

# COMMERCIAL INFORMATION AND CREDIT ANALYSIS PRESENTED IN A LOAN MEMORANDUM

**Truica Luiza Denisa**

*UniCredit Tiriac Bank , Relationship Manager Corporate, PhD. Student – Academy of Economic, Studies, Bucharest, Bucharest, 7th Brinduselor Str. , building G3, ap. 14,3rd district, denisa.truica@unicredit.ro, 0728.80.80.93,*

*For financing corporate companies, banks use own and varied forms of loan memorandums which gather commercial and financial knowledge about the client. Credits granted to companies, whether public or private, generally comprises loans for working capital and for fixed assets, financing such as overdrafts, term loans, syndicated loans, and revolving credit and working capital loans. Banks do analyze a set of basic and additional criteria such as the ability of continuing business, the expected future cash flows, security and collateral, the rate of return to the bank as well as the level of the whole business which the bank has done with them. Credit papers needed for the conclusion of the convention between the bank and a potential client are governed by Law No 58 – the Banking law and procedures issued by NBR. The composition and quality of a bank's loans should be reflected in its loan policy.*

*Key words: client, loan, analysis, ratios, bank*

A loan is the immediate possession of resources in exchange of a future payment promise involving also an interest payment that rewards the lender. Before granting any loan, it is necessary for the lender to know the purpose of the credit same as its legal purpose. On corporate segment, types of credit vary.

Generally, banks have their specific lending policies, which may change from time to time due to the market conditions or government regulations. Their policies are essentially based on the evaluation of the related risks such as the credit risk, interest rate risk and concentrated risk. The lending may be also authorized at a branch level if the branch portfolio allows that. In order to make proper lending decisions, banks purposely observe a set of general lending principles such as age and state of health, stability, integrity and honesty, sources of income, regular expenditure, existing connections, ability to manage financial affairs as well as margin, purpose, amount, repayment capability and security.

As corporations and companies represent the major category of clients, for the corporate lending banks do analyze a set of basic and additional criteria such as the ability of continuing business, the expected future cash flows, security and collateral, the rate of return to the bank as well as the level of the whole business which the bank has done with them. The usual procedures which banks apply in the loan granting to corporate borrowers specifically include submission of the application and required information, evaluation of the information, initial evaluation of the proposed security, negotiation, approval, legal examination of the security, signing of the contract, disbursement of the amount and recovery of the capital and interest. The credit granted to companies, whether public or private, generally comprises loans for working capital and for fixed assets, financing such as overdrafts, term loans, syndicated loans, and revolving credit and working capital loans.

## **The subjects of a loan memorandum**

**Overdrafts:** Overdrafts are usually granted to those companies desirous to use the credit amount not as a whole but rather in accordance with their needs and for a certain period without having to pay interest on the entire amount but on the term agreed for interest calculation. In such cases, whenever the company gets excess of capital it can repay parts of the credit and, consequently, decrease the amount outstanding.

**Export Financing:** As most major companies deal with exports, banks can offer short time credit to exporters until they recoup the money from importers, upon a collectibles guarantee for the lending bank.

**Loans for Fixed Assets Financing:** Such loans essentially include short-term, medium-term and long-term loans with respect to maturity. The security for such a lending may be uncovered, covered by cash equivalent, by personal guarantees or mortgage assets, collateral and, according to the type of repayment, it may comprise equal capital amortization, equal installment payment, specific terms, fixed or floating

interest etc. When loans in foreign currency are expected to be granted, banks usually tend to hedge their positions in the foreign currency but, very often, they rather speculate.

Syndicated Loans: Unlike the participation loans, the syndicated ones consist of an agreement specifying that two or more banks accept to directly lend to the same borrower or borrowers. In such a case, one of the banks plays the role of the agent bank while the others participate by own portions in the syndicate, the risks being shared by all of them.

## **The loan memorandum**

There are five stages to any new lending:

### 1. Introduction of the customer;

Lenders always choose their clientele. An important source of new business for most lenders is introductions from professional advisers such as accountants and solicitors. But, a bank has no obligation to lend to customers introduced in this way.

### 2. The application by the customer;

The application (credit request) can take many forms but should include a plan for repaying the loan and an assessment of the contingencies, which might reasonably arise, and how the borrower would intend to deal with them. It might be in detailed written form, or not.

### 3. Review of the application;

During this stage all the information must be tested. It is sometimes difficult to remember all the points to be covered during an interview and many lenders use a check list (a mnemonics) including: - character (about the individual's character); - capital; - capability/ability; - purpose/destination; - amount; - repayment; - terms; - security/insurance. Ability - this aspect relates to the borrower's ability in managing financial affairs and is similar to character (about skill, experience of the manager). Amount - Is the customer asking for either too much or too little? There are dangers in both and it is important therefore to establish that the amount requested is correct. The amount requested should be in proportion to the customer's own reasons and contribution. Repayment - It is important that the source of repayment is made clear. Where the source of repayment is income, the lender will need projections to ensure that there is a surplus of funds to cover the repayment after meeting other commitments. Insurance - The canons of lending should be satisfied of available security.

### 4. Evaluation and

### 5. Monitoring and control.

Both steps aim to establish the risk involved. Listing the pros and cons of a proposition is helpful.

Under the provisions of the Law No 58 – the Banking law, the credit documentation needed for the conclusion of the convention between the bank and a potential client are the following:

- Credit request;
- Current financial situation of the applicant and of any of its guarantors, including the projected cash flows for the repayment of credit and principals;
- Description of the guarantees for the entire payment of the debt, and if necessary an analysis of the goods representing the guarantee;
- Description of the credit conditions containing the credit value, the interest rate, the repayment procedure, the scope for using the credit;
- Specimen of signature for each person that authorized the credit and the name of the bank;
- Annual Balance Sheet and Profit and Loss Account for the last three years of operation (plus annexes);
- Company's Overview;
- Description of the current activity/ financial info;
- Description of the project proposed for credit granting;
- The cash-flow statement for the entire loan period.

As a summarize, it should be mentioned that before any loan is granted, the following questions must be answered by the customer: how much is required? the purpose of the loan (legal, moral and within the policy of the government and the bank, National Bank of Romania); length of time the advance is requested? (how long the money is required and whether the outstanding debt will be repaid monthly, quarterly etc); the source of repayment. Any customer must have sufficient resources to repay (capital + interest) the bank within the stipulated agreed time. The sources of the repayment could be from wages, dividends, an inheritance and profits and so on.

## **Credit analysis**

Credit analysis is the process of assessing the risk of lending to the business. The so-called credit risk must be evaluated against the benefits that the bank expects to derive from making the loan. The direct benefits are simply the interest and fees earned on the loan and possibly, the deposit balances required as a condition of the loan. Indirect benefits consist of the initiation or maintenance of a relationship with the borrower that may provide the bank with increased deposits and demand for a variety of bank services.

Credit risk assessment has both qualitative and quantitative dimensions; the former are generally the more difficult to assess. The steps in qualitative risk assessment are primarily gathering information on the borrower's record of financial responsibility, determining his or her true purpose for wanting to borrow funds, identifying the risks confronting the borrower's business under future industry and economic conditions, and estimating the degree of commitment the borrower will have regarding repayment. The quantitative dimension of credit risk assessment consists of the analysis of historical financial data and the projection of future financial results to evaluate the borrower's capacity for timely repayment of the loan and, indeed, the borrower's ability to survive possible industry and economic reverses.

The essence of all credit analysis can be captured in four basic factors or lines of inquiry:

- The borrower's character – most bankers agree that the paramount factor in a successful loan is the honesty and goodwill of the borrower;
- The use of loan funds – determining the true need and use of funds requires good analytical skills in accounting and business finance;
- Primary source of repayment – the analyst's accounting and finance skills are crucial in determining the ability of the borrower to repay a loan from cash flows. He must ascertain the timing and sufficiency of these cash flows and evaluate the risks of cash flows falling short.
- Secondary source of repayment – the collateral value should cover, in addition to the loan amount and interest due, the legal costs of foreclosure and interest during foreclosure proceeds. Even if the collateral is the preferred secondary source of repayment, others can be guarantors and co-makers, but in such cases, the collection usually requires expensive litigation and results in considerable ill will between the bank, borrower, and guarantor. In credit investigation, banks usually resort to the following sources of information:
  - Customer interview – it provides the most important information needed in credit investigation, including the type and amount of the loan required, sources and plans of repayment, eventual collateral and guarantors, previous and current creditors, primary customers and trade suppliers, accountants, main officers and shareholders etc.
  - Internal sources – credit files on any current or previous borrowings, checking account activity, other previous or current deposits, liabilities, income sources, assets, expenses and revenues etc.
  - External sources of information – specialized service agencies, newspapers, magazines etc.

Before granting a credit/loan, a bank makes a trustworthiness financial analysis of the customers. The main trustworthiness ratios which summarize the four categories of financial ratios are:

**Leverage ratios**

$$\text{Long-term debt ratio} = \frac{\text{long-term debt}}{\text{long-term debt} + \text{equity}}$$

$$\text{Debt-equity ratio} = \frac{\text{long-term debt}}{\text{equity}}$$

$$\text{Total debt ratio} = \frac{\text{total liabilities}}{\text{total assets}}$$

$$\text{Times interest earned} = \frac{\text{EBIT}}{\text{interest payments}}$$

$$\text{Cash coverage ratio} = \frac{\text{EBIT} + \text{depreciation}}{\text{interest payments}}$$

**Liquidity ratios**

$$\text{NWC to assets} = \frac{\text{net working capital}}{\text{total assets}}$$

$$\text{Current ratio} = \frac{\text{current assets}}{\text{current liabilities}}$$

$$\text{Quick ratio} = \frac{\text{cash} + \text{marketable securities} + \text{receivables}}{\text{current liabilities}}$$

$$\text{Cash ratio} = \frac{\text{cash} + \text{marketable securities}}{\text{current liabilities}}$$

$$\text{Interval measure} = \frac{\text{cash} + \text{marketable securities} + \text{receivables}}{\text{average daily expenditures from operations}}$$

**Efficiency ratios**

$$\text{Total asset turnover} = \frac{\text{sales}}{\text{average total assets}}$$

$$\text{Average collection period} = \frac{\text{average receivables}}{\text{average daily sales}}$$

$$\text{Inventory turnover} = \frac{\text{cost of goods sold}}{\text{average inventory}}$$

$$\text{Days' sales in inventories} = \frac{\text{average inventory}}{\text{cost of goods sold}/365}$$

**Profitability ratios**

$$\text{Net profit margin} = \frac{\text{net income} + \text{interest}}{\text{sales}}$$

$$\text{Return on assets} = \frac{\text{net income} + \text{interest}}{\text{average total assets}}$$

$$\text{Return on equity} = \frac{\text{net income}}{\text{average equity}}$$

$$\text{Payout ratio} = \frac{\text{dividends}}{\text{earnings}}$$

$$\text{Plowback ratio} = 1 - \text{payout ratio}$$

$$\text{Growth in equity from plowback} = \text{plowback ratio} \times \text{ROE}$$

***Financial ratios presented in a loan memorandum***

While analyzing a company's financial statements, the credit analyst might be overwhelmed by the sheer volume of data contained in the income statement, balance sheet, and statement of cash flow. Therefore they use only few ratios to summarize the firm's leverage, liquidity, efficiency, and profitability.

All credits have a destination precise and mandatory which can not be changed by the borrowers. Credits are granted under guarantees that are written the credit contract. The guarantees must cover the maximum amount of credit, amount consisting in the principal and interest. The bank shall reserve the right to verify to its customers (borrowers) the permanent existence and the integrity of the ensured guarantees during the whole period of the credit. In the case in which the bank shall establish the non-observance of the contractual terms, it shall withdraw the credits before the maturity date. During the validity of the credit, the beneficiaries of the credits have the obligation to deposit to the bank their balance sheet and the financial statement.

**Lending**

Bank loans finance different corporate groups in the economy. Manufacturers, distributors, service firms, farmers, builders, homebuyers, commercial real estate developers, retailers, and others all depend on bank credit. The ways in which banks allocate their funds strongly influences the economic development of the community and nation. Every bank bears a degree of risk in its granting of credit, and, without exception, every bank experiences some loan losses when certain borrowers fail to repay their loans. Whatever the degree of risk taken loan, losses can be minimized through highly professional organization and management of the lending function.

The composition and quality of a bank's loans should be reflected in its loan policy. The policy sets out the bank's lending philosophy and specifies procedures and means of monitoring lending activity. A written loan policy should serve to obtain three results:

- produce sound and collectible loans;
- provide profitable investment of bank funds;
- encourage extensions of credit that meet the legitimate needs of the bank's market.

A meaningful loan policy will express strategies in concrete terms. The desired loan mix should be quantified. The loan mix expresses the diversification sought by the bank in its loan placements. Diversification reduces the level of default risk that is associated with large concentrations of loans in a single category.

The bank's liquidity strategy should be indicated, because it acts as constraint on lending activity and because liquidity is partly determined by the maturity structure of the loan portfolio. The desired size of the loan portfolio expresses the bank's intended aggressiveness in expanding its loan portfolio. A highly aggressive loan policy has both a bright side and a dark side. The bright side is that a large loan portfolio might increase bank earnings. The dark side is that an aggressive policy might lead to lower credit standards, marginal loans, and an unacceptable amount of risk. Most borrowers are exposed to risks that threaten their ability to repay their bank loans. However, all collaterals brought as security should be insured. Most banks conduct loan reviews to reduce losses and monitor loan quality.

Loan reviews consist of a periodic audit of the on-going performance of some or all of the active loans in a bank's loan portfolio. Its essence is credit analysis, although, unlike the credit analysis conducted by the credit department as part of the loan approval process, credit analysis in loan review occurs after the loan is in the books. Other than its basic objective of reducing loan losses, some intermediate objectives of loan review are as follows:

- to detect actual or potential problem loans as early as possible;
- to provide incentive for loan officers to monitor loans and report deterioration in their own loans;
- to enforce uniform documentation;
- to ensure that loan policies, banking laws, and regulations are followed;
- to inform management and the board about the overall condition of the loan portfolio;
- to aid in establishing loan loss reserves.

Whatever means are used to conduct loan reviews; the following points should be covered:

- financial condition and repayment ability of borrower;
- completeness of documentation;
- consistency with loan policy;
- perfection of security interest on collateral;
- legal and regulatory compliance;
- apparent profitability.

When a problem loan is detected, the responsible officer should take immediate corrective action to prevent future deterioration and minimize potential loss.

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