Course Managers BPR

Textbook

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Author(s)	*René Verberk* *Miranda Visser*
Project	*TA Banque Populaire du Rwanda*
Contact address for this publication	Rabo International Advisory Services (RIAS) BV Croeselaan 18 Postbus 17100 3500 HG Utrecht Tel +31 (0)30 2163670 Fax +31 (0)30 2163677 *RIAS@rn.rabobank.nl*

Rabo International Advisory Services (RIAS) BV
Registered Chamber of Commerce, Utrecht no. 30133013

CONTENT

1 Organizing the process of crediting

Chapter Content

Content:
- Crediting as teamwork
- Steps in the crediting process
- Structuring the lending process
- Role of the credit officer

Learning Objectives

Objectives:
- Understand the importance of well structured crediting process for a bank
- Use the different roles in the team
- Organise the crediting process step by step

1.1 Crediting as teamwork

Teamwork

Successful lending is a team effort and therefore everyone who touches it, from the teller to the Director and even the Board of Directors, needs to understand it. Our common ground of course is our dedication to the small business market. From a purely economic perspective, we are the ones who are responsible for the allocation of a scarce resource (money). We allocate this resource making a credit decision: approve or decline a loan request. We should approve loan requests for purposes that will return not only the principal and interest, but will also give the borrower an adequate return, above and beyond the cost of capital. That is the economic rationale for what we do.

1.2 Steps in the crediting process

Steps in crediting process

In the crediting process there are 6 steps:
1. **Preparing a visit:** Before the first appointment with the client the loan officer has to do a internal research. Look to the information of the client, that already is available on the bank. It helps you to formulate the right questions.
2. **Business Analysis:** The process whereby the Commercial Officer evaluates the client using
the screening, application and loan appraisal tools.
3. **Financial Statement Analysis:** Reviews the income statement and also reviews the balance sheet and how to effectively use it to analyse a client's present asset, liability and equity situation.
4. **Cash flow Analysis:** Teaches the Commercial Officer how to use the cash flow tool to determine the client's repayment capacity. It is the most important part of analysing a client's business.
5. **Collateral**: Reviews the security requirements for the individual loan and details examples of various types of collateral.
6. **Loan Structuring**: It shows, after evaluating the repayment capacity, on how to properly evaluate the project needs and formulate a proper loan amount, repayment format, and disbursement conditions.

Well structured lending process

1.3 Importance of a well structured lending process

A highly structured lending process ensures:

- Efficiency – process more applications, disburse more loans (shortest possible time period from application to disbursement), satisfy more clients, and make more profits.
- Clear and easily understood processes and forms - improving the work flow for all participants, BANK staff and clients, in the loan process.
- Reduced risk - participants in the process are less likely to omit any details, eventually lowering the overall risk.

Step by step lending process

In summary, structure makes the process more efficient and easily understood, and reduces the risk.

1.4 Goals of having an established Step-by-Step lending process

The goals of the Step-by-Step Process are to eliminate borrowers that don't qualify early on, to manage risk and to balance it with efficiency, at each stage of the lending process. The process helps to reduce time for both the applicant and the institution before disbursement. It also ensures that a standard set of procedures and policies are respected, in order to implement a product consistently.
These measures will reduce credit risk by improving the institution's overall productivity and customer satisfaction.

Steps of the Lending Process
Step 1: NEW CUSTOMER INTRODUCTION, FIRST APPOINTMENT
1.1 First client contact – screening with Loan Administrator
1.2 Information session (optional)
1.3 Completion of Application Form by client
1.4 Commercial Officer obtains more information about the business and client for the application, reviews it with supervisor and decides whether to move forward or not
1.5 Commercial Officer starts file for client and fills in appropriate items on the Checklist
Step 2: LOAN APPRAISAL
2.1 Commercial Officer conducts site visit to business and reviews collateral options
2.2 External checks and references
2.3 Commercial Officer completes Loan Appraisal form and Cash flow form
2.4 Surprise visit to the company if necessary
2.5 Final analysis and loan structuring
2.6 Final review by Credit Manager
Step 3: APPROVAL
3.1 Submission to Credit Committee
Step 4: DISBURSEMENT
4.1 Loan documentation
4.2 Appropriate authority reviews all documentation and signs disbursement request; loan disbursed
Step 5: MONITORING

Each step should be assigned a maximum time period for completion and be planned by the organization for each loan product.
Commercial Officers must manage their time in a way that allows faster moving transactions to be underwritten and disbursed more quickly and slower ones to be moved down the
priority list. Commercial Officers must continuously set priorities within their own pipelines and move all clients through the process in the quickest manner possible.

Typical reasons for delays include:

- Long delays in receiving Credit Committee approval from the head office; some Commercial Officers will give the maximum locally authorized amount for this reason.
- The client takes a long time to submit all necessary documents.
- Lengthy legal and collateral registration processes in some countries.
- Delays in receiving information from clients to fulfill conditions of disbursement.
- Client delays in finishing part of a project so that the bank can disburse the next part of the loan.

New Customer

1.5 Step 1: New Customers Introduction

The goal at the first meeting with the applicant is to screen out applicants who are not eligible for borrowing under the bank's eligibility criteria and to sell the bank procedure and products to applicants who are eligible.
This first contact is important because this is where applicants get a chance to understand the bank's products and determine right away if they are in line with their expectations. It is important for the Loan Administrator or Commercial Officer to be well trained, understand the products and not waste time on ineligible clients.

Loan appraisal

1.6 Step 2: Loan Appraisal

A few sources Commercial Officers will use to perform their credit analysis are:

- Customer
- Documentation
- Site visit
- External checking

Site Visit

The site visit is one of the most crucial steps in the pre-approval process because direct observation and one-on-one conversations with each potential borrower provide precious information for the Commercial Officer in his/her assessment of the applicant's credit worthiness. A site visit allows the Commercial Officer to inspect the business premises and confirm what the borrower stated and wrote about the company's premises, production or sales space, assets, and inventory amounts and turnover. It allows
the Commercial Officer to meet and interview the Managers and employees. Lastly, the Commercial Officer can gather financial data to evaluate the potential of the business. The objective of the site visit is to make an objective judgment about whether the business is well run and has potential.

Next, the Commercial Officer should focus his/her visit on reviewing the entrepreneur's management capacity, market potential and importance of further financing through borrowing to further his/her business goals. If the Commercial Officer manages to remain objective, curious and thorough during the site visit, then it is a very powerful tool to evaluate the information gathered in the paperwork.

Credit is both an art and a science. Part of the site visit involves artistic thinking, using intuition (gut feeling) to determine if people are being honest about the information provided, talking to partners, family members of staff, and being flexible when site visits do not always take place as expected. Site visits can be used to double-check written information, but also to collect information on the applicant's skills and personality and whether or not s/he is a good Manager/owner.

The Loan Appraisal Form is a critical component in the decision making process and helps to answer three crucial questions:

1. Is there a GOOD FIT between the customer and the Bank?
2. Will the customer BE ABLE to repay?
3. What are the key RISKS?

External checking

A good Commercial Officer NEVER takes for granted what the customer says. Good lending practices depend on fact-checking and character-checking of the borrower from external sources. If the customer has borrowed before, it is essential to check whether the loan was repaid as agreed.
When dealing with larger loans the external checks on the client's character may be overtaken by more formalized "capacity" lending. This means that the financial indicators will be more important than, or just as important as, the character of the borrower. Therefore, in addition to looking at the historical cash flows for larger loans, more attention will be paid to the type of collateral and other financial indicators, such as competition and inventory levels/turnover.

The Commercial Officer reviews the Loan Appraisal and Cash flow forms. Then s/he completes his/her analysis and makes his/her recommendation, making sure the final documentation is in order and checklist is completed. This step is important because the Commercial Officer must be confident in recommending the potential client and business to the Manager and Credit Committee.

Two pair of eyes

The final review by the Credit Manager can also be referred to as: "Two Pairs of Eyes" As a general rule, it is important that every loan be looked at by someone who has not been involved in the loan process thus far. When dealing with new customers on larger loans, a second person should not only review the loan, but visit the customer before loan approval.
Loan Officers must remember of course, that they will be held responsible for their loans and overall portfolio. This step will make the Loan Officer feel stronger about the loan if the Credit Manager is satisfied with it.
In preparing the application it is, as part of the learning organization, very common to ask a colleague to reed the proposal and discuss the case.

Credit Committee

1.7 Step 3: Approval

Once the loan is structured and due diligence is completed, the deal should be presented to the Credit Committee. During the Credit Committee phase, each Commercial Officer will recommend prospective clients and applicable paperwork to the members and answer questions the committee may have. The Credit Committee discusses the merits of the proposed project, and votes to approve, approve with additional conditions, postpone, or reject.

Generally, most deals should be accepted if they make it all the way through to Credit Committee. If a high percentage of deals are rejected at the Credit Committee level, there is a need to look at the process up to this point. Otherwise, the client, Commercial Officer and Credit Committee have wasted a lot of time. These possibly could have been weeded out at an earlier stage, made easier for the client and more efficient for BPR.

Loan Is rejected

If a customer is rejected, the Commercial Officer should be very careful in communicating this to him/her, so as to avoid spreading negative perceptions of the institution in the same community. The Commercial Officer should communicate this information to the client in written form for documentation purposes. It should be either delivered promptly, or the client should be phoned and the letter should follow. The documentation can be simple – a short written letter on a standard form with a

Approved loan

section explaining the reason.

If a customer has been approved, the forms are approved and signed, including loan conditions. The client is informed by phone of the decision and an appointment is made to sign the loan documentation. If a deal is approved with additional conditions of disbursement, the client is informed of these conditions. Then the Commercial Officer aids the client in fulfilling the conditions by taking them through the process step-by-step.

Disbursement

1.8 Step 4: Disbursement

Each step leading up to this point is critical to an efficient overall approach, and the Commercial Officer must continue to be diligent throughout the entire process.

Even though the loan has been approved, there may still be some outstanding issues that need to be cleaned up, such as additional documentation, for example. If so, the Commercial Officer requests any additional loan documentation required for closing, and the loan agreements are then prepared.

Collateral registration

If required, the Commercial Officer arranges for collateral registration and insurance documentation. Sometimes BPR uses another individual with connections in the registrar or a lawyer who know the process. The lawyer prepares the loan and collateral agreements. The Commercial Officer completes the closing checklist. The Manager or another assigned staff member checks all documentation and conditions and completes a form confirming that everything is in order and requesting disbursement.
The documentation is signed by both the client, Manager and, where appropriate, the guarantors. A copy of all documentation and the repayment schedule are provided to the client.
The Commercial Officer ensures that all disbursement conditions have been met. The Commercial Officer instructs the client on the process of monitoring. Finally, the funds are disbursed to the client through his/her account or directly to the supplier if conditioned by the loan.

Monitoring

1.9 Step 5: Monitoring

During the disbursement process, the Manager and the Commercial Officer decide on the monitoring schedule for the client. This schedule depends on the credit history of the client and the high risk periods of the project. For example, a bank may have a rule that all clients are monitored within one week after disbursal to make sure the loan funds were used for the correct purpose. Clients are monitored quarterly thereafter, to make sure everything is going well. If there is a case with a client where a major sales contract is to be renewed between quarterly visits, the Commercial Officer should also schedule a visit at this time, due to the high risk of the contract not being renewed.

Role of the commercial officer

1.10 Role of the commercial officer

It is important for Commercial Officers to treat their customers well for the following reasons:
1. Commercial Officers are the first point of contact with the customer and build the reputation of BPR.
2. Marketing experts have long demonstrated that it costs five times more to get a new customer than to keep an old one. Financing relationships are build on trust between the customer and the bank. Trust takes time to create, and it is done through creating a polite but friendly and comfortable working relationship with customers. The customers of BPR should be seen and treated as its assets.
3. Contented customers are willing to refer others to BPR. Conversely, clients that have

been treated poorly are likely to tell their friends and business associates about the poor treatment they received. Further, they are more likely to tell their peers about a bad experience than a good experience. This is another reason why Commercial Officers' knowledge and behaviour towards clients is so crucial!
4. If the customers feel the BANK is treating them well, this increases their desire to be a good customer. This means higher repayment rates and more deposits

What are the essential skills that Commercial Officers should display in order to ensure that customers are well treated?
All salespeople need to deploy a triple combination of skills that blend into a persuasive approach:
1. Service: This is paramount. Everything from being prompt for a meeting to ensuring reliable after-sales service matters
2. Technical excellence: In product knowledge, for instance. Nothing less than 100% proficiency will do here. Anything less will be noticed and will dilute effectiveness.
3. Sales skills: The details of the many techniques that contribute to a persuasive approach must be actively built into your approach.

10 rules of customer service

Ten rules of customer service:
1. A polished first contact with any potential customer. As we one sais, "You never get a second chance to make a first impression." So, at the first meeting or on the telephone, the Commercial Officer should try to create an image of efficiency and friendliness from the outset.
2. Always be polite with any potential customer. Even applicants who are ineligible can speak to others who are potentially good customers, so it is important that they have a pleasant image of BPR.
3. Always be prepared for a meeting with a client. Before holding a meeting or making a visit to the customer's premises, Commercial Officers should make notes of what they must achieve in this meeting.
4. Professional presentation: part of maintaining a professional and helpful manner means not reacting negatively if a customer makes a claim that is incorrect. The Commercial Officer's main role is to listen and evaluate.
5. When asking a customer for information on his business, be careful how you phrase your request. To obtain the information necessary to make a loan decision, the Commercial Officer often needs to investigate the real workings of a customer's business. This is usually best obtained through a relationship of trust with the customer. This trust can be easily broken by asking questions undiplomatically.
6. Do not create false (unnecessarily hopeful) expectations. It is important not to promise a loan before the Credit Committee has approved it. Likewise, customers should be told how long they will realistically have to wait for approval and disbursement. If you make an appointment at a certain time, make sure you will be ready with what they need. Constantly communicate as to what is needed from the customer so there are no misunderstandings. If it looks as if you will have to decline the customer's request, do it as quickly as possible and explain the reasons so that they can understand and maybe apply again if and when the situation has improved.
7. Preserve confidentiality. Don't discuss a client's situation in the presence of other clients. It is important to preserve the confidentiality of information provided by borrowers. Confidentiality is an important duty of financial institutions. Don't discuss internal issues about BPR in front of clients. Commercial Officers represent BPR and should not involve clients in internal questions that can harm the reputation of the bank.
8. React quickly to the requests and needs of the customer. This lets the customer know that s/he is important to BPR.

9. Approach client complaints in a professional manner. If customers have complaints, deal with them calmly. Remember that an unhappy customer talks to twice as many people as a happy customer. Even unhappy customers can be brought back to satisfaction if their complaints are heeded. There may or may not be something the Commercial Officer can do to resolve the customer's problem, but just listening, sympathising and if necessary, apologising can help a lot.
10. Rejections: be pleasant but firm. It is important to explain why a loan has been refused clearly and avoid promising future prospects of a loan unless the customer has a good chance of getting a different decision next time.

2. Credit Risk Analysis

Content

- Lending as an art and a science
- What is a good manager
- Analysing the use of a loan
- Checking information
- Why are repeat loans important

Objective:
- Be able to make a food credit analyses
- How to get reliable information

2.1 Introduction

Lending is the business of taking risks. Every loan implies a certain level of risk. The principal risk for commercial officers is called credit risk: the risk that the borrower may not meet the terms of the loan and that secondary sources of repayment, such as collateral or other family income will be insufficient to cover the losses. Commercial officers are there to understand and manage risk, not to avoid it or deny it.
Credit analysis is the process of understanding and analyzing the credit of a customer as a means to evaluate the level of credit risk they represent. The commercial officer is responsible for this process. The result of the process is usually a conclusion that is presented to the decision makers about whether or not to make the loan. Credit analysis helps us define the level of risk and evaluate whether it is a risk worth taking.
When thinking of credit, one can try to understand and get information about the 5 C's:
- Character;
- Collateral;
- Capacity;
- conditions and
- capital.

Each one of them is critical to good credit analysis for high microfinance performance. This section focuses on character and a later section will provide guidelines on conditions.

2.2 Remember: Lending is both an art and a science.

Lending as an art

Part of the "Art" of lending is in:
- Making credit decisions based on complete information;
- Understanding the motivations and character of your customers;

Lending as a science

Building trust with your customers to help motivate repayment part of lending is also "Science":
- Obtaining the facts of the loan request (what is going on here?)
- Analyzing the information to tell the real story

• Preparing a cashflow and calculating repayment capacity.

The first step in the crediting process is to find out the key information regarding the customer's request. This is the bare minimum to assess eligibility of the borrower/ business:

- Loan amount requested and loan use
- Information about the borrower (company, individual, partnership)

Once you have ascertained that the borrower is eligible, move on to assess the 3 M's. The level of risk depends on several factors about the specific business. These can be summarized into three main categories, known as the 3 M's: Management, Money and Market.

Management: Is this the right business owner for the business. Is he/she a good fit? Is he/she reliable?
Money: Is this the right amount and structure of financing? What future sources of cash will the customer have to repay?
Market: Is this a good business opportunity? Is there a market? Are there customers?

2.3 Regarding management, what are good qualities for a business owner?

Qualities for a business owner

The Manager should have the right demeanor and character and be suited to the business. For example, if one is heavily involved in selling, it helps to be a good sales person and not a shy individual, who is terrified of approaching potential customers. A good Manager can make an average business opportunity successful. A poor Manager will fail at even the best business opportunity.
Management is the most important factor in whether a business idea is successful, because the Manager can make the business work by finding new customers, or finding new ways to solve a problem. Less experienced borrowers should stick to businesses with which they are already familiar or have experience, and grow them gradually.

Some criteria for potential borrowers include:
1. Skills: Do they have the management skills needed for this business?

- Experience related to this business and time spent working in the business;
- Track record in the business;
- Experience in a supervisory position;
- Skills related to the business, such as accounting, management, finance, technical skills for the particular job.

2. Do they have the personality and commitment to repay?

- Personal credit history patterns and behavior to meet obligations;
- Community responsibilities and roles that indicate commitment;
- Quality of business plan and focus on the details of the business.

3. Dependence on owner's draw and household income sources

- Are there other sources of income for the household (another earner)?
- How dependent is the owner on his/her draw to meet personal obligations?

Knowing your borrower

What do we want to know about the borrower?
Commercial officers are interested in finding out if this is the right financing and use of loan funds. In order to do so, they will analyze the cashflow projections.
When reviewing the financial aspect of a business, the commercial officer will ask several questions, such as:

- Is there a need for more working capital;

- How long is the cash cycle or operating cycle of the business?;
- How realistic are the growth projections of the business owner. Have they underestimated or overestimated sales figures?;
- Is this the right amount of financing? Can we reduce the amount? Do we need to increase the amount?;
- Can the borrower manage a larger cashflow associated with receiving a larger loan?;
- The cashflow will help answer the following question: Can the business repay the debt payments of principal and interest?

2.4 Analysing the use of loan

Use of the loan

Understanding the loan use is important because:

- It will affect the ability of the owner to make repayments and, therefore, it will affect the risk associated with the loan;
- It will tell you how soon that investment can produce cashflow for the business and a loan installment for the branch;
- It may tell you how the owner is paying her employees (and her own) salary. Is it coming from the cashflow of the business or is she using the loan to fund this amount?;
- Understanding how the owner plans to use the funds tells you something about the owner's level of skill, how the owner is thinking, and what s/he is prioritizing.

Thus, it is very important to ask and understand specifically how the loan proceeds will be used. Will the money be used to purchase equipment or raw materials? How soon can the investment produce cash for the business and repay a loan installment to the bank? The employees' and owner's salary should be paid from the cashflow of the business, not with the loan funds. The owner's salary should be drawn after the loan installment is paid.

2.5 Checking the information

Checking information

A visit to the applicant's residence should also be performed, whether located next to or separately from the business. The commercial officer should be able to determine the applicant's type of housing, its structural condition, household fixtures and appliances (or lack thereof) so that their impact on the loan application can later be measured. This can also be a useful indicator of the applicant's permanency of residence in the community.

Interviewing the client

Tips for commercial officers when interviewing a potential client:

- Be certain to ask all relevant questions, so as to get a clear picture about why the client needs the loan, how the client will use the loan and how regular payments can be made without unnecessary stress to the business/family.
- Get further impressions of the client's character, trustworthiness and reliability.
- Get a clear picture of the applicant's cashflow and how this will affect his/her ability to repay the loan.
- Review the screening and loan application forms before the site visit and compare them to what you see and hear on site.
- Ensure that the potential client fully understands his/her future loan obligations, especially the incentives for prompt payment and the consequences for paying late.
- Avoid doing business with a client who is not believed to be trustworthy.

- Seek a second opinion from a supervisor if for any reason there is doubt on a particular business-related matter. Character and cashflow assessments however, are the sole responsibility of the commercial officer.
- Before closing the interview, remind the applicant to visit the bank during the week to follow up on the status of his/her application. Schedule the applicant's visit after the Credit Committee meeting, when all applications for the week have been reviewed.

2.6 Why are repeat loans important for BPR

Repeat Loans

Repeat loans are very important because:

• If you serve clients well when they are small, you will retain them as customers as they grow;

• The processes should be more efficient for a second loan;

• The Commercial Officer already has a relationship with client and knows the business;

• The client is obviously satisfied with the organization or would not return for another loan.

The Commercial officer still needs to conduct the due diligence because situations change quickly with micro and small businesses. Also, as loans get larger, the risk to the Bank also increases.

3. Loan Structuring

Content
- Loan structuring
  - The right amount of money
  - Size of the loan matters
  - Risk of too short loan terms
  - How to detect the borrowers need
  - 5 key questions for commercial officers

Objective:
Make a tailor made loan proposal based on the real needs

3.1 Introduction

Most borrowers, all around the world, large or small, ask for more money and a longer term than they really need. Taking too large of a loan is one of the major reasons for default. Banks are often at fault for giving too large of loans to repeat customers, without truly taking into account their ability to repay. Clients are always better at taking money than repaying it. The challenge for a commercial officer is to identify how much money is appropriate and how the payments should be structured. The commercial officer should not necessarily give what the client requests, but work with clients in making them ultimately see why proper loan structuring is better for them. Again, the loan policy should provide clear guidelines for the commercial officer, so that excessive discretion is not used. Exceptions to policy should be sanctioned by a superior.

3.2 What is loan structuring

Loans Structuring

Loan structuring ensures that:
- The right amount of money is lent;
- for the right amount of time;
- with the right repayment frequency, and under the right circumstances

3.3 What are the risks associated with loan structuring

The risks associated with loan structuring are:
- The larger the loan, the larger the risk;
- Too much money is lent;
- Too little is lent to complete the project;
- The longer the term, the larger the risk;
- The right conditions are not set for disbursing or securing;
- The payment frequency does not match the business's operating/cash cycle.

3.4 Why does the size of the loan matters

The loan size should be enough to fulfill the needs of the project, but should not be too much so that repayment becomes unmanageable. Giving too large of a loan can put the borrower in jeopardy. No matter how much s/he might WANT to repay, s/he may not BE ABLE to repay.

Does the customer WANT to repay and will the customer BE ABLE to repay.

3.5 Is it good for the customer if we give the longest term loan available

Term of the loan

Giving a loan for too long a time allows the entrepreneur to use it for lots of purposes that you may not have expected (and which may not be successful!). If their business cycle is shorter, they may have to save up to repay the loan later on and this may be a very difficult thing to do when they also have other, household expenses. Also, customers pay BPR interest on the amount they have outstanding. If they can pay the loan earlier, it will be cheaper for them!!
If they repay exactly on time, they will be able to get a larger loan the next time! It is best to give a loan term that corresponds to the loan use. For example, shorter term loans are better for working capital and longer term loans are more suited for buying equipment and fixed assets.

3.6 What are the dangers of a loan with too short of a term?

Too short terms

Giving a loan for too short a time can mean that the entrepreneur's repayments will be too large and they will not BE ABLE to make their monthly payments.
It is the Commercial Officer's job to match the type of business and loan to the repayment period within the policy guidelines. Just because a bank only gives loans for 24 months, it may not be appropriate to give a loan for building a dormitory for this period. Giving a loan for too short a time can mean that the borrower's repayments will be too large and they will NOT BE ABLE to make their monthly payments. Generally, shorter term loans are for working capital purposes, while longer term loans are for fixed asset purposes. If there is a good business reason for an exception to the policy, the Commercial Officer should go ahead and make the case to his/her superior

The keys to building a good loan structure are:
Step 1: Loan Amount and Repayment Capacity
Step 2: Repayment Structure
Step 3: Disbursement & Other Conditions

3.7 How does the commercial officer determine the borrower's needs

Determining borrower's needs

Sometimes borrowers forget to include important parts of the project. For example, transport for the goods. It is the job of the commercial officer not to cut the loan to the bare minimum, but to help the borrower determine what is best and that the project costs are reasonable. Commercial officers should not necessarily give the loan amount the client requests. The commercial officer should understand and check the costs of achieving the borrower's plan.

How does the commercial officer determine the borrower's repayment capacity?
The repayment capacity of the borrower is proven through the use of two tools, the Loan Appraisal Tool and Cashflow Tool, which includes the Repayment Capacity. When structuring the loan repayment, the commercial officer must ask themselves five key questions before proceeding with the loan repayment schedule. These questions aid in reviewing their diligence in completing the Loan Appraisal Tool and Cashflow Tool to make sure that all the pertinent information has been thoroughly completed and verified internally and externally before the loan is structured.
The reader may note that potential income (with the loan) may be higher than current and/or historical income. In our experience and according to best practices, it

is important to look to historic cashflow, rather than only to projections that are more subjective. This is especially important in developing (un-transparent) markets, where assumptions can be wildly off target. Obviously, for start up businesses, this is not possible.
For start up businesses, commercial officers should be extremely cautious and conservative, given the higher level of risk associated with start-ups. They should base their calculations on conservative figures from another like business, taking particular nuances into consideration (capacity of equipment, location of business and experience of owner, compared to the like business).

Details regarding the 5 Key Questions the commercial officers must ask themselves:

5 Key Questions

1. <u>Are cashflow costs verified and reasonable</u>? Answer this question while comparing the loan with loans given to similar businesses.
One of the most important points here is to ensure that the cashflow is reasonable (sales and expenses) and that the repayment capacity has been calculated properly. If the cashflow is not realistic, the Commercial Officer is putting the borrower in jeopardy of defaulting. The foundation of all the loan decisions must be made upon good, complete information and a good cashflow.
All costs in the cashflow must be verified and reasonable, according to market prices. Credit officers should go to the market and check current prices and also compare this loan with other like business loans. This gives a good sense of the type of business. After a while a Commercial Officer will know all types of businesses and common sales prices, costs, expense categories and amounts, and equipment costs. It becomes second nature.

2. <u>Are the costs for producing the product or delivering the service over- or underestimated</u>?
This should be based on the business historical cashflow. Sometimes costs can be difficult to determine or are left out. Some examples of typical costs not included are administrative and sales employees' time, transport costs and losses from items that have been damaged. Costs must be kept conservative so that the business does not have difficulty in repaying the loan, but not too conservative so that the business has more cash than they know what to do with.
It may be that because the borrower wants to try something new, he needs a piece of machinery that would not be available on the local market. Factor this in and connect it to borrower's experience with the business to decide; is it worth the added delivery costs and learning to use a new machine?
Ask: Why do we not want the borrower to have too much cash on hand?
Answer: Because the borrower may take it out of the business and spend it on some other risky venture or personal matter, putting the loan repayment at risk.

3. <u>How long is the operating or cash cycle</u>? Is there a cushion for a longer cash cycle?
Cash cycle: How long is the period from when a client receives the loan funds to when they buy a product and to when cash is received from a customer who buys the product? The cash cycle for a bakery that buys flour on a weekly basis and produces bread daily is 1 day. A carpenter shop that produces school desks for schools might buy the raw materials in May, make 1000 desks, and then sell them in August, resulting in a cash cycle of 3 months. There should be a cushion in case the cash cycle is longer than predicted. For example, if considering a trade business, then approximately 7 days is appropriate. If considering a production or service-based business, allow for an approximate 25% delay in the cash cycle.

4. Does the experience of the borrower fit the loan amount, terms and project?
Look at the experience of the borrower: Should s/he take a smaller loan if this is a new business for her/him, or if there is some change with the expansion of her/his business? Should the Commercial Officer test the borrower and build trust and credit history before giving a big loan?

5. Is the owner's contribution sufficient, accurate and verified?

4. Credit Committee

Content

- ❖ Credit Committee
  - ➢ Role of the Credit Committee
  - ➢ General rules for a credit committee
  - ➢ How to make the decisions

Objective:
Conduct a structured meeting of the Credit Committee

4.1 Introduction

What is the Credit Committee and who is on it?

Organizing Credit Committee

The last stage in the due diligence process is the Credit Committee, where the decision is made to approve, reject or defer the loan request. This is the time to review the Commercial Officer’s analysis and give feedback to him/her. The Credit Committee not only reviews loans, but also serves as a regular review of the loan products and their performance (Ledgerwood, 2001).
The Credit Committee is therefore an important aspect of the loan process because it allows not only a thorough review of all loan applications, but also a regular evaluation of the individual lending products’ performance. The following guidelines aim to standardize the conduct of Credit Committee meetings.
The Credit Committee can take on a few different forms:
1. It can be made up of several Managers, who sit together and discuss loans and who have authorization to approve loans up to a certain limit (recommended).
2. Several Managers who review the loan individually, give their decision and then pass it on to the next Manager for review.
3. In some banks, the Credit Committee can be a single person.

We recommend that banks have a “Committee” that sits together and discusses the loans. One purpose of this type of Credit Committee is to provide a setting where loans are presented and can be discussed, questions answered and feedback given on the analysis and risks presented.
Commercial officers learn new skills and what to expect by having a ”live” Credit Committee. In this option the Credit Committee should be made up of 3–5 members to keep the decisions quick, yet give good feedback and analysis. The Credit Committee usually has various members for increasing levels of authority. In the case of larger loans, the loan may be approved at the branch level and then sent to a Head Office Credit Committee, also made up of 3–5 members, for final approval.

4.2 Are there general rules for the credit committee?

General Rules

General rules that the Credit Committee should follow are:

- Appoint a chairperson to facilitate;
- Limit the number of loans to review in one session;
- One meeting should not be more than two hours;

- All write-ups on loan applicants are to be received in advance;
- Start and end meeting on time;
- Set time limit expectation for presentations – five minutes;
- Standardize commercial officers' presentations;
- If the commercial officer is not prepared, defer the loan to the next meeting when the commercial officer is prepared;
- Save all Q&A until after the presentation;
- Limit Q&A session for each loan – ten minutes;
- Chairperson records outcome of CC and all members sign – approve, defer, or reject with comments.

Thus, in a two hour period, the Credit Committee can review eight loans if each loan review is not more than 15 minutes. If there are additional loans to be reviewed, they take a break and come back. Over two hours of reviewing loans is too much time to retain focus.

4.3 How does the Credit Committee make loan decisions?

Making decisions

After the presentation and discussion session, the chairman summarizes the loan application and a vote is taken. The Credit Committee can make decisions either by a majority vote or reaching a consensus, according to the banks policies. Decisions should rarely be made by one member and/or "influenced" by one member (i.e., chairman or most senior staff person).

5. Monitoring in a nutshell

Content:
- Monitoring plan, Timely reporting, Market developments (competition, supply, customers).
- Five reasons for monitoring a loan
- Most important factors to monitor

Objective:
Understand the importance of monitoring

5.1 Introduction

Commercial officers need to monitor regularly to:
- Remind clients of repayments that are coming due;
- Keep an eye on the clients;
- Understand the client's business development;
- Catch problems early;
- Document information in the file;
- Marketing;
- Build the client relationship;
- Establish trust;
- Give advice (not too much!);
- Allow Managers to review portfolio information.

5.2 In summary, Commercial Officers should monitor for five reasons

5 reasons for monitoring

1. To let the customer know that BPR is taking an interest in their business. The customer should understand that repayment is important to the BANK. The relationship should be supportive; it is in the interest of both the customer and the BANK that the business should develop successfully;
2. To catch any potential problem early. Why?
    • In case there is still time to try and work out the situation.
    • BPR can act before collateral disappears.
3. To document information gained and update the credit file. Why– why?
    • Recording the date of the visit helps to ensure the next visit will be made at the necessary time.
    • Good records aid quick decisions in the future.
    • To help your replacement quickly understand the entire history of the loan and easily continue the relationship with the customer, if you leave your position, for whatever reason.
4. To conduct marketing efforts; finding other customers through current clients and building a good name for BPR.
5. To build a relationship of trust and honesty with the client. A good relationship can help bring in new clients (through friends of the client), encourage repeat loans, encourage the client to repay on time and enable the Commercial Officer to better detect if something is wrong before a loan becomes delinquent.

5.3 What are the most important factors to monitor

The most important factors to monitor are the **changes** in (Pikholz, 2001):

1. Physical look of shop, raw materials, employees, etc.
2. Sales trends and inventory levels, accounts receivables and payables (if applicable)
3. Overall cashflow (sales and expenses) compared to analysis
4. Assets and liabilities
5. Major sums in or out of the business – purchases/sales
6. Major increases/decreases in receivables, payables or inventory
7. Competition
8. Suppliers and customers
9. Collateral condition

Does the Commercial Officer need to document the monitoring visit?
Absolutely! It is essential that the Commercial Officer and Manager document every visit and discussion they have had with the client. The Commercial Officer should complete a Monitoring Tool form to document the visit and current situation of the borrower. The purpose of this is to ensure that anyone picking up the file can understand the current situation of the client.