CREDIT RISK CERTIFICATION
US BODY OF KNOWLEDGE

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THE RISK MANAGEMENT ASSOCIATION

The Risk Management Association (RMA) is a not-for-profit, member-driven professional association serving the financial services industry. Its sole purpose is to advance the use of sound risk principles in the financial services industry. RMA promotes an enterprise approach to risk management that focuses on credit risk, market risk, operational risk, securities lending, and regulatory issues. Founded in 1914, RMA was originally called the Robert Morris Associates, named after American patriot Robert Morris, a signer of the Declaration of Independence. Morris, the principal financier of the Revolutionary War, helped establish our country’s banking system.

Today, RMA has approximately 2,500 institutional members. These include banks of all sizes as well as nonbank financial institutions. RMA is proud of the leadership role its member institutions take in the financial services industry. Relationship managers, credit officers, risk managers, and other financial services professionals in these organizations with responsibilities related to the risk management function represent these institutions within RMA. Known as RMA Associates, these 16,000 individuals are located throughout North America and financial centers in Europe, Australia and Asia.

Members actively participate in the RMA network of chapters. These chapters are run by RMA Associates on a volunteer basis and they provide our members with opportunities in their local communities for education, training, and networking throughout all stages of their financial services career. Chapters are located across the U.S. and Canada as well as in financial centers internationally.

RMA members also avail themselves of benefits offered through headquarters in Philadelphia, Pennsylvania. To assist members in advancing sound risk principles, RMA keeps members informed and provides access to industry information at this site; publishes a journal (The RMA Journal) and a variety of newsletters, books, and statistics; conducts many workshops and seminars; holds several conferences, an annual convention (Annual Risk Management Conference); and has numerous committees working on a variety of projects.

RMA welcomes all personnel involved in lending and risk management in member organizations to become RMA Associates.

Note: As a not-for-profit, professional association, RMA does not lobby on behalf of the industry.

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This material is part of RMA’s educational resources for commercial bankers at every stage of their careers. For more information, contact the Customer Care Department, RMA, 1801 Market Street, Suite 300, Philadelphia, PA 19103. Or contact us by: Phone 800-677-7621 / Fax 215-446-4101 / E-mail courses@rmahq.org or our website: www.rmahq.org.
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PURPOSE OF DIMENSION 1

The purpose of Dimension 1 is to provide tools and insights to support evaluation of a client’s industry, markets, and competitors.

Key topics in this Dimension are:

- Evaluating the client’s Industry.
- Industry/product life cycles.
- Industry risks
- Characteristics of key industry sectors.
- Evaluating the client’s market.
- Buyer/supplier profiles.
- Buyer/supplier concentrations.
- Entry/exit costs.
- Vulnerability to substitution.
- Evaluating competition in the client’s market.
- Profiling market competitors.
- Putting competition in the context of the market.

ADDITIONAL SKILL-BUILDING RESOURCES

The material in the Body of Knowledge provides an overview of knowledge related to topics covered by the Credit Risk Certification exam. Mastery of topics reviewed here is essential preparation for the exam, but no amount of reading and study can substitute for lending skills that must be acquired through formal classroom and on-the-job training. In addition to reviewing the Body of Knowledge, consider taking the following RMA courses to support your Dimension 1 skill building:

- Analyzing the Commercial Borrower’s Industry, Market, and Competitive Risk
- Cash Flow Analysis I: UCA Fundamentals
EVALUATING THE CLIENT’S INDUSTRY

Understanding the industry within which a company operates is key to understanding the total risk in lending to that company. The objective of this section of Dimension 1 is to provide insights to help you answer the question: “Does the company have a business strategy that makes sense within the context of general industry characteristics and economic trends?”

The three topics included in this discussion are:

• Industry/product life cycles.
• Industry risks
• Characteristics of key industry sectors.

INDUSTRY/PRODUCT LIFE CYCLES

In addition to general industry characteristics, businesses are affected by industry and product life cycles. Industries, companies, and products all have life cycles that are determined by their acceptance in the marketplace. Over time, sales for a successful product will grow, then level off, and eventually decline. You can recognize stages of product life cycles in the sales of such diverse products as light pickup trucks and minivans, personal computers, toys, and cassette tapes.

Product life cycles are influenced by demand for a product (however derived) and by the elasticity or inelasticity of that demand. Demand is simply defined as the need or desire for the sellers’ goods and services. Inelastic demand occurs when price is of little concern to the customer; therefore, a change in price has little effect on the demand for the product. When demand is elastic, a change in price results in a proportionate change in the quantity of the product or service demanded.

As products and services mature, they tend to become more price-sensitive (demand becomes more elastic). This flattening of the demand curve is part of the natural life cycle of a product and another way to understand the profit decline for mature-stage products, companies, or industries.

The same product life cycle concept of emerging, growth, maturity, and decline can be applied to businesses and entire industries.
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PURPOSE OF DIMENSION 2

The purpose of Dimension 2 is to provide tools and insights to support evaluation of a client’s management and management’s ability to formulate and execute business and financial strategies.

Key topics in this Dimension are:

• Management qualifications.
• Management experience.
• Management integrity.
• Management organization, style, and characteristics.
• Planning and control systems.
• Information technology systems.
• Shareholder/management relationship.
• Using third party information in the management assessment.

ADDITIONAL SKILL-BUILDING RESOURCES

The material in the Body of Knowledge provides an overview of knowledge related to topics covered by the Credit Risk Certification exam. Mastery of topics reviewed here is essential preparation for the exam, but no amount of reading and study can substitute for lending skills that must be acquired through formal classroom and on-the-job training. In addition to reviewing the Body of Knowledge, consider taking the following RMA courses to support your Dimension 2 skill building:

• Analyzing the Commercial Borrower’s Industry, Market, and Competitive Risk
• Cash Flow Analysis I: UCA Fundamentals
• Cash Flow Analysis II: Applied Concepts
MANAGEMENT QUALIFICATIONS

Just as you have expectations about the characteristics of financial statements of companies in different industries, because of your own knowledge and experience, you have an idea of what skills are necessary to effectively operate the business to which you are lending money. Skills and knowledge, coupled with an effective management style and uncompromising ethics, will generally ensure the success of a company.

Core competencies required to successfully manage a company include finance, production, distribution, sales, marketing, research and development, Technology, operations, and human resources.

All of these core competencies (with perhaps the exception of manufacturing and distribution in the case of retail companies or service companies) have to exist in some form or another within the company’s management team. These skills will have different emphasis and degrees of importance depending on the company and industry. You need to determine which skill sets are necessary for success. Then you must determine which managers possess those skills and assess how vulnerable the company is to losing the manager(s) with those critical skill sets. Part of your evaluation is to determine whether management acquired skills through:

- Formal education
  
  What academic degrees or other evidence of formal training are necessary to demonstrate the existence of particular skills and knowledge?

- On the job training (OJT)
  
  What on-the-job technical and knowledge-based training has been acquired in these areas?

In addition to comparing required core competencies with existing skill sets possessed by management, you need to assess the ability and willingness of management to learn new skills when business requirements change. This can be evidenced by continued education, attending seminars, and an attitude of “learning whatever is necessary” to keep the company moving forward. Make sure your customer is keeping pace with the industry.

Required skills fit into three categories:

- Technical

  Those core competency-based skills, upon which the company is founded, be it engineering, accounting, legal, chemistry, etc.

- Organizational
How does management organize the core competencies required so that the company functions efficiently? Are there current organization charts and job descriptions that reflect the needs of the organization and the strategic plan?

Is there evidence of orderly workflow and even distribution of work without bottlenecks?

- Management

What is the management style that blends the technical knowledge and the organizational structure and delivers the product or service to the market place?

A deficiency in any one of these areas can compromise the potential of a company. Many companies have been started by very intelligent people, but have subsequently gone out of business because they didn't possess either the organizational or the people skills necessary to operate a successful business. For all categories of required skills, it is important to ask the following questions:

- Is there an adequate supply of properly trained personnel?
- What is the rate of employee turnover?
- What are the hiring, advancement, and firing practices?
- What kinds of training are necessary?
- Is there a back-up plan (succession) for key functions?
- Is there a human resources function within the company and does it have complete personnel files, employee manuals, and policies that reflect current labor laws?
MANAGEMENT EXPERIENCE

It is vital to profile the management team’s depth of experience and skills, both to understand current management strengths and weaknesses and to determine if there is backup for the critical management skills needed to operate the business.

It is especially important when evaluating the CEO to ascertain how he/she compensates for his/her own deficiencies. Your goal is to understand how the CEO manages the strengths and weaknesses of the company’s management team. Through interviews and your own observation, develop answers to these key questions:

• What is the experience of each key manager, and how does that experience relate to the core competencies required by the job? If a manager’s skills are not perfectly matched to the requirements, how transferable are the existing skills and experience to the profile of required skills? Is there a track record of willingness and energy on management’s part to acquire new skills and experience?

• Do senior managers have the experience and skills to appreciate the impact of the other people in the company who deliver the other core competencies? Being willing to work in a team environment is an excellent attribute, but the manager must also have the experience and working knowledge of the other disciplines to be truly effective.

• Have the managers been successful at adapting to change? How flexible is the management team to take advantage of opportunities or to make difficult decisions in light of challenges to the success of the company? Phrase this question in a way that prompts your interviewees to show specific examples, saying: Tell me about a time when you had to alter the company’s course to respond to an unexpected turn of events.

• Has the company weathered any adverse circumstances or severe economic cycles? Experience responding to a variety of economic conditions is a success factor. Evidence of effective, ethical behavior in times of crisis or adverse circumstances is a success factor.

• Is the company in the same business with the same management and ownership it had when it faced those hardships?

• Has the management team grown in experience and skill to match the evolving size and complexity of the business? A large company with multiple business lines has more complex management needs than a smaller, one-business enterprise. Ask senior managers to describe how the company has grown (internal growth, merger, acquisition?) and how each stage of growth altered the management profile. Ask each key manager to identify the skill or expertise they would be most likely to recruit for if able to add one more manager to the team.
• Has management exhibited a creative track record of developing new products and services? Ask key managers to describe the process that resulted in the most recent additions to their product or service. Ask them to explain what has historically motivated the decision to expand the product suite, such as response to competition, desire to be the innovative market player, or request from an existing customer.

• Have they managed at all levels of a fully integrated labor force? Do they have experience with establishing compensation and benefit programs that attract, retain, and grow qualified employees? Do they possess the necessary experience with organized labor, if applicable?

• If the customer is a family owned enterprise, to what extent does the family control management decision-making? Has the family brought in outside, professional managers to supplement or succeed family management? Have family managers had meaningful and relevant professional experience outside the family business, to bring outside skills and perspectives into the business?

• Does the customer have a formal succession plan in place for key managers, and is the plan in active implementation? A company’s succession plan is vital to assuring you of some management continuity in the event of death, retirement or departure of a key manager. In addition, a customer’s commitment to succession planning provides business benefits to the company. Companies that plan for succession are identifying the abilities and qualities needed for individuals to succeed, meaning they are pursuing a management development strategy instead of simply reacting to employment needs. Companies that actively communicate advancement criteria may benefit through higher manager retention. Qualities of an effective succession plan include:

  – The company identifies its next leader in advance and communicates the choice of heir apparent to others inside and outside the company. As a result, the new leader has valuable time to adjust and to prepare for the new duties, others have time to adjust to the new structure, and there is continuity for outsiders such as vendors, bankers, and customers.

  – The company has a formal approach to developing successor family members’ or employees’ operational, technical, interpersonal, and financial skills needed to run the business.

  – Individuals not designated as successor, and other key employees, professionally respect the designated successors; customers and suppliers believe the designated successor(s) will adequately replace the current leader.
In a family owned business, the company provides compensation and other performance-based incentives for key non-family members to remain loyal despite not being eligible for family designated top management positions.

There is a plan in place to fund the senior owner’s retirement and for transferring business ownership in a way that does not excessively leverage the company. In addition to the balance sheet benefits of this approach, this strategy can help allay an elder manager/owner’s reluctance to step down by minimizing fears that the transition will impair company financial strength, the elder’s retirement resources, or both. If the company must be sold to facilitate a generational transition, there is a successor financing strategy defined in advance. If the buyer is likely to be a third party, the customer (or customer’s family) has already determined who will identify, profile, and pre-qualify prospective buyers, and who will be responsible for negotiating and managing the transaction. If the company is to be sold to existing family/partners/employees, a formal buyout plan is already in place.

The plan is being implemented, even if identified only as a contingency plan. In other words, designated successors or successor candidates are subject to performance reviews that include measuring progress in preparing for the next role; the plan is reviewed at least annually by key managers and board members to ensure it continues to be relevant to current circumstances; the company checks periodically to ensure that any designated plans for buyout financing are still feasible.

• Has management successfully employed outside advisors such as accountants, lawyers, and strategic planners to advise them in the core competencies? Recognizing a management deficiency is only half the battle; management must know how to use internal and external personnel resources to fill the skill voids.

• Have they demonstrated the mental toughness to defend themselves against internal or external threats to the success of their business?
# DIMENSION 3

## COMPLETE ACCURATE, ON-GOING AND TIMELY FINANCIAL ASSESSMENTS OF THE CLIENT AND ITS OTHER CREDIT SPONSORS

Dimension 3: Complete Accurate, On-going and Timely Financial Assessments of the Client and its Other Credit Sponsors

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CRC US Body of Knowledge // Dimension 3 // Complete Accurate, On-Going and Timely Financial Assessments of the...
PURPOSE OF DIMENSION 3

The purpose of Dimension 3 is to review the analytical tools needed to perform a financial assessment of the borrowing client and its credit sponsors. Key topics in this Dimension are:

• Gathering and Evaluating the Quality of Financial Data
• Accounting Fundamentals
• Balance Sheet Quality Analysis
• Balance Sheet Ratio Analysis
• Evaluating Your Customer’s Capital Structure
• Income Statement Quality Analysis
• Income Statement Ratio Analysis
• Financial Efficiency Analysis
• Financial Productivity Analysis
• Classifying Accounts for Automated Spreading Systems
• Comparing Financial Performance with Industry Peers
• Personal Financial Statements

ADDITIONAL SKILL-BUILDING RESOURCES

The material in the Body of Knowledge provides an overview of knowledge related to topics covered by the Credit Risk Certification exam. Mastery of topics reviewed here is essential preparation for the exam, but no amount of reading and study can substitute for lending skills that must be acquired through formal classroom and on-the-job training. In addition to reviewing the Body of Knowledge, you should consider taking the following RMA courses to support your Dimension 3 skill building:

• Financial Accounting
• Commercial Credit for Lenders
• Financial Statement Analysis
• Analyzing Personal Financial Statements and Tax Returns
• Analyzing Business Tax Returns
• Business Lending: Getting Behind the Numbers and More

GATHERING AND EVALUATING THE QUALITY OF FINANCIAL DATA

Appropriate financial information generally includes:

• *Three years of year-end financial statements.* For smaller companies and smaller credit exposures, signed tax returns may substitute for financial statements. At many financial institutions, credit exposures less than $1 million require only CPA compilations or company-prepared financial statements, which should be signed and dated by an officer of the company. When accepting a company-prepared financial statement, it is good practice to also require a signed tax return for each statement year. Credit exposures less than $5 million require CPA-reviewed financial statements, and larger credit exposures require audited financial statements. Require annual financial statements to be submitted no later than 90 days after the end of the fiscal year.

• *Interim financial statements.* At the time of underwriting, request interim financial statements as of the most recent quarter or month-end. Require the prior year’s quarterly or monthly interim statements if you are evaluating a request for seasonal financing, or if the customer is undergoing significant market or other change. Interim financial statements are almost always company-prepared. Require interim financial statements to be submitted no later than 30 days after the relevant month-end.
• **Management budgets with at least one year of projections.** The budget and projections should include detailed assumptions, to enable you to assess management’s logic and to prepare your own devil’s-advocate projections that test the company’s repayment ability in the event of a departure from planned financial and nonfinancial events. For seasonal loans or for loans to companies with rapidly changing financial performance, require a monthly projected cash budget in addition to a projected income statement and balance sheet for the forecast year.

• **Inventory and equipment schedules.** If your loan is to be secured, inventory and equipment schedules provide the details needed to estimate collateral value, and will help you determine if a formal collateral exam or equipment appraisal will be required. Inventory and equipment schedules should include details about acquisition dates and costs of classes of inventory, as well as cost, acquisition date and net book value of individual pieces of equipment or classes of equipment.

• **Accounts receivable and accounts payable agings.** If your loan is to be secured by accounts receivable, detailed aging, concentration, and bad debt provision information is required. Even if the loan is not going to be secured, aging and concentration information about both account debtors and creditors is needed to assess the quality of reported earnings and the accuracy of reported net worth. Receivable and payable agings and concentration reports also provide valuable insight into the borrower’s vulnerability to loss of customers or suppliers.

• **Personal financial statements and tax returns if applicable.** Personal financial details are appropriate when personal guarantees are to be required for loan approval. Personal statements should be dated within 90 days prior to the loan approval date and should be required to be updated annually, also within 90 days prior to the borrowing company’s annual loan review date. Personal financial statements should be signed and dated by the submitting individual, and only the guarantor’s assets/liabilities should be included on the financial statements. At minimum, assets owned jointly (such as with a spouse) should be noted as such. Substantial additional information about personal financial statements and tax returns is included later in *Dimension 3*.

The financial statement guidelines provided prior are general guidelines that do not take into account differences in company or transaction risk. In addition, you should consult your own financial institution’s guidelines that govern the nature, type, and frequency of financial data required for analysis and loan approval, and the required type of independent assurance required (i.e., reviewed versus audited statements). An explanation of the different levels of CPA engagement is included in the Accounting Fundamentals discussion to follow.
## Dimension 4: Assess Strength and Quality of Client/Sponsor Cash Flow

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DIMENSION 4: ASSESS STRENGTH AND QUALITY OF CLIENT/SPONSOR CASH FLOW

PURPOSE OF DIMENSION 4

The purpose of Dimension 4 is to review skills required to assess business cash flow. Key topics in this Dimension include:

- Cash cycle analysis.
- Cash flow statement analysis.
- Cash flow statement formats:
  - Direct
  - Indirect
- Analyzing cash flow.
- Alternate cash flow measures:
  - EBITDA
  - Free cash flow.
- Comparing cash flow to industry peers.
- Discovering borrowing causes and repayment sources.
- Developing cash flow projections.

ADDITIONAL SKILL-BUILDING RESOURCES

The material in the Body of Knowledge provides an overview of knowledge related to topics covered by the Credit Risk Certification exam. Mastery of topics reviewed here is essential preparation for the exam, but no amount of reading and study can substitute for lending skills that must be acquired through formal classroom and on-the-job training. In addition to reviewing the Body of Knowledge, consider taking the following RMA courses to support your Dimension 4 skill-building:

- Cash Flow Analysis I: UCA Fundamentals
- Cash Flow Analysis II: Applied Concepts
- Cash Flow Refresher for Experienced Bankers
CASH CYCLE ANALYSIS

The term *cash cycle*, sometimes called the asset conversion cycle, describes how cash moves through a business as its assets and liabilities shrink and expand in a fairly regular pattern. Cash typically moves to inventory, then to receivables, then back to cash. The amount of cash actually required to support the inventory portion of the cycle is reduced by the amount of trade credit available in accounts payable.

The flowchart below illustrates a simple cash cycle.

CASH CYCLE

![Cash Cycle Flowchart]

The duration and predictability of a company's cash cycle affect its need for working capital. You can measure the average length of a company's cash cycle by analyzing its days' sales in receivables and days' COGS in inventory and payables.

When a company has inadequate working capital (too little and not liquid enough) to get through a cash cycle, it will need to borrow. That borrowing will be long term if it is caused by a permanent lengthening of the cash cycle (declining efficiency) or by a permanent increase in the amount of cash needed daily (sales growth). The borrowing will be short term if it is caused by a temporary lengthening of the cash cycle or a temporary increase in the amount of cash needed daily.

Cash cycles vary with the type of business. For example, manufacturing companies that must invest in raw materials, work-in-process inventory, and finished goods usually have a longer cash cycle than companies that are able to convert purchased merchandise inventory directly to accounts receivable. Companies that can convert inventory directly to cash, by selling for cash or accepting national credit cards, have a shorter cash cycle than companies that offer their customers extended payment terms.
DIMENSION 5: EVALUATE COLLATERAL VALUES AND CONDUCT PERIODIC INSPECTIONS OF COLLATERAL

PURPOSE OF DIMENSION 5

The purpose of Dimension 5 is to review skills required to evaluate collateral. Key topics in this Dimension include:

• The Concepts of Quality and Verifiability of Collateral.
• Securities and Investments as Collateral.
• Accounts and Notes Receivable as Collateral.
• Inventory as Collateral.
• Plant and Equipment as Collateral.
• Intangible Assets as Collateral.
• Understanding the Real Estate Appraisal.

ADDITIONAL SKILL-BUILDING RESOURCES

The material in the Body of Knowledge provides an overview of knowledge related to topics covered by the Credit Risk Certification exam. Mastery of topics reviewed here is essential preparation for the exam, but no amount of reading and study can substitute for lending skills that must be acquired through formal classroom and on-the-job training. In addition to reviewing the Body of Knowledge, consider taking the following RMA courses to support your Dimension 5 skill-building:

• Asset-Based Lending for Non-Asset-Based Lenders
• Understanding and Interpreting Real Estate Appraisals
THE CONCEPTS OF QUALITY AND VERIFIABILITY OF COLLATERAL

Evaluating collateral begins with an understanding of the borrower’s asset quality and valuation. These topics are included in the Dimension 3 study guide materials, which you should read prior to reading this discussion of collateral considerations.

In this section, we will review specific considerations for evaluating assets commonly taken as collateral. Collateral concerns can be divided into two comprehensive areas:

• Quality. How good is the collateral? What is its value, and how readily can we expect to realize that value in the event of liquidation?

• Verifiability. How accurate is our assessment? Does the collateral conform to representations made by the borrower regarding type, quantity, and quality? Do we have the means to test the accuracy of the borrower’s representations for the type of collateral under consideration?

The primary types of property we will discuss in this section are:

• Securities and investments.

• Accounts and notes receivable.

• Inventory

• Plant and equipment.

• Intangibles

For additional information on evaluating quality of collateral, see also Dimension 3 for discussion of evaluating cash and cash equivalents.

For information about securing and perfecting interests in collateral, see Dimension 6, which also includes information about verifying insurance coverage of collateral.

NOTES:
DIMENSION 6

IDENTIFY REPAYMENT SOURCES AND APPROPRIATELY STRUCTURE AND DOCUMENT CREDIT EXPOSURES FOR THEIR INTENDED PURPOSE (LOAN STRUCTURE AND DOCUMENTATION)

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PURPOSE OF DIMENSION 6

*Dimension 6* focuses on appropriately structuring and documenting credit with respect to the identified repayment sources. In *Dimension 6* we will cover the following topics:

1. Identifying primary and secondary sources of repayment and financing.

2. Determining the loan structure, including loan support and covenants.

3. Documenting the credit, including perfecting liens and documenting third party support.

4. Regulatory compliance

5. Loan closing procedures.

6. Identifying and mitigating environmental risk.
ADDITIONAL SKILL-BUILDING RESOURCES

The material in the Body of Knowledge provides an overview of knowledge related to topics covered by the Credit Risk Certification exam. Mastery of topics reviewed here is essential preparation for the exam, but no amount of reading and study can substitute for lending skills that must be acquired through formal classroom and on-the-job training. In addition to reviewing the Body of Knowledge, consider taking the following RMA courses to support your Dimension 6 skill building:

• Cash Flow Analysis I: UCA Fundamentals

• Cash Flow Analysis II: Applied Concepts

• Structuring Commercial Loans I

• Structuring Commercial Loans II

IDENTIFYING PRIMARY AND SECONDARY SOURCES OF REPAYMENT AND FINANCING

Interviewing the Borrower about Expected Borrowing Needs and Resources

The first step in identifying sources of repayment is to ask the borrower about expected needs and resources. Questions to ask during the loan interview include:

• Primary sources:
  – How does the borrower expect to obtain funds for repayment?
  – What are the present main sources of financing? Banks? Suppliers?

• Additional sources:
  – What other sources of repayment are available? Other financing?
• Sale of fixed assets?
  – What are the secondary sources of financing? Sale of equity?
    Conversion to other types of debt?
  – Are finance companies or factors used for funds?
  – Do principals, relatives, friends, customers, or suppliers
    advance funds to the company?
  – What is the nature and extent of these loans?
• Suppliers:
  – Who are the major suppliers?
  – What are the regular trade terms offered to the company?
  – How good is their current relationship?
  – Are discounts taken? Are payments prompt?
  – Are any items currently in dispute or litigation?
  – Are any special terms or relationships involved?
  – Are any transactions with or through closely affiliated or
    mutually controlled enterprises?
  – Are contracts or franchises involved? What are the details of
    these relationships?
PERFORMING YOUR OWN ASSESSMENT OF PRIMARY REPAYMENT SOURCES

Next, perform your own assessment of primary repayment sources. Recall from your reading in Dimension 4 that there are five principal borrowing causes. Each of these causes also suggests a repayment source if the underlying cause reverses:

• Borrowing cause: current asset growth resulting from sales growth, both seasonal and permanent. Repayment source: liquidation of current assets when a seasonal asset build-up reverses itself as the seasonal operating cycle is completed, or when longer-term growth stops or reverses.

Current asset liquidation through a seasonal operating cycle is a very high quality source of repayment because it stems directly from company operations and demonstrates that the company's seasonal asset buildup is temporary. Current asset liquidation from curtailing longer term growth, or when sales recede, is a non-renewable source of cash flow that may also signal difficulties within the company's business model.

• Borrowing cause: current asset growth resulting from declining efficiency. Repayment source: current asset reduction resulting from improved efficiency.

A reduction in the cash cycle reduces the cash investment in current assets. Cash released through efficiency improvement is a quality source of repayment, although it may not be a repeatable source of repayment. For example, a company that improved its cash cycle by eliminating ten days from its collection period is not likely to be able to achieve a comparable improvement in subsequent years.

• Borrowing cause: fixed asset expenditures. Repayment source: sale of assets.

Keep in mind that sale of assets is usually not a high quality repayment source, as asset sales are generally infrequent and/or non-repeatable. An asset sale may produce desirable cash inflows, but these should generally be considered as one-time sources that are not presumed to be available for future debt service.
• Borrowing cause: reduction in trade credit. Repayment source: increase in trade credit availability.

When suppliers provide additional financing, the cash cycle decreases and fewer current assets need to be supported by external sources. Trade credit increases are quality sources of repayment, with the significant qualification that they are generally non-repeatable sources of new cash.

• Borrowing cause: decreases in net worth, including the result of unprofitable operations or the payment of dividends. Repayment source: net worth infusions from owners or new investors; change of policy to retain earnings instead of paying dividends; profitability improvement.

Outside capital supplied to the business is a valuable potential source of repayment, but absent a contractual agreement it is difficult to compel future capital contributions and thus new capital as a prospective repayment source is neither predictable nor dependable. Minimum net worth requirements enforced through loan agreements can encourage earnings creation and retention, but keep in mind that although retained profit makes a stronger borrower, profits themselves do not necessarily correlate to cash flow.

It is important to view fundamental profitability as a long-term driver of ability to repay debt, but the more useful measure of quality sources of repayment lies in analyzing the cash flow statement. Earnings retained in a business can contribute to long-term cash flow available to service long-term debt, but short-term operating needs must be satisfied first.

Other borrowing causes can include outlays for other asset acquisition (such as investments), and restructuring current or long-term liabilities. Of course, investment sales, or liability restructurings that introduce new capital can provide repayment sources.

To refresh your understanding of how to identify primary repayment sources, please review Dimension 4, which discusses performing cash flow assessments. In Dimension 4, you learn to use cash cycle analysis, cash flow statement analysis and projections to identify both primary borrowing causes and repayment sources. Also see Dimension 3, which reviews financial analysis tools and includes discussion of assessing the quality of earnings and assets.
IDENTIFYING SECONDARY AND TERTIARY REPAYMENT SOURCES

After you have identified potential primary repayment sources, and after you have compared your analysis with the borrower’s view of repayment source, evaluate potential secondary and tertiary sources. These will become key determinants of your loan structure (loan structure concepts are covered later in this Dimension).

Secondary and tertiary repayment sources include:

- Liquidation of collateral

  Sale, conversion, or liquidation of assets is often a primary source of repayment, as in the liquidation of current assets to repay a seasonal line of credit. If asset conversion is a primary repayment source, consider securing the loan to ensure the bank will have access to these assets to enforce collection of the primary source. If asset conversion is not a primary repayment source (such as for a term loan made to finance a capital asset), consider securing the loan to ensure access to a secondary source of repayment. If primary or other secondary repayment sources are uncertain or subject to interruption, consider securing the loan to provide enforcement, access, and control of assets as a secondary or tertiary repayment source.

  To help you qualify assets as potential collateral for the loan, see Dimension 5, which provides detailed analysis of collateral value and limitations for these types of assets:

  - Securities and investments.
  - Accounts and notes receivable.
  - Inventory
  - Plant and equipment.
  - Real estate
  - Intangible assets, including intellectual property.

- Performance of guarantees and other third party support.

  If your borrower is a closely-held entity, and/or if the borrower’s legal form of organization features limited liability, there may be a compelling reason to require personal and/or corporate guarantees or other forms of third party support. Growing private companies may be thinly capitalized; owners of closely held companies may need or prefer to remove earnings from the company; and companies that are part of closely held groups may easily transfer assets and repayment sources between related entities.
Third party support for loans may include:

- Personal guarantees
- Corporate guarantees
- Subordination agreements
- Comfort letters
- Letters of credit.

The effectiveness of each of these secondary/tertiary repayment sources may be limited by three factors: value, willingness, and enforceability. For example, the value of a personal or corporate guarantee is limited to the underlying resources provided by the guarantor. For the repayment source to be meaningful, you should assess the guarantor’s current and probable future financial resources. For a corporate guarantor, perform a credit analysis using tools provided in Dimensions 1 through 4. For an individual guarantor, assess personal financial statements and liquidity using techniques presented in Dimension 3.

Evaluate the willingness factor for potential guarantors or issuers of comfort letters, including individuals, affiliated entities, or other credit sponsors. Look for clues to suggest whether prior commitments have been honored, or whether there has been litigation to try to avoid honoring a contingent commitment. Determine if the guarantor has a financial or emotional stake in the success of the company whose obligations are being guaranteed.

To evaluate enforceability, make sure that you have documents that require a full, unconditional guarantee, and ensure that the structure of the transaction will stand up to legal challenges from company creditors or other parties. For detailed explanations of structuring third party support effectively, see Loan Support and Covenants and Documenting the Loan later in this Dimension.

- Non-operating resources

If you have identified operating sources of cash as the primary repayment source for a loan, it may be appropriate to consider additional resources analyzed earlier as a secondary repayment source. For example, there may be potential for additional capital from shareholders, or for a refinancing of an asset with a private lender. Bear in mind that absent enforceable contracts or agreements to compel this eventual source of repayment, the value of these resources is limited.
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PURPOSE OF DIMENSION 7

The purpose of Dimension 7 is to describe early signals of problem loans and to review appropriate responses to those signals. In Dimension 7 we will cover the following topics:

- Financial and nonfinancial warning signs.
- Account management alternatives for problem loans.
- Gathering information about the problem loan.
- Developing problem loan strategies.
- Bankruptcy considerations.
- Lender liability issues.

ADDITIONAL SKILL-BUILDING RESOURCES

The material in the Body of Knowledge provides an overview of knowledge related to topics covered by the Credit Risk Certification exam. Mastery of topics reviewed here is essential preparation for the exam, but no amount of reading and study can substitute for lending skills that must be acquired through formal classroom and on-the-job training. In addition to reviewing the Body of Knowledge, consider taking the following RMA courses to support your Dimension 7 skill building:

- Detecting Problem Loans
- Problem Loan Workouts
INTRODUCTORY NOTE

Dealing effectively with problem loans requires early detection. Any number of events can alert you and your borrower to a problem. The warning of a problem loan may come as a surprise, or as a result of a slowly deteriorating credit. Either way, when it occurs, you should immediately shift into your institution's problem loan procedures. Each institution has its own process, and it is not the intent of this section to suggest that one procedure is better than another. In Dimension 7 we present certain steps that are common to most problem loan approaches.

WARNING SIGNS

Nothing can be more chilling than to have a borrower walk into your office, hand over the keys to the plant, and say that they are unable to continue the operation. If the problem is a surprise, due diligence before funding and the subsequent monitoring of the loan were ineffective. (Due diligence, a term borrowed from the investment community, applies to the efforts of the analyst to identify the key issues of the credit.) The most important tool in detecting a problem loan is ongoing monitoring of the credit.

Early identification of a problem loan may be documented through your risk-rating system or through the process of putting the company's name on a watch list. Watch-listed credits are generally not those in imminent danger of bankruptcy. They may be identified as watch-listed because the company has changed management or is in a certain industry experiencing economic difficulty.

The earlier you can detect a potential loan problem, the more likely it is that you will successfully deal with the problem.

Appearance of a warning sign does not always mean that the loan has or will become a problem. It does indicate, however, that you should ask questions.

The causes of the problem could be financial or nonfinancial or some combination of both.