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Agricultural Production and Credit Project

مشروع الإنتاج الزراعي والائتمان

DRAFT

MANUAL OF CREDIT AND FINANCIAL

POLICIES FOR THE PBDAC

AND THE BDACs

USAID PROJECT NUMBER: 263-0202

CONTRACT NUMBER: HCC-263-0202-02

Prepared for:

The Principal Bank for Development and Agricultural Credit

Prepared by:

Chemonics Int'l Consulting Division

APCP Deliverable: WP-VI/1.2.5

January 1994

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MANUAL OF CREDIT AND FINANCIAL POLICIES
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CHAPTER I

CREDIT POLICIES

This chapter contains a set of credit policies that should be observed by all executive levels dealing with credit. Details on practical implementation for most of these policies will be explained in Chapters II and III.

FIRST: THE BANK'S MISSION AND PURPOSES

The primary mission of the PBDAC and BDACs is to provide a nationwide, long-term flow of development supporting financial services to Egypt's rural people and agricultural sector.

In implementing its primary mission the bank has to be financially viable; to operate without government subsidy; to marshal savings from rural clients as a main source of loanable funds; to charge rates of interest and charges at levels that are sufficient to cover operating costs (including expected losses); and to realize a reasonable profit if possible.

SECOND: CREDIT POLICY OBJECTIVES

The credit policy of this Bank has three objectives, in the following order of priority:

1. Granting Credit to Facilitate Operation of the the Agriculture Sector

The purpose of this type of credit is to finance agriculture production cost, such as: crop production, covered agriculture (e.g. green houses), production of milk and eggs, operation of agriculture equipment, and marketing of agriculture inputs and outputs.

This type of credit falls under "short term loans" since it is used to finance working capital.

2. Granting Credit to Develop the Agriculture Sector

The purpose of this type of credit is to increase and/or improve the agriculture production capacity such as: all types of mechanization, soil improvement, modernizing irrigation systems, improving animal, poultry and fishery production, and land reclamation.

This type of credit falls under "medium and long term loans" because it is used to increase and/or improve the agriculture production capacity.

3. Granting Credit For Rural Development Purposes

The purpose of this type of credit is to support economic activities in the rural sector and encourage them to depend on the Bank's credit as the main source for financing,

such as: light transportation projects among the villages, handicraft projects, light commercial projects (e.g. groceries and pharmacies), and housing for the villages.

This type of credit falls under any of the three types of credit (short, medium or long) according to its tenor.

THIRD: THE FIVE BASIC ELEMENTS FOR GRANTING CREDIT

This Bank, as a financial institution, follows five credit elements known as the five C's:

1. Character

This element concerns the customer's reputation such as honesty, knowledge about the activity that he runs, customer's management skills and his previous dealings with the bank.

2. Capital

This element mainly concerns the financial position of the customer, and in particular the working capital, the fixed assets, the customer's liabilities to others and the liquidity situation. The bank should check whether the trend in customer's financial position was improving or deteriorating during recent years.

3. Capacity

The main objective of bank credit is to improve the economic position of the customer so as to enable him to pay back the loan and its interest, as well as allow a reasonable profit to the customer . Otherwise there is no point in granting credit.

Therefore, this element focuses on reviewing the customer's ability to repay the loan and its interest. This is accomplished by studying the project's past profitability, cash flow projections during loan lifetime, and the prospects of marketing the project's output whose volume increases as a result of obtaining credit.

4. Collateral

The object of bank credit is to fund the financial gap in customers' economic activity, (rather than financing customer's possession of fixed or current assets).

Bank's policy is to require collateral not as a basis - per se - for granting credit, but to reduce the risks associated with granting credit to a customer who is involved in an economic activity falling within Bank's policy. Attachment "1" indicates the main types of collateral and basis of their evaluation.

Mortgages of fixed assets should be of first degree (buildings, lands, machinery and factory tools). The Bank is to observe the rules stated in the Egyptian commercial law with respect to chattel mortgage regarding movable assets (crops and commodities), and to observe proper endorsement rules in case of financing the project's receivables.

5. Conditions

This element concerns the purpose of the loan, its value, its standing as part of the customer's financial structure, and lastly method of repayment. Also, it includes special conditions pertinent to granting the loan if any, as well as the authority within the Bank to grant the loan according to schedule of Bank's lending authorities.

FOURTH: OTHER CREDIT RISKS

The five C's concentrate on the customer's activity, but there are other factors, outside this area, that may affect the decision of granting credit. These factors are usually covered by the feasibility studies; they are as follows:

1. The Nature of the Project

The focus is on degree of prevalence of similar projects in the environment surrounding the customer's project, and the project's size compared to competing projects. Also the availability of infrastructure in the area so as to support project's success.

2. Natural Factors

This factor concerns availability of elements that are essential to the success of the project, e.g. soil suitability, irrigation, seeds, and the appropriateness of the environment to production activity.

3. Auxiliary Factors

There are other factors that help to make the project succeed, such as e.g. availability of fertilizers, chemicals, pesticides, insecticides, fuel, technical extension, health and veterinary services, and finally machinery maintenance and overhaul.

4. Marketing Factors

This is the most important factor outside the project's sphere; it links between the project and the community's ability to absorb the project's output (or products).

The focus is therefore on the marketing methods, cost of marketing, the cost of transport, costs and methods of warehousing, etc.. Market conditions and competition should be taken into consideration.

There are no specific criteria regarding weights of these factors; but they have to be reviewed in light of their effect on the project's success, both in the short-run and in the long-run, and a professional judgment to be made accordingly.

FIFTH: PBDAC'S CUSTOMERS

For PBDAC's credit policy purposes, customers are of two types:

a) Individual Customer

The legal status here is individual ownership. His activity could be agricultural production and/or development, or rural development. His borrowing capacity is not more than L.E. 20,000.

The Village Bank is specialized in dealing with such customers. Granting of credit, and follow-up until full repayment, takes place in the Village Bank serving the area in which the customer's activity is located.

b) Project

The legal status can be individual ownership or partnership. The activity is directed towards agricultural production and/or development, or rural development. The borrowing capacity of the project exceeds L.E. 20,000. The project should maintain regular books of accounts so as to facilitate clear review of the project's financial transactions.

The Branch and bank higher levels are specialized in dealing with these projects. Credit follow-up and repayment are performed at the Branch (or higher level) in the concerned location.

SIXTH: PBDAC'S CREDIT LINES

According to the above definition of Bank customers, there are five types of credit lines:

1. Individual Customer

a) Line of credit of L.E. 1000 maximum per feddan for one year, to finance costs of agricultural production. The customer has to have a good reputation and to earn his living from agricultural activity that he practices himself and for his own account. No collateral is required except for "Heyaza".

b) Line of credit between L.E. 1000 and L.E. 20,000 to finance the individual customer's activities whether in the agricultural or rural sector. The customer activities should be in line with the bank's credit policy objectives, and he should be performing it for his own account. The five C's will be applied to this line of credit.

2. Project

a) Short term line of credit
b) Medium term line of credit
c) Long term line of credit

The project's activity should be in line with the bank's credit policy objectives and should have a borrowing capacity of more than L.E. 20,000. The five C's will be applied to those lines of credit.

SEVENTH: CASH FLOW AS A DETERMINANT OF GRANTING CREDIT

The decision to grant credit is made on the grounds that the customer will be economically better off after using bank credit, (assuming other economic factors that affect the customer's activity are held constant). Thus, the current practice of emphasizing collateral and the purpose of the loan should be replaced by the application of the five C's, with special emphasis on the third element concerning the ability to repay the loan by cash generated from the activity financed.

In other words it should be understood that the customer's economic standing will improve so as to enable him to repay the loan plus interest, and allow for a margin of profit to the customer himself. The practical application to this principle is to analyze the customer's cash flow, which determines size of the financial gap. Accordingly, the financial gap is the maximum credit to be granted irrespective of the collateral offered by the customer.

EIGHTH: DEBIT AND CREDIT INTEREST RATES

This part of the manual is devoted to policies related to determination of debit and credit interest rates. More details on implementation of those policies are given in Chapter V.

1. Authority to determine Debit and Credit Interest Rates

The Board of Directors of the PBDAC is the only authority to determine debit and credit interest rates. As an exception the Board may delegate such authority to the Chairman, if the national interest rate structure is rapidly moving up or down in the short run.

The Board's decrees related to determination of debit and credit interest rates are to be circulated to all Bank levels for implementation.

2. Method of Determining Credit Interest Rates:

The Board of Directors determines credit interest rates based on the Chairman's recommendations in light of the following: trend of national interest rate structure as observed by the Bank's Finance Sector, the rates of other competitive banks also as studied by the Bank's Finance Sector, and finally in light of recommendation of the Deposit Marketing Department for solicitation of deposits. The recommendations of the Chairman should include estimation of the cost increase or decrease resulting from applying the recommendation.

No level below the Board is authorized to pay higher rates than those determined by the Board. But the latter can authorize some flexibility to the Chairman up to 1% above the determined rate so as to attract large deposits and/or large depositors with specific importance to the Bank.

3. Determining Debit Interest Rates

The Bank policy is to have a unified rate of interest on all types of loans regardless of their purpose. This rate is to rise gradually with the increase in credit risk and loan duration. Accordingly, the debit interest rate on short term loans will be determined from time to time by the Board of Directors. It is called the Prime Rate, and is defined as the rate charged to the lowest risk customer on short term loans. In other words, it is the rate that the Board considers as a fair return on short term credit, under the most favorable conditions of the five C's.

The debit interest rate will increase gradually by a maximum of 3% to cover credit risk, or risks associated with long-term loan duration (i.e. uncertainty).

The Board of Directors will announce the debit interest rate structure from time to time, according to the conditions of the financial market and the competition with other banks, as follows:

Loan Duration: / Credit Risk	Short Term Loan (Less than One Year)	Medium Term Loan (From 1 Year to 3 Years)	Long Term Loan (More than Three Years)
Customer a.....	Prime Rate	.....	.....
Customer b.....	.....	.....	.....
Customer c.....	.....	.....	XXX

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The degree of risk on the customer's side gradually rises from a to b then to c, therefore the prime debit interest rate is charged to customer (a) for a loan duration of less than one year. The rate of interest also rises with the increase in loan duration by 1% from short to medium, then 1% from medium to long-term loans in view of uncertainty.

The customers in group c should not be granted long term loans. Categories of customers will be determined in Chapter IV on "Loan Classification".

The debit interest rates in the above matrix are the minimum rates to be agreed upon in contracts with customers.

4. Change of Interest Rates and Its Effect on Existing Contracts

The Board of Directors of the PBDAC has the right to change debit and credit interest rates according to changes in the financial market as well as the Bank's competitive standing. When such changes take place the following two rules will be applied:

a) If debit interest rates fall, the Bank will apply the lower rate on existing contracts, so that customers do not go to the rival banks. In case debit interest rates rise, it will have no effect on existing contracts, unless contracts allow the change. The latter exception is applicable at times of rapid changes in structure of interest rates at national level.

b) If credit interest rates rise, the Bank will apply the higher rate on existing contracts, to encourage customers to remain with the Bank. If credit interest rate falls, it will have no effect on existing contracts, unless contracts allow the change. The latter exception is applicable at times of rapid changes in structure of interest rates at national level.

N.B. Saving certificates (3 years and 5 years tenor) are long-term contracts and the interest rates applicable thereon are fixed.

NINTH: LENDING AUTHORITIES

The Board of Directors determined lending authorities as follows:

Levels	Secured Loans	Un-Secured Loans
Village Bank Manager	L.E. 20,000	L.E. 5,000
Village Bank Manager (Mechanization Loans)	L.E. 35,000	
The Branch Manager	L.E. 100,000	L.E. 20,000
PBDAC Chairman	L.E. 500,000	L.E. 100,000
PBDAC Board of Directors	L.E. 1,000,000	L.E. 200,000
PBDAC Chairman	L.E. 2,000,000	L.E. 500,000
PBDAC Board of Directors	L.E. 30,000,000	L.E. 30,000,000

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TENTH: CREDIT RECOMMENDATION REPORT

With the exception of the line of credit of L.E. 1000 per feddan for the small farmer, any credit should be recommended on the basis of a credit report containing the following:

1. Background information on the customer or the project, and results of the field visit and investigation.

2. Comprehensive analysis of the five C's.

3. The analyst opinion of the Bank's experience with the customer, based on previous loans already settled or current outstanding loans.

4. The customer's Balance Sheet and Income Statement (and summary of the Feasibility Study if any) to be attached to the credit report. (N.B. It is preferable to attach the Feasibility Study itself if it anticipates an unusual credit risk).

5. Cash flow analysis results.

6. Draft Loan Agreement to be attached to the report, indicating loan terms and conditions.

7. The analyst's recommendation regarding lines of credit proposed to be granted to customer or rejected.

In preparing the credit report, the following to be observed:

1. Understandable language

2. Accuracy of information with proper checking of sources. Relevant documents to be placed in the customer's file.

3. Objective analysis using the known financial ratios.

4. The report to be complete so that the higher level will not need to refer to further sources to make the credit decision.

Every customer is to have a credit file containing all information related to his bank transactions.

ELEVENTH: CREDIT FOLLOW-UP AND COLLECTION POLICIES

The Bank encourages business meetings between customers and credit staff so as to closely follow up on customers' activities. The credit staff can therefore predict customers' problems before they occur and find suitable solutions. Minutes of such meeting to be recorded in the customers' files for follow-up purposes.

The Bank policy emphasizes firmness in collection, and periodical reporting of overdues to the higher levels. If the customer delays repayment for more than three months, the Legal Department in BDAC or the PBDAC should be notified, to take legal action against the customer (in accordance with Loan Agreement conditions).

TWELFTH: PERIODICAL LOAN CLASSIFICATION AND ESTABLISHING PROVISIONS FOR BAD AND DOUBTFUL DEBT

The Credit Department staff at the Bank's four levels: Village Bank, Branch, the BDAC and the PBDAC are to classify loans according to the following categories:

1. Satisfactory loans
2. Substandard loans
3. Doubtful loans
4. Bad loans

The credit staff at the Bank's four levels will propose the provisions required according to the Central Bank of Egypt's directive No. 321. Implementation steps for applying this policy are explained in Chapter IV of this manual.

The Inspection and Internal Control Sector, and its counter Department in the BDACs, should ensure that the periodical loan classification policy is properly applied. This will be explained in Chapter IV of this manual.

THIRTEENTH: CREDIT RESTRICTIONS

The following summary is a list of credit restrictions:

1. According to the banking law, no one single customer is to be granted credit that exceeds 25% of the Bank's equity.

2. It is not allowed to any of the Bank's staff to participate in the analysis or in the approval of a credit application of any of his relatives up to the fifth degree, or customers with whom he has common interest (e.g. partnership).

3. It is not allowed to grant credit for the purpose of price speculation such as keeping land till its price rises, or storing seeds for resale in seasons where they are scarce.

4. It is not allowed to grant credit to any project which will contaminate or pollute the environment (such as drainage of residues in the Nile), or projects involving prohibited insecticides, or industries with smoke chimneys close to urban areas.

5. It is not allowed to grant credit to any customer whose rating according to the five C's is below "satisfactory".

6. It is not allowed to grant credit to customer who was declared bankrupt, for at least five years from date of bankruptcy. Also a customer who did not repay for more than 6 months should not be granted any loans for at least three years.

7. Documents signed in blank are not to be accepted. Also the customer's stamp should not be kept in the bank.

8. Perishable vegetables and fruits are not to be used as collateral.

Attachment "1"

MAIN COLLATERAL AND BASIS FOR EVALUATION

COLLATERAL	LEGAL PROCEDURE	BASIS FOR EVALUATION
I. FIXED ASSETS		
1. Agricultural land	Mortgage at the Real Estate Registration Office	65% of the market price
2. Buildings, warehouses, barns, depots and small plants	Mortgage at the Real Estate Registration Office	50% of lower of cost or market price
3. The customer's residence	Mortgage at the Real Estate Registration Office	50% of lower of cost or market price
II. CURRENT ASSETS		
1. Storable agricultural crops	Chattel mortgage	80% of market price
2. Agricultural inputs such as fertilizers, chemicals and seeds	Chattel mortgage	80% of market price
3. Agricultural Machinery	Commercial mortgage	65% of lower of cost or market price
4. Cattle	a) Small farmers with less than 10 heads: Trust receipt and insurance on cattle.	a) Monthly evaluation at 80% of the market price
	b) Big farmers with a loan of L.E. 200,000 or more: A project technical manager to be appointed as a custodian insured against infidelity, in addition to insurance on the cattle.	b) Monthly evaluation at 80% of the market price
III LIQUID ASSETS		
All deposits, saving accounts, saving certificates, etc..	Legal assignment to the bank and the right to implement it in case of default.	90% of real (not nominal) value

CHAPTER II

PRINCIPLES OF GRANTING CREDIT AT THE VILLAGE BANK LEVEL

FIRST: INTRODUCTION

The purpose of this chapter is to set the basic rules of granting credit at the Village Bank level.

It is known that credit decision mainly depends on the professional opinion of the credit analyst. Thus there is a need to establish some standards and criteria for granting credit so as to minimize credit risks as well as to narrow differences of opinion from one analyst to another.

The general framework of bank credit is bank's sharing in customer's credit risks, so as to help the customer succeed economically during and after granting credit. It follows that more information reduces credit risk. Therefore the Bank's various levels urge customers to disclose all information about their economic conditions so that the Bank can on best efforts reach a sound credit decision. In line with this policy, the Bank encourages Village Banks to use "The Manual of Credit and Financial Plan" because application thereof provides an amount of information that helps village banks review loan requests.

SECOND: VILLAGE BANK SPECIALIZATION

The Village Bank specializes in dealing with the individual customer characterized with small amount of requested finance.

The Village Bank offers two lines of credit:

First: A credit line of L.E. 1000 maximum per feddan for a year, to finance cost of crop production. This line could turn more than once a year as long as it is paid off.

Second: A credit line of L.E. 1000 to 20,000 to finance customer's activity in agricultural or rural sector. This line may be increased above L.E. 20,000 if the purpose is to acquire machinery.

THIRD: CONDITIONS OF GRANTING A LINE OF CREDIT OF L.E. 1000 MAXIMUM PER FEDDAN

PRINCIPLES	VERIFICATION METHODS
1. Good reputation, adequate expertise in farm management, ability to bear work responsibility, steadiness in meeting liabilities and repaying debt	* Investigation report based on checkings with trustworthy people in the village. Report on results of investigation to be placed in customer's file. * Village Bank's previous experience with customer and his ability to repay. Brief report thereon to be placed in customer's file.
2. Customer should be either an owner or a tenant who practices farming on his own. He gets L.E. 1000 per feddan. If his "Heyaza" is less than one feddan, the loan is reduced proportionately.	* Look up the Heyaza card, and record its data (or a copy thereof) in the customer's file. (To verify area, the Heyaza card's data to be matched with Heyaza lists if available at Village Bank). * Customer signs a credit application
3. Customer undertakes to repay loan and interest within a year. Customer's account should show zero balance for at least 8 consecutive days at any time during the year, before a new loan is granted.	* Customer signs a promisory note conditioned with repayment within a year. * Village Bank follows up on fulfillment of timely repayment. Results to be recorded in customer's file.

FOURTH: CONDITIONS OF GRANTING A LINE OF CREDIT BETWEEN L.E. 1000 AND L.E. 20,000

PRINCIPLES	VERIFICATION METHODS
1. Character	
* Good reputation; ability to manage the project	* Investigation report based on checkings with trustworthy people in the village. Report on results of investigation to be placed in customer's file.
* Customer should be known for his sense of responsibility and willingness to cooperate with the Bank and others to make the project succeed.	* Bank's past experience with the customer, especially his repayment ability. Brief report thereon to be placed in customer's file.
* Customer should be steady in meeting liabilities and repaying debt.	
2. Capital	
* Owner's equity should cover between 50-65% of total project's assets.	* In case the customer does not have a balance sheet; the Bank is to prepare an approximative one based on data provided by the customer in reply to Bank's questions. (See attachment "1" as an example)
* Equity should be improving in the last two or three years through project's profit.	* In case the customer has a balance sheet, it should be analyzed, and the conditions referred to should be covered.
* Customer should have reasonable liquidity that allows for running the project. Purpose of the loan is expanding the project or economically improving it.	* In both cases, the customer's balance sheet and results of analysis are to be placed in customer's file.
3. Capacity	
* Customer's projections for cash collection reveal his ability to repay loan and interest, while allowing for suitable profit margin.	* In most cases, the customer needs a discussion to get to know cash collection prospects. The Village Bank should help the customer do this, as such discussions reveal customer's awareness of his activity.
* The project achieves profit; and bank credit will improve the level of profit.	* Project profitability to be calculated as a ratio to owners' equity, to verify prospects for improvement after granting credit.

4. Collateral

* Mortgage of fixed assets (land and buildings) to be of first class whenever possible. Evaluation of the assets of loan purposes not to exceed two thirds of its market value.	* The customer executes mortgage on his fixed assets in favor of the Bank at the Real Estate Registration Office, and submits the documents giving evidence that this has been done.
* Current assets (agricultural crops and inputs, etc..) to be pledged on "chattel mortgage" basis; value for loan purposes not to exceed 80% of market value. They should not be highly perishable.	* Customer to complete conditions of "chattel mortgage" in favor of the Bank.
* Insurance to be effected on the project, especially in case of livestock raising.	* Customer to submit insurance policies assigned to Bank's favor.
* No loan to be granted without collateral unless owners' equity cover at least 65% of project's assets.	* Balance sheet analysis to be referred to for meeting this condition.

5. Conditions

* The loan purpose will enable the customer to repay loan principal and interest, while allowing for reasonable profit, during normal project cycle.	* Visit to project's site for actual verification of its existence and its need for the loan and loan's purpose.
* Loan repayment schedule matches project's cycle in a way that the project's liquidity is not affected.	* Project's cycle to be studied, and repayment schedule to be determined accordingly.
* In cases of loans exceeding LE 10,000, the customer should maintain a set of books that allow reviewer to measure project's profitability and to monitor loan spending on specified purpose.	* In cases of loans exceeding LE 10,000, the customer is to maintain regular books, this is to be stipulated in Loan Agreement.

FIFTH: CASH FLOW AS A DETERMINANT OF GRANTING CREDIT AND A MEASURE OF REPAYMENT ABILITY

Any project can be viewed as a set of cash inflows and cash outflows. If cash inflows exceed cash outflows the project is said to be liquid. In the opposite situation the project is said to be in need of liquidity.

Cash inflows include the project's cash revenues such as sale proceeds of agricultural crops upon harvest, proceeds of sales of livestock, milk sale proceeds in dairy projects, egg sale proceeds in poultry projects, etc. Also included are proceeds from selling byproducts such as animal hay, dung, and other farm residuals.

As to cash outflows, these include the cash paid for production requirements such as seeds, pesticides, fertilizers, labor, harvest expenses and other farm-related expenses, purchasing animal heads and their feed in case of livestock fattening projects, or chicks and their feed in case of poultry projects, etc..

Every project (agricultural or farm-related or other) usually has a cycle with a beginning and an end. This determination helps to follow-up on the project's revenues and expenses.

The analyst (with customer's help) would rather prepare the cash flow table on monthly basis when possible, so that the table covers the whole cycle.

The following table explains what's meant by Cash Flow:

Type of Flow / Month	1	2	.....	11	12	Total
Cash Beginning Balance						
Cash Inflows:						
Collections from current activities						
Collections from byproducts						
Collections from other activities						
TOTAL (1)						
Cash Outflows:						
Payments for procurement of materials						
Payments for labor wages						
Payments for fuel						
Other payments						
TOTAL (2)						
Difference: (1) minus (2)						
Cumulative Difference						

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This table shows the size and timing of the needed liquidity, represented by the cumulative difference between cash inflows and cash outflows in peak months of the cycle. This is the maximum limit that the Bank can grant as credit.

Upon agreeing on the value of the loan, the table referred to above is recalculated on the basis of inserting the loan value (or tranches) among cash inflow items, and inserting loan repayments and interest payments among cash outflow items. The final analysis, shown in the table under the "total" column, should indicate that total cash inflows exceed total cash outflows.

Based on the above, the Bank's credit policy has four main dimensions as follows:

a) The cash flow analysis is the basis for granting credit, because it clearly indicates the size of loan to be agreed upon with the customer.

b) The client is to be encouraged to use his own money to support his project so as to minimize credit and thus financing expenses. This will increase chances for success.

c) The Bank encourages clients to open an overdraft account (revolving credit) to minimize cost of finance.

d) The basic condition for granting credit is an evidence through cash flow analysis that total cash inflows exceed total cash outflows, including transaction related to the loan.

SIXTH: <u>CREDIT RECOMMENDATION REPORT</u>

After establishing the five C's the analyst prepares a report including a brief background on the customer's business, investigation and field visit outcome, and customer's future plans for expansion if any.

The report includes the results of reviewing the five C's. Lastly, it includes recommendation to grant credit, its size, and condition. The customer's file (including five C's review) is to be attached to the report, as well as the conditions that should be added to the Loan Agreement. (See attachment "2" as a guideline).

The Village Bank Manager examines the file and gives his opinion regarding the loan. If he approves the loan, he sends the file for implementation if the loan is within his lending authority. But if the loan exceeds the Village Bank Manager's lending authority, then upon his in principle approval, he sends the loan application and all supporting documents, to the Branch.

The customer's file should reflect all his dealings with the Bank such as copies of all correspondence, bank statements of account and summary reports of field visits by bank officers.

SEVENTH: <u>STEPS LEADING TO GRANTING CREDIT</u>

The credit analysis usually starts by a meeting between the analyst and the customer, with a broad discussion on customer's need for bank credit. Through this discussion the analyst gets to know that there is a project in need of bank credit, that the project falls within Bank's credit policy purposes, and that the customer is serious in making such request.

If the analyst feels convinced that the above three conditions are met, he asks the customer to submit the loan application, indicating nature of the project, reasons for project's need for bank finance, and size, type and duration of this finance.

The actual study of customer's request starts then, in accordance with steps clarified in this chapter regarding the five C's.

The analyst should follow the steps clarified in this chapter in order to end-up preparing a credit recommendation report. The analyst has the right to recommend granting the credit or to refuse it in light of considerations (or findings) that he presents in his report. The Village Bank Manager has to review the credit recommendation report and its attachments, and to give his opinion thereon in writing.

As a general rule, the decision to grant or refuse a credit should bear two signatures on the credit recommendation report, one of which is the Village Bank Manager's.

EIGHTH: <u>FOLLOW-UP</u>

The bank official (at the Bank unit granting the credit), or his delegate, will make a field visit to the project at least twice a year. The purpose of the visit is to get acquainted with any problems related to the project, especially the financial problems. The point is to verify client's seriousness towards his business, which enables him to meet his liabilities to the Bank. Those visits also have a side purpose which is finding out about other credit granting opportunities to the same client or other clients, and/or solicitation of deposits.

The bank officer should write a summary visit report on his observations and remarks about the customer's business, his seriousness, and his ability to repay on time. The officer can add any important information related to granting new credit to the customer or attracting deposits from him.

In case the customer delays repayment of the loan or an installment thereof the bank officer should make a surprise visit (unnotified) to know the reasons for delay and urge him to pay on time. If the officer gets the feeling that the customer is facing problems which might affect him economically or financially, he should immediately notify the credit officer to do the necessary steps to help the customer and preserve the Bank's interest.

If the customer doesn't repay for three consecutive months, the Branch is to be informed in order to refer the customer to the Legal Department at the BDAC for legal action against the customer according to the Loan Agreement. The Credit and the Internal Audit Departments at the BDAC or the PBDAC, as the case may be, are also to be notified.

Attachment "1"

BALANCE SHEET AS OF / / 19

Customer's Name:

ASSETS	**LIABILITIES**
Liquid Assets	Accounts Payable
Cash on Hand	Payables to Suppliers
Deposits	Other Payables
Current Assets	
Goods	
Crops	
Accounts Receivable	

Fixed Assets	Capital
Land	
Buildings	

TOTAL ASSETS	**TOTAL LIABILITIES**

Attachment "2"

CREDIT RECOMMENDATION REPORT

The Credit Recommendation Report should include the following elements:

Addressed to:	Name and position of the person to whom the report is addressed.
Submitted by:	Name of analyst who examined the customer's documents and analyzed his financial data.
Customer's Name:	The name of the customer who applied for the loan.
Credit Requested:	Summary of the loan application: size, type and duration of the loan.
Background on Customer's Activity:	Purpose of the activity, and customer's future plans for expansion. If the customer has partners, the value of their shares to be stated, also as a percentage to total.
Outcome of Investigations and Field Visits:	Results of bank and trade checking, and outcome from field visits to be stated.
Character (Management and/or Owner)	Background on the customer's experience and his assistants' experience in running the business.

Financial Analysis:	Briefing on standing and development in customer's assets, their usage and profitability, results of cash flow analysis and the feasibility study if any.
Repayment Schedule:	The agreement between the customer and the bank on the repayment schedule and sources of repayment.
Collaterals:	The collateral that the customer offered in guarantee of credit, basis of evaluation of the collateral, and its present market value.
Conditions:	Any unusual conditions agreed upon between the customer and the bank, (these are also to be included in the Loan Agreement).
Credit Risk Analysis:	Strengths and weaknesses from a credit point of view. (This part is actually the essence of the recommendation referred to below).
Recommendation:	The analyst's opinion about granting the credit, and conditions thereof.
Attachments:	All documents that the analyst considers to be a support for his recommendation to be attached, particularly the draft Loan Agreement and any unusual conditions agreed upon with the customer.

CHAPTER III

PRINCIPLES OF GRANTING CREDIT AT THE BRANCH LEVEL AND HIGHER LEVELS

FIRST: INTRODUCTION

The purpose of this chapter is to set the basic rules of granting credit at the Branch level and higher levels.

It is known in banking that credit decision mainly depends on the professional judgment of the various "granting" authorities. Thus there is a need for rules and criteria for granting credit, so as to avoid some credit risks and to narrow differences of opinion from one analyst to another.

The general framework of bank credit is bank's sharing in customer's credit risks so as to help the customer succeed economically during and after granting credit. It follows that more information reduces credit risk. The Bank's various levels therefore urge customers to disclose all information about their economic conditions, so that the Bank can on best efforts reach a sound credit decision. The Bank also fosters establishing investigation departments to collect information on client's conditions from market sources, with emphasis on client's performance and reputation.

SECOND: EVALUATION OF FEASIBILITY STUDIES

Feasibility studies give a complete picture about the economics of the project that needs finance. The purpose of the study is to reach an important conclusion that the project's profitability is higher than alternative investment opportunities, thus it is worthwhile to finance the project. In other words, sources of finance (whether own sources or borrowings from external sources like banks) yield a return during project lifetime, which is higher than, for example, the return on Investment Certificates issued by National Bank of Egypt on behalf of government. Normally in comparing the two returns mentioned above, we take into consideration taxes (if the project's return is subject to taxes) and cost of finance (if the project made use of borrowings).

Feasibility studies are therefore the way-in to getting acquainted with the economics of a project that is about to be established, or in cases of significant expansion in an existing project. Feasibility studies would be of less importance in cases of existing on-going successful projects that need bank finance of no great effect on the "size" of the existing project.

Feasibility studies differ from one project to another, but certain basic elements are common to (and should be covered in) most feasibility studies; such as:

* General idea of the project
* Demand (or market) study for the project's production
* Production and technical aspects of the project
* The project's production plan in the medium term (from 3 to 5 years)

* "Balance Sheet" and "Profit and Loss Account" projections according to the production plan, for the same period referred to above.
* Cash flow projections for the same period (derived from Balance Sheet and Profit and Loss Account)
* Sensitivity analysis to estimate the impact on the project if one or more of the assumptions of the study were to change, (in production, financial, or marketing aspects).

Feasibility studies, with the above mentioned elements, are a basic constituent of the decision to grant credit. Therefore the analyst should consider the following criteria when evaluating a feasibility study:

1. Accuracy and Objectivity of Data

The analyst should ensure that the information used in preparing the feasibility study are from professional and unbiased sources. In other words data were not affected in a way to make the project appear in an unrealistically optimistic image.

2. Consistency

The study as a whole should be consistent from the economic point of view and should not be self contradictory.

3. Assumptions of the Study

Feasibility studies are based on economic assumptions. The credit analyst has to be convinced that the assumptions are not far from reality and are achievable. If he is not convinced of some of the assumptions he has the right to modify or change

them according to his point of view, in coordination with customer. In case of sophisticated feasibility studies, related to sizable finance, the Bank fosters consulting its technical specialists, as the Bank has a number of experts in different fields such as: land reclamation, mechanization, livestock, poultry and agro-industry.

4. Customer's Economic Awareness of the Feasibility Study

In case of large and complex projects, the practice is to have a technical specialist conduct the feasibility study. This specialist is hired by the customer, and the credit analyst has to ensure that the customer (whether an individual or a company director) is fully aware and convinced of contents of the study.

5. The Credit Analyst's Conviction of the Study

The credit analyst has to be adequately convinced, without any outside influence, of the viability of the study. This has no specific criteria and is left to the credit analyst's professional judgment. Yet, a sound feasibility study is usually easy to understand, smoothly and logically presented, and the sensitivity analysis therein indicates adequate safety against reasonable changes in the initial assumptions on which the study was based.

If the analyst is convinced of the feasibility study, he accepts it as a basis for the discussion with the customer about financing the project, and it forms part of the customer's file.

THIRD: INTRODUCTION TO FINANCIAL ANALYSIS

For the purpose of this manual, financial analysis means a set of financial relationships derived from the customer's Balance Sheets and Profit and Loss Accounts for a certain historical period (preferably 3 years), which help measure the customer's financial abilities and limitations. These relationships (or ratios) can in some cases be compared with those of other customers who have the same line of business (or activity) so as to know about the customer's competitive position in the market.

The financial analysis presented in this manual is the minimum requirement to be covered by the analyst, prior to a decision to grant credit.

1. Scope of Financial Analysis

The financial analysis involves, as a minimum, studying the customer's Balance Sheets and Profit and Loss Accounts for the two years preceding request of the loan.

It is preferable that the financial statements be audited by a chartered accountant. If not, then the credit analyst is to ensure that the financial statements were taken from regular books, that are reliable from an accounting point of view. A visit can be made to the customer to review the books and discuss their documentary cycle and frequency of closing the books.

As a general policy, the Bank encourages its customers to maintain regular up to date book-keeping as per the commercial law. The Bank also encourages its customers to hire chartered accountants to audit their financial statements, especially if

the business has expanded in a way that management is separate from ownership. This practice provides an element of "trust" in dealing with the customer. It also secures the customer and protects him from unintentional violations of various laws such as taxes, social insurance, and labor laws.

2. Financial Statements Presentation

Presentation of financial statements differ from one project to another, but for purposes of financial analysis the statements are to be rearranged according to the attached models, so as to facilitate the calculations involved in financial analysis.

Presentation of the Balance Sheet is shown in Attachment "1".

Presentation of the Profit and Loss Account is shown in Attachment "2".

3. Methods of Financial Analysis

a) Horizontal Analysis

It is a comparison between two balance sheets for two consecutive years, to determine the changes in every item, as follows:

USES	SOURCES
Increase in Asset Items	Decrease in Asset Items
---	---
---	---
---	---
Decrease in Liability Items	Increase in Liability Items
---	---
---	---
---	---

The purpose of this analysis is to determine the financial changes (or trends) during the year subject to study.

b) Vertical Analysis

It is to find the relative percentage of every asset item to total assets; and percentage of every liability item to total liabilities.

The purpose of this analysis is to determine the relative importance of every item in the balance sheet.

c) Financial Ratios

It is to calculate the ratio between two or more items of the Balance Sheet or the Profit and Loss Account. There are many ratios; each serving a certain purpose in financial analysis. These ratios could be categorized into the following groups:

* Liquidity Ratios
* Safety and Repayment Ratios
* Activity Ratios
* Profitability Ratios

The following part of this manual explains the most common ratios, and their usage. These ratios are arranged herebelow according to the four groups mentioned above.

4. Liquidity Ratios

The purpose of the following ratios is to measure the customer's repayment capacity in the short run:

* Current Ratio = $\frac{\text{Current Assets}}{\text{Current Liabilities}}$

This ratio measures the adequacy of current assets in meeting (or covering) current liabilities.

The ratio depends on many factors, such as the type of business, sales and collection policy, and inventory turnover. If the ratio is less than "one", it means that the working capital is negative.

Some analysts consider that this ratio should be no less than 2:1.

* Quick Ratio = $\frac{\text{Current Assets Minus Inventory}}{\text{Current Liabilities}}$

This ratio is called the critical test. It is the ratio between the assets that are quickly convertible to cash with no loss, to the current liabilities. Banks consider that the acceptable ratio here is no less than 1:1 to ensure that client can meet his current liabilities quickly and without incurring losses.

* Cash Liquidity Ratio =

$$\frac{\text{Cash on Hand and At Banks + Negotiable Instruments}}{\text{Current Liabilities}}$$

This ratio measures the project's liquid assets' capacity to immediately meet current liabilities without waiting for receivables to be collected.

5. Repayment and Safety Ratios

The purpose of these ratios is to measure: 1) project's financial safety; 2) project's capability to manage its liabilities in a way so as to maximize profit, and 3) project's repayment ability.

* Debt/Equity Ratio = $\frac{\text{Total Debt}}{\text{Equity}}$

According to directives of the Central Bank of Egypt, this ratio should not exceed 2:1, so as to ensure the project's financial viability and to secure bank's interests.

* Ratio of Loans to Total Liabilities =

$$\frac{\text{Total Loans}}{\text{Total Liabilities}}$$

This ratio measures to what extent the customer relies on external financing.

If the above mentioned two ratios are high, this reflects the project's tendency to rely on external sources of finance. Therefore at times where interest rates are low, the return on equity rises; and at time where interest rates are high the return on equity falls. In the latter case the project will be subject to risks of inability to service (repay) debt.

* Fixed Assets to Debt Ratio =

$$\frac{\text{Net Fixed Assets (After Depreciation)}}{\text{Long Term Loans}}$$

A high ratio here indicates that loans are covered by the fixed assets that secure them. The acceptable ratio is not less than "one".

* Debt Service Ratio =

$$\frac{\text{Net Profit Before Taxes+ Depreciation + Interest Expense}}{\text{Loan Installments and Interest due During the Year}}$$

This ratio indicates the project's capacity, through funds generated from operation, to repay loan installments and interest due during the year.

* Interest Coverage Ratio =

$$\frac{\text{Net Profit Before Taxes + Interest Expense}}{\text{Interest Expense}}$$

This ratio indicates how many times the project's profits can cover its interest expense.

6. Activity Ratios

These ratios indicate the efficiency of utilizing the project's assets and its working capital.

* Current Assets Turnover =

$$\frac{\text{Sales}}{\text{Current Assets}}$$

* Fixed Assets Turnover =

$$\frac{\text{Sales}}{\text{Fixed Assets}}$$

* Total Assets Turnover =

$$\frac{\text{Sales}}{\text{Total Assets}}$$

If the above ratios are compared with similar projects and found to be below the prevailing average, then the project's volume of business is not suitable to the value of funds invested in its assets.

* Inventory Turnover =

$$\frac{\text{Cost of Goods Sold}}{\text{Average Level of Inventory}}$$

(Cost of Goods Sold = Beginning Inventory + Purchases - Ending Inventory)

Inventory is to be measured based on its average monthly or weekly level, so that the ratio will not be affected by the value of year-end inventory only. A high turnover means an expansion in business with no stagnant inventory. Also in year-to-year comparison of inventory turnovers, or comparison with similar projects, we should ensure that inventory did not drop below safety levels.

* Receivables Turnover and Collection Period =

$$\frac{\text{Credit Sales}}{\text{Average Level of Accounts and Notes Receivable}}$$

Then we derive the average collection period, which is defined as the number of days required to collect receivables, as follows:

* Average Collection Period =

$$\frac{360}{\text{Accounts Receivable Turnover}}$$

If the collection period is long, it indicates slackness in collection and a risk of doubtful debt.

The analyst should also compare the collection period with similar arrangements on the payable side (i.e. suppliers' facilities).

7. Profitability Ratios

These ratios measure the achieved profitability as the end result of the project.

* Return on Sales =

$$\frac{\text{Net Profit (After Taxes)}}{\text{Sales}}$$

* Return on Equity =

$$\frac{\text{Net Profit (After Taxes)}}{\text{Equity}}$$

* Return on Investment =

$$\frac{\text{Net Profit + Interest on Long Term Loans}}{\text{Equity + Long Term Loans}}$$

* Return on Total Assets =

$$\frac{\text{Net Profit (After Taxes)}}{\text{Total Assets}}$$

The continuous increase in the above ratios from one year to another indicates increased profitability of the project.

8. Break-Even Point Analysis

This analysis is used to determine the volume of production or sales at which total costs are equal to revenues, with no profit or loss. The lower this point, the greater the chance for the project to realize profits, and vice-versa.

To calculate the break-even point all cost elements are to be classified to: variable costs (that vary with volume of production), and fixed costs (that do not vary with volume of production).

The break-even point could be calculated by two methods:

a) Quantity Break-even Point =

$$\frac{\text{Total Fixed Costs Per Year}}{\text{Revenues - Variable Costs}} = \ldots.\%$$

This ratio represents production break-even point, or the rate of capacity utilization at break-even. Then by multiplying the latter by the volume of production corresponding to capacity utilization we get the number of units of output (or sales) at which revenues and costs break-even.

b) Monetary Break-even Point =

$$\frac{\text{Total Fixed Costs + Loan Installments - (Depreciation + Interest)}}{\text{Revenues - Variable Costs}} = \text{LE}$$

The result indicates the value of production or sales at which the project does not realize neither profit nor loss.

Break-even point analysis is particularly important to projects that are about to be established, because it indicates, pre-fact, the level of production or sales at which the project starts to make profit.

FOURTH: <u>CASH FLOW AS A DETERMINANT OF GRANTING CREDIT AND A MEASURE OF REPAYMENT CAPACITY</u>

If the analyst is satisfied with the feasibility study and finds that financial analysis confirms that customer's credit risks are acceptable, then the next step for the analyst is to study the customer's cash flow.

The period to be covered by the cash flow analysis differs in duration according to the term of the loan. It could be one year or less for short term loans, it may cover up to three years in medium term loans, and it may cover more than three years in case of long term loans. As a rule, cash flow analysis should cover the duration of the loan under study.

The elements of cash flow analysis are:

1) Cash inflows, mainly collections from sales
2) Cash outflows, such as for example wage payments (especially in labor intensive projects) or cash payments for purchase of machinery, etc.

It isn't sufficient to determine the value of cash inflows and outflows, but also their timing. They could occur monthly in most cases of short term credit, or quarterly in cases of medium and long term credit.

Therefore there is no ideal model for cash flow. It depends on the nature of the project, the nature of the accounts of which profit and loss account is composed, the duration of the loan and the frequency of cash flows calculation.

Attachment "3" is an example for monthly cash flow for a period of one year only. It is noted that cash flow is based on cash transactions only, and at the time they occur. The non-cash transactions are not accounted for.

For example, depreciation installments are not included as they do not represent a cash flow. Also credit sales are not included except upon collection. Taxes are included only upon disbursement; etc.

The purpose of preparing the cash flow table is to identify the financial gap in a project and its timing. It is defined in any month as follows:

The financial gap in month "x" =

> Beginning Cash at Hand and Held with banks + Cash inflow to the Project from the Beginning of the Whole Period till the End of Month "x" - Project Cash Outflow from the Beginning of the Whole Period till the End of Month "x".

The above definition determines the financial gap and the month in which it occurs. Accordingly the Bank can decide on the size and duration of the credit.

Naturally, the cash flow table covers future periods. There is no alternative but to use technical, economic and marketing assumptions which should have consistency with the life cycle of

the project. It is important that cash flow assumptions be consistent with the feasibility study and up-dated Profit and Loss Account for the project.

As a general rule to grant credit cash flow analysis is to confirm the project's capacity to repay the loan and its interest and leave a margin of profit for the project's owner. If this rule is not satisfied, then credit should not be recommended.

Accordingly, the credit analysis should include a cash flow analysis indicating as mentioned above that cash flow during loan lifetime will result in repayment of the loan plus its interest, and allow for a profit for the project. The purpose of bank credit is not to finance collateral submitted by customer, but to finance an economic activity, capable of repaying its obligations and making profit.

Thus, the financial gap as revealed by the cash flow analysis will determine the maximum amount of credit that the Bank can grant, and its duration. The analyst may reduce amount of credit if he finds that the project has certain credit risks that require precaution.

As a final procedural point, if the analyst ensures customers' need for credit, and the Bank's willingness to provide it, then the analyst is to incorporate the effect of the loan in the cash flow table. Loan disbursement is considered a cash inflow, distributed over months of disbursement. And loan repayment and interest are considered as a cash outflow, in specified dates as per Loan Agreement.

If the loan is smaller than the financial gap, the customer will be requested to either reduce his volume of business, or raise his reliance on self finance. The financial gap will therefore totally disappear after credit is granted.

The modified cash flow document which includes the effect of the loan as explained above is considered to be the project's plan of action. It should be pursued by the project, and the analyst uses it to monitor the project's activity.

During loan lifetime the cash flow document could be modified due to changes in the project economic conditions as opposed to the initially set assumptions. However the general rule referred to earlier should always apply.

When cash flow calculations are modified, reasons are to be clarified, as well as the new assumptions. All this information is to be placed in the customer's file.

FIFTH: THE USE OF COMPUTER IN FINANCIAL ANALYSIS AND CASH FLOW

The Bank encourages the use of computers in calculating the financial ratios, and to store the cash flow table in memory, for easy reference for modification as the need may be.

It is possible to buy software specifically prepared for financial analysis; or the Bank's MIS sector can help in this matter by preparing simple software for this purpose. As to cash flow analysis, Lotus 123 can be used, and MIS sector can help in this respect too.

3. Capacity

* Cash flow projections should prove that project will be able to repay principle of loan, its due interest, and allow for a profit margin.

* From the project's Balance Sheet, the analyst calculates the safety and repayment ratios, being:

  - Debt/Equity ratio
  - Ratio of loans to total liabilities
  - Ratio of debt coverage by fixed assets
  - Debt service ratio
  - Interest coverage ratio

* It is preferable if the above mentioned ratios were improving during the two years preceding granting the loan. Ratios are to be recalculated taking into account the size and duration of the loan under study.

* Through financial and cash flow analysis as well as professional judgement, the analyst is to be convinced with the customer's repayment ability.

* The project will realize profits, and credit will lead to increased profitability.

* From the financial statements, the analyst is to calculate at least the following ratios.

  - Inventory Turn Over = $\frac{\text{Cost of Sold Goods}}{\text{Average Level of Inventory}}$

  - Return on Sales = $\frac{\text{Net Profit (After Taxes)}}{\text{Sales}}$

  - Return on Equity = $\frac{\text{Net Profit (After Taxes)}}{\text{Equity}}$

  - Return on Total Assets = $\frac{\text{Net Profit (After Taxes)}}{\text{Total Assets}}$

* The above ratios should be improving during the two years preceding granting the loan.

* Through financial and cash flow analysis, and professional judgement, the analyst should be convinced of the project's profitability.

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4. Collateral

* Mortgage of fixed assets (land, buildings...) should be first degree if possible, recognizing only two thirds of market value for lending purposes.

* The customer is to mortgage his fixed assets at the Real Estate Registration Office in favor of the Bank, and submit to the Bank the relevant evident documents.

* Proper chattel mortgage on current assets (crops, agricultural inputs, etc..). Only 80% of the market value is recognized for lending purposes.

* Customer fulfills all conditions of the chattel mortgage on current assets, in favor of the Bank.

* Insurance on the project, (particularly in the case of livestock).

* Customer is to submit the relevant insurance policies, endorsed in Bank's favor.

* No loan to be granted without collateral unless project's capital covers at least 65% of its assets.

* Reference is to the analysis of the Balance Sheet for fulfillment of this condition.

5. Conditions

* Purpose of the loan will enable the customer to repay loan principal and interest, and allow for a profit margin, during project lifetime.

* Site visit to the project to verify its existence and its need for the loan and the purpose thereof.

* Repayment schedule of the loan to match project's cycle, in a way that project's liquidity is not affected.

* Studying the project's cycle, cash flow tables, and the repayment schedule derived therefrom.

* The customer is to maintain a set of books that allow the reviewer to measure project's profitability, and to monitor loan spending on its specific purpose.

* A Loan Agreement condition stipulating that customer should hold regular books.

* Periodical data to be derived from the books are to be agreed upon with the customer so as to follow-up on his activity periodically during loan lifetime.

SEVENTH: INVESTIGATION DEPARTMENTS

The Bank encourages its branches, BDACs, and PBDAC, to establish specialized Investigation Departments whose function is to collect information about prospective and existing customers. The reports of this department are highly confidential; they cover the first element of the five C's, which is "character".

The Investigation Department can obtain information through the following five sources:

1. Bank Checkings

This is done by contacting banks who have present or past relationships with the customer. The communication is either in writing or orally. In the latter case, a summary report for the communication is to be placed in customers' file.

This type of checking is done for prominent customers, and other banks expect reciprocity. The PBDAC encourages having cordial agreements between BDACs and other banks in their areas to exchange information about customers, while taking banks' secrecy into consideration.

2. Trade Checkings

The bank investigator contacts some sources in the market that the customer deals in, such as:

a) Customer's Suppliers:

To collect information about type and volume of the customer's transactions, to what extent his suppliers have confidence in him, whether they provide him with suppliers' facilities and at what terms, his repayment steadiness, and his management abilities.

b) Customer's Clients:

To inquire about type and volume of the customer's transactions, whether those clients enjoy payment facilities and on what conditions, whether the products they buy from the customer are easily salable, and whether the customer is supportive to his clients in various circumstances.

c) Customer's Competitors:

To collect information about his production and marketing abilities, his market share, his reputation, and his competitive behavior. This type of information is to be considered with some precaution.

3. Field Investigation

The Bank representative gathers information through field visits to the customer/or project to check operations facilities and precautionary measures, type and number of

laborers, prospective expansion plans, etc. He then prepares a visit report with his personal judgment on project's management efficiency.

4. Official Inquiries

This is done through the concerned government sources to check whether the prospective client has previously been declared bankrupt, or whether there has been a protest for non-payment against him, or disputes with the tax authority or social insurances, in a way that might negatively affect the project. This type of investigation is particularly conducted for customers whose projects are already on-going and existing in the market.

5. Aggregate Credit Facility Position (Central Bank of Egypt)

The Central bank provides credit information about customers who have bank credit of more than LE 40,000. The PBDAC, as a member of the banking system, is entitled to obtain such information.

The Bank's Finance Sector has a specialized unit that can easily obtain such information.

In all cases of above mentioned inquiries, the customer is to be notified that the Bank is conducting such investigations. Obtaining and circulating information should be done with prudence in a way not to affect customer's commercial and competitive standing. All information to be placed in customer's file.

EIGHTH: **CREDIT LINES DEALT WITH AT THE BRANCH LEVEL AND HIGHER LEVELS**

The branches and higher levels grant the following credit lines:

1. Short term credit (upto one year)
2. Medium term credit (1-3 years)
3. Long term credit (3 to 7 years).

The credit could be in the form of overdraft account (revolving) or a loan. Usually short term credit is in the form of overdraft, while long term credit is in the form of a loan.

Since Bank's policy is to rely on cash flow analysis as a basis for granting credit, while collateral is required to reduce credit risks, it follows that with longer loan durations more collateral is needed as cash flow projections are less reliable for longer future periods.

The Following is a Comparison Between The Three Types of Credit and Their Effect on the Bank's Credit Policy

Factor	Short Term Credit	Medium Term Credit	Long Term Credit
Duration	Up to one year	More than a year and up to 3 years.	More than 3 years and up to 7 years.
Purpose of the Credit	Financing the working capital	Financing farm buildings, soil improvement, mechanization and animal breedings.	Purchasing of land and buildings, land reclamation, and rescheduling existing debt.
Means of Reducing Credit Risks	* Repayment schedule should match customer's seasonal revenues. * Follow up on the customer quarterly or every agricultural season. * Obtain a promissory note from the customer, covering loan and interest.	* Focus on cash flow and sound project management. * High customer's share in the finance of new activities in the project. * Follow up on the customer semi-annually. * Obtain chattel or commercial mortgage and/or insurance in Bank's favor.	* Focus on cash flow and sound project management. * High customer's share in the finance of new assets. * Mortgage of new and old fixed assets so as to cover credit risks.

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The branch can provide the project with the usual bank services such as warehousing, opening letters of credit, issuing letters of guarantee, opening depository accounts. (Reference is to specialized manuals for those functions)

NINTH: CREDIT REPORT AND CUSTOMER'S FILE

The purpose of this part is to have the analyst summarize his financial analyses and his views thereon, leading him to his recommendation to grant credit and submitting this recommendation to the higher level and those authorized to grant the credit (as is explained in Chapter I under "Lending Authorities")

The following are the items that the credit report should contain:

Addressed to	:	Name and position of the person to whom the report is directed.
Submitted by	:	Name of th analyst who examined the customer's documents and analyzed his financial data.
Customer's Name	:	Name of the customer applying for the loan, his address, and nature of his main activity.
Credit Requested	:	Credit application's summary: size of the loan, type and duration.

Background on the Project	:	The purpose of the project, its initiation, development, size, plans for future expansion, shareholders and any other information that help to form an idea about the economics of the project.
Results of Investigation and Field Visits	:	Results of all inquiries and field visits to customer's project/site.
Character	:	Background on project's management and their experience, their accomplishments, for how long they have managed the project, and results of investigations thereon.
Financial Analysis	:	Financial information provided by the customer to support his loan request, results of financial and cash flow analysis, and any other financial information that the analyst sees important to present in support to his recommendation.
Repayment Schedule	:	Repayment schedule and the assumptions that were made to forecast project's revenues and expenses so as to justify the repayment schedule mentioned.
Collateral	:	Collateral offered by the project to guarantee the credit, their present value and basis of evaluation.

Loan Conditions	:	Any unusual conditions that will be incorporated in the Loan Agreement, such as: loan follow up, and data to be periodically submitted by the customer to the Bank.
Credit Risk Analysis:		Strengths and weaknesses from a credit point of view. In fact this section is the core of the recommendation referred to under next item.
Recommendation	:	The analyst's recommendation concerning granting the credit, and conditions thereof.
Attachments	:	All documents that the analyst considers to be a support to his recommendation, to be attached to this report, particularly the draft Loan Agreement, and any special conditions agreed upon with the customer.

It is noted that the language of the credit report should be understandable, clear, and not subject to misinterpretations. All information in the report to be supported by precise documents. In general, the report should be integrated, in a way that the reader can establish his own opinion by merely reading the report.

The customers' file should give a complete picture about all his transactions with the bank. It should include copies of all correspondences with the bank, statements of account, summary of field visits by the bank's officials, as well as results of inquiries.

TENTH: STEPS LEADING TO GRANTING CREDIT

The process starts with a meeting between the customer and the analyst, where they discuss the customer's need for bank credit. In the course of discussion, the analyst gets to know that there is a project in need of bank credit, that the project falls under the bank's credit policy purposes, and that the customer is taking the loan request seriously.

Once the analyst is convinced that the above three conditions are fulfilled, he asks the customer to submit an application for the credit, indicating nature of the project, reasons behind the need for bank credit, and its size, type and duration. At this point, the actual study for the client's request begins, according to steps that were covered in this Chapter concerning the five C's.

To fulfill the 5 C's requirements, the analyst asks for the feasibility study and/or copy of the project's Balance Sheets and Profit and Loss Accounts for the last two years. The analyst usually assists the project's management in forecasting (or estimating) the project's financial position as of the date of the discussion. This up-to-date financial position (or Balance Sheet) is directly used to prepare the cash flow tables, which are in turn prepared by deriving the following information:

1. Present "cash" balances at the project as a main item for preparing the cash flow tables.

2. Expected repayments from the project's debtors to be included in the cash inflows.

3. Expected repayments to the project's creditors to be included in the cash outflows.

4. This financial position (Balance Sheet) is used to forecast the customer's financial position at the end of every year throughout loan's lifetime.

Part of the process of collecting information is analyst's inquiries about the project from the Central Bank of Egypt or any other sources.

The analyst should follow the steps clarified in this Chapter, until he gets to preparation of the credit recommendation report. He has the right to recommend or reject the credit according to considerations presented in his credit report. He should submit the report to the higher level for their review and their feedback in writing.

As a general rule the decision to grant credit has to be presented to the credit committee. The committee consists of at least three persons, one of which has to be the Branch Manager, or the BDAC Chairman in case of BDACs, or PBDAC Chairman in case of the PBDAC. The decision to grant the credit is based on majority votes. In case of equal votes on two sides then the side that has the vote of the "Head" (of the concerned administrative level) outweighs.

Also as a general rule, rejection of the credit should be through two signatories on the credit report, one of which is the Head of the administrative level at which the credit application was examined.

ELEVENTH: CREDIT FOLLOW-UP

Granting credit depends on projections of future cash flow, and this is based on assumptions. Therefore, the analyst or his representative should follow-up on the customer twice a year, or more, according to the Loan Agreement conditions. The purpose of follow up is to verify that the assumptions on the basis of which the credit was granted still prevail at present. In case the assumptions are no longer valid, the analyst should get acquainted with the conditions in which the project is operating, and review the credit, then submit his recommendation to the higher level to decide on proceeding with the credit,or modifying it, or even ending it if it deems necessary.

The Bank encourages the follow up on his customers so as to minimize credit risks, to reduce the risks of customer's involvement in financial problems, that are better dealt with at their early stages.

In case the customer delays repayment, of the loan or an installment thereof, the bank officer makes a surprise visit (unnotified) to the customer, to get to know the reasons for the delay in payment, and to urge him to pay regularly. If the officer feels that the customer is facing problems that might negatively affect his financial standing, he should report it immediately to the credit officer, who in turn acts promptly to help the customer if possible, and to protect the Bank's rights.

If the customer doesn't repay for 3 consecutive months, the Legal Department at the BDAC or PBDAC (as the case may be) should be informed for legal action against the customer, according to the Loan Agreement. The Credit and Internal Audit Departments at the BDAC or PBDAC should be notified as well.

The Manual of Credit Procedures will give details on the accounting and statistical reports to be submitted to higher levels for follow-up purposes.

Attachment (1)

BALANCE SHEET ON / / 19

Value on / /19	Assets	Year of Comparison / /19	Value on / /19	Liabilities and Equity	Year of Comaprison / /19
	Current Assets			**Current Liabilities**	
x	Cash at Hand		x	Short Term Loans (Up to One Year)	
x	Cash at Banks				
x	Notes Receivable		x	Creditors and Suppliers	
x	Clients Accounts Receivable		x	Notes Payable	
x	Down Payments		x	Accrued Taxes	
			xx	**Total Current Liabilities**	
	Inventory				
	x Raw Materials				
	x Work-in-process				
	x Finished goods				
xx	**Total Current Assets**				
	Fixed Assets			**Long-Term Liabilities**	
x	Land		x	Long-term Loans (Over One Year)	
x	Buildings (net of Depreciation)		x	Provisions	
x	Tools and Equipment (net of Depreciation)				
x	Furniture (net of Depreciation)				
x	Vehicles (net of Depreciation)				
xx	**Total Fixed Assets**		xx	**Total Long-term Liabilities**	
	Other Assets			**Equity**	
x	Prepaid Taxes		x	Capital	
x	Deferred Revenue Charges		x	Reserves	
x	Other Debit Balances		x	Retained Profits	
xx	**Total Other Assets**		xx	**Total Equity**	
xxx	TOTAL ASSETS		xxx	TOTAL LIABILITIES AND EQUITY	

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Attachment "2"

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDING / / 19

Value During Year Under Review					Year of Comparison (Previous Year)
		x		Total Sales	
		x		Less: Sales Returned	
	x			Net Sales	
				<u>Operating Costs:</u>	
			x	Beginning Inventory	
			x	Purchases (Raw Materials, Packing Materials,..)	
		x			
				Less:	
			x	Ending Inventory	
			x	Direct Production Wages	
			x	Maintenance and Spare Parts	
		x	x	Operational Expenses and Fuel	
x				Gross Profit From Operations	
				Less:	
	x			General and Administrative Expenses	
	x			Sales and Distribution Expenses	
	x			Depreciation	
	x			Interest	
x				Income from Trade Activity	
		x		Capital Gain	
		x		Other Income	
	x			Less:	
		x		Capital Loss	
		x		Other Expenses	
	x				
x				Net Profit Before Taxes	
x				Taxes	
x				**Net Profit Before Distribution**	

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Attachment "3"

CASH FLOW TABLE FOR THE PROJECT
DURING THE YEAR 19...

Elements / Period in Months	Jan	Feb.	.....	Dec.	Total
a. Beginning Cash Balance (in Vault and at Banks)					
b. Cash Inflow Elements					
* Cash Sales					
* Other Cash Income					
Total "b"					
c. Cash Outflow Elements					
* Wages					
* Cash Purchases of Production Requirements					
* Social Insurance and Taxes					
Total "c"					
The Financial Gap a+b-c					

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CHAPTER IV

LOAN CLASSIFICATION

FIRST: INTRODUCTION

The purpose of loan classification is to determine the quality of the Bank's loan portfolio. Classification is conducted through semiannual reports to evaluate all outstanding loans granted to all Bank's customers.

The results of evaluation are related to both the customer and the loan. The purpose of the evaluation is to classify them together under one of the following four categories:

a) Satisfactory
b) Substandard loans:
   - For reasons not related to repayment ability
   - For temporary reasons related to customer's liquidity and repayment ability.
c) Doubtful loans
d) Bad loans

The practical results for this classification is to estimate the provision for bad and doubtful debt. Hence credit classification has direct effect on the Bank's profitability and its financial standing (Balance Sheet). The Bank's management and Board of Directors should pay special attention and priority to loan classification. Also, the Central Bank of Egypt has issued a directive to all banks for applying certain rules in loan classification; (Directive No. 321 dated September 9, 1991, copy thereof is in attachment "1").

The set of rules included in this chapter lead the Bank to an objective evaluation of the quality of its loan portfolio, as well as the proper application of the Central Bank's directive.

The rules in this chapter are applicable to all four levels of the Bank (village banks, branches, BDACs and PBDAC). Note that item "Sixth" is devoted exclusively to the line of credit of L.E. 1000 per feddan at the Village Banks only.

SECOND: CLASSIFICATION DEFINITIONS

The purpose of this section is to give precise definitions to the four loan classifications:

1. Satisfactory

This loan is granted to a customer of high credit worthiness and repayment ability, adequate collateral, as well as regular repayment uptill date of classification.

2. Substandard Loans

a) For reasons not related to repayment ability:

This loan is granted to a customer whose collateral is adequate, but the project faces temporary problems, such as: slow start-up, management long absence for medical reasons, ...etc.

b) For temporary reasons related to liquidity and repayment ability:

This loan is granted to a customer whose collateral adequately covers loan and interest, but there are temporary liquidity problems leading to inability to repay on time. This type of loans usually require re-scheduling. Examples are a customer who finds difficulty in collecting receivables, or a customer who had to pay for his purchases in cash while he had planned to buy on credit.

3. Doubtful Loans

In this case repayment of both loan principal and interest has become doubtful. Collateral is not adequate, or hard to convert to cash in a reasonable time. There may be other reasons that make it impossible for the loan to be fully paid on due date. As an example, a project that was based on an optimistic feasibility study, far from reality.

4. Bad Loans

This is the case when it has become evident that part or all of the loan is impossible to be repaid, and collateral is not adequate and not suitable to market conditions. The Bank is forced to go to court to protect its rights. Usually, this case occurs if the Bank was lax in monitoring its substandard or doubtful debt in a way that they deteriorate and become bad loans.

THIRD: RESPONSIBILITY OF CONDUCTING LOAN CLASSIFICATION

As a rule, loan classification begins at the Credit Department at the unit responsible for following up on the loan and the customer's activities. Evaluation mainly relies on field visits, information in customer's file and in his bank accounts. It is customary to open an account for the customer at the

Village Bank because of proximity to his business, so as to facilitate deposit and withdrawal transactions, (even if the authority to grant the credit is at the Branch or higher level). The same case may occur between PBDAC and BDACs, or BDACs and Branches.

Thus, in order to apply the above rule, all four levels of the Bank should start preparing a list of customers' names and their outstanding loan balances. The totals of these balances should conform with the general ledger on the date of evaluation. List of names of customers whose loans are followed up at higher levels should be sent there, together with their bank statement of accounts, for completion of classification.

The above loan classification rule is based on a credit principle, namely that the Credit Department is responsible for all three phases of credit: preparing studies for granting credit, granting credit, and repayment follow up and evaluation of credit.

FOURTH: BASIC INFORMATION NEEDED BEFORE LOAN CLASSIFICATION IS CONDUCTED

There are two main sources for obtaining the information necessary to start loan classification:

a) The Customer's Accounts:

A copy of the customer's statement of bank account should be available; and in case the customer has more than one account in various units of the Bank, all statements to be gathered and placed in his file at the main unit granting the credit. The account statements should cover the entire evaluation period.

b) The Customer's File:

The information in a customer's file differ from one customer to another according to the size and type of the loan. Yet the customer's file should have adequate information to make a credit decision about the customer. Thus all incomplete files should be completed before the process of classification begins.

The process of classification mainly relies on an analytical study of the five C's. Hence, the credit file should contain the following information: the credit application, the feasibility study, cash flow tables, customer's financial statements and the relevant financial analysis, loan agreement and repayment conditions, collateral and its legal aspects (mortgage... etc), investigation reports, follow up and field visits reports, and copies of all correspondence with the customer.

We may add to the above any outside information that can have an impact on the customer's activities, such as the establishment of similar projects in the same activity, which will have an effect on the project's competitive standing, or any new governmental decrees that affect the customer's activities, and any other factors that economically affect the project.

FIFTH: CREDIT RISK REPORT

After the list of outstanding loans is established, and after the customers' bank statements of account are prepared and their files are complete, the process of loan classification begins by preparing a short report on credit risk for each customer subject to classification.

This report mainly includes two elements:

1) Credit lines: Limits, and outstanding balances as of classification date.
2) Collateral and evaluation thereof.

Attachment "2" indicates a model of credit risk assessment report, that should be applied to all Bank's customers except for the credit line of L.E. 1000 per feddan, which is treated differently.

SIXTH CLASSIFICATION OF LOANS UNDER THE CREDIT LINE OF L.E. 1000 PER FEDDAN AT VILLAGE BANK LEVEL

The operational (or working capital) line of credit is granted against Heyaza. Therefore it is a line of credit that is unsecured. Classification of outstanding balances under this line therefore depends on repayment status. Classification here depends on the two following principles:

PRINCIPLE	EVALUATION
1. If follow-up reports indicate that the customer is expected to repay his loans plus interest on time.	Satisfactory
2. If the customer delays repayment of loan and/or its interest:	
- For 3 months maximum	Substandard
- For 6 months maximum	Doubtful
- For 12 months maximum	Bad loan

It is prohibited to grant new credit to a customer as long as his evaluation is below "satisfactory". Also, it is prohibited to grant new credit for 3 years to a customer that has been classified as "doubtful" or "bad" loan, even if he repaid all his obligations.

SEVENTH: CLASSIFICATION OF OTHER LOANS

The rules in this part are applicable to all the Bank's levels. Attention to be paid to the following points before classification process begins:

1) A list of the Bank Unit's customers (Village Bank, Branch...) to be prepared. The total balances should match with the general ledger on date of evaluation.

2) Customers whose accounts are at the lower level (Village Bank) are monitored at a higher level (Branch), and their statements of account are sent to the higher level for classification there.

3) The higher level (Branch) should combine the list of accounts forwarded from the lower level (Village Bank) to its own list, for classification at its unit.

4) In preparing the Bank Unit's list of customers, all the accounts in name of one customer are to be put together, for easy reference to his aggregate relation with the Bank.

5) All the customers' files should be complete and ready for checking.

The process of classification begins by filling the loan Classification Report through review and objective evaluation for every customer, according to the following steps.:

1. Character

Content: Good reputation, experience in farm management or project management, and management continuity.

Examination: Good reputation refers to steady repayment and fulfillment of undertakings. Experience in managing his farm and/or project refers to management's awareness of the project subject to finance and running thereof according to plans established at time when the loan was disbursed. Continuity refers to customer's practical ability to proceed with his business or project according to plans established at the time the loan was disbursed.

Documents and Features:

- Inquiries about the customer
- Bank's experience in dealing with the customer
- Accuracy and completion of information submitted by the customer.
- Customer's (or project's) Balance Sheet and Profit and Loss Account.
- Follow-up field visits reports.
- Customer's age and health condition.

2. Capital

Content: Customer's or project's financial strength, and improvement in Balance Sheet.

Examination: Results of the financial analysis indicate a strong standing. Net assets of the customer (or the project) are improving from one year to another as a result of the activity.

Documents and Features:

- Balance Sheet and Profit and Loss Account to be analyzed, with emphasis on net assets and profitability.

- List of changes in assets and liabilities in the two most recent years.

3. Capacity

Content: Customer's ability to repay Bank's debt uptill date of evaluation and in future.

Examination: Customer's repayment is done according to schedule, and his bank statement of account confirms this.

Customer's cash flow table, based on realistic assumptions, indicate customer's ability to repay his future obligations on time.

Documents and Features:

- Analysis of customer's statement of account and matching it with repayment schedule or Loan Agreement conditions to verify that payments were made on maturity dates.

- Restudy customer's cash flow table, and update it if there are any changes in the initial assumptions, so as to ensure that customer will easily meet his future obligations to the Bank.

4. Conditions

Content: Customer has abided with conditions agreed upon, especially regarding spending the loan in the specified purpose.

Examination: Both field visits and financial statements reflect that loan has been spent on the specified purpose, and that customer fulfills contract's conditions.

Documents and Features:

- Credit application and Loan Agreement.
- Plan of production or operation.
- Copies of proforma invoices for machinery or inventory that the analyst obtained during field visits.
- Field visits reports.

5. Collateral

Content: Collateral to be adequate and easily converted to cash.

Examination: Adequacy of collateral is determined through examining whether mortgage conditions are fulfilled, whether collateral is saleable if necessary, and whether its expected value is still reasonable vis-a-vis size of the loan, in accordance with agreement conditions.

Documents and Features: Chattel or real estate mortgage documents. Evaluation of collateral according to market value while deducting a safety margin for credit (as mentioned in chapters on "Principles of Granting Credit").

6. Numerical Evaluation of the Five C's

After the five C's are examined for every customer, a grade is to be given to every element as follows:

ELEMENT	GRADE	NUMERICAL EVALUATION
Character	Excellent	1
	Acceptable	2
	Weak	3
Capital	Excellent	1
	Acceptable	2
	Weak	3
Capacity	Good	1
	Probable Weakness	2
	Weak	3
Conditions	Fully Abiding by Loan Agreement	1
	Minor Loan Agreement Clauses are Ignored	2
	Major Loan Agreement Clauses are Ignored	3

Collateral	Loan Fully Covered	1
	Loan Partially Covered	2
	Loan Uncovered	3

By applying the above system, the customer is numerically graded in columns 6 to 10 in "Attachment (4)" on loan classification. Column 11 shows total numerical evaluation for the customer, it is used as an indicator for a general evaluation, according to the following system:

LOAN CLASSIFICATION	**NUMERICAL EVALUATION**
Satisfactory	5 -- 7
Substandard:	
- For temporary reasons.	8
- For reasons related to repayment Schedule	9
Doubtful	10 -- 12
Bad Loan	13 -- 15

In case of doubtful and bad loans the classifier should estimate the magnitude of the expected loss, guided by the Credit Risk Assessment table (Attachment "2") for every customer in these two categories.

The loan classification report is to be signed by the highest management level in the Bank Unit, (Village Bank Manager, Branch Manager, the BDAC Chairman or PBDAC Chairman).

It is prohibited to grant new credit to a customer classified below "satisfactory". Customers classified as "doubtful" or "bad loans" should not be granted new loans for three consecutive years; even if they have repaid all their obligations.

EIGHTH: FREQUENCY OF CLASSIFICATION, ESTABLISHMENT OF PROVISIONS, AND MEMO INTEREST

1. Frequency

Loan classification, as per the method clarified above, is to be conducted twice a years at end of December and end of June. All Bank's loans should be classified.

2. Provisions

Every unit in the Bank should form provisions for doubtful and bad loans. One of the following two methods could be used; whichever is more strengthening to the provisions:

a) Total provisions to be equal to total estimated loss under the relevant column in the classification reports, (whether the report covers small working capital loans of LE 1000 per feddan, or other Bank loans).

b) Total provisions to match with the requirements of the Central Bank of Egypt, as follows:

Satisfactory Loans	1%
Substandard Loans	20%
Doubtful Loans	50%
Bad Loans	100%

In both methods, the size of the suggested provision is to be compared with the size of provision at the general ledger. The difference to be provided if the need arises.

3. Memo Interest

According to the Central Bank of Egypt's circular No. 321 overdue interest for three months is to be set aside in a "memo" account. Therefore, even though this interest has accrued, it isn't recognized as Bank's income as long as it is not actually collected from customer.

NINTH: AUTHORITY OF THE HIGHER LEVEL TO APPROVE THE LOAN CLASSIFICATION REPORT, AND THE ROLE OF INTERNAL AUDIT DEPARTMENT

Classification results are not applicable until approved form the classification committee. The committee is composed of a representative of the Credit Department at the direct higher level, a representative of the Internal Audit Department at the BDAC or PBDAC and lastly the director of the unit where the classification was conducted. The Committee's decision is through majority votes.

The way the committee is composed ensures an unbiased classification decision, not subject to the biases of credit granting bank officials.

These committees are formed twice a year; they start their job as soon as a bank unit completes its loan classification, so as not to delay the Bank's accounting operations.

Any Bank administrative level is prohibited from granting new credit to any customer that has been classified below "satisfactory", without referring to the higher level for their opinion in writing.

TENTH: CLASSIFICATION OF CUSTOMERS FOR THE PURPOSE OF FIXING DEBIT INTEREST RATES

Chapter I in this Manual, on credit policies, stated that the Board of Directors of PBDAC will from time to time determine the prime interest rate. Such rate will be for excellent customers, applying for short term loans. It was also stated that such rate will be increased according to the loan duration and the extent of credit risk. Customers were categorized into three groups a, b, and c according to credit risk.

To determine the above three classifications, the Credit Department at any of the Bank's levels should prepare a preliminary evaluation for the customer based on the five C's, as explained in the Seventh Section in this Chapter, pertaining to "Classification of Other Loans", especially item 6 on "numerical evaluation of the five C's". Naturally this evaluation is to be conducted at a late stage in reviewing the loan request, immediately before granting the credit.

Customers fall under categories a, b or c if their numerical evaluation is 5, 6 or 7 respectively.

Inherent in this evaluation is a prohibition to the Credit Department at any of the Bank's levels to start a relationship with a customer that they do not, to start with, consider to be "satisfactory".

Attachment (1)

Central Bank of Egypt
Office of the Vice Governor

September 9, 1991

Subject: Basis for Classifying Assets and Contingent Liabilities for establishing Provisions

Mr. Chairman,
PBDAC

We would like to inform you that developing and increasing the viability of the banking system in Egypt necessitate the establishment of a system, which at minimum requires classifying assets and contingent liabilities in order to create sufficient provisions to meet its deficiency. It has been decided that banks must adopt the following:

First: Assets (either loans, accounts receivables or notes and bonds and contingent liabilities) whether private sector or public sector, should be classified every three months in the following way:

1) Assets and Contingent Liabilities:

These are the assets and the contingent liabilities which investigation reveals as being difficult to collect the principal and/or interest, but for which the bank holds adequate, secured and liquid collateral in the short term. These assets and contingent liabilities should be classified as follows:

(a) Sub-Standard Assets and Contingent Liabilities: This means the existence of early signs indicating some risk in collectability and requiring caution. Examples are: poor cash flow that affects timely payment; and weakness in the balance sheet. In this situation, bank is compelled to liquidate collateral to meet its claims.

(b) Doubtful Assets and Contingent Liabilities: The same as in part 1-a, however the level of risk is greater (as an example, inadequate and unsound collateral, negative net worth, ...) to the extent that collecting all claims from the client is doubtful. Probability of loss is higher than in part 1-a.

(c) Bad (Loss) Assets and Contingent Liabilities:
The same as in part 1-b, however, it is expected to charge off a major portion or all of the claims on the client.

In addition, it is expected that the Bank will observe the time frames indicated in the attached table when classifying the irregular assets and contingent liabilities.

2) Regular (Good) Assets and Contingent Liabilities:

These are all assets and contingent liabilities which are not classified as irregular. As a general rule, loans and contingent liabilities that are secured by either cash or liquid assets (such as certificate of deposits or treasury bills) are exempted from being classified even though there may be delay in payment or other negative indicators.

Second: Every three months, provisions will have to be established at minimum according to the following ratio:

DESCRIPTION	DECEMBER 31, 1991	JUNE 30, 1992
Regular Assets and Contingent Liabilities:	1%	1%
Irregular Assets and Contingent Liabilities:		
a. Sub-Standard	10%	20%
b. Doubtful	30%	50%
c. Bad (Loss)	80%	100%

Calculating the above is based on percentages of claims on client that are deemed unsecured by collateral and which are not liquid in the short term. The collateral should be pledged to the bank according to the rules laid out in the Central Bank's directive No. 298 issued on September 17, 1987.

Third: Accounting Treatment Re. Interest on Irregular Loans:

Interest on loans that are past due three months should be recorded on a memorandum basis and NOT appear in the balance sheet as part of the loans portfolio nor as part of the profit and loss account.

Fourth: Frequency of Classification and Establishing Provisions:

Banks are to investigate at least 60% of its assets and contingent liabilities each year, which will include all balance sheet items exceeding 3% of capital. Provisions should be established at the end of each three months. The Central Bank must be informed each three months by the results of investigation and classification of assets and contingent liabilities. Provision must be established at the point of informing the Central Bank.

Classification should be an on-going process and prepared by bank officials. The results of this process should be presented to the Board of Directors, a board committee, or any other senior official not in charge of granting credit. Credit files must be complete. They must include sufficient information to facilitate the investigation process in order to perform the classification process. Thus, as a minimum requirement credit files must include the purpose of the loan, sources of payment, collateral, the evaluation of collaterals and the legal documentation to support pledging.

Fifth: Government Guarantees of Loans:

The Central Bank reminds banks not to rely on any government guarantees of loans or contingent liabilities unless explicitly approved by the Minister of Finance.

Sixth: This directive replaces directive number 318 issued on May 15, 1991.

With respect.

Vice Governor

Farouk Mishriky

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Basis of Classifying Irregular Assets and Contingent Liabilities

(1) The Current Situation

Description	Sub-Standard	Doubtful	Bad
<u>Debit Current A/C's</u> Client broke agreement with the bank and in particular:			
- Deposits are less than interest for a period that exceeds	6 mons	9 mons	12 mons
- That the debit balance exceed the authorized amount by 5% or more for a period over	6 mons	9 mons	12 mons
<u>Loans and Contingent Liabilities</u> loans and contingent liabilities that are due and never been paid either for principle or interest for a period over	6 mons	9 mons	12 mons
<u>Notes</u> Principle or interest are due and never been paid for a period over	1 mon	3 mons	6 mons

(2) At the End of Dec. 1991

Description	Sub-Standard	Doubtful	Bad
<u>Debit Current A/C's</u> Client broke agreement with the bank and in particular:			
- Deposits are less than interest for a period that exceeds	5 mons	8 mons	12 mons
- That the debit balance exceed the authorized amount by 5% or more for a period over	5 mons	8 mons	12 mons
<u>Loans and Contingent Liabilities</u> loans and contingent liabilities that are due and never been paid either for principle or interest for a period over	5 mons	8 mons	12 mons
<u>Notes</u> Principle or interest are due and never been paid for a period over	1 mon	3 mons	6 mons

Basis of Classifying Irregular Assets and Contingent Liabilities

(3) At the End of March 1992

Description	Sub-Standard	Doubtful	Bad
Debit Current A/C's Client broke agreement with the bank and in particular:			
- Deposits are less than interest for a period that exceeds	4 mons	7 mons	12 mons
- That the debit balance exceed the authorized amount by 5% or more for a period over	4 mons	7 mons	12 mons
Loans and Contingent Liabilities loans and contingent liabilities that are due and never been paid either for principle or interest for a period over	4 mons	7 mons	12 mons
Notes Principle or interest are due and never been paid for a period over	1 mon	3 mons	6 mons

(4) At the End of June 1992

Description	Sub-Standard	Doubtful	Bad
Debit Current A/C's Client broke agreement with the bank and in particular:			
- Deposits are less than interest for a period that exceeds	3 mons	6 mons	12 mons
- That the debit balance exceed the authorized amount by 5% or more for a period over	3 mons	6 mons	12 mons
Loans and Contingent Liabilities loans and contingent liabilities that are due and never been paid either for principle or interest for a period over	3 mons	6 mons	12 mons
Notes Principle or interest are due and never been paid for a period over	1 mon	3 mons	6 mons

Attachment "2"

CREDIT RISK ASSESSMENT REPORT

Name of Bank Unit (that follows-up the loan): Village Bank or Branch: ----------
Name of Customer:
Date of Assessment:

First: CREDIT

Type	Authorized Limit	Outstanding	Overdue Unpaid	Due Date
Short term				
Medium term				
Long term	_____	_____	_____	_____
Total	_____	_____	_____	_____
Interest				
Overdue unpaid				
Not yet due				
		_____		
Total Claims on Customer			(a)	
		_____		

Second: SUMMARY & EVALUATION OF COLLATERAL *

Type of Collateral	Estimated Value
Saving/deposit account	
Crops under pledge	
Commodities under pledge	
Accounts receivable	
Machinery & equipment	
Livestock	
Poultry	
Land	
Buildings	
Other	
	_____

Total Present Value of Collateral _____ (b)

Collateral Excess (or shortage) over Credit (b) - (a) =

Prepared by ---------- Reviewed & Approved by ----------

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* For collateral evaluation, safety margins are deducted from present value, as explained in the chapters on "Principles of Granting Credit."

Attachment "3"

LOAN CLASSIFICATION REPORT
FOR OPERATIONS (WORKING CAPITAL) LINE
OF CREDIT OF L.E. 1000 PER FEDDAN
AS OF ..../..../19...

Bank Unit: Name of Village Bank

Customer's Name	Account No.	Date of Granting Credit	Repayment Date	Credit					Classification				Estimation of Expected Loss	Comments
				Authorized	Outstanding	Unpaid Interest Due	Interest Not Yet Due	Total	Satisfactory	Substandard	Doubtful	Bad		

Prepared by: ----------

Reviewed and Approved by: ----------

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Attachment "4"

LOAN CLASSIFICATION REPORT
AS OF ..../..../19...

Customer's Name	Account No.	Granted Credit	Outstanding Credit	Number of Loans	Five C's and Numerical Evaluation					Final Evaluation	Classification	Estimation of Expected Loss	Comments
					Character	Capital	Capacity	Conditions	Collateral				
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)

Prepared by: ----------

Reviewed and Approved by: ----------

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CHAPTER V

FINANCIAL POLICIES

FIRST: INTRODUCTION

The Bank's financial policies refer to the set of rules that the Bank applies to achieve the following three purposes:

1. The debit and credit interest rates structure, that the Bank offers to its customers, to be highly competitive in the Egyptian banking market, so as to achieve long term growth for the Bank.

2. The Bank's sources of finance to be renewable and constantly growing, so as to expand the base of funds available for credit, which is so far the main purpose of the Bank.

3. The Bank's sources of finance to have longer duration than its uses, so as to avoid liquidity problems.

The only way to achieve the above mentioned three purposes is to collect information either from inside or outside the Bank, and analyze it carefully, to deduce the approach that the Bank should follow within the following framework:

Policy	Policy Components	Source of Information
1. Determination of debit and credit interest rates structure	* Market interest rates	* Periodical follow-up on treasury bills' interest rate, and the Central Bank of Egypt's discount rate. * Follow-up on credit interest rates announced in newspapers by commercial banks. * Using investigation departments in collecting information about debit interest rates.
	* Cost of funds	* Periodical analysis of components of credit interest rates by referring to the Bank's trial balance produced on "accrual" basis.
	* Administrative cost	* Periodical analysis of elements of the Bank's administrative cost by referring to Bank's trial balance produced on "accrual" basis.
2. Renewing Bank's sources of funds	* Renewing and growing deposits	* Periodical check of balances and costs of deposits by referring to Bank's trial balance produced on "accrual" basis. * Conducting market studies to determine customers' needs and how to satisfy them. * Use Bank's units to obtain information on customers' needs.
	* Renewing and increasing foreign loans	* Analysis of foreign loan contracts and follow-up on implementation according to contract conditions, so as to encourage international organizations to offer more loans with easier terms. * Check reasons for slow utilization of some foreign loans in an attempt to activate it or amend their terms and conditions.

	* Overdraft from commercial banks	* Using investigation departments to collect information about interest rates on inter-bank borrowings.
3. Matching sources of funds with uses of funds	* Estimation of average loan duration	* Periodical analysis of Bank's trial balance, provided it is properly classified and produced on "accrual" basis.
	* Estimation of average length of deposits.	* Using sampling techniques to collect more information on deposits

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It is evident from the above framework that information taken from the Bank's General Ledger is essential to a rational bank financial policy. The accuracy of information derived from the General Ledger depends on two important principles:

1. Proper classification of accounts by following the Accounting Manual.

2. Accurate measure of income and expenses accounts by using the principle of "accruals". The Accounting Manual, which has been applied in the Bank starting July 1993, achieves both principles if it is properly and fully applied.

The framework presented above will be used in this chapter to present the Bank's financial policies.

SECOND: BANK'S SOURCES OF FUNDS

The purpose of identifying the Bank's sources of funds is to define the instruments of finance whose proceeds are used by the Bank for offering credit to its customers.

1. Deposits

These include the following types:

a. Current Deposits:	Allowed to non-individuals only.
b. Time Deposits:	For one year, one to five years, and more than five years.

c. Certificates of Deposit:	With monthly income, quarterly income, or with cumulative value.
d. Saving Deposits:	(With prizes)
e. Other Deposits:	Related to end-of-service remuneration, payments under letters of guarantee or letters of credit, down payments.

The Bank's policy aims at expanding in deposit solicitation being a stable source of funds that is less costly than borrowing from commercial banks. Also the Bank has a mission at the national level which is attracting rural deposits with the purpose of triggering rural development. There is no way of achieving fast rural development without a banking system based on intermediation.

2. Foreign Loans

In view of importance of PBDAC's role in financing and developing the agricultural sector, it gets credit facilities from international organizations such as: The World Bank, The Economic European Community, IFAD, KFW and the African Bank for Development.

The Bank's policy is to expand in obtaining foreign loans provided their interest rate is less than local interest rates. Foreign loans achieve the following purposes:

* Foreign loans are usually long term, compared to local sources of funds like deposits, therefore this provides stability of sources of funds.

* Usually, foreign loans include a technical assistance component that keeps the Bank in touch with international organizations and exposes the Bank to new technologies.

3. Overdraft Accounts with Commercial Banks

The PBDAC resorts to borrowing from commercial banks in order to meet its loan portfolio requirements. Overdraft accounts are short term, and subject to interbank borrowings rate of interest. The latter is highly sensitive to financial market fluctuations.

The Bank's policy is to reduce the use of overdrafts as a source of funding by increasing deposits and foreign loans as well as improving equity.

4. Equity

This includes Bank's capital and reserves, as well as capital grants that the Bank obtained in support of its role in financing and developing the agriculture sector.

The Bank's policy aims at increasing its reserves every year through profit retention, and solicitation of capital grants.

THIRD: EMPHASIZING PRODUCTIVE ASSETS

With the exception of equity, each source of funds has its own cost. For example there is interest on time deposits, on saving accounts, on foreign loans and on overdraft accounts with commercial banks. Therefore, these resources should be fully utilized in credit whose rate of return covers cost of funding, Bank's administrative costs, as well as achieve a reasonable profit as a return on Bank's equity.

Consequently, financing non-productive assets or assets that have a lower rate of return than that on credit (or lending) is considered a reduction of potential profit. The Bank's policy is to reduce non-productive assets to the lowest level possible. Specifically, the Bank's policy is:

1. To reduce, or get rid of, accounts receivable from government and companies, specially after the Bank divested itself from distributing production inputs.

2. To reduce balances of "other assets", and offset them with the corresponding "other liabilities"; and to restrict future growth of "other assets" and "other liabilities".

Since the Finance Sector is responsible for implementing the Bank's financial policy, they should coordinate with the Accounting Sector to implement the above two policies.

FOURTH: UNIT FOR GATHERING INFORMATION

A unit for gathering information to be established within the Finance Sector, supported by computer capability to store and analyze information. This unit will gather the following information:

1. Interest Rate on Treasury Bills

The Ministry of Finance issues three types of treasury bills: ninety one days bills, 6 months bills, and one year bills. The interest rate on each type is announced by the Central Bank of Egypt in the local news papers.

The unit referred to above should form a time series about interest rate development for each of the three types of treasury bills.

The importance of this information is that interest on the treasury bills is currently a pivot in determining the discount rate and other interest rates in the Egyptian market.

2. The Central Bank's Discount Rate

Starting January 1991, the Central Bank of Egypt's policy has been to fix its discount rate at about two points above the average interest rate on the 91 days treasury bills. The Central Bank issues a circular to all banks to announce its discount rate whenever there is a significant change in the interest rate on treasury bills.

The Bank unit concerned with gathering information should form a time series of the discount rate, in order to forecast interest rates in the future.

3. Credit Interest Rates

The public commercial banks advertise their interest rates on deposits either in the newspapers or in its branches halls. This is considered a good indicator of credit interest

rates. They reflect the status of liquidity at the commercial banks. In turn, they affect the depositors at the PBDAC. This information is used to adjust credit interest rates at the PBDAC, so as to be competitive.

The unit referred to above will gather information on credit interest rates in the four public commercial banks at least once a month. Information will be stored on the computer until needed for analysis.

4. Debit Interest Rates

There is no published information on debit interest rates. In fact banks consider these to be confidential information. Knowing the interest rate applied on a given customer can not be generalized because it is linked to certain conditions in the loan agreement.

Therefore, the search for information about debit interest rates should be done very discretely. For the most part, it all depends on work relationship between Bank's officers and counterparts in other banks.

Yet there are some unofficial sources of information which may be used to obtain some knowledge about debit interest rates. They are:

* Effective and continuous participation in the Banks' Association meetings and establishing professional relationships.

* Some of the members of PBDAC's senior management are also Board members of investments banks. They may be asked about trends in debit interest rates in latter banks.

* Some of the members of PBDAC's senior management are Board members for public holding companies as well as subsidiary companies. They may be asked about debit interest rates applicable to their respective companies' bank borrowings.

* The Bank's Credit Department, can be a good source of information regarding customers who demand reduction in debit interest rates because they are getting better offers from competitive banks.

All information collected should be dealt with in confidentiality, and should only be used to know about the Bank's competitive standing.

5. Interbank Interest Rates

There is no published information about interbank interest rates; and there is no motive for banks to advertise such information as long as there is no serious buyer or seller of liquid assets. What complicates things further is that interbank transactions are of very short term, only a few days in most cases. Also it is done between banks that have common interest, for example between a holding bank and a subsidiary bank.

The information gathering unit should collect some unofficial information on interbank interest rates through its relationship with the Bank's Association or by checking with some senior management of the PBDAC who are Board members of other banks.

The above information is specifically important because it is a strong indication with respect to interest rates on overdraft accounts with commercial banks.

6. Newspapers Clips

The local newspapers, specially the financial and economic ones, publish financial analysis and comments by senior government and banks officials on issues like inflation, interest rates and exchange rates. The Unit should keep such information well arranged and classified by subject, in order to be used in interest rates forecasts.

FIFTH: COST OF FUNDS

1. Definition

There is a cost to each source of funding, with the exception of equity. The Bank pays interest on deposits. Also, the Bank pays interest on overdraft accounts with commercial banks. Finally, the Bank pays charges on foreign loans which include, commitment fee, interest on used funds, and a low percentage on unused funds.

2. Methods of Measurement

Like any other measurement of cost, cost of funding is calculated by two methods: average cost and marginal cost. The basic difference between the two methods is the time factor. The average cost covers a period in the past; that may be one year or less. Therefore calculation thereof takes into account all credit interest rates applicable during the period under review.

On the other hand, the marginal cost is based on present (spot) cost, thus calculation thereof is based on present credit interest rates.

To emphasize the above, it is noted that during fiscal year 91/92 the Bank changed its credit interest rates structure three times to keep up with the changes in the financial market resulting from the new economic reform policy. Thus, in measuring the average cost of deposits during FY 91/92, we get the ratio of "costs of deposits" to "monthly average balances of all deposits". As to marginal cost, it is associated with a specific date; so measuring marginal costs for deposits at year-end for example, is by applying last schedule of credit interest rates to deposits' balance on that date.

3. Sources of Information

To calculate average cost and marginal cost, there is a need to collect information on sources and costs of funds on monthly basis by referring to the monthly consolidated trial balance prepared by the Accounting Sector.

According to the Accounting Manual issued on July 1st, 1993, this information is detailed as follows:

Source of Funds Name of Account	Account No. In General Ledger	Name of Cost Account	Account No. In General Ledger
a) Deposits:			
Current	Sub-group 41	Interest on current accounts	7401
Time Deposits	Sub-group 42	Interest on time deposits	7402

Saving Certificates	Sub-group 43	Interest on saving certificates	7403
Savings Accounts	Sub-group 44	Interest on savings accounts	7404
Other Deposits	Sub-group 45	Interest on retirement fund	7409
b) Overdraft with Commercial Banks:	4601, 4602 4603, 4604	Interest on overdraft	7407
c) Foreign Loans and Grants:	Sub-group 57 Sub-group 58	Interest on foreign loans	7410

Naturally the above table should be updated every time there is a change in the Accounting Manual. Also it should be modified every time the Finance Sector identifies and uses a new source of funds.

4. Average Cost of Funds

The definition of average cost of any source of funds is =

$$\frac{\text{Cost of Source of Funds}}{\text{Monthly Average Balance of the Source of Funds}} \quad \text{during a specified period}$$

All this information is historical, so the basis is to define the period in concern. This ratio is usually calculated for every source of funds for the previous fiscal year, then it is calculated for every month and year to date for the current fiscal year.

As to the general definition for the average cost for all sources of funds, it is:

$$\frac{\text{Cost of All Source of Funds}}{\text{Monthly Average Balances of All Sources of Funds}} \quad \text{during a specified period}$$

Monthly average of all sources of funds includes all types of deposits, overdrafts, foreign loans and equity.

5. Marginal Cost of Funds

The marginal cost of funds is usually calculated only upon changes in interest rates on deposits and overdraft. Interest rate on foreign loans rarely change, they are subject to long term contracts.

The marginal cost of funds can be calculated according to the following table:

Sources of Funds	Balance on Last trial balance	Relative importance to all sources of funds	Last applicable interest rate on the source of funds	Share of this source of funds in marginal cost of funds

Deposits:

Current
Time Deposits
Saving Certificates
Savings Accounts
Other Deposits

Overdraft:
Foreign Loans:
Equity:

TOTAL	_____	_____	_____
		100	
	_____	_____	_____

The share of a source of funds in the marginal cost of funds = Relative importance to all sources of funds x the last applicable interest rate on the source of funds.

The marginal cost of funds is the summation of the last column, and it is a percentage.

6. Comparison Between Average Cost and Marginal Cost

The average cost of funds is by nature historical, and it is the most important item of Bank expenses. It is therefore necessary to trace it historically, being a major component of profit calculation.

The marginal cost of funds by nature concentrates on present cost, therefore it is an indicator of the direction of the average cost of funds in the near future.

Hence it is expected that the marginal cost of funds will have larger fluctuations than the average cost of funds.

While the average cost of funds is used to monitor the Bank's profitability, the marginal cost of funds is used to determine the Bank's prime debit interest rate, as will be explained in this manual.

7. Basic Conditions for Calculating Average and Marginal Costs of Funds

The above explanation leads to emphasizing the following points:

a) The Importance of an Accrual System:

The accrual system means that every expense and revenue items is charged to the concerned accounting period, regardless of timing of actual cash settlement. If the accrual system is not applied accurately and periodically, all calculations and measurements of the cost of funds are considered to be a waste. For example, how would cost of deposits for a given month be calculated without charging the related interest accrued for that month.

b) The Importance of Minimizing Non-productive Assets and Reducing Non-classified Items i.e. Other Assets and Other Liabilities:

As a condition to calculate average and marginal cost of funding, provisions are deducted from their respective assets because provisions themselves are not a source of funding. As a condition to calculate both costs, other assets and other liabilities are reduced to the lowest possible level, till the

funding sources dominate the liabilities side in the Bank's balance sheet. The idea is to relate funding sources to productive assets and see how good are these funding sources invested.

c) The Importance of Producing the Trial Balance Accurately and Periodically:

All measurements related to cost of funds have a direct effect on the Bank's profitability. Accuracy is therefore essential in preparing the monthly Trial Balance, also timely submission thereof to PBDAC. This enables the Sector of Finance to measure the cost of funds and present it to Bank's senior management.

8. Monthly Report on Cost of Funds

The Sector of Finance prepares a monthly report on cost of funds, for Bank's management, as follows:

AVERAGE COST OF FUNDS

Source	Balance at End of Current Month	Average Monthly Balance Year-to-date	Cost In Current Month	Average Cost Year-to-date	Cost Rate For Current Month	Cost Rate Year-to-date	Cost Rate Last Year
Deposits							
Current							
Time Deposits							
Saving Certificates							
Savings Accounts							
Other Deposits							
Overdraft							
Foreign Loans							
Equity							
TOTAL							

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All the above data is obtained from the monthly consolidated Trial Balance.

As to marginal cost of funds, it is calculated by the method presented above, under item 5 of this section "Marginal Cost of Funds", every time there is a change in credit interest rates, as previously mentioned.

9. Analytical View of the Marginal Cost of Funds

The analysis of Bank's consolidated financial statements reveals that overdraft from commercial banks has been, and still is, a significant source of funds for the Bank. Yet its relative importance is diminishing because the Bank has been active in deposit mobilization, which is a move towards a desired direction.

Assuming that Bank's deposits will continue to grow at a relatively high rate like in the last two years, then overdraft from commercial banks is expected to continue to be a source of funds for the Bank in the medium term, 3-5 years.

Thus any substantial increase in loan portfolio in the sort-run will have to be funded by heavier reliance on overdraft accounts with commercial banks than on growth in deposits.

The Bank often faces large loan requests, "over L.E. 5 million". This kind of requests is subject to strong competition with commercial banks. Competition is mainly through the interest rate.

In negotiating interest on large loan requests, it is advisable to assume that cost of funds is the interest rate paid on bank overdraft only. The latter rate is usually slightly higher than average interest rate on deposits at the lending bank.

This advice gives the Bank an edge in negotiating with the prospective customer.

SIXTH: DETERMINATION OF ADMINISTRATIVE COST

1. Definition

Administrative cost includes all cost items related to the Bank as a financial institution. Therefore it includes all payroll charges, i.e. base salaries, incentives, fringe benefits, and employer's contribution to payroll social insurance. It also includes all operating costs such as rentals, office expenses, utilities and telephones... etc.

Administrative costs include previous years expenses if related to wages and operating expenses. Also included are provisions, or actual losses incurred by the bank on contingent liabilities or court orders.

However, administrative cost does not include depreciation as this is directly deducted from the value of fixed assets. Similarly, it does not include provisions for bad and doubtful debt, as these are directly deducted from the loan portfolio. The procedure of deducting provisions from the value of their respective assets does not conform with accounting principles; yet it is done for the purpose of financial analysis.

2. Methods of Measurement

Administrative cost is measured on the basis of actual, "historical" costs, with proper application of the accrual system. Information is therefore derived from the General Ledger and monthly Trial Balance.

Since the Bank has an employee redundancy problem, then the marginal cost of labor is zero.

3. Sources of Information

Information related to administrative costs are available in the Bank's consolidated Trial Balance.

According to the Accounting Manual issued on July 1, 1993, related accounts are as follows:

Administrative Cost Items	**Account Number in the General Ledger**
a) First Chapter	
Base Salaries	7101
Bonuses	7102
Incentives	7103
Allowances	7104
Cash Benefits	7105
Benefits In-kind	7106
Social Insurance	7107

b) Second Chapter

Commodities	7201
Services	7301
Transfers	7421
Provisions (Only for contingent liabilities and court orders)	7501
Other Expenses	7551
Previous Years Expenses (If related to wages and operating costs)	7701

4. Relating Administrative Costs to Loans

Profitability equation for banks may be presented as follows:

Profits Before Taxes =

Return on Loans + Return on Investments - Cost of Funds - Administrative Costs

And since PBDAC and the BDACs are specialized banks, i.e. with very small and almost non-productive investments, then the above equation can be simplified as follows:

Profit Before Taxes =

Return on Loans - Cost of Funds - Administrative Costs

If both sides of the equation are divided by the volume of loans, the result is:

Profit as a Percentage of Loans =

Average Interest Rate on Loans - Average Interest Rate on Sources of Funds - Administrative Costs as a Percentage of Loans

And since sources of funds should ideally be equal to volume of loans, then the above equation is balanced mathematically and financially.

For Example:

Bank's Profit as 1% on Loans =

17% as Interest on Loans - 11.5% of Sources of Funds as Interest thereon - 4.5% as a Ratio of Administrative Costs to Loans

The above equation leads to three important financial principles:

a) When relating administrative costs to loans, the latter should be net of provisions for bad and doubtful debt.

b) The above analysis shows the importance of ridding the Balance Sheet from all non-productive Bank assets, by deducting provisions from their respective assets, and minimizing "other assets" and "other liabilities", so that sources of funds will roughly equal net value of loans (productive assets).

c) Since interest rates are determined by financial market forces, outside the realm of the Bank, then the best way to maximize profits is to minimize administrative costs as a ratio to loans. This strengthens the Bank's competitive standing with other banks.

5. Monthly Report on Administrative Costs

Administrative Cost Items	Year to Date Previous Month	Cost of Current Month	Year to Date Current Month	Comparative Year
a) Chapter One				
Base Salaries				
Bonuses				
Incentives				
Allowances				
Cash Benefits				
Benefits In-kind				
Social Insurance				

b) <u>Chapter Two</u>

Commodities

Services

Transfers

Provisions

Other Expenses

(Previous Years Expenses)

TOTAL ADMINISTRATIVE COSTS	_____	_____	_____	_____
Net Loans After Deducting Provisions for Bad and Doubtful Debt	_____ (1)	_____ (2)	_____ (3)	_____ (4)
Ratio	_____	_____	_____	_____

1. Monthly average of loan balances (net of provisions), from beginning of fiscal year to the end of previous month, is derived from the monthly Trial Balance.

2. Net outstanding loans at end of current month .

3. Year-to-date monthly average of net outstanding loans.

4. Monthly average of net outstanding loans from beginning of last fiscal year to the end of comparative month.

The definition of outstanding loans follows the general ledger codes indicated below:

Short Term Loans	Sub-Group 21, 22, 23
Medium Term Loans	Sub-group 24, 25, 26
Long Term Loans	Sub-group 27

As to the definition of provisions for bad and doubtful loans is the balance of accounts number 5901 and 5902.

6. Final Remarks

Every now and then, the Sector of Finance may decide to provide top management with explanations for amounts appearing in monthly reports of administrative costs. This includes non-recurring expenses, such as: advertising campaigns and the impact of incentive distribution during festive periods. The idea is to remove sudden changes in the time series of administrative costs ratio.

SEVENTH: DETERMINING DEBIT AND CREDIT INTEREST RATES

1. Introduction

Starting July 1992, the PBDAC began to divest from distributing production inputs. This activity comprised 40% of the Bank's revenue and employed an equivalent percentage of its manpower.

The divestiture policy is causing the Bank to face a challenge regarding reduction of administrative costs. It is noted that while payroll cost remained at almost the same level, revenues from distribution of inputs decreased to 17.5% of Bank's total revenues in FY 92/93.

2. Allocation of Administrative Costs Between the "Lending" Activity and the "Input Distribution" Activity

Given that the Bank's main purpose now is "credit", and given that the input distribution activity is shrinking, then the current Bank's policy is to allocate to the input-distribution activity part of its administrative costs that is equal to revenues from such activity. Remaining administrative costs to be allocated to the "credit" function.

The outcome of this policy is to keep the input-distribution's results of operation at a breakeven point, and let the credit function absorb the remaining administrative costs.

According to the above policy, the Finance Sector is to determine, in the beginning of every fiscal year, the percentage of administrative costs that should be allocated to input-distribution activity. In doing so they would be guided by the previous year results of operation and Bank's policies in current year. Such a percentage is an approximation and may be modified during the course of the year.

3. Financial Market Impact on Interest Rates

In determining interest rates, Egypt's financial market is affected by the interest rate on treasury bills, the Central Bank rate of discount, and the status of liquidity in commercial banks.

The financial market plays a major role in determining interest rates. Banks compete among themselves within a range of +/- 1%. Thus, the data on interest rates, collected from the market by the Bank Information Unit, has a major impact on the Bank's decision in fixing interest rates.

Since the Bank is in strong competition with the other banks, it should continuously follow-up all developments in the financial market, so as to maintain a competitive standing.

4. Administrative Costs Impact on Interest Rates

As mentioned before the Bank's profitability equation can be stated as follows:

Profit as a Percentage of Loans =

Average Interest Rate on Loans - Average Interest Rate on Sources of Funds - Administrative Costs as a Percentage of Loans.

And as interest rates on loans and sources of funds are exogenous variables determined by the financial market, the Bank's way to maximize profits and compete with commercial banks, is to minimize administrative costs. This requires the collaboration of all Bank Unit.

5. Recommendation on Determining Interest Rates

It is clear from the above explanation that determining interest rates is subject to the proper interpretation of the financial market movements, as well as continuous efforts to reduce administrative costs.

The Finance Sector will assume responsibility of giving to Bank's management a recommendation on determining interest rates, supported by relevant information. The Finance Sector will also present the cost/benefit of this recommendation, guided by the Bank's profitability equation.

The Finance Sector can make use of the material presented below, under "Eighth-3", regarding the average loan duration and the average deposits duration, in determining the average interest rate on loans as part of the profitability equation.

EIGHTH: RENEWING SOURCES OF FUNDS AND MATCHING WITH USES

The Finance Sector should develop its Deposit Unit so as to perform the following tasks:

* Renewing and expanding the deposit base
* Renewing and increasing foreign loans and grants
* Estimating the average loans duration
* Estimating the average deposit duration

More details on the above tasks are given below.

1. Renewing and Expanding the Deposit Base

The main purpose of this task is to design a strategy to promote deposits, within an annual plan. The components of this strategy are: development of deposit products, simplifying deposit procedures, and designing and advertisement campaign directed to prospective customers of the Bank.

The design of the strategy, and annual implementation workplan, will require field marketing studies on clients' needs, seeking information and suggestions from employees at the Branch and Village Banks levels, and the use of marketing experts either from consulting firms or universities.

The Finance Sector prepares an annual plan for deposit promotion, based on the above mentioned studies and BDACS' plans; also including a budget for promotion. The plan is to be submitted to Bank's senior management for approval, then circulated to BDACs for implementation.

The plan is also to be shared with all Bank sectors to get them to know about Bank's efforts in deposit solicitation, particularly that marketing in general should be a concern of all Bank employees.

2. Renewing and Increasing Foreign Loans and Grants

As a result of the economic reform policy in Egypt, foreign currencies are now abundant, and foreign loans have become less important as a source of funds. However, foreign loans are desirable for reasons other than being a source of foreign currency, namely:

* Dealing with international organizations such as the World Bank implies that the PBDAC is financially viable. Thus, other organizations such as the EEC and IFAD are encouraged to provide the Bank with long term loans at easy conditions.

* Foreign loans are usually of longer term than local sources of funds, and at lower interest rates. (N.B. yet they require provisions for foreign exchange fluctuations).

Thus, foreign loans usually involve a reduction in cost of funds, as well as stability of sources of funds due to their long-term nature.

* Foreign loans usually include a grant to provide technical assistance. This feature helps in reducing cost of funds as well as providing a window on new technology.

The PBDAC has foreign loans agreements with the USAID, the World Bank, EEC, IFAD, the African Development Bank and KFW. Negotiations with the above organizations are highly sensitive because the purpose is to obtain foreign loans at a lower cost than the local cost of funds. This requires highly professional judgment.

In this area, the Finance Sector is responsible for performing the following tasks:

a) On New Foreign Loans:

The Finance Sector is to closely participate in the negotiations that precede a foreign loan agreement. The said sector reviews the contract conditions, submits related recommendation to Bank's top management, and follows up on the protocol leading to signing the contract. The Finance Sector is the liaison office between the funding source and the Bank throughout loan lifetime. Finally, the Finance Sector is responsible for preparing periodical follow-up reports required by the funding source.

b) Follow-up on Outstanding Foreign Loans:

The Finance Sector is responsible for implementation of foreign loans contracts terms and conditions on utilization and repayment. In doing so, the Finance Sector may ask for cooperation from other Bank's sectors. The Finance Sector is also responsible for preparing periodical follow-up reports that may be required by the funding source.

The Finance Sector, is to prepare working papers on major foreign loans indicating their performance, benefits to the Bank, as well as weaknesses. This helps Bank's senior management obtain adequate information, so as to modify the loan conditions if necessary, to increase them, or to cancel them.

c) Communicating with International Organizations:

The Finance Sector is to establish channels of communication with the international organizations that the Bank deals with, as well as other international organizations that the Bank can potentially deal with, e.g. Arab Development Funds. The purpose is to identify opportunities available to the Bank and to arrange for applying.

3. Estimating Averages Loan and Deposit Duration

One of the basic principles of finance is that sources of funds should have longer average duration than uses of funds, in order to avoid liquidity problems.

To identify the Bank's status vis-a-vis the above mentioned principle, it is necessary to estimate the average duration of deposits and loans. The Finance Sector may use probability samples techniques to obtain this information.

Sample techniques are less costly and more accurate in this context. The Finance Sector may use consulting firms to determine these estimates.

This study is to provide al least the following information about the sample units:

Information	Loans	Deposits
Size	Size of Loan	Size of Deposit
Duration	Loan Duration	Deposit Duration
Interest Rate	Interest Rate on Loan	Interest Rate on Deposit
Type	- Short Term - Medium Term - Long Term	- Current - Time Deposit - Saving Certificates - Savings Accounts - Other

The above design will allows for generalization of results of the sample survey to the Bank's loan and deposit structure.

The Finance Sector is to prepare a report on the results of the study for submission to Bank's management. The report is to include estimates of foreign loans' duration according to their contracts, and recommendations regarding matching sources of funds with their uses, while taking into account overdraft from commercial banks as well as equity.

The Finance Sector should prepare this kind of report once a year and present it to Bank's management, so as to assess improvement in matching sources of funds with their uses.

NINTH: THE FUTURE OF PBDAC'S FINANCE SECTOR

The PBDAC, as a financial institutions, considers money as a commodity subject to sale and purchase. The opportunity of realizing profit is not only through lending money at a suitable return, but also through attracting it at a reasonable cost. In other words the Bank's purpose is not only to lend but also to obtain deposits.

While deposits at PBDAC currently cover more than 50% of its loan portfolio, the Bank's objective is to expand deposits not only to cover the loan portfolio but also for the bank to become an exporter of deposits to other banks in Egypt. This mainly involves increasing bank services, banking awareness in the rural sector, so as to attract its deposits.

The main goal behind presenting the principles of finance in this manual is to lay the ground for the Finance Sector to handle the treasury function in the future once there is a surplus of deposits over loan portfolio. When the Bank reaches that stage, this manual should be re-written, with a different set of rules of finance, so to accommodate the new situation.