

# KASNEB

## CCP PART III SECTION 6

### CREDIT PRACTICE

FRIDAY: 27 November 2015.

Time Allowed: 3 hours.

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

#### QUESTION ONE

Denkmann Oluoch is a sole proprietor dealing in the sale of second hand clothes. He has been in this business for five years. To finance his business, he relies heavily on the use of credit cards, overdraft facilities from his bank and loans from Jijenge Co-operative Society in which he is a member. He holds an account with Uwezo bank and Jitegemee bank.

Denkmann Oluoch has defaulted in payment of most of his accounts for at least 120 days. As a result, his name has been forwarded to the credit reference bureau (CRB) as a defaulter. He is worried about the possibility of losing his house and car through foreclosure. This is not the first time his name has featured in the CRB. Two years ago, he had defaulted on the repayment of a loan from Jijenge Co-operative Society and he was listed as a defaulter in the CRB.

Denkmann Oluoch has approached Duke Mumo, the credit controller of Uwezo bank, from where he had acquired the mortgage facility and the car loan, to find out if the bank would be willing to allow him to restructure his debt.

Duke Mumo advised Denkmann Oluoch to seek the services of Christopher Roos, a registered debt counsellor and owner of Debt Counselling Experts Ltd. who could offer professional debt counselling advice on how to organise his finances and ultimately control his "huge appetite for debt". Denkmann Oluoch contacted Christopher Roos as advised by the credit controller of Uwezo bank. He filled in his debt counselling application form and left it with the debt counsellor.

Christopher Roos agreed to review Denkmann Oluoch's application form and developed the following new repayment plans for Denkmann Oluoch with lower monthly payments and interest rates and sent these to the credit providers for their agreement:

#### Proposed repayment plan for Denkmann Oluoch

Credit provider	Original annual interest rate	Industry rate	Monthly instalment before review	New agreed annual interest rate	New monthly instalment
	%	%	USD	%	USD
Home loan	10	7	7,703	7.5	4,970
Vehicle finance	15	6.5	1,605	7.5	1,050
Credit card 1 (Uwezo Bank)	23	4	1,610	5.5	480
Credit card 2 (Jitegemee Bank)	22	4	905	4.5	270
Overdraft 1 (Uwezo Bank)	18	4.5	1,580	5.0	430
Overdraft 2 (Jitegemee Bank)	20	6	1,760	7.0	1,150
Total			15,163		8,350

All the credit providers agreed with the new repayment schedule but raised the following questions:

1. How was it possible that even after Denkmann Oluoch defaulted on his Jijenge Cooperative Society loan, he was able to acquire a mortgage facility plus additional credit facilities?
2. With credit information sharing, how did Denkmann Oluoch access different credit products from different financial institutions?

As a partner at Debt Counselling Experts Ltd., you have been appointed by Christopher Roos to be in charge of Denkmann Oluoch account on debt restructuring.

Soon after your appointment, you held a meeting with Denkmann Oluoch so that you could take him through the process of debt restructuring. At the end of the meeting you realised that lack of information sharing among the financial institutions was one of the major reasons that encouraged Denkmann Oluoch's huge appetite for debt.

**Required:**

- (a) Discuss the six stage process of debt restructuring that Denkmann Oluoch's repayment schedule would be subjected to. (12 marks)
- (b) With reference to Denkmann Oluoch's situation, argue three cases in favour of debt restructuring. (6 marks)
- (c) (i) One of the functions of credit providers is to price credit correctly.

**Required:**

Analyse the above statement in relation to Denkmann Oluoch's case. (6 marks)

- (ii) Denkmann Oluoch seems to be suffering from the problem of "moral hazard".

**Required:**

Explain the term "moral hazard" with reference to the default made on the Jijenge Cooperative Society Loan. (5 marks)

- (iii) Justify the following statement: "credit information sharing among the financial institutions would have been the solution to Denkmann Oluoch's huge appetite for debt". (6 marks)

- (d) Apart from the information provided in the repayment plan, describe five additional sources of credit information that the debt counselling expert could have requested from Denkmann Oluoch for consideration under debt restructuring. (5 marks)

**(Total: 40 marks)**

**QUESTION TWO**

- (a) The following particulars were extracted from the books of Biashara Faida Bank Ltd. as at 30 June 2015:

Assets particulars	Amount Sh. "million"	Provision %
Standard	2,900	0.25
Sub-standard assets	1,080	10
<b>Doubtful assets categories (secured)</b>		
Up to 1 year	420	20
1 – 3 years	210	30
More than 3 years	180	50
Loss assets	90	100

The proportion of security available for the doubtful assets is 65%, 40% and 25% for the three categories respectively.

**Required:**

Assess the amount of provision the bank should make for each of the assets above. (6 marks)

- (b) Highlight four disadvantages of using a bank overdraft facility to finance a business. (4 marks)
- (c) Analyse five drawbacks of the informal credit rating approach. (5 marks)

**(Total: 15 marks)**

**QUESTION THREE**

- (a) With reference to asset finance, evaluate four factors that could affect the validity of title deeds in your country. (8 marks)

- (b) Discuss seven advantages of sale and lease back as a source of finance. (7 marks)

**(Total: 15 marks)**

**QUESTION FOUR**

- (a) Describe five principles of microfinance. (5 marks)
  
- (b) ABC Ltd. makes annual credit sales of Sh.1,500,000 and offers credit terms of 30 days. Debt administration has been poor and the average collection period has been 45 days with 0.5% of sales resulting in bad debts written off. As a result, ABC Ltd. has sought the services of a factor who is willing to take on the task of debt administration and credit checking, at an annual fee of 2.5% of credit sales. The company could save Sh.30,000 a year in administration costs. The payment period could be reduced to 30 days.

The factor will also provide an advance of 80% of invoiced debts at an interest rate of 14% per annum (3 % over the current bank rate). The company can obtain an overdraft facility to finance its accounts receivable at a rate of 2.5% per annum over the current bank rate.

**Required:**

As the credit controller of ABC Ltd., advise the management on whether to engage the services of the factor. Assume a constant monthly turnover. (10 marks)

**(Total: 15 marks)**

**QUESTION FIVE**

- (a) Explain four reasons why there is a global trend to migrate both credit and debit cardholders from magnetic strip to chip technology cards. (4 marks)
  
- (b) Loan defaults eventually lead to non-performing loans (NPLs) which in turn erode the profitability of banks and endanger their shareholders funds. To this end, banks have set up risk management departments to monitor credit quality and take early preventive measures to control NPLs.

One of the methods of monitoring credit quality is to identify early warning signs, commonly known as red flags.

Citing relevant examples, identify two red flags in each of the following categories:

- (i) Account operations. (2 marks)
  
  - (ii) Business operations. (2 marks)
  
  - (iii) Environment. (2 marks)
- (c) Outline five disclosures of interest rates that a lending institution should make to the customer prior to signing the contract. (5 marks)

**(Total: 15 marks)**

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