



## CCP PART III SECTION 6

### CREDIT PRACTICE

FRIDAY: 21 May 2021

Time Allowed: 3 hours.

Answer ALL questions. Marks allocated to each question are shown at the end of the question.

#### QUESTION ONE

##### CHEMICAL WAREHOUSE EXPANSION

AGRO Chemicals is a Limited Liability Company involved in the importation and manufacturing of chemicals. The company started from modest beginnings with a small warehouse. AGRO Chemicals experienced growth and as a result the company acquired adjoining blocks of land for expansion. The company sought a medium term (7 years) loan of Sh.101 million to purchase the land and expand warehouses. The property was taken as collateral.

AGRO Chemicals Ltd. was located within a residential area. But since chemical warehousing and trading are not prescribed activities requiring environmental protection Licenses under the National Environment Act, the company obtained business registration and local authority approvals for a chemical warehousing and trading facility which within a short period of time ended up holding bulk quantities of chemicals. Since the facility did not require any environmental approvals, the bank deemed the Environment and Social (E & S) risk profile high enough to warrant an E & S risk assessment as part of the credit appraisal for the loan application. The E & S risk assessment focused only on fire safety noting that the company had installed portable fire extinguishers and hydrant system.

No attention was paid to safe storage and handling of chemicals. No consideration was given to assessing the potential community health and safety risk from the location of the operation and whether the existing facility and proposed expansion met safe hazardous warehouse design standards, including safe distances from other buildings and sensitive targets.

Although the bank had correctly flagged the operation as having high E & S risks profile, the subsequent assessment failed to send a clear message through the credit appraisal process that the bank was exposed to a significant risk. That is, a warehouse with large quantities of poorly stored and managed hazardous substances with a mix of toxic, flammable, combustible and chemically reactive properties, in a residential area.

AGRO Chemicals Ltd. was no exception. In 2016, a fire broke out in the warehouse not only damaging a large portion of the chemical stocks, and the warehousing infrastructure but also releasing a plume of toxic vapour across the neighbouring community. Over 500 residents were hospitalised with breathing difficulties and eye irritation.

The incident made the headlines of local newspapers and all local television news networks. The facility was closed for six months pending the outcome of court proceedings. The company was subsequently ordered to relocate to an industrial zone. Aside from lost business, the company also incurred costs associated with site clean-up, site decontamination and warehouse relocation. After relocation, the company continued to incur depressed revenues as customers blacklisted the company and moved to other suppliers. The combined financial distress significantly impacted the ability of the company to commit to its loan repayment schedule despite rescheduling more than once. The loan became a non-performing loan and the bank was left with damaged and contaminated property as collateral.

The Chief Executive Officer (CEO) of AGRO Chemicals Ltd. is your friend and he has confided in you that all employees in assessment unit of the bank have no formal training in areas of credit analysis and risk assessment.

#### Required:

- (a) (i) Point out three environmental and social risks that the credit appraisal committee should have considered in appraising AGRO Chemicals Ltd. for a loan facility. (6 marks)
- (ii) Based on the case study, highlight five documentations that the bank should have examined during the assessment of the impact of environmental and social risk exposures before granting AGRO Chemicals Ltd. the loan facility they had applied for. (5 marks)

- (b) Citing evidence from the case study, list five triggers of credit risk stemming out of environmental and social risk exposure that could have led to default on the facility offered by the bank. (5 marks)
- (c) "Poorly managed environmental and social risk impact equals business risk for the client and credit risk for the bank".

With reference to the above statement:

- (i) Identify three consequences of poor assessment of E & S risk impact on the bank credit risk. (3 marks)
- (ii) Propose four measures the bank should take to improve credit appraisal system for E&S risk assessment during credit approval process. (8 marks)
- (d) (i) Discuss four credit analyst skills that would have assisted the bank employees in arriving at a decision that would have saved the bank from suffering loss due to non payment of the loan by AGRO Chemicals Ltd. (8 marks)
- (ii) Identify five ways that the bank could apply to improve the credit analysis skills of the employees. (5 marks)
- (Total: 40 marks)

#### QUESTION TWO

- (a) Explain four techniques of mitigating company's working capital challenges. (8 marks)
- (b) Discuss seven causes of delinquencies in microfinance institutions (MFIs). (7 marks)
- (Total: 15 marks)

#### QUESTION THREE

Corporate failure could be seen in terms of the inability of a corporate organisation to conform itself with its strategic path of growth and development to attain its economic and financial objectives as well as legal obligation. In line with this statement:

- (a) Highlight seven reasons why corporations fail. (7 marks)
- (b) Suggest four benefits of using management information systems in the management of accounts receivable. (8 marks)
- (Total: 15 marks)

#### QUESTION FOUR

- (a) (i) Explain the term "credit risk model". (2 marks)
- (ii) Highlight three reasons why credit risk modelling has become very popular in the recent past. (3 marks)
- (b) Explain five factors that influence interest rate charged on a bank loan. (5 marks)
- (c) Summarise five benefits of account receivables management. (5 marks)
- (Total: 15 marks)

#### QUESTION FIVE

- (a) Define "Economic Capital" as used by banks and financial intermediaries and examine the two principal issues it addresses concerning the management, shareholders and other key stakeholders. (5 marks)
- (b) Discuss five differences between "regulatory capital" and "economic capital". (10 marks)
- (Total: 15 marks)
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