THE CHARTERED INSTITUTE OF BANKERS (GHANA)
ASSOCIATESHIP EXAMINATIONS – FINAL

PRACTICE OF BANKING II – LENDING
OCTOBER 2017

EXAMINERS REPORT

Overall Results

Number of Candidates: 201

Number of Candidates who passed: 101

Number of Candidates who failed: 100

Two hundred and one candidates sat for the paper. Out of this, 100 students passed, with 124 failing representing a pass rate of 50.25% % compared to a pass rate of 40 % in April 2017. This is an appreciable improvement in performance over the previous sitting. There is however still room for improvement as higher pass rates have been recorded in previous sittings.

A detailed analysis of the results is shown below:

Analysis	
Distinction	1
Passes	100
FAIL A	23
FAIL B	41
FAIL C	36
TOTAL FAILURES	100
TOTAL	201
% Passes	49.75%

	Q. Number	Q1	Q2	Q3	Q4	Q5	Q6
Attempted		169	94	130	136	145	114
Pass		81	19	35	93	93	53
Fail		88	75	95	43	52	61
PERCENTAGE PASS		48%	20%	27%	68%	64%	46%

Question 1

Introduction/Background

- A risky industry, we must proceed with caution
- A family business engaged in export…. Do they have the necessary skills in place to cope with the intricacies of this sector?

Environment/Industry

- Agric sector, specifically fruit farming and the export of fruit products
- Support of the current government for this sector is keen
- Competition posed by exports from other countries into his target market
- Critical success factors include proactive measures to control epidemics, knowledge of export procedures and regulations, and good quality control

Management/ Resources - 3 Marks

- A family managed business
- We have no information about the role being played by Manu's wife and children.
- Does the farm manager have the requisite qualification and experience for the role that he is playing?
- The business is well resourced, with a sprawling orange and lemon orchard, and an articulator truck that carts his goods to the ports.
- Labour is hired on by day basis, which is acceptable practice in the agric sector.

Financial Analysis

Capital

- Low gearing ratio, with an increasing trend due to low level of borrowing relative to capital.
- Sustained retention of profits over the period –shows commitment.
- Retention for the current period was low due to the low level of profits earned over the period

Operations/Profitability

- Decline in the level of sales attributable to the epidemic that beset the farm.
- Gross margins declined for the same reason
- Net margins also declined, but at a greater rate due to lack of control over overheads

Liquidity

- Current and quick ratios declined due increases in payables and overdraft
- A level of below 2:1 is not good enough
- Receivables days worsened in the current year due to either a slippage in credit management or debtors finding it difficult to pay
- Payables days' purchases were nonetheless at comfortable levels possibly arising from seller credit terms
- Terms of trade are in effect in against the business and for that matter it should take steps to reduce its receivables levels otherwise cash will suffer.
- Overall liquidity appears tight

Debt Repayment

- Increase in overdraft utilization arose due to the difficulties experienced over the past year.
- This was reflected in a rapid decline in interest cover to very low level of 1.7 times.
- Two factor drove this decline – lower profitability and higher interest payable.

Proposition

- Customer is requesting for an increase in the overdraft facility from GHC 500,000 to GHC 1.0 million to finance working capital
- The is justified in view of the harm cause by the diseases to the orange and lemon trees
- Working capital requirements may be estimated as follows:

Working Capital Requirements

	2015	**2016**	**2017**
Cash Flow Cycle	142	146	208
Cost of Sales	533,000	617,000	637,000
Daily Cost of Sales (COS/365)	1,460.27	1,690.41	1,745.21
Working Capital Requirements	207,010	247,064	362,966

- Working capital requirements for the current year is estimated at GHC 362,966.

- Projecting by a growth rate of 25.0% would yield a requirement of less than GHC 500,000.00
- Projected gearing would be about 229.0% which is excessive.
- Customer would have to convince the bank regarding specific requirements otherwise we consider the proposed limit as being excessive.

Security

- A charge may be taken over the assets of the farm
- This includes the land and articulator truck.
- Book value of noncurrent assets amounts to GHC 236,600 which is woefully below the proposed exposure.
- Adding inventory and receivables of GHC 520,000 would give a value of GHC 756,600 which is still below the proposed exposure even without considering the forced sale value of the assets.
- Customer would need to supplement the security if we are to approve the whole amount requested.

Pricing

- Interest rate of 5% OBR due to high perceived risk
- Facility fees of 1.0%
- Commitment fees of 0.5%
- Loan administrations fees of 0.5% due to the level of monitoring that would be involved.

Projection/Repayment

Projection Assumptions	1.00
Depreciation Workings	0.50
Projected Income Statement	1.50
Projected Working Capital Changes	1.00
Projected Cash Flow Statement	1.50
Annual Repayment Obligation Conclusion	1.00

0.50

7.00

Assumptions

Sales Growth	25%
Gross Margin	30%
Overhead Expenses to Sales	10%
Inventory to Sales	29%
Receivables to Sales	30%
Payables to Sales	9%

Profit and Loss Extracts for the year ending 30 June
for the year ending 30 June

		2018
		GHC
Sales		1,037,500
Opening Inventory	240,000	
Purchases	786,250	
	1,026,250	
Closing Inventory	300,000	
Cost of Sales		**726,250**
Gross Profit		**311,250**
Overheads		103,750
Depreciation		60,400
Operating Profit		**147,100**
Interest Paid		-
Profit Before Tax		147,100
Tax		36,775
Profit After Tax		110,325
Dividend		55,163
Transfer to Income Surplus		55,163

Percentage of Sales Method

Balance Sheet Extracts	**2017**	**2018**	**CASH FLOW**
Inventory	240,000	300,000	-60,000
Receivables	248000	310,000	-62,000
Payables	73,500	91,875	18,375

Thomas Fruit Farms Ltd.

Cash Flow Projections as for the year ending

		2018
Profit Before Interest and Tax		147,100
Depreciation		60,400
Operating Cash flow BF WK Changes		207,500
Increase in Inventory	-60,000	
Increase in Receivables	-62,000	
Increase in Payables	18,375	
Change in WK		-103,625
Cash From Operations		103,875

- Cash from operations is bare adequate to cover cost of sales for the projection period
- Depending on utilization of OD there is the danger of a hard core developing
- The proposed exposure is clearly excessive and must be reviewed after discussion with customer about his actual needs.

Monitoring

- Regular site visits

- Farmers balance sheet
- Gross margin budget
- Accounts statistics
- Repayment schedule

Summary/Decision

- A very risky sector
- High projected gearing
- Inadequate security
- Customer's request for working capital support is overambitious.
- The amount requested should be scaled down to say GHC 700,000.00
- Or conversely the OD limit should be reviewed and any excess over the OD restructured as a term loan payable over a tenor of say three years.

Question 2

Introduction/Background

- Start-ups can pose significant risk – the bank must proceed with caution.
- Area ventured into also poses serious risks
- Why is the seller selling? Is it because the farm is not viable.

Environment/Industry

- Rearing of pigs, - animal husbandry
- Sector is exposed to risks particularly susceptibility of animals to diseases.
- Competition posed by local and international poultry and meat products.
- Critical success factors include proactive measures reduce the risk of diseases, and loyal pool of clientele.

Management/ Resources

- Acquah has virtually no experience in pig farming.
- We have not been told of any farm manager, - one needs to be appointed.
- The son though has requisite qualification lacks practical experience on the job – he would be helpful though.
- We must establish the role of the workers he intend to retain.
- The farm is well resourced

Financial Analysis

Capital – 1 Mark

- Gearing levels were relatively low though an increasing trend may be seen over the period.
- Retention of capital in the current year was good following a decline in capital in the previous year due to losses

Operations/Profitability

- Sales grow improved over the period from 25% to 30% which is a sign that business is viable.
- Gross margins were relatively stable at around 41 %
- Net margins were also stable at around 5%
- The levels were however low due to high overheads.

Liquidity

- Current ratio declined to very low levels due to increase in overdraft and trade payables
- Inventory days was high and worsened over the period
- Receivables however improved possibly due to improved management of credit
- Payables days worsened slightly though the levels are manageable

Debt Repayment

- Worsening overdraft levels a sign of tight liquidity
- Interest cover as at comfortable levels due to the low level of borrowing.

Proposition

- Customer is being offered a price of GHC 400,000 for the farm.
- What went into the pricing?
- This is lower than the book value of the business as at the end of 2017
- Book value of noncurrent assets amounts to GHC 332,500
- Current assets apart from cash amount to GHC149,400
- Even if the assets were depreciated, an implication that may be drawn is that the price is favourable to customer as nothing much has been added for goodwill.
- The bank's loan would amount to GHC 300,000.00
- This could be granted for a term of 5 years in view of the purpose
- Projected gearing would amount to 62.2% which is reasonable

Security

- A charge could be taken over the existing and future assets of the farm which has a book value of 632,500
- This provides adequate cover for the proposed exposure

Pricing

- Interest rate of 5% OBR to be charged due to high assessed business risk
- Commitment fees
- Legal fee

Projection/Repayment

Projection Assumptions	1.00
Depreciation Workings	0.50
Projected Income Statement	1.50
Projected Working Capital Changes	1.00
Projected Cash Flow Statement	1.50
Annual Repayment Obligation	1.00
Conclusion	0.50
	7.00

Loan Repayment Commitment

REPAYMENT

	INTEREST	PRINCIPAL	APPROXIMATION	TERM	ANNUAL REPAYMENT
Interest	27.00%	300,000.00	0.50	5.00	40,500.00
Principal		300,000.00		5.00	60,000.00
					100,500.00

Cash Flow Analysis
Projected Income Statement

	ACTUALS	ASSUMPTIONS	2018 PROJECTED
Sales Revenue	30.00%	125%	867,344
Direct Costs	59.47%	58%	503,059
Gross Profit	40.53%	42%	364,284
Overheads	32.12%	28%	242,856
depreciation	1.18%		8,190
Operating Profit			113,238

Balance Sheet Extracts

	% OF SALES JUNE 2018	JUNE 2018
Inventory	25.94%	225,000
Receivables	13.69%	118,750
Payables	11.17%	96,875

Cash Flow Projections

CASH FLOW PROJECTIONS

Operating Profit		113,238
Depreciation		8,190
		121,428
Change in Inventory	(45,000)	

Change in Receivables	(23,750)	
Change in Payables	19,375	
		(49,375)
Cash Generated From Operations		72,053

- Projected profits covers projected interest about three times which is impressive.
- However cash flow from operations is not adequate to cater for both repayment of principal and interest
- The exposure of GHC 300,000 is considered as high, though the prognosis may improve if and when his wife receives her retirement package and pays GHC 50,000.00 as promised

Monitoring

- Usual monitoring tools such as site visits, bank accounts statistics, management accounts and audited accounts

Summary/Decision

- High risk proposition
- Loan servicing projection is tight
- Projected gearing is high
- Approve 80% of proposed exposure subject to customer contributing 20 %.

Question 3

Background

- Family business, youthful couple, apparently the business was established three years ago.
- Highly risky sector especially where there is a housing glut

Environment/Industry

- Speculative developer
- Critical success factors good location, good design, unserved demands, affordable houses.

Management/ Resources

- Family managed business
- No permanent foreman.
- Should consider appointing one on a permanent basis
- Opportunity to acquire a huge land bank
- Modest resources

Proposition

The proposition should feature an analysis of the credit proposition in terms of amount purpose and term of the facility.

Item	Marks
Project Cost	1.00
Bank Contribution	1.00
Customer Contribution	1.00
Lending formulae	1.00
Phasing of Project	1.00
Lending amount	1.00
	6.00

- Customer wishes to develop all the houses at once.

- We must confirm the project estimates.

		Bank Share	Bank	Customer Share	Customer Contribution
Land	300,000.00	50.00%	150,000.00	50.00%	150,000.00
Construction of Roads and Utilities	370,000.00	50.00%	185,000.00	50.00%	185,000.00
Building cost of 10 Single-storey houses	6,000,000.00	70.00%	4,200,000.00	30.00%	1,800,000.00
Building cost of 40 Three-bedroom houses	2,500,000.00	70.00%	1,750,000.00	30.00%	750,000.00
TOTAL	9,170,000.00		4,535,000.00		2,135,000.00
Available Funds					500,000.00
Number of Phases	Customer total contribution divided by available funds				4.27
% of total project to complete in each phase	Assumption 4 equal phases				25.00%
Bank Lending = 25% of Project Cost			1,133,750.00		

- The bank will lend 1,133,750 representing 25.0% of the project for the first phase
- The facility would be by loan account to facilitate easier control and monitoring by the bank.

Security

- Legal mortgage over development.
- Security is adequate

Pricing

- Interest rate of 5% OBR due to high perceived risk
- Facility fees of 1.0%
- Commitment fees of 0.5%
- Loan administrations fees of 0.5% due to the level of monitoring that would be involved.

Projection/Repayment

Project Profitability

Project Profitability	Number of Houses	Price per House	
Sale of 40 three-bedroom houses @ 200,000	40.00	200,000.00	8,000,000.00
Sale of 10 single-story houses @320,000	10.00	320,000.00	3,200,000.00
Total Sales			11,200,000.00
Total Direct Cost	9,170,000.00		
Gross Profit			2,030,000.00
Gross Margin			18.13%

Project Cash flow

Sale of 25% of development		2,800,000.00
Loan	1,133,750.00	
Interest @ 28%	306,112.50	
Total Loan Commitment		1,439,862.50
Surplus Cash Flow		1,360,137.50

Monitoring

Relevant monitoring tools should be mentioned and justified.

- Planning permission
- Project development plan

- Confirmation of title
- Progress report
- Site visit

Summary/Decision

- A permanent foreman should be employed.
- Provided the estimates are confirmed, approve GHC 89,000 for the construction of 3 houses in the first phase of the project..

Question 4

(a) Definition of 'Credit Policy'

A credit policy is a document embodying written guidelines including the principles, rules and regulations governing the management of credit processes in an institution.

(b) 8 Elements of a credit policy

- Objectives of Policy
- Credit organizational structure
- Responsibilities
- Approval authorities, levels and limits
- Acceptable security
- Credit products
- Maximum term
- Minimum qualification of credit staff
- Exceptions to policy
- Frequency of review
- Pre-disbursement conditions
- Credit qualification criteria
- Pricing
- Penalties for late payment
- Repayment structure

Question 5

Introduction – definition of non-performing loans -

Factors Contributing to the incidence of bad debts:

Extraneous factors

Political

Economic

Social

Technological

Legal

Environmental including natural Disasters

Customer Factors

- Lack of planning
- Over ambition
- Poor corporate governance
- Poor financial planning
- Poor working capital management
- Concentration of receivables or payables
- Willful refusal to pay
- Industrial unrest
- Fraud by employees

Bank Factors

- Poor monitoring
- Poor appraisal
- Inadequate customer knowledge
- Connected lending
- Inadequate industry knowledge
- Poor structuring of credit

Question 6

(a) An open bridge is a bridge in which the prospective borrower has not yet exchanged contracts for the sale of his house whilst a closed bridge is a bridge where the prospective borrower has already exchanged contracts for the sale of his old house though the actual sale has not yet been executed

(b) Risks associated with bridging facilities

  - Collusion between borrower and buyer
  - Fall in housing prices
  - Third party interests in property
  - The house may not be sold

(c) How to deal with the risks :

- Reference from solicitors
- Enquire about other beneficial interests in the property
- Ensure market prices are stable

(d) Appraisal of bridging proposition

Assessment of Amount

The bank would lend the balance remaining on the new house plus amount to pay off old mortgage, if it wishes to take a first legal mortgage on the old house to support the second legal mortgage on the new house. Otherwise it could lend only the balance on the new house and be content with a second mortgage on both the old and the new house.

With the first option, the bank would lend GHC 70,000.00 as detailed below:

Cost of New House	95,000.00
Mortgage on New House	(30,000.00)
Balance required	65,000.00
Pay off old Mortgage	15,000.00
Bank Lending	80,000.00

½ Mark

Proceeds from old House	65,000.00
Balance	(15,000.00)

½ Mark

The proposition is not viable unless customer makes a contribution. A 20% fall in housing prices would further aggravate the position

The bank is nonetheless comforted by the fact that he has savings by way of treasury bills amounting to GHC 22,000.00.

Pricing

- Margin of 5 % over base rate due to high risks
- Facility fee of 1.0 %
- Valuation fees of 0.5 %
- Legal fees of 0.5%

Security

- First legal mortgage over old house valued GHC 35,000
- Second mortgage over new house equity valued at GHC 65,000
- Possible charge over treasury bill valued at GHC 22,000
- Security is adequate

Assessment of Repayment ability

On the face of it repayment would be in jeopardy as the proceeds from the sale of the old house is inadequate to cover payment of principle.

The bank is nonetheless comforted by availability GHC 22,000.00 to support the proposition by way of cash or in the event of delay in sales, as security for repayment of the debt.

Interest payment for one year would amount to GHC 22,400.00.

Interest payment for one month at the same rate would amount to GHC 1,867.00

Interest burden per month would be about 58% which is excessive.

Due Diligence

- Confirm approval of new mortgage
- Confirm value of houses
- Ascertain customer options in respect of treasury bill –as cash injection or security
- Confirm that planning permit has been obtained for the house.
- Ascertain his expenditure details
- Monitor house prices.

Decision

- Approve subject to GHC 12,000 contribution by customer.