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CCP PART III SECTION 6

CREDIT PRACTICE

MONDAY: 30 November 2020 **Time Allowed: 3 hours.**

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

QUESTION ONE

MKULIMA IMARA BANK (MIB) LIMITED

Mkulima Imara Bank (MIB) Limited is a bank whose membership is drawn from farmers. The bank has been operational since the year 2000. Its initial customer base was dairy farmers. The bank has credit facilities suitable for this group of customers to aid them in the purchase of dairy farming inputs among other needs.

Five years ago, the government conducted a research and identified a variety of potatoes that take three months to mature. After an evaluation, the government selected MIB Limited for a partnership so as to promote the growth of this crop across different parts of the country. The government financed the initial outlay to the interested farmers.

The first year of the trial went on well and the farmers, depending on the weather patterns managed three seasons of the harvest. The senior management of the bank is comprised of close relatives who are among the founders and the board of directors is composed of veteran dairy farmers.

The potato farmers have been recording poor repayments of their facilities due to the seasonality of their income. Further, the government's potato board (GPB) pays the farmers after three months from the date of submission of the produce into their stores for export. The interest rate charged on the initial outlay to the farmers was 9% per annum on a reducing balance since it was a subsidy from the government. So as not to lose the farmers, the bank chose to maintain this rate of interest.

Since a lot of work came about as a result of the new clients, the bank carried out a massive recruitment and hired graduates from all fields of study with the aim of giving them training on agriculture lending to bridge any skill gap. Most departmental heads lack requisite knowledge and experience in the respective professions but were endorsed to the positions owing to their connections with the board.

As a result, financial reporting has major issues and the regulators have issued warnings on several irregularities on quarterly bank reports, capital adequacy maintenance, liquidity ratio thresholds among other regulatory matters.

The loans are appraised by marketing officers while the accounts team maintains the farmers' accounts. The accounts team is charged with contacting farmers who are in arrears for payment follow ups before referring them to auctioneers for external recovery processes. The main criteria for granting loans to the farmers was the successful initial project as subsidised by the government, ownership of the farm and ownership of some farm and household assets.

The bank was certain that upon harvest, sufficient income would be generated to repay the loans in full. However, this has not been the case due to the effect of crop diseases and other adverse farming conditions including unstable weather patterns.

A review of the bank's lending process reveals that little has been done with regard to assessment of customer's credit worthiness. This explains why the bank has been recording increased delinquent loans and poor profitability. The interest spread also seems to give a negative margin since the government withdrew from the project. A sample of the delinquent loans has been linked to the bank's staff who took advantage and used unsuspecting farmers as conduits to get financing from the bank only to default and leave the customers under the bank's pressure to repay. The bank's performance has been on a downward trend and the regulator has threatened to place it under receivership unless the board of directors make the recommended changes within one year with the view of reviving it to meet the minimum performance indicators as laid out in the regulations. One of the board's resolution is now to hire a loan's management expert to turn around the bank's loan management as well as a corporate governance expert to advise on overall sound management of the bank, in line with prevailing best practices.

Required:

(a) You have been hired by the management of MIB Limited as the loans management expert:

(i) Assess five practices by the bank that have contributed to its dismal performance in loans management. (Support your answers with evidence from the case study). (10 marks)

(ii) Propose appropriate remedies to the practices identified in (a) (i) above. (10 marks)

(b) One of the most important ways MIB Limited could ensure its loans meet regulatory standards and are profitable is to establish a written loans policy. In line with this, discuss ten important elements that should be included in the loans policy document. (20 marks)

(Total: 40 marks)

QUESTION TWO

(a) (i) Explain the term "debt restructuring". (2 marks)

(ii) Examine five ways that debt restructure could benefit a business. (10 marks)

(b) Explain three steps for setting up an accounts receivable management system. (3 marks)

(Total: 15 marks)

QUESTION THREE

(a) Analyse three drivers of credit risk that a bank should consider in credit portfolio risk management. (6 marks)

(b) Describe three sources of financing temporary working capital needs. (6 marks)

(c) Enumerate three indicators of overtrading in a business. (3 marks)

(Total: 15 marks)

QUESTION FOUR

(a) Explain three uses of Capital Adequacy Ratios in management of banks. (6 marks)

(b) Argue three cases against the use of Univariate Models in prediction of corporate failure. (6 marks)

(c) Describe three challenges of credit risk modeling in banks. (3 marks)

(Total: 15 marks)

QUESTION FIVE

(a) Arriving at a workable solution among competing interest of commercial defaulters requires an understanding of dynamics of negotiation and agility of negotiators.

With reference to the above statement:

(i) Analyse three dimensions of negotiation. (3 marks)

(ii) Explain six principles of the interest-based strategy in commercial debt negotiations. (6 marks)

(b) In relation to the Central Bank of your Country's Regulatory Framework:

(i) Explain the meaning of the term "Risk-Based Supervisory Framework". (2 marks)

(ii) Assess four principal benefits of Risk-Based Supervisory approach adopted by central bank. (4 marks)

(Total: 15 marks)

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