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Granting Loans To Legal Entities As The Bank's Business Process

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Abstract

Granting loans to legal entities poses a challenge to the management in commercial banks. Regardless of intensive development of financial market, granting loans (either to corporate or retail sector) is the most lucrative banking business, in terms of the revenue generated. Granting loans to business entities is multidimensional task. On one hand, banks are trying to build as sizeable credit portfolio as possible with the aim of achieving satisfactory profit performances and on the other, in the loan approval process, it is very important to correctly assess credit-worthiness and monitor the approved loans for the purpose of adequate risk management. Hence, within the realm of loan granting, there is a specific „conflict" between traditional banking principles of liquidity, security and profitability of the placement. The analysis presented in the paper is focused on the loan approval process to business entities. The first part of the paper addresses the loan-approval technology itself from the point of submitting a loan application to the point of issuing the loan. The second part of the paper focuses on the loan assessment procedure, that is, methods and techniques of assessing credit-worthiness of potential debtors. The last part deals with the research results and conclusion.

Key words: *loan-granting process, credit risk, credit board, credit-worthiness assessment*

1. INTRODUCTION

Despite the financial market sophistication, a loan is still dominant form of the bank placement. As a result, loan placements may also be regarded as the most significant source of a bank's profitability. Considering that the profitability is ultimate business performance and bank loans are source of interest income, the loan-granting process management is of imperative importance. The loan-granting process follows adequate methodological guidelines as a set of mechanisms and procedures to which relevant credit documentation is being subject. Formalization of the loan-granting process improves efficiency in gathering and processing of credit documentation, but also facilitates the process of evaluation of the gathered data with a view to efficient making of credit decisions. In addition, the documentation flow is burdened with specific „check points" within which the data relevant for the loan approval are filtered. One of the most important check points refers to the assessment of the credit-worthiness of the loan applicant. The assessment of credit-worthiness includes identification of financial capacity of a future debtor as a source of depreciation of approved loan.

By means of credit analysis the client's financial standing and financial structure are examined and its character, capacity, collateral, capital and other relevant debtor's parameters assessed with a view to efficiently assessing the degree of placement risk. In the context of parameter analysis of the credit rating, the financial indicators have a significant role. As a set of ratios derived from the relation of specific elements of the balance sheet and income statement, these financial indicators are of great analytical and informative significance. By comparing them with boundary (desirable) values, the loan repayment capacity is the determined. Beside the financial parameters, as referential factors to assess credit-worthiness, the credit analyst gives special attention to the assessment of other relevant parameters such as: the situation in a business activity concerned, economic trends at regional level, and projections with regard to economic activity trends in the forthcoming period. The purpose of these analytical procedures is to properly assess the risk level and create the credit portfolio which is adequate from the viewpoint of the placement security and profitability.

2. LOAN APPROVAL PROCESS- METHODOLOGICAL CONSIDERATIONS

The first „check point“ in managing the loan-granting process is the phase in which the contact between the client and the bank has been established.

The basic principle of quality credit operations on which creation of stable and profitable credit portfolio is based reads: "get to know your potential client". The person who acts on behalf of the bank and is responsible for its credit exposure, has to, by virtue of his/her expertise, learn about the performance of the future debtor and establish the client-bank relationship based on principles of mutual trust, benefit and interest. This is a strategically important step and has a twofold function:

- on one hand it enables bank to examine the client's financial needs in a more efficient and complete manner so as to adjust its offer to its financial demands.
- on the other hand, being aware of the client's economic and financial performance and its permanent monitoring within the loan-granting process have essential signalling effect.

Namely, the bank receives timely signals about the client's possible financial problems, which may be significant determinant for manifestation of the credit risk in the loan repayment period.

In order to focus on essential client's performance, the bank assigns each client to respective client advisor/officer in charge of bank-client relationship management for each loan-granting activity. The advisor is the focal point as regards all the aspects of the bank's relationship with an individual client. This is a characteristic manifestation of CRM strategy for the implementation of which the person acting on behalf of the bank is in charge. It entails professional and responsible relation in the client relationship management.

Every client's advisor/officer is assigned a specific list of existing and potential clients, that is, every significant beneficiary of the bank „products“ should have his/her own loan placement advisor/officer whose responsibilities include as follows:

- marketing of the bank products among existing and target clients;
- contact with clients and negotiations concerning new credit arrangements;
- preparation of proposals for new credit arrangements to be submitted with a view to implementation of the loan approval process;
- preparation and signing of the documentation;
- regular analysis of credit risks that fall within the scope of his/her responsibility and submission of the report on the analysis results within the loan approval process;
- monitoring of credit exposure for the purpose of correct classification and reservation;
- timely recognition of warning signals indicating that the client will not be able to fulfill his/her commitments to the bank and giving recommendation that responsibility for any further actions concerning the relationship with this client be transferred to the organizational unit responsible for problem loans.

2.1 Submission and processing of the loan application

If the client (a company) decides to start cooperation with the bank as regards the future credit activity, the business meeting is arranged so as to learn about the client's business activities. Making a visit to the client, loan granting negotiations in the client's business premises, that is, the place in which the security instruments for the loan repayment are located (if it is a loan secured by real estate as a collateral) are all aimed at detecting and eliminating risk factors that are not evident from the available documentation. During the visit the following elements are assessed:

- territorial circumstances and the client's environment, techniques and technological conditions in terms of quality, market position and development prospects,
- professional and human quality of management bodies and mangers, strategies, unique business policy, disagreements between management and members of shareholders' group which jeopardize the company operation,
- the level of administration (accounting, organizational level, efficiency and reliability of the information system),
- circumstances which permanently jeopardize the company operation (change of environment resulting in the revenue contraction, out-dated resources, culturally underdeveloped environment, low-skilled labour, technological negligence and the lack of organization etc.),
- the client's assets (capacities at the client's disposal for business operation, the level of capacity utilization, the assets not required for operation, etc.)
- circumstances which affect the realization of the loan purpose,
- whether the work processes are taking place in the client's business premises,
- the state of assets proposed as a security instrument, that is, the factors affecting its market and recognized value are assessed.

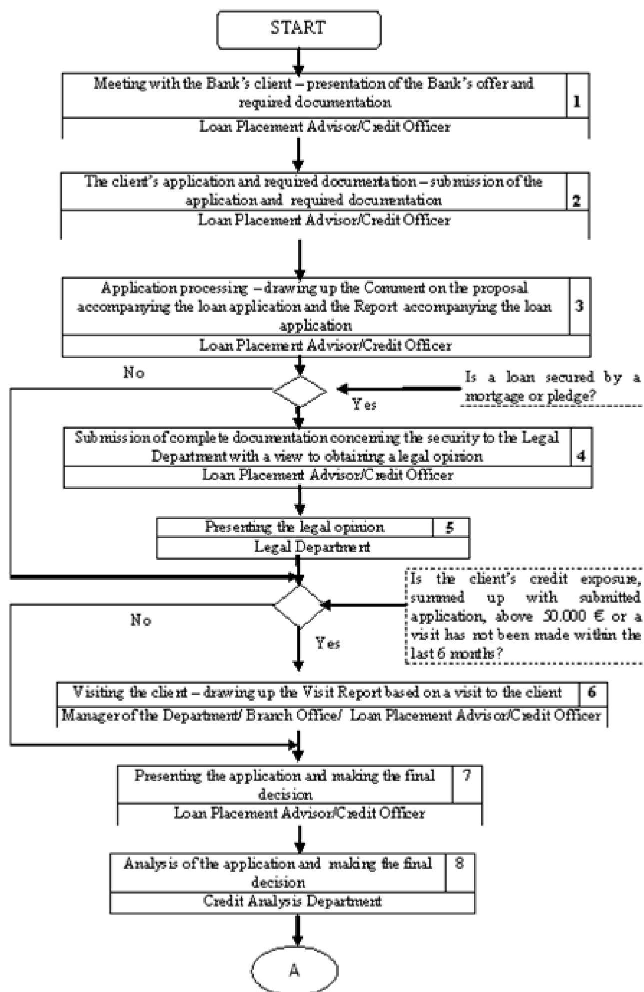

Figure 1. Submission and processing of the loan application and making the decision

Following the visit, it is further assessed whether the loan application is justified and if the assessment is positive, the process is continued with a view to completing the client's dossier by filing necessary documents therein (the application for short-term, i.e. long-term loan, a questionnaire about the loan applicant, a letter of approval for obtaining the Report by the Credit Reference Agency for natural and legal entities, documentation related to the status, finances and the type of security provided (mortgage/pledge)).
Furthermore, it is necessary to check the documentation completeness and data accuracy by means of: cross-checking the data, comparing them with the data in central databases of the Bank, with the previously submitted data about the same client, with the data on the client's official internet presentation as well as on the internet presentations of competent state authorities and public institutions (Business Registers Agency, Association of Serbian Banks – Credit Reference Agency, National Bank of Serbia). All this is needed so as to properly examine the parameters that are relevant for assessing the placement risk. If mortgage or pledge is offered as a type of loan security, it is necessary to submit the security-related documentation to the legal department with a view to obtaining a positive legal opinion on eligibility of proposed object of pledge as a security instrument. The documentation completed in this way is then forwarded to the Credit Analysis Department and/or other organizational units/persons responsible for analysis of the client's credit rating.

2.2 Preparation of proposals and making the credit decision

The analysis of credit rating and preparation of the credit decision proposal for the bank's client is within the competence of the Credit Analysis Department. It starts with the process of checking the data completeness and accuracy performed by the credit analyst. In the process of checking the data completeness the following elements should be taken into consideration:

- the loan amount requested, where in applications for lower loan amounts, any information of minor importance may be left out, whereas in applications above the specific amount[*], the entire set of data will be required,
- the category into which the client falls by the extent and scope of its operations, where for smaller clients the data of minor importance do not have to be submitted subject to the assessment of the credit analyst,
- the type of the requested credit product and the manner of securing the bank's claims.

The data accuracy is checked in the Credit Analysis Department in the same manner as when checking their accuracy in the Front Office. If it is established that the data are not accurate or that, on the basis of submitted data, the appropriate credit analysis cannot be made, the credit analyst will return them to be modified, i.e. corrected.
Upon completed analysis of the loan application, the credit analyst produces:

a) the assessment of the debtor's credit rating[†] including as follows:

- brief description, if it is estimated that the credit rating corresponds to the requested credit product,
- more detailed description of negative aspects of the debtor's credit rating

b) credit decision proposal,

is submitted to his/her direct superior for approval, who may return the preparation procedure for credit decision proposal to any of the previous phases, may change the loan application assessment and/or credit decision proposal or may agree to both. The proposal prepared in this way is sent to one of competent credit boards for decision.

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[*] The value up to which limit the complete set of data is not required is stipulated by the bank's internal by-laws.
[†] The procedure of assessing the credit-worthiness of legal entities will be addressed in more detai in the second part of the paper.

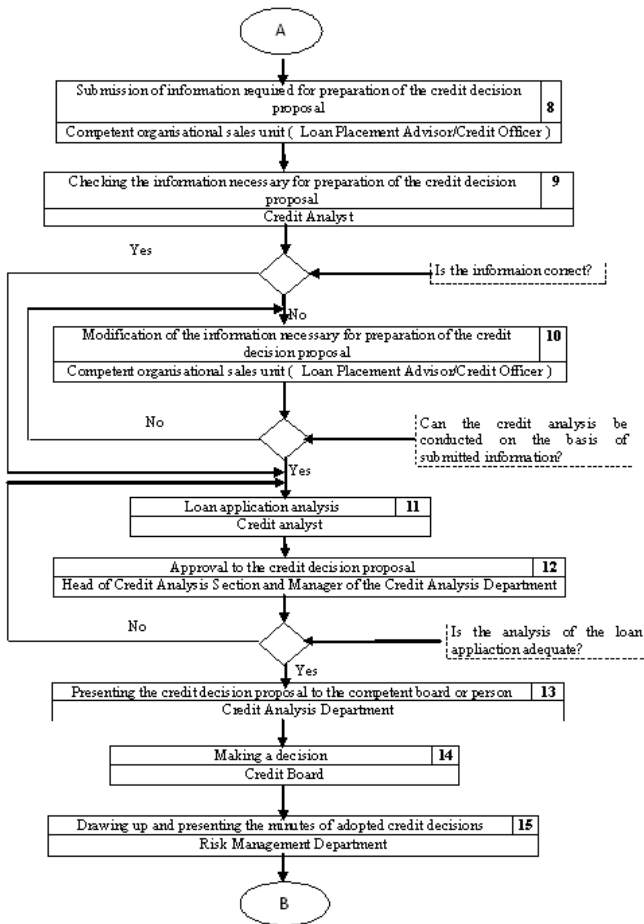

Figure 2. Loan application analysis

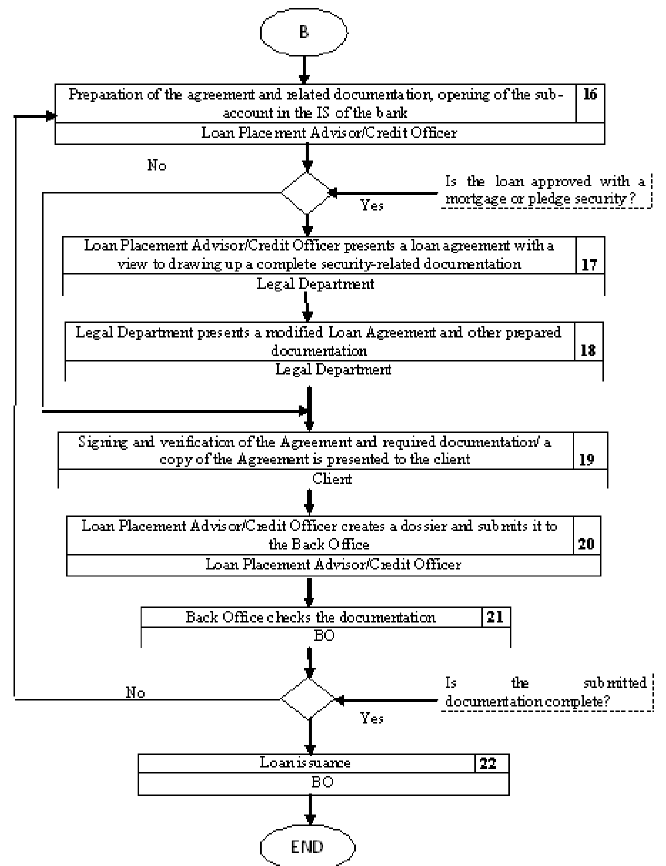

Figure 3. Preparation of the agreement, related documentation and issuance of the loan

The process of analysing the credit rating results in classifying the client into one of risk categories and making the final decision by which the loan application is either accepted or declined.

2.3 **Loan issuance**

The activities in this phase of the loan granting process are directly reliant on the decision of the credit board on accepting or declining the loan application. Following the positive decision of the credit board, and notification of loan approval, the contractual and other related documentation is drawn up (in accordance with terms set out in the decision) and loan sub-account set up in the application of the bank's information system. If the loan has been approved along with the security instruments such as the mortgage, the pledge of chattels or the pledge of securities, the loan agreement is submitted to the Legal Department with a view to drawing up complete required security-related documentation. Prepared agreements and documentation are delivered to the client for verification and signing, the loan dossier is created and sent to the Back Office (BO), first in an electronic form and after the funds have been released, also in an original form. Upon the receipt of documentation, one more check of documentation accuracy is performed after which the loan funds are issued.

2.4 **Loan monitoring**

The final phase in the loan management refers to monitoring of approved loans including the regular analysis of developments or changes in a project/company as well as the analysis of change impact on major credit risks and sources of repayment, from the point of the loan approval to the point of its repayment.

In the course of repayment period the problems in payment of loan commitments may arise. Loan repayment problems emerge as a function of internal and external factors. The bank's management response to this situation should include the following steps: (Graddy & Spencer, 2000)

a) Never let a debtor feel as a delinquent; try to establish a certain degree of cooperation with the debtor;

b) When the debtor fails to meet any provision of the agreement, the reasons for such behaviour should be determined;

c) It is necessary to make an action plan concerning the cooperation with the debtor with regard to the debt service in the forthcoming period;

d) Be uncompromising, but also positive when activating the debtor's pledge (collateral);

e) Avoid threat letters (various reports);

f) Contact the debtor in the most adequate (straightforward) manner;
g) Do not enter into a discussion with the debtor when he/she fails to pay the first annuity, but consider that as common matter.

3. LAON ASSESSMENT PROCEDURE

The aim of the bank loan process management is to minimize the credit risk. The credit risk emerges in all cases as a result of the bank's loan approval or issuance of the credit instrument, such as a guarantee or a letter of credit, on the client's behalf. There are no risk-free loans. The risk simply means the possibility that the client, who takes the loan or requires the bank to issue a letter of credit/guarantee on his behalf, will not be capable to fulfill its commitments to the bank within the due dates on the basis of the principal repayment and payment of instalments and fees. At the same time, the risk implies combination of threats and possibilities: the threat of default and possibility of regular loan payment along with the respective interest.
The credit risk may be minimized through the careful analysis of all loan applications before the final decision of the credit reference agency as well as sound management of the loan repayment process. The principal aim of these activities is the bank's profit orientation in terms of income made as an interest margin (the difference between the active interest rate and the price of secured sources of funds –an average passive interest rate) increased by the fees calculated by the bank on the basis of the risk undertaken (Association of Serbian Banks, 2004). Therefore, it is very important that the bank, in the process of the loan approval, establishes the client's credit rating by means of credit analysis. To this end, the client's credit rating includes fulfillment of commitments to the bank on the basis of the principal repayment and payment of interests and fees within due dates.

3.1 Classic credit analysis

Classic credit analysis is a structured labour-intensive process which involves the following steps in the company analysis (Šarlija, 2009):

- Motivation – why does the company need money? The bank officer's task is to find out information about the company and compile the information in accordance with the policy and attitude of the bank towards this company.
- Review of the company's operation and strategy – is the company aware where it is heading to?
- Analyse financial reports so as to highlight the trends and potential weaknesses of the company Establish projections and determine trends.
- Assess the purpose of loan in relation to expected cash flow.
- Analyse industrial structure/ economic sector – trends, the company's standing within the industrial/economic sector, potential impact of legislation.
- Evaluate the company management and operative strategy,
- Prepare credit documentation and insurance.

In the classic credit analysis the credit officer's and credit analyst's task is, through analysis of relevant information, to detect potential weaknesses of the company, establish a diagnosis and envisage the scenario according to which the company will operate in future. In order to make an adequate assessment, they have standard analytical techniques available to them to estimate probability of (non)fulfillment of commitments to the bank.

3.2 “6K” analysis

One of possible approaches to credit rating assessment is the analysis and evaluation of the client by application of 6K analysis including the following analyses: character, capacity, capital, collateral, condition and control. (Rose & Hudgins, 2005)

A. **C**haracter – the client should have clearly defined purpose of the loan and serious intention to repay the loan according to the agreed time schedule; broader understanding of the loan applicant's character also involves other elements in the assessment of its credit rating; thus a separate analysis and an assessment of the following elements is produced: (1) the debtor's characteristics, in terms of his/her attributes and business reputation, and (2) characteristics of the company he/she runs as an owner or a manager; as far as the character of the company is concerned (in circumstances when the ownership does not coincide with the management), from the aspect of credit rating, the company's character is more significant than the character of an individual in capacity of the owner or manager; therefore, under the term „character“ the company's qualities are specified, such as: (1) business reputation, (2) type of business activity, (3) the company's legal status. (Vunjak, Ćurčić, & Kovačević, Corporate and Investment Banking, 2008)

Table 1. Elements and indicators of the loan applicant's character

Elements	Indicators
Responsibility	The manager's personal qualities (company owner)
Integrity	Business experiences with the loan applicant: own experiences and experiences of its most important buyers and suppliers
Punctuality	Timely fulfillment of commitments
Consistency	State of the business ledger (promptness, clarity, reliability)

Source: (Bartles, 2001)

B. **C**apacity – the client should have a legal capacity to conclude agreements and empowered management to run entire business dealings; additionally, the client is expected to have production and financial capacity to service its commitments, whereas in relations with creditors the financial capacity

„measured“ by expected net cash flow is preferred; the bank as a creditor is primarily interested in: whether the client will have a positive cash flow in the forthcoming period and whether it will make a sufficient profit to repay the loan without undermining and jeopardizing the achieved level of business operation; the client may repay the loan from the following sources: earned net profit, income from the property sale, income from the sale of shares, borrowing from other creditors. (Vunjak, Ćurčić, & Kovačević, Corporate and Investment Banking, 2008)

Table 2. Elements and indicators of the loan applicant's capacity

Elements	Indicators
Profit	Sales volume Profit margin
Future profit	Scope and nature of business
Existing debt	Debt-asset ratio, debt-capital ratio
Cost structure	Location Licences and product trademarks Market reputation of the company Management quality Continuity/discontinuity in business operations Short-term and long-term debts Operating costs

Source: (Bartles, 2001)

C. **C**apital (cash)– the client is expected to have such a scope of business transactions that produce the cash flow sufficient to fulfill all commitments, also including those to the bank; if the business transactions do not generate sufficient cash flow to meet the commitments to the bank, as the final instance, the debtor's capital, which makes the difference between the value of the total property and total commitments, serves a function of credit-worthiness; the capital reflects the accumulated wealth of the loan applicant and is an indicator of successful business operation in the previous period; the assessment of the loan applicant's capital is used for analytical purposes by applying the standard procedures for assessment of credit rating; the debtor's assets reduced by commitments is an upper limit of borrowing capacity and serves as a security for repayment of the loan. (Vunjak, Ćurčić, & Kovačević, Corporate and Investment Banking, 2008)

Table 3. Elements and indicators of the loan applicant's capital

Elements	Indicators
Physical assets	Own net assets
Capital investments	Interest on planned investment The most significant creditors Liquidation value Confiscation costs

Source: (Bartles, 2001)

D. **C**ollateral – security instruments which reduce the bank's risk of loss and must have value which, from the moment of their activation to the moment of their encashment, is sufficient to cover entire loan debt, including default interest and other costs; securing the loan payment is aimed at covering „the weak points“ of the loan applicant's credit rating; the collateral may be any suitable instrument (assets) at the debtor's disposal which may be used towards the debt payment if the payment is impossible to be made in regular manner, in accordance with the loan depreciation schedule;

Conditions or circumstances refer to the analysis of environment in which the client is doing business. Additionally, it is necessary to establish the trends and perspectives of the business activity the company is performing as well as the macroeconomic framework; the analysis should include economic projections within the loan repayment period as well as other features of the future debtor which make its business dealings particularly sensitive to the business cycle fluctuations.

E. **C**ontrol – refers to the review of the legislation so as to determine whether it may affect the financial standing of the loan applicant and in what way; what is more, it is necessary to maintain permanent communication between the creditor and debtor with a view to controlling the use of approved funds.

3.3 Analytical procedures in assessing the credit rating

The process of analysing the credit rating results in placing the client into one of the risk categories and making the final decision based on accepting or declining the loan application. The credit analyst may use various procedures to determine the credit rating including as follows (Kovačević, 1992):

- the method of comparative analysis, in which analysts mainly rely on the balance sheet and income statement and compare operation of the reviewed company with a company operating within the same economic sector/business activity,
- the method of trend analysis, in which analysts mainly use the balance sheet and income statement so as to compare several consecutive years, expressing the statement items in both absolute and relative values as rates, that is, the indexes of annual variations.
- the method of indicators' analysis is based on the analysis of financial indicators such as: liquidity, indebtedness, profitability and a loan repayment capacity indicator,
- the method of analysis of the statement on financial power of the company.

The most prevailing procedure used by credit analysts is the method of financial indicators' analysis and comparative analysis of similar companies.

3.4 The most commonly used financial indicators in the credit analysis

Financial indicators are obtained as relations between relevant categories of the balance sheet and income statement and have a great analytical importance in assessing financial structure and financial standing of a potential debtor. By comparing the values of these financial indicators with the desired values, the clearer picture is obtained of the loan applicant's capacity, possibilities of the loan repayment and justification of the loan application in general. The most commonly

used categories of financial indicators include as follows: liquidity indicators, indebtedness indicators (sources of finance), activity indicators, profitability indicators and cost-efficiency indicators. The categories, i.e., specific financial indicators, the method of their calculation and boundary values of specific indicators are shown in a table in an integrated manner.

Table 4. Overview of financial indicators for credit rating assessme

Indicators' Group	Indicator	Calculation methods	Desired value
Liquidity indicators	Current ratio indicator	Short-term assets /Short-term liabilities	2 and more, not less than 1
	Quick ratio indicator	(Short-term assets - stock /Short-term liabilities	1 and more
	Financial stability indicator	Long-term assets/ Capital + Long-term liabilities	less than 1
Indebtedness indicators	Indebtedness indicator	Total liabilities/Total assets	0.5 and less
	Own finance indicator	Capital/ Total assets	more than 0.5
	Finance indicator	Total liabilities/Capital	1 or less*
	Interest cover	Ebit/Annual interest costs	as large ratio as possible
	Indebtedness factor	Total liabilities/Net profit + Depriciation	as small ratio as possible
	Coverage level I**	Own capital/ Long-term assets	1 and less
	Coverage level II***	Own capital + Long-term borrowed capital/ Long-term assets	1 and less
Activity indicators	Total assets turnover coefficient	Sales income /Average total assets	as large ratio as possible
	Debt turnover coefficient	Sales income /Average debt	as large ratio as possible
	Stock turnover coefficient	Sales income /Average stock	around 1****
Profitability indicators	Gross profit margin	Profit before tax + Interests/Sales income	as large ratio as possible
	Net profit margin	Profit after tax + Interests/Sales income	as large ratio as possible
	Return on assests (ROA)	Net profit + Interests /Average total assets	as large ratio as possible
	Return on equity (ROE)	Net profit/Average total equity	as large ratio as possible
Cost efficiency indicators	Cost efficiency of total operation	Total income/Total expenditures	as large ratio as possible
	Cost-efficiency of sales	Sales income/Sales expenditure	as large ratio as possible

Source: Authors' presentation (Vunjak, Financial Management (Business Finance), 2008) and (Malešević & Vranjković, 2007)
*In most banks the credit rating threshold complies with the ratio of 30:70% to the benefit of borrowed capital.
**Also called „golden rule of banking“
***Also called „golden rule of balance sheet“
****Low-value indicator implies that the client uses funds in an unproductive manner, whereas the high-value indicator entails that stocks are frequently exhausted resulting in loosing buyers.

4. RESEARCH RESULTS

On the basis of analysis of actions, procedures and practice in the loan granting process of the three leading and two minor banks in Serbia, it has been established that the credit process is structured from separate but interdependent phases of loan granting process as shown in the figure.

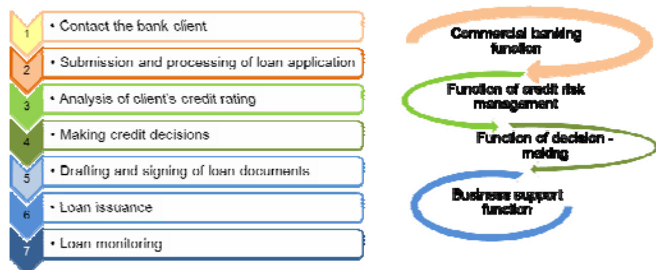

Figure 4. Credit process structure

Furthermore, present-day practice of more developed banks is to split the credit risk management functions from everyday activities pertaining to customer relations and credit-related activities. The responsibility of the credit risk management function includes overall management of portfolio of (risk) placements with the aim of creating and maintaining the stable and profitable portfolio. Organisation sections or units (directorates, departments etc.) in charge of credit activities or activities related to commercial banking are responsible for the bank relations with individual credit beneficiaries in line with the policy and procedures that are determined at the level of credit risk management function.

This division of responsibilities ensures necessary „checks and balances“, thus enabling the bank to create stable and profitable placement portfolio able to resist unfavourable cyclical trends in economic environment.

The analysis proved that, in the process structured in this way, the credit analysis, that is, the content and procedure of assessing the beneficiary's credit rating, has a crucial role in minimizing the risk exposure. By examining this aspect of the bank operation, it was noted that there is a practice of undertaking numerous „steps“, involvement of more participants, complexity of approach, analytical procedures etc. In credit analysis great importance is also attached to so called financial indicators of business entities' operation (liquidity, indebtedness, profitability, cost-efficiency etc.), the number and relevance of which depend on the type of loan, its maturity, credit and guarantee exposure of the client etc. On the other hand, it is also observed that there is a dominant practice of „parameterization“ of financial indicators that are used in the credit analysis – the credit rating assessment, that is, the quality of the client's operation is examined in correlation with (scientifically and professionally) previously defined standards of convergence and/or (tolerable limits) of divergence.

Common practice of the banks in Serbia is to select financial indicators that are calculated for every loan applicant, and then compared with relevant standards (boundary values) to be met by financial coefficients. In addition, the credit analyst has to be capable of combining all indicators together. For example, the client may have quite a low profitability, however its liquidity coefficient may be above the average, which will provide for regular debt service toward the bank. This means that the credit analyst has to decide whether a prospective client is credit (un)worthy. Moreover, although there are boundary values for financial indicators suggesting whether the client is credit-worthy, the credit analyst has to be capable of conducting multi-factor analysis of a potential debtor's financial standing. Although boundary values of financial indicators have a corresponding signalling effect in assessing the credit rating, they may not be considered universal standards as far as each individual client is concerned. The comprehensive analysis of credit-worthiness includes development of empirical studies based on financial data so as to select the most relevant financial indicators as a benchmark in assessing credit-worthiness of the potential debtor. Practice proves that, with a view to envisaging, but also preventing the risk, it is necessary to analyse all relevant data available to the bank, from the analysis of balance sheet indicators to the analysis of situation in a respective business activity performed by the client,

analysis of the state of economy, territory, i.e., the client's country of residence.

5. CONCLUSION

In contemporary banking theory and practice the complex methodologies and instruments for assessment of loan applications are recognized, that is, the technology for their analysis and processing. The aim is to provide comprehensive gathering and processing of information about the client's business dealings of importance for the bank's decision-making process, but also a segmented approach during their evaluation.

It is further insisted on proceduralization, formalization and defining (the content) of the process as well as on standardization of procedures. Hence, it is reasonable that in contemporary bank organization, the function of commercialization of offer is detached from the function of credit activities, credit risk management and decision-making. This division of responsibilities ensures necessary „checks and balances“, that is, an adequate balance between the principle of profitability and security of the placement. This bank's orientation is motivated by the need for ex ante credit risk management, that is, minimization of (potential) losses resulting from the credit being unpayable.

Loan granting as the bank's business process entails taking of numerous steps, involvement of more participants, complexity of approach and analytical procedures, which are organized so as not to lose the bank's efficiency and operability in the relationship bank-client, and as a result, decrease the bank's competitiveness at the market. This is achieved by means of standardization and proceduralization of the credit process

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