kasneb

CCP PART III SECTION 6

CREDIT PRACTICE

FRIDAY: 1 December 2017. **Time Allowed: 3 hours.**

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

QUESTION ONE

SOFTCASH LTD.

Softcash Ltd. specialises in providing auto loans to consumers with low incomes and poor credit records. Most of the company's loan applicants have an average monthly household income of Sh.28,000. Almost a third of the applicants have no bank account, and only 4% of the applicants own their own home.

The lending process of Softcash Ltd. begins with customers filling an application form when they arrive at a dealership. They work with a sales representative and the dealership manager to select a vehicle and discuss financing terms. Buyers are then required to make a down payment of 10% and the 90% balance is financed by Softcash Ltd.

Buyers are expected to make regular payments to the dealership for a fixed period of three years. The loan attracts high interest rates reflecting the risk of the borrowers pool. Defaults during the repayment period are common and tend to occur relatively early in the repayment period. About 35% of loans are defaulted during the first year of repayment and only 40% are paid in full.

Due to the high default rate, Softcash Ltd. has adopted credit scoring in order to determine the creditworthiness of each applicant. Employees at the dealership are responsible for collecting information from applicants during the sales process, and much of this information is not formally recorded. Prospective buyers are asked for basic information about their income, family, work status and scheduled debt payment.

With the adoption of credit scoring, the company has started to pull information from the major credit bureau and is using a proprietary algorithm to assess each applicant's risk profile. The scoring algorithm achieved impressive risk stratification. The loan repayments made in the first year after credit scoring was put in place, have shown great improvement.

Softcash uses the assigned credit score to establish a schedule for minimum down payments. Each applicant is required to make a down payment. The amount of the down payment depends on the applicant's credit score but not on the type of car being purchased. An applicant deemed as low risk is eligible to obtain financing for a larger range of vehicles, in particular, newer, lower-mileage cars that are more expensive.

The adoption of credit scoring allows the company to make systematically different offers to loan applicants with different risk profiles. Profits per transaction increased by over 20% for each risk category.

One of the members of the Board of Softcash Ltd. strongly feels that in as much as the loan recovery has improved, the management of Softcash Ltd. should consider outsourcing debt recovery activities. The other members of the Board are non-committal on the issue, but have tasked the credit manager to develop an outsourcing policy for consideration.

Required:

(a) Explain four challenges that Softcash Ltd. could be facing in lending to its customers. (8 marks)

(b) Analyse four sources of information that Softcash Ltd. could use to assess credit risk of its customers. (8 marks)

(c) Justify the adoption of credit scoring by Softcash Ltd. (8 marks)

(d) Suggest six types of information about a customer that a credit score model should consider. (6 marks)

(e) Highlight ten areas that might be incorporated in the proposed outsourcing policy. (10 marks)

(Total: 40 marks)

QUESTION TWO

(a) Virtually any person, including an evasive debtor, can be located because there is always a "paper trail".

Required:
With reference to above statement:

(i) Explain the term "skip tracing". (2 marks)

(ii) Explain three main objectives of skip tracing. (3 marks)

(b) "Every applicant seeking to engage in agent banking business shall, on a one off basis, submit the required information to the central bank".

Required:
With reference to the above provision:

(i) Propose five contents of the required information. (5 marks)

(ii) Enumerate five reasons why an agency contract could be terminated. (5 marks)
(Total: 15 marks)

QUESTION THREE

(a) Describe five assets of a debtor which cannot be taken over under the warrant of execution. (5 marks)

(b) Highlight five objectives of the Consumer Protection Act in your country. (5 marks)

(c) Janet Lendi is considering various sources of finance to raise additional capital for her business.

With reference to the above statement, assess five factors that might influence Janet Lendi's choice of source of finance. (5 marks)
(Total: 15 marks)

QUESTION FOUR

(a) With reference to bank credit, distinguish between the following terms, "time liability" and "demand liability". (4 marks)

(b) Describe four faults in lending procedures which could lead to poor quality loans in lending institutions. (4 marks)

(c) Examine seven matters that might be addressed by a deposit taking Savings and Credit Co-operative Society (SACCO) when reviewing its liquidity policy. (7 marks)
(Total: 15 marks)

QUESTION FIVE

(a) Explain the term, "seasonal datings" as used in trade receivables management. (2 marks)

(b) Memphis soft drinks palour is currently offering trade credit of "net 35 days". Its credit sales amount to Sh.50 million with an average collection period of 50 days. In order to increase the demand for its products, the company reviewed its credit terms to "net 45 days", with an expected 10% increase in sales. Under the new terms, the average credit period is expected to be 60 days.

For every Sh.1.00 of sales, the company incurs Sh.0.70 in variable costs and the company's pre-tax required rate of return on investment in receivables is 18%.

Required:

(i) Analyse the impact of the change in credit terms to the management of Memphis soft drinks parlour. (11 marks)

(ii) Advise the management of Memphis soft drinks parlour on whether to implement the change in credit period. (2 marks)
(Total: 15 marks)

....