Procedures for Guaranteed Loans

Basic Types of Loans, Loan & Guarantee Application, Follow-up
Amended as of February 15, 2010

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1. Preamble

This brochure is intended to sum up and explain basic procedures otherwise contained in "Participating Bank Agreement" and "Operating Guidelines".
In addition, in order to provide some basic banking guidelines, we have added the following items:

- a brief explanation as to what types of loans are suitable for what purposes, and how to negotiate with potential borrower terms of such loans, without exposing bank to unnecessary risks.
- basic explanation of recommended clauses for loan agreements (used in international banks).
- basic instructions, how to describe potential borrowers and their relevant markets.
- recommended tables which can be used both in loan and guarantee applications.

2. Types of loans

In many cases decision of type of loans should be clear – if the client needs financing of purchase of fixed assets, the banker tries to arrange a fixed asset financing (capex) loan. If the client needs to finance inventories or receivables, the banker should try to arrange a working capital loan.
If the client needs to finance both fixed assets and working capital, it is highly advisable to provide 2 different loans reflecting 2 different purposes of the loans.
The recommended limits to loans are dependent of financial outlooks of the client. Such outlooks are usually reflected in financial projections. These are frequently based upon the existing historical financial statements. For decision making re volume of loan, please see ICBG brochure "Financial Analysis Guide for SME Borrower". Recommendable limits to loans may vary according to:

- Cash flow generation outlooks of the client.
- Type of loan (fixed asset versus working capital).
- Type of activity of client (production versus trade).
- Outlook of industry of the client.
- Reputation of the client.
- Whether loan is secured, partially secured or unsecured.
- And finally also according to type and reliability of collateral (real estate versus movable collateral versus no collateral at all).
- Other factors may also play some role in deciding level of risk banks want to take in specific cases – e.g. security risks in the given location etc.

For basic information about types of loans, please see the following text.

2.1. Secured versus Unsecured Loans

Secured or partially secured loans are not without risks. The collateral security may lose part or all of its value, movable security can disappear etc. In general, secured and partially secured loans are safer, because the borrower has something to lose by eventual foreclosure (seizure of fixed assets), and therefore tries harder to repay the loan.
Providing totally unsecured loans to SME lenders is not recommendable without support of third party guarantees or guarantee company. If the client does not have sufficient collateral, the bank should investigate possibility of getting ICBG guarantee. The "collateral security" may include a combination of:

- Pledge of the financed assets (machinery, real estate, inventories, receivables etc) if it is legally feasible. It is advisable to take pledge of the financed assets even if legislation does not allow for easy foreclosure of such assets. It is a legal obstacle for the borrowers against selling such assets without repayment of loan. This is important if the borrower falls into troubles and is eventually tempted to minimize repayment of loan.

- Pledge of reliable real estate collateral. This should be duly registered in "Land Register" books. The bank should make fair appraisal of value of such collateral, in order to avoid risk of a fraud based upon taking loan against overvalued collateral and subsequent wilful default on repayment of loan.
- Additional security: Third party guarantees, third party accession to debt, development guarantees (ICBG) etc. It is advisable to combine eventual ICBG guarantee with some other security or guarantee. Even if such security is relatively small, it is still something the borrower may lose. It is also advisable for banks to get security promissory notes signed by borrower.

2.2. Committed versus Uncommitted Working Capital Loans

Uncommitted loans are repayable upon request of bank. They are provided "Until Further Notice" (UFN). Providing an uncommitted loan is a great legal advantage for bank and a great disadvantage for borrower. Uncommitted facilities are usually credit lines provided for very good clients with more banks. Such clients usually rely upon drawing loans from more banks and can therefore risk taking uncommitted lines.

Uncommitted credit lines frequently cover more products – usually revolving loans, sub-limits for overdrafts, guarantees, Letters of Credit, and financial derivatives.

SME borrowers usually do not like taking uncommitted credit lines – they do not want to be exposed to danger of sudden un-planned withdrawal of financing. Banks are sometimes able to offer lower interest rates for uncommitted credit lines, because their risk is somewhat smaller in case of un-committed loans.

Fixed Asset financing loans are always committed – sudden withdrawal of financing is not technically possible

2.3. Purpose of Loan: Fixed Asset versus Working Capital Loans

The borrower should give clear information, whether he needs loan for financing of current assets (working capital) or fixed assets (capital expenditures – in banking jargon called as "capex" loans).

In case the client needs both working capital and capex financing, it is advisable to provide two separate loans. It is because these two purposes are usually best served by different repayment schedules.

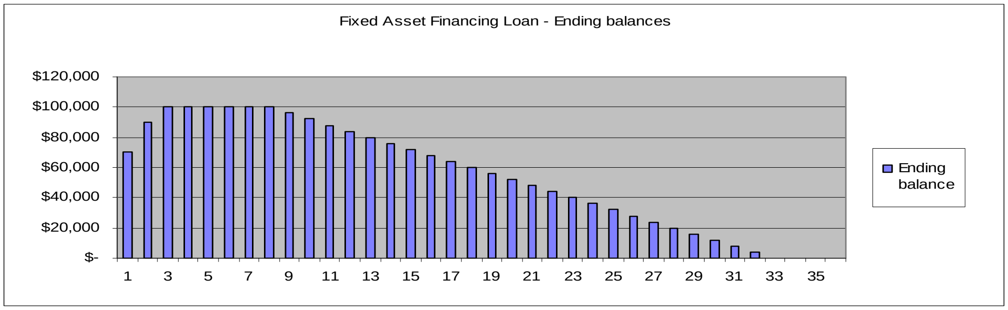
2.4. Fixed Asset Financing (Cap-Ex) Loans

Fixed asset (capex) loans serve primarily for financing of purchases of machinery, real estate, etc. Sometimes purchases of intangible assets like patents, key money, contracts or purchases of other companies may be financed. Debt financing of intangible assets should be done with extreme care – sometimes it is difficult to make correct assessment of value of such assets.

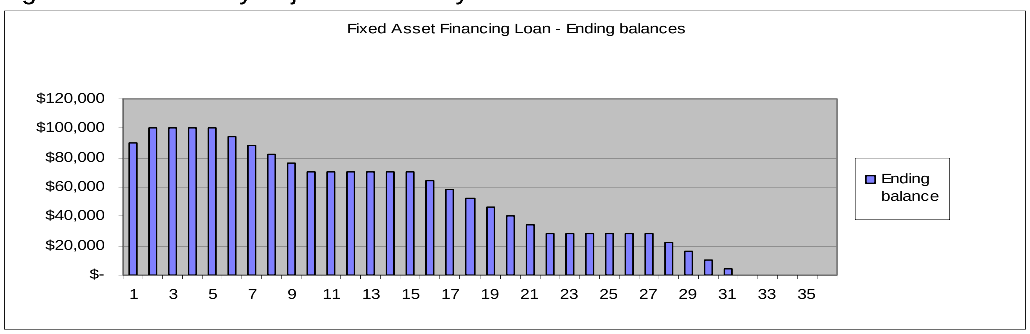
These loans should have realistic but not too long repayment schedule, because:

- Financing of bigger fixed assets from too short loans is very risky – the client may not be able to repay. His ability to refinance such a loan may be easily impaired by imbalance in financial indicators (e.g. too low current ratio after purchase of fixed assets from short term financing).
- On the other hand, term of the loan should be somewhat shorter than lifetime of the financed asset. By giving a 6 year loan for financing of machinery with lifetime of 4 years the banks may be exposed to risk of default – in case the borrower has no other machinery with which to keep on with production.

Fixed asset (capex) loans usually rely on regular repayment from cash generated on the financed assets. In case the fixed purchased machinery/real estate does not begin to generate cash immediately after purchase (because of assembly time, dry run testing etc), a grace period covering such delays is provided.



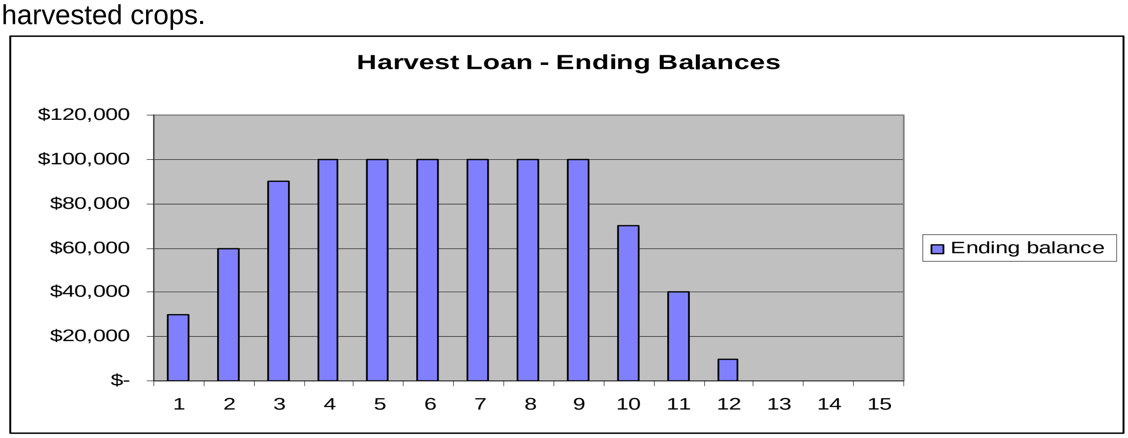
Typical capex loan is provided “in multiple draw-downs” - as payment of invoices e.g. for supplied machinery, for assembly of machinery etc. Therefore the loan is drawn during one or more months, according to incoming invoices (in illustration chart – during 3 months after the first drawdown). Then the borrower has grace period (here 6 months) to finalize assembly and test the machinery before full use. After grace period, the loan is repaid in regular or seasonally adjusted monthly installments.



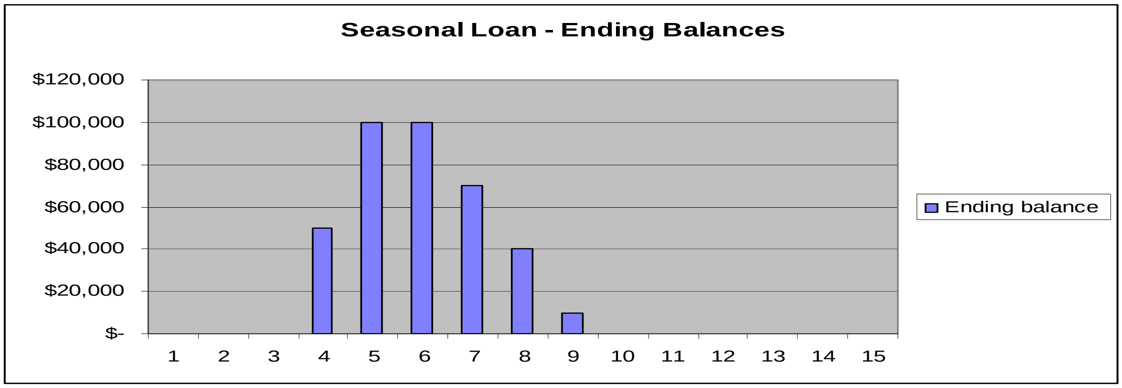
This illustration chart presents repayment schedule for a hotel which has negative cash-flows in October-March and therefore is able to make repayments only in April-September. Similar repayment schedules can be applied for financing of real estate (purchases or construction), only the drawing period is usually longer, as well as repayment period.

2.5. Seasonal working capital loans

Such loans are often needed by clients, who need to span seasonal growth of working capital needs. Typical examples are farmers, who take a loan for purchase of seeds and fertilizers, toil the land, sow the seeds, harvest the crops and repay the loan from sale of harvested crops.



The illustration chart presents a typical harvest loan for farmers growing cereals or oil seed plants in Europe. In case there are more harvests in a year, the harvest loans can be accordingly shorter.



Another illustration presents a seasonal loan extended to bottler of soft-drinks. He needs to buy large inventories of sugar, concentrates and plastics for bottles just before peak season – which is summer. He can start repaying soon – immediately after reaching peak of production in July or August.
Similarly a textile reseller may order a big supply of summer clothing before summer. He takes a loan for financing of "summer clothing supply" in April, and may repay in July, when the seasonal clothing is sold.

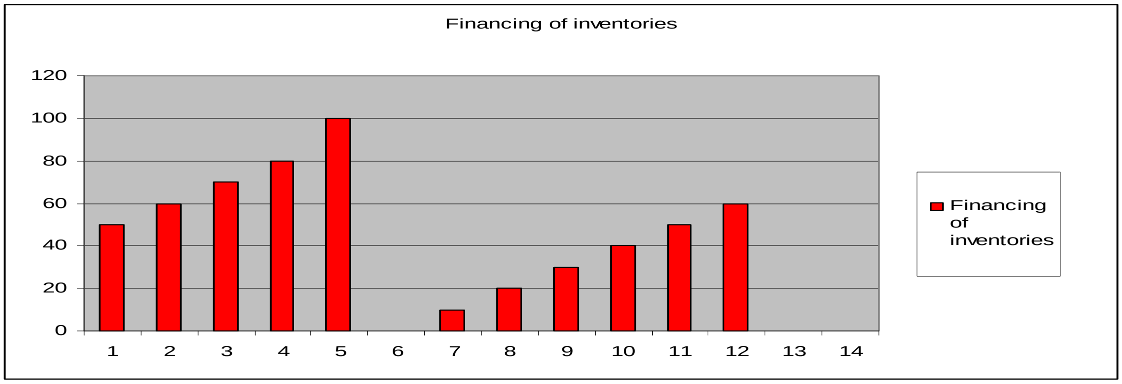
2.6. Working capital loans with bullet and balloon repayment

Some businesses have less fluctuating needs for working capital financing, but are not able to repay such loans within one year without disruption of their operations. The bank then can provide several types of facilities, as follows:

- Self-liquidating working capital loan. Usually it is financing of receivables, which are pledged, ceded or assigned to bank. The borrower sends an invoice to customer. The invoices should be visibly marked as pledged for benefit of bank. (Without marking the invoice as pledged the pledge is not usually effective. This is so called "silent pledge" – such a pledge is rather a moral obligation to make a real pledge upon request of bank.) He gives a copy to bank. Bank sets a new limit on revolving credit or overdraft account (usually 70% of receivable). The "off-taker" must pay the invoice directly to the bank – not to the client. Financing of specific receivables may overlap, but only under a pre-approved limit (credit line). This is suitable for small volumes of big receivables.
- Similar scheme as before, only the bank directly buys the receivables with discount. The bank has nevertheless a recourse to borrower – so the sale of receivable is not in fact "final". This system is close to "factoring" of receivables – it is purchase of receivables by specialized factoring companies.
- Bills of Exchange – a similar scheme as above, only the bank buys Bills of Exchange covering such transactions at a discount.
- Regulated "revolver" loan with bullet repayment for financing of inventories. Regulation can be done on monthly or bi-weekly basis – if the borrower needs to finance inventories, he checks his inventories (sometimes together with bank officer) and sends to bank list of financed inventories. Then the bank sets "regulated limit" of loan accordingly to the last check of financed inventories – usually at 40-70% of "checking level". If inventories are zero, the limit is zero. This is done e.g. for financing of car inventories in showrooms – the bank usually has control over the cars by keeping their technical and registration books in bank's safe boxes. The bank may also have a pledge and pre-approved papers for acquiring of ownership title to the financed cars.
- Regulated "revolver" loan with bullet repayment for financing of receivables. The same scheme as above, but the client submits lists of pledged receivables (silent pledge or open pledge, as the case may be).
- Unregulated "revolver" loan with bullet repayment. This is usually done against very good real estate collateral. Even then the bank usually reserves right to cut down the credit limit accordingly to level of financed inventories, if the bank finds that level of inventories falls down. It is advisable for banks to have clauses allowing for regulation of the limit in emergency situations.

- Amortising middle term working capital loan. ICBG regulations do not encourage guaranteeing of such loans, because it is difficult to monitor over a longer period, how the funds are used. This scheme may nevertheless be more acceptable, than bullet repayment – in cases when bullet repayment would cause total disruption of activities of borrower. (If such cases happen, banks usually reschedule bullet loan into amortising loan, anyway.)

In many banks, regulated working capital loans with bullet repayment may present as much as 50% of their loan portfolios. In most cases such loans are "regulated" on monthly basis. The regulation processes are rather demanding, both on credit officer and on back office operations.



Another example presents company producing plastic bags for storage of ensilage. Their inventories are almost sold out just before harvest of fodder corn. The company repays a large part of working capital loan. Then it starts building up their inventories again, and with growing inventories, the bank allows higher drawdown. The bank decides whether to refinance the loan by the year end – before "rolling over" of the loan, the bank makes random check of the financed inventories and re-examines financial strength of the borrower.

If the bank decides against granting of a new revolver, the revolver can be repaid from sale of inventories, or by refinancing from another bank. If neither option is feasible, the revolver loan is rescheduled into a new amortizing loan, which gives the borrower time for gradual sale of inventories or finding other financing.

It is important to keep working capital loans in balance with volume of current assets. Banks should discourage borrowers from buying fixed assets from ST loans, unless they reliably prove they loans can be repaid within term of the loan.

2.7. Quasi-credit exposures

Banks can approve committed or uncommitted "credit lines" under which sub-limits for some non-credit products can be covered. Usually such facilities are covered by pledge of cash on term or current accounts. Banks may nevertheless decide to cover such products by carve-out from credit lines in case of very good borrowers with bigger credit lines.

The quasi-credit exposures are re-calculated into credit exposure by usage of rule of thumb or statistics methods.

The most usual non-credit products are:

- Payment guarantees – the bank guarantees to pay to supplier of the client after dispatching of goods for the client in case of default of client.
- Non-payment guarantees – the bank guarantees to pay instead of its client upon occurrence of certain event. Such guarantees are often used in public tenders for supplies of goods or construction works for big investors. Such guarantees usually include: bid bonds, performance bonds and retainer bonds.
- Letters of Credit – the bank guarantees payment to off-taker against submission of Bill of Lading (authorized confirmation of shipment of goods).

- Financial derivatives – these are mostly off-balance sheet items (OBSI). Their “quasi-credit exposures” are calculated by multiplication of “notional” (nominal) amount of transaction by “conversion factors”. These factors are calculated as formulas reflecting type of transaction, tenor of contract and volatility of exchange rates of underlying currencies or interest rates, if applicable.

2.8. Credit officer as advisor to borrower

During or after meeting with client, credit officer should prepare draft of structure of loans and other products.
Credit officer should participate with borrower in making of projections for lifetime of loan. Our spreadsheets allow for working out financial statements for 4-5 years in a row. The credit officer can prepare one or two “history” years and three or four “projection” years, if need be. The spreadsheet automatically calculates cash flows and basic financial ratios. The future financial ratios should be in compliance with recommendations in our “Financial Analysis Guide for SME Borrower”. The projections should reflect market position of the client. E.g. the borrower should have lower profitability if operating in conditions of perfect competition, or higher profitability in case of dominant market positions etc.
In case of doubt, credit officer should consult with credit risk department of his bank.
Upon seeing that there is a reasonable chance of providing credit to the client, credit officer should ask the client for documents necessary for approval of loan and eventually of guarantee for the loan.

3. Documents related to submission of loan and guarantee applications

The list of documents is included in “Documentation Checklist” which is available as one of sheets in CF calculation file. Here we provide our checklist and our comments to its items:

	Documentation Checklist				قائمة الوثائق	
	Borrower Name	الزامي	تطبيقات مستقبلية*	اخرى**	اسم المقترض:	
	Code	Mandatory	** If applicable	* Optional	الرمز:	
	Bank				المصرف:	
No.	Do we have this document/info?				هل هذه الوثيقة موجودة في الملف ؟	
1	Loan guarantee agreement - ICBG template				اتفاقية ضمان القرض بين المصرف والشركة	1
2	Loan agreement - ICBG template (or acceptable for ICBG)				اتفاقية القرض (بين المصرف والزبون)	2
3	** Pledge agreement endorsed for the benefit of the bank, appraisal of pledge assets.				الرهن لصالح المصرف مع تقييم مستقل لقيمة الرهن	3
4	** Trade or company registration				الشركة/الرخصة/شهادة تسجيل المشروع	4
5	Applicants Financial statements				البيانات المالية للمقترض في حال توفرها	5
6	Applicant's D				الهوية الشخصية للمقترض	6
7	Cash-Flow, 1Y historical, projections for life of project.				التدفق النقدي المتأتي لسنة واحدة من عمر المشروع	7
8	Financial Ratios				النسب المالية	8
9	** 3rd party personal guarantee, Promissory Note				كفالة الكفيل الشخصي	9
10	* Request for Guarantee (preferrably with loan approval)				كتب طلب الضمان/موافقة دائرة الائتمان في المصرف	10
11	** Applicant's membership in trade or industry association				عضوية المقترض في اي من الاتحادات الصناعية او التجارية	11
12	*Copies of site visit report or of electricity and water bills				تقرير زيارة المشروع او ايصالات الماء والكهرباء	12
13	* Credit bureau reports (CBI)				تقرير لوضع الائتمان للمقترض من البنك المركزي	13
14	* Special relations statement (bank-borrower)				علاقة المقترض بالموظفين العاملين بالمصرف*	14
15	* Life insurance policy - assigned to the Bank				بوليصة التأمين على الحياة لصالح المصرف*	15
16	* Insurance of fixed assets - assigned to Bank				بوليصة التأمين على موجودات المشروع*	16
*	Optional				* تطبيقات مستقبلية	
**	If applicable				** اخرى	
	After Approval of Guarantee					
17	ICBG letter for approving the guarantee				كتاب الموافقة على الضمان	17
18	Copy of ICBG invoice for 2%				اشعار المطالبة بعمولة الضمان	18
19	Table repayment of the loan				جدول تسديدات القرض	19
20	Statement evidencing that bank paid the fees and the guarantee is effective				اشعار من المصرف بتقديم عمولة الضمان بحسب الشركة	20

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1. ICBG Loan Guarantee Agreement

This is the guarantee itself – in form of an agreement. It is issued by ICBG and signed by lending bank. It contains the basic identification of lending bank, borrower and the guaranteed loan (purpose, amount, tenor, interest, drawdown and repayment schedules).

2. Loan agreement

We strongly recommend usage of ICBG template of loan agreement, or at least following of basic rules of this template. The template is based upon "Common Law", nevertheless during the last 20 years banks in many "Civil Law" countries began to adopt some features of "Common Law" loan agreements. The presented template is a compromise in between long common law contracts and usually shorter civil law contracts.

It constitutes several "events of default" in addition to the basic event of default – it is default on repayment of loan. This allows the bank to take some remedial actions with borrower in the case of impairment of his position, even before the time, when the loan becomes overdue.

Breach of any of the following covenants is an "event of default" and constitutes right of the bank to consider and enforce some remedial action.

The bank usually monitors the client on quarterly basis. In case the bank finds out that the borrower breached one or more of the covenants, the bank has legal ground for asking for additional security, sooner repayment etc.

The additional covenants in ICBG template are listed in loan agreements under three sections as follows:

Section IV *NEGATIVE COVENANTS*

1. ***Negative pledge****: borrower shall not create or cause to be created any mortgage, pledge, or lien on any property acquired without the written consent of Bank;*
2. ***Pari Passu****: except where the loan is secured by borrower, the borrower shall not rank worse than pari passu its unsecured and unsubordinated obligations to Bank.*
3. ***Ownership Clause:*** *ownership of enterprise does not change materially without the written consent of Bank.*

Section V *AFFIRMATIVE COVENANTS*

1. *Borrower shall maintain a current ratio of at least _________________;*
2. *Borrower's Debt to Equity ratio shall not exceed_____________;*
3. *Borrower's Debt to EBITDA ratio shall not exceed_____________;*
4. *Borrower must continue to conduct its activities in substantially the same manner and keep its property in working order;*
5. *Borrower must maintain adequate accounting records and submit to Bank financial reports in yearly or quarterly periods, upon request of bank.*

Section VI *EVENTS OF DEFAULT*

The occurrence of any of the following events shall constitute an "Event of Default:"

1. ***Default on Loan****: Borrower shall fail to pay principal or interest due on this loan after the amount becomes due;*
2. ***Default on covenants****: Borrower shall default on any of covenants in this agreement;*
3. ***Default on information duties****: borrower fails to inform the bank about material changes in business and financial conditions of the enterprise or information submitted in application or later will have proven to be materially false;*
4. ***Cross-Default****: borrower fails to pay on any loan or financial obligation outstanding to any creditor;*
5. ***Material adverse change****: impairment in Borrower's financial condition takes place, which may threaten repayment of the loan.*

Upon the occurrence of any Event of Default, Bank may, by written notice to borrower, declare the unpaid principal balance of the loan together with all interest accrued thereon, to be due and payable in full.

The most basic covenants, which are usually accepted even by the best borrowers, are ranked according to importance as follows:

- Pari passu (ensures at least equal treatment of bank with other unsecured or similarly secured lenders)
- Negative Pledge (prevents the borrower from pledging assets to other lenders)
- Cross-Default (alerts the bank in case of defaults against other lenders)
- Ownership Clause (protects bank in case when business is sold to less reliable new owners)
- Material Adverse Change (protects bank, when operations of business deteriorate)

It is advisable for banks to adopt the ICBG template. It allows the bank to take remedial measures in the most expected situations. Some good clients may insist on dropping out or alterations of some clauses, usually when they plan change of ownership, new loans etc. Banks may decide to negotiate dropping less important clauses. Average clients should not have problems with signing of the "template loan agreement".

3. Pledge Agreement endorsed for the benefit of the bank.

This agreement should follow strictly all legal regulations and habits. An experienced local lawyer should examine, whether the pledge agreement is valid and enforceable.
Even when banks rely largely upon ICBG guarantee, they should take pledge covering the rest of their exposure. This significantly decreases "moral hazard risk". In other words, the borrower has something to lose and tries to repay harder.
Certificate from land register should contain ownership title and all liens on the property.
It is advisable to have the pledge of real estate finalized and registered before draw-down of the loan. The loan agreement should contain "condition precedent" in this respect. Alternate solution – to disburse loan "against proposal for entering pledge submitted on land register" – may be too risky, especially if processes at land register are not absolutely reliable.
The banks should evaluate enforceability of pledges of machinery, cars etc. In some civil law countries banks tend to use "temporary cession of ownership title" (e.g. for financing of farming machinery). This is a good solution, in countries where central register of pledges of movable assets is not available or reliable.
Banks should examine, whether pledges marked in "ownership certificates" or "technical certificates" are legally enforceable. Banks may decide to take such pledges, but should be prepared for possible legal difficulties with their enforcement.
Non-bank financial institutions also take full ownership title (mainly "financial leasing companies"). This option is usually precluded from banks by banking legislation. Owners of bank may nevertheless establish a sister company, financed by the bank, which may take ownership titles and administration of financial leasing contracts.

4. Company and trade registration certificates

This is meant for businesses which have to be registered in company and/or trade register. In case of doubt of what is applicable, an experienced local lawyer should be consulted. The certificates help the bank decide, whether the borrower is allowed to operate his business. It may also help in establishing of his/her identity.

5. Applicant's Financial Statements

These are available from clients which keep double entry accounting. Smaller businesses with single entry accounting usually keep only "cash-in, cash out" ledgers. Crude financial statements can be constructed by client and credit officer in most cases.
For closer details both for single entry accounting and double entry accounting clients see section Cash Flow.

6. Applicants ID

This should be applicants ID, or eventually Iraqi or foreign passports, ration cards, if applicable, and if they can help in identifying the borrower.

7. Cash Flow, 1Y historical, projection for lifetime of loan

As it was mentioned in section 4., historical financial statements should be easily obtainable from clients keeping double entry accounting books. Most small businesses keep only single entry accounting books.

7.1. Historical statements - clients with single entry accounting

Many smaller businesses in Iraq (as well as in other countries) do not have to keep double entry accounting books. Smaller businesses usually work with local variations of single entry accounting.
ICBG trainings are primarily dealing with such cases (see e.g. Mohamad the Carpenter). This means that the borrower in such cases is not able to fill in double entry accounting financial statements as per ICBG application forms.
Credit officer must therefore take over existing data from the client – at least “cash in and cash out” for the last one to three years. This in itself is enough only if the client does not have any assets (except cash) and liabilities or any changes in assets (except cash) and liabilities.
If the client keeps only single entry books and has assets and/or liabilities, than the credit officer must write down status of assets and liabilities relevant for the business as of the application date. This will help in making a crude “balance sheet” of the business. If it is possible, it is very helpful to construct past balance sheet – as of one year ago, or as of the last fiscal year end.
Then there is remaining task to properly construct past and future cash flow statement and P&L statement. There are several possibilities:

- The client knows his sales and his “cost of goods sold”. This allows for easy construction of “past P&L” and with changes in assets and liabilities also for “past CF”. Often it is beneficial to include “direct labor expense” into “cost of goods sold” – as opposed to administrative and general labor expense. Having past P&L is crucial – it helps in realistic assessment of future P&L. Credit officer should get “sales assumptions” – it means breakdown of units sold, unit prices, total sales of product group, similarly total sales of another product group etc.
- The client knows his sales but does not know his “cost of goods sold” (COGS) because he does not keep track of his inventories. Then the client should make an estimate, how much his inventories changed in the given period. Cost of purchases of inventories minus growth or plus decrease in inventories should give a base for COGS. Inclusion of direct labour into COGS should be also considered. The resulting gross margin should be compared to industry averages.
- In case the client does not even make an estimate of his COGS, the credit officer may use industry averages. Giving loans to borrower who has not even a realistic estimate about COGS and gross margin is not recommendable – it may be rather risky.
- Depreciation charges – small businesses often do not take care about them. Credit officer should evaluate, whether they are of material nature. In positive case, credit officer should include depreciation into P&L – otherwise he would present too optimistic picture of profitability of the business.
- Other operating costs – credit officer should make “labour expense assumption” – wages and salaries per employee in groups of employees, number of employees in groups (workers, foreman, engineers, technicians, administrative, directors etc) and total summation of labour expenses. <u>*The labour expense should include at least some minimum salary or wage of owner and his family, if they work in business*</u>. If this is not included, the resulting cash flows are not reflecting true costs of business and are too optimistic. This can lead to unrealistic repayment schedules and subsequent defaults or rescheduling.

It is often beneficial to split labour expense into variable labour and fixed labour. Such a breakdown allows for calculation of variable costs separately – which in turns allows for calculation of "breakeven point" – it is a point of sales where the company becomes profitable.

In regard of cash-flow versus P&L calculations, there are basically these options:

- either the client knows better his CF and "changes in balance sheet" and credit officer can roughly construct past P&L and thus profitability of the firm
- or the client knows better his profitability and P&L and changes in balance sheet – then the credit officer can construct past CF.
- or the client does not keep track record of profitability and changes in assets/liabilities, **and is not even able to make a reasonably accurate estimate**. This may be a risky borrower. In such cases the best way may be to postpone the loan till the client starts keeping reasonably good track record of his inventories, costs etc.

With the help of past financial performance record, the client with credit officer should be able to construct projections of financial statements for duration of the loan.

7.2. Historical statements - clients with double entry accounting

The business should have reasonably good track record both of sales and of "cost of goods sold". Credit officer and client should make basic sales and costs breakdowns consistent with financial records. This will enable them to make realistic projections for lifetime of loan.

7.3. Projections for lifetime of loan

Lifetime of loan may in fact depend on projections, and projections should include repayment of loan and interest. The question is where to start? The answer depends on type of loan.

Working capitol loans

These should be given for periods covering the seasonal needs of client. Usually it is less one year. The most typical examples are listed as follows:

- Farming "harvest" loan: drawdown at moment of purchase of seeds and fertilizers. Additional drawdown possible for covering application of agrochemical agents. Repayment within about two month after finishing harvest. The cycle should last less than 12 months, nevertheless, in cases where sale of harvest can last longer, 14 month cycle may be tolerated.
- Farming loans for feeding of animals: drawdown against purchase of young animals, repayment after sale of animals. Animals are usually fed in "shifts" which may be overlapping. For instance young calves are bought in two groups, one 6 months after the other. Their feeding cycle is one year. Sale of one group of bulls helps in cash flow needed for fodder for the second group. In such a case 6 month or 12 months loans with gradual drawdown and one-off repayment may be a suitable option.
- Inventory financing before and during peak season: This applies for businesses with peak of sales in certain months. Such loans may be taken by sellers of apparel before summer season, by sellers of delicacies before Ramadan, by producers of soft-drinks before and during summer, by granaries at time of harvest etc. Usual loan term is 3-10 months.
- Non-seasonal working capitol financing: usually 12 months regulated revolvers, for very good clients also middle term amortizing loans up to 4 years, if the client is profitable, but his current ratio is not strong.

Fixed Asset Financing (capex) loans

- Fixed asset financing (capex) loans – Total of loans should not exceed 400-500% of yearly EBITDA. Most fixed asset financing loans should be amortising with repayment schedules of under 5 years.
- Capex loans for financing of heavy machinery and real estate are sometimes provided for 6-15 years, but their tenor should not be longer than about 60-70% of lifetime of the financed (and pledged) fixed assets. ICBG does not issue guarantees over 5 years.

Projections

The projections may differ from historical statements due to the following reasons:

- Smaller or bigger increase of sales reflecting purchase of new production machinery, with the same "gross margin percentage" – i.e. the same relation of cost of goods sold as percentage of sales. In case of really big increase of production, credit officer should take into consideration, whether there is a ready market for the planned increase. This increase in itself may have positive impact on profitability – because "overhead" administrative and selling costs usually are "fixed" or at least they do not have to grow as fast as direct costs of production.
- Increase of "gross margin percentage". Sometimes lower consumption of direct labour and/or direct materials may result from purchase of modern machinery.
- Combination of both factors.
- Decreasing sales – this happens in "dying" or "shrinking" industries. Examples may be apparel and textile industries in Europe, which are shrinking due to increasing Chinese competition. It is possible to get repayment even from businesses with shrinking sales, but - of course - it is rather risky.
- Various changes in environment, regulations, customs, changes in "barriers of entry" may have a big and sudden impact on profitability of businesses.

8. Financial ratios

These are dealt with in bigger detail in "Financial Analysis Guide for SME lending". Here we recapitulate some of the most important ratios:

- Interest coverage – should be > 150% - if it is close to 100% or less, it means that the borrower may have troubles in paying interest consistently;
- Debt / EBITDA should be < 400% - in case debt is higher than four times EBITDA, repayment capabilities should be very closely examined in projections, before giving a loan.
- Funds Flow / Current debt – ICBG started to use this financial ratio, as far as its evaluation is more simple (it must be more than 100%). This is the key ration in Wells Fargo underwriting process.
- Current Ratio should be > 100% - also in projections. If it is smaller than 100%, short term liabilities of the business are not likely to be repayable in sort term.
- Debt / Equity < 100% - this is a rule of thumb only – nevertheless banks are usually reluctant to risk higher amounts, than is the equity of owners. There is an exception – profitable trading companies may get working capital loans with much higher leverage (D / Equity up to 500% or even more) in case of proven good performance, and if the financed assets are pledged and "reliable",

Another important set of ratios are days in inventories, receivables and payables.

- Days in inventories are inventories expressed as share of COGS, times 365. The ratio differs in various industries, seasons etc. Trend of longer days in inventories is usually an important sign of CF problems which may lead to bankruptcy.
- Days in receivables are receivables as share of revenues, times 365. Trend to longer days in receivables may be even more serious sign of CF problems than negative trend in days in inventories.
- Days in payables are payables expressed as share of COGS times 365. Longer days in payables are positive for cash flow of the firm. Shorter days in payables call for closer examination – either the borrower is willing to pay sooner, or suppliers may be decreasing their credit limits for the borrower, which may also be a warning sign.

9. Personal guarantor – if applicable

In addition to identification of guarantor, reasons why he decided to give guarantee and his financial position should be elucidated.

10. Bank Credit Department Approval

This should contain basic parameters of loan / purpose, limit, tenor, repayment schedule. It should be appendix to application for guarantee.

11. Applicants Membership in trade/professional Association

This serves for better identification of borrower, and eventually as an evidence of his/her professional capabilities.

12. Copies of site visit report

Credit officer or another person authorized by bank should visit the business and meet the owner or manager of the business. The site visit should include description of business, descriptions of operations, photographs, situation map and remarks regarding scope of operations, cleanliness and order in premises and similar remarks.
Site visit may be accompanied by electricity and/or water bills of applicant. These documents serve in general for sorting out fraudulent borrowers with non-existent or defunct businesses. In cases when bank officers carry out site visit and know the business personally, the electricity/water bills documents usually will not have to be demanded.

13. Credit Bureau Report from CBI

This is a standard service provided by CBI. There is a strong correlation in between past repayment problems and probability of future default. We understand that the report does not give good picture now, because many lending institutions do not send their info to CBI. Absence of this report is not therefore crucial.

14. Special relations statement (bank-borrower)

This document shall be provided namely in case when such relations can have negative impact on willingness of borrower to repay the loan (e.g. when the borrower is a big shareholder of bank, or close relative of such a shareholder etc).
Banks should have a clause in loan guarantee agreement, stating that special relations between the bank and the borrower, which can have impact on re-payment moral of borrower shall be revealed, in case when such relations exist.

15. Life Insurance Policy

Banks sometimes may want to have life insurance policy blocked for purpose of repayment of loan. This is appropriate for relatively higher loans. Life insurance policy is not always achievable – for older borrowers and or in insecure environment in some parts of Iraq.

16. Insurance of Fixed Assets

Banks should have insurance policies of machinery/real estate blocked for purpose of repayment of loan. Insurance policy for smaller fixed assets is not always achievable, especially in insecure environment.

17. ICBG Letter of Approval of Guarantee

This is issued by ICBG immediately after approval. Please take into account that the approval automatically expires after 120 days, unless you agreed with ICBG a longer term. It is proof for bank, that guarantee was approved, before disbursement of loan and issuance of guarantee.

18. Copy of ICBG pro-forma Invoice for Guarantee Fee

This is also issued by ICBG after approval of guarantee. Fee should be paid with disbursement of loan, without payment the guarantee is not effective.

19. Repayment table for the loan

Please propose realistic repayment schedule. Pushing for too short repayment schedule just to get easy approval does not pay. Too frequent rescheduling of loans throws bad light on judgment of bank personnel.
It helps to use our “Interest Calculation Spreadsheet” in excel, it presents charts of balances in monthly periods and also monthly interest charges. You may adjust grace periods and/or principle repayments in order to accommodate sums paid to expected cash flows of the client.

20. Evidence of Payment of Guarantee Fees by Bank

Please send the evidence of payment of guarantee fee to ICBG in time. This allows the ICBG to check, if and where the payment is delayed, which sometimes happens during transfers from one bank to another.

4. Basic recommendations how to fill in an application form

For filling in financial data, see section and “Financial Analysis Guide for SME Lenders”. The financial data can be transferred into application form from “cash flow matrix” automatically, if you decide to use our CF template.
In addition to financials, the application form distributed in 2006 has 10 sections, dealing with description of borrower, conditions of loan etc. Even when you do not use this application, you should try to answer the following items – if they are applicable. We have prepared some recommended “prefabricated answers” for some of the sections. Some answers are not meant to be mutually exclusive, so you can sometimes choose more answers. Such additional information to these prefabricated answers is important and welcome.
Now we recapitulate sections and basic choice of possible answers.

1. & 2. Borrower, Enterprise information: Brief description of enterprise

We have prepared groups of possible answers (also available on drop down menus). The first one describes “type business” – with recommended choices as:

- workshop,
- factory,
- wholesale,
- retail,
- construction,
- or other businesses, as appropriate

Describe development stage of business – basically whether the business is established or new and if its owner is or is not experienced. The recommended choices are as follows:

- established business,
- establishment of a new branch,
- start-up of an experienced person,
- start-up of a person new to business.

3. Purpose of requested loan

Please, avoid general unspecific phrases like “expansion of business”, or “purchase of new machinery”. This does not say much about what the money are used for. Without stating

clear and specific use of funds, there is a much bigger risk, that the client will use funds for some risky purpose and gets into trouble with repayment.
Purpose should be stated clearly: e.g. purchase of a 4 years old bottling line “XXX Megafill 1200” with capacity of 1200 PET bottles per hour, for US$ 300,000.
We discourage using the same loan for purchases of fixed assets and financing of working capital. Different purposes are usually better financed by different loans with different repayment schedules.
Proposed answers for purpose of loan are:

- machinery,
- building,
- both machinery and building,
- new
- used
- repair
- enhancement
- inventories
- receivables
- seasonal purchase of inventories etc.

4. Effect of loan on enterprise

This is a question, which should be closely examined. We have prepared a range of possible answers. New working capital loans usually help expand business, at least seasonally. New capital expenditures are usually supposed to bring along higher sales or lower unit costs or both. Sometimes new machinery is needed just to keep pace with quality of products of competitors, or as a replacement for obsolete machinery.
It is important to evaluate realistically what the impact may be. Clients sometimes tend to be overly optimistic. You may ask for views of experts from industry, if you can protect confidential information from them - i.e. disguise the specific loan and borrower from them.
The proposed answers are:

- robust increase of sales
- moderate increase of sales
- necessary replacement of machinery
- savings of labour, material costs
- increase of quality of production
- necessary repairs of machinery with no increase in capacity etc

5. Sources of repayment (+sales assumptions)

Here you should state, whether sales and profits will go up and how much, or whether they will remain flat (or even go down).
Sales (and operating costs) assumptions may be better done on a separate excel spreadsheet, especially in case the client sells more than one product or more types of product (i.e. when the client sells for instance foods and electric appliances). We provide examples of possible calculations on a separate excel sheet. Application may contain results of such calculations.
Having stated future profits, you should compare them to repayment of the loan. Now there may be several sources, from which the loan can be repaid:

- Cash flow from business itself
- Cash flow also from other businesses (if yes, then name them and explain their nature)

6. Loan track record: Has the client borrowed before?

We suppose banks will not be able to get checking from all other banks and lenders in Iraq. Banks should get credit information from credit bureau of CBI. In addition, banks should ask

for information from the last lenders, if they know that the client has loans from other banks or has just repaid loans from other banks.
Problems with repayment of previous loans do not automatically mean that the client is not good. It is important to look if and why there were problems with repayment. The problems may have been in unrealistic repayment schedule. Typical mistake is giving one year loan for purchase of a relatively big capital expenditure with payback period of e.g. 4 years. Even if the client is very good, the loan may have to be rescheduled.

7. Suppliers

Name suppliers or write their type and approximate number. It may be risky to be dependent upon one supplier (if it is not a regulated monopoly). The recommended answers are as follows:

- One supplier (economic condition called monopoly)
- Several strong suppliers (economic condition called oligopoly)
- Numerous possible suppliers (economic condition called perfect competition)

8. Customers

Name customers or write their type and approximate number. It may be risky to be dependent upon one or two major customers. Nevertheless such risks can be mitigated if there are other potential buyers. Prepared answers are as follows:

- One customer
- Several strong customers
- Numerous possible customers

9. Market

We have prepared set of answers for questions related to “market”.

Relevant market

When “market share” is discussed, it is important to indicate, what is the relevant market. It can be town quarter, village, town, governorate, Iraq etc. Relevant market is the market, where direct competitors of the client compete with him or her. For a village bakery the relevant market may be a village, or a district, if it sells its goods in such an area.
Recommended answers include these markets:

- Village
- Town quarter
- Town
- Governorate
- Region (as Kurdistan, Anbar, middle Iraq, southern Iraq)
- Iraq
- Middle East
- Global

Market share

Please try to indicate market share in per cent. A small village bakery may have market share 40% on its relevant market, if its relevant market is a village and if there are 2-3 bakeries. On the other hand a much bigger town bakery may have market share of only 2% if it sells its goods in all town. If you are not able to make an estimate of market share in per cent, try to establish “market share” as follows:

- Relatively small (under about 10%)
- Important, not dominant (about 5% -25%)
- Dominant (about 25%-40%)

- Strongly dominant (about 40%-80%)
- Monopoly (close to 100%)

Most SME borrowers have rather relatively small market share.

Character of products, price sensitivity

This means price sensitivity of customers. Usually it is very high in case of staple foods and similar commodities. Price sensitivity is lower, when products have an established reputation of high quality or luxurious looks etc. A bakery renowned for exceptional quality of its bread may command above average prices. Prepared answers include character of products as follows:

- Commodity (very high price sensitivity)
- Large scale production (high price sensitivity)
- Customized or exclusive production or services (lower price sensitivity – customized or exclusive goods or services)
- Luxury goods (very low price sensitivity – by extremely exclusive goods or services)

10. Management

Everybody rightfully expects, that entrepreneurs should be good managers, or at least should hire good managers. Nevertheless even managers of good clients usually have both strengths and weaknesses, which may have impact on decision on loan or guarantee approvals. We have prepared range of management strengths as follows:

- long term practice
- excellent education
- good knowledge of market
- long term relations with private customers
- long term relations with GOI off-takers
- long term relations with municipal off-takers
- knowledge of advanced production processes

Management weaknesses can be listed as follows:

- new to business
- new entrepreneurs
- lack of “state of the art” know how

If you have some knowledge about management strengths/weaknesses you may indicate them in remarks.
We have also prepared several possible answers for “succession plans in the event of ill health or death”, as follows:

- children are working in the business
- other relatives are working in the business
- partners may take over the business
- other people may take over the business
- no specific succession plans.

5. Submission of guarantee application

5.1. Application package

In principle, banks should strive to submit all applicable documents as per documentation policy. At the very minimum, banks should submit the following documents with application for guarantee:

- The Loan Agreement template – ICBG may make recommendations for adding some specific covenants.

- Draft pledge agreement, where applicable.
- Company registration in case of registered companies.
- Financial statements or available data about financial performance (single entry accounting results plus overview of assets and liabilities, preferably historical for past 1-3 years and projections for lifetime of loan). Projections should be based on sales and costs assumptions, worked out in a reasonable detail.
- Application form or written comments answering relevant topics as per ICBG demands (see article 4.-Basic recommendations how to fill in an application form).
- Applicants ID.
- Copy of site visit report, preferably with photographs – eventually with enclosed copies of invoices or bills for electricity and water.

ICBG recognizes there may be cases, where some documents may not be achievable at the moment of submission, or may not be achievable at all. These may include the following:

- life insurance may not be achievable due to security situation, age of applicant etc.
- insurance of purchased machinery may not be available due to security situation; nevertheless, the bigger amount, the more desirable is to have an insurance policy blocked for the benefit of the bank.
- Electricity and water bills are proof that the business exists; they do not have to be submitted in cases when the bank is sure the business is in operation.

5.2. Approval process

Before approval, ICBG analyst may ask you for additional explanations by phone or e-mail. It is preferable to keep track record of additional explanations as e-mail messages. If you communicate via phone, always try to send a “confirmation e-mail” as soon as possible. This may prevent many misunderstandings – phone conversation gets often misinterpreted. Approval process (cycle time) should not exceed:

- 10 working days for guarantees not exceeding US$ 25,000 (approved by DG).
- 40 working days for guarantees exceeding US$ 25,000 (approved by Advisory Board).

The present cycle time is about 5-40 days – as far as some applications are now being decided by Advisory Board.
Approval or rejection should be communicated *within two working days* after decision (meeting of Advisory Board. Banks receive “Letter of Approval of Guarantee” and “Pro-forma invoice”.

5.3. Disbursement of loan, validity of approval and guarantee

After receiving “Letter of Approval of Guarantee” from ICBG, you should communicate to the client that loan can be disbursed. This is usually done after meeting some specific “conditions precedent”. If the client changed his or her mind and does not want to use the approved bank loan, you should communicate this to ICBG without delays.
Warning re validity of approval: The ICBG **approval is valid 60 days** after approval decision, in case the client is interested in disbursement of loan after this period, you should submit new updated application.
If loan is disbursed, you should do at the same day the following steps regarding ICBG:

- Send the guarantee fee to account of ICBG in your bank (if there is any) or to ICBG in another bank, by wire transfer (as per pro-forma invoice). Guarantee fee is payable upfront for one year.
- Send to ICBG copy of accepted wire-transfer (payment order) or bank checking or other relevant evidence of this payment. The best way is to scan the document and send it to ICBG by e-mail.

Warning re validity of guarantee: Please bear in mind that the guarantee becomes valid only after payment of guarantee fee is received by ICBG. Guarantee fee covers validity of guarantee for one year after disbursement. In order **to prolong validity of guarantee for another year**, the bank must pay a new guarantee fee calculated on the then outstanding

volume. (Now defined as 2% of guaranteed portion, while the guarantee may cover up to 75% of outstanding).
ICBG reserves right to withdraw approval of guarantee, if guarantee fee is not paid without undue delays. ICBG naturally wants to avoid situation when banks would pay guarantee fee late and only for those clients which fall into troubles with repayment.

5.4. Follow up of repayment, servicing and information duties

The banks are obliged to take appropriate care about the guaranteed loans. Most obligations of banks are briefly described in part 7 of “PBA Operating Guidelines”. Here we are giving explanations, bigger details and more detailed recommendations.

5.4.1.Restricted activities of banks

Once a loan is disbursed and guaranteed by ICBG, the bank shall not without prior written consent of ICBG do any of the following:

- Change terms of the loan (principle, interest rate, term, collateral etc);
- Perform unplanned collection actions placing the bank into a better position vis-à-vis ICBG.
- Agree to release of any part of collateral (unless the loan is repaid in full);
- Sue upon loan documents;
- Waive claims against borrower or its guarantor, or resolve the loan for less than amount owed.

5.4.2. Monthly reporting of outstanding volumes

The banks shall also inform ICBG on monthly basis primarily about repayment of guaranteed loans. ICBG shall send an e-mail with “table” (also in excel) listing all guaranteed loans of the bank. The bank shall confirm the outstanding volume as of the last day of the given month and shall send back the amended or confirmed table without delays, at latest as of 10th month of the following month.
In case the loan is not repaid according to original “repayment schedule”, the bank shall elucidate reasons why this happened and what steps the bank plans to do in regard of overdue repayments.
ICBG expects the banks to report monthly on the form pictured hereinafter about repayment of outstanding guaranteed loans and eventual defaults on payments.
ID denominated and US$ denominated loans shall be entered in their relevant currencies.
ICBG recalculates US$ subtotal into ID

Ashur Bank - Suli			بنك آشور
outstanding/overdue amounts			المبالغ غير المسددة
of ICBG guaranteed loans			للقروض المضمونة ICBG
29-Feb-08	1215	ID/US$	2/29/2008

Loan Volumes in ID — قيمة القروض بالدينار العراقي

رقم العامل	رقم الوكالة	اسماء المقترضين المختصرة	مبلغ القرض	المبالغ المسددة	المتبقي من القرض	المبالغ غير المسددة	عدد الأيام المتبقية	ملاحظات
sub m#	app #	Borrower short name	Limit of loan	Repaid	Outstand. Loan	Overdue Amount	Overdue days	Remarks
5	3	XXX	15,360,000	3,600,000	11,760,000	0	0	

Columns for outstanding volume, overdue days, accumulated installments) must be checked after each installment term. After sending the chart to ICBG via e-mail, the chart should also be signed by bank representative and sent as a hardcopy to ICBG for filing.

5.4.3. Monitoring financial performance of borrower

This should be done **at least on annual basis**. Central banks sometimes insist on semi-annual or quarterly monitoring, usually for bigger clients. ICBG may also ask for more frequent than yearly monitoring - for more sensitive cases.
Many SMEs do not keep reliable financial statements during the year, or do not keep double entry books at all. In such cases, the bank may take one or more of the following measures:

- Propose the loan as amortizing on monthly basis – flow of repayments is an evidence of continuing economic activities of the firm;
- In case of grace period on fixed asset (capex) loan – the bank should preferably pay for invoices related to approved project; the bank should make a site visit or two, if possible, to see whether the fixed assets are installed and the project is carried out successfully;
- In case of regulated working capital loan, the bank should make random visits in order to check, that the financed current assets really exist (inventories, receivables);
- By the event of random or regular quarterly visit, the bank should also ask for the last financial statements, or at least for estimate of financial performance, if formal statements are not available.

5.4.4. Advice ICBG about any request for rescheduling or new loans

Rescheduled loans may or may not be guaranteed by ICBG – depending upon financial condition of client. Providing a new loan may or may not be an attempt for repayment of old loan with a new loan. It can serve as a substitute for rescheduling of the old loan. Alternatively, new loan may increase leverage of borrower and undermine his repayment capabilities. Therefore ICBG naturally reserves right to look into these matters.

5.4.5. Changes in ownership or management of the borrower

Sometimes such changes have very negative impact on the borrower. The most problematic cases are as follows:

- A limited liability company may be sold by its ageing owner to new owners, sometimes much less experienced, the business may sometimes suffer during transition time.
- A trade (sole proprietorship) is inherited by family after death of the founder, and the children work in other professions; again the business may suffer temporarily or even may be liquidated.

In case the bank has “ownership clause”, it can theoretically consider immediate repayment of loan. This is not realistic, in almost all cases – just because the business may be in troubles, usually it does not have cash for repayment.
The bank may use this clause for asking for additional security (pledge of additional real estate, additional 3rd party guarantees etc). Banks may try to ask for additional security even without “ownership clause”, but without this clause, their position is weaker.

5.4.6. Material adverse change

The bank should inform about any “material adverse change” in position of the borrower. Again, the bank and ICBG may agree on an attempt to get additional security, if the “change” has really negative impact on repayment capabilities of the client.

5.4.7. Inspection of loan documentation of the guaranteed loans

ICBG reserves a right to inspect loan documentation. This may be important before final pay-out of ICBG guarantee. ICBG personnel is responsible for making sure, that bank has its loan documentation in order, and that default of client was not facilitated by negligence of bank.

5.4.8. Liquidation of collateral

ICBG reserves a right to approve any liquidation of collateral. This step has direct impact on amount of guarantee pay-out and ICBG is interested in seeing that collateral is not liquidated under fair market value.

5.4.8. Changes in interest rate

ICBG reserves a right to approve any changes in interest rate of the guaranteed loans. Up to a certain degree, imposing penalty interest may have positive impact on willingness of borrower to repay the loan. On the other hand, it is natural, that bank may forgive interest charges to a client in trouble to cope with repayment of principle. Stopping charging of interest may have two reasons:

- It may be a part of re-scheduling package, where the bank and the borrower agree on slower repayment schedule. Forgiving penalty interest charges may be an incentive for the client to provide additional security etc.
- The bank may decide to drop charging any interest, when it sees that the client will have problems with repayment of principle alone. Charging interest which most probably will not be paid distorts accounting records of the bank.

5.4.9. Classification of loans

Banks must classify their loans according to CBI regulations. Banks shall be sending their CBI classification of guaranteed loans on the form shown in the article 5.4.2. – along with overdue days. Banks may have reasons to downgrade classification of certain loans against "overdue days" criterion. This may apply to cases where overdue days are still low, but the borrower is out of business, the business is abandoned by owners etc.

5.4.10. Additional collateral and additional fees of bank

Banks shall not impose additional demands on deposits, collateral commissions, fees etc, except as disclosed in their loan guarantee application. ICBG reserves right of approval of any of such changes for continuation of its guarantee.

5.5. Actions of bank after default of borrower on repayment of loan

In case of delinquency, we recommend to negotiate with the borrower immediately. As a minimum, we recommend the following steps:

- D 2-3 : SMS message
- D5: SMS message + follow-up phone call;
- D7: reminder letter + follow-up phone call;
- D15: 1st registered legal warning letter to borrower and guarantors + follow-up phone call;
- D30: 2nd registered legal warning letter to borrower and guarantors + follow-up phone call;
- D45: 3rd registered legal warning letter to borrower and guarantors + follow-up phone call;
- D60: the delinquent loan case should be transferred to late collection or remedial or legal department – as the case may be – in order to start the legal collection process.

At the same time, the bank should immediately try to find out what are outlooks of alternative re-scheduled repayment.

- If the borrower defaulted on an instalment of an amortizing loan, it is frequently possible to re-schedule the loan and avoid additional problems;
- If the borrower defaulted on "bullet" repayment (e.g. of a revolving or overdraft loan), the loan can frequently be rescheduled into an amortising loan. If financial situation of the borrower is good and the borrower is cooperative and honest, it is sometimes possible to provide a new loan.
- Rescheduling of loan is possible also in "dying industries" – but only if the borrower has a very good chance to repay the loan before the final close-down of the business.

In general, if the borrower provides open and true information and is willing to cooperate, and his financial situation is not totally hopeless, rescheduling of loan is usually preferable to

seizure of collateral or litigation. This is valid especially in cases, when the borrower still has positive operating cash flows. This gives a chance for repayment of loan, while seizure of collateral may mean, that the seized assets may end up in “fire-sale” (forced sale), and that the loan may not be fully repaid.
Rescheduling of loan also may be advisable, when the borrower needs to gain some extra time for sell-off of pledged real estate. Industrial or business real estate is better sold when under operation, than closed down. If real estate sale takes less than some 6-12 months, usually the sale does not bring maximum value. This may have negative impact on recovery percentage of the loan.

5.5.1. Default continuing for more than 60 days – meeting with borrower and other measures – legal aspects of collection efforts

In case the default is protracted (i.e. installment is NOT repaid or rescheduled) over 60 days after its occurrence, the bank should call a meeting with the borrower and ICBG representative, with the aim of establishing further steps – i.e. whether further rescheduling or seizure of assets (litigation) shall be followed. In due advance before the meeting, the bank should check completeness of its documentation, and also completeness of explanatory information from client, dealing with his problems and outlooks. Calling a meeting with a borrower who has no credible materials explaining his situation and no credible plan going forward is not much useful.
Upon transfer of the defaulted case to “remedial” or similar department, the bank should immediately withdraw such case from bonus base of the relevant loan officer and transfer it into “malus” (penalty) base. In case of successful work-out the borrower can be re-assigned to loan officer and into his bonus base again. This ensures full coordination of loan officers.
Seizure of assets, litigation or filing for bankruptcy or foreclosure is usually more suitable under the following conditions:

- when the borrower is not providing true and honest information, is not cooperative and tries to move valuable assets from his firm or trade in effort to avoid repayment of the loan;
- when the borrower tries to collude with 3rd parties to build-up fraudulent liabilities with the aim to minimize repayment of bank loan;
- when the client’s gross operating cash flows are negative and are likely to remain negative and his economic standing seems to be hopeless.

Sometimes seizure of assets or bankruptcy filing may be more suitable approach. In general, even after 60 days of default, it is preferable to investigate possibilities of rescheduling, partial refinancing etc.
Rescheduling – if possible - usually has the following advantages:

- the borrower has a chance to escape bankruptcy, so he or she is usually more cooperative;
- as a result, the bank may achieve additional security, which may be denied in case of litigation or filing for bankruptcy;
- even if the borrower goes bankrupt or out of business after some time, a part of loan may be repaid by then and recovery of loan by bank can be higher.

5.5.2. Measures recommended in case of re-scheduling of loan

As far as the borrower is in default, his business plans usually appear to be less reliable than at the time of approval of the loan.
Bank is therefore entitled - from business point of view - to demand better coverage by collateral, additional guarantees etc – if such instruments are available.
The bank should strive seriously to achieve one or more of the following measures:

- notary-registered irrevocable attorney power for sale of pledged real estate;
- additional promissory notes or demand-bills;
- pledge of additional real estate;
- pledge of additional machinery;
- pledge of additional inventories or receivables;

- security cession of ownership rights to machinery or equipment;
- additional personal guarantees of family members or business partners of the client;

If the borrower is in very weak financial condition, the bank should also strive for "notary-registered attorney power". This instrument means that the bank can recover loan by sale of pledged real estate without waiting for decision of court.
Any eventual additional security shall be related to the whole outstanding amount – the bank is not allowed to split outstanding loan into two parts, one secured better for the benefit of bank, and one secured worse, and covered by ICBG guarantee.

5.5.3. Defaults continuing for more than 180 days – request for pay-out

In case of **default exceeding 180 days**, the bank may decide to call the ICBG guarantee. Within additional **60 days after calling the guarantee** ICBG shall transfer the guarantee value to a blocked account by the requesting bank.
If a meeting with borrower was not held before 180 days threshold, such a meeting with borrower should be called as soon as possible. The meeting should be well prepared, so that the bank and ICBG may decide effectively, whether to pursue rescheduling, litigation or out-of court settlement with the client.
The meeting of course does not have to come to a definite conclusion, but it is highly advisable to reach a definite solution, in order to avoid repeated meetings and site visits.

5.5.4. Activities of bank and ICBG after payment to blocked account (180+60 days after default)

ICBG reserves the right to oversee steps and measures taken by bank in order to achieve repayment of the loan. This is stipulated to prevent situations, when the bank would not develop any activities, or when the bank would not exhaust all practical measures leading to repayment of loan or of its part.
The most important "continuing activities" of the bank can be listed as follows:

- The bank should discuss with ICBG options of "out-of-court settlement" – and eventually discuss them with the borrower.
- In case the borrower is not cooperative, the bank must keep on taking legal steps – according to practically available security.

5.5.5. Measures recommended in case of litigation, seizure of assets, filing for bankruptcy

Starting litigation against a defaulting client, filing for seizure of assets or filing for bankruptcy usually decreases cooperativeness of the borrower in default. The bank should consult all steps with lawyers experienced in bankruptcy proceedings.
Very frequent reasons of failure of litigation against defaulting clients are formal shortcomings in loan documentation:

- formal mistakes in address of borrower,
- formal mistakes in description of seized assets,
- inconsistencies in loan agreements and pledge agreements etc.

Check everything carefully before filing litigation or bankruptcy with a reliable lawyer. If in doubt, invite other lawyers for alternate opinions. Try to repair old legal shortcomings and try to avoid making new legal shortcomings.
Option of out-of court settlement still can and should be evaluated, but it must be discussed and approved by ICBG.

5.5.6. Pay-out of guarantee from blocked account to credit account -

In order to receive final pay-out from blocked account to credit account, the bank must cooperate with ICBG and both parties must conclude that further steps are not likely to bring any reasonable additional repayment.

The basic situation for making the final pay-out is when the bank filed for bankruptcy of defaulted borrower, and the borrower was liquidated – then there is nothing more to do. Bankruptcy procedures may take a long time. Therefore ICBG may agree to pay-out also before the borrower is liquidated. We are listing some of such situations as follows:

- the borrower has not been liquidated yet, but it is clear above reasonable doubts, that the pay-out from liquidation will be negligible;
- The borrower has disappeared or died and has left no assets behind, which could be claimed;
- Other cases, when waiting for bankruptcy or liquidation would evidently bring no positive results.

5.5.7. Transfer of receivable to ICBG

At the moment of pay-out, receivable (i.e. the loan) of the bank is ceded or transferred to ICBG, unless ICBG waives this option in writing in advance. In the case of cession of the receivable to ICBG, the bank submits all relevant loan documentation and keeps complete back-up copies of this documentation.
ICBG continues with collection efforts, and the bank is providing all reasonable requested assistance.
Regardless whether the receivable is ceded to ICBG or remains by the bank, any proceeds of collection efforts shall be divided between ICBG and bank on pro-rata basis.

5.6. Actions of bank and ICBG after final pay-out of guarantee to credit account

In order to limit occurrence of “credit frauds”, banks and ICBG should monitor from public sources symptoms of credit fraud behavior by defaulted parties. In case such symptoms are detected, ICBG may decide to take legal steps against borrowers suspected of committing credit fraud. The monitoring period should cover 2-3 years after final pay-out.
Symptoms which may indicate “credit fraud” by defaulting borrowers include among other the following:

- The borrower after default buys expensive real estate, cars, firms or other expensive assets and there is no reasonable legal explanation how these purchases were financed.
- The borrower after default becomes involved in ownership or operational control of a business or a firm, equity of which cannot be reasonably and legally explained, and which therefore may have been financed from proceeds of a previous credit fraud, it is from embezzled inventories or other assets etc.

In such cases, ICBG may consider taking legal steps, in cooperation with bank. These steps include but are not limited to:

- Filing new litigation against the borrower, aiming for foreclosure or reclamation of embezzled cash or assets;
- Filing criminal charges against the borrower, if his/her behaviour falls under embezzlement or credit fraud clauses of relevant penal codes.

The monitoring period is terminated and the file is closed after 2 years, or at most, after the eventual credit fraud would be forfeited or statute-barred.

Appendices:

Recommended Guarantee Application

Use circles, arrows or ticks for fields for marking answers in multiple choice questions.

Preliminary Loan Guarantee Application for ICBG page 1

Try to fill in yellow fields on page 1, mark applicable fileds from multiple choices, if possible

1 Identification of Borrower — Bank XYZ

Borrower or names of owners	XXX					
Name of business, firm	Bakery Yusuf					
Type of business	workshop, manufacturing					
Address (town, governorate)	Baghdad					
Number of employees	Male	5	Female jobs	3	Total F+M	8
Number of potential new jobs	Male	2	Female jobs	1	Total F+M	3

Remarks:

2 Enterprise, business information

	Product 1	Product 2	Product 3	Product 4	Product 5
Short name of product, service	Bread	Apple cakes	Pizza		
Primary production in physical units per year	360,000	3,600	180,000		
Primary production in ID 000s per year	360,000	3,600	180,000		
New business or established business?	New	Established	Years in operation		6

Remarks:

3 Purpose and structure of requested loan — Loan ID 000 10,000 — Total Loans 10,000

If Fixed Assets	Machinery	Real est.	Both	New	Used	Repair	Enhancement
If machinery, than type, output		Pizza Oven X-B-007, Italy					
If real estate, description, value							
If working capital, then financing of		Inventories		Receivables	Both	Other	Seasonal
Tenor in months	12	Grace period in months			2	Int.rate p a.	18.00%
Instalments	Monthly	Quart.	Irregular according to seasonal CF			Bullet	Other

Remarks:

4 Effect of loan on business, enterprise

Robust increase of sales	Moderate increase of sales		Necessary replacement of machinery
Savings of labor, material costs	Increase of quality of production		Necessary repairs of machinery

Remarks:

5 Sources of repayment

CF from business	Additional CF from other businesses as
Primary collateral, its value (if any)	The purchased "Pizza Oven"
Secondary collateral, its value (if any)	

Remarks:

6 Repayement track record

The cilent did not have any loans	The client had loans from bank ……………………… and repaid them in time
The client had the following problems with repayment	

Remarks:

7 Suppliers

one supplier	several suppliers	numerous possible suppliers	

Remarks:

8 Customers

one customer	several customers	numerous possible customers

Remarks:

9 Market

Village	Town quarter	Town of	Governorate of		Baghdad	Kurdistan
Anbar	Niniweh	Basrah	Southern Iraq	Middle Iraq	Whole Iraq	Middle East	Global
Market Share		Small <10%	Stronger but < 25%	Dominant < 40%		Dominant <80%

Remarks:

Character of products

Commodity	Large scale production		Customized production	Luxury goods	

Description of products sold or services rendered

Remarks:

10 Management

Years of practice		5	Experienced	Technical education		Yes, Technical High School
Succession plans	Children	Other relatives	Partners	Other		None

Remarks:

Recommended Table for Cash Flow Projections

The breakdown follows International Accounting Standard # 7. It has clearly separated sections for operating, investment and financing cash flows. You should be using this or a similar breakdown.

Cash Flow Statement - IAS # 7

Repairs of household appliances US$

		31-Dec-2008	31-Dec-2009	31-Dec-2010
Oper. Profit + extras minus tax	15,600	15,600	15,600	15,600
Depreciation Addback	6,000	6,000	6,000	6,000
Gross Operating CF	21,600	21,600	21,600	21,600
Plus / Minus				
chg in Receivables		(15,000)	0	0
chg in Inventories		0	0	0
chg in Other Current Assets		0	0	0
chg in Advances Received		0	0	0
chg in Payables		0	0	0
chg in Other Current Liabilities		0	0	0
Net Operating CF		6,600	21,600	21,600
Net Purchase or Sale of Fixed Asets		(5,000)	0	0
Investment CF		(5,000)	0	0
Interest and Other Fin. Charges		(2,370)	(180)	0
Dividends / Subscriptions, Other Chng Eq + Res		0		
Change in ST Loans		6,000	(6,000)	0
Change in LT Loans		0	0	0
Change in LT Payables				
Financing CF		3,630	(6,180)	0
Total Cash Flow		5,230	15,420	21,600
Beginning cash		2,000	7,230	22,650
Ending cash	2,000	7,230	22,650	44,250

Recommended Table for Profit & Loss Projections

The breakdown follows International Accounting Standard # 7. It has clearly separated sections for operating, investment and financing profit. You should be using this or a similar breakdown.

Profit & Loss - IAS # 1

Repairs of household appliances — *US$*

	31-Dec-07	YoY %	31-Dec-08	YoY %	31-Dec-09	YoY %	31-Dec-10
Sales	60,000	100%	60,000	100%	60,000	100%	60,000
Other revenues	0	-	0	-	0	-	0
Commissions	0	-	0	-	0	-	0
	0	-	0	-	0	-	0
	0	-	0	-	0	-	0
Total core revenues	**60,000**	**100%**	**60,000**	**100%**	**60,000**	**100%**	**60,000**
Minus COGS	(15,000)	100%	(15,000)	100%	(15,000)	100%	(15,000)
Gross Profit Margin	45,000	100%	45,000	100%	45,000	100%	45,000
General Admin Exp	(19,200)	100%	(19,200)	100%	(19,200)	100%	(19,200)
Operating Expenses	(4,200)	100%	(4,200)	100%	(4,200)	100%	(4,200)
	0	-	0	-	0	-	0
	0	-	0	-	0	-	0
	0	-	0	-	0	-	0
Depreciation	(6,000)	100%	(6,000)	100%	(6,000)	100%	(6,000)
Operating Profit - EBIT	15,600	100%	15,600	100%	15,600	100%	15,600
Interest received		-		-		-	
Other Fin Revenues		-		-		-	
Interest Paid	0	-	(2,070)	9%	(180)	0%	0
Other Fin Charges	0	-	(300)	0%	0	-	0
Profit Bef.Extras & Tax	15,600	85%	13,230	117%	15,420	101%	15,600
Extraordinary Rev.	0	-	0	-	0	-	0
Extraordinary Exp.	0	-	0	-	0	-	0
Profit Before Taxes	15,600	85%	13,230	117%	15,420	101%	15,600
Corp.Inc. Tax	0	-	0	-	0	-	0
		-		-		-	
NET PROFIT	15,600	85%	13,230	117%	15,420	101%	15,600
EBITDA	21,600	100%	21,600	100%	21,600	100%	21,600

Recommended Table for Financial Ratios

The breakdown follows practices of big international banks. It contains also calculation of Z-score and evaluation of 4 basic ratios which are important for evaluation of financial strength of borrowers. Banks should be using at least some of the most basic financial ratios from this table.

Financial Ratios — *A - 11*

Repairs of household appliances — *US$*

Liquidity Ratios		31-Dec-07	31-Dec-08	31-Dec-09	31-Dec-10
Working Capital		7,000	21,230	42,650	64,250
Working Cap / TA		14.29%	31.12%	54.93%	68.90%
Current Ratio		-	453.83%	-	-
Quick / Acid Ratio		-	120.50%	-	-
Cash ratio		-	120.50%	-	-
Activity Ratios					
Days in Inventories		122	487	487	487
Days in Receivables		0	0	0	0
Days in Payables		0	0	0	0
Leverage Ratios					
Interest Coverage		-	754%	8667%	-
Debt/EBITDA		0%	28%	0%	0%
Bank Debt /EBITDA		0%	28%	0%	0%
Debt/Equity		0%	10%	0%	0%
Bank Debt /Equity		0%	10%	0%	0%
Z-score	*factor*	probably bad <123%<neutral<290%<probably OK			
Working Cap/TA	0.717	14%	31%	55%	69%
RE / TA	0.847	100%	91%	100%	100%
EBIT / TA	3.107	32%	23%	20%	17%
Equity / Debt	0.42	500%	500%	500%	500%
Sales / TA	0.998	122%	88%	77%	64%
Total Z-score		**526%**	**468%**	**474%**	**460%**
Z-Score Valuation		OK	OK	OK	OK
Profitability Ratios					
Return on Assets		32%	23%	20%	17%
Return on Equity		32%	19%	20%	17%

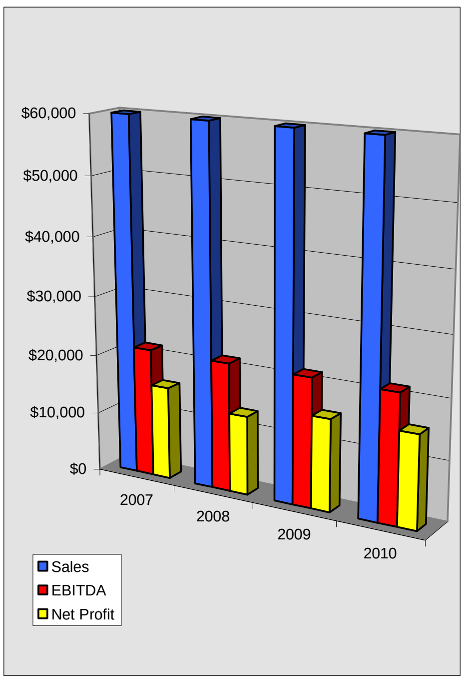
Basic Entry Criteria					
Interest coverage >	150%	OK	OK	OK	OK
BankDebt/EBITDA <	400%	**OK**	**OK**	**OK**	**OK**
Current Ratio >	100%	**OK**	**OK**	**OK**	**OK**
BankDebt/Equity <	100%	**OK**	**OK**	**OK**	**OK**

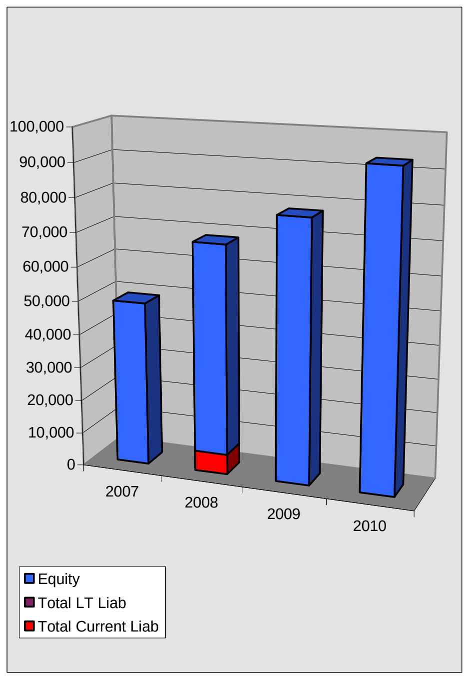
Recommended Executive Summary

The executive summary contains sales, EBITDA, net profit, current and long term liabilities equity of the borrower.
It also contains Debt/EBITDA after expected drawdown of the proposed loan. This ratio is a relatively strong indicator of repayment capabilities of borrower.

Sales, EBITDA, Net Profit

Repairs of household appliances				*US$*
	2007	2008	2009	2010
Sales	**$60,000**	**$60,000**	**$60,000**	**$60,000**
EBITDA	**$21,600**	**$21,600**	**$21,600**	**$21,600**
Net Profit	**$15,600**	**$13,230**	**$15,420**	**$15,600**
Debt/EBITDA after drawdown		**92.59%**		
Total Current Liab	**$0**	**$6,000**	**$0**	**$0**
Total LT Liab	**$0**	**$0**	**$0**	**$0**
Equity	**$49,000**	**$62,230**	**$77,650**	**$93,250**





Sales and costs assumptions

Structure of “Sales and costs assumptions” is usually very specific for different types of businesses. Therefore the following example can serve only as an inspiration for other types of businesses.

The borrower should bring his/her own data. The borrower is “in” the business, and should have the best knowledge of the structure of sales and costs, of the most important items, which small items can be neglected or approximated etc.

Here we present an example of business with 3 sources of revenues. It is a hotel with a café and a restaurant.

*Hotel *****		2008		Revenues and Oper Exp		
US$		number of units	sales/unit	per day	per month	total p.a.
12 month a year					30	12
rooms		28	$38	$1,064	$31,920	$383,040
chairs in quahwanna		20	$22	$440	$13,200	$158,400
chairs in restaurant		20	$34	$680	$20,400	$244,800
Total Revenues						$786,240
		Cost Base	cost as %			
cleaning, heating	rooms		14.00%			$53,626
coffee	qahwanna		35.00%			$55,440
food	reastaurant		38.00%			$93,024
COGS TOTAL						$202,090
Gross Margin						$584,150
depreciation						$120,000
		US$	per month	# of workers	per month	
manager			$3,200	1	$3,200	$38,400
technicians			$1,200	2	$2,400	$28,800
cooks, waiters			$420	16	$6,720	$80,640
Total labor				19	$12,320	$147,840
rentals					$15,000	$180,000
hospitality					$1,000	$12,000
telecoms, other					$1,200	$14,400
Total Operating Costs						$474,240
Total Operating Profit						$109,910
EBITDA						$229,910

The breakdown per chair or room and day allows for comparison with your personal observations. It is possible to make an estimate (after one or more visits) how many people sit on one chair in a day, what they order and pay on average etc. Sales per room should take into account probable occupancy rates (mostly it is about 50%).

Labor expense should include wages or salaries of owner or owners, if they work for the business in any function. Omission to do so usually greatly distorts calculation of repayment capabilities of the borrower.