BANK STRENGTHENING MANUAL

USAID | Iraq Economic Governance II

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Introduction

The purpose of the Bank Strengthening Credit Reference Book is to help the Credit Department of banks to create or improve lending policies and procedures, credit guidelines and other reference tools. It is not a credit policy manual.

This book is a compilation of various documents concerning credit issues. It also reflects personal experience, and aim at facilitating the implementation of the suggestions and recommendations made to the banks, on a wide range of credit related topics.

The documents enclosed are only examples and as such must be adapted by the banks according to their individual needs, to improve or create tools for credit management, in compliance with local banking regulations and laws.

BearingPoint is not responsible for the use made of these documents, or for any misunderstanding in its adaptation, by the banks

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CREDIT DEPARTMENT FUNCTIONS AND DUTIES

The Credit Department of a Bank assumes the lending activity, which is the primary function of a Bank. Its organization differs from bank to bank, according to its needs. It can be organized by regions, industries, clients, kind of resources or terms (CT or LT).

The following document describes the basic functions of this department, regardless of its organization. It has been divided in two main parts. Assessment, which includes all the analysis and approval tasks, and monitoring, which concerns mostly the administrative, and follow up duties. The tasks described hereafter are not exhaustive.

General

The basic functions of a Credit Department are to handle all matters concerned in the granting and controlling of credits.

The authority to grant credits is devolved from the Board of Directors of the Bank through the Chairman, to appropriate assemblies or individuals, such as the Credit Committee, the Head of the Department or the branches' managers.

The Credit Department has two main functions, assessment and monitoring. Monitoring may include work out.

The credit procedures manual will describe the work methodology for each task attributed to the staff of the department.

Training of the Credit Department personnel is the responsibility of the department Management. Each member of the department must be made fully aware of their duties and tasks to be carried out. The allocation of tasks within the credit functions should be carried out in such a way that there is a clear division of duties.

Assessment should include

- Receive and record credit applications from bank's branches or from clients directly.
- Assess the information accompanying the credit application

- Analyze the applicant's business plan and financial documents, in order to assess the risk, the ability of the applicant to repay the loan, and the availability of collateral. Prepare a detailed Credit Analysis and Loan Assessment, for presentation to the higher authority, according to a standard format and guidelines.

- Propose to the client a different loan structure, if possible and/or necessary.

- Examine the legal documents submitted to confirm the legality of the request

- Interview the applicant at its place of business and obtain further information where necessary, and verify the information described in the business plan.

- Approve or decline the request, and present the application with a proper recommendation to the Credit Committee, for final approval or refusal.

- Advise the branch (if applicable) of the credit decision.

- If approved, prepare the loan agreement containing the terms and conditions of the loan, the collateral agreement, and all the necessary legal documents which are to accompany the loan agreement.

- Submit the legal documents to the legal department for review.

- Submit the collateral agreement to the valuation department.

- Have the client sign the legal documents.

- Complete registration of any legal documents where such is required.

- Obtain such legal opinion as may be necessary.

- Ensure that borrower's account has been opened, and open a credit account.

- Prepare and maintain for each borrower, a file containing all the information related to the client and the loan, including copies of all legal documents, and all information concerning any which may have affected or may affect the loan and the legal structure of the borrower.

- Assist the branches in maintaining a relationship with each borrower.

- Accompany the branch officer on visits to the borrower, from time to time.
- Calculate the interest due on each credit and ensure payment at due date.
- Maintain a schedule of all dates when principal and interest are due, and contact the borrower, through the branch, immediately if payment is not received.
- Prepare all accounting entries concerning the loan.
- Provide the management of the Bank such reports as requested.
- Maintain a close liaison with the monitoring division.
- Co-operate with other departments of the bank where necessary.

Monitoring should include

- Monitor all outstanding credits and to ensure that all-necessary action is taken to reduce the level of risk to the Bank.
- Ensure borrowers keep time sensitive information current
- Provide reports on the Bank's loan portfolio, its conditions, diversification, performance and profitability, to the management of the Bank
- Ensure that interest payments and principal repayment are received when due, and take action to recover any overdue amount.
- Take active steps to recover all loans classified as bad or doubtful, and exercise full control of such loans.
- Provide the Bank management with advice and recommendations on credit policies, new products, loan recovery, credit procedures, documentation, commissions, fees, etc..
- Obtain information on industries, products, level of profitability, markets, industry ratios and other important statistics, which may help the management in its credit, decisions (database).

- Maintain a close relationship with loan approval division and other departments of the Bank
- Keep track of the global credit exposure of the Bank.
- From time to time Conduct a credit review of each borrower at intervals as may be deemed necessary
- Classify the loans according to international standards, and National bank regulations.
- Make such provisions for loan losses as required by the National Bank.
- Ensure that the Bank's credit operations are in compliance with all statutory regulations.
- Carry out all such activities as may be requested by the Bank.

This list is not exhaustive. The tasks described will be allocated to the different units of the Credit department in accordance with its organization.

3

LOANS CLASSIFICATION AND CLIENTS RATING

Loans are usually rated according to the guidelines of local Banking Authority. This document indicates the usual International standards not only for rating of the loans for reserve purposes, but also for classifying the clients according to objective or subjective criteria.

Classification of the clients is independent from loans rating. It reflects their general financial situation, and the past experience with the bank. A client may be considered very good even if he experiences temporary problems which may lead to the downgrading of a loan.

1. Loans Classification

<u>This classification has been designed according to international standards adopted by the main international auditing firms. Provisions may vary according to local regulations.</u>

Classification	Standards	Provisions
Standard /Pass	♦ Collateralized loans which have not yet come due ♦ Collateralized loans which are overdue up to 30 days ♦ Inadequately collateralized loans which have not yet come due ♦ Un-collateralized loans which have not yet come due	2%
Watch	♦ Collateralized loans which are overdue 30 to 90 days ♦ Inadequately collateralized loans which are overdue up to 30 days	10%
Substandard	♦ Collateralized loans which are overdue 90 to 180 days ♦ Inadequately collateralized loans which are overdue 30 to 90 days ♦ Un-collateralized loans which are overdue up to 30 days	25%
Doubtful	♦ Inadequately collateralized loans which overdue 180 days ♦ Un-collateralized loans which are overdue 30 to 90 days	50%
Loss	♦ Collateralized loans which are overdue over 180 days ♦ Inadequately collateralized loans which are overdue over 180 days ♦ Un-collateralized loans which are overdue 90 to 180 days	100%

2. Clients rating

Clients can be assigned a rating. Only those belonging to the highest categories should be considered as potential borrowers.

<u>Very good</u>

- Has demonstrated ability to produce recurring profits
- Had a positive cash flow for several years
- Has a strong financial performance
- Has a high level of liquidity has a minimal balance sheet leverage industry is in favorable market conditions
- Has repaid previous obligations towards the Bank in due time and has a good track record with the Bank

<u>Good</u>

- Has demonstrated its ability to generate recurring profits
- Has a positive cash flow has a good level of liquidity
- Has a low balance sheet leverage, financially stable
- Satisfactory relationship with bank

<u>Average</u>

- Has a positive cash flow
- Has high working capital needs
- Works within weak market conditions
- Has average financial leverage
- Certain unsatisfactory aspects on financial performance
- Doubt as far as timely payment of debt is concerned
- Security liquidation may be necessary

<u>Weak</u>

- Has negative cash flow
- High leverage
- Low net worth
- Lack of resources or alternative sources for repayment
- Bad track record
- Works in a poor economic environment
- Partial or total loss could be expected

<u>Poor</u>

- Has negative cash flow
- Very high leverage
- Negative net worth
- No definitive sources of repayment
- Lack of liquid assets and collateral
- Bad track record

4

GUIDELINES FOR CREDIT ANALYSIS AND LOAN ASSESSMENT

This document outlines the general principles of credit analysis and loan assessment. It explains the reasons for lending, the benefits and the risks. It describes the elements that have to be taken into consideration when analyzing a loan request.

This guide does not enter into all the details of financial analysis but merely indicates the areas of concern.

1. Introduction

Lending is the primary function of a bank.

The credit department has a major role in the system as a source of creation of assets and source of revenues. But it also involves risks and potential losses.

Sound banking practices requires assurances that the loans will be repaid. Losses quickly erode the assets of the bank and results in the loss of confidence of actual or potential depositors, who are one of the main sources of funds for lending.

The requirements of safety and the reliability of its loan portfolio govern a bank's lending activity.

Credit analysis serves as a function of screening loan applications and assessing the ability of the clients to repay their loans.

<u>Look at the risk in term of cash flow repayment and not according to the possibility of selling collateral, as the collateral is usually difficult to sell and often not sufficient to cover the debt.</u>

If a client does not show that he can repay from his own resources, a bank should not lend him, even if he has substantial assets. Of course appropriate collateral must be taken as a guarantee, should there be a cash flow shortfall.

Lending money to a company, which is already in financial jeopardy, is dangerous and reprehensible.

In the past banks relied upon their personal knowledge of the clients and their business, as they did not have access to financial statements or projections. The banks familiarized themselves with the nature of the clients business, the ethics of the management and its ability to run the company efficiently. In addition they often depended on collateral as primary source of repayment in case the client defaulted on his obligations. In the present world environment, such personal knowledge gained through experience and proximity is no longer practical or possible. The growth of the businesses, in size and complexity has diluted the banker's ability to make a sound judgment and decision, solely on personal knowledge. At the same time the competition and the complexity of the banker's marketplace has reduced the ability to gather such personal information.

This is why it is important for the bank to have a good idea of the present and expected financial condition of the companies.

Financial statements have evolved as primary tools to assist lending officers in evaluating the risks and assess the companies' performance.

The bank must lend only when it has full confidence in the ability of the clients to repay the loans.

The credit analyst will base his judgment on three main criteria:

- Ability to generate a maximum sales revenue
- Financing the assets investment with a minimum risk to creditors
- Managing the operations and costs to optimize the profits

2. Credit risk analysis and company's assessment

The purpose of credit analysis is to identify the risks to which a bank may be exposed over the life of a project financed by the bank, and to evaluate if the transaction is structured in a way that make those risks acceptable to the parties involved.

2.1 Knowing the business

A lending officer (LO) must have a good understanding and knowledge of the company and its business, in order to form a sound judgment and make proper recommendations.

The main tasks of the LO are to:

- Develop a detailed understanding of the Borrower
- Obtain and verify information
- Identify the risks
- Make recommendation and suggest strategies for risk mitigation

- Help borrower define his borrowing needs in terms that fit within the bank's lending capabilities

There are three main components to a company: The management, the company's business, and the project.

Management: What are its strengths and weaknesses? Does it have the skill and the experience to see a project through to completion?
Does it appear serious and honest? What do we know about it? Past experience?

Business: How mature is the industry? Is there a market for the product? What is the competition? Is there enough supply of raw material? What experience does the bank have with the company?

Project: Does the project make sense and does the company have the capability and the skills to operate at optimum levels.

Has the management team developed a plan that shows clearly the reason for the project? Is the purpose of the loan justified? Is the company financially sound and how was the past performance? Is the company capitalized enough to withstand potential losses or shortfalls in liquidity? Are the sources of repayment apparent and sufficient?

All these components have to be clearly defined in the business plan prepared by the Management.

2.2 Obtaining and verifying the information

Information concerning the company and the project will be gathered from different sources, including the borrower, government entities, industry specialists, and various agencies. In some cases consultants may be appointed to study the feasibility of the project or to evaluate the accuracy of one of its component.

The most important information supplied by the borrower is the business plan.

A business plan is a complete and comprehensive description of a business, how it is managed and the environment in which it operates. This plan must be detailed.

The following outline the major sections of a business plan:

a) Executive summary

The executive summary is important, because this is what people read first.

It should be as short as possible, clear and concise, and highlight the business. It should include the following description:

- A short history of the Company and its organization. When was it founded?
- A brief description of the business and its environments.
- The legal structure.
- The objectives. Marketing plan.
- The purpose of the plan
- The proposed financing

b) The company

- Description of the organization of the company
- Description of the business objectives

c) Management

- Background. Qualifications. Experience

d) Production and operations

- What does the company do or produce
- Place on the market
- Competition. Local and international.
- Production factors
- Pricing. Structure. Terms of payment.
- Currencies of payments. Exchange risk.
- Local infrastructure
- Equipment-Plant
- Production plan

e) Marketing

- Strategy. Plans
- Sales organization
- How to compete
- Choice of distribution channels
- Promotions
- International business
- Attendance to international exhibitions.

f) Environment

- Are there any environmental problems
- How are the problems solved
- Does the company comply with local regulations
- What environmental benefit will the new investments bring?
- Environmental opportunities

g) Financial presentation. (Three years actual and future projections for the length of the credit) Balance sheet, Profit and loss account, Cash flow

The business plan must explain the various items and parameters of these documents. What are the assets and liabilities made of, what is the inventory, quality of accounts receivable, and currencies of payment. Terms of payment, explanation of projections calculations, assumptions, ratios...etc. <u>All the information provided by the company should be verified</u>

The business plan should be presented with documents, which will substantiate that the information provided is accurate. Never take anything for granted.

- Certificate of incorporation
- Authorized signatures- certificate of incumbency
- Bye-laws of the company-shareholders agreement
- Corporate resolutions

The bank will physically inspect the company to check inventory, collateral, real estate etc.

The bank will try to obtain outside information regarding the market, the supply and the competition.

Ministries or government agencies will be contacted to verify information such as environmental matters.

Credit checking will be done with other lenders, if possible.

2.3 Identification of potential risks

The objective is to identify the main risks pertaining to the project:

a) Country risk:

The analysis of the country risk will concentrate on the political stability of the country where most of the goods produced are mostly sold.

For goods exported it will be necessary to evaluate other risks like exchange control problems and money transfer problems, country records on servicing external debt.

The LO should also look at indicators such as exchange rates movements

b) Guarantor risk:

If a third party guarantees the loan, the risk on this guarantor must be looked at in the same way as that of the borrower

c) Project risk:

It is important to analyze the risks that might affect the completion or the management of a project.

For example weather conditions, late delivery of equipment, strikes, may affect the time taken to complete a project. An entire season could be lost, resulting in the inability for the company to service the debt, due to a cash flow shortfall.

Also a project could be disrupted by external elements such as electricity, gas or water shortage.

Guarantees of maintenance, availability of spare parts is important to reduce the project risks.

d) Market and commercial risk:

Analysis of an industrial company should address the market risks.

The projections will be supported by a review of the industry outlook and by historic data. The local market and the competition should be assessed by obtaining whenever possible, independent information and confirmation for the assumptions.

e) Production, supply risk:

Problems of supply, costs of labor, raw material prices should be addressed and verified.

f) Management risk:

Test the management ability to adapt to new technology and to compete in a free market. Experience, reputation, competence and qualifications should be verified

g) Environmental risk:

This risk should be seriously examined.

When a bank takes title to property as collateral, it may incur direct liability for damages.

Environment problems may affect the ability of the client to repay his debt. To the contrary environmental opportunities may improve the client financial condition by reducing expenses.

Check the compliance with national environmental laws. Non-compliance can result in product liabilities that may affect the cash flow of the borrower.

h) Financial risk:

Analysis of the balance sheet and the income statement should identify existing financial risks.

Particular risks that deserve attention include capitalization risk where low equity would result in a limited ability to absorb potential losses, or to serve a high level of debt.

The analysis should address any liquidity problems and include alternative sources of liquidity, including other bank lines.

i) Exchange risk.

The exchange risk can arise from different elements

- Loan in a foreign currency, which has to be repaid in that currency. This risk can be mitigated by invoicing sales (export) in the same currency as the loan and use the proceeds to repay the loan

- Import or export payable in foreign currencies This risk can be mitigated by compensating payments and receipts in a similar currency (Or by FX coverage if possible)

2.4 Financial risk analysis

The financial risk analysis focuses on:

a) Financial documents/Projections

The balance sheet
The profit and loss account
The cash-flow statement

The balance sheet reflects the company's financial structure. It shows the liabilities and the assets of the company, and its net worth. The balance sheet also indicates the ability of the company to repay debts should it not be able to do so from the cash flow.

The profit and loss account or Income Statement shows if the company has generated any profits or losses.

Checking includes.
- Operating margin consistent with industry trends
- Sales growth consistent with market share and market size assumptions.
- Operating profit growth consistent with margins and sales growth

The relation between the B/S and the P&L is reflected in the net worth of the company (Retained earnings), which is the difference between the assets and the liabilities

The cash flow statement is the report of flows of funds in and out of a company.

It allows to determine if the ability to repay its debt.
It shows the potential need for working capital financing.
It reflects the changes in the balance sheet.
A C/F statement will include:

- The sources of cash
  - Profit (before depreciation)
  - Sales of assets
  - Capital increase
  - Borrowing

- The uses of cash
    - Inventory purchases
    - Assets acquisition
    - Repayments of debts
    - Payments of dividends (discretionary expenses)

b) Key ratios analysis

Current ratio: a broad measure of liquidity. Indicates relationship between current assets and current liabilities. Should be above 1. Current assets/ Current liabilities.

Quick ratio: a more severe measure of liquidity that shows the relationship between the more liquid current assets and the current liabilities**.** Cash + marketable securities + accounts receivable/current liabilities.

Debt to Net worth: indicates the dollars owed the creditors for each dollar of internal funds. It also measures the possibility of new external financing. Total liabilities/ Net worth. Maximum 2. The lesser the better. Should not be more than two, but depends on the industry. The higher the ratio, the greater is the financial risk. That means that the company might not be able to repay its debts. The ratio depends on the industry and the cycle of conversion of the current assets.

A company with a high business risk should have a higher owner's equity.

Gross profit margin: indicates dollars of gross profit resulting from each dollar of sales. Depends on the industry. Gross profit/ Net sales

Operating margin: Operating profit/ Net sales

Debt service coverage ratio: allows to measure how many dollars of cash flow will be available to repay each dollar of loan principal and interest. The DSC should be above one.

Net cash flow/ Principal + Interest

The summary of financial analysis and key ratios included in the credit application presented to the Credit Committee will enable the members of the committee to make a sound credit judgment.

2.5 Evaluation and conclusion

- Evaluation

All the facts assembled during the analysis should be taken into consideration to do the final evaluation of the project. The evaluation should have three perspectives:

- The risk assumed by the bank
- The opportunities to improve the performance of the borrower
- The benefits for the bank

- Mitigation

Risk mitigation is developed to protect the bank against events that could cause the risk for the bank to deteriorate:

- Financial ratios
- Supply, sales agreements
- Adjustments to the term of the loan
- Insurance protection
- Guarantee- proper collateral
- Reporting
- Exchange risk coverage
- Environmental opportunities

Mitigation will be reflected by the covenants included in the loan agreement.

- Benefits for the bank

- Revenues
- Developing banking relationship

3 Security

<u>A sound credit analysis does not rely on the liquidation of security for repayment.</u>

Nevertheless given the uncertainties surrounding many borrowers, it is appropriate to seek security to protect the bank interest.

Determining the value of security depends on several factors:

- Current value of the assets
- Future liquidation value
- Liquidity of the collateral
- Cost to the bank to liquidate

The bank has to ensure that it will have priority in the distribution of the liquidation proceeds, by taking security: mortgages, first liens, and titles. This means that no other lenders can be repaid before the secured lender.

Guarantees from shareholders, banks, and parent companies should be thoroughly analyzed. The lender should not make a decision to lend, simply on the basis of the guarantors.

4 Loan Agreement

The loan agreement is an important part of the credit process. It should be drafted as to limit the risks as much as possible and include all lending conditions and mitigation covenants. Funds must not be disbursed before the agreement has been duly executed.

5

BASIC LOAN APPROVAL PROCESS AND FOLLOW UP

1. Target Market Definition

2. Initiation

- Client Request
- Prospect Discovery
- Outside Referral

3. Evaluation

- Purpose
- Business
- Management
- Financials

4. Negotiation

- Term
- Repayment
- Covenants
- Collateral
- Other

5. Approval

- Credit Analyst
- Credit Department Manager
- Credit Committee

6. Documentation

- Legal Drafting
- Documentary Review
- Collateral Checks
- Other

7. Disbursements

8. Administration

- Follow-through
- Financials
- Covenants
- Collateral
- Loan Payments
- Credit Review

9. Repayment

- Principal
- Interest

10. Problem Situation

- Early Recognition
- Strategy
- Re-negotiation of Terms
- Legal Counsel

11. Loss

- Collection Efforts
- Legal Efforts
- Bankruptcy

6

KEY FINANCIAL RATIOS

It is important to calculate certain financial ratios, when assessing the quality of a loan and the associated risks.

A ratio is an instrument, which enables a loan officer to measure the degree of risk and the profitability of a company, and its ability to repay a loan, and helps him and the Credit Committee to make a sound credit decision.

There are many ratios that are utilized in the credit analysis process; however, order to simplify this process, only the most important ratios have been identified. This list is not exhaustive, and therefore the Credit Department may wish to expand this list with additional ratios.

The five key areas of credit analysis are:

Profitability: represents the degree to which a business is able to produce sales greater than the cost of doing business.
Efficiency: represents the effectiveness of the company's management of its resources and activities.
Leverage: the difference between the funds supplied by the business owners and the financing supplied by creditors.
Liquidity: the ability of the company's management to meet current obligations.
Debt service coverage: Measures how many currency units are available to repay each currency units owed to the Bank

Profitability

Operating Profit Margin: The calculation is Operating Profit/ Net Sales x 100. This ratio represents the percentage of profits retained from each sales dollar. In the analysis, this ratio should remain stable or increase over time. Furthermore, a detailed breakdown of expenses is required in order to understand any changes in the ratio.

Net Profit Margin: The calculation is Net Profit/Net Sales x 100. This ratio measures the business ability to generate profit from each sales dollar. In general, this ratio should move in the same direction as the gross and operating profit margin. Changes in this ratio require a closer look at non-operating expenses, for example: interest expense.

Direct Cost and Expense: The calculation is Cost of Goods Sold/Net Sales x 100. This ratio indicates the percentage of each sales dollar used to fund expenses. An upward trend may indicate reasons for declining profitability and a downward trend may indicate good cost control.

Efficiency

Inventory Days on Hand: The calculation is Inventory/Cost of Goods Sold. This ratio indicates management's ability to efficiently manage inventory and a low ratio is good. A large increase in this ratio may indicate a deliberate management decision to make a large purchase or perhaps there is a possible supply disruption.

Accounts Receivable Days on Hand: The calculation is Net Accounts Receivable/Net Sales. This ratio indicates management's ability to collect receivables and this ratio is critical to a company's cash flow. It is necessary to analyze the accounts receivable aging schedule and receivables concentration and poor quality receivables (past due and worse) can significantly increase this ratio and have an effect on a company's cash flow.

Accounts Payable Days on Hand: The calculation is Accounts Payable Cost of Goods. This ratio measures financing by suppliers to the company and management's bill paying habits. Increasing days on hand may indicate cash flow problems. Likewise, if the accounts receivable days on hand increase significantly, it may indicate a short-term solution to cash flow problems. In general, a company with cash flow problems will delay payments to its suppliers.

Return on Assets: The calculation is Net Profit before Taxes/Total Assets. This ratio measures the return on investment represented by the assets of the company. It is better to analyze as Net Profit before Taxes to eliminate the effect of taxes.

Return on Equity: The calculation is Net Profit/Net Worth. This ratio measures the rate of return on owners' equity. This ratio measures management's ability to operate a profitable company and if the ROE is good, then the company should be able to generate additional equity.

Leverage

Debt to Assets: The calculation is Total Liabilities/Total Assets. This ratio indicates the degree to which external creditors (for example using bank loans instead of financing from retained earnings) fund assets. In this analysis, the lower the figure, greater is the ability of the company to repay loans in the event of liquidation.

Debt to Net Worth: The calculation is Total Liabilities/Net Worth. This ratio measures how many $ of bank or other financing there are for every $ of owners' equity. This ratio indicates the company's ability to borrow more money. A high ratio equals high risk.

Liquidity

Current Ratio: The calculation is Current Assets/Current Liabilities. This ratio measures the current assets available to pay current obligations. The analysis must be aware of accounts receivable and inventory quality and, if either are poor, then this measure can be misleading.

Quick Ratio: The calculation is Cash + Government Securities + Net Accounts Receivables/Current Liabilities. This ratio is a more severe measure of current liquid assets that are available to pay current obligations.

Debt Service Ratio

DSR: Net Cash Flow/Principal + Interest. This ratio that measures the ability of the company to repay its debts to the Bank should be above 1.5. The greater the better.

7

COLLATERAL MARGIN LIST

Banks are required to secure their loans, to mitigate the risks, by taking security interest in their clients' assets, regardless of the potential available cash flow.

The security interest is called collateral. The value of the collateral should always be superior to the amount of the loan (With the exception of cash collateral). The document hereafter describes the types of collateral that are acceptable and the loan to value requirements usually considered as adequate according to International Standard.

The following memo outlines the various types of assets that the Bank can and should accept as collateral. In addition, the Collateral Margin List provides for lending margins against this collateral. In other words, what is the maximum loan amount the Bank will approve against a percentage current market value of the asset? We also refer to this as the **Loan to Value** or **Maximum Loan Advance Requirements.** All Loan To Value requirements are net of current assets, and all collateral values are based on the current market values of the assets held as collateral, unless the Bank specifically notes a different amount. As part of the loan to value analysis, the collateral value sources should be documented in the file and reviewed periodically as to their reasonableness, or the maintenance of their quality and condition, hence the continuation of their current market value. In the case of collateral, the borrower agrees in advance that some specified assets of the borrower would be taken over and sold by the bank to pay the loan in the case of default.

The most common types of collateral can be summarized as follows:

Inventory
Accounts Receivable
Registered Collateral
Pledged Collateral
Real Estate
Other Collateral

<u>Inventory</u>

When lending is based on inventory as the only collateral, the bank should lend no more than **50%** of the collateral value. A lien on inventory is a "floating" lien, which means there is a constant stream of new items coming into inventory and a constant stream of

sales that take the items out of inventory. The assumed inventory that would be available in the case of default can only be a rough estimate based on previous experience.
The formulation in the Loan Agreement or Collateral Agreement defining the inventory that would be transferred to the bank in the case of default could be as follows:
"All present and future inventory, including but not 1imited to:

a) All goods and other property which are held for sale or lease
b) Or furnished under any contract of service
c) Or are raw materials, work-in-progress, supplies or materials used or consumed in the business
d) Including substitutions, replacements, additions, etc.
e) Including all inventory that may be returned or repossessed."

The borrower should submit monthly inventory reports. The records should be subject to an audit or review by the bank and the bank is permitted to make unannounced visits to check the inventory. If possible, the bank also should take Accounts Receivable as part of its collateral along with the Inventory to avoid misunderstandings if another creditor is able to obtain a lien or position in the Accounts Receivable.
Different kinds of companies will have different types of inventory. For example:

- Wholesale/Retail Stores: goods being held for sale
- Manufacturer: raw materials, work -in-progress. Finished goods
- Leasing Co.: goods that are leased

Accounts receivable

When lending is based on Accounts Receivable as the only collateral, the bank should lend up to a designated percent (usually **50-70%** and certainly no more than **70%** maximum) of average eligible or "good" Accounts Receivable. Eligible accounts receivable are those that result from normal business sales that are not more than 90 days past due. Accounts Receivable that result from judgments, employee loans, counterclaims or more than 90 days past due are not eligible accounts receivable.
Account payments can be controlled in several different ways:

a) The bank allows the borrower to continue to collect the accounts with the understanding that the bank has the right at any time to require that the payments be made to the bank.

b) The bank allows the borrower to collect the accounts receivable, but it requires that all collections be deposited in a special account. A percentage of the money in the special account goes to reduce the loan and the balance is used as working capital by the borrower.

c) Receivable payments are made to a special account tightly controlled by the bank. All receipts become loan payments against a 'Line of Credit' and the borrower obtains cash by drawing against the Line of Credit.

d) If a borrower starts showing signs of financial problems or if there are indications of a possible default under a Line of Credit, then the bank must take control of the accounts and notify the Accounts Receivable individuals/companies to make payments now directly to the bank.

Language in the Loan Agreement or Collateral Agreement should be: "The borrower grants to the bank a security interest in all accounts now owned or hereafter arising, including all proceeds from the disposition or collection of accounts receivable, all borrower's rights as an unpaid supplier, including rights to reclaim the goods and borrower's rights to goods securing the accounts receivable."

Furthermore a "Borrowing Base Certificate" should be provided by the borrower on a monthly basis, to indicate the changes in receivables and the amount of borrowing available to him. An "Assignment of Receivable" will be attached to the loan agreement.

Registered Collateral

In contrast to pledged collateral, registered collateral is not physically given to the bank, but remains in the possession of the borrower. The pledging of the collateral is carried out by means of an entry in a special register. This specifies that in case of default by the borrower, ownership will be transferred immediately to the bank. Some examples of registered collateral are:

a) ***Livestock.*** By recording sheep, goats, cows, horses, etc. in the official records of a central registry – maintained by the Central Bank or separate government agency – or in a central registry maintained by the bank, a herder can obtain a loan.

b) ***Trucks/Autos.*** A transport company or tourism company can obtain a 1oan using the security of the trucks/autos as collateral, in which case this registered collateral is entered in the register of the transport authorities or similar organization.

c) ***Aircraft.*** Airlines can obtain a loan on the security of the aircraft, in which case the registered collateral is entered in the aircraft, register of the Civil Aviation authorities.

Pledged Collateral

In this case, collateral is physically kept in the possession of the bank during the term o f the loan. If the borrower defaults, then the bank can sell the collateral to cover loan payments. Language in the Loan Agreement or Collateral Agreement could be as follows: "The collateral of ________________ is to secure or cover any and all bank charges, including principal, interest, interest past due and fees and/or commissions. If the borrower does not provide additional collateral within an appropriate period after the request has been made by the bank, or if the borrower becomes past due with his/her obligations to the bank, then the bank has the right to sell the collateral at its sole discretion."

Some examples of physically held collateral are:

- Stocks/government bonds
- Precious metals (gold, silver, etc.)
- Artworks
- Time/savings deposits

Real Estate

Real estate, in general, maintains or increases its value over time and therefore represents a good type of collateral for a bank. In order to be legally correct, real estate collateral requires official registration. This registration allows the bank to quickly take over the real estate if a borrower defaults. In addition, it gives clear priorities in case the borrower attempts to use the same real estate as collateral with other banks.
Every registered lien on real estate is numbered 1, 2, 3, etc. in accordance with the chronological order of its entry in the land register. If a borrower defaults, then claim No. 1 is paid first, followed by claim No. 2, etc., in the order of entry.
A bank before accepting real estate as collateral should check that it has a No. 1 claim and, if not, then what number claim would the bank have. It is also the obligation of the borrower to notify the bank if, after giving the bank a No. 1 claim or lien, the borrower gets an additional loan from another bank using the same real estate as collateral. That second bank would therefore have a No. 2 claim or lien. The first bank needs to ensure in this instance that the new claim or lien does not weaken its position or No. 1 claim.

Some examples of real estate collateral are:

a) Real Property
    - Land
    - Buildings

b) Independent and Permanent Rights
   - Rights over Buildings
   - Water Rights

c) Co-ownership Shares
   - Flats/Apartments

d) Mines
   - Iron ore
   - Minerals

Other collateral

In addition to the major assets outlined above, the Bank may consider taking other assets as collateral. It should be always remembered that the present or future value of collateral has to be adjusted for amortization; that market prices have also to be taken into consideration; and, that a sufficient margin between the amount of the loan and the value of the collateral has to be considered.

Some examples of other types of collateral are:

- Factory machinery and equipment
- Tools
- Furniture
- Computers
- Company cars

Loan to Value Requirements

Limit	Definition
< 75%	Income producing/owner occupied real estate
< 60%	Farm land
< 40%	Raw land. Defined as non-income producing land, with no permits/approvals for development
< 70%	Land development and construction. All approvals must be in place before closing of the loan.

< 75%	Secured loans where real estate and building assets are collateral.
< 50%	Inventory: raw material, work-in-progress and finished goods
< 70%	Accounts Receivable: only those up to 90 days.
< 65%	Business assets: machines, equipment, tools, spare parts and other working assets
< 60%	Livestock
< **100%**	Time/savings deposits
< 75%	Precious metals: gold, silver, etc.
< **100%**	Central Bank government bonds
< **50%**	Stock of publicly traded companies
< **50%**	Other collateral: furniture, computers, company cars, and household items

8

WARNING SIGNS OF PROBLEM LOANS

Banks should be aware of the various signs that may indicate that a loan might deteriorate and become a problem for the bank. Banks must find a quick solution to correct problem loans in order to avoid losses.

The management, the operations, the financial situation and the banking practices of the customers can generate the warning signs.

Management:

- Change in behavior or personal habits of key people
- Marital problems
- Change in attitude towards the bank/banker, especially a lack of cooperation
- Failure to perform personal obligations
- Changes in management, ownership or key personnel
- Illness or death of key personnel
- Inability to meet commitments on schedule
- Recurrence of problems presumed to have been solved
- Inability to plan
- Poor financial reporting and controls
- Fragmented functions
- Venturing into new acquisitions, new business, new geographic area, or new product line
- Desire and insistence to take business gambles and undue risk
- Unrealistic pricing of goods and services
- Neglect or discontinuance of profitable standard lines
- Delay in reacting to declining markets or economic conditions
- Lack of visible management succession
- One-person operations showing growth patterns that strain the capacity of the owner to manage and control Change in the business, economy or industry
- Labor problems

Operations:

- Change in the nature of the company's business
- Poor financial records and operating controls
- Inefficient layout of plant and equipment
- Poor use of personnel
- Loss of key product lines, franchises, distribution rights, or sources of supply
- loss of one or more major, financially sound customers
- Substantial jumps in size of single orders or contracts that would strain existing productive capacity
- Speculative inventory purchases that are out of line with normal purchasing practices
- Poor maintenance of plant and equipment
- Deferred replacement of outmoded or inefficient plant and equipment
- Evidence of stale inventory, large levels of inventory, or inappropriate mix of inventory

Financial:

Balance Sheet

- Failure to get statements in a timely fashion
- Slowdown in receivables collection period
- Deterioration in customer's cash position
- Sharp increases in dollar amounts or percentage of Accounts Receivable
- Sharp increases in dollar amounts or percentage of Inventory
- Slowdown in inventory turnover
- Decline in current assets as a percentage of total assets
- Deterioration of the liquidity/working capital position
- Marked changes in mix of trading assets
- Rapidly changing concentrations in fixed assets
- Large increases in reserves
- Concentrations in non-current assets, other than fixed assets
- High concentration of assets in intangibles
- Disproportionate increases in current debt
- Substantial increases in long-term debt
- Low equity, relative to debt
- Significant changes in balance sheet structure
- Presence of debt to/due from officers or stockholders
- Qualified audit
- Change of accountants

Income Statement

- Declining sales
- Rapidly expanding sales
- Major gap between gross and net sales
- Rising cost percentages/narrowing margins
- Rising sales and falling profits
- Rising levels of bad debt losses
- Disproportionate increases in overhead, relative to sales
- Rising levels of total assets, relative to sales/profits
- Operating losses

Receivables Aging

- Extended average age of receivables
- Changes in credit policies
- Extended terms
- Replacement of accounts receivable with notes receivable
- Concentration of sales
- Compromise of accounts receivable
- Concentrations of seriously past due accounts
- Receivables from affiliated companies

Banking

- Declining bank balances
- Excessive note renewals or unanticipated note renewals
- Poor financial planning for fixed asset requirements or working capital requirements
- Heavy reliance on short-term debt
- Marked changes in the timing of seasonal loan requests
- Sharp jumps in the size/frequency of loan requests
- Loans where more than a single source of repayment cannot be easily or realistically identified
- Loans where the purpose is ”working capital”
- Calls from existing suppliers requesting credit information to evaluate requests for special terms or expanded credit information to further evaluate the company
- Calls from new suppliers, requesting credit information to open new credit lines
- Appearance of other lenders in the financial picture, especially collateral lenders
- Evidence of checks written against uncollected funds

9

CHECKLIST FOR EARLY WARNING SIGNS

The following checklist for Financial Early Warning Signs should be distributed to all analysts in the Credit Department and used as a mean to identify and resolve potential problems that may arise with a loan. The specific purpose of this checklist or early warning system is to resolve problems before a loan deteriorates.

Name of Borrower: **Date:**	
Type of problem	**Description of the problem**
1. Deterioration in Borrower's cash position	
2. Slowdown in Accounts Receivable collection	
3. Slowdown in Inventory turnover	
4. Changes in composition of A/R and Inventory	
5. Multiple Liens on the same asset	
6. Concentration in "other" non-current assets	
7. Increasing Operating leverage	
8. Increases in A/R "returns" and "charge-off"	
9. Increasing Sales but with declining margins	
10. High dividends payments	
11. Loans to company insiders	
12. Labor problems	

13. Lack of management experience and/or key management departures	
14. Over-reliance on single supplier/product/customer	
15.Absence of controls: dirty plant, frequent accidents and poor inventory	
16. Products and/or equipment subject to technological obsolescence	
17. Capital withdrawals	
18. Poor financial controls	
19. Venturing into new business and investment areas	
20. Poorly coordinated inter-office transactions	
21. Lack of client contact/plant visits	
22. Adverse industry developments	
23. Other reasons	

LOAN AGREEMENT

Agreement dated between (the Bank), doing business under license No , represented by, and (the Borrower) represented by duly authorized to make commitments on behalf of the Borrower.

Preamble

Whereas the bank is a commercial bank authorized to provide financing to companies and individuals of the Republic of as provided in its lending policies,

Whereas the Borrower has proved its ability to borrow, pledge its assets as collateral, and that the provisions of the Loan Agreement (the Agreement) and their performance do not breach the Borrower's activities, or any of other applicable statutes, agreements or documents,

Whereas the Bank has agreed to extend a loan (the Loan) to the Borrower in the amount of , on the terms and conditions set forth in this Agreement,

now therefore, the parties hereby agree as follows:

Article I - Standard Terms and Conditions

Section 1.1 - Incorporation of the Standards Terms and Conditions:

The provisions of the Standard Terms and Conditions dated are hereby incorporated into and made applicable to the Agreement with the same effect as if they were fully set forth herein.

Section 1.2 - The headings of Articles and sections, as well as the table of contents are inserted for convenience of reference purpose only and shall not be used to interpret the Agreement.

Article II - Principal terms of the Loan

Section 2.1 - Loan amount and Loan currency:

The Bank agrees to lend to the Borrower, on the terms and conditions set forth, or referred to in the Agreement, an amount of for .

The Loan shall be available subject to the observance of Standard and Conditions and the subsequent conditions:

<u>Section 2.2</u> - Financial terms:

a) The Loan is granted for a period of starting

b) The last date of reimbursement is

c) The principal amount of the Loan shall be reimbursed in successive equal instalments, commencing:

d) The Loan is subject to a variable interest rate, determined in respect of plus a margin set up at the beginning, in the amount of % per annum
Interest shall be calculated in accordance with the Standard Terms and Conditions

e) The interest shall be paid on according to schedule 1 in appendix to this agreement

f) In the event the Borrower is unable to make repayment of the Loan on the relevant repayment date according to the Agreement, the relevant amount shall bear interests of %, calculated in accordance with this section

<u>Interest on overdue payments</u>:

- shall accrue from the first day, day to day, on the actual numbers of days, until the repayment date,
- Shall be calculated on the basis of a 360 day year for the actual number of days shall be paid promptly on demand

g) Fees

<u>Section 2.3 -</u>

The Borrower shall, unless the Bank otherwise agree

a) Maintain a debt service coverage ratio of no less than_______
b) Pledge a collateral to the Bank at least equal to 150% of the amount of the Loan
c) Provide a contribution to the project of a minimum of ____%

Section 2.4 - Repayment guarantees

Guarantees for repayment are:

- The Borrower pledged property in the amount of
- The Borrower and the bank conclude a Collateral agreement binding to this Agreement
- Transfer of cash flow
- Other

Article III - Financial and operational Covenants

Section 3.1 - Conduct of Business and Operations

In addition to the general undertakings set forth in the Standard Terms and Conditions, the Borrower shall:

a) Promptly take all actions within its power to maintain its legal existence to carry on its operations, and to acquire, maintain and renew all rights, properties, privileges and franchises that are necessary for the conduct of its business
b) Not sell, transfer, lease, or otherwise dispose of any of its assets that shall be required for the efficient carrying on of its operations or the disposal of witch may prejudice its ability to perform satisfactorily any of its obligation under this agreement
c) Promptly notify the Bank of any proposal to amend, suspend or repeat any provision of its statutes and shall afford the bank an adequate opportunity to comment on such proposal prior to taking any action thereon and in any event not amend its statutes which may be inconsistent with the loan agreement
d) Promptly advise the Bank of any decision concerning reorganization or liquidation at least two months prior to taking such any such action
e) Ensure that any payment with regard to the sales of products, whether received before or after shipment are received by the bank until the Loan is fully repaid
f) Notify its customers of the Bank account number for the purpose of payment orders and ensure that such orders bear the mention “Subject to collateral for Bank loan”
g) Not replace or misuse any collateral
h) Not utilize any collateral in barter transactions

i) Operate with efficiently and in accordance with sound technical and business practices and in accordance with the environmental standards satisfactory to the bank, and will maintain adequate records

i) Exercise its rights in relation to the Loan, in such manner as to protect its interests
j) And those of the Bank, and comply with its obligations under the Agreement
k) Adopt, maintain and comply with an annual business plan
l) Enable the bank to inspect the sites, works and construction, and any relevant records and documents
m) Take and maintain with responsible insurers such insurance against such risks and such amounts as shall be consistent with sound business practices, and as specified in the Standard Terms and Conditions
n) Prepare promptly and furnish to the bank all information as the bank may reasonably request, relating to the Loan and to the administration and operations of the Borrower
o) Not pledge any of its assets to any parties other than the Bank, except as the Bank shall otherwise agree
p) If any statutory lien is created on any assets of the Borrower as security for any debt, the Borrower shall grant at no cost to the Bank an equivalent lien satisfactory to the Bank to secure the payment of the principal amount of, and interest and other charges on the Loan.

Section 3.2 - Environmental covenants

a) Ensure that the business is conducted with environmental standards in compliance with the regulations existing in the Republic of, and, wherever possible with international environmental and worker health and safety requirements
b) Implement environmental procedures with regard to health protection and safety requirements including special safety requirements concerning the handling of chemicals
c) Promptly inform the bank of all hazards, incidents or accidents, which may have an adverse environmental impact or cause death or injury and of the actions taken by the Borrower with regard to such events, also any events of force majeure, which may lead to a temporary, or permanent, partial or total, suspension of works.

Section 3.3 - Reporting

The reports referred to in the Standard Terms and Conditions shall include the following specific features.

a) Actual or expected difficulties or delays in normal course of business, and the steps taken to overcome the difficulties and avoid delays
b) Key personnel changes in the staff of the borrower
c) Progress of the business during the reporting period

d) Any event which was not in compliance with the applicable laws or resolutions of the parliament, Government and Ministries of the Republic of, including all legal actions affecting the Borrower an any penalties applied to the borrower in connection with such event
e) All matters which may have an impact on the normal course of business of the Borrower or its economic situation

Section 3.4 - Financial records and reports

The Borrower shall maintain procedures, records and accounts adequate to reflect in accordance with accepted accounting standards and recognized sound -administrative and financial standards and practices, the operations and financial conditions of the Borrower, and its subsidiaries, if any.

The Borrower shall:

(i) Have its records, accounts and financial statements, for each financial year, audited in accordance with accepted auditing principles and standards consistently applied, by independent auditors, acceptable to the Bank
(ii) Furnish to the bank as soon as available, but in any case no later than months after the end of each Financial year, copies of its financial statements for such Financial year
(iii) Furnish to the Bank such other information concerning such records, accounts and financial statements, as the Bank shall from time to time reasonable request; and
(iv) Furnish to the bank as soon as available, but no later than 60 days (sixty) a business plan in respect of the next Financial year in form and substance satisfactory to the Bank
(v) A plan for any further privatization of the share capital of the Borrower

Section 3.5 - Negative Financial Covenants

The Borrower shall not, except as the Bank shall otherwise agree, take one of the following actions, other than in the ordinary course of business, and shall provide to the bank all such information thereon as the bank shall reasonably request;

(i) Enter into any agreement or arrangement or in any way or under any condition to become obligated for all or any part of any financial or other obligation of another person, including any subsidiary or affiliate
(ii) Enter into any financial transaction with any person, including any shareholder of the Borrower, except in the ordinary course of business, on ordinary commercial terms, and on the basis of arm’s length arrangements

(iii) Enter into any partnership, profit-sharing or royalty agreement, or similar arrangement, whereby the Borrower's income or profits are, or might be, shared with any other person
(iv) Make any prepayment or repurchase of any debt (other than the Loan) or make any repayment of such debt unless it shall, if the Bank so requires, contemporaneously make a proportionate prepayment or repayment of the principal amount then outstanding of the loan in accordance with the Standard Terms and Conditions
(v) Shall transfer, lease or otherwise dispose of all or substantial part of its assets which would have a material adverse effect on the Business of the Borrower or its business, or which would have the effect of a merger, consolidation or reorganization of the Borrower or the Borrower's business
(vi) Undertake or permit merger, consolidation, or reorganization
(vii) Enter into any management contract or similar arrangement whereby its business or operations are managed by any other person, including any subsidiary or affiliate
(viii) Form any subsidiary, or make or permit to loans or advances to, or deposits (except for deposit with commercial banks in the ordinary course of business) with other persons or investments in any in any person, including any subsidiary or affiliate; provided, however, that the Borrower may invest in short term marketable securities acquired solely to make use of its unutilized resources
(ix) Make capital investments (other than investments for which the Loan was provided) in any year for which provision is not included in the business plan
(x) Enter into a loan agreement with any other Bank or enterprise for any reason, during the period of the Agreement

Section 3.6 - Other Financial Covenants

The Borrower shall not unless the Bank shall otherwise agree:

a) Declare or pay any dividends
b) Have at the end of each financial Year, a liquidity ratio of less than________
c) Make changes, or permit to be made, to its share capital, its statutes or its main business, except in accordance with the Agreement.

Article IV- Suspension, acceleration, cancellation

Section 4.1 - Suspension

Section 4.2 - Acceleration of maturity

Section 4.3 - Cancellation

Article V - Effectiveness

Section 5.1 - Conditions to effectiveness

As an additional condition to the effectiveness of the Agreement, the Borrower shall have transferred all of its other bank accounts in local or foreign currencies, to the Bank

Section 5.2 - Termination for failure to become effective

If within 90 days after the date of this Agreement the Loan has not become effective, the availability of the Loan will be terminated.

Article VI – Miscellaneous

Section 6.1 - The following addresses are specified for the purpose of the Loan

For the Borrower:

For the Bank:

Section 6.2 - Fees and costs

The Borrower shall bear any professional, banking transfer or exchange fees and costs incurred in the preparation, execution and registration of the Loan Agreement, the Guarantee Agreement, if any, and the Collateral Agreement, and any related documents

Section 6.3 - Disclosure

The information contained in this Agreement and any other related legal documents shall remain confidential.

In witness thereof the parties hereto, acting through their duly authorized representatives have caused the Loan agreement to be signed and executed in ________ copies and delivered at_________ Republic of , as of the day and year first above written.

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COLLATERAL AGREEMENT

Date:

Place

(The Bank),

represented by __________________on one part, and _____________(The Pledger)

represented by __________________, on the other part, have concluded the following agreement:

1. The Bank has granted to the Pledger, under the Loan Agreement No __________, dated___________, a credit facility (The Loan) in the amount of__________, maturing__________

2. As guarantee for full repayment of the Loan, when due, of both principal and interest, the Pledger hereby pledges to the bank certain property and assets (The Collateral), as described in the attached schedule, owned by the Pledger, which may be sold in accordance with existing laws of the Republic of

3. The attached schedule describing the nature of the Collateral constitutes an integral part of this agreement.

4. The value of the collateral at the date of the execution of this agreement, is estimated at

5. The Pledger guarantees that the Collateral given as guarantee to the Loan is free and clear of any liens, mortgages and other attachments.

6. The Pledger has the right to process the Collateral, where necessary, and in this case the work in process, semi-finished or finished goods, resulting from the processing will become part of the collateral.

7. The Pledger hereby undertakes:

   - To ensure the safe storage and appropriate maintenance of the Collateral

- To insure the Collateral against all risks of destruction and/or deterioration, at its fair market value, and to assign the policy in favor of the Bank
- Not to create any other liens on the Collateral until it has fulfilled all of its obligations under the Loan agreement
- Not to sell the collateral without the previous agreement of the Bank except in the course of normal business transactions
- In the event of the sale of the Collateral, with the previous agreement of the Bank to repay immediately to the Bank the Loan, principal and interest
- Not to utilize the Collateral in barter transactions, nor as compensation in kind
- To give the Bank the right to inspect the Collateral, at the convenience of the Bank
- In case of sale, except in the course of normal business transactions, damage, deterioration, destruction of the Collateral, even with the consent of the Bank, to notify the Bank, within one business day, and to replace the collateral within seven days, with goods of the same value, or to reimburse the bank of an amount equivalent to value of the collateral affected, and to amend the Collateral Agreement or conclude a new one
- To transfer to the Bank the rights under the Loan Agreement, to sell the Collateral, to repay the Loan, principal and interest, without arbitrage proceedings, in the event that the Pledger is unable to repay the Loan, when due.

8. The Pledger confirms and acknowledges his responsibilities under article____________of the Criminal Code of the Republic of, concerning this agreement.

9. The Bank reserves the right:

- To control the use of the collateral and its value. The inspection may be carried out in the form of an examination of documents, physical inspection, or inspection by experts where necessary
- In the event the principal and interest of the Loan remaining unpaid when due, under the provisions of the Loan Agreement, to seize and sell the Collateral at the fair market value without recourse to arbitrage
- To require from the Pledger compensation for any shortfall of the collateral value, where sale of the Collateral is insufficient to cover full repayment of the debt, including principal and interest
- To recover the Loan prior to the final repayment date, without any arbitrage or courts decisions, in the event of breach of the Pledger commitments under this Agreement and other events, as provided under the current legislation of the Republic of

10. This Agreement is cancelled or terminated in the event:

    - Of fulfillment of all commitments by the Pledger, and the full repayment of the Loan, principal and interest
    - Of the expiration of the validity of the rights guaranteed by this Agreement

11. In the event of reorganization or liquidation of the Pledger, or the transfer of the rights to the Collateral, the Pledger undertakes to repay the loan, principal and interest, before the latest date of repayment of the Loan, as provided in the Loan Agreement.

12. This Agreement becomes effective from the date of registration and is binding until the full repayment of the Loan, principal and interest, and/or the validity of the rights guaranteed by his Agreement.

13. This Agreement has been executed in three (3) copies: two (2) for the Bank and one (1) for the Pledger.

14. This Collateral agreement is subject to registration with:

<u>BANK</u> <u>PLEDGER (Authorized signature)</u>

12

CODE OF ETHICS

1. Statement of Purpose

A Bank is a public trust that is dependent on the confidence of our customers and the community at large. The people we serve have a right to expect that those associated with the Bank will fulfill their professional responsibilities and conduct their personal affairs in accordance with high ethical standards and with an unswerving commitment to the maintenance of public confidence and respect. Given the importance of this fundamental concept. And in recognition of the need to develop a common understanding of its implications, the Board of Directors have adopted the following Code of Ethics as a guide for all Directors (members of Board of Directors), Officers and Employees of the Bank. The code focuses on some of the more sensitive issues that are subject to individual judgment. This Code of Ethics is designed to complement existing personnel policies. In addition the Code recognizes that the appearance of inappropriate conduct can be just as harmful to the Bank's reputation as actual misconduct. All Directors, Officers and Employees are expected to subscribe, not only to the provisions of the Code, but also to the spirit in which it is being presented. Questions concerning any aspect of the Code should be submitted to President of the Bank.

2. Conduct of Personal Affairs

In the business of banking, the degree of personal integrity is considered a basic measure of the professional competence of management. To deny or ignore the importance of integrity could seriously jeopardize the Bank's most important strength – the confidence and respect of customers and employees. In judging personal integrity, the banking public and our employees will consider not only professional behavior but also personal conduct. It is vital, therefore, that all Directors and Officers conduct their personal affairs, including financial matters, in a manner that enhances their leadership credibility and the Bank's reputation in the community.

3. Conflicts and Potential Conflicts of Interest

The business and personal activities of Directors, Officers and Employees should be conducted in a manner that avoids **actual** or **potential** conflicts of interest. In addition, we should be aware that the appearance of a conflict of interest might be just as damaging to the Bank's reputation as an actual conflict. Each Director, Officer and Employee should therefore examine their activities in an objective manner, in order to determine if a disinterested observer (whether a customer, supplier, stockholder, superior, acquaintance or regulator) would have grounds to believe that the Director, Officer or Employee is in a position of real or potential conflict of interest; and, if so, take necessary action to remove himself/herself from such a situation.

3.1. Insider Transactions

If a Director or Officer (or member of his/her immediate family) is aware of a personal or professional financial interest, either direct or indirect, in a bank loan, purchase, sale or investment decision involving the Bank, the individual must disclose the interest and disqualify himself/herself from participating in both the deliberations and subsequent decision. In addition, the individual must never directly or indirectly attempt to influence those who do make the decision. All such insider transactions and disclosures must be recorded and maintained in a file by management. A full disclosure of all facts pertaining to any transaction that is subject to any question concerning the possibility of a conflict of interest must be made before consummating the transaction. Actually, the office of the President/CEO must send to all Directors and Officers a Declaration Form to be completed, signed and returned. The Declarations will be reviewed and an appropriate report made to the Board of Directors.

3.2. Role of Personal Friendship and Family Ties in the Conduct of Bank business

Directors and Officers shall not use their positions within the bank to obtain or seek to obtain personal favors from other persons or institutions for themselves, family members or personal friends.

3.3. Reciprocity with Other Financial Institutions

Under no circumstances will the Bank be a party to a formal or informal reciprocal arrangement with any other financial institution for the purpose of providing personal benefit or gain to any Officer or Director of the bank that is not available to the general public.

3.4. Borrowing from Customers

Borrowing from customers, providers of professional services, or anyone else is prohibited except from those customers that normally engage in lending as a primary business function. When borrowing from such an entity, an Officer or Director must not seek or accept more favorable personal loan terms than are available to the general public. In addition, such personal loans must not be preconditioned on any reciprocal agreements involving the Bank or bank business. This policy prohibits implicit as well as explicit agreements.

4. Professional Conduct

4.1. Confidential Information

Confidential information about the customers of the Bank that is acquired by a Director or Officer through affiliation with the Bank is considered to be privileged and must be held in the strictest confidence. It is to be used solely for corporate purposes and not as a basis for personal gain. Except for normal credit reporting procedures and properly documented legal demands, such information should not be transmitted to persons outside the corporation, including family or associates, or ever to others within the bank who do not need to know such information in discharging their duties. The restrictions in this paragraph also apply to the reports and statements prepared for use in the bank's business and not generally released.

4.2. Disclosure to Auditors and Examiners

Inquiries made by the banks outside independent auditors, members of the internal audit division or Central Bank examiners should be responded to candidly, and no adverse data should be concealed. In addition, Directors and Officers have an obligation to offer any other information that may help auditors or examiners prepare a proper evaluation.

4.3. Giving and Receipt of Gifts

Directors and Officers must decide conscientiously whether or not acceptance of a gift or benefit from a bank customer or supplier will create an obligation or will cause misinterpretation. As a general rule, gifts of nominal value (up to X) that are small tokens which serve as general advertising may be accepted. Any gift of significant cash value should be politely refused. A gift of money should never be accepted regardless of the amount. This policy also pertains to the receipt of gifts by members of the immediate family of a Director or Officer. Any attempt by a bank customer or supplier to give a gift of greater than nominal value (up to X) should be disclosed to the President/CEO in writing stating the circumstances and response. No Director or Officer may take a gift other than nominal value (up to X) to a recipient if the relationship between the donor and recipient was created through a banking transaction.

4.4. Entertainment

Directors and Officers may engage in reasonable business-related entertainment of nominal value (up to X) such as lunches or dinners. Significant entertainment expense for any person or firm is to be avoided whether or not the expense is attributable to infrequent, expensive events or very frequent, nominally expensive occasions. In accepting entertainment, Directors and Officers must decide conscientiously whether or not the result will create an obligation or cause misinterpretation. Accepting significant entertainment from any person or firm is to be avoided whether or not the expense is attributable to infrequent, exclusive events or very frequent nominally expensive occasions.

4.5. Disclosure of Corporate News and Information

Financial information about the Bank is not to be released to any person not officially authorized to have such information unless it has been published in official bank reports or otherwise made generally available to the public in accordance with applicable regulations. The President/CEO must approve exceptions to this policy. The President/CEO or his designee(s) must approve general bank information prepared for release to the media. All Directors and Officers should be sensitive to the problems which could result from the premature release of confidential information related to the bank's activities or its future plans.

4.6. Release of Customers' Names

Lists of customers' names may not be released in any form without the approval of the President/CEO.

4.7. Recommending Firms and Providers of Professional Services to Customers

Directors and Officers should not recommend attorneys, accountants, insurance brokers or agents, stock brokers, real estate agents and other professionals to customers unless in every case several names are given without indicating favoritism.

4.8. Legal, Tax and Investment Advice

No Director or Officer should provide a customer with advice on matters concerning the law, tax problems or the preparation of tax returns, except as may be required in the ordinary course of his/her employment at the bank or, in the case of a Director, in the ordinary performance of his/her business or profession.

4.9. Fees for Speeches and Articles

Directors and Officers should not accept fees for speeches made or articles written in conjunction with official bank business.

4.10. Major Civil or Criminal Proceedings

Should any Director or Officer become involved in major civil or criminal proceedings that might prove embarrassing to the Bank, the President/CEO should be notified.

5. Outside Activities

5.1. External Employment and Affiliations that may conflict with Bank Business

Officers of the bank must obtain the prior approval of the President/CEO for contemplated outside employment. In no instance should an officer engage in any outside employment or affiliation which may reasonably subject the Bank to criticism or adverse publicity, or which will encroach on bank working time or necessitate such long hours that would affect or interfere with the bank's effectiveness. A Director or officer, who serves on any outside Board of directors or Trustees, proprietary or not-for-profit, should abstain from board votes on matters that significantly affect the Bank's business. Under no circumstances should any Officer own or operate an outside business involving the lending or investing of money or the rendering of any other services offered by the Bank.

Likewise, it is generally not acceptable for any Officer to: (1) prepare, audit or certify statements or documents upon which the bank might rely for lending or other purposes; (2) render investment counsel or other advice based upon information, reports or analyses that are accessible primarily from or through bank employment; (3) render professional services for any bank supplier or loan customer. Exceptions to such given rule must be approved in advance by the President/CEO.

5.2. Charitable Contributions

Charitable contributions in terms of both time and money by Directors and Officers are encouraged. The Bank will not reimburse Directors and Officers for financial contributions, but may authorize the use of bank time and facilities for reasonable charitable involvement with the approval of the appropriate department head.

5.3. Involvement in Political Activities

Bank facilities, equipment and supplies may not be used by or on behalf of any political party or candidate. Officers may engage in political activities provided these activities are not conducted on bank time, and provided that they are done as individuals and not as representatives of the bank. The Bank itself may not be placed on record as favoring or opposing any political party or candidate. The Bank will not reimburse Directors and Officers for political contributions. Officers who wish to run for major elective office must obtain the prior approval of the President/CEO.

6. Bank Resources

6.1. Use of Bank Resources for Personal Needs

As a general rule, The Bank resources may not be used for personal needs. However, Directors and Officers who donate their time and energy in support of charitable or other projects so as to reflect positively on the Bank may make reasonable use of the bank's resources, such as occasional secretarial assistance, letterhead, use of conference rooms, etc. Under no circumstances is the Bank property to be removed from the premises without management's permission.

Directors, Officers and Employees may purchase assets sold by the bank, but must pay fair market value. Management must consider the general value level and nature of the asset in determining procedures that are to be used in the conduct of the sale.

7. Board of Directors

7.1. Loans to Directors

Any personal loan to a Director or a Shareholder must meet the same standards as would apply to any other borrower of the bank with regard to pricing, collateral and repayment.

7.2. Potential Conflicts of Interest

In the event a Director in discharging the duties of his/her official bank capacity finds himself/herself in a position of potential conflict of interest such that his/her knowledge of a situation would cause, directly or indirectly, a potential conflict of interest, should immediately remove himself/herself from all further discussions, deliberations and subsequent decisions, and have the written record showing the reason for this action.

7.3. Involvement in Operations

A Director's role cannot be expected to extend to the normal day-to-day operations of the bank. In the event that a Director, when conducting normal business or personal banking at the Bank, becomes aware of an operating problem, such observation should be reported directly to the President/CEO. In no instance should a Director unilaterally reprimand or attempt to correct the situation with the Employee.

8. Enforcement and Monitoring of Code

The Bank, on an annual basis, should seek and retain on file written acknowledgment from its Directors and Officers that such persons and their subordinates, if applicable, are cognizant of this Code of Ethics and the policy statements contained herein. Reports of violations of this Code of Ethics will be treated seriously by management, will be investigated, and may, if substantiated, serve as grounds for disciplinary action ranging from reprimand to recommendation for dismissal. Unethical conduct will be neither accepted not countenanced under any circumstances and will, upon investigation and if substantiated, serve as grounds for dismissal, in the manner prescribed in the Employee Manual. All senior officers and department managers of the Bank are responsible for the monitoring and enforcement of this Code of Ethics within their specific areas of management responsibility. Concerns expressed by Employees to their supervisor and/or to senior management should be treated in strictest confidence, and should not be used as a basis for any direct or indirect sanction, or disciplinary treatment provided, however, that self-reporting does not become a basis or grounds for non-discipline.