AN ANALYSIS OF THE FUNDAMENTALS OF THE CREDIT APPRAISAL PROCESS. ARE FINANCIALS OVEREMPHASISED?

(THE PRACTICE AT MERCHANT BANK GHANA AND LAURENTIAN BANK CANADA)

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LE PROCESSUS D'APPROBATION DE CRÉDIT – UNE ANALYSE DES PRINCIPES FONDAMENTAUX, DONNE-T-ON TROP D'IMPORTANCE À L'ANALYSE FINANCIÈRE?

<u>LA PRATIQUE À LA MERCHANT BANK ET À LA BANQUE LAURENTIENNE</u>

RÉSUMÉ

La Banque, dans le cours de ses opérations et ses activités, fait face à de nombreux risques, notamment le risque de marché, de crédit, d'opérations, de réputation, de conformité, de gestion et de liquidité. Toutefois, la plupart des sérieux problèmes bancaires sont directement reliés à l'application négligente des normes de crédit pour les emprunteurs et les contreparties, à une médiocre gestion des risques du portefeuille, et à un manque d'attention aux changements économiques et autres facteurs qui pourraient influer négativement la réputation de crédit des contreparties de la Banque.

Le risque de crédit a plusieurs définitions, mais peut être généralement défini comme étant le risque de perte financière résultant du défaut d'un client(incluant l'émetteur d'un titre, d'un garant de ce titre ou d'une contrepartie) de rencontrer ses obligations financières ou contractuelles à l'égard de la Banque pour des raisons d'insolvabilité ou autres.

Le processus d'approbation de crédit, tel qu'utilisé dans ce contexte, réfère à l'analyse et l'évaluation des demandes de crédit reçues par la banque, afin de permettre à celle-ci de prendre une décision pour prêter ou ne pas prêter. Le but est de maximiser le taux de profit ajusté pour le risque de la banque, tout en maintenant son niveau d'exposition au risque de crédit à l'intérieur de paramètres acceptables. Cela comprend les procédures utilisées pour identifier et évaluer les divers risques impliqués dans chaque transaction, et le rôle que chaque risque joue dans le processus décisionnel.

Pour diverses raisons, certaines banques considèrent qu'effectuer une évaluation de crédit approfondie ou une revue préliminaire consciencieuse représente pour eux un défi considérable. Quelques fois, la pression compétitive ou la complexité des transactions financières à analyser rendent la tâche ardue. Toutefois, le plus souvent, c'est un manque

de connaissances adéquates quant au processus d'identification et d'analyse des risques de base qui transforme l'évaluation de crédit en une tâche si difficile.

Les connaissances requises sont fondamentales et, pour cette raison, elles jouent un rôle vital pour rendre le processus d'évaluation de crédit plus efficace. Il est dit que plus de la moitié des prêts délinquants sont le résultat de ne pas avoir pu identifier les facteurs de risque clés à la transaction d'affaires. En effet, l'industrie bancaire américaine avait démarré une campagne nommée "Focusing on the Fundamentals" dans les années 1990s, où l'objectif de cette campagne était d'aider les banquiers à mieux gérer les hauts niveaux de pertes sur prêts et d'actifs non performants (problèmes qui résultaient, selon l'industrie bancaire, de l'inhabilité à identifier les risques clés). (Joseph W. May, Journal of Commercial Lending, Nov.1993)

Afin de réduire ou résoudre le problème des crédits médiocres, la tendance actuelle est de séparer la fonction de crédit (laquelle établit les politiques de crédit et les procédures de gestion des risques, incluant les latitudes d'emprunt) de la fonction des unités d'affaires (laquelle s'occupe du développement d'affaires, de relation avec les clients commerciaux et corporatifs, et du respect des conditions du financement).

Cette séparation des fonctions a du mérite, vu que le secteur crédit peut identifier les risques tout en effectuant ses autres tâches et responsabilités. Toutefois, l'analyse de crédit effectuée par les unités d'affaires, lors de la présentation des demandes de crédit, est toujours absolument essentielle et importante. La raison est simple : c'est eux qui sont en relation directe avec les clients et qui ont accès à des informations cruciales auxquelles le secteur crédit n'aurait pas accès. Ils doivent donc comprendre à fond tous les facteurs de risque et ils doivent pouvoir formuler des demandes de crédit appropriées, car c'est là-dessus que repose la décision de prêter ou de ne pas prêter (Siegel Joy 1994). La gestion efficace du processus d'évaluation de crédit est essentielle au succès à long terme de toute institution financière.

En résumé, les risques fondamentaux qui doivent être identifiés et analysés lors du processus d'évaluation de crédit sont les suivants :

- Risque d'affaires
- Risque de gestion
- Risque environnemental
- Risque de sécurité
- Risque financier
- Risque d'opération du compte

Ainsi, dans la première partie de cette étude, nous présentons une analyse détaillée des divers types de risque et comment ceux-ci peuvent être identifiés et évalués, incluant comment déterminer si ces risques font partie des facteurs clés de succès du client. Il a été dit que l'analyse des risques est un miroir qui, si utilisé efficacement, devient un outil puissant pour les prêteurs. (Kenneth Scott 2003)

Toutefois, un bon processus d'approbation de crédit n'est rien s'il n'est pas appliqué selon de solides principes fondamentaux de gestion de risque de crédit. Ainsi, durant la deuxième partie de cette étude, nous avons posé un regard sur la publication nommée "Principles for the Management of Credit Risk" (Basel, September 2000), où le Comité de Bâle pour la Supervision Bancaire a défini les quatre principes de base requis pour qu'une banque puisse opérer selon un processus d'octroi de crédit sain. Nous avons donc effectué une revue des politiques de crédit et des procédures administratives des deux banques choisies comme sujets, la Banque Laurentienne et la Merchant Bank. Nous avons tenté d'établir si celles-ci varient de façon significative, considérant que nous avons à faire à deux pays dans des juridictions différentes, des environnements économiques et geo-politiques différents, où l'appétit pour le risque diffère grandement, avec l'objectif ultime d'évaluer leur impact sur la fonction de crédit.

Théoriquement, tous les risques énumérés antérieurement sont considérés importants et sont à analyser pour évaluer le risque de crédit relié à chaque demande de prêt. Par conséquent, ils apparaissent dans les demandes de crédit de la plupart des banques. Toutefois, il a été proposé que, lors du processus d'évaluation de crédit, les banques mettent occasionnellement une trop grande emphase sur l'analyse du risque financier, car ils perçoivent les données financières comme étant très importantes.

La troisième partie de ce document tente d'établir si la Merchant Bank et la Banque Laurentienne (les deux sujets choisis) mettent trop d'emphase sur l'analyse financière dans la pratique courante. Pour ce faire, nous avons étudié le processus d'évaluation de crédit, tel qu'identifié et utilisé par les deux banques.

Nous avons effectué la révision de dossiers de clients réels, s'assurant d'analyser divers types de dossiers (petites et moyennes entreprises, grandes entreprises, multinationales, etc...), tout en examinant d'un œil critique l'analyse financière et son rôle dans l'évaluation du risque de crédit.. Nous avons passé en revue divers documents utilisés par les banques pour déterminer le risque financier des compagnies (i.e. : rapports financiers annuels, rapports internes, projections de mouvements de trésorerie, plans d'affaires, etc...), afin d'évaluer leur fiabilité et leur importance dans le processus d'évaluation de crédit, tel que vécu dans les deux institutions. Nous avons aussi complété des entrevues avec le personnel clé dans les secteurs de Gestion du Risque de Crédit, de Vérification, de Recouvrement, et dans les Centres d'Affaires.

Suite à notre étude, nous concluons les suivants:

1. Les deux institutions accordent trop d'importance à l'analyse financière dans le processus d'approbation de crédit.
2. Bien que les résultats d'une entreprise portent à croire qu'elle maintient une bonne santé financière, ceci ne veut pas dire qu'elle est un bon prospect en tant qu'emprunteur.
3. La présence des états financiers vérifiés ne garantit pas la véracité de l'information présentée.
4. Les états financiers sont un compte rendu historique des affaires de l'entreprise, et bien que les plus récents états financiers puissent démontrer une excellente performance, ceci n'est pas une garantie pour les performances futures.

5. Certains des facteurs financiers considérés importants par les institutions financières, tels que la croissance des ventes et la profitabilité, ne sont pas nécessairement des indicateurs positifs.
6. Les standards et conventions comptables sont tels qu'il y a bon nombre de comptables et vérificateurs qui sont disponibles pour manipuler légalement les données financières.
7. Lorsque nous donnons trop d'importance à l'information financière, ceci peut nous porter à avoir une image déformée du profil général du risque d'un emprunteur.
8. La seule façon d'assurer une évaluation pertinente de l'analyse de risque d'un emprunteur est de comprendre le secteur d'activité des affaires de ce dernier.

Finalement, nous considérons la contribution fournie par le personnel de crédit dans les deux institutions financières d'une importance capitale, car ces personnes ont plusieurs années d'expérience pratique. Nous aurions pu étudier le processus d'évaluation de crédit de façon théorique, en passant en revue les œuvres de divers auteurs qui ont écrit sur le sujet. Toutefois, puisque le prêt bancaire est un art, et non une science exacte, nous croyons que l'information de première main obtenue sur les diverses questions et problèmes nous permettront d'avoir un meilleur aperçu sur le processus d'évaluation de crédit, lequel semble être bien connu mais peut encore apparaître quelque peu obscur. Enfin, si ces connaissances sont à la portée de la main de toutes les banques, pourquoi y a-t-il encore chez certaines banques un si grand nombre de prêts considérés sous les normes et un besoin pour la restructuration des prêts et la perception de mauvaises créances ?

Les recommandations à la fin de cet exposé sont proposées pour le bénéfice des deux institutions financières. Puisque l'acquisition de connaissances est un exercice perpétuel, ainsi toutes les opportunités qui nous mènent à acquérir des compétences additionnelles et à agrandir notre base de connaissances doivent être considérées comme un privilège plutôt qu'une critique sur un système ou l'autre.

AN ANALYSIS OF THE FUNDAMENTALS OF THE CREDIT APPRAISAL PROCESS, ARE FINANCIALS OVEREMPHASISED?

THE PRACTICE AT THE MERCHANT AND LAURENTIAN BANKS

ABSTRACT

The Bank, in its operations and its activities, faces various types of risks notably market, credit, operational, reputation, compliance, management and liquidity risk. [1]However, a major cause of serious banking problems continues to be directly related to lax credit standards for borrowers and counter parties, poor portfolio risk management and a lack of attention to changes in economic or other circumstances that could lead to a deterioration in the credit standing of the bank's counter parties.

Credit risk has several definitions, but in general it can be defined [2]"as the risk of financial loss resulting from the failure of a borrower, including the issuer or guarantor of a security or counter party to meet its financial or contractual obligations with respect to the Bank, due to its insolvency or bankruptcy"

The credit appraisal process, as used in this context, refers to the analysis and evaluation of credit requests received by the bank, in order to arrive at a decision on whether or not to lend. The goal is to maximise the bank's risk adjusted rate of return by maintaining credit risk exposure within acceptable parameters. It covers the procedures used for the identification and the evaluation of the risks involved in each transaction and the role each type of risk plays in the decision making process.

Many banks find carrying out a thorough credit appraisal or basic due diligence a substantial challenge for various reasons. There are sometimes competitive pressures or complex financial deals that are difficult to understand. However, more often than not there is lack of adequate knowledge and understanding of how the basic risks are to be identified and analysed.

[1] Basle Committee on Banking Supervision 2001 'Principles for the management of credit risk'
[2] ibid p 3

This knowledge is considered fundamental to the credit appraisal process and for this very reason it plays a vital role in its effectiveness. The inability to identify key risks inherent in business transactions leading to poor credit analysis has been said to account for more than half of all substandard credit. Indeed in the 1990,s a campaign for the US banking industry designated [3]"Focusing on the Fundamentals" was launched to help bankers deal with the high level of loan losses and non performing assets resulting from this problem.

The bid to resolve the problem of substandard credit has also led to the current trend, where the credit function (that establishes credit policies and risk management procedures with lending limits) is separated from the business line function (commercial and corporate banking/relationship management who are responsible for business development, client relations and compliance with financing conditions).

This separation has its own merits. The credit department acts as extra eyes for risk identification amongst other functions and arguably prevents moral hazard. The credit analysis done by the business units in the presentation of credit requests is however still absolutely important. This is because the business line function has direct relationships with the clients and has access to crucial information that is not available to the credit department. [4]This underscores the fact that they must thoroughly understand all the risk issues and formulate good credit or loan proposals, as this is what the decision on whether or not to lend hinges on as confirmed by Siegel Joy. The effective management of the credit appraisal process is essential to the long-term success of any banking organisation.

Broadly the fundamental risks that are identified and analysed in the credit appraisal process are the following:

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[3] May J. W. (2000) 'Focusing on the fundamentals' *Journal of Commercial Lending* Vol. 85 No. 6 November 2000

[4] Joy S. 'Write it right: These tips can improve your credit analyses' *Commercial Lending Newsletter* Vol. 26 No. 11 November 1994

- Business risk
- Management risk
- Environmental risk
- Security risk
- Financial risk
- Account performance risk

The purpose of this dissertation, in the first part of the study was to present a thorough analysis of the various types of risks and how they can be identified and evaluated, including how to determine if they are part of the client's critical success factors. [5]The credit appraisal mirror has been described by K M Scott as one of the tools available to lenders that if used effectively can be all powerful.

A good credit appraisal does not result in much success if a bank does not operate under sound principles for the management of credit risk. For the second part of the study therefore we studied the recommendations of Basle under the "Principles for the Management of Credit Risk". As part of the study we reviewed the relevant credit policies and administrative procedures of the BLC and MBG to find out if they are in compliance with these principles.

In undertaking a thorough credit appraisal following a request for a facility, all the risks enumerated earlier are said to be important. Accordingly they are required to be analysed to determine the credit risk of the request and their analysis is featured in the loan applications of most banks. The general observation of the main practitioners i.e.(credit analysts, credit risk managers, business unit heads and relationship managers) is that financial risk analysis, due to its perceived importance, is overemphasised.

[5] Scott K. M. (2003)'Understanding Mirror Images', *Risk Management Association Journal* Vol.85 No. 7 April 2003

The third part of this dissertation sought to establish, with respect to the two banks chosen as subjects, whether or not this actually occurs in practice. In order to do this, we studied the credit appraisal process at both banks.

The work involved review of actual client files. It was important to analyse various types of clients (small and medium businesses, large corporate entities, multinationals), and look critically at financial analysis as it pertains to the evaluation of credit risk. The various documents used by the Banks to determine the financial risk of the companies (i.e.: annual reports, management accounts, cash flow forecasts and business plan of the company) was also reviewed in order to evaluate their credibility and importance in the credit appraisal processes of both institutions. Interviews were also held with key staff in the Credit Risk Management Departments, Business Units, Audit Departments and Recoveries Units.

From the study we arrived at the following conclusions:

1. Financials are overemphasised in both institutions in the credit appraisal process
2. The fact that the financials of a company show a healthy position does not mean that it is a good lending prospect.
3. The presentation of audited financial statements does not guarantee the authenticity of all the information presented in the statements
4. Financial statements present a historical account of the affairs of a company and even though the latest financials may show excellent performance it is not a guarantee of future performance.
5. The figures that financial institutions zero in, like growth in sales and profitability may not necessarily be positive indicators.[6]
6. Accounting standards and conventions are such that there is room for unscrupulous accountants and auditors to massage figures legally.
7. Overemphasis on financial information plays down the importance of the other elements in risk analysis and may lead to a distorted picture of the overall risk profile of the borrower

[6] Boyadjian and Warren (1991) *Risks, Reading Corporate Signals*, London, John Wiley and Sons

8. It is only in understanding the business of a borrower that any meaningful risk analysis can be undertaken.

Finally, we consider vital the input provided by key credit staff of both banks, as they have several years of practical experience. This topic could be looked at from the theoretical point of view, by reviewing the work of various authors on the subject. However, since lending is an art and not a science, we believe a first-hand experience of issues added benêficial insights into a process that appears to be well known, but which in reality may not be so. Indeed, if such knowledge were available to all banks, there would have been a lower level of substandard credit and less pressure for restructuring and recovery of loans.

The recommendations made are for the benefit of both institutions. Since the acquisition of knowledge is considered as a perpetual experience, any opportunity to add to our skill set and knowledge base should be considered as a privilege rather than a critique of one system over the other.

LITERATURE REVIEW

Undertaking a thorough credit analysis of a request presented by a client has been the bane of many a Credit Analyst or Relationship Manager as the case may be as the role is handled by different categories of persons at different Banks. Research has revealed that this is principally due to the fact that there is no text that provides comprehensive information on what to look out for when analysing these risks. [7]Hrishikes Bhattacharya, has for example tried to provide comprehensive material for credit appraisal but was not been able to raise all the key issues that may arise. Various banks have also tried to design manuals that provide information on these risks but in the main they have ended up simply describing the risks invariably in prose form but have not been able to exhaust all the areas under each type of risk or prodded the analysts mind as to what questions one needs to get answered to obtain the required information.

In the case of Merchant Bank there have been some attempts to provide a guide for the training of new analysts, which will at the same time act as a refresher for old analysts, but this has rather been sketchy[8]. In the case of Laurentian Bank there is a manual [9]'Guidelines for the preparation of credit applications' but is not as comprehensive as what this dissertation has sought to do. Part one of this dissertation is therefore to serve as a reference for Relationship Managers/Analysts in the discharge of their duties.

In the second part of this dissertation we sought to review the recommendations of the Basle Committee on Banking Supervision with regard to credit risk management known as the 'Principles for the Management of Credit Risk'. Credit Risk is a major source of bank failures and the recommendations of the Basle Committee have been made after several sessions from seasoned bankers from all over the world. They have sought to put into this document recommendations that the two banks studied have adopted as part of their management systems for credit risk. What the dissertation addressed is what these recommendations are and whether the Banks' had adopted these principles in practice. In doing that we had to review the Credit Policy Manuals of both banks to find out the

[7] Hrishikes Bhattacharya (1999) *Credit Appraisal and Lending Decisions*, Oxford University Press
[8] Credit risk analysis, Credit Risk Management Department. Merchant Bank 2001
[9] Guidelines for the preparation of credit applications, Laurentian Bank, 2003

policies outlined therein were in line with the recommendations made by the Committee. In certain instances also we sought to find out if the Banks put the policies stated in active practice.

The third part of the dissertation sought to establish if financials are overemphasised in the credit appraisal process. The question originated from the challenges encountered by analysts in their appraisal of various credit requests from all categories of clients. Infact the issue had also come up at various credit conferences of the MBG when the Bank sought to determine if its credit appraisal processes had to be redesigned. This was in the wake of problems that the Bank had encountered with clients that appeared to be financially sound from their annual reports but that had defaulted nonetheless. A contact with BLC also revealed that this was a subject that had come up at various fora of the Credit Risk and Corporate Departments and was of keen interest to them.

A critical review of literature on the subject however proved to be quite disappointing. There were various articles on how to undertake in-depth financial analysis covering the whole gamut of ratios, financial data and the importance of the whole process on the credit appraisal process. [10]Erich Helbert gives a particularly helpful insight on what is important in financial information. The articles on Getting behind the numbers in the Risk Management Association Journals also offers great aid to understanding the 'stories' behind the numbers reported. There was also material on the misinterpretations that could be ascribed to financial information if the analyst was not shrewd as described [11]Jason Winsor. [12] Gronseth, Helleloid and Wilson also give in-depth information on what lenders want and expect.

[10] Erich A Helbert (2002) *Techniques of financial analysis*. McGraw Hill 11th Edition

[11] Winsor J. 'The financial performance game' Risk Management Association Journal, Vol. 83 No.2 October 2000

[12] Gronseth M.D, Helleloid A.B and Wilson R.T'Financial Statements, what do today's lenders want and expect' Risk Management Association Journal Vol.89 No. 2 October 2000

What was obviously absent was the role that this process should play in the credit appraisal process as a whole and the importance that should be placed on this with regard to the analysis of the other risks. There was also not enough information of the actual kind of analysis that should be undertaken for various categories of customers. There also appeared to be no previous work on whether or not financials are given too much prominence in the credit appraisal process. This is what the third part of the dissertation sought to address.

PART ONE – FUNDAMENTALS OF THE CREDIT APPRAISAL PROCESS – RISK ANALYSIS

INTRODUCTION

The main objective of credit risk analysis is to determine the ability and willingness of a borrower to repay a credit facility and to examine the appropriate covenants that should be imposed on the borrower in order to safeguard the position of the bank as a lender. This exercise is absolutely essential, as the Bank is only willing to assume a certain degree of risk on each loan proposal.

In undertaking the credit appraisal for facilities, there are guidelines as contained in the Credit Policy document or operations manual of most financial institutions, which identify the general content and format of the credit request. More important in regards to the content, is the issue of the fundamental risks analysed. These risks may come under various headings and various descriptions, and there are often differences in what they should cover, but on the whole these come under the form and scope as indicated below.

From the theory and practice of lending as presented by Kenneth M Scott ,[13] the credit appraisal process (risk analysis) is supposed to act as a mirror through which all potential deals are looked at to determine if they are acceptable. Scott concludes that credit appraisal is one of the most powerful tools available to the banker for the management of credit risk.

Below is a presentation of the various risks that go into a solid credit risk analysis.

1.1 BUSINESS RISK

This refers to the risk of the business as an entity and also the risk of its operations. To be able to undertake a good analysis of the risks of a business it is mandatory to know the business very well. Consequently, one needs to take a look at the sources of information

[13] Scott K. M. (2003)'Understanding Mirror Images' op cit. p 82

on the business, such as onsite visits, the borrower himself, the accounting firm used by the borrower, the borrower's staff, his competitors and his suppliers. The following are some of the areas one must investigate thoroughly to ensure that this risk is adequately analysed.

1.1.1 Core activity of the business:

- Is it a workshop, assembly line, retail sales or services oriented company?
- What is its average production time? Does production time hurt the capital of the business; does it affect the inventory levels negatively so that potential sales are lost?
- What type of services or goods is offered?

1.1.2 Entrance into the industry/Competition:

- Is it easy for others to enter into the industry or are there trade barriers?
- What are the required levels of technical expertise and technical know-how? What level of capital is required?
- How easily can competition develop in the industry in which the client operates?
- What is the firm's strategy in order to beat the competition?
- Does it have a comfortable market niche? How can it improve its position?
- What about the availability of raw materials?

1.1.3 Type of operations:

- Are the operations of the business labour intensive or capital intensive?
- If operations are labour intensive, are employees readily available? What kind of wages do they receive and are they regulated, unionised?
- If operations are capital intensive, what is the condition of the fixed assets? When are they to be replaced or expanded? Is the availability of equipment assured?

1.1.4 Conditions of the company's facilities:

- Are the facilities well maintained or are there signs of deterioration?
- When are improvements due and is an expansion possible?
- Has the business confirmed that there are no pollution problems?

- Are the facilities specialised or general in nature?
- Could they be sold or sub leased to another type of firm

1.1.5 The company and technology:

- Are technological changes frequent in this field?
- Is substantial employee retraining or equipment change required?
- Can these changes be made within a reasonable time and at a reasonable cost?
- Is the technical equipment adequate and well maintained?
- Does the equipment belong to the firm or is it leased?
- Are there alternative solutions to the capital expenditures?

1.1.6 Sales and/or production schedules:

- Are the sales and/or production seasonal or continuous?
- In the case of seasonal sales, is the production regular or irregular?
- What happens to the facilities and the employees during slack periods?
- What is the impact on the carrying costs of the company?
- Is the production of the company based on orders or estimates?
- Are advances paid on the orders of the company?

1.1.7 Nature of the inventories:

- Do inventories consist of specialised products or products that can be used for other purposes? Do they consist of raw materials, goods in process or finished goods?
- Are there personalised packaging materials?
- Is inventory rotation adequate?
- Are the inventories perishable, or do they easily become obsolete within a short time?

1.1.8 Raw materials – components and supply:

- Are raw materials easy to obtain?
- Are the costs predictable?
- Are the suppliers reliable?

- Is the order lead-time long?

1.1.9 Nature of the finished goods/work or goods in process:

- Are the finished products specialised or are they easy to sell?
- How long can these products be stored, given style and novelty?
- If there are goods in process, can they be easily sold "as is", or must they be finished prior to sale?
- What are the necessary elements to get them to the finished goods stage? What are the costs?

1.1.10 Payment conditions offered by suppliers:

- Are the terms satisfactory and does the firm take advantage of them?
- Do they compare favourably with the terms offered by other suppliers?
- Is it possible to have these terms improved?

1.1.11 Specialised and non-specialised labour:

- Is a labour force readily available?
- Is training adequately provided for the labour force?
- Are the employees loyal or are they quick to badmouth the company or leave their employer?
- What is the salary structure?
- Is the staff strength stable or decreasing?

1.1.12 Labour relations and unions:

- What is the nature of relations maintained with the union?
- When does the collective agreement expire?
- Will its renewal lead to a substantial increase in wage costs?
- What is the labour turnover?
- What is the quality and availability of labour?

1.1.13 Market risk:

- What percentage of the market is the business controlling?
- Is the company in a monopolistic or oligopolistic market, i.e.: is it a price taker or a price maker?
- Is the market for the business' product national or international?
- What is the present stage of the life cycle of the product manufactured or sold by the business?

When answers to these questions have been provided, the credit analyst will be in a position to determine the risk of lending to that business. If, for example, the company is into the production of a commodity that requires imported raw material, and you (the banker) are aware that due to the exchange control regulations it will be increasingly difficult to pay for exports, then it is a "red flag" or a critical success factor. A critical success factor is a factor without which the company will find it difficult to operate. It is also a factor that needs to have been identified by the business, and for which management has contingency plans. These success factors exist for every company. The good credit analyst is the one that identifies these factors and finds out the company's perceptions and contingency plans for them.

1.2 MANAGEMENT RISK

The management risk of a company refers to the risk associated with personnel at the helm of the company's affairs. The analysis of management risk should take into consideration the persons who are able to influence the decision-makers. It should additionally take into consideration the sometime complex organisational politics and power struggles between key personnel.

The sources of information on the borrower are again quite numerous: the borrower himself, the borrower's competition, on-site visits, his relationship with the bank, his staff and any other person to whom the bank has access to and who knows the borrower appreciably. Detailed below are the points to consider when making the analysis. It must however be emphasised that the information received may be subjective, and should therefore be verified whenever possible.

1.2.1 Trustworthiness of management:

- What is the educational and social background of management?
- What is its reputation within the community at large and the business community?
- What is the past credit history of key management?
- Is there a code of ethics and does management follow its guidelines?

1.2.2 Management skills:

- Does management have knowledge of the industry sector?
- Does management regard planning, marketing, cost controls, etc… as important tasks to ensure the company's success?
- Do they have the appropriate skills to ensure proper operations, cost controls, etc…?
- Can management help the company to adapt to technological change?
- Does management give the professional staff leeway to exercise their professional judgement, or does it interfere in areas it has no concrete knowledge?
- Is management looking to expand the company's capability or is it content with the current state of affairs?
- Does management sacrifice the future in favour of short-term results?
- Is the bottom line the only concern for the company?

1.2.3 Key personnel/age/succession:

- Does management rely on a single person or is it dominated by family-owners that lack professional capabilities?
- Will management positions be filled in a short while?
- Is there any succession planning?
- Does younger management receive adequate training?
- Is management offered profit sharing or other benefits that bind them to the company?

1.2.4 Goals set by management:

- Can management achieve the goals that they set? Are they realistic or are they overly ambitious and involve too much risk?
- Is the planning focused on goal achievement?
- Are the company's results compared to its forecasts?

1.2.5 If the owners of the business are not its managers, then the following questions need to be considered:

- What motivates the owners?
- Do the owners share a sense of responsibility?
- Do they show leadership, do they have enough control?
- What type of relationship do they maintain with management?
- Do the owners or members of management have financial problems or personal goals that would entice them to withdraw from the company amounts that it cannot afford?

1.2.6 Board of directors:

- Has a board of directors made up of persons not related to the company been formed?
- Who are the members of the board of directors?
- Do they have a good understanding of the line of business?
- Do they work in related fields?
- Are they dynamic and responsible?

1.2.7 Overall assessment process:

- What are management's reactions to the questions and/or concerns raised?
- Are they aware of the important factors and do they pay attention to them?
- Are their decisions and/or projects logical and attainable?
- Is management honest, evasive, arrogant or co-operative?
- Have they maintained a good business relationship with the Bank?
- Do they adopt a realistic attitude to major issues?
- Are there any indications of conflicts or confusion?

It is usually recommended that a meeting be held with management in order to discuss the relevant issues that may have come up during the information seeking process. This meeting gives an even more critical insight into the fibre that management is made of. Temptation often leads us to conclude on management's ability to handle the affairs of a company too hastily. The erroneous impression is that, if they are educated and have some level of exposure, then they must be good managers. However, so many other factors come into play that one must take care to eliminate as much subjectivity as possible.

It is argued that the most important element under management is its integrity. An honest management will provide authentic financial information and present the facts as they are on the ground. There are others who would argue on the side of expertise, as that is what it takes to run a business. The two are undoubtedly critical success factors for management.

1.3 ENVIRONMENTAL AND/ OR SOCIAL RISK

Economic, political, legal and socio-cultural factors all impact businesses in various ways. Socio-cultural factors, such as demographics, income distribution, social mobility, lifestyle changes, and normal practices of the people also form part of the environment, along with health and other factors. Environmental issues related to health hazards are now very important, since a client's failure to comply with government regulations may lead to a reduction in the client's solvency ratio, a reduction in the value of the security held by its banker, legal action, a tarnishing of its reputation (or even the bank's reputation). The possible sources of information are the local newspapers, national papers and specialised business magazines, the borrower and other clients. Questions and issues to be addressed are listed below.

1.3.1 Compliance with environmental rules and regulations:

- Does the company use any chemicals that may be considered dangerous?
- Does it have any dangerous waste products? How are they disposed off?
- Are there precautions taken in the event of an environmental accident?

- Does the company have an environme il permit to operate?
- Has the company had problems with c npliance in the past?
- Is the factory situated in a highly po lated area, where the presence of hazardous substances could endanger health?
- Do the adjoining properties produce w te that may endanger the client's operations?

1.3.2 Economic events and their impa on the client's business:

- What are the major economic events a he local, national, international levels?
- How will they affect the client's bu ness (labour, supply of goods, delivery and exports, etc…)?
- How will the economic situation evol to in the next 12-18months?
- What is the impact of inflation, mon y and taxation policies on the business (i.e.: on its interest rates, import and exp prices, cost of inventories, labour and debt service)?
- How will this affect asset valuation an replacement costs, purchase habits, etc…?

1.3.3 Government regulations:

- Are there any restrictions in place for nvironmental protection? How do they affect the client?
- Are there any protectionist tariff polici in regards to the client's industry?
- Is the business subject to zoning, licen ig or royalty regulations?
- Is the business affected by national int est policies, such as in the energy sector?
- Does government impose any price co rols?
- Are there import and exchange regulat ns and how do they affect the client?

1.3.4 Demographic, social and market actors:

- Are the borrower's products/proje suited to demographic changes, such as population growth or decline, income nd age?
- Is the sector based on well-established roducts or fads?
- Is the project suited to cultural practic and/or religious beliefs?

- Does the client play a dominant role in the sector?
- What is the client's market segment? (Note: In difficult times, companies dealing with the upper market segment are less affected by the risk of demise.)

1.3.5 Political and legal factors:

- What is the current political situation in the country?
- How does it affect the business?
- What are the laws of the country and their impact on the company's operations?

1.4 SECURITY AND/OR COLLATERAL RISK

For every facility that is granted, the Bank has to decide whether or not to cover its exposure. It must then clearly define what it will accept as security, as every security and/or collateral has an element of risk attached to it. The analysis of this risk is necessary to ensure that the bank adequately evaluates its collateral for each borrower, in order not to be fooled into thinking that it has a fall back position, when in reality this is not the case. If, for some reason, the Bank decides to leave an exposure uncovered (without security/collateral), this must also be justified in some way, as it is a rule of lending that facilities should only be granted when cash flows can support its repayment. Nevertheless, the Bank needs to have a fallback position, or else it will face total financial loss in the event of default. Factors that affect the level of security risk are numerous.

- Perishability of the security: If the condition of the collateral deteriorates then the goods cannot be sold.
- Price volatility: If the security is in the form of commodities, then pricing will have a real impact on its value.
- Marketability: Specialised assets (like drug manufacturing plants and industrial equipment) may be difficult to sell.
- Documentation risks: Incomplete collateral documentation may lead to the Bank's inability to realise on default of the customer.

- Lack of and/or improper valuation of security/collateral: Unrealistic valuation leads the Bank to overestimate its realisation value for collateral.
- Insurance coverage: One needs to determine if there is insurance to cover fire, theft, flooding, legal liability, operating losses and perhaps receivables (if from clients overseas). Security that is covered by adequate insurance (with assignment to the Bank) reduces the risk of loss upon the collateral's deterioration or destruction.
- Consideration of overriding interest in the property given as collateral: Overriding interest refers to a party who is in a position to claim an interest in the property prior to the bank's charge.

1.5 FINANCIAL RISK

The review of financial information provided by the business (i.e.: balance sheet, income statement, projected cash flow statement and any other financial information that may be provided) allows the Bank to evaluate financial risk for its client. Other sources of information on the financial standing of the company are: the borrower's accountant, finance manager or auditor, solvency reports, etc… The points to consider are as detailed below.

1.5.1 Financial statements:

- Are they audited? Do the auditors have a good reputation? Has the company changed auditors lately?
- Is the statement without qualification?
- How current are the statements? How relevant are the accompanying notes?
- Are interim or in-house statements available?

1.5.2 Significance of the figures:

- Are the financial statements consolidated or non-consolidated?
- Do they reflect the true value of the assets and the performance of the borrower?
- Is the cash flow between the subsidiaries clearly indicated?
- What are the rights and/or guarantees associated with the commitments?
- What is the nature of the assets and the true value?

- What will be the impact of debt or future commitments on profitability?

1.5.3 Relevance of the ratios:

- How do they compare through the fiscal years?
- How do they compare to the industry?

1.5.4 Profitability:

- Do profits support the sales figures?
- Do profits support the working capital?
- Will profitability ensure the repayment of long-term debt?
- Will the rate of return of the assets and/or shareholders' equity be maintained?
- Is the profitability sufficient to ensure an adequate standard of living for the owners?
- Is sales growth acceptable?
- Are earnings provided by the core business or from exceptional items?

1.5.5 Cash assets:

- Are they adequate enough to meet the requirements of a normal operating cycle, to pay creditors and to repay existing commitments to the bank?
- Are the accounts receivable and payable days, as well as inventory, acceptable within the industry?
- Does the company have excessive loans?

1.5.6 Financing capacity:

- Are forecasts prepared and are the assumptions acceptable?
- How did past forecasts compare with actual figures?
- What would happen if forecasts did not materialise within a margin of between 10% and 50%?

It should be noted that financial forecasts are especially relevant when the purpose of the financing is to start up a new company, finance a project, support seasonal sales and allow for major changes in company operations.

1.6 ACCOUNT PERFORMANCE RISK

The company's history and account performance at the Bank will also reflect on the credit appraisal process. With a new client, the Bank may look at its existing account with its prior banker. If company accounts are not available, the Bank may look at management or shareholders' accounts. Some of the issues reviewed in order to project future company operations are as follows:

- How well has the account performed to date?
- Is it in line with its cash flow projections?
- Has the company broken any covenants or failed to live up to promises?
- Have there been some returned cheques and is there any overdue interest?
- Is there multi-banking and cross firing of cheques?
- Is there a high level of hardcore borrowing?
- Is the account taking more time to manage than normal?

1.7 CONCLUSION

Many credit problems reveal basic weaknesses in the credit review process. It is believed that, with the requisite understanding of the fundamental risks inherent in a credit request and thus a thorough analysis of these, the bank will be in a position to address some of these weaknesses. Furthermore, the banking industry is becoming increasingly competitive, and with the globalisation of credit markets, there are more loan syndications, complex loan requests and the use of derivative instruments.

[14]The understanding of the fundamental credit risks will form the knowledge base upon which the expertise to appraise more complex credit requests will be built.

[14] Mueller H.'Credit Policy: The Anchor of Credit Culture' Citicorp Credit Policy Committee 1994

PART TWO – PRINCIPLES FOR THE MANAGEMENT OF CREDIT RISK AS DETERMINED BY THE BASLE COMMITTEE AND AS APPLIED BY THE TWO FINANCIAL INSTITIONS

INTRODUCTION

The realisation that credit risk is a major cause of serious banking problems has led banks to adopt credit risk management procedures and principles for its management. The Basel Committee on Banking Supervision, in its paper [15]"Principles for the Management of Credit Risk", outlined sound principles that cover broadly the following areas;

a) Establishing an appropriate credit risk environment
b) Operating under a sound credit granting process
c) Maintaining an appropriate credit administration, measuring and monitoring process
d) Ensuring adequate controls over credit risk

It is our intention to outline in general the principles under each of the areas and to determine if the two financial institutions under study have adopted them.

2.1) ESTABLISHING AN APPROPRIATE CREDIT RISK ENVIRONMENT

2.1.1) Principle one: The board of directors (BOD) should have responsibility for approving and periodically reviewing the credit risk strategy and significant credit risk policies of the bank. The strategy should reflect the bank's tolerance for risk and the level of profitability the bank expects to achieve for incurring various credit risks.

As with all other areas of bank activities, the BOD has a critical role to play in overseeing the credit granting and credit risk management functions. In fact, every bank is expected to develop a credit risk strategy or plan that establishes the objectives guiding the bank's credit granting activities and adopt the necessary policies and procedures for

[15] Basle Committee on Banking Supervision 2001'Principles for the Management of credit risk op.cit.

conducting such activities. The BOD should review the strategy and procedures periodically.

The credit risk management system at the Laurentian Bank of Canada (BLC) is determined by its Credit Policy Manual (dated June 7, 2004). The Credit Committee of the Bank prepares the document with a special mandate from the BOD who determined the general policy outline

In managing its credit risks, the Bank complies with all laws, regulations and directives, in particular with the Bank Act and related regulations, the Guidelines of the Office of the Superintendent of Financial Institutions, the standards of sound business and financial practices of the Canada Deposit Insurance Corporation, and the manual of the Canadian Institute of Chartered Accountants. In the case of the Merchant Bank (MBG) the Credit Risk Management is determined by its Credit Policy Manual dated August 2004 prepared by the Credit Risk Management Department with a mandate from the BOD who also determined the general policy outline. The document complies with the Banking Act 673, Bank of Ghana Regulations and Basle Committee Principles for the management of credit risk. Both documents outline amongst other things the respective banks' appetite for risks and the reward there from.

Each bank periodically reviews the credit policy manuals. For BLC this is done every two years, but for MBG the reviews have not been regular. Reviews have been known to have more than 5 years interval. The problem has however been identified and the present policy is to undertake a review every year.

2.1.2) Principle two: Senior management should have the responsibility for implementing the credit risk strategy approved by the BOD and for developing policies and procedures for identifying, measuring, monitoring and controlling credit risk. Such policies and procedures should address the credit risk in all of the bank's activities and at both the individual credit and portfolio levels.

Senior management is responsible for implementing the credit risk strategy approved by the BOD. For both banks the Credit Risk Management Department is responsible for *ensuring that the banks credit granting activities conform to the established strategy and that written procedures are developed and implemented with loan approval and review responsibilities clearly and properly assigned.*

The mandates of their credit departments amongst others are the following:

- *Be the driving force behind the credit risk management of the bank.*
- *Elaborate the policies, procedures and information systems related to the risk management of actual and potential risk of the bank.*
- *Authorise credit within the delegated limits.*
- *Determine credit risks in policies and products of the bank*
- *Develop credit policies and submit them to Credit Committee for approval.*
- *Prioritise actions for improving credit risk management at the Bank.*
- *Evaluate credit applications, track client progress and ensure that deteriorating loans are reported and action taken as appropriate.*

2.1.3) Principle three; Banks should identify and manage credit risk inherent in all products and activities. Banks should ensure that all products and activities new to them are subject to adequate procedures and controls before being introduced or undertaken, and approved in advance by the BOD or its appropriate committee.

The basis for an effective credit risk management process is the identification of the existing and potential risks inherent in any product or activity. This is even more important for complex credit granting activities like asset securitisation, customer written options, credit derivatives and credit linked notes. The Credit Risk Department of both banks as indicated earlier, undertakes this activity. This job is simpler in the case of MBG, as the Bank offers the more traditional banking products.

2.2) OPERATING UNDER A SOUND CREDIT GRANTING PROCESS

2.2.1) Principle one: Banks must operate within sound credit granting criteria. These criteria should include a clear indication of the bank's target market and a thorough understanding of the borrower or counterparty, as well as the purpose and structure of the credit, and its source of repayment.

Establishing sound, well-defined credit granting criteria is essential to approving credit in a safe and sound manner. The criteria should set out who is eligible for the credit and for how much, the types of credit available and the terms and conditions under which the credit should be granted.

Banks must receive sufficient information to enable them to undertake a comprehensive assessment of the risk profile of the borrower. At the barest minimum, the following factors are considered essential for the credit review process:

- *The purpose of the loan and the source of repayment.*
- *The integrity of and reputation of the borrower.*
- *The current risk profile of the borrower and its sensitivity to economic and market conditions.*
- *The borrower's repayment history and current capacity to repay, based on historical financial trends and cash flow projections.*
- *A forward-looking analysis of the capacity to repay based on various scenarios.*
- *The legal capacity of the borrower to assume the liability.*
- *For commercial credits, the borrowers business expertise and the status of the borrowers economic sector and its position within the sector.*
- *The proposed terms and conditions of the credit, including covenants designed to limit changes in the future risk profile of the borrower.*
- *The adequacy and enforceability of collateral or guarantees under various scenarios.*

Once these credit granting criteria have been established, the onus is on the bank to ensure that the information it receives is adequate for a sound credit decision to be made.

The credit review process of both banks has been studied in depth, as detailed in the third part of this dissertation. Suffice it to say at this point that, in general, the factors recommended above are all covered in credit risk applications or requests.

The problem however lies in the quality of the information received and, at times, the weight placed on some of the factors as compared to the others.

Target market

BLC has stated in its mission that it wants a stable market share in the commercial sector. It has a stated preference for businesses that have a demonstrated record of profitability, which normally excludes start up companies. Exceptions aside, it has stated that loans need to be secured by either inventories, accounts receivable, equipment, real estate, financial securities or guarantees of individuals of considerable net worth.

The main target market is companies where BLC is the main banker, or where it has a chance of becoming so, and companies in whose industries it may have experience. Industries in which the Bank has little experience are only to be considered in cases where financial partners, such as the Caisse de Dépôt, Fonds des Travailleurs du Québec, Société de Développement Industriel, or established venture capital firms, have provided significant equity capital or when the Bank holds easily marketable securities.

The Bank has also clearly indicated the preferred sectors and products, which are in the areas of transportation, manufacturing and distribution, or companies in related industries. The areas in which it does not wish to do any financing are: wood product manufacturing, forestry and logging, oil and gas extraction, textile mills and clothing manufacturing, textile/clothing/footwear wholesaler distributors, telecommunications, construction, arts/entertainment/recreation, and motor vehicle and parts dealers. The rest include film production, restaurants and bars, caterers and bowling centres and illegal activities.

In the case of Merchant Bank, four customer types have been identified as the target market. These are corporates, investment institutions, government and financial institutions. Lately SME's and retail clients have been added albeit on a smaller scale. No clear-cut guidelines have been given on the characteristics of these customer types.

There also appears to be a policy lapse on the sectors of the economy in which the bank is interested in financing. Discussions with the senior management of the Bank indicate that the sectors of the economy that the Bank is interested in are being defined. Limits for geographical areas and products will be allocated in due course. The tentative date for this is September 2005.

The credit policy has however defined the areas in which the bank is not interested in financing as: hostile acquisitions, politicians or political parties, money laundering activities, start-ups and trade in banned substances or endangered species.

MBG facilities need to be secured preferably by landed property, plant and equipment, life policies, inventories, accounts receivable, equipment, financial securities or guarantees of individuals of considerable net worth.

Understanding the borrower's business

It is a credit policy of both banks that the business of the counter party or the borrower should be thoroughly understood, and they therefore undertake a comprehensive risk assessment of the borrower, as well as the risks inherent in the transaction, through the credit appraisal process as detailed in part three of this dissertation. From interviews held with the heads of credit risk, the general policy is that the banks have no business lending to sectors that are not very well understood.

The purpose and structure of the facility and the primary source of repayment are also covered in the credit appraisal process.

Trustworthiness of borrowers

There are strict policies in place at BLC to ensure that credit is granted to trustworthy and credit worthy borrowers. The Bank has a policy of checking the Equifax reports of individuals involved in a business and also Equifax reports on the business itself. The relationship managers are also encouraged to know their clients, even out of business circles.

In MBG this is done through soliciting opinion requests on their clients from other banks. Relationship Managers are also encouraged to know their customers out of business circles. The downside of this is that sometimes this may lead to over familiarity with the client with its attendant problems.

Source of repayment: lending against cash flow not collateral

Whilst banks can utilise transaction structure, collateral and guarantees to help mitigate risks (both identified and inherent) in individual credits, it is a precept of lending that transactions should be entered into primarily on the strength of a borrower's repayment capacity. The reasoning behind this is obvious. There is risk in the event of foreclosure, as the proceeds of any collateral sale may fall short of the outstanding debt. That notwithstanding, banks are required to have policies covering the acceptability of various types of securities and their continuing valuation, in order to ensure its continuing enforceability and realisation.

With regards to collateral, the BLC has outlined the various types of security that are acceptable, as well as the standard margin. For example, for financial securities, the margin ranges from Canada savings bonds and Quebec savings bonds that have 100% face value plus accrued interest, Federal bonds that have 95% face value, provincial bonds at 85% through to emerging market funds that have 35% face value.

In the case of MBG, the securities that are normally preferred (landed property, treasury bills, guarantees from first class financial institutions) are outlined. The margins for MBG are not outlined in the CPD but for the treasury bills and guarantees; it could be pegged at 95%. In the case of landed property the value depends on various factors and is therefore not predetermined. The maximum value is supposed to be 70%.

There are also systems in place to ensure that this security is properly valued and managed, work that is done by the Credit Administration Unit of BLC (attached to its business unit) made up of analysts, administrators and legal experts. The Credit Risk Management (CRM) department of MBG performs this function.

Specialised Lending

The Basel Committee recommends that, when banks participate in loan syndication or other loan consortia, they must do their own credit analysis, and not rely on the analysis done by the lead underwriter or external commercial loan ratings. This practice is upheld at BLC, which has a special business unit responsible for large corporate and syndication lending. This group, which is made up of senior Relationship Managers, formulates credit proposals, which are then sent to the Credit department for the usual credit appraisal.

At MBG syndicated lending is not very common, but in the few instances that the Bank has been involved in transactions of this nature it has undertaken its own credit appraisal of the proposal.

Current market indications are that this Bank will be more involved in this type of lending. This is because the facilities sought by the large corporates, multinationals and parastatals are becoming too big for the balance sheet of one bank to handle. In certain instances, even if the balance sheet could support such an exposure, it would be better to share the risk. En plus the Central Bank has made a policy to stop granting waivers to banks to exceed prudential requirements.

2.2.2) Principle two: Banks should establish overall credit limits at the level of individual borrowers and counter parties, and groups of connected counter parties that aggregate in a comparable and meaningful manner different types of exposures, both in the banking and trading book and on and off the balance sheet.

An important element of credit risk management is the establishment of exposure limits on single counter parties and groups of connected counter parties. BLC has established the following rules to guide them in this matter:

- *The Bank must not undertake any commitment with a financial institution(s) that exceeds 25% of the gross capital multiple of its capital (same as net worth).*

- *The Bank must not undertake any commitment with a borrower or group of related borrowers that exceeds 10% of its gross capital multiple.*
- *The Bank must not undertake any commitments to an industry group that exceeds 25% of its gross capital.*

In the case of MBG we operate under the Banking Law PNDC Law 225, which indicates the following:

- *The Bank must not lend on an unsecured basis to one client or group a sum exceeding more than 10% of its net worth.*
- *It must not lend on a secured basis more than 25% of its net worth to a single company or group of companies.*

The Basel Committee also expects limits to be set for particular industries or economic sectors, geographic regions and specific products. This is indeed done at BLC, where such limits by portfolio concentration, risk limit by region and per product are officially established in the Credit Policy Manual. This is done to ensure that the Bank's credit granting activities are adequately diversified. In order to be effective, limits are generally binding and not subject to consumer demand. Further, all exceptions to the limits proposed are referred to the Bank's BOD. From the files reviewed during the study, no requests for exceptions were sighted and as confirmed by our discussion with the senior credit staff and the Audit section at BLC, such exceptions are indeed rare.

This recommendation has been taken by MBG, but the Bank has not yet set any limits for particular sector or geographic regions. Lending is therefore for the moment undertaken on an adhoc basis for particular sectors. The issue is being addressed at present with the help of Corporate Banking, Research and CRM Departments. General limits have however been set for particular products.

Risk rating and return

A common problem amongst banks is the tendency not to price a credit or overall relationship properly, such that the bank does not receive adequate compensation for the *risks incurred. BLC had this problem a few years ago, and had to change its system for establishing its BRR (borrower risk rating system) for the present one, as described in part three of this dissertation. This enabled the Bank to be more adequately compensated based on the client's risk rating. For MBG, it also has within the past year had to adopt a new credit risk rating system known as the Credit Grade Matrix, which has proved more useful in measuring the risk of clients. This has led to a better compensation for its risk assets even though there are still problems. The thrust of the problem appears to be that, due to market conditions, some clients have to be rated higher than the recommendation of the Credit Grade Matrix, much to the chagrin of Credit Risk Management.*

2.2.3) Principle three: Banks should have clearly established processes in place for approving new credits as well as the amendment, renewal and re-financing of existing credits.

Depending on the structure of a bank, there may be several units involved in the credit granting process. These may include individuals from the business unit function, the credit analysis function and the credit approval function. In addition, the same counter party may be approaching several different areas of the bank for various forms of credit. It is therefore important that all these are co-ordinated to ensure that sound credit decisions are made.

All credit applications submitted for approval at BLC must necessarily indicate all the facilities approved by various sectors of the Bank, both for the borrower and for any related parties and/or owners and/or guarantors. As the Bank operates in different geographical areas, the application must also state the unit or branch where the facilities are available.

MBG requires that all limit applications indicate in the aggregate, all facilities granted by the Bank and its subsidiaries. It also takes into consideration group exposure. Being a smaller bank, the branch where the borrowing is available is not stated, but the source of *the application is usually the operation point of the client, where the borrowing is accessed.*

Credit review function

Credit review is the analysis of a credit request by an analyst independent of the relationship manager. The analyst makes an independent assessment of the quality of a credit or of a credit relationship, based on the documentation provided, principally financial statements, credit analysis provided by the relationship manager and collateral appraisals. At the Laurentian Bank, various approving authorities in the Credit Department perform this function. Each of the four approving authorities is supposed to analyse the credit files received comprehensively, before a decision to lend is made. If there are misgivings about any of the risk aspects, the relationship manager is required to give an explanation or additional information. If, after all that, the assessment is that the level of risk is not acceptable to the Bank, the facility is declined. If the risk is acceptable, the loan is approved.

For Merchant Bank the process is similar. The CRM have both appraisers and approvers but even though an approver might appraise a credit request, normally the functions do not overlap. After the appraisal of the facility the comments raised are sent to the RM for his/her comments. If these are satisfactory and the risk is considered as acceptable the facility is approved, if not it is declined.

Lending Limits

With respect to the lending limits, the Credit Department of the Bank has the authority to approve new loans up to a limit of CND7.5M and reviews up to CND10M. Four individuals who have incremental limits ranging from CDN100K to CDN3M approve loans up to these amounts. The Deputy Head of the Credit Department approves limits of more than CDN3M up to CND5M, whilst the Head of the Credit Department approves limits from CDN5M up to CDN7.5M and reviews up to CDN10M.

The Internal Credit Committee can approve facilities from CND7.5M up to the maximum limits as set up by the Board, including the set limits for public and Para public sector *accounts and treasury. The Board Risk Management Committee approves limits above these.*

At MBG, there are two approving authorities for CRM who have limits of up to USD100, 000 and up to USD 300,000. Limits above these are handled by the Credit Committee who can approve facilities up to USD1.5million. The Credit Committee can only recommend facilities above its limits for ratification of the Finance Sub-Committee of the Board. The Board may however reject it if it considers the risk unacceptable.

Team of qualified business unit and credit staff

Banks must develop a corps of credit risk officers who have the experience, knowledge and background to exercise prudent judgement in assessing, approving and managing credit risks. A bank's credit granting approval process should establish accountability for decisions taken and designate who has the absolute authority to approve credits or change credit terms.

BLC has a team of qualified staff to manage its credit risks. The Bank however appears not to have a formal training programme for the continual development of its staff. In fact, the strategy so far has been to poach already trained staff from other banks. The problem with this strategy is that it does not guarantee future success, as continuous training is necessary to ensure that credit staff maintain the requisite level of expertise. This problem has already been identified and it is expected that the Bank will put into place a policy of ongoing training in order to change the status quo.

MBG has in place well qualified staff to undertake this function and although its formal training programme falls short of the ideal it is better structured than that of BLC. The year 2005 has been declared as the year of training by the bank and as such measures are being put in place to ensure that there is wide spread training in all the business and functional units.

Amendment, refinancing and renewal of existing credit

Both Banks have clearly stated guidelines for the preparation of facility applications in regards to format and content. There are also guidelines for the application, when it pertains to a refinancing, amendment or review of a credit facility.

The review process for each client at BLC ensures that any deterioration in the client's financial position is detected early. Thus the Bank maintains a close relationship with the client and monitors market trends and other aspects of the business (i.e.: competition, economic trends, etc...). For the Bank's lending portfolio, each client's risks are assessed no less than once a year, and for its commercial loans, annual reviews must be done within 120days after the client's fiscal year end so as to make use of the latest financial information available.

In the case of MBG the process is very much the same. Review dates are set to coincide with the date of receipt of the company's financial statements, and for related companies it is expected that reviews of all group members will be co-ordinated so that they can be undertaken at the same time. At the review, all aspects of the risk issues are assessed and the risk grading is subsequently reviewed, and may be changed depending on the outcome.

2.2.4) Principle four: All extensions of credit must be made on an "arm's length" basis. In particular, credits to related companies and individuals must be authorised on an exception basis, monitored with particular care and other appropriate steps taken to control or mitigate the risks of "non-arm's length" lending.

Extensions of credit should be made subject to the criteria and processes described earlier. When this is done, it creates a system of checks and balances that promotes sound credit decisions. It is therefore mandatory that directors, senior management and other influential parties (e.g.: shareholders) do not seek to override the established credit granting and monitoring processes of the Bank.

Related parties may include the Bank's subsidiaries and affiliates, its major shareholders, directors and senior management, and their direct and related interests, as *well as any other party that the Bank exerts control over or that exerts control over the Bank. There is always a potential for granting credit on a "non arm's length" basis to these parties, and the Bank must guard against that while ensuring that credit granted to them is suitably monitored. Such controls are most easily implemented by ensuring that the conditions of credit are not more favourable than credit granted to non-related borrowers under similar circumstances and by imposing strict absolute limits on such credits.*

A possible measure of control is the disclosure of the terms of credits granted to related parties. It is imperative that the Bank's credit granting procedures are not altered to accommodate these related companies and individuals.

For both banks these principles are upheld.

2.3) Maintaining an appropriate credit administration, measurement and monitoring process.

2.3.1) Principle one: Banks should have in place a system for the ongoing administration of their various credit-risk bearing portfolios.

Credit administration is a critical element in maintaining the safety and soundness of a Bank. Once a credit is granted, it is the responsibility of the business unit, often in conjunction with a credit administration support team, to ensure that the credit is properly maintained. This includes keeping the credit file up to date, obtaining current financial information, sending out renewal notices and ensuring that covenants related to the borrowing are being upheld.

Given the wide range of responsibilities of the credit administration function, its organisational structure varies with the size and sophistication of the Bank. It is recommended that where individuals perform sensitive tasks, such as inputting into the computer or keeping custody of sensitive documents they should report to managers who are independent of the business units and credit approval processes. It is imperative to include the following functions:

- *The efficiency and effectiveness of credit administration operations, including monitoring documentation, contractual requirements, legal covenants, etc.*

- *The accuracy and timeliness of information provided to management information systems.*
- *Adequate segregation of duties.*
- *The adequacy of controls over all " back office" procedures.*
- *Compliance with prescribed management policies and procedures, applicable laws and regulations.*

For the various components of credit administration to function properly, senior management must understand and demonstrate that it recognises the importance of this element of monitoring and controlling credit risk.

For both banks, the issue of credit risk is taken very seriously and the function is given the appropriate level of recognition by top management. At BLC the Unit includes all the functions recommended. Its problem at the moment is in the area of the adequate segregation of duties, as it appears to be understaffed. In the case of MBG, the unit has evolved over the past two years when it was taken over by a more proactive management. Efforts are being made to ensure that its mandate covers all the required functions and that it has the requisite complement of trained staff.

2.3.2) Principle two: Banks must have in place a system for monitoring the condition of individual credits, including determining the adequacy of provisions and reserves

Banks should develop and implement comprehensive procedures and information systems to monitor the condition of individual credits and single obligors across the various portfolios of the bank.

For both banks, Relationship Managers (Rms' are responsible for monitoring credit quality, including ensuring that relevant information is passed on to those responsible for assigning internal risk rating to credit. In addition, the Rms' are responsible for monitoring on an ongoing basis any underlying collateral or guarantees.

For BLC, these functions of the Rms' are overseen by its Credit Administration department that is attached to its Business unit (an entity that is entirely different from its CRM). The reason for this separation of duties is clear: there is a tendency for hard-pressed Rms' (who have a lot of work and who are rewarded on loan volume and profitability) to neglect this function.

For MBG in recent times, there has been a call to rewarding Rms' for loan volume and profitability. This means that there is a problem brewing and the Bank needs to ensure this aspect of the work is either rewarded or forms part of the functions of CRM in the absence of a credit administration department.

Provisioning for BLC is done in line with guidelines from the Canadian Banking Act and related guidelines. The observation is that BLC is swift with issues of provisioning and there is not the tendency to suppress the reporting of substandard debt, as we are wont to do at MBG.

MBG in respect of receipt of any adverse information of an imminent loss situation would take the steps to make the necessary provision in line with Bank of Ghana regulations. The management of the Banks provision policy lies with the CRM of the Bank.

2.3.3) Principle three: Banks are encouraged to develop and utilise an internal risk rating system in managing credit risk. The rating system should be consistent with the nature, size and complexity of the bank's activities.

An important tool in monitoring the quality of individual credit as well as the total portfolio is the use of an internal risk rating system. A well-structured internal risk rating system is a good means of differentiating the degree of credit risk in different credit exposures of a bank.

The two financial institutions have Borrower Risk Rating systems that are tailored to their needs and are described in detail in the third part of this dissertation.

The ratings assigned to individual borrowers and counter parties at the time credit is granted are reviewed on periodic basis. To ensure that the internal ratings are consistent and accurately reflect the quality of credit, for both institutions (Borrower Risk Rating) BRR for clients are recommended by Rms' but it is the Credit Risk staff that have the final say in the risk grading.

2.3.4) Principle Four: Banks must have information systems and analytical techniques that enable management to measure the credit risk inherent in all on-and-off balance sheet activities. The management information system should provide adequate information on the composition of the credit portfolio, including identification of any concentrations of risk.

The effectiveness of a bank's credit risk management process is highly dependent on the quality of management information systems. The information generated from such systems enables the Board and all levels of management to fulfil their respective roles, including determining the adequate level of capital that the bank should be holding. The quality, detail and timeliness of the information are therefore critical.

It is also important to ensure that the banks have a management information system in place to ensure that exposures approaching risk limits are brought to the attention of senior management in a timely manner.

At BLC the Credit Department is charged with the credit appraisal of all requests, to determine if the risk involved is acceptable to the Bank and if it is commensurate with the return proposed. This occurs in the case of on and off balance sheet items.

The Bank also has very efficient management information systems. Reports for monitoring and information purposes are generated for the business units credit department and top management for the proactive management of risk. The Bank has also upgraded its banking software programme (September 2004) for SME loans by introducing a scoring system, which is expected to be more efficient.

To assist MBG in the determination of the credit risk in on and off Balance sheet items, the CRM department is charged with the appraisal of all facilities to determine their risk profiles. Before then, the Rms' are supposed to have determined the risk in the credit application and how it should be reduced to acceptable limits, if it is recommended for financing.

MBG has recently changed its banking software programme from Microbanker a to(Integrated Computerised Banking Application) ICBA. The change was brought about by a management decision to ensure that the software programme in place is able to generate all the specified reports that would provide it and other units the information required to handle its credit portfolio on a proactive basis. The system also provides the Bank with the information necessary to prepare reports that are used for monitoring purposes to the Central Bank.

Additionally the CRM Unit of the Bank has also recently introduced new information reporting, which highlights irregular facilities as soon as they occur and facilitates the remedial management of problem credits.

2.3.5) Principle five: Banks must have in place a system for monitoring the overall composition and quality of the credit portfolio.

A continuing source of credit-related problems in banks is concentrations within the credit portfolio. Concentrations occur when, amongst other things, a bank's portfolio contains a high level of direct and indirect facilities to:

- *A single counter party*
- *A group of related counter parties*
- *A particular industry or economic sector*
- *A geographic region*
- *An individual foreign country or a group of countries with related economies*
- *A type of credit facility*
- *A type of collateral*

- *A high level of concentration exposes the bank to risks in the areas in which the credit are concentrated.*

It is to address these risks that BLC has clearly set limits in its CPM for the geographic areas in which it operates with limits for each region. Additionally, it has indicated the concentrations by product for each region. These limits are adhered to, even though it is stated that the Bank may grant exceptions. The Bank had its fingers badly burned in 2001 when it was overexposed to Canadian Airlines, which subsequently went bad, seriously affecting the Bank's operations.

MBG has also had its own problems with over concentration on the timber industry in 1999. When the industry lost its lustre due to a government embargo on the export of unprocessed round logs, the Bank found itself highly exposed in the industry with no prospect of recovery. Even though MBG has still not come out with limits to mitigate concentration risk, the CRM unit, which is very proactive, is in the process of building a database to act as a form of warning signal pending the finalisation of the limits.

Even though managing concentrations of risk is important, it will be prudent for a bank to desist from booking good credits only because of this type of risk. The bank should be aware of the problem to ensure that it is adequately compensated for the risk that it is taking.

2.3.6) Principle six: Banks should take into consideration potential future changes in economic conditions when assessing individual credits and their credit portfolios, and should assess their credit risk exposures under stressful conditions.

An important element of sound credit risk management involves discussing what could potentially go wrong with individual credits and credit portfolios, and factoring this information into the analysis of the adequacy of capital and provisions. This 'what if" exercise is expected to reveal previously undetected areas of potential credit risk exposure under stressful conditions.

This proposition is vigorously upheld at BLC, where information on the economy is readily available and where potential future changes are usually the subject of various economic and social bulletins. Sensitivity analyses also form part of transactions that are not of a short-term nature and are likely to impact heavily on its books, if anything untoward were to happen.

Increasing future changes in economic conditions and the likely effect on MBG's credit portfolio is featured in detail in limit applications/credit requests. Sensitivity analyses are also being undertaken frequently to ensure that the Bank is not undertaken by events.

2.4) ENSURING ADEQUATE CONTROLS OVER CREDIT RISK

2.4.1) Principle one: Banks must establish a system of independent ongoing assessment of the bank's credit risk management process and the results of such reviews should be communicated directly to the BOD and senior management.

Due to the fact that various individuals throughout a bank have the authority to grant credit, the bank needs to have an efficient internal review and reporting system in order to manage effectively the banks various portfolios. This system should provide the BOD and senior management with sufficient information to evaluate the performance of the relationship managers and the condition of the credit portfolio.

Internal reviews conducted by individuals independent of the business units provide an important assessment of individual credits and the overall quality of the credit portfolio. The reports of such reviews should go directly to the BOD.

BLC has an effective credit appraisal and reporting system. Credit by BLC is granted by any of the four approving authorities of the Credit Department, the Credit Committee or a committee of the Board. The Credit Department keeps copies of the approvals and copies of all refusals stating the reasons are provided. These reports are periodically reviewed.

The Audit Department periodically undertakes a review of the files in the business unit and the Credit Departments. Relationship Managers are given a chance to respond to queries raised. These reviews are taken very seriously as staff members have been known to lose their jobs through reports indicting them for negligence, and in some cases, for sheer mismanagement of the advances of the Bank.

At Merchant Bank, CRM, the Credit Committee or the Finance Sub-Committee of the BOD grants credit. There is a reporting system where copies of all the approvals are kept by CRM. Reports of all facilities approved are sent to senior management.

Internal reviews are conducted by the Internal Control Department of the Bank to the BOD. Relationship Managers are given a chance to respond to queries raised. These responses are attached to the report. The issue is not given the level of importance it deserves however as the same sort of problems keep recurring. Necessary sanctions have to be put in place for non-compliant Rms' are their supervisors.

2.4.2) Principle two: Banks must ensure that the credit-granting function is being properly managed and that credit exposures are within levels consistent with prudential standards and internal limits. Banks should establish and enforce internal controls and other practices to ensure that exceptions to policies, procedures and limits are reported in a timely manner to the appropriate level of management for action.

The goal of credit risk management is to maintain a bank's credit risk exposure within parameters set by the BOD and senior management. The establishment and enforcement of internal controls, operating limits and other practices will help ensure that the credit risk exposures do not exceed levels acceptable to the bank. Such a system will enable bank management to monitor adherence to the established credit policies.

MBG and BLC take Credit Risk Management seriously, even though at both banks the systems and controls in place to have this monitored fall short of perfection, it is obvious that they constitute an important function of the BOD.

At both Banks, the Credit Risk Management or Credit Departments (as they are known respectively at MBG and BLC) are in the process of some form of restructuring to ensure that their functions are performed efficiently. More emphasis is also being put on the function of internal audit whilst management is willing to spend a fortune on MIS systems to complement this function.

2.4.3) Principle three: Banks must have a system in place for managing problem credits and various other workout solutions.

One reason for establishing a systematic credit review process is to identify weakened or problem credits. When this is recognized early there is a better chance of recovery.

Effective workout programs are therefore very critical. It is recommended that, when a bank has serious credit related problems, the workout function must necessarily be segregated from the function that originated the credit. It has been proven that the additional resources, expertise and concentrated efforts of a specialised team normally improve collection results.

BLC and MBG have separate units that handle accounts that are problematic. At BLC the policy and practice is that accounts for which repayment remains outstanding for more than 90days are transferred to Recoveries through the Credit Department. For MBG the period varies. The policy states a period of 90 days but the practice is for the business unit to hold on for much longer, which in certain instances leads to the deterioration of the credit, albeit in certain cases they are eventually paid off.

PART THREE – THE CREDIT REVIEW PROCESS – A STUDY OF TWO FINANCIAL INSTITUTIONS

This segment of the report presents an overview of the credit appraisal process at two different banks, the Laurentian Bank of Canada and the Merchant Bank (Ghana) Limited. For the purpose of this study, a concentration was made on commercial credit, as both banks engage in this kind of lending. Since the risks are similar, to all intents and purposes, the risk analysis process at both banks was deemed to be comparable.

The methodology involved a random study of credit files in the portfolio of both banks. The credit files were those of existing clients, new credit applications received, and of declined requests. A special effort was made to have a mixed sample incorporating a variety of client types (small and medium businesses, large corporate etc). The analysis was done by segmentation of the clients into very large corporates and parastatals, medium to large corporates and small and medium enterprises (SMEs)

We also interviewed the approving authorities at the Credit Departments of both banks, followed by discussions with the Relationship Managers, the Loans Recovery Units, and the Internal Audit Departments. Our main objective was to be able to determine if financial analysis is accorded as much importance as the other risks in credit appraisal at either institution.

3.1 THE CREDIT REVIEW SYSTEM AT THE LAURENTIAN BANK OF CANADA (BLC).

The Laurentian Bank of Canada is a Canadian chartered bank that offers highly competitive products and superior personalised services to meet the banking and financial needs of individual borrowers and medium sized businesses.

With more than a century of financial stability and community involvement behind it, Laurentian Bank seeks to accelerate its growth by expanding its geographical presence and responding swiftly to evolving markets and customer needs, whilst providing its shareholders with a competitive return on investment. In order to achieve this aim, the Bank seeks to maintain high quality on and off balance sheet assets.

The bank's main areas of activity are retail financial services, agency banking, commercial and corporate banking and brokerage operations, capital markets and investment operations.

As for the Bank's lending operations, they are divided into credits to the following areas:

- Personal loans
- Mortgage loans to both individuals and corporate bodies
- Commercial credit (i.e.: credit to small and medium businesses, large corporate bodies, multinationals, etc…
- Agricultural loans

3.1.1 RISK ANALYSIS FOR MEDIUM TO LARGE CORPORATES

Medium to large corporates with regard to BLC could be described as firms that have total borrowing limits between USD250K to USD7.5M. Designated personnel at the Credit department approve facilities within this range. The Credit Committee must also approve all facilities in excess of this amount. For this category of clients, the following have been noted in regards to the risk analysis undertaken:

3.1.1.a) Management risk; A fundamental analysis of management is always done. There is no particular format, the onus being on the relationship manager or analyst (as the case may be) to provide the relevant details. The analyst usually wants to confirm if indeed management has the basic qualifications needed to steer the company's affairs. Invariably, most loan applications received indicate that management is qualified and experienced. However, there are a few instances where management is found wanting for e.g. where it is deemed not to have the requisite expertise to undertake a new venture or there is an absence of succession planning, etc... Whenever the owners are also the managers of the business, much emphasis is placed on their trustworthiness and on their credit rating. Efforts are also made to determine if they have managed other businesses in the past, and how well they may have fared.

3.1.1.b) Environmental risk:

Environmental issues are very important, especially for businesses where such risks come into play (i.e.: chemical plants, gas and oil producers, etc...). However, public awareness of such issues has resulted in numerous laws and guidelines being established by the government and other regulated institutions over the past few years. The Laurentian Bank of Canada presently always considers environmental issues (where relevant) when assessing a borrower's request for funds.

The Bank has designed a detailed questionnaire on environmental issues that must be completed and attached to each loan application. Information required includes, whether or not the company uses dangerous materials in production, discharges dangerous waste materials, has a valid permit to use these substances, has ever infringed on environmental laws, has contingency plans in case of an environmental hazard, and whether or not it uses BPC in its operations. In determining the client's credit risk rating, as per the bank's internal rating standards, a weight of approximately 5.5% is placed on compliance to environmental matters.

Other broad environmental factors, such as legal/political, social, cultural and technological factors, are also analysed in detail, depending on the nature of the loan application. Information on these issues abound and includes statistics from various research findings. The challenge here is to be able to determine the relevant information for the analysis.

3.1.1.c) Account performance risk:

This usually covers how the account has performed to date, in terms of all the products that it has with the Bank (i.e.: loans, mortgages, trade finance, swaps and forward transactions). Included in the loan application is a detailed analysis of the account's profitability for each product, the transaction and management fees, and a detailed discussion of whether or not the client has complied with all the borrowing covenants, including ratios set for inventory, receivables and debt/equity ratios. It is interesting to note that, the client pays default fees if these ratios are not respected. In addition to that its account is downgraded.

3.1.1.d) Business risk:

This area of risk analysis is usually very well undertaken, as the Bank considers it very important to understand its clients' businesses. The Bank has stated it its Credit Policy Manual the types of industries it is interested in financing. BLC also has a policy of not putting money into any business it does not understand thoroughly, however promising the business may be. Of particular interest is the fact that there are usually statistics available on various industries, with regard to their performance in the economy, their share of the global market, financial results of various companies in the industry, growth and future prospects of the industry etc.

Our observation is that account managers do not always deem actual industry analysis on the loan application important, to the consternation of the Credit Department. In some cases, the appraisers have information on key industries, which the Bank finances, and are thus able to evaluate the client's performance compared to the competition. In the case of less-known industries, the account manager would do a more thorough industry analysis, when presenting his loan application. Other key issues mentioned are competition, technology, entry barriers, raw material supply, and marketing of the company's products, channels of distribution and future prospects.

3.1.1.e) Security and/or collateral risk:

Security, where considered appropriate for this category of debt, is mainly in the form of inventory and receivables. The bank finances up to a maximum of 75% of receivables and 40% of stock, depending on their quality and on the nature of the business. A detailed analysis is made of receivables and stock to remove any compromising elements. In the case of receivables, the figure is adjusted for overdue items; receivables to related companies and priority debt (social security, federal and provincial taxes). In the instances that the company owes any of its debtors (i.e. its debtor is also its creditor) this amount is deducted from its debt. The margin is taken on the resulting figure. For stock, the nature of the raw material is analysed to determine if it is saleable or not. WIP is normally not considered as saleable, unless in exceptional circumstances. Raw materials when saleable are added to finished goods. Deductions are then made for unpaid goods purchased within the last 30days (Canadian law gives a supplier priority over all other creditors for such goods) and for priority debt. The margin is taken on the resulting figure.

The bank also accepts bonds, publicly traded shares, mutual funds, treasury bills, bankers' acceptances and life insurance policies as collateral for loans. There are maximum percentage limits for each category of assets. In the event that non-marketable assets are offered, they are subject to evaluation and authorisation by the Credit department. In the case of more solid property, such as charges over immovable and movable assets, all documentation is expected to be in place before draw down. Analysis of risks as it pertains to these securities is based on their discounted values and how easily they can be realised.

3.1.1.f) Financial risk:

This appeared to be the most detailed part of the risk analysis process for this category of client. The following documents are normally required:

Audited annual financial statements/accounts for the last financial year

MFA (Moody`s Financial Analysis) 5 yrs. input where available

Management accounts (in-house or interim financial statements)

Projected profit and loss statement and balance sheet

Commercial credit report

Cash flow projections

Amortisation schedules

Ageing Analysis of debtors and stock

Report on the official standing of company

Any other relevant financial report

The audited financial statements are analysed by means of the MFA software. This software calculates the entire key recommended financial indicators on the balance sheet and P&L account, as well as ratios in relation to key areas to analyse such as:

Liquidity: Current ratio, Quick asset ratio

Leverage: Debt/net worth, Debt/tangible net worth

Profitability: Return on assets, return on equity, Gross margin, Operating profit margin, Net profit margin, dividend pay out rate

Activity: Accounts receivable days, Accounts payable days, Stock days, Net sales/working capital, Net sales/fixed assets

Growth: Sales growth, Net profit growth, Net worth growth, Total assets growth.

The MFA software also has other interesting features, such as being able to calculate probability of default (PD%), by using an immense amount of data on corporate bodies (it is reputed to use the world's largest private company database). It is therefore especially suited for the middle market credits for which market insights into prospects are sometimes not available/accurate. Adjustments in terms of industry risk and environmental issues are made to the PD%, in order for the Bank to arrive at a PD figure that is used for in-house analysis purposes.

The Bank also has a programme in place to calculate the LGD (i.e.: the loss given default). It indicates the percentage loss following the realisation of securities, the Exposure at Default (EAD), which corresponds to the credit facilities at the time of default, and the Expected loss (EL), the anticipated loss amount during a one-year period.

Another system in place is used for calculating the Borrower Risk Rating (BRR), which corresponds to the level of risk associated with each borrower. This is done by using an excel programme designed by the Bank. The calculation is done using as a base the PD% to which the following adjustments are made:

- Industry: Each industry in which the bank operates has been assigned a risk weighting, and when this is entered into the system, it triggers an automatic adjustment.
- Environment: Whenever the industry in which the borrower operates involves some kind of environmental risk, this is entered into the equation as an adjustment.
- Other elements - Any other qualitative factors that could affect the borrower's risk are entered here. For example, if the government enact a law encouraging or discouraging a specific industry or sector of an industry, if there is full tangible security covering a facility, if the company's president has just been accused of fraud, etc...

After these adjustments have been made, the system generates ratings of between 1 and 17, the lower the figure the better the client's risk grading:

- Excellent risk: from 1 - 6
- Very good risk: from 7 - 9
- Average to good risk: 10 -11
- Average risk: 11 -12
- Acceptable risk: 11 - 13
- Watch list loans: 14 -16
- Doubtful accounts: 17

Attached to all corporate loan requests are commercial credit reports that go way beyond checking references. The Bank subscribes to Equifax, which is Canada's largest commercial database and is said to have reports over two million businesses across the country. Information provided by this report include the following; trade payment data, legal suits/judgements, third party collections, inquiries made by other credit grantors, banking information, returned cheques, payment/risk trends, credit manager comments, bankruptcy data. Any untoward trends in this report give the leeway to downgrade the client's BRR risk rating.

Management accounts (in-house or interim financials) are more often than not attached and considered as very relevant to the loan application, especially to check actual performance against the projections made earlier, and to detect early warning signals. Projected balance sheets and P&L accounts are also often requested to determine the company's ability to plan and project ahead. As part of the documentation are the most recent cash flow projections analysed in detail, as well as the ageing analysis of debtors and stock. The detailed analysis of the latter is done on a form known as the "Calcul de la Valeur de l'Emprunt", which basically adjusts these figures for overdues, debts to related companies, priority debts, finished goods as well as w.i.p. on a monthly basis.

An official report on the standing of the company is also usually enclosed with the loan application, as it determines the company's good standing in regards to its statutory obligations. Other relevant financial data, such as amortisation schedules, presentations, purchase and sales contracts, explanation of complex deals and business plans are attached where appropriate.

3.1.2 RISK ANALYSIS FOR VERY LARGE CORPORATES, MULTI-NATIONALS AND PARASTATALS

The risk analysis undertaken for this category of client follows broadly the same pattern as for the first category of clients mentioned in segment 2.1.1, except for the following:

3.1.2.a) Management risk:
Especially for government guaranteed loans, this is often not considered a major risk issue. The general line of thought is that management has already proven their worth by the time they get into these positions. On the other side of the spectrum, some very large corporates provide up to date information on all key staff, including age, experience, qualification, organisational charts, succession and retirement plans.

3.1.2.b) Security/Collateral risk:
These credit facilities are normally either guaranteed by the government or are on a "clean basis" sometimes with a "negative pledge". This means that loans are approved without obtaining any security and/or approved on the condition that the borrower gives

the Bank a written promise not to provide any security to any other lender. In the event the exposures are too large for the bank to handle, there are syndications, where the security risk is determined by the group of banks, who then may decide on tangible, intangible or financial securities as the case may be.

3.1.2.c) Financial risk:

There is a lot of emphasis on financial analysis for this category of clients, and it is often undertaken both by the client as well as by the Bank. The financial data and analytical figures are often corroborated by industry information, feasibility reports, including extended projections, project presentations, marketing reports, and other financial data.

3.1.2.d) Legal issues:

The legal implications of syndicated lending, lending to organisations that have complex relations to other bodies, and the legal implications that could derive from cross border lending, are thoroughly analysed where necessary.

3.1.3 RISK ANALYSIS FOR SMALL AND MEDIUM ENTERPRISES

This portfolio does not represent a large percentage of the Bank's commercial lending portfolio in monetary terms. However, this group of clients remains an important part of the portfolio because of the Laurentian Bank's image as a bank for the people. The credit analysis undertaken for this sector is significantly different from that of the large corporates and multinationals, obviously because of the different risk factors that come into play.

3.1.3.a) Management risk:

This appears to be extremely important for small and medium businesses. The usual details of management are provided, including more personal details, such as marital status and family life. The credit rating of key management is also determined by means of the Beacon score (a score assigned by Equifax for individuals). The main parameters for the assignment of this score are the following:

- How the individual has performed on previous debt

- Outstanding amounts of debt owing
- Credit report from suppliers
- Listing of the institutions that have requested credit reports on the individual
- Whether the individual has been involved in any bankruptcies or fraud
- Returned cheques
- Judgements obtained on the individual
- Previous work experience

The data provided gives a pretty good picture of the nature of the individual. The general conception is that if an individual is able to manage his credit well, more often than not he is in a position to run a good business too. Whilst this is not cast in stone, experience seems to suggest that , but for a few exceptions, this is normally the case.

3.1.3.b) Environmental risk:

This type of risk is addressed; depending on how relevant it is for the company under consideration (its operations, the type of collateral security held, etc…). It is treated with the same level of seriousness, irrespective of the amount of the loan requested.

3.1.3.c) Account performance risk:

If the commercial account has been with the Bank for an amount of time, then it is easy to determine how the account has performed. Key issues that crop up are the use and respect of previous lending limits, request for overdrafts and returned cheques. If on the other hand the account were new, then the banking history of the owners and/or management would be checked, in order to estimate probable account performance for the business. We must remember that one of the Bank's targets is to try and acquire the accounts of all key management staff, as it still wants to maintain its strength as a retail bank.

3.1.3.d) Business risk:

The SME business can be said to be from a cross section of the sectors of the economy. Due to the nature of the industry business risk is undertaken very well in order to understand the business of the client and give advice on what financing is required for its operations and how it can be managed. BLC is very strong in this area of the market and has been known to have grown a lot of companies with humble beginnings into larger corporates. To ensure that business risk is undertaken well, relationship managers are given clients in similar industries so that some level of expertise is built.

3.1.3.e) Security/Collateral risk:

The facilities granted to small and medium businesses are normally secured, with the type of security depending on the type of loan. Inventory and receivables are used to secure overdrafts and revolving facilities. Here again, overdue items, priority debt, and debt to related companies are removed form the receivables and the bank accepts up to 75% of the remaining figure as explained earlier. Stock is also accepted up to a maximum of 40%. Sometimes a chattel mortgage is taken over the assets of the company. This chattel mortgage (or "hypothèque mobilière" in Quebec) is equivalent to a charge over the assets of the company, but it does not give the Bank all of the legal powers offered by a 1st debenture. For term loans and other forms of financing, the bank may take a lien on tangible security (immovable property or other specific assets). Personal guarantees are required of owners and/or key management for all forms of lending to this group of clients. As well as addressing the security risks, the loan application also provides an estimated realisation value for the assets held as collateral.

3.1.3.f) Financial risk: For this type of customer, the following documents are required in order to complete the financial analysis:

Annual financial statements

Projected cash flow statement

Management accounts

Equifax report

Risk rating grid

Personal income statement account of owners/shareholders

Report on official standing of company/enterprise

For this type of commercial lending, it is not necessary to use the MFA for financial analysis. In many cases, the financial statements are "compilations", albeit there are some "reviewed" and "audited" accounts. However, the analysis still needs to cover the key areas (i.e.: liquidity, leverage, profitability and efficiency). It is based primarily on why the events occurred, rather than bland statements of facts.

Sometimes, cash flow projections are attached and analysed, depending on the amount of the loan and the size of the client (usually the larger corporates in this category of small and medium business). The commercial Equifax report, as described in the first part of this chapter, is also required for all businesses. In addition, an Equifax report is also obtained for owners/managers, in order to assess their credit worthiness, as this often has a direct impact on the financial health of the business.

A grid designed by the bank, taking into consideration various elements (management risk, financial risk, market risk, and adjusted for security risk) generates the risk rating of the company). The weight is greatest for issues under financial risk. A report on the standing of the business entity is generated by accessing the website of the registrar of companies (for Quebec), in order to ensure that the business is in good standing. Other information may also be required, such as corporate and/or personal tax returns and confirmation of tax payments, etc….

3.2 THE CREDIT APPRAISAL PROCESS AT THE MERCHANT BANK (GHANA) LIMITED

Merchant Bank (Ghana) Limited is a limited liability company incorporated in 1971, which commenced business in March 1972 as the premier merchant bank in Ghana. The Bank paved the way for the growth of merchant banking in Ghana and has thereby contributed immensely to the economic development of the country.

The bank is currently transforming itself into a universal bank. As part of the process, the Bank has lined up programmes of strategic importance for all categories of staff to ensure that all are part of the change it is currently undergoing. The principal objective of the bank is to promote a culture of excellence at all levels of activity, thereby attracting quality clientele with naturally healthier assets, in order to ultimately affect positively the Bank's bottom line.

The bank's main areas of activity are now Corporate banking made up of commercial and institutional banking, and Merchant banking made up of investment banking, corporate and advisory services, registrar services and finance and leasing. Currently, the Bank's credit portfolio includes small and medium enterprises, medium to large corporates, and multinationals and parastatals. It does not yet offer any retail banking services (personal loans), however this is a possible line of expansion that is currently being looked into.

3.2.1 RISK ANALYSIS FOR MEDIUM TO LARGE CORPORATES

3.2.1.a) Management risk: The key areas covered in loan applications are the name and age of the key personnel, their academic background and also their work experience, including their experience in the current line of business. These are commented upon in all loan applications. Other factors considered necessary are the functional relationship of management, and the identification and analysis of power blocks (if any). Purportedly, this is analysed to ensure that the management team is a cohesive one, and not only a group of people qualified and experienced in their own right, but unable to co-ordinate their functions and activities.

The issue of succession planning for key management positions is also an important and relevant factor for medium corporates. In Ghana, lack of or poor succession planning is a very common problem amongst this type of client. Management information systems are also considered as important and commented on, even though sometimes the commentary is not relevant . Employee morale is also addressed, especially for companies that have a large lower level labour force.

3.2.1.b) Environmental/social risk:

Environmental issues are considered very important in Ghana, and they are required to be addressed in each loan application, where relevant. A few years ago, this was hardly the case, but now each business is expected to have a certificate giving it authority to operate issued by the Environmental Protection Agency. Some of the issues that come up are whether the company is producing harmful waste products, whether they are being disposed off properly, whether the company is situated in a right area and whether it is production is not causing physical degradation to the environment e.g. erosion or pollution of a water body.

Other key elements that play a part in the analysis are political and legal risks. Ghana is a third world country where political tensions may often be rife which may affect business operations and therefore the political climate is monitored carefully especially where certain governments have been known to pursue agendas that may be harmful to local industry. In respect of legal risks, business law in respect to certain industries is relatively underdeveloped which may seriously affect business activity. With regard to socio-cultural factors, there is scanty information on population demographics, income distribution, social mobility, lifestyle changes and consumer preferences, and it is therefore difficult to assess the impact of these issues on the client's business. Thus, such matters are often not discussed in credit applications.

3.2.1.c) Account performance risk:

Account conduct and profitability reviews whether the limits of existing facilities (if any) have been respected, whether expected turnovers have been realised and whether there have been sufficient swings in the case of overdraft facilities. Other things looked at are whether there were a lot of returned cheques on the account (both inwards and outwards) and if loan repayments were on schedule.

A profitability analysis that covers profits made from each of the facilities granted, including the processing and commitment fees, is completed. An attempt is made to determine the cost of managing the account. Some of the factors that come into play are: the number of requests made to overdraw the account, whether or not the customer demands a lot of attention, whether he is difficult to please and if the Bank's time is invariably spent on resolving problems, etc. Since there is no mathematical model for scientific analysis in place, the costs assigned to managing the account are purely subjective.

3.2.1.d) Business risk:

One of the key issues here is the nature of the operations of the business, and how it fares in the industry in which it is operating. The information provided on the loan application on how the company is performing compared to the industry standards is normally difficult to validate, as there is often a lack of financial information available on the other players in the industry. In some cases, no industry analysis is done, as there is a lack of any serious databases providing information on industries, and consequently a lack of statistics. Often conclusions are made either based on a general feel for how the industry is performing, or based on the customer's opinion of his business and its competitors, none of which is objective.

The issue of competition, and the various strategies used by clients to overcome competition are quite relevant to the Bank's risk analysis process, as a large number of businesses are in commerce and trade (that often perceived to be the most lucrative sector of the economy by owners). For manufacturing companies, the Bank will look at the level of sophistication of a client's equipment, and at how easily the company can maintain or replace existing equipment. It will also look at whether the equipment could be sold or leased to another party in the event of difficulty. Government regulations as regards the industry in question are also a factor, along with other issues pertaining to specific matters related to the nature of the business (such as raw material supplies, inventory composition, labour relations, energy requirements and key markets).

3.2.1.e) Security risk:

The key area covered is whether or not all security has been perfected in accordance with the last credit request (i.e.: if all security documents have been received and signed, and if all insurance in respect to these securities has been submitted). The nature of the security is also considered. The bank usually takes various kinds of security, but by far landed property forms the bulk, with properties in the city much preferred, in view of problems the Bank has had in the past with collateral in remote areas. Valuation reports are mandatory, and values are discounted by the Bank where considered necessary.

The ease with which the security can be realised is also considered. In the event that the credit grading of the company has deteriorated, additional security is usually demanded. If such additional security is not available, this is considered a relevant risk issue that must be resolved. If there are other lenders, an assessment is made to determine if the bank is in a preferred position. If the facility is on a "clean basis", then a justification must be made on it remaining as such.

3.2.1.f) Financial risk:

The documents used in evaluating the financial risk of clients include the following:
Annual financial statements, management accounts, cash flow projections, analysis of debtors/ creditors/stock, FAMAS financial report.

The key areas covered in the financial analysis are growth, profitability, liquidity, leverage, coverage, and efficiency. Some of the key ratios measured are:
Growth: Sales, Net worth, Total assets, Profitability

Profitability: ROA, ROE, Gross margin, Operating profit margin, net profit margin
Liquidity: Current ratio, acid test ratio
Leverage: Debt/net worth, debt/tangible net worth
Coverage: Interest coverage
Efficiency: Sales to total assets, stock days, debtor days, creditor days, sales to working capital
The financial ratios are calculated by the FAMAS financial analysis software package. Despite being a good software package, the data generated on the financial status of the borrower is unfortunately compared to industry parameters that may not always be suited to the economy of Ghana or of Africa as a whole. Consequently, the FAMAS report only serves as a prompter for more relevant explanations from the client.

Management accounts are also reviewed and analysed, in order to compare them to the last annual financials and to cash flow projections. An analysis of debtors, creditors and stock is also made. Where relevant, amortisation schedules and other relevant financial information are attached.

The Bank has in place a risk grading system that ranges from A1 to A6 and B7 to B9, which means that there are nine different grades for an account. The grading is done my means of a scoring system of between 1-100 of specific characteristics of the business. The characteristics are broadly under the sections indicated below;
General- Max no of points 25; General features of the business unit, nature of the industry, whether family business, middle market or blue-chip, credit history etc
Financials- Max no of points 35; Profitability, growth, liquidity, security arrangements, reliability of financials, capitalization etc
Ability to service and repay Max no of points 18; Past credit history, cash flow etc
Management- Max no of points 20; Integrity, skill, succession arrangements etc
The higher the score the lower the credit risk of the client. The performing accounts range from risk levels of A1 to A6 whilst the non-performing accounts are in the B category covering doubtful, substandard and loss accounts.

3.2.2 CREDIT APPRAISAL FOR MULTINATIONALS AND PARASTATALS

The credit analysis undertaken here follows the same format as that undertaken for the larger corporates. The following risk areas may however be analysed differently.

3.2.2.a) Management risk:

This analysis is undertaken, but rarely proves unsatisfactory, as management integrity and capability are prerequisites to arrive at such high levels of responsibility in such companies. For government institutions, some management appointments are political. When this is the case the Bank may find itself in a difficult position. If the government guarantees the lending, then it may not be much of an issue. However, if loans are not government guaranteed the Bank's strategy is to decline the request tactfully.

3.2.2.b) Security risk:

The facilities to multinationals and parastatals are sometimes granted either on a "clean basis" (i.e.: no security is demanded at all), or they are granted on a "negative pledge" (i.e.: the Bank is not provided with any security, and the client undertakes not to provide any other lender with security). In other instances, the bank covers its position with either deposits on other accounts, has arrangements to collect funds from business outlets, has a lien perhaps on goods in a warehouse or other acceptable security arrangement.

3.2.2.c) Financial risk:

There is much emphasis put on financial analysis for this group of clients. The borrower usually readily provides most of the financial information requested. This is especially so in the case of multinationals, who often retain accounting staff of high calibre. The financial data is often corroborated by industry information, feasibility reports, including extended projections, project presentations and marketing reports.

In the case of the parastatals sometimes there is a decision lend in instances of institutions that may not necessarily be performing if the funds are required for an essential commodity e.g. crude oil etc. Government guarantees such debt.

3.2.2.d) Legal issues:

Some special legal issues may arise with this type of financing. Sometimes it may centre on issues relating to offshore lending, syndication, leveraged buyouts, complex security arrangements and cross border relationships with other affiliates of the client. In each instance the analysis is to ensure that the Bank is not in a legally disadvantaged position that will hinder its collection of the outstanding debt.

3.2.3. RISK ANALYSIS FOR SMALL AND MEDIUM ENTERPRISES

SME's are classified as such by the Bank more often because of the nature of the set up than the actual limits approved for these establishments, even though this may play a part in their definition. Currently the Bank is in the process of redefining its concept of SMEs and the role this business sector will be required to play in its operations.

These firms are often registered as sole proprietors or enterprises, even though the general trend is to encourage them to register as corporate entities. Areas of risk considered in the preparation of credit applications are described below and not necessarily exhaustive.

3.2.3.a) Management risk:

These firms are noted for being owner managed. Knowing the person behind the business is therefore considered even more important here. The Bank requests the name, age qualification and experience in the type of activity undertaken. The general trend, as seen by the Bank, is that the entrepreneurs are generally not highly educated but have been found to have good business acumen. Efforts are also made to know the clients out of the business setting (if possible), to find out what kind of people they are i.e. their interests, habits, family situation, etc… This kind of information gives the Bank a truer picture of the business owners.

The businesses are usually also quite small in nature and as such; the problem that usually comes up is that the owner makes all the key decisions in the company. However, when he is not around, the business comes to a standstill. The entrepreneurs are therefore encouraged to undertake succession planning, but this is something that usually has to be tactfully approached. For this type of company, the Bank encourages a key man insurance scheme, as without the key person the business dies off (the Bank has experienced this on a few occasions in the past).

3.2.3.b) Environmental risk:

Efforts are made to ensure that the company is complying with environmental regulations. However, once again the lack of information makes the analysis of this risk in terms of socio-cultural factors difficult. There is scanty information on population demographics, income distribution, social mobility, lifestyle changes and the like. Assessing how these factors impact on credit risks is therefore a big problem.

3.2.3.c) Account performance risk:

This is extremely important for small and medium enterprises, especially as the Bank often has no real confidence in the clients' financial statements. What is normally looked at are the debit and credit turnovers indicating the deposit and withdrawal trends, whether withdrawals are mainly by cheque or by cash, the payees of the cheques and the incidence of returned cheques both inwards and outwards. The Bank also looks at whether there are frequent requests for overdrafts, how quickly these overdrafts are rectified when granted, whether facilities granted are used for the required purposes, and of course if the client is doing split banking (i.e.: banking with more than one institution at a time).

3.2.3.d) Business risk:

Every effort is made to understand the customer's business by obtaining information from the customer himself and from others in the industry. As stated earlier, there is a dearth of information on various industries, but relevant statistics are not often available in Ghana, making it well nigh impossible to know of market share, market size, market trends and the contribution of the industry to the economy.

However, a peculiar feature of businesses in Ghana is that they are most often involved in commerce, either domestic or import-export based. They require working capital support and the margins are very thin because of the high level of competition involved. For this reason, whenever there is the least problem with cost management, the business runs into difficulties, and before long has to be closed down. Many companies also suffer from a lack of the proper structure required to function well in a difficult economy (i.e.: good bookkeeping systems, staff remuneration structures, business plan formulation and proper recruitment procedures).

The bank normally believes that the information gleaned from the account performance is often more reliable than that from the financials. A difficulty arises when funds from the client's sales are not all passed through his account held at the Bank, and are instead used for the purchase of forex on the open market or for the payment of suppliers in cash. In such circumstances, the volume of business is understated and there may be difficulty in making a lending decision on the account. An analysis of the profitability of the account is normally attempted to determine the cost of running the account, but this process is not very objective.

3.2.3.e) Security risk:

The Bank considers whether all security in respect of the last loan application have been perfected, whether the security can be realised without any impediments, whether it is fully covered by insurance, and whether there is a need for additional security. As the risk of lending is generally higher for this type of customer, the Bank normally prefers tangible security. However, when this is not available, a charge over the assets of the company or hypothecation of the enterprise's stock is taken as additional collateral.

3.2.3.f) Financial risk:

Here the bank normally does not use FAMAS for the analysis of the financial information as the accounts have relatively small and simple accounts. They may request the following financial information, where available: audited accounts/reviews/compilations, cash flow statements/projections, ageing analysis of debtors/creditors/stock, management accounts.

An analysis is made of this information on the loan application. However, what the Bank has come to realise is that the majority of these clients are reluctant to prepare financials. They are often only prepared at the request of the Bank, or when the client thinks that the annual provisional tax assessment by the Internal Revenue Service is too much, and he deliberately underreports profits to pay less tax. In either case, it is difficult to make any financial analysis and arrive at the right conclusion, as the premises are false.

3.3 ARE FINANCIALS OVEREMPHASISED?

From the survey conducted at BLC a total of 60 credit files were selected at random from the three client categories (20 for each category). In the case of the multinationals and parastatals, 17 credit files contained very detailed financial analysis and other types of financial information, and even though the other aspects of risk were also analysed it was not given the same attention to detail as that of the financial analysis. The main risk issues considered by the approving authorities also appeared to be more skewed to financial issues. In the case of the middle level clients the figure was 14 whilst for the SME clients this was 12.

Interviews were held with the key staff at the Credit Department responsible for the approval of loans. The information obtained was that the analysis of risks is in general satisfactory even though there were instances in which more relevant information could have been provided. The discussions also revealed that for top and middle level clients key financial ratios and indicators had to be acceptable for a facility to be approved. In other words, even if all the risk areas were acceptable and the financials results were not within an expected minimum performance, then the facility was likely to be rejected. On the other hand, if the financials were acceptable and the other areas of risk perhaps management or account performance revealed some weaknesses, there was a higher probability of the facility being approved. For the SME clients however, the discussions revealed that even though financial risk analysis was considered important, the likelihood of approving a facility that did not have good financials but had a record of honest management or a history of a good account conduct was higher.

Discussions were also held with the Rms on the kind of analysis they did on their credit applications, which revealed that a greater part of the time was spent on the analysis of the financials, notwithstanding the importance of the other risk areas. The general trend of the information provided was that the bank placed a premium on the financial performance of the company, and to get a facility approved this had to be very well done. This conception appeared to be more in relation to the multinationals and corporates.

Discussions were also held with the Audit department to find out their views on the quality of the risk analysis done. In their view, more could be done to improve the risk analysis process at the bank. The issue of training was raised to make the Rms capable of identifying key success factors of each credit request. A key point that was made is that in relation to financial information, more effort has to be made to find what events led to the results (i.e.: the reason behind the figures instead of reporting just the facts), and for the SMEs the information gleaned is that the quality of analysis was sometimes poor.

In the case of Merchant Bank, the survey revealed that 16 credit files out of the sample size of 20 for the multi-nationals and parastatals placed a premium on financial risk analysis. In the case of medium corporates this figure stood at 15 whilst for the SMEs this stood at 13.

From discussions held with the key staff of the MBG credit department, the general perception is that the analysis of risks is on the whole acceptably done, but there is significant room for improvement as are peculiar problems with each risk area. In respect to financial analysis, indications are that this is the first thing requested when a customer, irrespective of the type of organization, requests a facility. Experience has however shown that it is wrong in asking for the same level of financial information from all categories of borrowers. What happens is that one ends up burdening small to medium companies with the preparation of financial information that does not reflect what is happening in the business, and worse still, precious hours are wasted in analysing them. The observation is that financials may be given too much relevance in respect to the SME and middle level corporates.

From the above then one could conclude that financials are over emphasized at both banks. For BLC it appeared to be more in the case of the high end clients (multinationals and parastatals) as well as the medium corporates, whilst for MBG it appeared to be more in the instance of medium corporates and SME's. This state of affairs has the potential of generating serious problems.

3.4 SETBACKS OF OVEREMPHASIS

[16]The fact that financial statement analysis shows a healthy position of a company does not mean that the company is a good lending prospect (i.e.: it is solvent and will continue to be solvent). There are aspects of the business that it does not capture like competition, lack of raw material supply or key management resignations. In the case of BLC, there was a company XXX Inc. where all the key financial ratios appeared to be in order. Sales had been particularly growing fast, resulting in higher profits, but of course this did not portray the intense competition in the industry. The company was exporting sophisticated computer software to the US from Canada. Unfortunately, in less than 18months the company had to be wound up because a Japanese company entered the market and seriously undercut its prices. In another instance, a pharmaceutical company YYY Pharmaceutica that had been performing very well as reflected in its last financials, which revealed a solid balance sheet with enviable growth figures, suffered a serious setback. This occurred when its wonder drug had to be withdrawn from the market when further testing by the national medical association revealed possible life threatening side effects.

[16] Boyadjian and Warren (1991) *'Risks, Reading Corporate Signals'* London, John Wiley and Sons op.cit pp

In order that the directors of a company may not get away with the falsification of the facts, the financial statements are subject to external audit. What this produces is a letter to the effect that the figures have been scrutinized and subjected to established audit procedures and, according to the auditors, a true picture has been painted of the company's affairs. Many people hasten to conclude that when this is done the accounts are the truth, the whole truth and nothing but the truth. This may however not be necessarily so. What one needs to remember is that, although the auditors are under an obligation to exercise independent judgement, it is sometimes difficult because it is the company that employs them. If they regularly disagree on serious matters and issues, they may either be dismissed or asked to resign. There is no doubt auditors are faced with dilemmas when they do not want to lose a major client, which may lead to a compromise of their principles. [17]One just needs to look back at how Arthur Anderson, one of the big five accounting firms helped the US energy giant, Enron hide debts and losses in 2002.

In lending one comes across all types of financial statements, from simple compilations through reviews to audited accounts. One can imagine that if even an audit cannot guarantee authenticity, then what happens for e.g. in the case of a simple review? How reliable can this be as the basis of a lending decision?

Financial statements present a historical account of the performance of a company. There is therefore always the risk that things might have substantially changed after its presentation. In a bid to mitigate this risk, the banks usually have a policy that facilities be reviewed within 90days of a borrower's financial year-end. It however happens that sometimes the accounts are presented late, and consequently any information provided is well past its date of relevance. There was an instance where a company ZZZ Inc. presented accounts for year-end 2002 for a facility requested in June 2004. In such a case any analysis done will be totally irrelevant.

Oftentimes, financial statements are also sanguine about future prospects, new products are described with relish whilst risk issues are played down. The financial data can create

[17] www.time.com/time/business/article/0,8599,263006,00.html

a false sense of security. Profitable operations and a healthy asset base only tell us that a company has prospered in the past. There is an implication that this will continue, but this presupposes that management will cope as effectively in the past with any challenges. The danger lies in the crude assumption that past trends can be extrapolated into the future.

Another grave problem that has been noted with financial statements, especially in Ghana, is the importance of this document to management itself and thus the reliability of the information that goes into its preparation. For Merchant Bank for example, the middle level corporates are the fastest growing customer base and for some of these clients financials are produced because it has to be done. Additionally all the salient facts are normally not reported. It is a relatively well-known fact that in some instances two sets of accounts are produced (one for the tax man and one for the banker) which shows that neither can be trusted. For the SMEs the situation is sometimes even worse, as the financials are compilations or reviews and are most often outdated.

The financial statements sometimes contain information that is presented in a way that makes analysis difficult. In addition, the notes do not explain the figures and principles used. It is therefore the job of the analyst to select the relevant data from this morass. The analysts try their best to employ certain established techniques to get the required information. By and large however they tend to use the key financial ratios as indicated elsewhere in this paper. It may be however easy to miss key figures.

There are misconceptions about some of the figures that are of key interest in the account. Banks are overly concerned with profit, as this seems to indicate that a business is doing well. [18]As Di Lorenzo has indicated, profit when recorded does not mean that the company has amassed that amount of cash and is waiting to spend it. It just means that the amount received from trading and other activities is deemed to exceed the amount incurred in expenses. A profitable company may therefore have serious liquidity

[18] Di Lorenzo F. 'Getting behind the numbers Part4, Profitability, it is not just the bottom line' The Risk Association Management Journal Vol.83 No.7 April 2001

problems. It is also assumed that the balance sheet is a valuation statement but this is simply not true. The values attributed to the assets may be far from their real worth as they are normally based on the historical cost concept.

The accounting standards and conventions also leave room for interpretation. Accounting is not a science but an art, and profit numbers and values for assets and liabilities could be nudged up or down legally without breaking the rules. For e.g. in the valuation of stock, the company may chose to use LIFO or FIFO, the former reduces the value of the stock and thereby leads to a lower profit figure and lower taxes, whilst the former leads to the opposite effect. Financial experts could then to an extent paint the kind of picture that they wish of a company.

Overemphasis on financial statements means that other aspects of the risk analysis will be played down which can prove to be costly for the bank. It is imperative that the lender understands the business into which he is putting his money and this cannot be done without a thorough analysis of business risk. If this is not undertaken, there is no way a good financial analysis will mitigate risks like inadequate raw material supply or lack of an adequate market. A company that is not compliant with regards to the environmental laws prevailing will not have a leg to stand on if its license is withdrawn. Additionally companies with a management without integrity will most likely not present honest financial statements.

CONCLUSION/RECOMMENDATION

Financial risk analysis is undoubtedly an important part of the credit appraisal review process. This however does not justify its overemphasis. For a thorough credit appraisal leading to a sound lending decision, equal importance needs to be given to the other risk areas. The qualitative and the quantitative issues need to be looked at as an ensemble. Indeed one should start with the business risk to be able to build a solid understanding of the company before the other risk aspects are considered. It is only in this way that the bank will be able to maintain healthy risk assets. In fact, two well known authors on risk,

[19]Boyadjian and Warren, have said: "The process by which a company makes money has economic, social and human dimensions that are as important as the financial aspects. We ignore these at our own risk".

[19] Boyadjian and Warren (1991)' Risks, Reading Corporate Signals' London, John Wiley and Sons

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