

TUTORIAL KIT
OMEGA SEMESTER

**PROGRAMME: BANKING AND
FINANCE**

COURSE: BFN 422

BANK LENDING AND CREDIT ADMINISTRATION

DISCLAIMER

The contents of this document are intended for practice and leaning purposes at the undergraduate level. The materials are from different sources including the internet and the contributors do not in any way claim authorship or ownership of them. The materials are also not to be used for any commercial purpose.

BFN 422: BANK LENDING AND CREDIT ADMINISTRATION

QUESTION ONE

- (i) It is commonplace for the banks that lend unsecured to insist on execution of negative pledge by the borrower. Explain the term negative pledge.
- (ii) The elements that constitute a good credit facility transcend considerations of structure alone, but include a lot of other loan aspects. Briefly discuss **Six** requirements of a good credit facility.

Answer

A Negative pledge covenants implies restrictions on any forms of mortgages, pledges, or lien over the present and future assets of the borrower during the duration of the loan It prevents possible encumbrances of the borrower's assets or earnings in favour of other lenders.

B. Credit facility is said to be good if its package, among other requirements,

- (i) Lends to easy, close, and effective monitoring by the account officer, relationship manager, and/or other loan officers of the bank.
- (ii) Engenders high volume of activities (turnover) in its operational current account form which the bank earns a lot of transactions processing fees, such as commission on turnover (COT).
- (iii) Triggers sales of other bank products to the borrower, such as foreign exchange, time or fixed deposits, fund transfer, etc all of which produce income multiplier effect for the credit facility.
- (iv) Subsumes unambiguous transactions paths or dynamics, which, which ensure hitch-free disbursements, utilizations, and repayments as envisaged at the time of granting the credit facility. (v) Conforms with the tenets of the so-called self-liquidating credit facilities, which are common among asset-based loans.
- (vi) Offers loan loss remedial options – usually in terms of adequate, easily realizable, collateral to secure the credit facility – as well as other ways – out strategies.
- (vii) Returns as reasonable value on investment as measured by the relative net yield on the credit facility.

QUESTION TWO

- (i). Enumerate **Four** representations and warranties commonly found in most loan agreements
- (ii) There are certain conditions that must be fulfilled by the borrower prior/precedent to its disbursement of funding of the loan. Discuss **Four** of them

Answer

Some of the representations and warranties commonly found in most loan agreements

include the following:

- (i) Financial statements (i.e balance sheet, profit and loss account, cashflow statement of value-added, etc) are correct as presented.
- (ii) There has not been any material adverse change in the financial condition of the borrower after the dates of the reported financial statements.
- (iii) The borrower's business is not subject to any litigation, whether pending or threatened, in the courts of law.
- (iv) Collateral offered to the bank to secure the loan belongs to the borrower and is not in any way encumbered.
- (v) The borrower does not require superior approval or consent for the loan that is yet not in place.

The conditions precedents may deal with issues such as:

- (i) Execution of the accepted offer letter, or executed loan agreement, to the bank by the borrower.
- (ii) Execution, and return to the bank, of all security documents in respect of the assets financed or pledge by the borrower to the bank as collateral to secure the loan facility.
- (iii) Perfection of the bank's legal charge over the security/title documents to the assets, including landed property, pledged to it by the borrower to secure the loan.
- (iv) Submission to the bank of the borrower's board resolution authorizing the borrowing on the stated terms and conditions, as well as naming the principal offers that should operate the loan account.
- (v) Payment of all upfront fees and commissions on the loan facility including processing, arrangement, management, or legal fees as might be applicable.

QUESTION THREE

- i. The causes of lending fraud can be ascribed to the act of acting against laid down rules, principles and formulated policy. Discuss.
- ii. How can lending frauds be controlled?.

Answer

A LENDING FRAUD

This is the act of acting against laid down rules , principles and formulated policies aimed at guiding lending ,i.e. there are some rules as to when and how to lend, the kind of person or character to lend to, the kind of securities to be fulfilled before the loan is drawn. Thus acting against laid down rules and regulations will give rise to lending fraud. Lending is a very important function because it is an area where a bank can lose huge sum of money.

CAUSES OF LENDING FRAUD.

1. Failure to comply with laid down procedures.
2. Misrepresentation of facts.
3. Fictitious borrowing or ghost borrowing, the customer becomes a ghost borrower when he and the banker collaborates with the customer having untraceable or wrong address.
4. Unofficial borrowing or cheque exchange or I owe you.
5. Lending against uncleared effects, uncleared effects are cheques that has not been cleared in the clearing house.
6. Deliberate premature draw down of loan facility
7. Kite flying or cross firing i.e. a customer with an account in two different branches of the same bank draws a cheque on one account and pays it into another branch, and the act is to draw against uncleared effect.
8. Overvaluation of collaterals.
9. Double pledging of collateral.
10. Wrong loan pricing i.e. you regard a customer who is not a prime customer as a prime customer and giving him a prime interest rate which is lower than the normal interest rate.
11. Negligence
12. Inefficient management control and poor internal and external audit.

PERPETRATORS OF LENDING FRAUD

1. Loan officers
2. Branch managers
3. Management and executive officers
4. Directors
5. Cashiers
6. Supervisors
7. outside collaboration (customers).

MOTIVATION TO LENDING FRAUD.

1. Urge to get rich quickly.
2. Anticipated favor.
3. Employment of undesirable character.
4. When officers are dissatisfied
5. Cost of incentives and opportunities.

HOW TO CONTROL LENDING FRAUD

1. Detection, Investigation, publicity and monitoring.
 - a. Discipline staff by taking actions.
 - b. Publicity campaign.
 - c. Continuous monitoring of account..
2. There must be a good credit policy.

QUESTION FOUR

Dumoz Industries Ltd was incorporated ten years ago as an importer of various car batteries and accessories. In recent times it has added to its list of activities production of motorcycle tubes and tyres to take advantage of the increasing use of motorcycle as a means of public transportation system in the country.

At present the company enjoys at your bank an overdraft limit of ₦1 million and a loan of ₦400,000 repayable in 10 equal installments. The company started trading on cash basis but credit sales have been introduced since 1991. You hold as security fixed and floating charge over the company's assets duly stamped and registered for ₦1.4 million.

The directors have just called on you asking for a further loan of ₦500,000 to enable them produce more motorcycle tubes for which orders totaling ₦800,000 have been received. The directors ask you to upstamp the mortgage and if requested they are prepared to give personal guarantees. The loan if granted is to be repaid at ₦50,000 per month after three months moratorium. The stock as at 31/12/92 was ₦3, 600,000.

The Accounts For the Past three Years are as follows:

	1993	1994	1995
	₦'000	₦'000	₦'000
Fixed Assets.	2,000	2,400	2,800
Stock.	3,900	4,900	6,000
Debtors.	4,600	5,000	9,000
Prepayments.	550	680	985
Cash and Bank	50	20	15
	<u>11,100</u>	<u>13,000</u>	<u>18,800</u>

<i>Financed by:</i>	1993	1994	1995
	₦'000	₦'000	₦'000
Share Capital (₦ 1 each).....	3,500	3,600	6,000
Reserves	800	600	1,900
Creditors	5,000	6,100	7,000
Taxation	1,200	1,400	1,500
Dividends	200	300	1,500
Bank	400	1,000	900
	<u>11,100</u>	<u>13,000</u>	<u>18,800</u>

Turnover	9,000	10,000	12,000
Profit before tax	1,568	1,764	2,940
Profit after tax	800	900	1,500

Required:

- (i) Outline the points in favour of the proposal and points against.
(ii) What would be your final recommendation?

Solution

The points expected to be covered in questions are as follows:

(A) Accounting Ratios

	1991	1992	1993
1. Current Ratio	$\frac{9,100}{6,800}$ = 1.34:1	$\frac{10,600}{8,800}$ 1.20:1	$\frac{16,000}{10,900}$ 1.47:1
2. Acid Test	$\frac{5,200}{6,800}$ = 0.76	$\frac{5,700}{8,800}$ 0.65	$\frac{10,000}{10,900}$ 0.92
3. Stock Turnover	$\frac{9,000}{\frac{1}{2}(3,600 + 3,900)}$ = 2.4 times	$\frac{10,000}{\frac{1}{2}(3,900 + 4,900)}$ 2.3 times	$\frac{12,000}{\frac{1}{2}(4,900 + 6,000)}$ 2.2 times
4. Profitability	$\frac{800 \times 100}{9,000}$ = 8.9%	$\frac{900 \times 100}{10,000}$ 9%	$\frac{1,500 \times 100}{12,000}$ 12.5%
5. Debtor Turnover	$\frac{4,600 \times 365}{9,000}$ = 187 days	$\frac{5,000 \times 365}{10,000}$ 183 days	$\frac{9,000 \times 365}{12,000}$ 274 days
6. Creditor Turnover	$\frac{5,000 \times 365}{9,000}$ = 203 days	$\frac{6,100 \times 365}{10,000}$ 223 days	$\frac{7,000 \times 365}{12,000}$ 213 days

(B) Points in Favour

- (i) The business of the company is not speculative and the current assets are more than enough to cover the current liabilities though a stronger position is more desirable.
(ii) Profitability has continued to increase from year to year.
(iii) Turnover has been improving steadily and should continue to do so with the new line of business.
(iv) There had been order already for the goods to be financed with the new borrowing.
(v) Source of loan repayment is known and reliable.
(vi) The fixed assets, the value of which will continue to appreciate, are more than adequate to cover both the old and the new borrowings of the company.

Points Against

- (i) The liquid assets were not enough to cover the current liabilities. With this position the business would not be able to meet its immediate commitments.
- (ii) The stock turnover was not rapid enough. It takes over 4 months to dispose of the stock in each year. Considering the type of business the stock turnover which gets slower each year was too sluggish.
- (iii) Because it increasingly became difficult for the company to dispose of its stocks which continued to mount it had to allow its debtors a much longer credit period in 1993 while it took a shorter credit period from its creditors. This was not a healthy situation as the company would be hard pressed to meet its obligations to its creditors.

Conclusion

- (i) The stock turnover of the companies in the same business should be investigated.
- (ii) The company should be asked to provide a cash flow statement.

The company's new line for which it is seeking the new borrowing is viable. If the cash flow projection is realistic and satisfactory the proposal should be considered.

QUESTION FIVE

Lending policies are likely to differ from bank to bank, as a result of different experiences, different human resources, different knowledge, different practices, and different preference by top management staff. However, there are some basic issues on which every financial institution that lends must pronounce upon. Discuss.

QUESTION SIX

Credit administration involves creating and maintaining credit files. In most banks, the person who issues the loan is supposed to monitor it. In some organizations, the internal auditor does the monitoring alongside with the inspector. NDIC examiners, look at the credit portfolio of banks to be sure that they have credible loans which are performing, non-performing (Doubtful, substandard, lost). The process of loan management is very crucial and important right from when the customer approaches the bank and he/she is granted a credit facility to perhaps when the loan becomes problematic. In the light of the above outline and briefly discuss the lending process.

QUESTION SEVEN

- (a) Mention six parties who are involved in credit administration.
- (b) Mention and briefly explain six factors that cannot be controlled by banks in loan administration.

QUESTION EIGHT

The Banking and Finance Student Association, Covenant University, Ota is organizing send-off party for the final year class later in July, 2010. You have been selected to give a talk on Lending Principles. Discuss the main issues to address in your presentation.

QUESTION NINE

“A loan agreement is an agreement between the lender and the borrower which detail obligation of both parties, which makes certain warranties and usually places certain controls and restrictions on the borrower”. List and explain five of them.

QUESTION TEN

Discuss the specific factors on which every financial institutions that lend must pronounce upon.

Answer

The purpose of a written down policy is to ensure compliance to the laid down rules and regulation, by the bank lending policy and objective regard the loan portfolio and also to provide a standard framework within which they can operate.

Lending policies are likely to differ from bank to bank, as a result of different experiences, different human resources, different knowledge, different practices, and different preference by top management staff. There are some basic issues on which every financial institution that lend must pronounce upon, and these are referred to as:

- Underlined Factors
- Specific Factors

SPECIFIC FACTORS

- I. The marketing of your funds: you must know the proportion of funds to be allocated to all sectors.
- II. Review the policy from time to time.
- III. Terms and condition in which you lend, you only lend to customers who has been in account with you.
- IV. Problem loan must be specified in the policy: problem loan arises as a result of change in policy, loss of key officials. Even when problem loan occurs it is the lending officer who must bring it to the attention of management.
- V. Secured and unsecured credit limit: the lending policy must state who must give what loan, e.g. secured as distinct from unsecured. The administrator of credit is a routine matter and it is important for every bank to develop a handbook or a manual procedure. Rules and regulation guarding lending operation, this must also be reviewed as at when necessitated by changes in the internal and external environment of lending.

- VI. Security, a good security does not make a bad loan good, security is a residual decision, something you fall back on, when it becomes difficult to get repayment from your customer. The policy must specify the kind of securities it will take.
- VII. If your lending policy must serve any useful purpose, it must be stated in writing and the pronouncement must be unambiguous, it must be communicated widely and properly. Your lending policy when pronounced may bring about change in your organization structure, procedure and practices. The policy must bring out low skill gap(Need for training and Education).

QUESTION 11

What strategies do banks employ in their efforts to recover bad debts from their customers?

QUESTION 12

List ten types of collateral/Securities that are acceptable for bank lending and discuss five of them into details.

QUESTION 13

What are the observed causes of problem accounts?

QUESTION 14

Because many banks flout the rules and guideline put in place in respect of Statutory Returns to the Central Bank of Nigeria, the banks are liable to penalties.

QUESTION 15

Discuss the control and preventive measures which banks are expected to take in order to prevent loans/advances from becoming problematic.

QUESTION 16

To enable a banker decide whether to lend or not to lend to customer who has requested for an overdraft facility or a term loan, what performance assessments/measurements will the lending banker use in order to arrive at a logic decision?

QUESTION 17

What, in your opinion, are the causes of frauds in bank?

QUESTION 18

Suggest useful methods of control of frauds in banks.

QUESTION 19

Discuss the types of Statutory Returns which money banks/Commercial banks are expected to render to the Central Bank of Nigeria.

QUESTION 20

How can a Bank Manager monitor the advances in his Branch?

ANSWER TO QUESTION 11

Debt Recovery Strategies

i. Department of Debt Recovery

Staff of debt recovery Department systematically goes after the debtors. This system has proved effective and much recovery has been achieved using staff.

ii. Recovery Agents

These are professional debt recoverers that use many unorthodox methods to recover bank debts. Their earning is an agreed percentage of what they are able to recover.

iii. Litigation

When debt becomes hard core and the debtors are unwilling to cooperate the bank goes to Court. It is not always easy as there are adjournments over and over but the bank usually has its way at last.

iv. Realization Of Perfected Securities

This is the easiest method of debt recovery provided there is perfection of the securities taken from start shares can be sold, and properties can also be sold and proceeds used to pay off the debts.

v. Assistance from NDIC/EFCC

The NDIC has assisted many banks in their recovery strategies over the years. This became prominent in the period between 1996 and 1998 when Failed Banks

Tribunals were set up. NDIC was introducing legal firms to banks who assisted them by writing letters of demand to the debtors. Much recovery was achieved. Demand to the debtors. Much recovery was achieved.

ANSWER TO QUESTION 12

The following securities will be acceptable to the lending banker as security for credits:

- Land and building (legal or equitable mortgage to be taken)
- Debentures on all assets/machinery
- Equipment leasing
- Trust receipt or Trust Letter
- Stocks and shares
- Life insurance policies
- Domiciliation of payment of Book debts
- Assignment of bank Credit balances
- Guarantee of third party
- Hypothecation of goods as security
- Domiciliation of Payment of Debts

1. a). **Legal Mortgage on Land**

- i. Submission of title deeds by the customer to the Branch (Review Unit).
- ii. Land search of Title Deeds by Legal Department to ensure that the property indeed belongs to the mortgagor. The Legal Department issues a certificate of good title once it is satisfied with the issue of ownership.
- iii. Inspection of the property to determine the issue of encroachment before the certificate of good title is issued.
- iv. Upon issuance of certificate of good title the mortgage document is prepared by the Legal Department
- v. Mortgage Document (usually six copies) is then returned to the branch for execution (signing) by the customer and the surety as in the case of a tripartite legal

mortgage (TLM). A TLM is an agreement amongst three parties, the borrower, the surety, and the bank for the property of the surety to be used as security for the borrower's facility.

- vi. Upon due execution by the above, the documents are returned to the Legal Department along with the perfection documents.
- vii. The appropriate bank signatories then sign the documents and an external solicitor is instructed to perfect the legal mortgage.
- viii. Once this is done, the bank now has a legal right to the property offered by the mortgagor, which is vested in the mortgage document.
- ix. The perfected documents are forwarded to the Legal Department by the external solicitors and the Legal Department in turn forwards the original copy and the counterpart to the branch for safekeeping as one of their security documents.

1. b). **Equitable Mortgage on Land**

- i. Submission of the title deeds by the customer (Landed Property).
- ii. All parties to the transaction duly execute completion of memorandum of deposit.
- iii. It should be noted that the equitable mortgage only passes an equitable interest as opposed to the legal mortgage, which passes a legal interest as a result of the mandatory governor's consent obtained to a legal mortgage transaction. A legal mortgage is a right in *rem*, i.e. it gives to the mortgagee, a legal estate in the land so that he has rights against the property itself as well as his right of personal action against the borrower. On the other hand an equitable mortgage is a right in person only i.e. a personal right against the borrower or owner to enforce a claim by invoking the aid of the court but giving no right against the property.

2. **Debentures**

A debenture can be defined as an instrument issued by a person or company acknowledging the indebtedness of a specified sum or an amount, which is outstanding, owned by the company, payable at a fixed date with interest thereof.

In effect, it is a charge over the company's assets or the person's assets. Basically, we have *floating* assets debenture, which attaches all the borrower's assets, and *fixed* assets debenture, which attaches only the specific assets of the company as contained in the debenture document.

Procedure

- i. The customer submits a list of assets i.e. land or chattel to the branch.
- ii. The list is forwarded to the Legal Department for preparation of the debenture document.
- iii. Four copies of the debenture document are forwarded to the branch for execution by the customer and all parties to the debenture.
- iv. Once the customer executes the documents, they are returned to the Legal Department along with the following perfection documents.
 - a). Memorandum and Articles of Association of the company customer.
 - b). Resolution of the Board of Directors of the company authorizing the creation of debenture/charge.
 - c). Photocopy of the company's Certificate of Incorporation.
- v. The authorized signatures of the bank also execute the documents after which an external solicitor is instructed to perfect the debenture. This is done at the Corporate Affairs Commission (CAC) Abuja.
- vi. Once this is done, the bank has a charge over the assets (Fixed or Floating as the case may be) of the company.

The original and one of the counterparts of the duly perfected debenture are forwarded to the branch by the Legal Department for safekeeping as on one of their security documents.

3. Guarantees

A guarantee is a written undertaking or promise by one person who is called the guarantor or surety to be collaterally responsible for the present or future debt, default or miscarriage of another, called the principal debtor. Such promise is being made to the person to whom the principal debtor is or will become liable. To be collaterally responsible means that the original debtor is not released from his liability until all the

debt is paid. All the guarantor promises to do is to pay the whole or part of the debt if the principal debtor fails to do so.

Procedure

- i. The branch instructs the Legal Department to prepare the guarantee document. (In some banks, there are standard forms for guarantee made ready for execution).
- ii. The Legal Department prepares the guarantee and the authorized signatories of the bank execute the document
- iii. The duly executed document is then forwarded to the branch for the customer and the guarantor to execute.
- iv. The duly executed documents are kept by the branch as part of their security documents.

4. Equipment Leasing

Basically, there are two types (1) The Finance (2) Operating Lease.

Finance Lease is the type mostly handled by the banks as lessors and it is either a direct lease or sale and lease back.

The **Direct Lease** involves the bank providing the finance with which to acquire the equipment, while the **sale-and lease back** involves the original owner of an equipment (customer) who is also the user of the equipment deciding to sell the equipment to the lessor (the bank) but with the understanding that the same equipment must be let out (leased out) to him, so that, he can continue to use it and pay the bank the agreed rentals. This arrangement eases the customer's cash flow position. Rental is spread over the economic life of the equipment and there are usually no secondary lease terms but rather a provision for disposal of the equipment according to the terms as agreed by the parties.

The **Operating Lease** is an agreement whereby the owner hires out the equipment to individual users or lessees from time to time for specific periods during which each hirer uses the equipment subject to payment of periodic rentals for such use.

Procedure (Sale and Lease back)

- i. The branch receives an application for lease facilities from the customer.

- ii. The equipment to be leased is inspected to ensure that it is in good working condition.
- iii. The branch obtains approval for the lease transaction from the Head/Office.
- iv. The branch instructs Legal Department to engross the lease agreement documents, which should include the equipment leasing agreement and the sale agreement.
- v. The legal Department obtains the list of equipment to be inserted in the engrossment along with the terms agreed upon, which will be incorporated in the lease agreement.
- vi. Once the document is ready (four copies) they are forwarded to the branch for the customer's execution
- vii. The bank authorized signatories, usually one Director and the Company Secretary, will execute on behalf of the bank.
- viii. After execution by all parties, they are stamped at the relevant stamp duties office.

5. Trust Receipt (Trust Letter)

This is a document signed by the borrower customer who has obtained finance from the bank to acquire goods for sale. The goods have been pledged as security. However, the title to the goods is in the bank's possession. To obtain the goods for sale, the bank releases the documents of title *against the customer's signature on the Trust Receipts* as per the terms in which the customer agrees to sell the goods and pay directly to the bank for liquidation of the facility in place.

This arrangement protects the rights of the bank which otherwise it can lose when it gives up the title documents without the pledge.

Procedure

- i. The customer pledges the goods as security for a facility. In doing so he surrenders the documents of title to the goods to the bank.
- ii. If the bank is agreeable, after due verification, funds are released for payment for the goods (may be imported goods).
- iii. When goods are to be sold for repayment of facility granted, customer asks that documents of title be released to allow for clearance of goods.
- iv. The bank prepares a trust receipt, which is executed by the customer over a N50 stamp and duly witnessed.
- v. The document is kept in safe custody as one of the bank's security documents.

- vi. Title to goods is released to the customer who is now able to deal with the goods and effect repayment of facility.

ANSWER TO QUESTION 13

The observed causes of problem accounts are:

- i. Poor liquidity in customer's business leading to pressure for payment against uncleared effects.
 - ii. Window dressing: A situation where the customer deposits a sum of money into his account and withdraws same amount immediately in order to boost the turnover of the account
 - iii. Frequent request for temporary excesses over and above approved limits
 - iv. Cross firing of cheques: Very common at month ends in order to reduce limits or press down balances on accounts that have been irregularly overdrawn
 - v. Skipping payments on loan installments
- Increase in the number of status enquiries from other banks about the customer's account.

Answer to Question 14

Returns and Sanctions

- i. A warning letter to the MD/CEO.
- ii. Imposition of fine on the bank
- iii. Imposition of fine on the bank official
- iv. Denial of certain services to the bank until compliance with the rendering of the returns
- v. CBN may suspend the bank's operating licence

In the very extreme, the bank's operating licence may be withdrawn

Answer to Question 15

The control measures to ensures that lending (Loans/Overdraft) does not become problematic.

- a. Do a thorough analysis of the proposal for lending before approval and disbursement
- b. Ensure that adequate security is taken and duly perfected before draw down is allowed
- c. Monitor the use of funds lent to prevent diversion of funds to other projects.

- d. Lend within agreed limit, no matter the pressure from the customer to exceed limit. Control excess requests.
- e. Call attention of customer to observed low performance or turnover. The customer may be split banking.