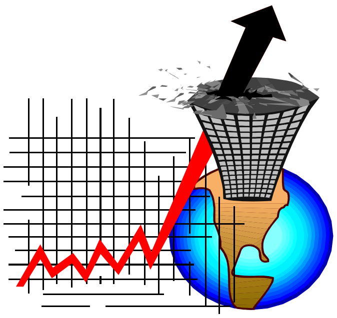
Module 8



Credit Administration

IN THIS MODULE

This module aims to provide directors with the basic knowledge and skills of innovative credit management practice in the credit union, particularly on capacity-based lending.

SPECIFIC OBJECTIVES:

After completing Module 8 on Credit Administration, directors will be able to:

1. Recognize the major lending risks, its causes and implications in credit union sustainability
2. Be aware of the Board's responsibility in lending
3. Understand the concept and importance of capacity-based lending
4. Be familiar with the tools used for prudent credit management

FYI

The facilitator is encouraged to insert "Ice Breakers" in between topics. The facilitator should be very sensitive to the level of participation. Participants should be highly motivated at all times.

CONTENT:

1. Lending Risks, Causes and Implications
2. Board's Responsibility in Lending
3. Capacity Based Lending
4. Tools for Prudent Credit Management

FORMAT:

Pre-Course Work:

The participants shall bring along the completed pre-course work on the latest delinquency rate (by PAR – Portfolio at Risk) and what it was (delinquency rate) before the management instituted delinquency control measures that are considered successful. The facilitator or the Training Director shall request the participants to also list these loan delinquency control measures.

The participants also receive a sample copy of Lending Policy for advance reading.

At the Workshop:

The facilitator adopts appropriate and interactive methods of exercises, small and big group discussions, brainstorming, presentation and summation of group output.

Credit Union Project:

In this module, Directors gained knowledge on the importance of Credit Administration. They are now ready to commence their eighth credit union project to be submitted for assessment to the Registrar of the Credit Union Directors Competency Program.

The participants are required to:

1. Carry out a 3 hour workshop on Credit Administration attended by all Board members and the Manager of the credit union
2. Prepare a Report to be submitted to the Registrar of the CUDCC
3. Make a risk assessment of the lending operations of their credit union
4. Formulate recommendations to control the risks in lending operations of their credit union

MINIMUM TIME:

4 hours (240 minutes)

LIST OF HAND OUTS AND MATERIALS

PowerPoint and Materials

1. Lending Risk, Causes and Implications to Credit Union Operation, ppt. – page 342
2. Board Responsibility in Lending, ppt.– page 348
3. Capacity Based Lending, ppt. – page 352
4. Debt Service Calculator – page 359
5. Delinquency Report – page 360

Equipment/Materials:

1. OHP or LCD
2. White Board pen

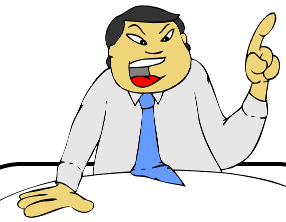
SESSION GUIDELINE

1. Preliminary Activity-10 Minutes

Ask each participant his/her expectations from this workshop and publish them on the white Board. Present the module objectives in power point or through overhead projector, whatever is available.

At the end of Module 8, Directors will be able to:

1. Recognize the major lending risks, their causes and implications in the credit union operations
2. Be aware of the Board's responsibility in lending
3. Understand the concept and importance of capacity-based lending
4. Be familiar with the tools used for prudent credit management



Note to Facilitator

Group the participants into four or five teams. Participants should sit with their teams. This should contribute to positive group dynamics. The participants may be regrouped in different teams every day to give opportunity for more interaction. Regrouping is advisable if modules are carried out separately.

2. Lending Risks, Causes and Implications to Credit Union operation – 40 minutes

Using the list of Portfolio at Risk (pre-course work), introduce the first exercise. Divide the participants in small groups consisting of 5 members and ask them to discuss the following questions in 10 minutes.

Exercise 1 (Group):

1. What are the major risks in lending?
2. What are the causes of these major risks in relation to the internal policies or processes of the credit union?
3. What are the implications to credit union operations?

Ask the participants to share their answers. It could be written on a flip chart or OHP. Summarize their answers. The following would most likely be the responses of the participants. Use PowerPoint Presentation.

Major Risk	Causes	Implications to Credit Union Operation
Delinquency	• incomplete credit investigation • inadequate credit analysis and poor credit judgment • poor loan documentation • share capital and/or savings leveraging • granting the loans without applying the 5 Cs of credit • inadequate loan monitoring and follow-up	• No liquidity • Decreasing the Net Profit • Therefore, Institutional Capital will not significant increase • Lessens ability to provide services to members • Results in RATIONING credit

Major Risk	Causes	Implications to Credit Union Operation
	• poor lending policy • poor training of lending employees • not strictly following the loan policy	• Diminishes ability to provide for operational cost including competitive staff salaries • Poor image in the community

Emphasize that delinquency is the most important test of institutional strength and it affects all of the key ratios of the credit union operation.

Exercise 2 (Participants from same Credit Union):

Discuss the following questions for 10 minutes:

1. How your credit union determines the loan is delinquent?
2. What kind of reports the Board receives from the management on the quality of the credit union loan portfolio? How do these reports help you to evaluate the quality of your loan portfolio?
3. Describe in your own words the process of calculating Allowance for Loan Losses

Facilitate the sharing of responses. Write them on the flip chart so that you can refer to them later.

Definition of Loan Delinquency:

Explain that **Loan delinquency is the failure of the borrower to pay loan amortization upon due date**. Clarify responses of the participants to question no. 1 with the following statement:

A loan account is considered past due after 1 day missed payment, whatever is the mode of payment – daily, weekly, bi-monthly, monthly, semi-annually, annually or seasonal. The whole balance becomes past due account even if it is not due yet because the whole portfolio becomes a potential bad debt. It is an early warning device because at an early stage, the management becomes alarmed.

Delinquency Report:

Based on the above definition of delinquency, the Board should be well informed on the risk involved in the loan portfolio. Therefore, the Board should know the details of the delinquency. Distribute the sample Delinquency Report to the participants and seek comments on the format.

Sufficient Provision for Allowance for Loan Losses

Adequate protection of assets is a basic tenet for credit union competitiveness. Protection is measured by:

- comparing the adequacy of the allowances for loan losses against the amount of delinquent loans and
- comparing the allowances for investment losses with the total amount of non-

regulated investments.

Protection against loan losses is deemed adequate if a credit union has sufficient provisions to:

- cover 100% of all loans delinquent for more than 12 months, and
- 35% of all loans delinquent for 1-12 months.

Inadequate loan loss protection produces two undesirable results: inflated asset values and fictitious earnings. Most credit unions are not anxious to recognize loan losses, and much less, to charge them off against earnings. That unwillingness leads to widespread abuse of the principles of safety and soundness. Reported net income is overstated, asset values are inflated, provisions for loan losses are inadequate, and member savings are not adequately protected.

Many credit unions are not concerned about the inadequacy of their allowances for loan losses since they view their capital reserves as the primary source of protection against loan losses. This erroneous idea is gradually changing as management becomes convinced that it is much easier and less painful to use the allowances for loan losses as the primary source of protection, rather than having to get approval from the membership to diminish capital reserves because of losses.

Conclude this sub-topic underscoring the reasons for ensuring the quality of the loan portfolio:

- Funds loaned to members accounts for about 80% of assets at risk
- More than 80% of income of credit unions comes from loans
- Loans not repaid through one reason or another constitute direct losses to the credit union through loss of assets and indirect losses through income not received

3. Board Responsibility in Lending – 60 minutes

Explain that as discussed in Module 2-Board Duties and Responsibilities, directors have the responsibility to:

- Protect member assets
- Ensure quality service
- Consider member needs

One of the primary duties of the Board is to establish policies to ensure sound management of the credit union. Once the board has determined their role in the credit function, it would be easy for them to define the role for others.

Exercise 3 (Participants from same Credit Union):

Discuss the following:

Briefly give descriptions of the functions performed by the following in ensuring the quality of your credit union portfolio:

- Board of Directors

- Credit Committee
- Loans Officer
- Chief Executive Officer

Allocate 20 minutes for the discussion. A written report should be prepared by the participants (per credit union).
Present the PowerPoint on the Functions in Loan Administration and Monitoring. Ask the participants to compare their responses to your presentation. Get feedback on the differences in their practices.

Who is Responsible?	Functions
Board of Directors	• Ensuring sound and updated credit management policies are adopted for the safety and soundness of the credit union • Defining the responsibilities of the officers and staff responsible for the administration and monitoring of the loan portfolio • Ensuring that there is clear communication of the objectives and priorities of lending in relation to the overall plan of the credit union • Assessing risk on all types of lending the credit union is involved or will be involved in the future • Monitoring of the loan portfolio by reviewing and analyzing loan reports to ensure the quality of loans
Credit Committee	• Assisting the employees to identify risks in the current loan portfolio, and report findings to the Board • Minimizing or reducing risks by ensuring that applications are complete, followed by the appropriate level of investigation and analysis • Reviewing of the loan policy and recommending to the board changes required to ensure quality of loan portfolio
Loan Officer	• Complying with board approved policies and operational procedures • Providing timely follow-up, and review of all loans • Completing full applications, thorough investigations, and analysis of all loans. • Recommending the approval of the loans based on the policies and 5 C's of credit • Taking appropriate and timely action on loan delinquency
Chief Executive Officer	• Design appropriate internal operational procedures to implement board policy • Ensure the appropriate reports are completed and forwarded to the board • Review and control the internal loan process

Underscore that a well written loans policy strictly implemented is the key to the quality of the loan portfolio. The critical issue in the success of a credit union is the development and adherence to a policy that clearly defines lending authority and practices.

4. Lending Policy– 40 minutes

At this point the participants are clear about the importance of a well written lending policy and the people in the credit union responsible for implementation of the policies. In this sub-topic, you will be discussing the areas covered in the policy.

Exercise 4 (Group):

Divide the participants into smaller groups of 5. Distribute at least 20 Meta cards for each group. For 15 minutes, ask the participants to prepare a checklist of the areas covered in a comprehensive lending policy. Explain that they have to discuss the answers before writing down the key words on the Meta card. Ask them to post the answers on the wall or white board.

The following would most likely be the answers:

- Purpose or objective of the policy
- Eligibility of the Borrower
- Documentation of the loan
- Assessment – 5 C's of credit, credit investigation, credit scoring
- Delegation of Approval authority
- Types of loans- unsecured and secured
- Loans to Related Interests
- Securities
- Interest Rates
- Delinquency Control – action to be taken, sanctions
- Reporting – monthly reports, accounting of loan delinquency

Refer to the sample lending policy distributed in advance to the participants.

5. Capacity Based Lending Program– 60 minutes

Present the PowerPoint on the principles of Capacity Based Lending:

a. The security of the credit union is more important than the applied or requested credit needs of any individual member.
b. To answer the needs of a borrower-member, the credit union needs to evaluate the risk involved in lending; and, set the limit that the credit union is willing to assume or grant.
c. Loans are granted to members based on good standing and capability of the member to repay.
d. Each loan necessitates a thorough credit investigation.
e. The protection of savings deposits and share capital of all members and the credibility and security of the credit union are more important than the increase in the volume of transactions and operations, and/or growth of assets.
f. Loan program to members is a privilege, rather than a right inherent to membership.
g. No new loans shall be extended to member-borrowers with delinquent accounts.
h. The credit union has to prove its financial soundness, operational security and ensure balance between risks, diversification and profitability.

i. To limit the risk of lending and to diversify the loan portfolio, the credit union has to limit loans to members who are within the geographical area stated in the by-laws.
j. The loan portfolio is limited by type of loan.
k. Commercial, real estate and agricultural loans have to be covered sufficiently by collateral.
l. The credit union may finance viable projects up to 70% only of the total project cost.
m. The remaining 30% shall constitute the proponent's counterpart

Continue the presentation of the 5 C's of Credit. Simultaneously introduce the Credit Scoring Tool for Individual and Business (page 335-341).

The criteria for granting loans are the five (5) C's of credit: capacity, character, condition, collateral and capital, which are to be measured using the Credit Rating Form.

1. **Capacity** – This refers to the member-borrower's proven capability to repay the loan on the agreed terms: i.e. size of amortization and frequency of payments. This information is derived by computing the net disposable income of the member-borrower. As a basic rule, the repayment terms should coincide with the member's cash flow, which could be daily, weekly, semi-monthly or monthly. When the payment is quarterly, semi-annually or annually, the member-borrower should nonetheless be required to make monthly interest payments on the loan.

   In determining the capacity of the member-borrower/co-borrower to pay, the following are taken into consideration:

   - Total monthly amortization of the debt
   - Total debts of the member-borrower or co-borrower in applicable cases (inclusive of debts to the cooperative as well as from other sources)
   - Tangible asset value and their appraised value including share capital
   - Regular savings and share capital accumulation
   - Good credit record with credit union, neighborhood stores, relatives, friends and other lending institutions

2. **Character-** This refers to integrity, credibility, trustworthiness of the member-borrower and or the co-borrower in applicable case, which among others, pertains to one's personal honesty, dealings, reputation within one's residence, neighborhood and organization and/or other affiliations one is a member of. Relatives, friends, must be checked. Character indicates the stability of the member-borrower as to his/her investment. This is indicated by the following:

   - Good record of loan repayment with the credit union
   - Good record of loan repayment with other institutions (stores, banks, relatives, etc.)
   - Good reputation in the neighborhood, work, organizations etc.
   - Regular savings habit.

3. **Capital** –this refers to the regular, consistent amount of savings or contributions made by the member-borrower (or his/her co-borrower) in the credit union and other institutions, which leads to the build-up of financial, material resources.

4. **Collateral-** this refers to any personal or movable asset, as well as real or immovable asset owned by the member-borrower in his/her name that is offered as security for a

loan. It could also be a personal or real property owned by a third person, which is offered by this third party as security for the loan. All loans should be collateralized, with the share capital as the minimum security.

5. **Condition**-refers to external factors affecting the socioeconomic circumstances of the loan applicant and the loan. These factors are:

    - Legality of the proposed project
    - Environmental soundness of the project
    - Appropriateness of the business in relation to the climatic conditions

Introduce the Debt Ratio Calculator. The form is used to determine the capacity of the member to pay (the first C). The calculator will help the loan evaluator to assess the true capacity of the member to pay. Use the following assumptions in filling up the Debt Ratio Calculator:

• Annual Primary Income	:	US$12,000
• Other Income 1		2,400
• Utilities		100
• Children Education Expenses		200
• Other Monthly payments		150

Explain that the Board must fix the Debt Service ratio. In general practice, 28% to 35% for Debt Service Ratio is a safe calculation.

6. Conclusion– 10 minutes

Conclude the session highlighting the topics discussed.

- Lending Risks, Causes and Implications
- Board’s Responsibility in Lending
- Capacity Based Lending
- Tools for Prudent Credit Management

End this module by emphasizing the “holistic approach of resolving loan delinquency and that credit union leadership shall not be discouraged to adopt an innovative approach such as capacity-based lending to ensure attainment of the credit union’s mandate for the members.”

7. Credit Union Project– 20 minutes

In this module, Directors gained knowledge on the importance of maintaining a quality loan portfolio. They are now ready to commence on their eighth credit union project to be submitted for assessment to the Registrar of the Credit Union Directors Competency Program.

The participants are required to:

1. Carry out a 3 hour workshop on Credit Administration attended by all Board members and Manager of the credit union
2. Prepare a Report to be submitted to the Registrar of the CUDCC
3. Make a risk assessment of the lending operations of their credit union
4. Formulate recommendations to control the risks in the lending operations of their credit union

The project necessitates the involvement of other board members, Managers and key staff of the credit union.

CREDIT UNION PROJECT
CREDIT ADMINISTRATION

PROJECT DESCRIPTION:	
Conduct a 3 hour workshop for the Board members on Credit Administration. The workshop assesses your cooperative's risks on lending and also aims to improve the effectiveness of your Credit Management Policy.	
PROJECT ACTIVITY	**EVIDENCE REQUIREMENTS (WHAT WE NEED TO SEE)**
• Prepare a 3 hour workshop on Credit Administration to be attended by all Board members and the Manager of your cooperative	• Schedule of the Workshop • Directors Information Kit containing - Credit Administration
• Carry out the workshop with full attendance of the Board and Manager	Attendance Sheet of the Workshop
• Prepare a Report to be submitted to the Registrar of the CUDCC	Report on the Workshop with the following contents: • Proceedings of the Workshop • Assessment of the Risks: Portfolio at Risk • Reviewed Policy on Credit Management • Portfolio Housekeeping Measures

Credit Rating Scale – Business

Name of Member-Borrower: ____

Address: ____

1. CHARACTER = 10

Criteria	**Maximum Raw Score (MRS)**	**Rating or Scoring**
1. Does the Member-Borrower (MB) have a good record of credit payment to the credit union and other institutions?		
Credit Union: Does he/she have a proven habit of repaying loans to the coop?	1	5 or 0
Other credit union/banks identified: Does the member has a proven habit of repaying loans to other financial institutions identified by him/her?	1	
Credit Bureau: Does he/she have no negative record at the credit bureau?	1	
2. Good Will/ Reputation		
2.1. Does the MB possess a good reputation in the business community and with other organizations?	2	
2.2. Does the MB command respect in the community?	1	
3. Is the MB a permanent resident of the community (Housing Stability)?		
3.1. Less than 5 years	1	
3.2. over 5 years	2	
4. Human relations		
4.1. With the family	1	
4.2. In the workplace	1	
4.3. In the community	1	
Total	**10**	

2. CAPACITY TO PAY = 70

Criteria	Maximum Raw Score (MRS)	Rating or Scoring
1. Does the MB have a stable business?		
If not	0	
If yes, how long: Less than 5 years More than 5 years	3 5	
2. Is the purpose of the loan capable of earning a net surplus	10	
3. Has the business grown over the years?	2	
4. Is the cash flow available and sufficient to meet future loan amortization?	15	
5. Is the Return on Investment of the business adequate to meet the payment requirement?	15	
6. Does the payback period match the proposed duration of the loan?	10	
7. Are there other loan exposures besides this loan being applied for in the primary or somewhere else? (degree of indebtedness and liabilities)		
▪ If no	10	
▪ If yes	3	
Total	**70**	

3. CAPITAL STATUS = 5

1. Does the MB maintain savings deposit with the credit union regularly?	1.5	
2. Are there personal properties, savings and business assets that can serve as collateral for the loan? (Asset base)	1.5	
3. Is the asset base growing? (or is the MB saving only for the reason of taking a loan?)	1	
4. Is the net worth favorable (degree of indebtedness)	1	
Total	**5**	

4. COLLATERAL/CO-MAKERS = 10

Criteria	Maximum Raw Score (MRS)	Rating
1. Can the collateral be easily converted to cash any time?	2	
2. Is the value of the collateral more than the loan amount applied for and can meet the policy valuation?	2	
3. Is the collateral free from encumbrances or lien?	2	
4. Is the co-maker willing to pledge his Savings Deposit/Share Capital and to accept the salary deduction agreement for the duration of the loan?	2	
5. Is the spouse willing/has consent on the loan applied for?	2	
Total	**10**	

5. CREDIT CONDITIONS = 5

Criteria	Maximum Raw Score (MRS)	Rating
1. Is the project/business environment friendly and legal?	1	
2. Does weather conditions severely affect the project?	1	
3. Is the market ripe for the project?	2	
4. Is the community economically active to guarantee some degree of success for the project?	1	
Total	**5**	
GRAND TOTAL	**100**	

Evaluated by: Date:

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Loan Officer

Credit Rating Scale – Individual

Name of Member-Borrower: ____

Address: ____

1. CHARACTER = 10

Criteria	Maximum Raw Score (MRS)	Rating
1. Does the Member-Borrower (MB) have a good record of credit payment to the credit union and other institutions?		
Credit Union: Does he/she have proven habit of repaying loans to the coop?	1	
Other credit union/banks identified: Does the members have a proven habit of repaying loans to other financial institutions identified by him/her?	1	
Credit Bureau: Does he/she have no negative record in at the credit bureau?	1	
2. Goodwill/ Reputation		
2.1. Does the MB possess a good reputation in the community and with other organizations?	2	
2.2. Does the MB command respect in the community.	1	
3.Is the MB a permanent resident of the community (Housing Stability?		
3.1.Less than 5 years	1	
3.2.over 5 years	2	
4. Human relations		
4.1. With the family	1	
4.2. In the workplace	1	
4.3. In the community	1	
Total	**10**	

2. CAPACITY TO PAY = 70

Criteria	**Maximum Raw Score (MRS)**	**Rating**
1.Does the MB have a stable job?		
If not	0	
If yes, how long: Less than 5 years More than 5 years	5 10	
2. What is the frequency of the regular income of the MB?		
▪ Daily, weekly, semi-monthly, monthly? ▪ Bi-quarterly, quarterly? ▪ Semi-annual?	10 5 5	
3.Does the regular income of the member match the Debt Service Ratio set by the Board? ▪ YES ▪ NO	25 0	
4.Will the duration of the proposed loan match the anticipated duration of the job of the MB? ▪ YES ▪ NO	10 0	
5.Are there loan exposures besides this loan being applied for? (Degree of indebtedness and liabilities) ▪ If no ▪ If yes	15 5	
Total	**70**	

3. **CAPITAL STATUS = 5**

1.Does the MB maintain a savings deposit with the credit union regularly?	1.5	
2. Are there personal properties, savings and business assets that can serve as collateral for the loan? (Asset base)	1.5	
3. Is the asset base growing? (or is the MB saving only for the reason of taking a loan?)	1	
4. Is the net worth favorable (degree of indebtedness)	1	
Total	**5**	

4. COLLATERAL/CO-MAKERS = 10

Criteria	Maximum Raw Score (MRS)	Rating
1.Can the collateral be easily converted to cash any time?	2	
2.Is the value of the collateral more than the loan amount applied for and can meet the policy valuation?	2	
3.Is the collateral free from encumbrances or lien?	2	
4.Is the co-maker willing to pledge his Savings Deposit/Share Capital and to accept the salary deduction agreement for the duration of the loan?	2	
5.Is the spouse willing/has consent on the loan applied for?	2	
Total	**10**	

5. CREDIT CONDITIONS = 5

Criteria	Maximum Raw Score (MRS)	Rating
1.Does the job of the member involve illegal activities and/or environmentally harmful activities? ▪ YES ▪ NO	 0 2.5	
2. Does the member's job pose health hazards to himself or others? ▪ YES ▪ NO	 0 2.5	
Total	**5**	
GRAND TOTAL	**100**	

Evaluated by: Date: ____________________

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Loan Officer

Credit Rating Approval

The Credit Rating is used to determine the probability that the borrower will repay the loan. This is made up of the Credit Rating Scale used by the Credit Committee or Loan Officer to rate the borrower based on the five (5) C's of Credit.

This rating shall serve as guide to categorize the borrower on the probability of loan repayment, or if not, whether the borrower is required to secure the loan with collateral.

The credit rating scale shall serve as basis for decisions by the Credit Committee and is derived as follows:

Credit Rating	Decision/Requirements
70% and below	Disapproved, since it has high probability of failure to repay the loan.
71% to 80%	Approved, but needs collateral, co-makers, obligate savings, and close supervision
81% to 90%	Approved, but needs any collateral and sustained supervision
91% to 100%	Approved with or without collateral