports to management, assuring as never before that loans managers are able to remain close to the bank's principal earning asset, the loan porifolio. Controlling loan quality and planning its growth and improvement are key management tasks and responsibilities.

### Recommendations

1- One should not become confident in receiving the assets of the company by becoming over confident as to the monetary amount. Only the liabilities are worth 100 cents on the pound. A forced sale, liquidation or collection can deplete value of assets such as, inventory, fixed assets, very quickly.

2- A profitable business warrants credit, and where shareholders are willing and able to contribute in more equity is sound. This factor

weighs all of the basic C's of credit, with great emphasis being placed on the honesty, integrity, and ability of management.

3- All available exits must remain accessible. Rotation sometimes becomes dangerous in a weak loan because the lending bank could have the loan on its books when the company gets into trouble.

4- If a loan agreement proves to be warranted, then detailed notes should be made as to what requirements are to be incorporated in the agreement.

### Summary

Clearly, bankruptcy in any form is not a pleasant experience for the debtor or the lender. Many bankruptcies could be avoided, or their impact reduced, however, if bank lending officers followed a few guidelines in dealing with their commercial customers.

By knowing and frequently servicing the borrower, potential problems can be recognized early. Regular plant visits keep the account officer in touch with the company so that he or she can observe how it is actually operating. Complete and careful analysis of the business and its principals



can help him learn the facts about all aspects of the business and its management. Diligence in obtaining and perfecting security agreements is important when the loan is made, as well as later if inadequacies in documentation are discovered. Proper use of attorneys and accountants can minimize legal problems throughout the entire relationship. And, if a problem develops and persists regardless of the lender's close attention, the courage to take unpopular actions with the debtor may reduce the ultimate damage to all parties involved.

# CHAPTER

A

## Appendix A

### How to Appraise Management

#### A Check List

The following check list should be a helpful guide to all bankers in seeking answers to the key credit question of how to appraise management. It represents the kind of information men actually engaged in top management of industry think we bankers have in deciding whether or not an enterprise is well managed.

Obviously, each case has its individual aspects so that not all questions apply directly to all situations. The fundamental and comprehensive approach, however, can be adapted to some basic phase of all types of business.

### Credit Analysis - The Personal Factor

#### I. Management Control

##### A. Company Objectives

1. What are the Company's objectives?
2. Are long term programs planned to meet objectives?
3. Does the long term plan include all major activities of the Company?
4. Does the plan provide for results that can be achieved and are acceptable to management, stockholders and employees?
5. Does the Company have a long range forecast of its financial requirements which reflects all of the Company's objectives? How accurate have forecasts been in the past?
6. Do all administrative personnel understand the general objectives, and are their programs and projects directed toward the same target?

7. Is the plan reviewed frequently and brought up-to-date?
8. Is the plan sufficiently flexible, permitting sights to be altered promptly as changing conditions require?

B. Company Policies and Principles of Operation

1. Does the Company have written policies and principles of operation which are in harmony with its objectives?
2. Are they understood and practiced by all levels of management and supervisory personnel?
3. Does a healthy Corporate climate exist in which the whole management group can thrive, and develop and prepare itself for the greater responsibilities which lie ahead?

C. Organization

1. Is the organization of the Company set up to effectively and efficiently carry out the objectives?
2. What is the type of organization?
  - a. Is the executive staff composed of specialists?
  - b. Are the separate functions departmentalized?
3. What is the professional reputation, integrity, experience, age, service with the Company, and turnover of the executive personnel?
4. Does the Company employ an executive development program? Are understudies being trained for every executive position to provide for contingencies and to insure continuity?
5. Are executives rewarded in proportion to results achieved?
6. Are organization charts maintained?
7. Are functions (responsibilities, authority and relationships) and standards of expected performance:

- a. Clearly defined for all positions?
  - b. Maintained up-to-date?
  - c. Understood by all affected persons?
8. Is decision-making authority delegated to the lowest practical level of management?
  9. Is there proper coordination of the entire organization plan with all related departments?
  10. Does the Company employ Value Engineering techniques in its activities to achieve the lowest cost of operations?
  11. What is the worker environment? Is it pleasant? Do the employees appear to be working efficiently?
  12. Does the management operate with an enthusiasm that creates internal pressure forcing those actions which are required to assure optimum profit growth?
  13. Is the top executive group performing their total management job as masters holding the reins of control and not as slaves buried in the details of their activities (a climate which requires crisis decisions and fire-fighting is dangerous)?

D. Administration

1. How does the Company effectively control overall operations, and what type of standards and yardsticks are used?
2. Are there adequate follow-ups to assure attainment of objectives? Are variances of actual results versus established goals quickly and sharply spotlighted and corrective steps promptly taken?
3. Does management employ specific programs to keep abreast of the constant improvements and developments in their field of activity?
4. Is there a formalized means to assure the establishment and up-to-date maintenance of adequate systems, procedures, and practices?

5. Does the Company employ an effective management audit practice to assure that its performance conforms with objectives, policies, systems, procedures and programs?
6. What is the character of the reception given to guest in the visitors' reception room, vendors in the purchasing office, and prospective employees in the employment office?

## II. Marketing and Sales

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### A. Market Research

1. Is there a market research department?
2. Is it properly staffed?
3. Are markets studied before new product development?
4. Is market research used in advertising planning?
5. Is market research used in planning sales, quotas, distributor, retail coverage?
6. How big is the market - present and future?
7. Are sales trends analyzed - past, present and future - in each product line? By geographic areas?
8. What are the changing characteristics of those areas, both geographic and product-wise? (i.e. trend to suburbs, shift of market potential.)
9. Are areas analyzed on basis of sales potential and desired sales share?
10. Are weak and strong areas checked periodically?
11. Is there a continuous coverage program?
12. Are industry and area sales figures available, and is the company using them?

13. Are internal statistics available regarding characteristics of population for product-income, number in family, buying habits, type of shelter?

B. Tools to do the Market Research Job - Are these Available?

1. A skilled market research manager.
2. Association information (trade information).
3. Census reports - all phases.
4. Sales reports - weekly detailed analysis of sales, inventory, competitive standing on all lines.
5. Government agencies (i.e. Dept. of Commerce).
6. Trade magazines.
7. Advertising agencies.
8. Field surveys - consumer, retail, distributor - both product and sales.
9. Analysis of model sales by area and reasons for discrepancies.

C. Sales

1. Is the company generally sales-minded, or is this confined to sales department?
2. Is sales forecasting on a long range basis?
3. Does the future of the industry indicate an increasing or decreasing market?
4. What are the break-even points, the financial levels, and sales levels, by product lines?
5. What is the share of industry on each line? Is it increasing or decreasing?
6. Are sales policies in writing? Is direction established by policy, not by individual?
7. Are service policies sound and adequate for future growth?
8. Are sales quotas by each line and each area established?
9. Is effect of volume on manufacturing overhead taken into account in sales plans?
10. What is the export market size and share, by line?

D. Advertising and Sales Promotion

1. Is advertising and promotion expense in line with direct selling expense?
2. Is there a good cooperative advertising program, if suitable to the business?
3. Is there a well-thought-out, well-integrated, national advertising program?
4. Are there regular promotions, salesmen's contests, keyed in with national advertising?
5. Where required, are there seasonal promotions to overcome seasonal sales fluctuations?

E. Sales Training

1. Is there a sales training department?
2. Are there salesmen's bulletins?
3. Is there a sales manual?
4. Are there salesmen's kits, charts-tools for both retail and wholesale salesmen?
5. Are there regular field and headquarters sales training meetings?
6. Are there field sales training crews, if required?

F. Sales Control

1. Is there a sound practice of finished goods inventory control and forward buying time cycle in order to minimize working capital investment?
2. Are there regular records of weekly sales and field inventory?
3. Are there reports by territory on sales and competitive position?
4. Are there selling expense budgets?
5. Do sales managers spend most of their time in the field with the field sales organization?
6. Is headquarters and field sales organization decentralized and divisionalized?
7. Are there regular weekly sales reports from field and headquarters?
8. Are sales overbalanced in favor of government, industry, or consumer, which might cause trouble in any of those particular areas?
9. Are inventories and warehouse space adequate?

G. Sales Force

1. Are there individual product line sales managers?
2. Is there adequate sales personnel in the field?
3. Is supervision adequate - field and home office?



4. Are salesmen properly trained?
5. Is the compensation plan good as to incentive, method, amount? Does it encourage long range building as well as immediate sales?
6. What is the morale of sales force? Is there excessive turnover?
7. What are procedures for hiring and training salesmen?

H. Competition

1. Are there advantages over competition in product, sales, or merchandising?
2. Does competition have advantages in any of these fields?
3. What will be the impact of new competition?
4. What about future competition in same product, or new products?

I. Products

1. Is product line diversified?
2. Are quality, design, and consumer appeal good?
3. Is there a long range program on product line?
4. Are frequent field survey methods used to keep finger on pulse of product acceptance? To get new product ideas? To confirm future developmental plans?
5. Are new product lines needed? If so, what's being done about?
6. Is the product one which might be easily obsoleted? If so, are there plans to cope with this?
7. If a product line is seasonal, are there other lines to balance factory and sales overheads? What are cyclical volume problems, if any and how are they met?
8. What is the reputation of the Company and its products?

J. Pricing

1. What is the pricing policy or formula? Does it allow adequately for contingencies, flexibility and volume variations?
2. Are prices, discounts, allowances, in line with the industry?
3. Do prices and discounts allow a satisfactory profit for manufacturer, distributor and retailer?

4. Do right relationships of prices and discounts exist between manufacturer, distributor and retailer?
5. Is discount structure properly established?
6. Do payment terms encompass cash discount, ordinary terms, dating ahead terms?

K. Distribution

1. Is there an adequate number of wholesale outlets? What is their quality?
2. Are wholesale outlets independent or factory-owned? If the latter, is financing adequate?
3. Are wholesale areas too large to be handled properly?
4. Are key centers (depending on population or customer concentration) covered by well-staffed and properly divisionalized wholesale outlets?
5. Is there thorough retail coverage, particularly in key areas?
6. What is the wholesalers' opinion of manufacturer and his products?
7. Are there policies and programs to aid the wholesaler in proper management of his business with respect to overhead factors, sales, promotion, advertising, and dealer aids?
8. Does the manufacturer have continuing programs to aid distributor and dealer in moving merchandise?

III. Manufacturing

A. Plant

1. In what type of facility does the Company perform its operation?
  - a. Where located?
  - b. Owned or leased?
  - c. Size of areas?
  - d. Is any of space unused at present?
  - e. Where would any expansion take place?
  - f. Cost of space?
  - g. In what condition is the facility?

2. Has any consideration been given to decentralization?
3. What degree of security is there against strike, sabotage, etc?
4. Is the plant safe from fire, explosion, etc?
5. Is location good for raw materials, market and source of labor?
6. Is plant well lighted and ventilated?
7. Is good housekeeping maintained?

B. Equipment and Facilities

1. Are they modern and up-to-date?
2. What portion is general purpose equipment?
3. What portion is special purpose equipment (i.e., peculiar only to this Company's process)?
4. Is it in satisfactory condition?
5. Is a preventive maintenance program used?
6. Is an equipment replacement program in effect?
7. Is all equipment being used?
8. Is there any equipment on the books at value not being used which is obsolete or worn out?
9. What is the ratio of maintenance expense to direct labor? Is this too high? If so, why?
10. Are good safety practices employed for personnel protection?

C. Plant Operations

1. Is the plant well laid out to provide efficient and orderly process of production, material handling, stores and associated functions?
2. At what level of capacity does the plant generally operate?
3. If sales fluctuate, what is done to minimize effect on plant operations?
4. Is the capacity greater than needed or insufficient?
5. Is there a definite program established to obtain improvement, simplification and economies in equipment, methods, processes, materials, labor and overhead?
6. What is the worker productivity both direct and indirect? What is the trend?
7. Does the company use an incentive system? What type? To what extent is it employed? What is its effectiveness?
8. What effort has been made to obtain level production?

IV. Purchasing  
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- A. How important is the purchasing function to the operations? Are purchasing specialist used?
- B. Do purchased materials represent a large percentage of the product costs?
- C. Do items purchased have technical complexity?
- D. What is the annual value of purchases?
- E. Are adequate controls exercised on commitments by members of management such as the financial officer, works management, engineering, sales, purchasing agent?
- F. In what manner are the controls maintained?
- G. Do you consider the purchasing function of profit-making operation or is it used only as a facilitating service?
- H. Are any of the important purchased items subject to abnormal economic conditions such as governmental control, patents, rareness or monopoly?
- I. Is reciprocity practiced and, if so, to what extent?
- J. How is purchasing performance measured?
- K. If the Company has multiple plant operations, is the purchasing centralized or decentralized and what benefits accrue from methods used?
- L. Are relations with vendors good? How is this determined?
- M. How are vendors selected?
- N. Are there automatic checks and balances for:
  - 1. Control of requisitioning authority?
  - 2. Distribution of paperwork to all persons who should have information?
  - 3. Matching of orders, invoices and actual receivals?
  - 4. Inspection of receivals?

- O. Does the procurement group keep abreast of technological developments, and are they constantly searching for new sources of supply, new and better materials and methods, and lower prices for the operations?

V. Material Control

- A. Are modern and efficient methods employed to control inventories?
- B. Are inventories maintained at the optimum level?
- C. Is turnover rate high enough?
- D. If inventory size and balance get out of line, is explanation requested of steps being taken to revert to a normal position?
- E. Are materials properly and efficiently recorded and stored to provide minimum of obsolescence, deterioration and pilferage?
- F. Are modern materials handling methods used for transportation and storage?
- G. Is a good system for physical inventory of materials in effect to overcome any surprises in loss or value?

VI. Production Planning and Control

- A. Is a sound and efficient program for production planning, scheduling and control in effect?
- B. Are production schedules made as far in advance as possible to insure availability of materials, level manufacturing, loading and minimum turnover and movement of workers?
- C. What is the record on meeting customer delivery promises?
- D. Is there good control over movement of work-in-process materials, and is this inventory kept at a minimum consistent with an efficient manufacturing cycle?

VII. Quality

- A. Is top management quality minded?
- B. Does the Company use modern quality control techniques?
- C. How does this company's product compare with competitors?
- D. Are there markets of any significance which this Company cannot serve because quality does not meet the requirements?
- E. What is the in-plant performance on rejects and repairs? Is it excessive?
- F. Is the product uniform?
- G. Does the Company have materials conservation and salvage program which provides the best method of utilization and disposition?
- H. Are customer returns of defective material excessive?
- I. Does top management include a review of product quality reports?
- J. Is the quality function used for:
  - 1. Better vendor and customer relations?
  - 2. Reducing manufacturing costs?
  - 3. Product improvements? or
  - 4. Limited to inspection activity only?

VIII. Cost Control

- A. Are costs known and is effort made with any success to control them?
- B. What products are unprofitable, and are steps being taken to make them profitable? Is intelligent use made of the cost data in setting sales prices, valuing inventories, etc?

- C. Have standard operating ratios been established, and do they make intelligent use of them?
- D. Are budgets used effectively?
- E. What is the break-even point? If it is high, what steps are being taken to reduce it?
- F. How would the Company fare in any recession in business? Is there a planned program of what would be done if there is a down turn in business of 10% - 20% etc? Can economies be effected immediately?
- G. Are costs increasing or decreasing, and why?
- H. Are the cost methods adequate? Are they calculated for the purpose of providing a historical record, or are they used to control operations?
- I. Are sufficient reserves maintained for equipment and materials inventories?
- J. Are non-recurring expenses identified and separated from regular operating expenses?
- K. Is vigorous control exercised over indirect expense?
- L. Are effective employee motivation programs employed for improvement of profit results, customer satisfaction and product quality?

IX. Research and Engineering

- A. What importance does the Company place on research for the
  - a) improvement of its existing products, manufacturing equipment and process, and
  - b) development of new products, manufacturing equipment and processes?
- B. Are the research activity objectives in harmony with the overall Company objectives, and is its active program well directed to accomplish effective results?

- C. In the development of new products, manufacturing equipment and processes, has proper consideration been given to:
1. Future market volume and profit potential?
  2. Product quality?
  3. Review of manufacturing consideration?
  4. Sufficient trial runs to avoid "bugs" when in factory production?
  5. Standardization of equipment and materials?
  6. Economy in manufacturing?
  7. Simplification of processes?
  8. Minimum labor content?
  9. Minimum of maintenance?
  10. Caution against over-engineering?
  11. Use of existing inventories of materials? and Is all of this done before project authorization is given? What has been the Company's experience?
- D. What control does top management have over the research and engineering programs, projects and budgets?
- E. How does this activity keep abreast of the (a) industry's new developments, and (b) customers' specific programs and requirements?
- F. How do they keep informed of competitive developments?
- G. How is the Company geared to make rapid changes in its programs?
- H. How much money does the Company spend for this activity? What percentage of net sales? How does this compare with competition?



- I. What results have been accomplished in the past? What percentage of present sales are due to improvements from research and engineering?
- J. Are the facilities adequate to accomplish the results expected?
- K. Are working conditions, patent and publication policies, and salaries such that top-notch research and engineering personnel are attracted?
  
- X. Industrial Relations  
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- A. What is the management's attitude on industrial relations as a whole, and how well is it set up to handle this important function?
  - 1. What is the title of the person in charge of Industrial Relations?  
(Place on organization chart will indicate to a great degree the attitude of management).
- B. Does the Company employ good programs for:
  - 1. Employment?
  - 2. Wage and Salary Administration?
  - 3. Medical Care?
  - 4. Employee Welfare?
  - 5. Employee Services?
  - 6. Training?
- C. Is the Company unionized? If so, how long has it been unionized? What is the union? Suggest a review of the contract for any peculiar conditions. What is the Company-Union relationship?
- D. What is the morale of the employees and their attitude toward the Company? What is the rate of employee turnover as related to (a) the area in which the Company is located, and (b) its competitors?
- E. What is the record on absenteeism and lateness are related to (a) the area in which the Company is located, and (b) its competitors?

- F. Does labor make unreasonable demands resulting in restriction of output, inflexibility, etc...?
- G. On employee wage rates and fringe benefits, how does the Company compare (a) with the area in which it is located, and (b) with its competitors?
- H. If the Company is out of line on employee wage rates and fringe benefits, is it not probable that it will ultimately be obliged to get in line with the area and its competitors?
  - 1. What are the potential long term costs of the fringe benefits?
    - a. Insurance
    - b. Pensions, etc...Are they actuarially sound? Funded or non-funded?
- I. What effect would such a cost increase have on its operations?
- J. Is there an effective training program for all key personnel.
- K. Are all key positions protected with trained replacements?
- L. Is the Company training personnel for the expansion of its operations?
- M. Is there harmony and cooperation existing among key employees and between departments and divisions?
- N. Does the Company have good two-way communications through out the organization?
- O. Does the Company have an effective program to enlighten employees on the true economic "facts of life"?

P. Is front line supervision functioning effectively and are they paid properly?

R. Does the Company use an effective system for evaluating employee performance? Are employees, in fact, given frank and friendly merit reviews of present performance against predetermined standards? And, are they offered counsel and encouragement to self-improve themselves for future opportunity?

XI. Public Relations

A. What is the Company's reputation in the area in which it is located?

B. What does the general public think about the Company?

C. Does the Company maintain good relations with the press?

D. Does the Company participate actively and financially in worthy community projects?

E. Does the Company participate in activities which promote the general welfare of the industry?

F. Is the external appearance of the facility (building and grounds) attractive and an asset to the community?

XII. Legal

A. Does the Company have a well-established service which:

1. Routinely keeps the Company management informed about:

a. Relevant laws, public regulations and public policy?

b. The rights conferred and obligations imposed by Company contracts and other commitments to avoid defaults and conflicting commitments?

2. Passes upon the wording of contracts and intra-company documents imposing obligations upon the Company (including union documents) where accurate expression and clear understanding are essential?
3. Establishes and maintains or supervises certain Corporate procedures relating principally to stockholders, to the Board of Directors, to security regulatory bodies and other public authorities?
4. Passes on the maintenance and discard of documents and records?

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