Credit Analysis

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ABSTRACT

The past decade has seen dramatic losses in the banking industry. Companies that had been performing well suddenly announced large losses due to credit exposures that turned sour, interest rate positions taken, or derivative exposures that may or may not have been assumed to hedge balance sheet risk. In response to this, commercial banks have almost universally embarked upon an upgrading of their risk management and control systems.

The major purpose of credit analysis is to identify risks in lending situations, draw conclusion regarding the likelihood of payment and make recommendations as to the proper type and structure of the loan in the light of the perceived financing needs and risks.

Credit analysis is the quantitative and qualitative analysis of a company, which help to determine the company’s debt service capacity, or how capable it is to pay back its principal payments to the bank or other creditors. Credit analysis is concerned with identifying, evaluating and mitigating those risks which may result in a company not being able to meet its creditors’ claims.

Credit analysis involves the examination of the link between management performance or capacity and the working relationship of a company’s assets, liabilities and equity as shown on its balance sheet, the result of its operations as reflected in its income statement and cash flow. The evaluation of the company’s financial statements and the ratios that indicate the efficiency of the company’s performance will thus provide an indicator of the probability of success of the ability to service its debt in the future.

INTRODUCTION

In recent years, with the trend of the economic globalization and volatility of financial market, credit risk management will be the focus in finance. The field of credit risk and corporate bankruptcy prediction gained considerable momentum (e.g., Bharath and Shumway, 2008; Davydenko, 2008; Korteweg and Polson, 2008) due to the increased competition in the field and the challenges of the present financial crisis. Credit risk is one of the main risks of commercial banks that will affect the banks’ ability of sustainable operation.

Credit risk assessment is performed through the development of models usually based on a classification approach, in order to distinguish potential defaulters from non-defaulters. Generally, classification refers to the assignment of a finite set of objects into predefined classes according to Altman, Avery, Eisenbeis and Stinkey (1981) and Doumpos and Zopounidis (2002).


To clarify how banks actually underwrite loans, Uchida (2011) employed unique data on small and medium-sized enterprises (SMEs) in Japan obtained from the Management Survey of Corporate Finance Issues in the Kansai Area in June 2005. In this survey, a responding firm (borrower) answers questions on the extent to which its main bank focuses on (or emphasizes) 22 firm characteristics when the bank underwrites its loans. This information enabled to measure the emphasis that banks place on their screening process. On balance, they find that the three most important factors when banks screen borrowers are their relationship with the borrower, the strength of the borrower’s financial statements, and the collateral and/or guarantee pledged. It is interesting that these respectively correspond to soft information, hard
information, and collateral/guarantees, all considered important factors when banks screen loans. They are also consistent with the classification of lending technologies in Berger and Udell (2002, 2006), i.e., relationship lending, financial statement lending, and fixed asset lending.

In the literature about insolvency prediction, traditional statistical and econometric techniques like linear discriminant analysis models and multiple logistic regression models have been widely used to discriminate between failed and non-failed firms on the basis of financial ratios. Altman, Haldeman and Narayanan (1977) were the first to use a statistical model to predict default probabilities of firms, calculating Z-Score using a standard discriminant model. In 1977, Hand and Henley modified the Z-Score by extending the data-set to larger-sized and distressed firms. This model was for many years one of the most prominent models for the calculation of the credit risk evaluation of banks borrowers. Lately, more accurate ones such as logistic regression, neural networks, smoothing non-parametric methods and expert systems have been developed in the field of credit risk measurement by Hand and Henley (1997), Hand and Henley (1997) and Giudici (2003).

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Studies aiming at developing new models which are compatible with new mathematical programming based discriminant analysis were also conducted. While Sueyoshi (1997, 2003) tried to combine discriminant analysis and data envelopment analysis using goal programming and mixed integer programming, Loucopoulos and Pavur (1997) suggested a model which enables dividing into three-group classification. Although there are several models in different fields in the literature, which were developed with different models, there is a consensus on “minimum deviation model” as the model which gives the most proper results in a significant portion of studies (Choo and Moy, 1996; Karacabey, 2003).

Factor analysis is used in most of the studies which are conducted to prevent use of another financial ratio, which repeats the information provided by a financial ratio, in the model. There are several studies which generate factors that cover the information in the financial ratios instead of financial ratios using factor analysis (Pinches, Mingo and Carruthers, 1973; Johnson, 1978; Laurent, 1979; Mear and Firth, 1986; Aktas et al, 2001; Canbas et al, 2004), which can be described as a technique which simplifies and reduces complex and numerous data available (Kline, 1994). Although factor analysis can cope with this problem, this technique causes loss of information in a specific ratio.

The deficiencies of the model in conjunction with the progress made in other fields have led to the development of a plethora of new classification approaches. Some of the most extensively studied new classification paradigms include, among others, rule induction algorithms and decision trees (Breiman, Friedman, Olshen and Stone, 1987), neural networks (Ripley, 1996), nearest neighbor algorithms (Duda, Hart, and Stork (2001)), fuzzy sets ( Zadeh, 1965), rough sets Pawlak (1982), support vector machines Vapnik (1998), operations research methods (mathematical programming, multi-criteria decision aid). Lee and Urrutia (1996) also analyzed the performance of hybrid credit scoring models, but their study was limited on the introduction of discriminant analysis’ results as an additional input to a neural network model. Wang, Wan and Zhang (1999) applied neural network to credit risk assessment for the first time in China. The results demonstrate the effectiveness and robustness of neural network are better than discriminant analysis (Wang, Feng, 1999). Zhang, Fu and Tang (2003) researched on neural network and proved that neural network in credit risk assessment with high precision (Zhang, Zhongzhi, 2003).

In 2007, Doumpos and Zopounidis conducted the first study within the field of credit risk analysis exploring a combination model based on popular statistical and machine learning classification methods, including discriminant analysis (linear and quadratic), logistic regression, classification and regression trees (CART algorithm), nearest neighbors algorithms, probabilistic neural networks, and support vector machines. Several other studies used survival time analysis to predict bank failure. Whalen (1991) proposed and empirically evaluate the application of a Cox Proportional Hazards model to predict bank failure. Henebry (1997) used a Proportional Hazards model to evaluate the predictive power of cash flow variables, while Laviola, Marullo-Reedtz and
Trapanese (1999) showed that the prediction of bank failure estimated via a Cox Proportional Hazards model outperforms logit and probit regression models for Italian data. Bharath and Shumway (2004) employed a time-dependent proportional-hazards model to evaluate the predictive value of the Merton (1974) structural model. Fantazzini and Figini (2004) compared the Random Survival Forests proposed by Ishwaran and Kogalur (2007) with the logit model in terms of forecasting performances, both in-sample and out-of-sample. Their findings confirmed previous evidence (Fuertes, Kalotychou - 2006), founding that the logit model is equally preferred or even more preferred to alternative more sophisticated competing models. Starting from the statements of the Basel Agreement, based on generalized linear models (GLM), which are a family of models including logistic regression, Grossi and Bellini (1997) have analyzed a method to classify bank customers according to their future ability to refund money.

Other prediction models have been criticized for using only one technique, for being nonsystematic or for consisting of anecdotal results. To overcome this problem, Galindo and Tamayo (2000) used a multi-strategy approach including: statistical regression (probit), decision-trees (CART), neural networks, and k-nearest-neighbors on the same data set. Originally, many algorithms and methods were used by statisticians, computer or physical scientists and their use has spread to many business applications. Within economics, most studies have been concerned with neural networks. Compared to other prediction models, Neural Networks present at least three significant advantages. The first is their ability to model complex relationships an analyst might not be aware of. For example, when the banker believes that the likelihood of a loan repayment can be explained by variables, without insufficient foundation theory, the Neural Networks can provide the additional intelligence for successful modeling. The second is, no matter what analytical tool is best in an application, Neural Networks can often be used as a benchmark of what might be possible using another method. The third one is that, as organizations are increasingly pressed to make credit decisions that are both quick and accurate, Neural Networks can assist in speeding up the decision process while maintaining or improving the success rate of credit decisions (Matoussi, 2010).

**BASIC CONCEPTS**

The "five C's" – the basic components of a credit analysis

Character is the general impression the customer makes on the prospective lender or investor. The lender will form a subjective opinion as to whether or not the company is sufficiently trustworthy to repay the loan or generate a return on funds invested in the company. The background and experience in business and in the industry will be considered. The quality of the references and the background and experience levels of employees will also be reviewed.

Capacity to repay is the most critical of the five factors; it is the primary source of repayment – cash inflows and cash generated by the company. The prospective lender will want to know exactly how the borrower intends to repay the loan. The lender will consider the cash flow from the business, the timing of the repayment, and the probability of successful repayment of the loan. Payment history on existing credit relationships - personal or commercial- is considered an indicator of future payment performance. Potential lenders will also want to know about other possible sources of repayment.

Capital is the money personally invested in the business by the shareholder borrower and is an indicator of how much the shareholder has at risk should the business fail. Interested lenders and investors will expect a contribution from borrower’s own assets and to have undertaken personal financial risk to establish the business before asking them to commit any funding. The capital investment is seen also as a proof for shareholder’s commitment in the business.

Collateral (or guarantees) are additional forms of security the customer can provide the lender. Giving a lender collateral means that an own asset is mortgaged, such as a property, to the lender with the agreement that it will be the repayment source in case the loan is not repaid from the established sources as per terms and conditions agreed for the financing. A guarantee, on the other hand, is just that - someone else signs a guarantee document promising to repay the loan if the initial lender cannot. Some lenders may require such a guarantee in addition to collateral as security for a loan. A collateral is considered „the second way out” by the lender in case the credit goes wrong.

Conditions describe the intended purpose of the loan and the conditions under which the credit is being granted. Will the money be used for working capital, additional equipment, inventory or for a long term investment? The lender will also consider local and macro-economic conditions and the overall climate, both within the industry and in other industries that could affect the business.
The importance of risk analysis in credit evaluation

The nature of the business and the competitive environment in which the company operates determine to a large extent the asset investment, financial decisions and profit dynamics of the company. Risk analysis is performed to understand the company’s competitive position, its strategy, and its effect on financing needs. The bank expects the principal and the interest to be paid. The risk that the bank takes is that the company will not be able to pay back whole, or a part of the total sum so all the credit applications should thoroughly be analyzed.

The following steps should be followed:

Identify the risks
Define and document all risks inherent in the management, product, company, industry and economy that could possibly affect the company’s operations, and thus its ability to service its debt. This is done through information gathering - the more relevant information, the better.

Evaluate the risks
It should be evaluated how and to what extent the risks might affect the operations of the business. Generally the business risk regards the quality and efficiency of the assets, performance risk is determined through income statement analysis and financial risk is determined by how liabilities are funded by the assets. Management risk is determined by how well management controls the above three major risks.

Mitigate the risks
After a thorough understanding of the risks has been made, it is in the bank’s best interest that the risks are minimized and even fully mitigated. Once the interrelationship of all the risks has been defined, a balance must be found between the risks and return, which is done through the structure of the loan agreement, collateral, as well as appropriate covenants and established pricing.

The main factors that mitigate interest rate risks are: established limits on mismatch positions, hedging with financial futures or other instruments; management monitoring exposure.

A complete analysis is one that incorporates all available information regarding the company and industry in which it operates. It is extremely important to know your customer and a bank will enter a relationship with a customer only after it will obtain insight information about company’s activity, financial position, plans for the future as well as details about experience of the management team.

The banks usually use the following sources of information:

- customer interview - it provides the most important information needed in credit investigation, including the type and the amount of loan required, sources and plans for repayment, business plans and feasibility studies, collateral, previous and current creditors and structure of existing credit facilities, customers and suppliers details, information about management, shareholders, strategy and also relevant information about market and market share.
- internal sources - credit files on any current or previous borrowings, checking account activity, other previous or current deposits, internal reports on market/industry/players on the market etc.
- external sources - other banks that the client has connections with, Credit Information Bureau Database, Payment Incident Bureau Database, governmental organization, industry association, press releases, the electronic archive for real movables guarantees, court files information etc.

MAIN ELEMENTS OF THE CREDIT ANALYSIS

Before looking at the types of loans available from commercial banks, it is important to understand the perspective of the typical commercial loan officer when he or she analyzes a loan proposal. There is often a lot of confusion and resentment about the relationship between bankers and entrepreneurs. The entrepreneur believes the banker does not understand and appreciate his or her business requirements, while the loan officer may have had bad experiences with entrepreneurs who expect to borrow more than a million dollars (collateralized only by a dream), the loan officer has had to foreclose on a default by a small business or certain internal norms or regulations impose the lender to follow a more restrictive policy. Banks are in the business of selling money and capital is the principal product in their inventory. Bankers, however, are often personally risk averse and have internal controls and regulatory restrictions affecting their risk tolerance.
The bank’s shareholders and board of directors expect loan officers to take all steps necessary to minimize the bank’s risk in each transaction and obtain the maximum protection against default. As a result, the types of loans available to growing companies, the terms and conditions, and the steps the bank takes to protect its interest all have a direct relationship to the proper assessment of risk. The management team assigned to obtain debt financing from a commercial bank must embark on an immediate risk-mitigation and risk-management program to prepare for negotiating the loan documentation.

**Loan proposal characteristics**

Although the exact elements of a loan package will vary depending on a company’s size, industry, and stage of development, most lenders will want the following fundamental questions answered:

a) Who is the customer?
b) How much capital do they need and when?
c) How will the capital be allocated and for what specific purposes?
d) How will the borrower service the debt obligations (application and processing fees, interest, principal, or balloon payments)?
e) What protection (collateral) can the borrower provide the bank in the event that he is unable to meet the agreed obligations?
f) What are the key business matrices and how well are they measured, monitored and understood (the diagnostic “dashboard”)?

These questions are all designed to help the loan officer assess the risk factors in the proposed transaction. They are also designed to provide the loan officer with the information necessary to persuade the loan committee to approve the transaction. It must be understood that the loan officer (once convinced of the company’s creditworthiness) will serve as an advocate on clients’ behalf in presenting the proposal to the bank’s loan committee and shepherding it through the bank’s internal processing procedures. The loan documentation, terms, rates, and covenants that the loan committee will specify as conditions to making the loan will be directly related to how the company can demonstrate its ability to mitigate and manage risk as described in the business plan and formal loan proposal.

The loan proposal should include the following categories of information, many of which might be included under the business plan:

**Summary of the request.** An overview of the history of the company, the amount of capital needed, the proposed repayment terms, the intended use of the capital, and the collateral available to secure the loan. Also the proposed pricing is included under this section.

**Borrower’s history.** A brief background of your company; its capital structure; its founders; its stage of development and plans for growth; a list of customers, suppliers, and service providers; management structure and philosophy; main products and services; and an overview of any intellectual property owned developed; group structure and support offered by the parent are also to be considered.

**Market data.** An overview of trends in the industry; the size of the market; the market share of the company; an assessment of the competition; the sustainable competitive advantages; marketing, public relations, and advertising strategies; market research studies; and relevant future trends in the industry as well as expectations for the future.

**Financial information.** Multi-scenario financial statements (best case/ expected case/worst case), federal and state tax returns, company valuations or appraisals of key assets, current balance sheet, credit references, and the income statement. The role of the capital requested in the plans for growth, an allocation of the loan proceeds, and the ability to repay must be carefully explained. A discussion over the ability to make the loan repayments on a timely basis must be supported by a projected cash-flow statement broken out in a monthly format for the whole lifetime of the loan. When presenting the collateral that might be available to support the loan request, it should not be assumed that the collateral will be viewed by the lender on a dollar-for-dollar basis. For example, real estate valued at $100,000 might only be viewed by the lender as representing between $50,000 to $85,000 (50 to 85 percent) of actual loan collateral value. Other assets such as equipment, inventory, and accounts receivable might have a loan collateral value between 0 and 70
percent in the eyes of the lender (internal discount factors are being applied in connection to the collateral type, location, market comparable, credit currency and others).

Schedules and exhibits. As part of the loan proposal, there should also be attached certain key documents, such as agreements with strategic vendors or customers, insurance policies, leases, and employment agreements. Résumés of the company’s principals, recent news articles about the company, a picture of the products or site, and an organizational chart should also be appended as exhibits to the loan proposal.

Structure of the credit analysis

Every bank has a specific format of the credit analysis, but they include most of the issues that will be further discussed. Generally, the analysis of the credit should include the following elements:

A. Description of the Loan (Purpose, Amount, Repayment Source, Terms, Security)

There are a number of types of loans available from a commercial bank, one or more of which could be tailored to meet specific requirements. Loans are usually categorized by the maturity of the loan, the expected use of proceeds, and the amount of money to be borrowed. The availability of various loans will depend on both the nature of the industry and the bank’s assessment of company’s creditworthiness.

The types of loans traditionally available include:

Short-term loans. These are ordinarily used for a specific purpose with the expectation by the lender that the loan will be repaid at the end of the project. For example, a seasonal business may borrow capital in order to build up its inventory in preparation for the peak season; when the season ends, the lender expects to be repaid immediately. Similarly, a short-term loan could be used to cover a period when the company’s customers or clients are in arrears when the accounts receivable are collected, the loan is to be repaid. It may be secured by the inventory or accounts receivable that the loan is designed to cover, or it may be less secured (that is, no collateral is required). Unless a company is a start-up or operates in a highly volatile industry (increasing the risk in the eyes of the lender), most short-term loans will be unsecured, thereby keeping the loan documentation and the bank’s processing time and costs to a minimum. Lenders generally view short-term loans as “self-liquidating” in that they can be repaid by foreclosing on the current assets that the loan has financed. Because the bank’s transactional costs are low, and it perceives a lower risk during this short period, short-term loans can be easier for a growing business to obtain. Short-term borrowing can also serve as an excellent means for establishing a relationship with a bank and demonstrating creditworthiness.

Operating lines of credit. Lines of credit consist of a specific amount of capital that is made available to a company on an “as needed” basis over a specified period of time. A line of credit may be short term (60 to 120 days) or intermediate term (one to three years), renewable or nonrenewable, and at a fixed or fluctuating rate of interest.

Intermediate-term loans. These loans are usually provided over a three- to five-year period for the purposes of acquiring equipment, fixtures, furniture, and supplies; expanding existing facilities; acquiring another business; or providing working capital. The loan is almost always secured, not only by the assets being purchased with the loan proceeds but also by the company’s other assets, such as inventory, accounts receivable, equipment, and real estate. This arrangement usually calls for a loan agreement, which typically includes restrictive covenants that govern the company’s operations and management during the term of the loan. The covenants are designed to protect the lender’s interests and ensure that all payments are made on time, before any dividends, employee bonuses, or noncritical expenses are paid.

Long-term loans. These are generally extended for specific, highly secured transactions, such as the purchase of real estate or a multiuse business facility, in which case a lender will consider extending a long-term loan to a small company for 65 to 80 percent of the appraised value of the land or building (as a general rule, commercial banks do not provide long-term financing to small businesses. The risk of market fluctuations and business failure over a ten- or twenty-year term is simply too high for the commercial lender to feel comfortable).

Financing lines for issuance of letters of credit and letter of guarantees. The letters of credit are issued by commercial banks, mainly in connection with international sales transactions to expedite the shipping and payment process. In a typical letter-of-credit scenario, the seller demands that payment be made in the form of a letter of credit, and the buyer
must then make arrangements with its bank to issue the letter of credit. The buyer’s bank, often in conjunction with a corresponding bank, will then communicate with the seller of the goods, explaining the documents that it requires (such as a negotiable bill of lading) as a condition to releasing the funds.

B. Description of the Company
The description of the company including the name, industry, description of the activity, the legal form, ownership, holding or mother company, group structure should be made. It should also be mentioned the market share of the company, the products or services it provides and the major suppliers, major clients and major competitors. The suppliers and clients are very important for the analysis because if the company is dependent on its suppliers or clients, they should be analyzed too, as the failure of one means the failure of the company.

C. Credit History
Any lender would want to know whether the client has paid past credit accounts on time. However, late payments are not an automatic reason for not granting the loan. At the same time, having no late payments in the credit report does not mean granting the loan.

D. Analysis of the Market/Industry
The Bank should identify and evaluate the vulnerability of the company to external factors and its ability to protect against them.

As the market is concerned, it should be analyzed:

a. Market structure (monopoly, oligopoly)
b. Market size (number of participants, market share)
c. The dimension of demand for the product (market assessment)

The most important issues related to the industry analysis are:

a. Rate of industry growth
b. Life cycle - it should be determined if it is a growth, mature or declining industry
c. Industry development (strong, weak, old or new)
d. Industry trends - it may be a seasonal or cyclical industry.

All the risks related to the industry should be identified. These risks may be: production risks, transportation risks, distribution risks.

E. Financial analysis of the borrower
A company’s financial statements contain a series of relationships that are peculiar to a particular business, which can be described by analyzing individual components of each financial statement and by ratio analysis. They also reflect conditions in the industry and general economy and result from decisions taken by management in controlling the overall affairs of the company.

Financial analysis using business or financial ratios provides a mean of assessing a company's strengths and weaknesses. Using data from the balance sheet and income statement, various ratios can be computed which can then be compared directly to those of competing companies of varying sizes. Comparing the firm's operating results with those of specific competitors or the industry as a whole helps identify relative strengths and weaknesses. In addition, comparing changes in a firm's ratios over time can highlight improvements in performance or problem areas needing attention.

Generally, financial ratios are calculated for the purpose of evaluating aspects of a company's operations and fall into the following categories:

a. liquidity ratios
b. solvency ratios
c. profitability ratios
d. efficiency ratios

a. Liquidity Ratios
The company should provide information that indicates whether or not the business will be able to pay its creditors, expenses, loans falling due at corresponding periods in time. A company may be profitable but if it fails to generate enough cash to settle its liability is said to be insolvent.
Suppliers and providers of short-term finance are interested in these ratios as they are used in assessing the ability of the business to settle its current liabilities. Liquidity ratios indicate the ease of turning assets into cash.

b. Solvability ratios
The balance sheet is one of the most important financial statements of a company, which highlights the financial position of a company at a particular date. The cash flow and income statements record performance over a period of time, while the balance sheet is a snapshot in time. The balance sheet provides information on what the company owns (its assets), what it owes (its liabilities), and the value of the business to its stockholders (the shareholders' equity). The reason it is called a balance sheet is that both the sides balance, or Assets = Liabilities + Equity.

The balance sheet provides a creditor with many clues to a firm’s possible future performance. In order to acquire assets, a company must pay for them with either debt (liabilities) or with the owners' capital (shareholders' equity).

c. Solvency ratios
These ratios are also called the leverage ratios. These are mostly used by providers of finance to assess the finance risk of the business. Increasing amounts of debt in a business’s capital structure means that the business is becoming heavily geared. This condition negatively affects long-term solvency because it represents increasing legal obligations to pay interest periodically and principal at maturity. Failure to make these payments can result in bankruptcy.

Long-term solvency has to do with the business’s ability to survive for many years – the bank must assure that the “going concern” accounting principle is fulfilled when decided to finance a certain business. The aim of long-term solvency analysis is to point out early that a business is on the road to bankruptcy. Declining profitability and liquidity ratios are key signs of possible business failure. As indicated earlier on, the ratios on their own carries less business meaning unless interpreted together with other non-financial indicators, such as loss of key suppliers, threatened litigation against the business, failure to settle liabilities and failure to adapt to new technologies.

d. Profitability Ratios
The objective of profitability relates to a company’s ability to earn a satisfactory profit so that the investors and shareholders will continue to provide capital to it. A company’s profitability is linked to its liquidity because earnings ultimately produce cash flow.

e. Efficiency Ratios
Efficiency ratios provide information about management's ability to control expenses and to earn a return on the resources committed to the business. Management is required to maintain an optimum level of working capital. If an entity is having high inventory levels it will incur high storage costs, theft, insurance costs and stock losses. Likewise having low stock levels will disturb the production run of the company as it will regularly run out of inventories thereby loosing important business opportunities. The same can be said about receivables, having more receivable the company may run the risk of bad debts but also being too strict with debt repayment period may result in loss of customers.

The asset management ratios are also known as working capital ratios or the efficiency ratios. The aim is to measure how effectively the firm is managing its assets. These ratios are designed to answer the question: does the total amount of each type of asset as reported on the balance sheet seem reasonable, too high, or too low in view of current and projected sales levels? If the company has too many assets, its cost of capital will be too high hence its profit depressed. On the other hand, if asset are too low, profitable sales will be lost.

F. Cash flow and projected cash flow analysis
Loans must be paid back in cash, and the most direct way of evaluating a company’s ability to generate sufficient cash to pay back the debts is Cash Flow and Projected Cash Flow. Cash Flow Statement is a very important tool for credit analysis.

Cash Flow is essentially the movement of money into and out of the business; it's the cycle of cash inflows and cash outflows that determine the business' solvency.

G. Collateral Analysis
Collateral represents assets provided to secure an obligation. Traditionally, banks require corporate borrowers to commit company assets as security for loans. Under such arrangements, a party who owes an obligation to another party (borrower) posts collateral (to the bank) in order to secure the obligation. In the event that the party defaults on the obligation, the secured party seizes the collateral.
Collateral is one of the main factors that influence the decision on crediting along with financial standing and effectiveness of the credit transaction and is the secondary source of loan reimbursement.

*Types of Collateral*
The main types of collateral accepted by banks are:
- Mortgage on real estate, commercial property
- Pledge on securities, on accounts, on Company’s shares or equipments
- Cash deposits
- Letter of Comfort Guarantee
- Bill of Exchange or Promissory Note
- Assignment of receivables

*Requirements to the collateral*
The forms of the collateral are determined in every particular case based on the character of the crediting project and the financial standing of the borrower.
In order to be accepted, the collateral should have the following features:
- MARKETABLE – meaning the quick possibility to transfer the collateral into money facilities
- ASCERTAINABLE – meaning the collateral is easily to identify
- STABLE – meaning that the nature of the security will not change; for example no deterioration of the quality of receivables.
- TRANSFERABLE – meaning the collateral is legally available

*Collateral valuation*
The pledged value of the collateral should cover the amount of the borrower commitments on total loan agreement (the loan amount, the amount of interest rate payable in the course of the nearest year), the expenses related to the collateral enforcement and of the other amounts according to the provisions of the loan agreement.
In order to provide sufficient liquidity of the mortgaged property, in case of passing of the title on property to the Bank, its mortgaged value becomes lower than its market value fixed by the evaluator in his report.

**H. SWOT analysis**
The SWOT analysis provides information that is useful in matching the firm’s resources and capabilities to the competitive environment in which it operate.

a. Strengths
Every organization has some strength. In some cases this is obvious, for example, dominant market share. In other cases, it is a matter of perspective, for instance, a company is very small and hence has the ability to move fast. It is important to note that companies that are in a bad position also have strengths. Whether these strengths are adequate is an issue for analysis.

Strengths represent the advantages the companies have, in relation to the competitors. Strengths could be:
- a new, innovative product or service
- patents
- strong brand names
- location of the business
- good reputation among customers
- quality processes and procedures
- any other aspect of the business that adds value to the product or service.

b. Weaknesses
Every organization also has some weakness. In some cases, this is obvious; say for example higher costs of production. In other cases, it is a matter of perspective, for example, a company has 99% market share and is open to attack from every new player.
It is important to note that companies that are extremely competent in what they do, also have weaknesses. How badly these weaknesses will affect the company is a matter of analysis. A weakness could be:
a weak brand name
high cost structure
undifferentiated products and service (i.e. in relation to competitors)
location of the business
poor quality goods or services
damaged reputation

c. Opportunities
All organizations have some opportunities that they can gain from. These could range from diversification to sale of operations. Identifying hidden opportunities is the mark of an astute analyst.
The opportunities that exist at present or possibly in the future that the company can take advantage to increase its sales, improve productivity and make its operations more efficient must be described.

An opportunity could be:
an unfulfilled customer need
removal of international trade barriers
a developing market such as the Internet
mergers, joint ventures or strategic alliances
moving into new market segments that offer improved profits
a new international market
a market vacated by an ineffective competitor

d. Threats
No organization is immune to threats. Threats are external to the company’s business. An analyst should identify the threats that exist at present, or possibly in future that could affect the company’s performance or operational result.
A threat could be:
shifts in customers tastes away from the company’s products
a new competitor in the home market
price wars with competitors
a competitor has a new, innovative product or service
competitors have superior access to channels of distribution
taxation is introduced on the product or service

SWOT analysis can be very subjective. Two people rarely come-up with the same final version of SWOT. The analysis should be used as guide and not as a prescription.

I. Credit Decision
Once the loan proposal has been submitted, the process thereafter should not be a mystery or an indefinite process. Below are some key questions to ask the commercial loan officer once the proposal has begun to go through the evaluation process:

- What are the top three strengths and weaknesses in the proposal?
- Does this proposal seem to be a fit with the bank’s current lending practices and objectives?
- What problems or challenges do you foresee and how can we overcome or mitigate these negative factors?
- What key terms or covenants should be anticipated and why?
- What transactional or closing costs should be anticipated?
- How will the decision be made?
- How long will the process take?
- If the proposal is rejected, will there be another chance to amend the initial proposal and resubmitted? Is that a waste of time?
- Are there any other lenders or sources of debt capital that would be recommended?
Negotiating the Loan Documents

Negotiating the financing documents requires a delicate balance between the lender’s requirements and the customer needs. The lender will want to protect all of the rights and remedies that may be available to mitigate the risk of loan default, while the customer will want to minimize the level of control the lender exercises and achieve a return on the assets that greatly exceeds the debt-service payments. Before examining each document involved in a typical debt financing, main aspects under a credit transaction that might be negotiable should be known:

**Interest rates.** These will generally be computed in accordance with prevailing market rates, the degree of risk inherent in the proposed transaction, the extent of any preexisting relationship with the lender, the cost of administering the loan and also the maturity of the loan (long term loans should always be more expensive than short term loans do to liquidity adjustment costs that have to be applied).

**Collateral.** The loan must be secured by mortgaging assets that have a value equal to or greater than the proceeds of the loan. Under such circumstances, certain assets of the business might be kept outside the mortgage agreement so that they are available to serve as security in the event that more money is needed later. Beyond the traditional forms of tangible assets that may be offered to the lender, the intangibles must also be considered (such as assignment of lease rights, key-man insurance, or intellectual property) as candidates for collateral. Naturally, these assets could be very costly to sacrifice for a growing company in the event of default.

**Restrictive covenants.** These provisions are designed to protect the lender’s interests, and the typical loan agreement will contain several kinds. A breach of covenants is an event of default, allowing the bank to declare the default and accelerate the loan. Still, a bank will usually take legal actions only after it has tried to implement a restructuring solution and it did not work.

Affirmative covenants encompass obligations (and the subsidiaries’, except as otherwise provided) during the period that the loan is outstanding, and may include the following affirmative acts that must be done:

a. provide audited financial statements at regular intervals (usually quarterly and annually with the annual statement to be prepared and certified by an independent certified public accountant).
b. provide copies of all financial statements, reports, and returns that are sent to shareholders or to governmental agencies. Provide access to the properties, books of accounts, and records.
c. keep and maintain proper books of accounts.
d. comply with all applicable laws, rules, and regulations.
e. maintain the corporate existence (as well as that of any subsidiaries) and all rights and privileges.
f. maintain all property in good order and repair.
g. maintain any agreed dollar amount of net worth (or any agreed ratio of current assets to current liabilities).
h. keep and maintain proper and adequate insurance on all assets.
i. pay and discharge all indebtedness and all taxes as and when they are due.
j. purchase and pay premiums due on life insurance on named key personnel (wherein the company is named as beneficiary).
k. Maintain certain levels of various financial indicators
l. Turnover clause (route a certain amount of total collections or total sales through the accounts held with the bank)

Negative covenants (generally negotiable) encompass certain actions for which the lender’s consent must be obtained and depend in large part on the company’s financial strength and economic and operational requirements. The lender’s consent must be obtained in order to:

a. engage in any business not related to the present business.
b. Maintain the same shareholder structure
c. create any mortgage, lien, or other security other than pending security on the property securing the loan.
d. create any mortgage, lien, or other encumbrance, including conditional sales agreements, other title-retention agreements, and lease-purchase agreements, on any property of the company or subsidiaries (unless excepted).
e. incur any new indebtedness except for trade credit or renewals, extensions, or refunding of any current indebtedness.
f. the right to incur indebtedness may be conditioned on compliance with a specified ratio (actual or pro forma) of pretax income to interest expense for a designated period.
The contractual clauses can also be classified in: financial clauses (meant to monitor the financial health of the company) and non-financial clauses (mainly the negative covenants).

In order to assure transparency to the customer, it has to be clearly mentioned the frequency of the contractual covenants monitoring.

**Prepayment rights.** Regardless of the actual term of the loan, it could be negotiated for the right to prepay the principal of the loan without penalty or special repayment charges. Many commercial lenders seek to attach prepayment charges that have a fixed rate of interest in order to ensure that a minimum rate of return is earned over the projected life of the loan.

**Hidden costs and fees.** These might include closing costs, processing fees, filing fees, late charges, attorneys’ fees, out-of-pocket expense reimbursement (courier, travel, photocopying, and so on), court costs, and auditing or inspection fees in connection with the loan. Another way that commercial lenders earn extra money on a loan is to impose depository restrictions, such as a restrictive covenant to maintain a certain balance in the company’s operating account or to use the bank as a depository as a condition to closing on the credit facility.

As a conclusion, taking into consideration all the information provided in the analysis the bank accepts or not to grand the credit. The bank can also ask the company to fulfill some additional conditions such as:

a. The company cannot apply for another loan without the written approval of the bank or the bank will be granted the right of first refusal in case a new banking product is required by the company;

b. The company should carry on a certain level of the payments through the bank – either represented by a percentage of total banking operations or total turnover or as a fixed percentage/amount (the non-fulfillment of the condition might indicate a decrease in company’s business or redirecting collections of the company through the accounts held with other banks);

c. The company will not pay dividends without the written approval of the bank;

d. The shareholders will not withdraw money without the written approval of the bank.

The international banks base their credit decision on credit scoring.

**CREDIT SCORING**

Each bank must apply a consistent evaluation and rating scheme to all its investment opportunities in order for credit decisions to be made in a consistent manner and for the resulting aggregate reporting of credit risk exposure to be meaningful. To facilitate this, a substantial degree of standardization of process and documentation is required. This has led to standardized ratings across borrowers and a credit portfolio report that presents meaningful information on the overall quality of the credit portfolio. In the following part, a credit-rating procedure is presented that is typical of those employed within the commercial banking industry.
Types of risk in lending activity

The following are definitions of the risk levels of borrowing facility:

a. Substantially risk free
Borrowers of unquestioned credit standing at the pinnacle of credit quality: basically, governments of major industrialized countries, a few major world class banks, and a few multinational corporations.

b. Minimal risk
Borrowers of the highest quality. Almost no risk in lending to this class. Cash flows over at least 5 years demonstrate exceptionally large and/or stable margins of protection and balance sheets are very conservative, strong and liquid. Projected cash flows (including anticipated credit extensions) will continue a strong trend, and provide continued wide margins of protection, liquidity and debt service coverage. Excellent asset quality and management. Typically large national corporations.

c. Modest risk
Borrowers in the lower end of the high quality range. Very good asset quality and liquidity; strong debt capacity and coverage; very good management. The credit extension is considered definitely sound; however elements may be present which suggest the borrower may not be free from temporary impairments sometime in the future. Typically larger regional or national corporations.

d. Below average risk
The high end of the medium range between the definitely sound and those situations where risk characteristics begin to appear. The margins of protection are satisfactory, but susceptible to more rapid deterioration than Class 3 names. Some elements of reduced strength are present in such areas as liquidity, stability of margins and cash flows, concentration of assets, dependence upon one type of business, cyclical trends, etc., which may adversely affect the borrower. Typically good regional or excellent local companies.

e. Average risk
Borrowers with smaller margins of debt service coverage and where definite elements of reduced strength exist. Satisfactory asset quality and liquidity; good debt capacity and coverage; and good management in all critical positions. These names have sufficient margins of protection and will qualify as acceptable borrowers; however, historical earnings and/or cash flow patterns may be sometimes unstable. A loss year or a declining earnings trend may not be uncommon. Typically solid local companies. May or may not require collateral in the course of normal credit extensions.

f. Management attention risk
Borrowers who are beginning to demonstrate above average risk through declining earnings trends, strained cash flow, increasing leverage, and/or weakening market fundamentals. Also, borrowers which are currently performing as agreed but could be adversely impacted by developing factors such as, but not limited to: deteriorating industry conditions, operating problems, pending litigation of a significant nature, or declining collateral quality/adequacy. Such borrowers or weaker typically require collateral in normal credit extensions. Borrowers generally have somewhat strained liquidity; limited debt capacity and coverage; and some management weakness. Such borrowers may be highly leveraged companies which lack required margins or less leveraged companies with erratic earnings records. Significant declines in earnings, frequent requests for waivers/deferrals of covenants and extensions, increased reliance on bank debt, and slowing trade payments are some events which may occasion this categorization.

g. Potential weakness
Borrower exhibits potential credit weakness or a downward trend which, if not checked or corrected, will weaken the asset or inadequately protect the bank’s position. While potentially weak, the borrower is currently marginally
acceptable; no loss of principal or interest is envisioned. Included could be turnaround situations, as well as those previously rated low, names that have shown deterioration, for whatever reason, indicating a downgrading from the better categories. These are names that have been or would normally be criticized as "Special Mention" by regulatory authorities.

h. **Definite weakness; no loss**

A borrower with well-defined weakness (es) that jeopardize the orderly liquidation of the debt. Borrowers that have been or would normally be classified "substandard" by regulatory authorities. A substandard loan is inadequately protected by the current sound worth and paying capacity of the obligor. Normal repayment from this borrower is in jeopardy, although no loss of principal is envisioned. There is a distinct possibility that a partial loss of interest and/or principal will occur if the deficiencies are not corrected.

i. **Potential loss**

A borrower classified here has all weaknesses inherent in the one classified above with the added provision that the weaknesses make collection of debt in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. Serious problems exist to the point where a partial loss of principal is likely. The possibility of loss is extremely high, but because of certain important, reasonably specific pending factors, which may work to the advantage and strengthening of the assets, its classification as an estimated loss is deferred until its more exact status may be determined. Pending factors include proposed merger, acquisition, or liquidation, capital injection, perfecting liens on addition collateral, and refinancing plans.

f. **Loss**

Borrowers deemed incapable of repayments of unsecured debt. Loans to such borrowers are considered uncollectible and of such little value that their continuance as active assets of the bank is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

The form described here is a single rating system where a single value is given to each loan, which relates to the borrower's underlying credit quality. At some institutions, a dual system is in place where both the borrower and the credit facility are rated. In the latter, attention centers on collateral and covenants, while in the former, the general creditworthiness of the borrower is measured. Some banks prefer such a dual system, while others argue that it obscures the issue of recovery to separate the facility from the borrower in such a manner. In any case, in the reported system all loans are rated using a single numerical scale ranging between 1 and 10. For each numerical category, a qualitative definition of the borrower and the loan's quality is offered and an analytic representation of the underlying financials of the borrower is presented. Such an approach, whether it is a single or a dual rating system, allows the credit committee some comfort in its knowledge of loan asset quality at any moment of time. It requires only that new loan officers be introduced to the system of loan ratings, through training and apprenticeship to achieve a standardization of ratings throughout the bank (Santomero, 1997).

**Credit assessment methods**

Credit scoring is a scientific method that uses statistical models to assess an individual's credit worthiness based on their credit history and current credit accounts. In some banking institutions, credit scoring is mostly used to determine in which of the 5 classes, the credit will be included. According to their own norms the banks decide to which category of clients they grant the loan, but most of the international banks base their decision on credit analysis report. The criteria and indicators used might vary from one bank to another; however the principles considered should be the same. The credit scoring (for legal persons) is generally based on qualitative and quantitative criteria such as:

A. Qualitative Criteria. Management quality, business strategy and environment, collateral received customer transparency and quality of financial statements presented, buyers / suppliers’ diversification, technology used, age/size...
of the company and track record, quality and evolution of the competition, are considered the most useful tools for evaluating the quality of business and management.

Table 1. Example of Qualitative Criteria Evaluation by an international bank

<table>
<thead>
<tr>
<th>Management quality, business strategy</th>
<th>Collateral received Other than the tangible ones</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accumulated experience within the main firm activity, good business strategy, well known company.</td>
<td>Corporation’s guarantee</td>
</tr>
<tr>
<td></td>
<td>Letter of comfort</td>
</tr>
<tr>
<td></td>
<td>None of the above</td>
</tr>
<tr>
<td>Accumulated experience within the main firm activity, business strategy in development, well known company.</td>
<td>Corporation’s guarantee</td>
</tr>
<tr>
<td></td>
<td>Letter of comfort</td>
</tr>
<tr>
<td></td>
<td>None of the above</td>
</tr>
<tr>
<td>Limited experience within the main firm activity and leading team, business strategy in development and good reputation.</td>
<td>Corporation’s guarantee</td>
</tr>
<tr>
<td></td>
<td>Letter of comfort</td>
</tr>
<tr>
<td></td>
<td>None of the above</td>
</tr>
<tr>
<td>Limited experience within the main firm activity and new leading team, business strategy in development.</td>
<td>Corporation’s guarantee</td>
</tr>
<tr>
<td></td>
<td>Letter of comfort</td>
</tr>
<tr>
<td></td>
<td>None of the above</td>
</tr>
<tr>
<td>One-person dependency, no business strategy and limited experience.</td>
<td>Corporation’s guarantee</td>
</tr>
<tr>
<td></td>
<td>Letter of comfort</td>
</tr>
<tr>
<td></td>
<td>None of the above</td>
</tr>
</tbody>
</table>

Table 2. An example of Ownership Structure Evaluation

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Collateral received Other than the tangible ones</th>
</tr>
</thead>
<tbody>
<tr>
<td>Majority owned by a powerful international company</td>
<td>Corporation’s guarantee</td>
</tr>
<tr>
<td>Majority owned by a medium international company</td>
<td>Letter of comfort</td>
</tr>
<tr>
<td>Majority owned by a weak international company</td>
<td>None of the above</td>
</tr>
<tr>
<td>Majority owned by a local powerful company</td>
<td>Corporation’s guarantee</td>
</tr>
<tr>
<td>Majority owned by a medium/weak local company</td>
<td>Letter of comfort</td>
</tr>
<tr>
<td>Majority owned by management</td>
<td>None of the above</td>
</tr>
<tr>
<td>Owners with little power</td>
<td>Corporation’s guarantee</td>
</tr>
<tr>
<td>Majorit owned by investments funds</td>
<td>Letter of comfort</td>
</tr>
<tr>
<td>Disputes among shareholders/owners</td>
<td>None of the above</td>
</tr>
<tr>
<td>Unknown shareholder structure</td>
<td>None of the above</td>
</tr>
</tbody>
</table>

B. Quantitative criteria refer to main ratios calculated based on the financial documents of the company; the following ratios might be considered:

- Current ratio
- Solvability
- Operating profit margin
- Interest cover
- Equity ratio

Each of the above factors has a certain percentage (quantitative criteria might have a higher importance than qualitative criteria, for example quantitative criteria might represent 40% while qualitative criteria might represent 60%). After analyzing all the provided data, each factor will be granted a mark according to the risk degree. By multiplying the mark with the percentage we obtain a weighted result. The sum of the weighted results represents the customer financial performance.

The financial statements of the companies are analyzed in detail, with the following focuses:

- Income statement: Development of revenues, analysis of profitability, analysis of the company’s evolution versus historical evolution and peers figures. Changes have to be clearly described – cause/effect analysis.
Balance sheet: analyze the adequacy of leverage versus asset base
Cash flow: it is extremely important for credit decision, especially for companies with a lower scoring (it is presumed that companies with a better financial standing can obtain funds for temporary cash-flow gaps more easily); volatility has to be analyzed (cause/effect analysis) and future capital needs have to be assessed.

The rating marks could be from 1 to 5, 1 being the greatest mark and 5 the lowest one, corresponding to one of the following categories:
- performing credit
- credit under supervision
- credit under standard
- doubtful credit
- credit with losses

The setting up of the financial performance of the borrower
The determination of the quality of the borrower is assessed by including the customers in one of the five categories and it is based upon a classification system:

Table 4. Classification of borrowers according to the financial performance

<table>
<thead>
<tr>
<th>Category of the credit</th>
<th>Current credit</th>
<th>Credit with deferred payment</th>
<th>Due credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Performing credits</td>
<td>Credits under supervision</td>
<td>Due credit</td>
</tr>
<tr>
<td>B</td>
<td>Credit under supervision</td>
<td>Credit under standard</td>
<td>Doubtful Credit</td>
</tr>
<tr>
<td>C</td>
<td>Credit under standard</td>
<td>Doubtful Credit</td>
<td>Credit with losses</td>
</tr>
<tr>
<td>D</td>
<td>Credit doubtful</td>
<td>Credit with losses</td>
<td>Credit with losses</td>
</tr>
<tr>
<td>E</td>
<td>Credit with losses</td>
<td>Credit with losses</td>
<td>Credit with losses</td>
</tr>
</tbody>
</table>

Source: Cezar Basno, Constantin Floricel, Nicolae Dardac, Moneda-credit-banci, 1997

A: borrowers with a profitable activity and a solid financial having ensured the proper conditions of supply and marketing, technology, administration and human resources which safely provide the reimbursement of the due installments and the related interests at maturity.

B: borrowers with a good economic and financial standing at present, with good creditworthiness ratios, but for the next period there are low chances to maintain these performances at the same level, due to either technological or administrative problems, related to the nature and the object of the activity.

C: borrowers have at present a satisfactory economic and financial standing, but with a trend of worsening of their production ratios, efficiency of the activity etc.

D: the economic and financial standing of the borrowers is characterized by inferior ratios, with fluctuations on short-term between a satisfactory and unsatisfactory activity.

E: borrowers have an unprofitable activity, with losses, involving uncertainty regarding the capacity of the reimbursement of the credit and related interests.

The classification of the economic agents according to this system is based upon the analysis of the economic and financial performances, according to criteria such as:
- type of the company;
- nature of the activity and the position of the company in this realm;
- liquidity;
• financial autonomy ratio;
• economic and financial structure;
• collaterals;
• stability
• dependence on the supply and demand markets;
• level of the government support;
• management quality;
• prospective of the economic and financial activity.

According to their importance in the evaluation of the credit quality, each criterion receives points. The final scoring is obtained adding all the points for all the criteria.

According to the observance of the reimbursement terms, the credits could be classified in the following categories:
• current loans – there are not at maturity or the installments were paid in due time according to the stipulations of the contract;
• loans with deferred payments- the due installments and the related interests were not paid within 30 days after maturity;
• due loans – the payments of the credit installments and the related interests exceeded more than 30 days;

According to their quality, the credits could be classified as follows:
• Performing credits (with low risk)- no risk placements which enables the reimbursement of the debt according to the contract clauses.
• Credits under supervision-granted to customers with very good economic and financial records but who for short periods of time they faced difficulties in reimbursing the installments and the related interests. This category also includes credits that are not at maturity or reimbursed in due time, but which have been granted to some customers with a trend of diminishing their turnover in the future according to the bank forecasting (due to problems related to their performance, their competitiveness, depreciation of the equipment etc).
• Credits under standard: risky placements, which could affect the reimbursement of the debt. They are not sustained by the net capital value or by the reimbursement capacity of the borrower. The losses implied by this kind of credits are undertaken by the banks if the reimbursement is made only partially.
• Doubtful credits (with major risk): the reimbursement or their liquidation is very difficult as they are not or partially covered
• Credits with losses- they cannot be reimbursed.

CONCLUDING THE LOAN CONTRACT

Anytime a company borrows money, documents delineating the terms of the loan have to be signed – how much is being borrowed; what collateral will be used; what the lender’s interest is, the reimbursement schedule and the agreed guarantees.

The Loan Agreement
The loan agreement sets forth all the terms and conditions of the transaction between the borrower and the lender. The key provisions include the amount, term, repayment schedules and procedures, special fees, insurance requirements, special conditions to closing, restrictive covenants, the company’s representations and warranties (with respect to status, capacity, ability to repay, title to properties, litigation, and so on), events of default, and remedies of the lender in the event of default. The legal department (or attorney) and accountant should carefully review the provisions of the loan agreement and the implications of the covenants. They should also analyze the long-term legal and financial impact of the restrictive covenants. It should be negotiated for the establishment of a timetable under which certain covenants will be removed or modified as the ability to repay is clearly demonstrated.

The Security Agreement
The security agreement identifies the collateral that will be mortgaged in order to secure the loan, usually mentioning terms of the loan agreement (especially with respect to restrictions on the use of the collateral and procedures upon default). The remedies available to the lender in the event of default range from selling the collateral at a public auction...
to taking possession of the collateral. The proceeds of any alternative chosen by the lender will be used principally to repay the outstanding balance of the loan. The security agreements are used to file and declare the loan with the state and land-records authorities. It is used to give notice to the company’s other existing and potential creditors that a security priority has been granted over any subsequent claim – in case of default and collateral enforcement. (Presuming that the legal actions regarding publicity over collateral have been fulfilled, a bank shall usually have a priority over the guarantees in case of default).

The Guaranty

The guaranty, which the shareholder or the administrator personally execute, serves as further security to mitigate the risk of the transaction to the lender. There should carefully be reviewed and negotiated the conditions of the guaranty, especially with respect to its term, scope, rights of the lender in the event of default, and type of guaranty provided. For example, under certain circumstances, the lender can be forced to exhaust all possible remedies before proceeding against the guarantor, or may be limited to proceeding against certain of the guarantor’s assets. Similarly, the extent of the guaranty could be negotiated so that it is reduced annually as the company grows stronger and the company’s ability to meet its repayment schedule becomes more evident. Although bankers understand and acknowledge an entrepreneur’s resistance to providing a personal guaranty, they will often seek this protection from the company’s principals to further mitigate their risk.

This is especially true if the business is highly leveraged, has operated for fewer than three years, or pays bonuses that absorb most of its profits. Why do lenders usually insist on these protections? The lender’s primary goal is to influence management to treat the funds borrowed from the bank prudently. In essence, the guarantee is a psychological tool, designed to keep pressure on the principals of the company to ensure prompt and regular repayment (Sherman, 2005).

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