The determinants of credit risk mitigation in lending to Black Economic Empowerment (BEE) companies, from a banker's perspective.

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DECLARATION

I declare that the research report: The determinants of credit risk mitigation in lending to Black Economic Empowerment (BEE) companies, from a banker's perspective, is my own work and that all sources I consulted have been acknowledged in a complete list of references.

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ABSTRACT

The previous political dispensation limited black people's participation in the South African economy. Poor credit records, lack of training, resulting in skills and capacity gaps further limited entry into the lending market. These aspects are considered the main limitations in obtaining finance for the Small, Medium and Micro Enterprises (SMMEs).

This research report focuses on how credit risk can be mitigated by commercial banks in lending to Black Economic Empowerment (BEE) companies in the medium to large market. Exploratory research was conducted using various methods to achieve methodological triangulation. These methods consisted of a literature review, interviewing experts in the field and case studies. A qualitative research approach was followed. It was found that the lack of own contribution and security were still prevalent in the medium to large market, but the quality of management (little training and skills) was deemed not to be a limitation as suitable credit risk mitigants were identified. No credit risk mitigants were identified to mitigate poor credit records. It is postulated that by adopting and applying the identified credit risk mitigants, commercial banks can increase their success rate in lending to BEE companies. It will further assist in the transformation of black people and compliance with the Financial Services Charter.

It is recommended that a similar study be conducted in the agriculture, hunting, forestry and fishing industry. The reasons why BEE companies applications are declined could also be investigated. Further studies could also explore other external factors such as economical, legal and social that could have an influence on the funding of BEE companies.

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CHAPTER 1

ORIENTATION

1.1 INTRODUCTION

During the apartheid era the majority of South Africans were systematically and purposefully restricted from meaningful participation in the South African economy. Since 1994, the newly elected democratic government embarked on various programmes to correct the injustices of the past. The process started with the Reconstruction and Development Programme (RDP). However, it became apparent that sustainable economic development could not only be achieved through such programmes. The development of Small, Medium, and Micro Enterprises (SMMEs) became an important focus to assist with empowerment, job creation and consequently to contribute to economic growth in South Africa.

Various laws were amended and new legislation was introduced to assist with the empowerment of the previous disadvantaged members of the South African community. The most important new legislation introduced, are the following (Woolley, 2005):

- The Promotion of Equality and Prevention of Unfair Discrimination Act

- The Restitution of Land Rights Act

- The Employment Equity Act

- The National Empowerment Fund Act

- The Competition Act

- The Policy Framework Act

- The Preferential Procurement Act.

The necessity of these pieces of legislation is evident in the nature and size of empowerment transactions that characterised the first few years of the post-apartheid dispensation. The first empowerment transactions focused mainly on the transfer of ownership (shareholding). The rand value and the number of Black Economic Empowerment (BEE) transactions since 1993 are depicted in Figure 1.1.

Figure 1.1 BEE merger and acquisition trends
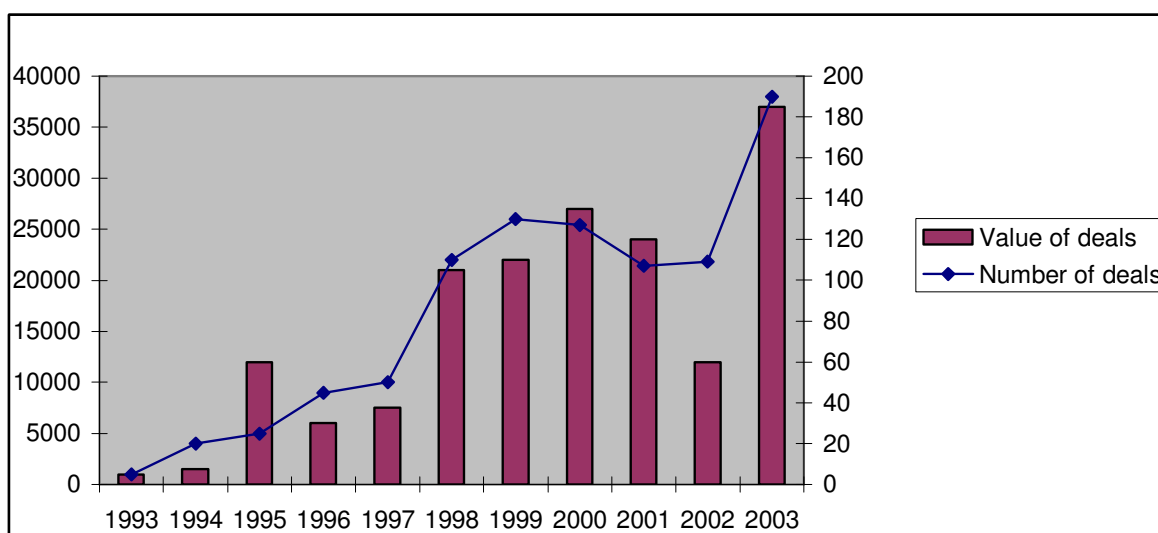
Source: Lalu, (2004: no page).

The number of BEE transactions steadily increased from 1993 to 1999. However, a decline is noticeable in the number and value of BEE transactions after 2000. This decline prompted the Government to form the Black Economic Empowerment Commission. The Commission recommended that specific targets be set and that these be achieved over a ten-year period. The number and value of BEE transactions increased in 2003, in lieu of the Broad-Based Black Economic Empowerment Act being promulgated (Woolley, 2005).

As a consequence of the Commission's recommendation, the Broad-Based Black Economic Empowerment Act 53 of 2003 was promulgated with a view of attaining economic equality. The Act 53 made provision for issuing codes of good practice. The

draft Codes of Good Practice on Broad-Based Black Economic Empowerment was published during December 2004 for public comment.

A significant element of the draft codes is the proposed BEE scorecard that will be used by government to rate companies when they tender for government business. It is envisaged that the scorecard will have a direct impact on all business in South Africa and therefore warrants a focus in this report. The code describes seven key dimensions of transformation, as depicted in Figure 1.2.

Figure 1.2 Key Dimensions of Transformation
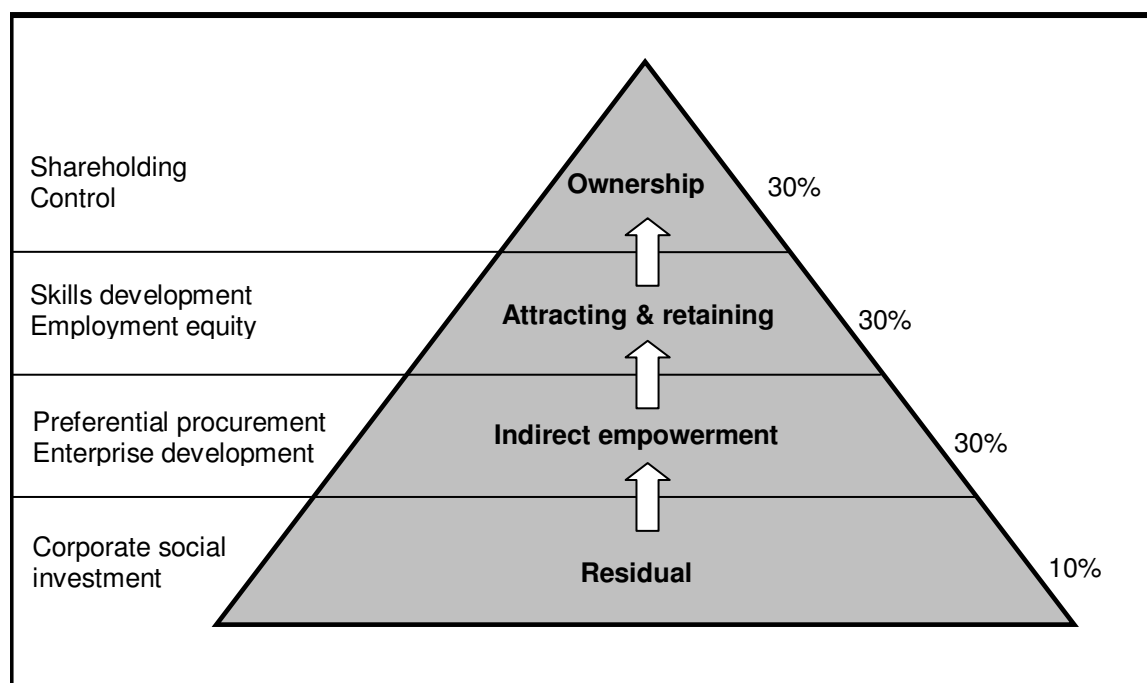
Source: Woolley (2005: 26).

These dimensions are: shareholding, control, skills development, employment equity, preferential procurement, enterprise development and a residual that is considered as corporate social investment. The key dimensions of transformation, on which companies will be scored, are listed on the left-hand side of the Figure 1.2. It

commences with a broad-base input and moves from industry specific to company specific. The base of the triangle has an impact on all South Africans through corporate social investment. The next level in the triangle becomes more industry specific, focusing on indirect empowerment of BEE companies through preferential procurement and enterprise development.

The next level is particular to the relevant company and includes the development of employees and the representation of black persons at all levels within the company. Lastly, companies will be scored in terms of black ownership through shareholding and the number of black persons in executive management. The percentages represent the weighting of each of the dimensions.

The banking industry in South Africa has a critical role to play in the transformational process. According to Harris (2003), the banking industry, in terms of the Financial Services Charter (FSC) is expected to finance Broad-based Black Economic Empowerment transactions and to facilitate BEE within its own structures. Banks are also expected to provide traditional banking services, taking of deposits and granting credit facilities, to all South Africans (Schoombie, 2000; Marais, 2004).

Given the past inequalities in South Africa, BEE lending is perceived to be high risk and the research focuses on the credit risk mitigation that can be applied by commercial banks in assessing the lending decision and credit risk when advances and equity investments are considered for BEE classified companies. The past inequalities therefore impact the credit process in banks and the identification of credit risk mitigants that commercial banks can apply, become very important.

1.2 OBJECTIVES OF THE RESEARCH

The identification of credit risk mitigants is very important elements to minimise credit risk. Given this and the issues mentioned previously, the objectives of the research have been defined as follows:

- To investigate the credit policies being used by commercial banks in South Africa when funds are advanced to BEE companies.

- To identify the credit assessment model used by commercial banks when advances to BEE companies are considered.

- To identify the credit risk mitigants that can be applied by commercial banks when advances are considered for BEE classified companies.

1.3 ASSUMPTIONS

The first assumption is that lending to BEE companies is perceived to be high risk, given the background of the majority of South Africans.

The second assumption is that commercial banks in South Africa have credit policies and procedures in place to assist in lending to BEE companies.

The third assumption is that the same general credit lending principles are applied by all the commercial banks in South Africa and that commercial banks are seeking innovative solutions to mitigate their risk in lending to BEE companies.

1.4 DELIMITATIONS

The investigation will be specific to South Africa and will focus on the lending practices employed by the big four South African commercial banks when lending to BEE companies. The total advances/loans made by the big four represent 86% of the total advances made (PricewaterhouseCoopers, 2005).

The research will exclude public listed companies and all applications that can be credit scored. It will mainly focus on unlisted companies/mid corporate market. These entities are defined as companies with an annual turnover in excess of R50 million and/or shareholders equity bigger than R5 million and/or general banking facilities in excess of R5 million.

As the information (client files) would not be readily available from other banks, the research will be limited to applications received at one of the South African commercial banks. The applications received for new and/or increased facilities and/or where existing facilities were renewed, will be included in the sample. Due to the banking principle, which requires client confidentiality, the cases identified will not be referred to by specific client's name, and will be referred to appropriately to ensure data integrity and that the bank's requirements are not compromised.

1.5   IMPORTANCE OF THE RESEARCH

Lending to BEE companies is considered new territory for commercial banks in South Africa. The main purpose of the research is to identify how commercial banks can apply credit risk mitigation when advances and equity investments are considered for BEE classified companies. Limited empirical research findings are currently available on the subject, especially in the South African context.

Once the credit risk mitigants have been determined, a possible benefit is the potential to structure transactions to make them more acceptable for the commercial banks. It will also assist BEE companies to address these credit risk mitigants in their business plans when applying for funding.

These findings could also:

• Increase the success rate of credit applications where funding of BEE companies are required

• Assist in the economic transformation of black people

• Increase exposures by commercial banks to BEE companies

• Assist banks to comply with the FSC.

1.6   STUDY ENVIRONMENT

The banks in South Africa are increasingly facing regulatory requirements and adherence to international standards. The impact of the proposed Credit Bill in the regulatory environment, and the Basel II requirements, to comply with international standards, will have on the South African banking industry is not yet fully understood.

The business landscape is furthermore becoming more challenging due to the intensifying competition from other role players entering the traditional banking services market. Foreign banks have also shown a keen interest in the South African banking industry. The Barclays/Absa transaction is considered to be the biggest foreign direct investment in South Africa to date. This transaction can be seen as a vote of confidence in the country and the South African banking system (Cronje, 2005).

According to the South African Reserve Bank (2004) the total funds of banks amounted to R1 498,1 billion with the four biggest banks representing approximately 83% of the total banking sector. The four biggest banks are considered to be Absa Bank Ltd, First Rand Ltd, Nedbank Bank Ltd and Standard Bank Ltd.

A key impact in the foreseeable future, to transform the financial sector in South Africa, is the FSC. Adopted by all financial institutions in 2002, the Charter serves as guiding principles and targets for the financial institutions to assist in the government's black economic empowerment strategy.

1.7   CLARIFICATION OF CONCEPTS

Concepts for this study were aligned with the FSC and are therefore defined as follows (Financial Services Charter, 2002):

Black People are Africans, Coloureds and Indians who are citizens or permanent residents of the Republic of South Africa (Financial Services Charter, 2002).

BEE is the economic empowerment of all black people, including women, workers, youth, people with disabilities and people living in rural areas, through diverse but integrated socio-economic strategies and is similarly defined in the Broad-Based Black Economic Empowerment legislation (Republic of South Africa, The Code of Good Practise Broad-Based Black Economic Empowerment, 2004: 6).

Black Owned Enterprise refers to an enterprise that is at least 50,1% owned by black persons and where there is substantial management control(Financial Services Charter, 2002).

Black Empowered Enterprise means an enterprise that is at least 25,1% owned by black persons and where there is substantial management control (Financial Services Charter, 2002).

Black Influenced Enterprise means an enterprise that has between 5% and 25% ownership by black persons and where there is reasonable participation in management control (Financial Services Charter, 2002).

Black Woman Owned Enterprise means an enterprise with at least 25,1% representation of black women within the black equity portion of management (Financial Services Charter, 2002).

Substantial Management Control in a Black Owned Enterprise is evidenced by the level of black representation on the Board of Directors and must be not less than 25,1% of all directors serving on a board (Financial Services Charter, 2002).

Enterprise is an accepted legal persona such as a Close Corporation, Incorporated Company, Private or Public Companies (Financial Services Charter, 2002).

For the purpose of the research report a BEE Company is an enterprise, which met any one of the above definitions of ownership or where black people wish to acquire shareholding or interest in a new or existing business.

Risk to a banker is the perceived uncertainty connected to an event specific to the risk being perceived. PIC Solutions (2005) defines **credit** as: The right granted by a creditor to an applicant to incur debt and defer its payment.

Credit risk can be defined as the potential that a borrower or counter party will fail to meet its obligations in accordance with the terms of an obligation's loan agreement, contract, or indenture (Sobehart, Keenan & Steyn, 2003).

Commercial banks are banks that accept deposits and make retail, commercial and real-estate loans (Saunders & Cornett, 2003).

1.8   LAYOUT OF THE RESEARCH

Chapter one provided an orientation to the research by giving a brief overview of Black Economic Empowerment and the role of Commercial Banks in South Africa. Details of the objectives, scope and importance of the research have also been discussed. In addition, key concepts have been clarified to avoid confusion.

The theoretical foundation of the study is elaborated upon and a literature review is done in chapter two. This chapter is also concerned with a detailed study of credit risk management practices in South Africa and the rest of the world. The first part of the chapter covers the available literature on the subject. In the second part, the importance of credit risk management is discussed.

The problem, sub-problems and propositions are stated in chapter three. The propositions are set to govern the thinking process during the research.

A full exposition of the investigation is given in chapter four. It covers the research design, data collection and analysis. The limitations of the research are also addressed.

Chapter five provides the results of the investigation and forms the basis for chapter six where the results are discussed.

Chapter six ends with concluding remarks and recommendations.

CHAPTER 2

THEORETICAL FOUNDATION OF THE STUDY AND LITERATURE REVIEW

2.1   INTRODUCTION

Chapter one served to define the objectives, the importance of the study and the study environment. It was also indicated in chapter one that very little empirical studies have been done in lending to BEE companies. In the first part of this chapter the roles of banks and related research are investigated. The risks banks face and the importance of credit risk management are discussed with specific focus on credit assessment. Quantitative and qualitative credit assessment models are examined as well as the various components of the qualitative credit risk assessment model.

2.2   BANKING

Banking originated in medieval times where medieval bankers conducted their business from benches in the street. The word "bank" derives from the French word *banque* and the Italian word *banca*, meaning "bench" or "money changer's table". The term bankruptcy (*bancorupto*) is derived from the Italian convention of breaking the bench of a banker or merchant who was unable to settle his credit (Smith & Walter, 1997; Valdez, 2000; Rose, 2002).

The first bankers most likely used their own money to fund their operations. They exchanged money of foreign travellers to the local currency and discounted commercial paper to supply merchants with working capital. The source of funding changed when wealthy customers deposited money with the bank. These funds were used to make loans to merchants, shippers and landowners at interest rates ranging from 6% per annum to as high as 48% a month for the riskiest ventures (Rose, 2002).

2.2.1 Role of Banks

Banks play a significant role in modern society. They are considered the most important enabler of financial transactions in any country's economy and are the principal source of credit (Rose, 2002). Banks are also the custodians of nation's money, which are accepted in the form of deposits and paid out on the client's instructions (Sinkey, 2002; Harris, 2003).

A bank's role has expanded considerably and is no longer limited to the taking of deposits and providing credit. Banks also perform the following activities (Fourie, Falkena & Kok, 1998; Valdez, 2000):

- Money creators: Commercial banks create money by way of deposit liabilities. In contrast to liabilities of other businesses, bank liabilities (cheques) are generally accepted as a means of payment.

- Managers of the payment system: This refers to the payment of cheques through the Automatic Clearing Bureau (ABC). It also facilitates payments of credit and debit cards, internet and cell phone banking and automatic teller machines.

- Creators of indirect financial securities: Commercial banks hold assets that are subject to specific risks, while issuing claims against them in which these risks are largely eliminated through diversification.

- Information agents: Commercial banks developed sound databases of client information and the information is not publicly available (asymmetric information). The information is only shared with other banks by way of a bank code or a full general bank report.

- Financial 'spectrum fillers': The capital market cannot supply the full range of instruments required by borrowers. Commercial banks assist in this regard by supplying specific instruments to fill the gap.

- Dealers in foreign currency: Due to the globalisation of the world's economies this has become a very important function. Commercial banks assist in the conversion of currencies, transfer of funds and negotiate foreign financing.

Despite South Africa still being classified as a developing nation, it is generally accepted that South Africa has one of the most sophisticated banking infrastructures in the world, offering an internationally competitive service and product range (South African Reserve Bank, 2004).

2.2.2 Challenges facing South African Banks

Banks are the custodians of a nation's savings and cannot afford to make poor lending decisions as it has a direct impact on its shareholders. The shareholders are principally individuals whom have, either directly or indirectly through their pension funds and insurance policies, invested in the banks (Harris, 2003).

One of the greatest challenges facing the South African banking sector is how to assist in achieving the country's goals, namely the transformation of the economy. One of the areas were commercial banks can contribute towards facilitating transformation is the funding of ownership transfer and the funding of BEE companies. According to Gunnion (2005), financing remains one of the main limitations of empowerment transactions. Given the past inequalities in South Africa, black people traditionally have no equity to support the lending, have no security to offer, have poor credit records, limited training and skills (Schoombie, 2000).

2.2.3 Empowerment of entrepreneurs

The success of any modern economy is dependent on its ability to grow and sustain an environment conducive for entrepreneurship to emerge and thrive. Entrepreneurs contribute to economic growth and job creation through the establishment of new businesses (Mazzarol, Vlery, Doss, & Thein, 1999). In South Africa, as in many other

countries, small business development and the empowerment of entrepreneurs has been adopted as a national strategy to ensure economic growth (Pretorius & Van Vuuren, 2003). It is therefore not surprisingly to find a fair amount of research done on Small, Medium and Micro Enterprises (SMMEs) in South Africa. Limited research is available that focuses on the medium to large market. There is clearly a gap in the existing available literature.

It is important to note that most large companies started as SMMEs run by entrepreneurs. According to Harris (2003), the growth of the BEE SMMEs has been very slow, not due to a lack of money, but due to a shortage of viable business opportunities. The performance of BEE SMMEs has historically been poor which is evident in local and international experience in a high failure rate in new business ventures (Harris, 2003). Due to the nature of start up capital, it would be more ideal for venture capital funds to fund new ventures and not commercial banks (Bender & Ward, 2002; Brigham & Ehrhardt, 2002).

2.2.4 Importance of financial assistance

Bank finance is the primary source of debt funding. Commercial banks extend credit to different types of borrowers for many diverse purposes, either for personal, business or corporate clients (Saunders & Cornett, 2003). Finance has always been perceived to be the most important SMME support system (Schoombie, 2000). However, Netswera (2001) identified access to information as the most important support system followed by access to finance. The lack of financial support was the second most reported contributor to start-up failure, after education and training for the years 2001 and 2002 (Orford, Wood, Fisher, Herrington & Segal, 2003). In 2003, due to changes in the categorisation of the measurements in this year, the lack of financial support was again identified as the main support for system for SMMEs (Orford et al, 2003). Pretorius and Shaw (2004) found that South African commercial banks mainly base their credit decisions on the applicant's creditworthiness and the

amount of security offered rather than the quality of the applicant's business plan or the potential of the business venture.

In Figure 2.1 the different objectives of banks and entrepreneurs are depicted. It is evident that banks are more risk adverse than entrepreneurs. There is, however, common ground between the banks and entrepreneurs where funds are advanced.

Figure 2.1 The difference in the perspectives of banks and entrepreneurs
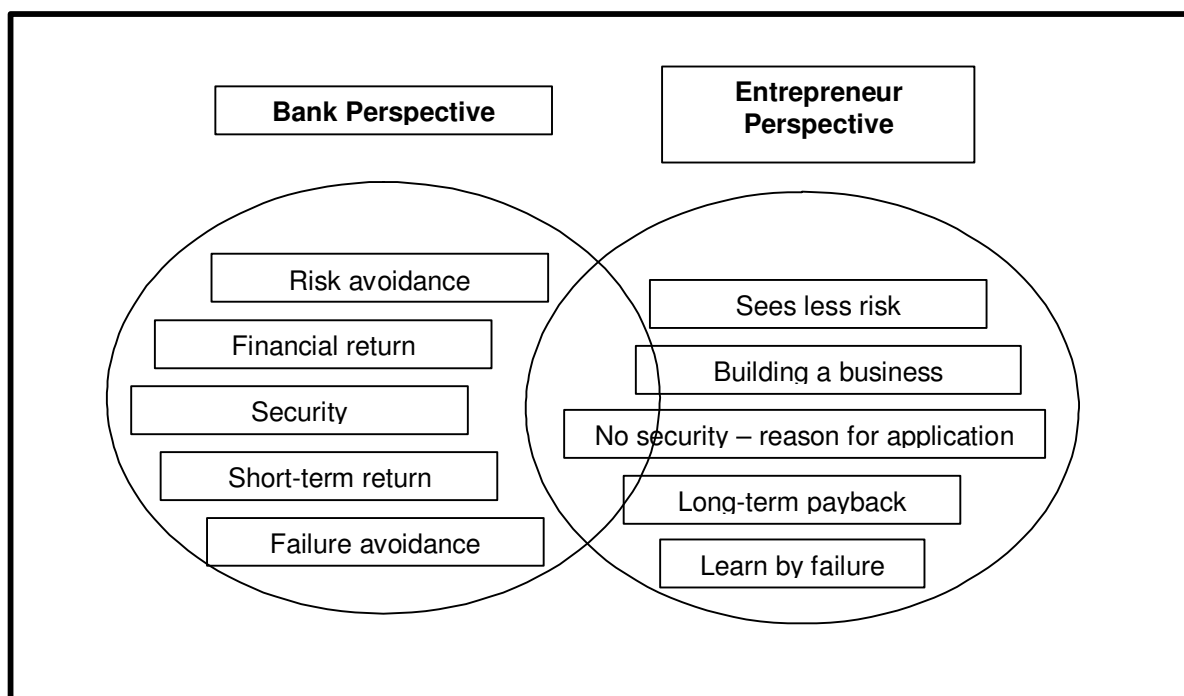
Source: Pretorius & Shaw (2004: 240)

The first part of this chapter highlighted the significance of small business empowerment and linked to that the importance of any business to have access to debt finance. The applicant's creditworthiness and amount of security offered plays an important role when a request for credit is considered. However, South Africa's

past history had an adverse effect on the majority of South Africans creditworthiness and their ability to acquire assets (security).

The next section will contain an overview of the main risks banks face and the importance of credit risk management with a specific focus on the qualitative credit assessment model being used.

2.3   Banking risks

Bessis (2002:11) defines banking risks as "adverse impacts on profitability of several distinct sources of uncertainty". These sources of uncertainty that banks are exposed to, are depicted in Figure 2.1.

Figure 2.1 Main types of risks in banking
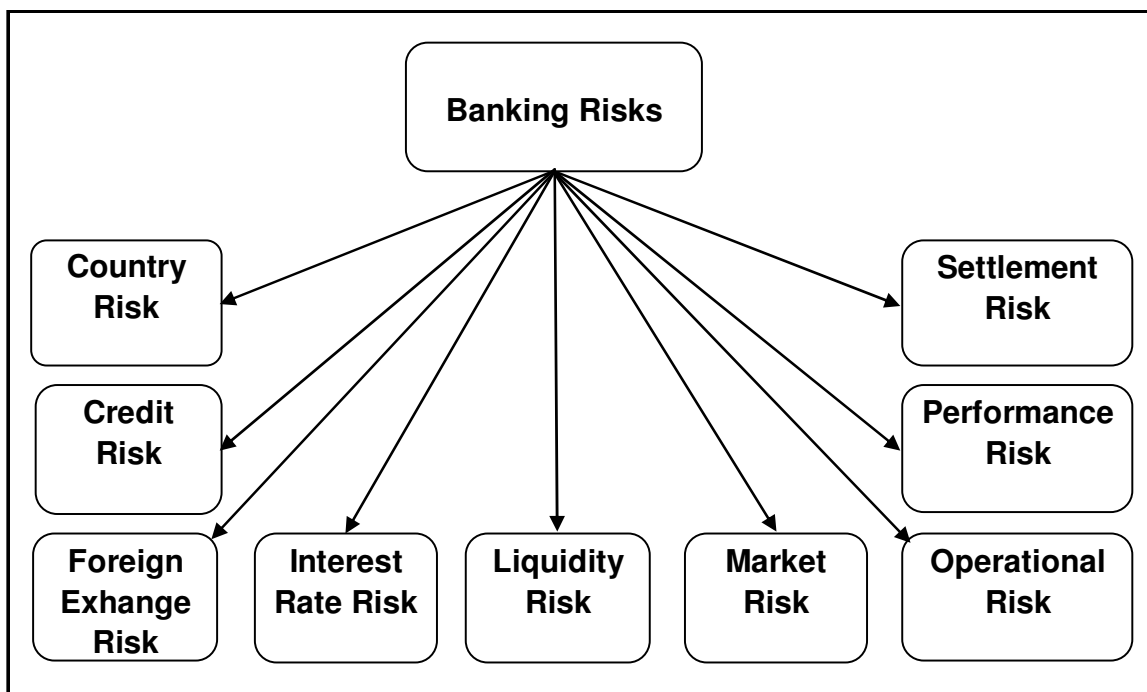
Source: Bessis (2002: 12).

A bank is exposed to interest rate risk when the maturities of the bank's assets and liabilities are mismatched (Saunders & Cornett, 2003). If interest rates rise and a mismatch occur in maturities by holding longer-term assets than liabilities, the market value of the assets will decline by a larger amount than the liabilities. This could result in economic losses and insolvency (Bessis, 2002).

Country risk is associated with the risk that foreign borrowers cannot repay the debt due to foreign currency shortages, adverse political and economical conditions or interference by the foreign government (Saunders & Cornett, 2003).

Market risk is the risk incurred in the trading of assets and liabilities when interest rates, exchange rates and other asset prices change (Saunders & Cornett, 2003). Due to increase competition the interest income of banks is declining and banks are concentrating more on non-interest income (Bessis, 2002).

Operational risk is the possible risk that existing technology or support systems will fail or malfunction. It also includes human errors, fraud and non-compliance with an institution's procedures and policies (Bessis, 2002).

Foreign exchange risk is the possibility that exchange rate fluctuations can adversely affect the value of a bank's assets and liabilities held in foreign currencies (Bessis, 2002).

Liquidity risk occurs when there is a sudden surge in liability withdrawals resulting in a bank to liquidate assets to meet the demand (Bessis, 2002). A relevant example in South Africa is the demise of Saambou Bank during 2002.

Although electronic transfers of funds between banks happen in real time, the actual cash settlement takes place at the end of the day. The receiving bank faces a within day settlement risk (Caouette et al, 1998).

Performance risk exists when the transaction risk depends more on how the borrower performs for specific projects or operations than on its overall credit standing (Bessis, 2002: 16).

Credit risk arises because the possibility that the expected cash flows from advances and securities held, might not be paid in full. Credit risk is considered the most lethal of the risks banks face (Cade, 1999). Systematic credit risk is the risk related to macro economic conditions affecting all borrowers.

2.4   CREDIT RISK MANAGEMENT

The risk profile of banks is fundamentally different from that of other financial institutions, like stockbrokers and insurance industry. An integral part of banking is the management of credit risk and it is done through well-diversified portfolios of exposure. Most banks fail because of poorly managed credit risk (Rose, 2002).

Credit risk management primarily focuses on loss avoidance and the optimisation of return on risk. Financial institutions in the world are facing two major challenges. Firstly, they need to deliver increasing returns and value to shareholders and secondly, they need to determine how to capitalise on the New Capital Accord's (Basel II) minimal capital requirements (Belmont, 2004).

Commercial banks and other financial institutions experienced an increase in competition in the United States during 1980 and early 1990. This resulted in a change in lending practices. Due to the competition and the pressure to deliver increasing returns, banks increased the granting of credit facilities to marginal borrowers. These facilities were aggressively priced to compensate for the increase in risk. Although the strategy delivered short-term results, credit losses followed and in many cases caused banks to fail (Koch & MacDonald, 2003). The failure of banks can therefore, not only be linked to unfavourable economic environments, but also to the nature of the credit policies they employ.

Basel II is expected to be implemented by 2008 and is aimed at aligning the regulatory capital model with the economic capital model. The Central Bank of a country stipulates the minimum capital requirements a bank should hold. The minimum regulatory capital requirements will depend on the risk profile of the bank. Banks will have to differentiate between the different classes of assets, based on their underlying risk. Through Basel II, financial institutions can reduce their regulatory capital requirements if they have a good overall risk profile. Banks with poor quality advances will be required to have higher minimum capital requirements (Milligan, 2004).

Banks in South Africa, however, face an additional challenge. Not only do they have to compete in the global market and comply with Basel II, they are also required to provide finance to the previously disadvantaged members of the South African community who have been excluded from the economy in the past. At present, this is still seen as a higher risk option mainly because the underlying risk is not clearly understood.

2.5   CREDIT RISK

Credit risk is considered the oldest form of risk in the financial markets. Caouette, Altman & Narayanan (1998: 1) state that "credit risk is as old as lending itself", dating back as far as 1800 B.C. The first banks, which started in Florence seven hundred years ago, faced very similar challenges that banks face today. Although managing credit risk is their core competency, many banks failed due to over-extension of credit (Caouette et al, 1998).

Bank credit is the primary source of debt financing available for most customers in the personal, business or corporate market. The underlying need for credit varies across these markets. Banks generally also want to increase the base of their income and use credit extension as an opportunity to cross sell other fee generating services when a customer applies for credit facilities (Koch & MacDonald, 2003).

The most prominent risk assumed by banks is credit risk. This is due to the various factors that influence a borrower's ability to repay the credit facility. The borrower's ability to repay is closely linked to the general economic conditions of a country. In favourable economic conditions the ability to repay increases, which could be due to a favourable interest rate environment, low inflation, increased income levels or a combination of these factors. The opposite is however true in poor economic conditions.   The borrower's ability to repay is adversely effected under these conditions due to a reduction in disposable income (Koch & MacDonald, 2003).

Credit risk can be defined as the potential for a borrower or counter party to fail to meet their obligations in accordance with the terms of an obligation's loan agreement, contract or indenture (Sobehart, Keenan & Steyn, 2003).

2.6   CREDIT ASSESSMENT

Credit analysis is the first step in the process to tailor-make a solution to fit the customer's needs. The assessment starts with an understanding of the customer's needs and capacities to ensure there is a good fit in terms of the financing solution.

The credit analysis process, traditionally employed by the first banks, does not differ fundamentally from the processes used today (Caouette et al, 1998; Rose, 2002). Credit assessment is the most important safeguard to ensure the underlying quality of the credit being granted and is considered an essential element of credit risk management (Cade, 1999).

The credit quality of an exposure generally refers to the borrower's ability and willingness to meet the commitments of the facility granted. It also includes default probability and anticipated recovery rate (Saunders & Cornett, 2003).

Banks consider the following issues when the credit risk inherent in a single business is assessed (Bluhm, Overbeck & Wagner, 2003):

- Default probability: What is the likelihood that the business will default on its repayment over the term of the facility?

- Exposure at default: In the event of a default, how large will the outstanding exposure be?

- Recovery rate: In the event of a default, what fraction of the exposure may be recovered through bankruptcy proceedings or through some other form of settlement?

Banks employ both qualitative and quantitative models to assess the default risk of advances. These models are not mutually exclusive and one or more models can be used to do the credit assessment and to evaluate the credit risk (Davis & Williams, 2004).

Credit models can be divided into three main categories, namely; qualitative models, credit scoring models, and newer models. Qualitative and credit scoring models are considered default models and are more generally applied (Saunders & Cornett, 2003). Newer models are used for credit risk measurement and pricing include models such as Credit Risk+ and CreditMetrics (Anderson, Maxwell & Barnhill Jr., 2002) and loan portfolio and concentration risk include models such as KMV Risk Advisor and KMV Portfolio Manager Model (Cade, 1999; Saunders & Cornett, 2003).

According to Rose (2002), the more traditional methods of credit assessment can be divided into two categories:

- A credit scoring system (quantitative model) uses pre-identified factors that are empirically related to the likelihood of default. A rating system (behavioural scoring) ranks advances according to a host of relevant factors (Altman, 2002). It furthermore ranks borrowers into different default classes (Saunders & Cornett, 2003). These types of credit scoring models are used to approve credit for individuals, small businesses and residential mortgage loans. The automated credit scoring procedures are more objective than judgmental evaluations

(Oleksiw, 2003). Although credit scoring allows for quicker decisions and is considered to be cheaper, continually updating the model and statically verifying results could make this more expensive in the long run. Financial models are also used for credit rating, credit pricing, for collection strategies and as an early warning system (Caouette et al, 1998; Cade, 1999).

- A credit analysis (qualitative model) is used by the credit official to evaluate a borrower's character, capital, capacity, collateral and the cyclical aspect of the economy, or generally referred to as the five C's (Strischek, 2000). Qualitative models are also referred to as an 'expert systems' and are based on the subjective judgement of the individual who makes the lending decision (Sinkey, 2002). Factors specific to the borrower and to the market are considered to enable an individual to make a credit decision (Saunders & Cornett, 2003).

Lending in the business market is often complicated, unique to the specific business or is of such a nature that a less mechanistic process needs to be followed (Saunders & Cornett, 2003). Lending to BEE companies is considered unique given the nature of the lending, being to previously disadvantaged South Africans.

The research focuses on the medium to large market and privately owned companies with no public debt and these companies are not publicly traded. This market is also characterised by the limited use of credit scoring models in the market segment identified (Caouette et al, 1998). The term credit analysis is used to describe the process for assessing the credit quality of business and the method will be further investigated.

2.7   CREDIT ANALYSIS - THE FIVE C'S.

The five C's are considered the fundamentals of successful lending and have been around for approximately 50 years. Initially only character, capacity and capital were considered. However, over the years collateral and conditions were added. This provided an even more comprehensive view and clearer understanding of the

underlying risk and resulting lending decision (Beckman & Bartels, 1955; Reed, Cotter, Gill & Smith, 1976; Sinkey, 2002). According to Murphey (2004a), these principles should be the cornerstone of every lending decision.

2.7.1 Character

Character refers to the borrower's reputation and the borrower's willingness to settle debt obligations. In evaluating character, the borrower's honesty, integrity and trustworthiness are assessed. The borrower's credit history and the commitment of the owners are also evaluated (Rose, 2000). Character is considered the most important and yet the most difficult to assess (Koch & MacDonald, 2003).

2.7.2 Capacity

Capacity refers to the business's ability to generate sufficient cash to repay the debt. An analysis of the applicant's businesses plan, management accounts and cash flow forecasts (demonstrating the need and ability to repay the commitments) will give a good indication of the capacity to repay (Sinkey, 2002; Koch & MacDonald, 2003).

2.7.3 Capital

Capital refers to the owner's level of investment in the business (Sinkey, 2002). Banks prefer owners to take a proportionate share of the risk. Although there are no hard and fast rules, a debt/equity ratio of 50:50 would be sufficient to mitigate the bank's risk where funding (unsecured) is based on the business's cash flow to service the funding (Harris, 2003). Lenders prefer significant equity (own contribution), as it demonstrates an owner's commitment and confidence in the business venture.

2.7.4 Collateral

Collateral (also called security) is the assets that the borrower pledges to the bank to mitigate the bank's risk in event of default (Sinkey, 2002). The amount and type of collateral will depend on the type and purpose of the debt finance. Lenders normally require the owners of the business to sign suretyships supported by collateral. Collateral might take the form of a bond over fixed property, cession of investments (including insurance policies) or the encumberment of a business's inventory, debtors, equipment or immoveable property.

Collateral should not be viewed in isolation. It is largely dependent on the character, capacity and capital of the borrower. Collateral cannot be a substitute for any of the C's and it cannot compensate for insufficient information (Basel Committee on Banking Supervision, 2000).

2.7.5 Conditions

Conditions are external circumstances that could affect the borrower's ability to repay the amount financed. Lenders consider the overall economic and industry trends, regulatory, legal and liability issues before a decision is made (Sinkey, 2002). Once finance is approved, it is normally subject to terms and covenants and conditions, which are specifically related to the compliance of the approved facility (Leply, 2003).

The credit analysis process consists of a subjective analysis of the borrower's request and a quantitative analysis of the financial information provided. Although the "five C's" are well-known credit assessment principles, commercial banks have developed their own qualitative credit risk assessment models to assess whether the bank will agree to lend to a specific business (Sinkey, 2002).

2.8 QUALITATIVE CREDIT ASSESSMENT MODELS

Credit assessment models are mainly based on the following aspects, focussing on the borrower (Rose, 2002; Koch & McDonald, 2003; Nathenson, 2004):

- Background

- Financial Position

- Security

- Conditions and covenants.

2.8.1 Background

The first step in the process to analyse a credit application is to determine the borrower's willingness to repay the requested credit facility (Murphey, 2004b). The borrower's willingness to pay is very difficult to determine and the borrowers past credit history can provide valuable information. Banks also obtain information from the local credit bureaus. After analysing the credit history, the type of business and the quality of management are investigated.

2.8.1.1 Type of business

The company's history is evaluated in terms of the type of business and the industry in which it operates. A key factor is the industry in which the company operates. It plays a significant role since each industry is influenced by various internal and external factors. The various industries are classified by the Standard Industrial Classifications or SIC codes (Rose, 2000). The factors that forms the basis of this analysis includes (Koch & MacDonald, 2003; Nathenson, 2004):

- Type of industry.

- Market share.

- Quality of products and life cycle.

- Is the business labour or capital intensive?

- The current economic conditions.

- Seasonal trends.

- The bargaining power of buyers and sellers.

- Competition.

- Legislative changes.

These factors lead the banker to form a view of the specific company and industry. The banker would regard this as a potential risk mitigant if he/she is confident about the company and industry and prospects for both appear to be positive.

The low interest rates in South Africa currently, would for example, have a positive effect on various industries, as the cost of finance is fairly low. However, the strong Rand has an adverse effect on exporters (less foreign currency earned) and certain manufacturing industries due to cheaper imports. The South African clothing industry is an example of an industry that has been adversely affected. Employees have been laid off and some factories have closed down. Credit decision in this industry would require a careful consideration of potential risk mitigants.

2.8.1.2 Quality of Management

The quality of management in the specific business is evaluated taking reputation, integrity, qualifications, experience and management ability of various business disciplines such as finance, marketing and labour relations into consideration (Sinkey, 2002; Nathenson, 2004). These factors can be regarded as a risk mitigant if a banker views these positively.

Bankers recognise the essential role management play in a company's success. Much of its success can in fact be attributed to competent leadership. Companies with strong and competent management teams tend to survive in an economic downturn. Privately owned companies are generally managed by its owners. In this instance, succession planning must be in place, as the role of management remains vital to the success of the company (Koch & MacDonald, 2003).

A company's reputation, referring specifically to credit, is based on past performance. A borrower has built up a good reputation or credit record if past commitments were promptly met (observed behaviour) and repaid timeously (Rose, 2002; Koch & McDonald, 2003).

It is evident that bankers consider a myriad of factors when the background of a company is evaluated. Individual factors are rarely all positive and a general view is normally taken. Certain individual factors can have an overriding impact such as the integrity of management. No funds will be advanced if the integrity of management is doubtful. If an industry was considered high risk, bankers would be circumspect to lend money to companies operating in that specific industry. The problem, however, is that banks have existing exposures to companies that operate in the high-risk industries and these have to be managed accordingly.

2.8.2 Financial position

The company's financial position is evaluated by assessing past financial performance and projected financial performance. A company's past financial performance is reflected in their audited financial statements (Koch & MacDonald, 2003). Financial projections consist of projected cash flows demonstrating the need for the facility and the ability to repay the facility (Sinkey, 2002).

2.8.2.1 Past financial performance

At least three years audited financial statements (balance sheet and income statement) are required for data analysis. A financial spreadsheet is used to undertake the analysis. As mentioned in section 2.7, banks also use quantitative models in the assessment of credit applications.

Commercial banks utilise the financial spread (i.e. audited financial statement analysis and ratio calculations - DuPont) and it is applied through the Moody's Risk Advisor. The model also performs a peer comparison and calculates the probability of default (Koch & MacDonald, 2003).

Financial ratio analysis can be divided in at least four categories of ratios (Koch & MacDonald, 2003):

• Liquidity ratios reflect the company's ability to meet its short-term obligations. According to Conradie and Fourie (2002), the general norm for the current ratio is 2:1. The current ratio is calculated by dividing the current assets by the current liabilities.

• Activity ratios indicate whether assets are efficiently used to generate sales.

• Leverage ratios indicate the company's financial mix between equity and debt and potential volatility of earnings. High volatility of earnings increases the probability that the borrower will be unable to meet the interest and capital repayments. New firms present less attractive credit risk due to the variance of earnings in comparison to more established firms with history of financial performance. According to Harris (2003), depending on the particular industry, a ratio of 50:50 debt to equity is deemed acceptable where the business' future cash flows are discounted.

• Profitability ratios supply information about the company's sales and earnings performance.

The cash flow analysis is done once the ratio analysis has been valuated. The cash flow analysis allows the banker to distinguish between reported accounting profits (net income) and cash flow from operations (cash net income). Cash flow from operations gives an indication of how much cash is generated from normal business activities. The cash flow generated must be sufficient to service the banking facilities (Sinkey, 2002; Koch & MacDonald, 2003).

2.8.2.2 Financial projections

The company borrowing the money usually provides the bank with financial projections. These include cash flow projections and the assumptions used in the cash flow forecast. The assumptions the company uses, are also an indication of management perception of business landscape in which the company operates. These assumptions are evaluated against the company's past performance, industry averages and expected economic trends (Nathenson, 2004).

The projections also reveal the purpose, amount and type of finance required. It also provides insight into the company's ability to generate sufficient cash flow to service the debt (Murphey, 2004b; Nathenson, 2004). Banks must ensure that the type of financing is aligned to the purposed of finance (Rose, 2000).

Increase in debt furthermore leads to an increase in interest charges, which could put the cash flow under pressure (Koch & MacDonald, 2003). Vance's (2004: 31) comment appropriately describes the importance of cash: "Cash is king; you pay your bills with cash. Cash is as necessary to every business as blood is to a human body".

Companies have basically only three sources of cash to repay their banking facilities (Rose, 2000):

- Cash flows generated from sales. The source of repayment mostly preferred by bankers is cash flow from sales as it demonstrates the sustainability of the business operations.

- The sale and liquidation of assets. Selling income-generating assets to meet its financial commitments is normally the first signs of possible trouble in a business.

- Funds raised by obtaining debt or issuing equity. Both these options are only short-term solutions and cannot be sustained over the long term.

The importance of the company's ability to generate sufficient cash flow to service the banking facilities was highlighted in this section. Debts are repaid from cash flow, not earnings. If a business does not demonstrate the ability to generate sufficient cash to repay the facility, no banking facilities will be approved. In the next section, security taken by banks will be discussed.

2.8.3 Security

A secured advance is an advance backed by a first claim by the bank on certain assets (collateral or security) the borrower owns in the event of a default. The bank will only have a general claim against the borrower's assets if the advance is unsecured (Saunders & Cornett, 2003).

Security is something valuable which is ceded or pledged to the bank by the borrower to support the borrower's intention to repay the money advanced. Security is taken to mitigate the bank's risk in the event of default and is considered a secondary source of repayment (Koch & MacDonald, 2003).

2.8.3.1 Principles of good security

The asset should belong to the borrower, and no other person or institution should have a better claim than the bank. It is important to note that the value of these security items can be determined fairly accurately, remain fairly stable in value and

can be realised quickly with little additional expense. The bank must furthermore be in a position to obtain effective control over the items offered as security (Koch & MacDonald, 2003).

Security items, where the bank must make a contribution or pay any arrears before receiving the value of the security items, should be avoided (Rose, 2000). Lastly, all security taken should be legal and effective prior to the utilisation of any facility (Murphey, 2004b). Once the borrower has the funds, the perfection of security items can become protracted.

2.8.3.2 Different types of security

Security can be divided into tangible and intangible security. Banks normally prefer tangible security as these items generally adhere to the principles of good security. Another feature of tangible security is the value that can be placed on these items. The security value of an asset is based on the estimated re-sale value of the assets at the time of disposing of it (McManus, 2000). An overview of the more common forms of security will be given below, commencing with tangible security.

2.8.3.2.1   Tangible security

- First covering mortgage bonds are taken over residential, commercial, industrial and agricultural properties. The specific type of property is valued by the bank to determine the property's market value for security purposes (Rose, 2000). The security value placed on a property depends on whether the property is unimproved (vacant land) or improved, where it is located, and the demand for the property. The security value can therefore range from 40% to 80% .It is not uncommon for banks to grant 100% loans of the market value on residential properties. The first covering mortgage bond is registered in favour of the bank and the bank can acquire the property in the event of a default (McManus, 2000).

- The bank can also take a cession of the borrower's assets (Rose, 2000). The person transferring the rights is known as the cedent and the bank as the cessionary (McManus, 2000). Cessions can be taken over the following assets:

  - Cession of fixed deposits or other investments with the bank or other financial institutions banks can be taken done (Rose, 2000). The market and security is equal to the amount of the investment and can be liquidated quickly instantly in event of default.

  - Life policies not only provide life cover in event of death of the insured but also offer a surrender value (Rose, 2000). The market value of a life policy is equal to the amount of life cover and the security value is equal to the surrender value. When the bank liquidates the life policy only the surrender value less any arrear premiums will be paid to the bank.

  - Shares listed on the Johannesburg Stock and Securities Exchange can also be taken as security (Rose, 2000). Shares listed in the category, Development and Venture Capital, are not considered desirable and are normally not considered as security. The bank's risk is further mitigated if shares in various listed companies are offered as security and there is a demand for these shares. Shares in blue chip companies are also more desirable. The market value of the shares is equal to their selling price. Due to the fluctuation of shares prices, the market values of the shares held by the bank are updated on a regular basis. The security value ranges from 50% to 60%, depending on the spread of shares taken. Listed shares can easily be liquidated by selling the shares on the open market.

  - Unit trust can also be taken as security. The market value is the selling price as quoted in the news media. The security value of unit trust ranges from 50% to 75%.

- The owner of a moveable asset can also pledge an asset to the bank (Rose, 2000). The bank must have actual possession of the asset, but legal ownership remains with the owner. The most common type is the pledge of Kruger Rands.

The market value is the market price quoted on the Johannesburg Stock and Securities Exchange and the security value is 50% of the market price.

It is evident from the above overview that tangible security can be liquidated fairly quickly with minimal costs. Although it has been mentioned that no security value can be placed on intangible security, there are exceptions. The exceptions are mainly due to the difficulty of determining the security value.

The next section deals with the exceptions and the most common forms of intangible security.

2.8.3.2.2   Intangible security

A further covering mortgage bond over fixed property can be taken by the bank. However, another party or financial institution holds the prior ranking bonds and will have the first claim against the property (Vance, 2004). The same valuation process as for first covering mortgage bonds is followed by the bank. No security value is generally placed on further covering mortgage bonds. The reason for this is that the first or prior bondholders are entitled to recover the full amount of the registered bond plus an additional amount specified in the cost clause. The cost clause can range from 0% to 20% of the registered bond amount. However, if there is sufficient value in the property, a security value can be placed on the bank's further covering mortgage bond. In the instance where a property has been valued for R100 000 and the first bondholder registered a R10 000 mortgage bond over the property, the claim of the first bondholder will be limited to R12 000 (R10 000 plus 20% cost clause). There is sufficient value (R88 000) left in this example for a bank to register a second bond over the property. After making full provision for first bondholders, a security value can be placed on the property by the bank as the second bondholder. The consent of the first or prior bond holders must be obtained before the bank may litigate against the property. It can result in a long legal process and the recovery of the bond amount might become protracted.

When banks finance working capital for trading entities a cession of trade debtors are normally taken as security. The market value of the trade debtors are determined by investigating the quality and spread of the debtors and the terms granted to the debtors. All doubtful debtor amounts are deducted to determine the market value. The security value is approximately 30% of the determined market value. If the debtors are insured and a cession of the insurance cover is held, a larger amount can be extended as security value (McManus, 2000). It is difficult to collect money from the debtors in the event of default and the process can be extremely cumbersome (Rose, 2000).

Shareholder loans can also be ceded to the bank. No market or security value is placed on these loans. A cession of shareholder's loans prevents the shareholders from taking money out of the company without the prior approval of the bank. In case of liquidation, the shareholders will have a concurrent claim against the company in terms of their shareholders loan. Any amounts received in terms of the concurrent claim will have to be paid to the bank as the shareholder loans are ceded to the bank. Banker's regard a ceded shareholders' loan as an asset and are sometimes taken to restore the solvency of a company.

General and special notarial bonds can be taken over moveable assets. These assets include stock, equipment and machinery (McManus, 2000). The bank determines the market value of these assets and no security value is placed on it. General and special notarial bonds are not a very sound form of security as it can be very difficult to realise these items. Stock is traded on a daily basis and is normally converted into cash in difficult times. Equipment and machinery are sometimes also converted to cash to assist the business's cash flow and very little value might be left for the holder of the notarial bond (Rose, 2000).

Unlisted shares are often offered as security. Although the bank will take a cession of these shares, no value will be extended against shares. It is difficult to determine the market value and there is generally no demand for these shares.

A third party can provide a suretyship for the debt of the borrower. Should the borrower not be in a position to repay he debt, the bank will then call on the surety for repayment (Koch & MacDonald, 2003). It is normal banking practice for the banks to take the suretyships of the shareholders/directors when funds are advanced to a company (Rose, 2000; Vance, 2004). The same principle applies when lending to Closed Corporations, where members provide suretyships and to Trusts, where the trustees would provide suretyships. However, if the legal entity is of sound financial standing, facilities can be approved without the required suretyships. Any form of security can also support a suretyship. The amount of the suretyship is normally taken as the market value and the security value is dependent on the security value of the supporting security (McManus, 2000).

When fixed property and movable assets, i.e. equipment, machinery and stock, are taken as security, the bank must ensure that these assets are adequately insured and that a cession of the insurance policy is taken (Vance, 2004).

It is evident in the above discussion that various forms of security are available for banks to mitigate the possible default risk. The discussion addressed the most common forms of security taken by banks, however, the list is by no means exhausted.

2.8.4 Covenants and conditions

Banks normally include covenants when credit facilities are granted to protect the bank's interest. The primary role of covenants is to serve as an early warning system (Nathenson, 2004). Covenants can either be negative or positive (Sinkey, 2002). Negative covenants stipulate financial limitations and prohibited events (Rose, 2000; Koch & MacDonald, 2003). Some examples of negative covenants are:

- Cash dividends cannot exceed 50% of the net profit after tax (financial limitation).

- No additional debt may be obtained without the bank's prior approval (prohibited event).

Positive or affirmative covenants stipulate the provisions the borrower must adhere to (Rose, 2000; Koch & MacDonald, 2003). Some examples of positive covenants are:

- Audited financial statements must be provided within 90 days of the company's financial year-end.
- The borrower must maintain the following financial ratios:
    - Interest cover ratio of 4:1 (defined as earnings before interest and tax divided by interest paid).
    - Gearing ratio of 2:1 (defined as total liabilities divided by owners equity).

Conditions normally stipulate that all the security relevant to the loan should be in order before any funds will be advanced.

2.9   CONCLUSION

It is evident that very little empirical research has been done in South Africa specifically in the medium to large market. Commercial banks face a myriad of risks, which has to be managed effectively. The qualitative credit assessment model was discussed and this model is mainly used by commercial banks to determine the default risk of an application. An analysis of the most common types of security taken by commercial banks was also done.

Given the past inequalities in South Africa, black people traditionally have no equity to support the lending, have no security to offer, have poor credit records, limited training and skills. These were considered the main limitation for SMMEs to obtain funding. The following results would be achieved if a comparison was done based on the main components of the qualitative credit assessment model:

- Background: Poor credit records, limited training and skills.

- Financial Position: No equity to support the lending.

- Security: No security to offer to support the lending.

Given the above "misalignment" the question remains: How do commercial banks in South Africa mitigate their risks when advances to BEE companies are considered? For the purpose of the research study, the limitations identified in the SMME market will be used as a framework to investigate the situation in the medium to large market.

The research problem and sub-problems will be formulated in the next chapter.

CHAPTER 3

PROBLEM STATEMENT AND PROPOSITIONS

3.1 INTRODUCTION

The previous chapter dealt with the theoretical foundation and a literature review as a basis for this chapter where the research problem and sub-problems are formulated. Propositions are set to govern the thinking process during the investigation.

3.2 PROBLEM STATEMENT

The research problem refers to the general area of focus for the research (Strauss & Corbin, 1998). A problem statement is a clear precise and concise statement of the issue being investigated with the aim of finding a solution (Van der Wal, 2004).

Given the past inequalities in South Africa, lending to SMMEs is considered high risk. It is not clear whether the same limitations are present in the medium to large market. Commercial banks will find it difficult to approve finance for medium to large companies if the same circumstances exist in the medium to large market as for SMMEs.

As a result the problem statement can be defined as follows: How can credit risk be mitigated by commercial banks in lending to BEE companies in the medium to large market?

The research is closely linked to the dilemma facing South African commercial banks and it is imperative that credit risk mitigants be identified to assist in mitigating the bank's risk.

3.3 SUB-PROBLEMS

To identify what principles should be used in lending to BEE companies?

Proposition 1: Commercial banks have clear credit policies to evaluate BEE applications.

If commercial banks have clear credit policies in place, it is important to determine how BEE applications are assessed.

Proposition 2: Commercial banks consistently apply the same credit assessment model (e.g. the 5 C's) in the assessment of BEE lending (i.e. lending is lending).

What are the credit risk mitigants that can be identified?

Proposition 3: Credit risk mitigants can be identified to mitigate commercial banks risk when advances are considered for BEE classified companies.

By applying the identified credit risk mitigants, it is possible to soften the credit risk inherent in BEE transactions.

3.4 RATIONALE

The fundamental objective of lending is to approve profitable advances with an acceptable risk profile.

Banks should have clearly defined risk policies, which should be consistent with their business strategies. A credit policy formalises lending guidelines credit officials need to follow and adhere to when dealing with credit applications. A credit policy stipulates preferred advances qualities and lays down procedures for granting, monitoring and reviewing advances. The bank's credit philosophy determines the level of risk the bank will take and in what form (Sinkey, 2002).

The credit philosophy also establishes the bank's credit culture, which is reflected in the bank's lending principles, and how risk is analysed (Koch & MacDonald, 2003). Diversification limits are also set to ensure that risk or lending is not concentrated in certain areas (Saunders & Cornett, 2003). A bank's credit policy should be reviewed on a regular basis to ensure it remains relevant, but also since it is examined by regulatory authorities and the bank's auditors (Austin & Cocheo, 2002).

A commercial bank's credit policy fulfils a very important function. It determines the bank's credit philosophy and credit culture. Commercial banks in South Africa have developed their credit culture over many years and culture does not change overnight. Lending to BEE companies is considered new territory for commercial banks and might require an alternative lending paradigm.

Commercial banks employ both qualitative and quantitative models in the assessment of credit applications (Davis & Williams, 2004). These models are not mutually exclusive and one or more models can be used to do credit risk evaluation or credit assessment. Qualitative credit assessment models (which incorporate the 5 C's) are mainly based on the following aspects referring to the borrower (Rose, 2002; Koch & McDonald, 2003; Nathenson, 2004):

- Background

- Financial position

- Security

- Conditions and covenants.

The nature and scope of qualitative credit assessment used by commercial banks in the assessment of BEE company applications needs to be determined. If the same generic model is used for all applications, then credit risk mitigants needs to be identified to mitigate the bank's risk.

A commercial bank's credit policy formalises lending guidelines for credit officials to follow and adhere to when credit applications are assessed (Koch & MacDonald, 2003). These formalised lending guidelines are used to mitigate the bank's risk. In no formalised guidelines are in place for BEE companies, credit risk mitigants needs to be identified and included in the lending guidelines.

3.5   CONCLUSION

In this chapter the problem statement was stated in general terms, followed by a series of sub-problems and propositions. Propositions are set to govern the thinking process during the investigation.

In the next chapter an exposition of the research design and analysis will be given.

CHAPTER 4

RESEARCH DESIGN AND ANALYSIS

4.1   INTRODUCTION

The previous chapters served to provide a framework of the purpose and importance of the research. It addressed the theoretical foundation of the study and a literature review. The problem statement, sub-problems and propositions was consequently formulated in chapter three and this chapter therefore involves an exposition of the research design and analysis.

4.2   QUALITATIVE RESEARCH

Unlike quantitative research, qualitative research consists of a body of research techniques that do not attempt to measure, but rather seek insight through a less structured and more flexible approach (Gray, 2004). Exploratory research is conducted when there are few or no earlier studies, which can be referred to. In exploratory research the focus is on gaining insight into the subject and to become familiar with the subject area for more rigorous investigation later (Cooper & Schindler, 2003). Exploratory research can be conducted by using multiple methods to achieve triangulation and can consist of a combination of the following (Saunders, Lewis & Thornhill, 2000; Gray 2004):

- A literature search

- Talking to experts in the field

- Interviews

- Case studies

- Surveys.

In this two data collection methods was used, namely interviews (discussed in section 4.3) and case studies (discussed in section 4.4) to obtain a sound understanding of the credit evaluation processes, methods and practices commercial banks employ in assessing advances. Personal interviews were conducted with senior officials in some of the different commercial banks. Once the information was obtained, client files of BEE companies with approved banking facilities, which served as case studies, was investigated to determine whether sound lending parameters/criteria were applied. It was determined how the bank's credit risk was mitigated in the absence of an equity base (own contribution), management skills, acceptable credit record and collateral.

4.3 INTERVIEWS

According to Gray (2004), interviewing is an ideal method to obtain data relating to people's views, knowledge and attitudes. Interviews can be divided into the following three broad categories (Flick, von Kardorff & Steinke, 2004; Gray, 2004):

• Structured

• Semi-structured

• Unstructured (non-directive, focused and informal conversation).

Structured interviews are used to collect data for quantitative analysis. Semi-structured and unstructured interviews are used to collect qualitative data and allow the researcher to probe more detailed responses. A semi-structured interview consists of a list of issues or questions that will be covered during the interview. It also allows the researcher to follow the same interview protocol (Gray, 2004).

The semi-structured interview technique was deemed the most suitable method in meeting the aim and objectives of the research. Self-administered semi-structured interviews were employed in the research report and abstracts of the results are given in Appendix D.

4.3.1 Population and sampling

A purposive convenient sample was used for the interviews and involves a conscious selection of the population groups to be included in the study (Cooper & Schindler, 2003). The big four banks selected, in alphabetical order, are:

• Absa Bank Limited

• FirstRand Bank Limited

• Nedbank Limited

• Standard Bank of South Africa.

The aim was to interview a senior credit official of each of the big four commercial banks. Two of the four banks selected, declined to be interviewed, as some of the questions were deemed to be too sensitive. They were however, prepared to participate if the questionnaire consisted of close-ended questions. The two banks interviewed still represented 46% of total advances/loans made by commercial banks in South Africa and the participation of only two commercial banks are not deemed a limitation.

The questions used in the semi-structured interview, were designed to collect data regarding the commercial banks' credit policies, qualitative assessment models and credit risk mitigation. An example of the questionnaire is enclosed in Appendix A.

According to Gray (2004), internal validity is strengthened when the questions used in the semi-structured interviews are directly related to the research objectives. The questions were also based on the literature review. To ensure further validity, the questions were pilot-tested with 3 senior credit officials who were not part of the target population. They also gave advice for certain changes to the questionnaire. Given the low participation, external validity is restricted. During the self-administered interviews, the researcher was open-minded and care was taken not to lead the

respondents in answering the questions. To ensure consistency, the same interview protocol was followed in each interview thereby increasing the reliability (Gray, 2004).

4.3.2 Data collection and analysis

The semi-structured interviews served to gather qualitative data on how the commercial banks in South Africa process applications for BEE companies and to form an idea of credit models used to assess BEE companies credit applications. The research participants were required to share the current practices employed by their banks in lending to BEE companies. The questionnaire was used as a guideline to ensure that all the relevant topics were covered. Interviews were conducted during September 2005 and voice recordings of the interviews were made.

The voice-recorded interviews were analysed and the information obtained reported accordingly. Abstracts of the results are given in Appendix D. According to Straus and Corbin (1998), some researchers believe that qualitative data should not be analysed and that it should merely be presented. The information provided is qualitative in nature and a detailed analysis will therefore not be required. It is important to note that the information specific to the banks, has been treated as confidential. Were deemed necessary, aliases were assigned to the various banks or results reflected collectively.

4.4 CASE STUDIES

Once it has been determined how the commercial banks in South Africa treat applications for BEE companies, actual cases were analysed to determine how credit risk was mitigated. According to Yin (1994), there are six main sources of evidence for case study data namely documentation, archival records, interviews, direct observation, participant observation and physical artefacts. In this research report, documentation (client files) has been chosen as a source of data. This source of data collection has the following strengths and weaknesses (Yin, 1994):

Strengths:

- Stable – can be reviewed repeatedly

- Unobtrusive – not created as a result of the case study

- Exact – contains exact names, references and details of an event

- Broad coverage – long lifespan

Weaknesses:

- Access – problems with confidentiality, access restricted

- Biased selectivity – if collection is incomplete

- Reporting bias – reflects unknown bias of researcher.

4.4.1 Population and sampling

The target population of the case studies included all credit files where funding was done for BEE companies. The sample had to conform to the criterion as indicated in chapter one (1.4) and a purposive sampling method was used (Cooper & Schindler, 2003). A judgement sample of 30 cases were investigated to identify the lending criteria used and to establish what risk mitigating principles were applied. According to Perry (2001), the minimum number of cases ranges between 2 to 4. The maximum on the other hand ranges from 10 to 15 cases. Given the exploratory nature of the research, 30 cases were selected.

4.4.2 Data collection and analysis

The data collection was done by analysing the 30 case studies. The qualitative credit assessment model given in chapter two was used as a framework. An example of the evaluation template is enclosed as Appendix B. The evaluation template was completed for each of the client files identified for the study and the same protocol

was followed in every case to increase reliability. Due to the principle of bank client confidentiality, no names were used and the cases were referred to as case 01 to case 30.

Mainly qualitative data was obtained and was analysed using a simple method of addition and turned in to quantitative data in order to discuss. The aim of the analysis was to identify how credit risk was mitigated. The research will also try to identify risk mitigating factors. Each credit risk mitigant identified in the process, were reported accordingly. Due to the exploratory nature of the research, in depth statistical analysis of the data collected, at this stage will not have any significant value.

4.5 LIMITATIONS

According to Gray (2004), case studies are sometimes sample and context specific and lack generalisability of the research results. Generalisations can only be made if a study is replicated three or four times in different circumstances (Yin, 1994). Due the banks confidentiality policies, the accessibility of client files is restricted and the replication of the study would be difficult. The data analysis and collection was time consuming and difficult.

4.6 CONCLUSION

This chapter provided an exposition of the research design and analysis. Due to the exploratory nature of this study, a qualitative research approach was used. The limitations of the research methodology were highlighted. Although the researcher took extreme caution in the process of conducting the interviews and analysing the case studies, the potential of bias and subjectivity cannot be eliminated entirely. The research results are presented in the next chapter.

CHAPTER 5

PRESENTATION OF RESEARCH RESULTS

5.1 INTRODUCTION

The results obtained from the interviews and case studies are presented in this chapter. As mentioned in section 4.3.2, these results were obtained under the presumption of confidentiality and the results are given for the banking group and case investigated as a whole. Extreme care was taken to neither identify any bank or client in this study. The results obtained from the interviews are presented in the first part of the chapter and the results obtained from the case studies presented in the second part of the chapter. These results are discussed in chapter six.

5.2 INTERVIEWS

Only two of the four commercial banks identified participated in the semi-structured interviews. The results are considered a representative sample for the reasons given in section 4.3.1. The results from the semi-structured interviews were obtained under the presumption of confidentiality and that the results will be presented for the participating banks as a whole. The tape-recorded interviews are in the possession of the researcher. The participating banks will collectively be referred to as commercial banks. Abstracts of the interviews are reflected in Appendix D.

The questionnaire used was aligned with the research propositions and consisted of three categories, credit policy (Category A), credit assessment models (Category B) and credit risk mitigation (Category C). The presentation of the results is given in the same order.

5.2.1 Credit Policy

<u>Category A: Questions 1, 2 & 3</u>

These questions focused on whether the credit policies of the commercial banks cater for lending to BEE companies and if so, the guidelines for lending to BEE companies. Other methods employed by the commercial banks to assist in lending to BEE companies were also explored.

According to the abstracts of the interviews, in Appendix D, the commercial banks interviewed do not have a separate credit policy to cater for BEE companies. All use a generic credit policy, which is based on sound lending principles (2.6; 2.8; 3.4). The credit policy is deemed to be "colour blind" and does not discriminate against any person or group of people on basis of race, beliefs or any other features. Some guidelines in refining their credit policies have evolved over time and it is envisaged that these guidelines could be included in the respective credit policies in future.

The commercial banks are also consulting with various role players in the industry to assist in lending to BEE companies. Ongoing discussions are held with industry indemnity scheme providers to provide collateral to the bank under certain conditions. Commercial banks are also in continuous discussion with larger businesses, especially those who provide contact work, to assist in the mentoring and skills transfer to BEE companies in the start-up phase of these businesses. Certain government contracts do not allow the commercial bank to take a cession of the contract to mitigate the bank's risk. The banking industry is currently lobbying with government to have some of the terms and conditions of these contracts amended. Bank products are constantly being revisited and new products have been implemented to cater for lending to BEE companies as reflected in Appendix D.

5.2.2 Credit Assessment Models

Category B: Questions 4, 5 & 6

The questions focussed on the credit assessment models used in general, the credit assessment models used in the assessment of lending to BEE companies and the process followed by the banks when these applications are received for assessment.

According to abstracts of the interviews, in Appendix D, the commercial banks used qualitative credit assessment models (2.8) to assess credit applications in the medium to large market segment. In the individual and small market segment applications were credit scored (2.6). A qualitative credit assessment model is used in the assessment of a BEE company's credit application. The model focused mainly on the quality of management, the industry, financial position and collateral.

A detailed investigation is done into the quality of existing and new management of the business to obtain a sense of the individuals at the helm and what value they can add to the business (2.8.1.2). The contribution is measured not only in terms of equity value, but equally important the contribution in terms of intellectual capital. Industry and sector specific information (2.8.1.1) is assessed in terms of political, economical, technological, environmental and legislative factors that could potentially impact the industry. The role of applicant in the specific industry is also examined as reflected in Appendix D.

A full analysis of the company's historical financial performance (2.8.2.1) and projected cash flow is done (2.8.2.2). Future cash flows are discounted and the ability to service the requested facilities are done. The commercial banks might then decide to deviate from the set benchmarks in terms of specific financial ratios, once they obtained a better understanding of the cash flows and ability to repay. The type of financing must furthermore be in line with the purpose of the funding as reflected in Appendix D.

The various types of collateral (2.8.3) offered are examined and suretyships by the owners are taken to show moral commitment.

It is evident, from Appendix D, that the commercial banks also utilise deal-making forums before an application is forwarded for assessment. Officials from the Business Banking and Credit departments are included on this forum. The aim of this forum is mainly to consider how the bank can facilitate the application and to provide guidelines on how the identified risks can be mitigated. All these aspects are included in the credit application and then forwarded for credit assessment. Mandate holders, within a mandate specific to that mandate holder, approve applications. Should a mandate holder decline an application, he/she would then refer it to a higher mandate holder for a final decision.

5.2.3 Credit Risk Mitigation

<u>Category C: Questions 7 & 8</u>

The questions focussed on the main limitations/constraints for BEE companies in obtaining funding and how credit risk can be mitigated in lending to BEE companies.

According to Banks 1 and 2 (Appendix D), the following are considered the main limitations/constraints:

- Little or no own contribution/equity (2.2.2).

- Absence of acceptable security (2.2.2).

- Lack of management and technical skills (2.2.2; 2.2.4).

- No or poor credit history. Credit rating agencies only keep adverse records and no positive reports (2.2.2).

- Limited guidelines are set for funding of BEE companies (3.3; 3.4).

- Staffing was also identified by one of the commercial banks (Bank 2) as a possible constraint as it was not possible to address applicants in their own language.

- Fronting and no direct involvement of the BEE partner/s.

- Legal constraints, more specifically certain government contracts which could not be ceded and existing tax laws which have an adverse effect on the transfer of assets of a company (i.e. capital gains tax).

- Section 38 of the Companies Act prohibits any financial assistance by the company to any person wanting to acquire shares in the company.

- The impact that Basel II and the proposed new Credit Bill will have on the funding of BEE companies, are not yet fully understood at this stage.

According to Banks 1 and 2 (Appendix D), credit risk can be mitigated in lending to BEE companies by the following:

- Indemnity schemes providing collateral, such as Khula.

- Providing finance to allow a black person to take up a small shareholding and as the business performs, to increase the shareholding and finance.

- Establishing a proper mentorship programme and to have accredited mentors. There is a potential for experienced retired executives to look after a few BEE companies and to mentor them.

- Partnership between the bank and the BEE company, where the bank takes an equity stake in the company.

- Franchising was also deemed a risk mitigant. The franchisor provides training, assists in compiling the business plan and monitoring the business on a daily bases.

An opinion (Bank 1) was raised that banking is not only about lending money, but also to build a relationship with the client. Commercial banks have undertaken to lend to BEE companies in terms of the FSC. It is therefore required that more specific

guidelines be provided, that a credit policy change would not suffice, but that a total solution be offered.

It is evident that commercial banks currently use generic credit policies. Although guidelines exist in lending to BEE companies, these have not yet been incorporated into the bank's credit policy. Commercial banks are consulting with various role-players in the industry to assist them in lending to BEE companies. Deal-making forums have been established to assist in structuring the applications before the application is forwarded for assessment. Various risk mitigants have been identified of which some have already been employed by the commercial banks.

In the next section the results from the case studies are presented.

5.3   CASE STUDIES

In the second part of this chapter the results of the case studies are presented. An explanation of the research template used is given in Appendix C. A summary of the results is presented in Appendix E and a spreadsheet of all the results is given in Appendix F.

The relationship between BEE ownership and total exposure will first be presented where after the remainder of the results will be presented covering the main components of the qualitative assessment model. The main components are background, financial position, collateral and covenants and conditions. These results are presented in sections 5.3.1 to 5.3.4 and in section 5.3.5 the credit mitigants identified, are given.

5.3.1   Relationship between BEE ownership and total exposure

It is important to determine the percentage BEE shareholding to ascertain the level of BEE ownership. The perception is that banks will only finance BEE companies where

there is a low level of BEE shareholding or involvement as the risk is deemed more acceptable (2.2.2).

In figure 5.1 the BEE ownership of the case study sample is presented.

Figure 5.1 BEE ownership of the companies investigated
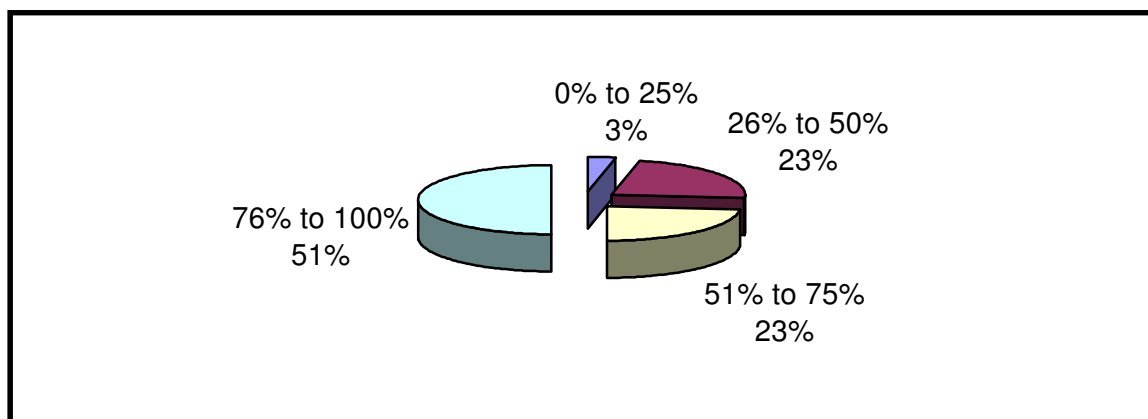
It is evident that in 74% (51+23) of the cases, the black ownership was more than 51%. This is an indication that banks consider facilities at all levels of shareholding and not only focusing on those transactions where there are small BEE ownership. Thus level of BEE shareholding is not considered a limiting criterion when advances are considered. The results further indicate that the bank's credit policy is "colour blind" (5.2.1).

It is further important to determine the level of total exposure to ascertain the level of facilities accorded to BEE companies in the medium to large market. The perception is that banks will only approve limited amounts of finance to BEE companies (2.2.2; 2.2.3).

In figure 5.2 the total exposures of the sample are presented.

Figure 5.2 Total exposures of the companies investigated
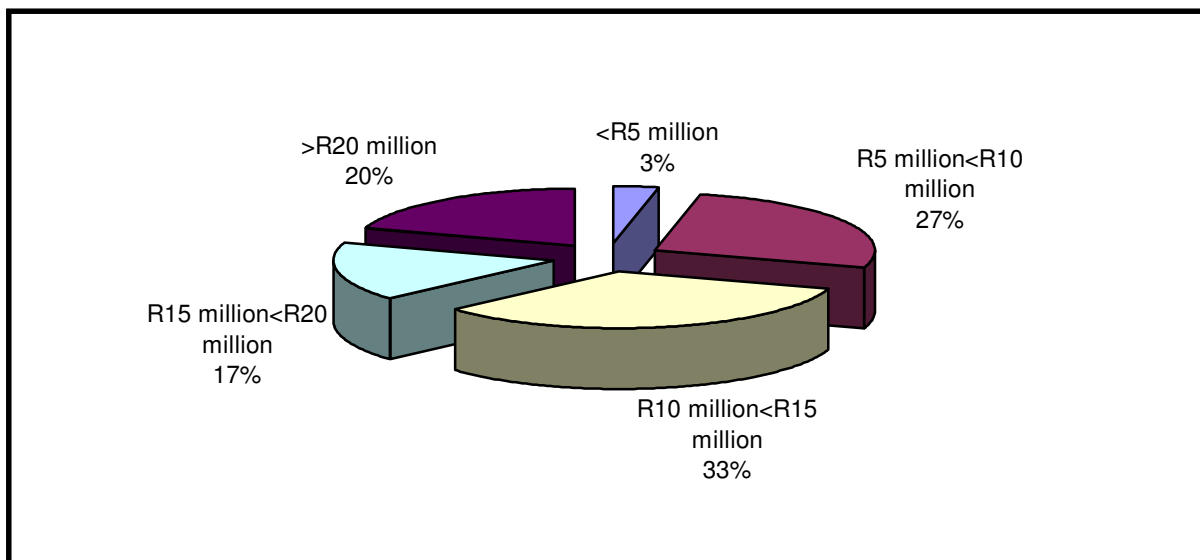
The results, however, indicate that the total exposure is quite evenly spread across the sample, and that this could be an indication that the bank is prepared to consider facilities at all levels of exposure. The majority of the total exposure was in excess of R10 million, which indicates the sample was mainly representative of the large market. The level of facilities is not considered an important criterion when advances are considered for BEE companies.

5.3.2 Components of credit assessment

The qualitative credit assessment model consists (2.8) of the background, financial position, security and conditions and covenants.

5.3.2.1 Background

The results presented cover the credit history of the owners; the borrowing entity; the industry type and the quality of management. The past credit history of the borrower is an indication of the borrower's willingness to pay. A good credit history indicates that there were no previous defaults.

Traditionally South African commercial banks will not entertain an application for facilities where the credit record was not clear (2.8.1). In figure 5.3 the results of the credit history of the owners are presented and in figure 5.4 the results of the borrowing entity.

Figure 5.3 Credit history of the owners
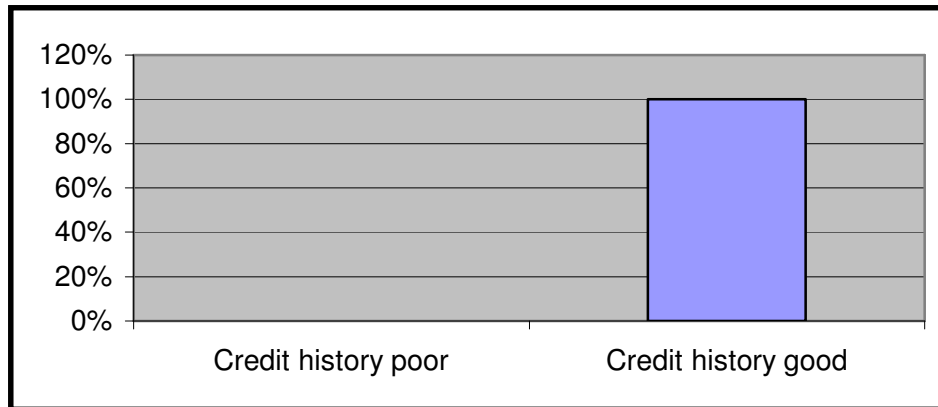
The results indicate that in all the instances the owners had clear credit records. The sample only consisted of approved facilities and is an indication that clear credit records still play an important role in the evaluation criteria. It is also evident that the bank's credit policy is strictly adhered to (3.4).

Figure 5.4 Credit history of the borrowing entity
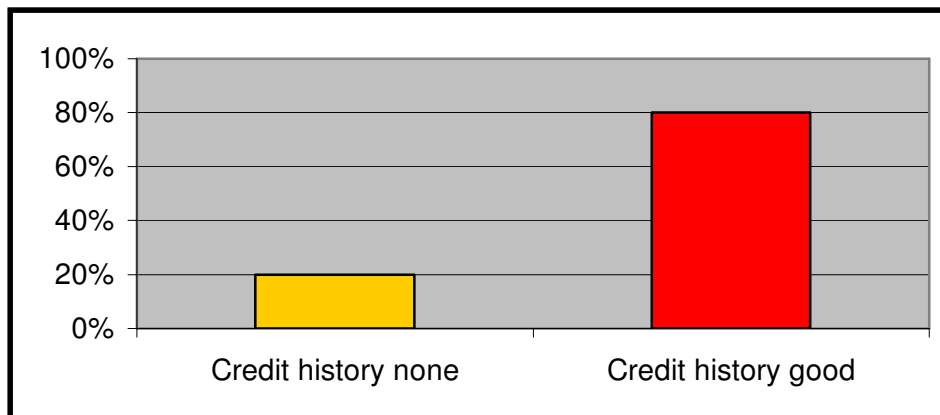
The results indicate that in 20% of the cases the borrowing entity was newly formed and consequently had no credit record. In 80% of the cases, the borrowing entity had a good credit record. The sample only consisted of approved facilities and is an indication that clear credit records still play an important role in the evaluation criteria.

When facilities are considered, banks also consider the risk profiles of the industry in which the borrowing company operates (2.8.1.1). The agriculture, hunting, forestry and fishing did not form part of the sample. In figure 5.5 the results of the facilities granted in the various industries are presented.

Figure 5.5 Facilities granted in the various industries
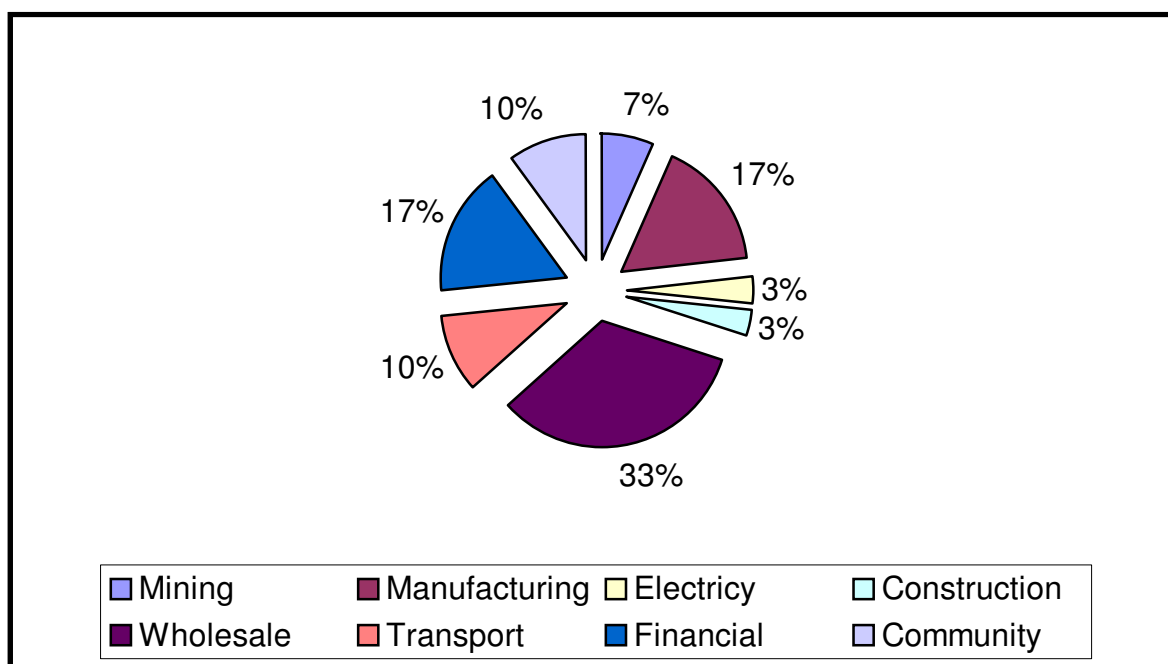
The results indicate that the majority of the facilities were granted in the wholesale/retail trade (33%), manufacturing (17%), and financial intermediation (17%) industries. These industries represent 67% of the sample and can be indicative of the industries in which the banks are currently comfortable to lend in. It can also be an

indication that BEE companies are starting to play a more prominent role in theses industries.

The quality of management is considered very important, as the success of a company is dependant on the ability of the management team (2.8.1.2). In figure 5.6 the quality of management in terms of depth, experience and skills are presented.

Figure 5.6 Quality of management in terms of depth, experience and skills
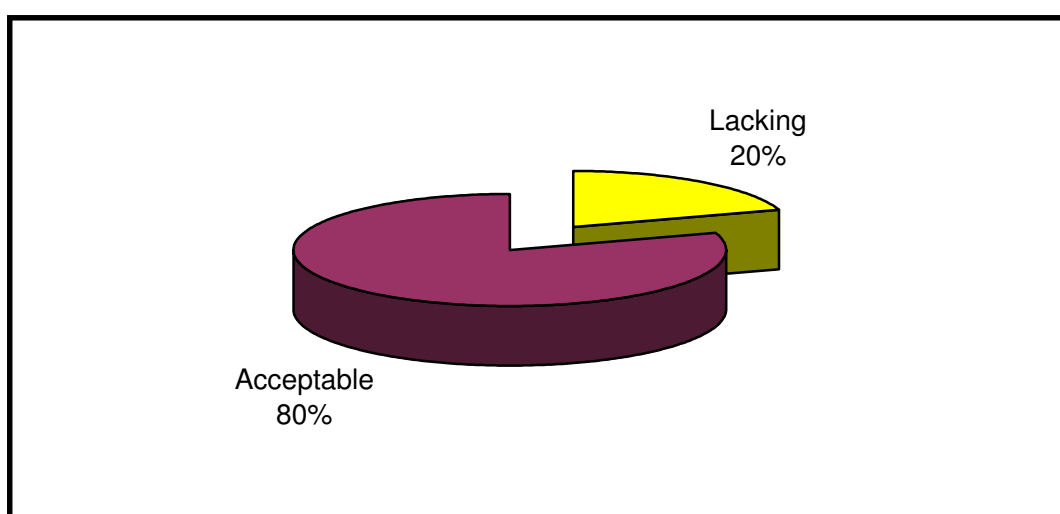
The results indicate that in 80% of the cases, the qualities of management were deemed acceptable. This is an indication that quality of management and previous experience is still an important condition for lending in the medium to large market. It can also be construed that the shareholders have already acquired these qualities and skills from previous experiences, which enable them to operate successfully in the medium to large market.

The remaining 20% identified some aspects of the quality of management were lacking. This was mainly due to lack of succession planning and experience. In these instances alternative risk mitigants were identified which gave the bank comfort.

5.3.2.2 Financial position

The results presented will cover the financial structure, past financial performance, financial projections, purpose and type of finance and source of repayment.

When considering financial structure in terms of gearing and liquidity, commercial banks prefer not to be the major stakeholder in the business venture and require an own equity contribution by the shareholders. In figure 5.7 the results of the financial structure in terms of gearing are presented.

Figure 5.7 Financial structure in terms of gearing
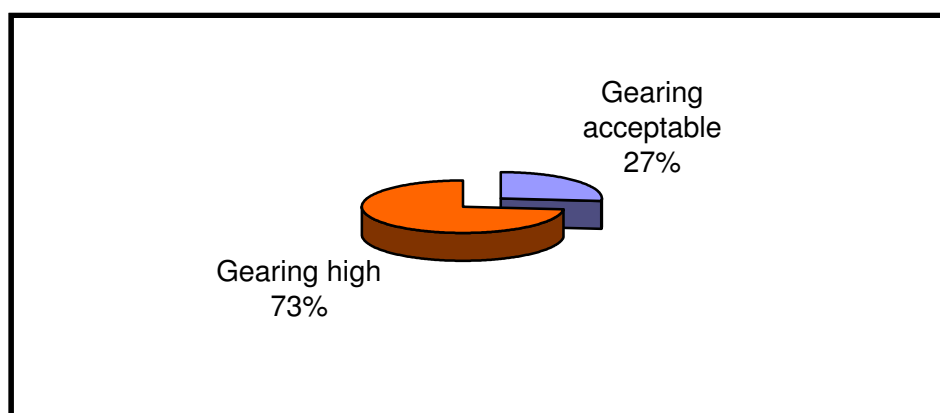
The results indicated that 73% of the sample was above the set norm of the gearing ratio of 50:50 debt to equity (2.8.2.1). This is contrary to the norm of 50: 50 debt to equity (2.8.2.1). This can be an indication that BEE owners lack the capital, needed to invest in the business and banks are prepared to take a risk. However, these transactions were still accommodated by the bank either in terms of alternative risk mitigants or the relaxation of the set norms as specified in the relevant bank's credit policy.

In figure 5.7 the results of the financial structure in terms of liquidity are presented.

Figure 5.8 Financial structure in terms of liquidity
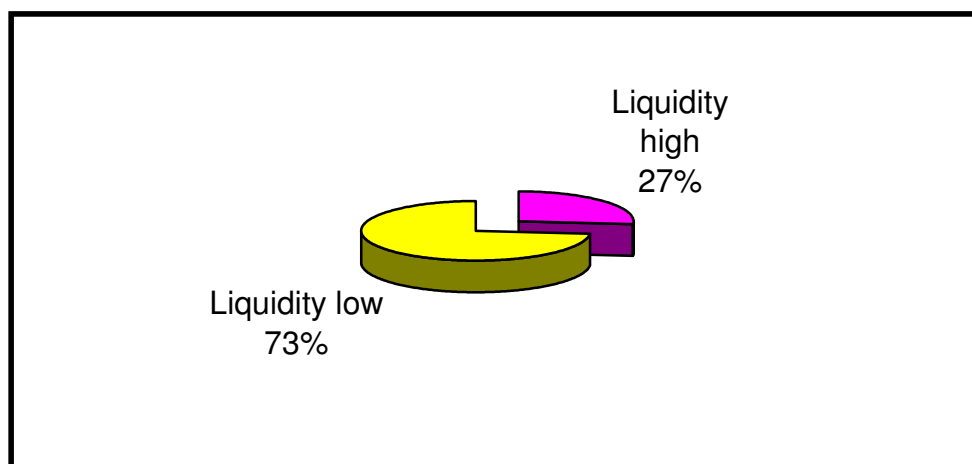
The results indicated that 73% of the sample was above the set norm of 2:1. This is contrary to the general for the current ratio of 2:1 (2.8.2.1). However, these transactions were still accommodated by the bank either in terms of alternative risk mitigants or the relaxation of the set norms as specified by the relevant credit policy.

The high gearing and low liquidity can also be due to that set norms were used across the various industries. Commercial banks normally adjust the set norms for the various industries.

Although the results of high gearing and low liquidity reflected a 73% deviation from the set norm, the two are not related and it is merely a coincidence that the same percentages were obtained.

The past financial performance of a borrowing entity is considered an important indicator of past financial success (2.8.2.1). In figure 5.9 the past financial performance is presented.

Figure 5.9 Past financial performance
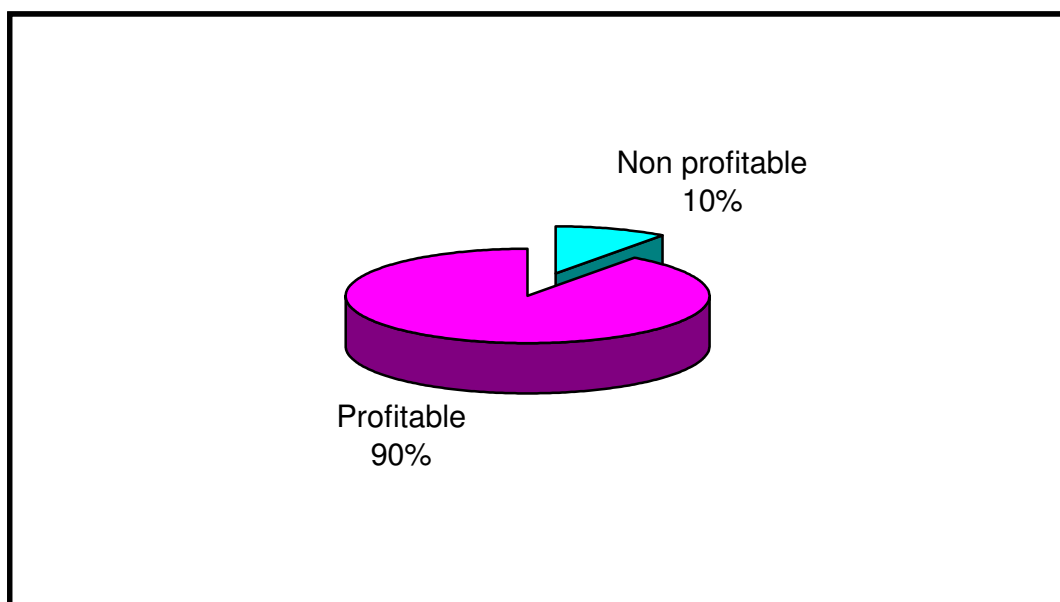
The results indicate that in 90% of the cases the company had a profitable past financial performance. This indicates that a profitable track record is a critical risk mitigating factor.

The remaining 10% of the cases examined either had no past financial performance as they were totally new entities or were not profitable. The financial projections of these entities indicated an improvement in the profitability. The projections were deemed acceptable and finance was approved.

The financial projections indicate the company's ability to generate sufficient cash flow to service the banking facilities (2.8.2.2).

In figure 5.10 the financial projections are presented.

Figure 5.10 Financial projections
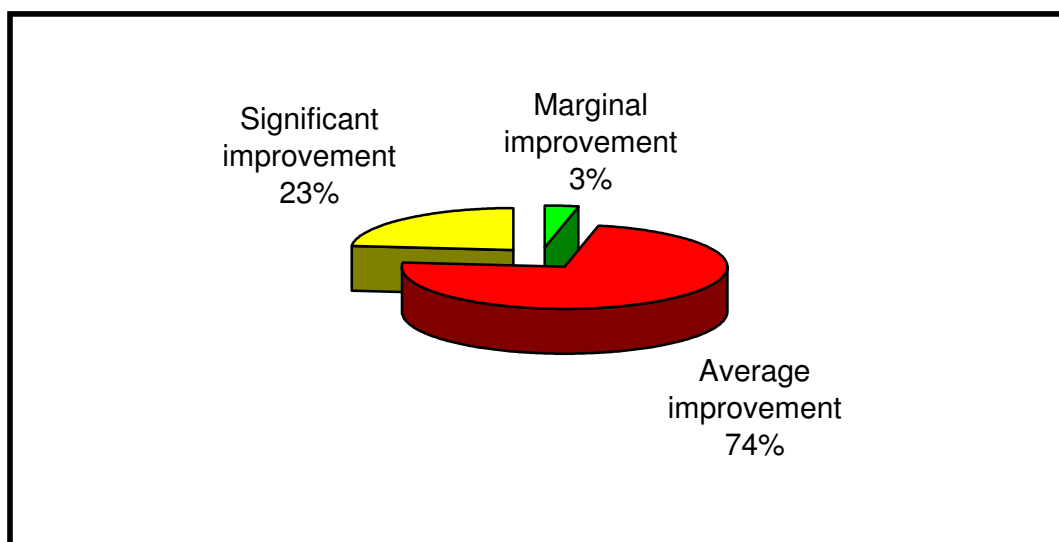
It is evident from the results that in 3% of the cases, a marginal improvement occurred, 74% of the cases reflected an average improvement and in 23% of the cases projected significant improvements. This is indicative that commercial banks only approve advances in instances where the projections are positive (2.8.2.2), but they also played a major role in the improvement of these companies.

5.3.2.2.1   Purpose and type of financing

Commercial banks must ensure that the type of finance is aligned to the purpose of finance (2.8.2.2). A summary of the results obtained in this section is given in Appendix E.

In Figure 5.11 the purpose and type of financing are depicted.

Figure 5.11 Purpose and type of financing
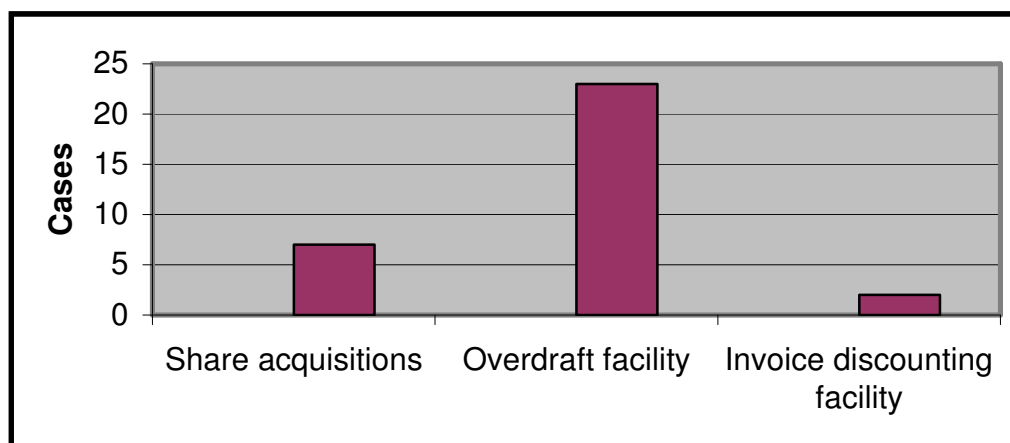
In 7 cases share acquisitions were funded on a term-loan facility with a general notarial bond being registered over the assets of the business in the majority of the instances. Working capital was provided in 25 cases with 23 being financed on overdraft facility and 2 with invoice discounting facilities. In 80% of the cases, both short term (overdraft) and medium/long term (share and/or asset acquisition) were financed. This is the normal functuality of commercial banks (5.2.2).

5.3.3 Security

In all the cases investigated (as per Appendix F), it was found that the bank took some form of security (2.8.3). In 29 of the cases the suretyship of the owner/directors were taken (Appendix E). In one instance, no suretyships were taken. Given the quality of the debtors, a cession of debtors was taken and a suitable covenant was put in place. The facilities were small in relation to the total value of the debtors held. First continuing covering mortgage bonds were taken in 14 cases of which 8 were used as security for mortgage/commercial loans and the remaining 6 were used as security for overdraft and term loans.

5.3.4 Covenants and conditions

Normal banking conditions pertaining to the pre-disbursement of funds, such as all security must be legally in order before any funds can be advanced, were excluded from the investigation. It was found that in 47% (Appendix E) of the cases no conditions or covenants were determined and it could imply that it was not deemed necessary to have an early warning mechanism in place. Negative and positive covenants were set in 30% of the cases. These covenants dealt mainly with the protection of the equity base of the borrowing entity and the frequency at which financial information, such as management accounts were to be supplied to the bank.

5.3.5 Additional methods of credit risk mitigation identified

The main purpose of the research report is to identify credit risk mitigation factors that can be applied by commercial banks when advances are made to BEE companies. The credit risk mitigation results are presented below in no specific order. These are fairly specific and should not be generalised across the 30 cases. The following instances of credit risk mitigation factors were identified:

- Key management contracts can be entered into to secure the involvement of the outgoing shareholders. These contracts can have tenures of between 18 months to 3 years.

- Key-man insurance can be taken on the lives of certain key management members to cover some of the debt incurred.

- The exiting shareholders agreed to delayed payment. The exiting shareholder can be required by the bank to cede certain portion of the proceeds received back to the company. These funds are released to the seller over a period of time.

- By applying the correct banking product such as invoice discounting to finance debtors. This type of product improves the bank's control and reduces the risk.

- Partnership between the BEE company and the bank, where the bank takes an equity stake in the business.

- Involvement of a shareholder where a publicly traded company provide a letter of comfort or suretyship.

- An overseas company providing a letter of undertaking from a foreign bank.

- An agreement between the bank and a supplier. The bank funded a commercial property for a BEE company with very high gearing. The supplier undertook to pay any shortfall on the bond repayments in the first 3 years.

- Where movable assets are financed, a buy-back agreement can be obtained from the manufacturer to buy back the assets under certain terms and conditions.

- By providing finance to franchisees of accredited franchisors.

- Off-take agreement between BEE company and debtor. The purchaser (debtor) undertakes to purchase the products (the same must conform to a certain criteria) of the BEE company.

- Confirmation of state tenders and contracts with big businesses.

The above credit mitigants were used by the bank where deviations occurred to mitigate the bank's risk where deviations occurred from the credit policy.

5.4   CONCLUSION

In this chapter the results obtained from the empirical investigations were presented. The research was conducted to determine how commercial banks' credit policies catered for BEE applications, the credit assessment models used and the limitations/constraints BEE companies experience in obtaining funding. The main purpose of the research was to identify credit risk mitigation factors that can be applied by commercial banks when advances are made to BEE companies.

In the next chapter the information obtained from the literature review and the empirical studies will be discussed. The chapter will be ended with a general conclusion and recommendations.

CHAPTER 6

DISCUSSION, CONCLUSIONS AND RECOMMENDATIONS

6.1   INTRODUCTION

Chapter one presented the broad objectives of the study and the chapter was concluded with a brief discussion on the chapter layout. Chapter two presented the theoretical foundation of the study and literature review. The role of Banks and various risks banks faced were discussed. An overview of credit assessment was given and the components of the qualitative assessment model were discussed in detail. The research problem was presented in chapter three, as well as sub-problems and propositions. Propositions were set to govern the thinking process during the research. Chapter four focussed on the research design and analysis. A qualitative research methodology was followed and the limitations were highlighted. In chapter five the research results are presented and interpreted.

The aim of this chapter is to provide a logical closure for the research report. In the first part of the chapter the results are discussed, with cross-reference to the literature review. The discussion also addresses to what extent the problem statement, propositions and research objectives have been met. In the second part of the chapter the research study is concluded with recommendations.

6.2   DISCUSSION OF RESULTS

The research objectives are aligned with the propositions and are closely linked to the dilemma facing South African commercial banks. The research propositions are repeated for ease of reference.

Proposition 1: Commercial banks have clear credit policies to evaluate BEE applications.

<u>Proposition 2</u>: Commercial banks consistently apply the same credit assessment model (e.g. the 5 C's) in the assessment of BEE lending (i.e. lending is lending).

<u>Proposition 3</u>: Credit risk mitigants can be identified to mitigate commercial banks risk when advances are considered for BEE classified companies.

Semi structured interviews (4.3) were used to investigate propositions 1, 2 and 3. Case studies were used to investigate proposition 3. In section 6.2.1 the results from the semi structured interviews (proposition 1) are discussed. An abstract of the interviews conducted are given in Appendix D.

6.2.1 Credit assessment models used by Commercial Banks

The participating commercial banks used both quantitative and qualitative credit assessment models in the assessment of credit applications. BEE applications in the medium to large market are more inclined to be assessed in terms of a qualitative credit assessment model (5.2.1). The qualitative model incorporates the five C's (Sinkey, 2002) and is mainly based (2.8) on background, financial position, security, conditions and covenants (Koch & MacDonald, 2003; Nathenson, 2004).

Although the commercial banks had credit policies in place, none of them addressed how lending should be done to BEE companies. Guiding principles have been given and new ones are being developed (5.2.1). The commercial bank's credit philosophies in lending to BEE companies are currently evolving and a new credit culture is being established (Koch & MacDonald, 2003). The participating commercial banks have demonstrated the willingness to explore various avenues to assist in the lending to BEE companies. Not only are they co-signatures of the FSC (1.1; 1.6), but they are in constant discussions with government and big businesses to address some the limitations/constrains in lending to BEE companies (5.2.1).

In section 6.2.2 the results from the semi structured interviews (propositions 2 and 3) are discussed.

6.2.2   Qualitative assessment model

The qualitative assessment model (2.8) is used by commercial banks in the assessment of BEE Company's credit applications in the medium to large market (5.2.2). Although the same qualitative assessment model is used for all applications, commercial banks have deal-making forums assisting in the structuring of BEE credit applications (5.2.2).

According to studies done in the SMME market (Scoombie, 2000) black people traditionally have no equity to support the lending, have no security to offer, have poor credit records, limited training and skills (2.2.4). Although these four factors played a role in the SMME market, the question emerged how prevalent they were in the medium to large market. The participating commercial banks interviewed also considered the four factors as constraints (5.2.3). It was, however, evident from the case studies investigated that the four constraints are still prevalent.

It has now been ascertained from sections 6.2.1 and 6.2.2 that commercial banks used generic a credit policy and basically the same qualitative credit assessment model. Given the four constraints, case studies were investigated to determine how the bank's credit risk was mitigated where there was a deviation from the bank's credit policy (proposition 3).

In sections 6.2.2.1 to 6.2.2.8 the results obtained from the case studies are discussed. It is apparent that advances were approved to BEE companies irrespective of the percentage of shareholding or the amount involved (5.3.1). This is an indication that commercial banks do not consider these as limitations.

The format of qualitative assessment model will be used to discuss the remainder of the results obtained from the case studies.

6.2.2.1 Credit history

The cases used in the sample consisted of approved facilities. The owners had clear credit records and no facilities were approved to a borrowing entity that had a poor credit record (5.3.2.1). This could indicate that a good credit history is still an important consideration when a credit application is assessed (2.8.1) and that the bank consistently applies the credit policy (3.4). This finding is in line with one of the findings of Pretorius & Shaw (2004) that South African Commercial Bank's finance is mainly based on the applicant's creditworthiness (2.2.4). According to Murphey (2004b) the willingness of borrower to pay is the most difficult to determine (2.8.1). The research study did unfortunately not reveal how a poor credit record can be mitigated.

6.2.2.2 Industry type

Facilities were approved in the wholesale/retail trade (33%), manufacturing (17%), and financial intermediation (17%) industries. These industries represent 67% of the sample and can be indicative of the industries in which the banks are currently comfortable to lend in (5.3.2.1).

The aim of the research was not to ascertain which industry type is more conducive to lending to BEE companies or which industries the commercial banks prefer to lend in. The manufacturing industry alone consists of 60 sub-sections. This would require detailed focus and could be an interesting topic for future research studies.

6.2.2.3 Quality of management

In 80% of the cases investigated, that the quality of management was deemed acceptable (5.3.2.1). This can be due to the fact that management has built up skills and experience when the business was still small or that the person had the necessary experience and skills when the shareholding was acquired. The quality of management is not considered a constraint in the medium to large market (5.3.2.1). It was also found in 83% of the cases that management and owners were the same individuals. The quality of management might be more prevalent in the SMME market, especially when new business ventures are financed.

From the cases investigated, it was evident that if the quality of management is lacking, obtaining key management contracts with the outgoing shareholder/s can mitigate the risk to a large extent. If there is no succession planning in place, key-man insurance can be taken on the existing management to soften the bank's risk. The bank can also take an equity stake in the business and appoint a mentor (5.3.5).

6.2.2.4 Financial structure

According Scoombie (2000) black people traditionally have no equity to support the lending (2.2.2). Using a ratio of 50:50 debt to equity (2.8.2.1), depending on the industry, is deemed prudent when a business future cash flow is discounted (Harris, 2003). In 73% of the cases the gearing was above the norm and it can be an indication that BEE owners are lacking own contributions to invest in the business (5.3.2.2). The high gearing and low liquidity can also be due to the set norms used, as the same has not been adjusted for the various types of industries. It is evident that the set norms for gearing and liquidity are in some instances relaxed to accommodate the transaction (5.3.2.2). This finding is in line with the results obtained from the interviews (5.2.2).

From the cases investigated, it was evident that if the gearing is above the norm, delaying payments to the exiting shareholder can mitigate the credit risk. A small shareholding is obtained by the BEE ownership in the first year and as the business performs, the shareholding and finance is increased. This is an effective way to lower the gearing. Using an appropriate finance product, such as invoice discounting, can also mitigate credit risk. When moveable assets are financed, a buy-back agreement (or repurchase undertaking) can be obtained from the manufacturer. In the case of vehicles (motor cars, busses and trucks), the same is sold with a full maintenance plan and in terms of the buy back agreement; the manufacturer undertakes to repurchase the item finance. For instance, in the first year, the item will be bought back at 90% of purchase price, in the second year at 80%, third year at 70% and so forth (5.3.5).

In the instance where a commercial property is financed, the manufacturer can provide the bank with an undertaking to pay any shortfall on the bond repayments in the first three years or until such time an acceptable loan to valuation has been reached (5.3.5).

6.2.2.5 Past financial performance and financial projections

The past financial performance and financial projections fulfils an important function in the assessment of a credit application as it demonstrates the ability of the company to service the debt (Murphey, 2004b; Nathenson, 2004; Koch & Macdonald, 2003).

In 74% of the cases, the company's financial projections reflected an average improvement. These companies are, however, well positioned to take advantage of future business in terms of procurement (5.3.2.2). In 23% of the cases there were significant improvements in the financial projections and in one case, the contracts obtained increased from 6 to 32 contracts in view of the BEE ownership structure.

The past financial performance and financial projections were not regarded as a limitation. However, if financial projections are not satisfactory, the same can be strengthened by the confirmation of state tenders and/or contracts with big businesses. The bank can also obtain a cession of an off-take agreement between the BEE company and debtor.

6.2.2.6 Purpose and type of funding

In 80% of the cases investigated both short-term (overdraft) and medium/long term (share and/or asset acquisition) were financed. This can be an indication that banks prefer to offer a total solution to their customer (5.3.2.2.1). Asset funding is normally self-securing through the value of the underlying asset. Invoice discounting is a risk-mitigating product, which can be used to finance <u>any</u> company that does not fully comply with the qualitative assessment model. It was also evident that the type of financing was aligned with the purpose of financed required (Rose, 2000).

6.2.2.7 Security

Security is taken to mitigate the bank's risk in event of default and is considered a secondary source of repayment (Koch & MacDonald, 2003).

Security was taken by the bank in every instance (5.3.3). The majority of the security taken can be termed "intangible security" (2.8.3.2). It can possibly be an indication of the lack of tangible security on the part of the BEE owners, which is in line with findings of Scoombie (2000). This finding is further in line with one of the findings of Pretorius & Shaw (2004) that South African Commercial Bank's finance is mainly based on the security offered (2.2.4). Cognisance must also be taken that, especially in the larger market, the quality of management and financial performance of the borrowing entity is more acceptable and that less emphasis can be placed on tangible security (2.8.3).

From the cases investigated, it was evident that if security is not deemed acceptable, the exiting shareholder can be required by the bank to cede a certain portion of the proceeds as security towards the company's facilities. For example, 30% of the proceeds can be ceded as security and after each year, 10% is released depending on the financial performance of the company. The risk can also be mitigated through the involvement of a shareholder (5.3.5).

In some instances, the shareholder might be an overseas company and can also be a letter of undertaking from a foreign bank. The ultimate shareholder (shareholding is held through a subsidiary) can also be required to provide a suretyship (pro rata to their shareholding) or a letter of comfort for the facilities of the BEE company. An indemnity scheme can also be approached to provide collateral (5.3.5).

6.2.2.8 Covenants and conditions

The primary role of covenants is to serve as an early warning system to protect the bank's interest (2.8.4).

It was found that in 47% of the cases no conditions or covenants were set and it can be an indication that it was deemed not necessary to have an early warning mechanism in place (5.3.4) and that the overall risk profile of the borrowing entity was deemed acceptable. Various covenants are however, available to the banks to protect the bank's interest (2.8.4) and it was found that in 30% of the cases investigated, that positive and negative covenants were stipulated. It can be an indication, that although the overall risk profile of the borrowing entity is deemed acceptable, the same will be further enhanced due to the adherence to the set covenants.

In Table 6.1 a summary of the four main limitations are given together with the credit risk mitigants that can be applied:

Table 6.1 Limitations and credit risk mitigants

Limitation	Credit Risk Mitigants
Poor credit history	• None
Quality of management	• Key management contracts • Key-man insurance • Franchising • Mentorship
Lack of own contribution	• Exiting shareholder receives delayed payment • Correct banking product • Bank takes an equity stake • Listed shareholder provides a suretyship or a letter of comfort • Overseas shareholder provides a letter of undertaking • Agreement between bank and supplier • Buy-back agreement • Franchising • Off-take agreement
Lack of security	• Exiting shareholder receives delayed payment • Correct banking product • Bank takes an equity stake • Listed shareholder provides a suretyship or a letter of comfort • Overseas shareholder provides a letter of undertaking • Franchising • Indemnity schemes

It is evident from Table 6.1 that there is various ways commercial banks can mitigate their credit risk when advances for BEE companies are considered.

6.3   CONCLUSION AND RECOMMENDATIONS

The primary objective of the determinants of credit risk mitigation in lending to BEE companies was met successfully. The results of the credit risk mitigants have been given in sections 6.2.1 to 6.2.2.8 with possible solutions and alternatives. The secondary objectives of determining the credit policies and qualitative assessment

models used by commercial banks were partially met, mainly due to two of the big four commercial banks not participating in the research.

There will always be a paradox between banks and borrowers, irrespective of the borrowers, as banks tend to be risk adverse. Given the past inequalities in South Africa, black people might not always meet the set criteria of the Commercial Banks, when funding is required. The limitations/constraints, identified in previous research in the SMME market, might not be as prevalent in the medium to large market. In the medium to large markets black people buy into an existing business. These businesses have a proven track record, a history of profits and are established in the industry. This makes lending easier. In the SMME market the commercial banks have to deal with new ventures with very little or no history.

It is also evident that the various role players such as the commercial banks, Government, big businesses and even the exiting shareholders are seeking innovative solutions to assist in the lending to BEE companies. Commercial banks are slowly changing their lending paradigms and new guidelines are being set. The ability to service/repay the facilities is considered one of the most important elements in the assessment of a credit application.

From a banker's perspective, any market segment or industry has its own inherent risks. Various risk-mitigating factors are available to mitigate a bank's risk in the funding of BEE companies. Lending to BEE companies must not be seen as a business risk but rather as a business opportunity.

The following aspects are recommended for consideration and possible action:

• Commercial banks should collaborate with franchisors to develop a financial package in terms of own contribution, security, training and ongoing mentorship.

• Commercial banks should identify accredited mentors to assist with the management of companies where the quality of management is lacking.

- The identified credit risk mitigants can be included in the guidelines for funding of BEE companies and can be used at deal-making forums.

- Companies that wish to facilitate black ownership can also use the identified credit risk mitigants. Some of these aspects can be addressed upfront and be included in the business plan.

The following is recommended for further research:

- A similar study can be conducted in the agriculture, hunting, forestry and fishing industry.

- The reasons why applications are declined, in the medium to large market, could also be investigated.

- Further studies can also be done to identify the industry type most conducive for lending to BEE companies or which other external factors such as economical, legal and social could also be explored.

- The research only consisted of a judgemental sample and further research could be done to verify the results.

It is postulated that by adopting and applying the identified credit risk mitigants, commercial banks can increase their success rate in lending to BEE companies and also increase their exposure to BEE companies. It will further assist in the transformation of black people and compliance with the FSC.

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APPENDIX A: Semi Structured Interview Questionnaire

MBL Research

A banker's perspective on the determinants of credit risk mitigation in lending to black economic empowerment (BEE) companies

Questionnaire to be used in the semi structured interview.

A. Credit Policy

1. How does your organisation's existing credit policy cater for lending to BEE companies?

2. What guidelines are set for the funding of BEE companies?

3. Please explain any other methods employed by your organisation to assist in lending to BEE companies.

B. Credit Assessment Models

4. Please give an overview of the qualitative credit assessment model used by your organisation.

5. What qualitative credit assessment models are used the assess credit applications of BEE companies?

6. What process is followed within your organisation when a BEE company credit application is received?

C. Credit Risk Mitigation

7. What do you consider as the main limitations/constraints for BEE companies in obtaining funding?

8. How can credit risk be mitigated in lending to BEE companies?

Thank you for your time and assistance. Kindly note that bank specific information provided would be treated with the utmost confidentiality. Information obtained would be published for the banking group participating members as a whole.

PG Meyer

September 2005

APPENDIX B: Evaluation Template

Evaluation template to be used for data collection

Brief comments to be given on headings listed below.

Case number: 1 to 30.

A. Background

1. Credit Record
    None……………………………………………………………………………………….
    Good……………………………………………………………………………………….
    Poor……………………………………………………………………………………….

2. Industry type SIC
    Code:………………………………………………………………………………………
    ……………………………………………………………………………………………

3. Quality of Management
    Depth………………………………………………………………………………………
    Experience/skills…………………………………………………………………………
    ……………………………………………………………………………………………..

B. Financial position

4. Financial structure (Balance sheet)
    Gearing……………………………………………………………………………………..
    Liquidity……………………………………………………………………………………..

5. Past financial performance (Income statement)
    Profitability…………………………………………………………………………………

6. Financial projections
    Marginal improvement/average/significant
    Influence of BEE…………………………………………………………………………..
    ……………………………………………………………………………………………

7. Purpose of finance
    Share acquisition
    Working capital
    Asset acquisition
    Crises borrowing
    ……………………………………………………………………………………………

8. Type of financing

……………………………………………………………………………………………………
……………………………………………………………………………………………………

9. Source of repayment

……………………………………………………………………………………………………
……………………………………………………………………………………………………

C. Security

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D. Covenants and conditions

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E. Summary of how credit risk was mitigated.

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APPENDIX C: Explanation of the evaluation template

The research template is based on the qualitative credit assessment model and the concepts used are explained below.

Total exposure: The total exposure is the sum of all facilities availed of by the BEE company. If suretyships were obtained, the facilities of the individual sureties were also included.

Credit history of owners and borrowing entity: These were determined by using the information obtained from the various credit bureaus at the time of the application.
None = no existing record exist with no prior enquiries.
Poor = prior adverse reports.
Good = prior enquiries with no adverse reports.

Industry type: The cases were classified by the industry in which the BEE company operates. The Standard Industrial Classifications or SIC codes were used.

Quality of Management: In privately owned companies the owners and management is normally the same people. This was evident in 83% of he sample cases.
Dept = if succession planning was in place, it was deemed acceptable.
Experience and skills = Suitable qualifications and/or more than 3 years related experience was deemed acceptable.

Financial structure
Gearing (Total liabilities divided by equity) = Lower than 100%, reflected by L and higher than 100%, reflected by H.
Liquidity (Current assets divided by current liabilities) = Higher than 200%, reflected by H and lower than 200%, reflected by L.
No adjustments have been made for the different types of industries.

Past financial performance: If a profit was made it was deemed acceptable.

Financial projections and source of repayment: were based on cash flow forecasts.

Marginal = up to 8% increase in revenue.

Average improvement = between 9% and 15% increase in revenue.

Significant improvement = more than 15% increase in revenue.

Security, covenants and conditions: A full exposition of these items has been given in chapter two and a further explanation is not deemed necessary.

APPENDIX D: Abstracts from interviews

The results from the semi-structured interviews were obtained under the presumption of confidentiality. The participating banks will be referred to as Bank 1 and Bank 2. The tape-recorded interviews are in possession of the researcher and the abstracts were made for ease of reference.

A. Credit Policy

1. How does your organisation's existing credit policy cater for lending to BEE companies?

Bank 1:"…existing policy is very generic…does not specifically talk to BEE or any thing else…policy is colour blind…policy not prescriptive how you overcome credit extension inhibitors…have a specific unit that has given guidelines…mitigate risk in terms of pricing…risk mitigants such as indemnity schemes…equity injections…mentorship…"

Bank 2:" …credit policy is not that specific to lending to BEE companies….one generic credit policy… and it might be a shortcoming…still in an evolutionary phase in lending to BEE companies…."

2. What guidelines are set for the funding of BEE companies?

Bank 1:"…have a specific unit that has given guidelines…mitigate risk in terms of pricing…risk mitigants such as indemnity schemes…equity injections…mentorship…"

Bank 2:"…have broad guidelines…lending not as stringent…mindful of the historical context of BEE companies. Like a partnership approach…track record…skills base…industries were there are growth prospects… and state contracts…"

3. Please explain any other methods employed by your organisation to assist in lending to BEE companies.

Bank 1:"…product point of view …structured specific products…try to mitigate risk…pricing models…risk/reward relationship…talking to certain indemnity scheme providers…corporates who are providing contracts…providing mentorship or hand

holding…certain government contracts preclude taking cession of them…lobby with governments departments to have term and conditions amended…"

Bank 2:"…understanding and awareness what BEE lending is…strategic imperative, but we are still a bank…any of the banks can claim that they fully understand BEE lending and…10 years after democracy we are still learning…. You must set a culture, climate and understanding and ...risk appetite for BEE lending…"

B. Credit Assessment Models

4. Please give an overview of the qualitative credit assessment model used by your organisation.

Bank 1:"…use qualitative model…called judgemental model…no credit scoring at this point in time…quality of information…credit bureau only keep adverse information and not positive profiles…"

Bank 2:"...strong analysis on the jockey…who we are lending to…how long have we be lending to those people and what is our experience of lending to them…Analysis of the BEE component coming in…how do they enhance the proposal…not fond of passive partners...like active participation of the BEE partner…insist on …suretyships to give some form of moral support...fronting is not allowed…type of business…quality of management…if they thin on equity contribution, what other contribution do they bring in...intellectual capital...financial analysis…security…deals must make business sense…must be within risk guidelines…different forms of security…management contracts..."

5. What qualitative credit assessment models are used the assess credit applications of BEE companies?

Bank 1:"…model into 2 large components…business risk assessment and other being financial risk assessment… business risk assessment looking at management…existing and incoming what value…industry and sector specific information…Porters five forces…PESTEL factors…take a view of the industry…. financial risk assessment…financials…historical as well as projections and cash flow analysis…collateral within and outside of the business…move away from credit policy…defined bench marks…gearing ratio needs to be the following…for BEE type of deals…move away from it…take a holistic picture…"

Bank 2:"…qualitative credit assessment models are pretty generic to all the banks…differ between the banks in two areas. First area, some banks are further down the line…setting specific BEE lending policy guide lines…secondly,…some banks have learnt to deal…on trail and error a lot earlier than other banks".

6. What process is followed within your organisation when a BEE company credit application is received?

Bank 1: "…committee level…even before a deal is put in the credit space…high level committee of the bank…are we happy with the parties we dealing with…the structure…the pricing…inherent risk…not credit committee…all relevant stake holders…how can we facilitate in doing the deal…".

Bank 2: "…not dedicated teams to do it….mind set is that it will become business as usual…disadvantage…not every body at the same skills level to deal with these applications…benefit…will eventually entrench…the mindset to deal with BEE companies at a broader level within the organisation…discussion…at a deal forum of a particular request…is this bankable or not bankable…BEE deals are not declined at source, must be escalated to a higher level…see if there is potential in the deal…".

C. Credit Risk Mitigation

7. What do you consider as the main limitations/constraints for BEE companies in obtaining funding?

Bank 1: "…very little equity/own contribution…lack of acceptable security…lack of management and technical skills…at appropriate level required….no credit record or adverse credit history…fronting plays a big role…no direct involvement…BEE partner to bring value, new networks/contacts…certain contract one cannot take cession of…implications of the National Credit Bill…Basel II…legislative frame work…have a holistic frame work…"

Bank 2: "…no track record…no banking history/relationship…in most cases…new territory for the bank...taking on entrepreneurial risk…no firm guide lines…do not have strong recourse to the shareholders…cash flow discounting as oppose to security lending…qualitative aspects …overrides security aspects…staffing limitation…cultural issues…communication…limitation on jockeys…can the person make a success of the business…absence of equity…skills …training…"

8. How can credit risk be mitigated in lending to BEE companies?

Bank 1: "…four broad issues equity, collateral, management skills and adverse credit records…collateral…indemnity schemes…equity…bring in vendors,… National Empowerment Fund…people are prepared to wait… put options…increase shareholding…management issue…mentorship…hold hands…experienced white executives…on retirement wanting to put something back into the industry…taking 3 or 4 BEE companies under their wing…transferring their skills…credit bureau issue… most of the banks… have moved away from declining application on poor credit history …looks at the deal in context of the overall position…most banks want relationships…"

Bank 2: "…partnership with the bank taking up an equity stake…mentorship program…structuring in particular with acquisition… of shares…put options against the previous sellers…tying them in with management contracts…type of industry…with strong growth potential…assessment of qualitative factors…management not have the skills…type of product used to drive your funding...not everything on overdraft…asset based finance structures…share acquisition structures…franchising…skills transfer…set structures…easily controllable and easily monitor problems…".

APPENDIX E: Summary of the cases investigated

TOTAL EXPOSURE & BEE OWNERSHIP			
	Detail	**Number**	**%**
Total exposure	<R5 million	1	3%
	R5 million<R10 million	8	27%
	R10 million<R15 million	10	33%
	R15 million<R20 million	5	17%
	>R20 million	6	20%
BEE Ownership	0% to 25%	1	3%
	26% to 50%	7	23%
	51% to 75%	7	23%
	76% to 100%	15	50%

BACKGROUND			
	Detail	**Number**	**%**
Credit History	**Owners**		
	None	0	
	Good	30	100%
	Borrowing entity		
	None	6	20%
	Good	24	80%
Industry type	Agriculture	0	0%
	Mining	2	7%
	Manufactoring	5	17%
	Electricity	1	3%
	Construction	1	3%
	Wholesale & Retail trade	10	33%
	Transport	3	10%
	Financial Intermediation	5	17%
	Community Services	3	10%
Quality of Management	Lacking	6	20%
	Acceptable	24	80%

FINANCIAL POSITION

	Detail	Number	%
Financial Structure	Gearing high	22	73%
	Gearing acceptable	8	27%
	Liquidity low	22	73%
	Liquidity acceptable	8	27%
Past financial performance	Non profitable	27	90%
	Profitable	3	10%
Financial projections	Marginal improvement	1	3%
	Average improvement	22	73%
	Significant improvement	7	23%
Purpose of finance	Share acquisition	7	23%
	Working capital	25	83%
	Asset acquisition fixed	7	23%
	Asset acquisition movable	14	47%
	Crises borrowing		
Type of financing	Overdraft	23	77%
	Invoice Discounting	2	7%
	Short & medium/long term	24	80%
	Mortgage/Comercial loan	8	27%
	Vehicle/Asset finance	14	47%
Source of repayment	Demonstrated	3	10%
	Not demonstrated	27	90%

SECURITY

	Detail	Number	%
Type of security	Suretyships	29	97%
	Cession of debtors	12	
	Cession of life policy	7	
	Cession of unlisted shares	3	
	Cession of bank investment	5	
	General noterial bond	9	
	Asset finance agreement	13	
	Continues covering mortgage bond	14	

COVENANTS & CONDITIONS

	Detail	Number	%
Covenants and conditions	None	14	47%

APPENDIX F: Detail of case study analysis

Case number	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25	26	27	28	29	30
Total exposure																														
<R5 million																				X										
R5 million<R10 million	X				X		X		X						X		X				X					X				
R10 million<R15 million			X								X	X		X					X			X			X	X			X	X
R15 million<R20 million		X		X		X							X										X							
>R20 million								X		X						X		X						X					X	
BEE Ownership																														
0% to 25%				X																										
26% to 50%	X				X		X		X			X		X															X	
51% to 75%		X	X					X			X								X	X		X								
76% to 100%						X				X			X		X	X	X	X			X		X	X	X	X	X		X	X
BACKGROUND																														
Credit History:																														
Owners																														
None																														
Poor		X																												
Good	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Borrowing entity																														
None		X	X				X			X					X	X														
Poor																														
Good	X			X	X	X		X	X		X	X	X	X			X	X	X	X	X	X	X	X	X	X	X	X	X	X
Industry Type:																														
1																														
2		X														X														
3							X				X	X						X			X									
4				X																										
5													X																	
6	X	X							X					X		X		X				X				X			X	X
7						X																	X			X				
8																X					X			X			X			X
9						X			X	X																				
Quality of Management:																														
Depth	A	A	A	N	A	N	A	N	N	A	A	N	A	A	A	A	A	A	A	A	A	A	A	A	A	A	A	A	A	A
Experience	A	A	A	A	A	A	N	A	A	N	A	A	N	A	A	A	A	A	N	A	A	A	A	A	A	A	A	A	A	A
Skills	A	A	A	A	A	A	A	A	N	N	A	A	N	A	A	A	A	A	A	A	A	A	A	A	A	A	A	A	A	A
FINANCIAL POSITION																														
Financial Structure:																														
Gearing	H	H	H	H	H	H	H	L	L	H	H	H	H	H	H	H	H	H	L	L	H	L	H	H	H	L	H	L	H	H
Liquidity	L	L	L	L	L	L	L	L	H	L	L	L	L	L	L	L	L	H	H	L	H	H	L	H	H	L	L	H	L	H

	C1	C2	C3	C4	C5	C6	C7	C8	C9	C10	C11	C12	C13	C14	C15	C16	C17	C18	C19	C20	C21	C22	C23	C24	C25	C26	C27	C28
Past financial performance:																												
Profitability	A	A	A	A	A	A	N	A	A	A	A	A	A	A	N	A	A	N	A	A	A	A	A	A	A	A	A	A
Financial projections:																												
Marginal improvement							X																					
Average improvement	X	X		X		X			X	X		X	X	X		X	X	X	X	X	X		X	X	X	X	X	X
Significant improvement			X		X			X			X	X				X								X				
Purpose of finance:																												
Share acquisition	X	X				X		X	X	X	X				X				X									
Working capital	X	X	X	X	X	X		X	X		X	X	X		X	X	X		X	X	X	X	X	X	X	X	X	X
Asset acquisition fixed				X					X			X		X		X			X								X	X
Asset acquisition movable	X	X	X			X		X				X	X			X					X	X	X		X	X		X
Crises borrowing																												
Type of financing:																												
Overdraft	X	X	X	X	X	X		X	X		X	X		X	X	X		X	X	X	X	X	X	X	X	X	X	
Invoice Discounting													X															X
Term Loan	X	X				X		X			X	X				X						X				X		
Mortgage/Comercial loan				X						X			X		X		X		X								X	X
Vehicle/Asset finance	X	X	X			X		X				X	X			X					X	X	X		X	X		X
Source of repayment:																												
Demonstrated	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Not demonstrated																												
SECURITY																												
Suretyships	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	N	X	X	X	X	X	X	X
Cession of debtors				X				X			X	X	X	X		X			X		X		X			X	X	X
Cession of life policy							X				X					X			X		X		X	X		X		
Cession of unlisted shares															X				X	X								
Cession of bank investment					X	X			X		X					X							X					X
General noterial bond	X	X	X			X						X	X			X			X		X					X		
Asset finance agreement		X	X			X		X				X	X			X					X	X	X		X	X		X
Continues covering mortgage bond	X	X			X		X	X		X			X		X		X			X			X		X		X	X
COVENANTS & CONDITIONS																												
None				X		X				X				X	X	X	X		X	X			X	X	X	X	X	
Negative covenants		X					X			X	X	X	X	X					X				X					X
Positive covenants	X		X		X		X	X		X	X	X	X	X					X				X	X	X			X
CREDIT RISK MITIGATION																												
Qualitative model		X	X		X	X		X			X	X		X				X			X	X		X	X	X		X
Other	X			X			X		X	X			X			X	X	X		X	X				X			