The use of points recording method to reduce credit risks of non-performed personal loans

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Abstract.

Non-performed loans is a serious risk faced by loan granting banks as it leads to freezing part of the banks' money for the inability of borrowers to pay back. That exposes the bank to loss, especially, when there are no sufficient financial warranties that may be used to repay the loan. The long time for administrative and legal disputes may also cause the bank to loose efforts, time, and alternative investment opportunities. Thus, the present study aims at clarifying the concept of credit and its risks, the significance of adopting modern methods like the one used in the present study, to reduce the risks of granting credit for non-performed loans, and to preserve the rights of the banks.

The present study is based on a major hypothesis which assumes that using points recording method reduces the risks of credit granting as well as the costs of non-performed debts. That enhances taking lending decisions according to modern scientific principles. The present study emphasizes the importance of points recording method before lending to protect the banks from loss of time and efforts which may result from administrative and legal disputes between the bank and the borrower. The present study recommends using modern methods to reduce the risks of credit granting and its coasts.

Section one.

The research methodology.

The problem of the study.

Non-performed loans is a serious problem faced by the banks as it results in freezing a considerable part of the Banks's money for the borrowers' inability to repay the premiums and profits of loans. The bank which grants such loans suffers great losses that exceed the income of the alternative opportunity of investment. These losses are due to the lack of debts, profits, and sufficient financial warranties that can be used to pay back the loans. Besides, non-performed loans reduce the average of money circles which, as a result, reduces the Operational capacity of its resources and profit rate. The banks' pre granting procedures are insufficient to avoid the problem of non-performed loans. Suggestions that support the ability of credit to depict the process of

lending according to good practical bases to avoid the risks of non-performed loans should be presented.

The significance of the study.

Clarifying the concept of credit, its risks, importance of using modern methods to reduce the risks of credit, and the importance of reviewing credit to reveal the ability and continuity of clients to pay back the loans to avoid non-performed debts and preserve the rights of banks.

The objectives of the study.

To reduce the coasts of banking services and achieve the highest rate of incomes, the banks should take care of banks' loans granting position since it increases the incomes when there are risks accompanying the decision of credit granting.

The present study aims at:

1 -Identifying the concept of loan and its risks.

2 -Comparing the current procedures of loans granting with the proposed method.

The hypothesis of the study.

The present study is based on the hypothesis that using points recording method reduces the risks of credit; non-performed debts, and enhances lending decisions according to modern scientific bases.

Data collection and analysis.

In the theoretical part of the study, relevant sources and references have been used. While, in the practical part, the research sample has been a group of loans granted by a group of the Iraqi banks; the agricultural bank, the real estate bank, Al-Rafidain bank, and Al-Rasheed bank for the period fixed in the documents of the financial supervision office, whose various reasons of non-performance.

Section two.

The theoretical part.

Loans.

First: The concept of loans.

The loan is an action between two parties; the grantor, who rents money to the second party; the borrower, who borrows the money for or without a profit. Credit facilities are granted after checking the financial position of the borrower, his\her ability and qualification to pay back the debts and profits of the loan during the fixed dates for the incomes of repaying the loan, (1)

Banks' loans are defined as the banking services through which clients; individuals and institutions are provided with the required money. The borrower pledges to repay the debts, profits, commissions, and expenses once or as premiums in the fixed dates.

The borrower pledges also to provide warranties that enable the bank to take back the money, without any loss, in case the borrower stops repaying, (2).

Second: Types of loans.

Loans are divided into three types:

1 -Consumptive loans; Are the loans which are granted to individuals for buying durable goods which are personally used.

2 -Speculative loans; Are the loans which fund the financial speculation activities in the money markets.

3 -Sectorial loans; Are the loans which are granted according to the sector; industrial, agricultural, trade, or real estate. These loans are long term loans.

4 -Unsecured loans; Are the loans which are granted without financial warranties depending on the client's financial reputation and his\her financial position.

5 -Secured loans; Are the loans which are granted for financial warranties for repaying the loan and profits.

6 -Short term loans; Are the loans which are granted for 3-6 months; less than a year. These loans are used for seasonal expansion.

7 -Medium term loans; Are the loans which are granted for 5 years. These loans are used for funding capital operations.

8 -Long term loans; Are the loans which are granted for 10 years. These loans are used for funding capital expenditure; to developed factories and purchase equipment.

Third: Risks of granting loans.

Researchers differed in identifying the risks of granting loans; (Groaning) stated that risks can be classified according to their sources into three groups:

1 -Credit risks; These risks are related to the borrower's inability to fulfill his\her commitments towards the bank.

2 -Market risks; These risks are related to the changes in the environment around the bank which result in many bad effects on the bank including:

A- Profit prices risks.

B- Exchange prices risks.

C- Prices securities risks.

3 -Operational risks; These risks are related to the internal environment of the bank. They include:

A- Financial abundance risks.

B- Operations risks.

C- Legal risks.

D- Commitment risks.

E- Strategic risks. (4).

4 -Criteria of granting loans.

Banks adopt a number of criteria for granting loans. The (cs5) is considered the most adopted criterion. According to this sample, the bank examines the available criteria in the clients. These criteria are:

1 -Personal criteria.

This criterion focuses on the client's personality which is the base for granting the loan. This criterion is the most influential in the risks that may face the bank. The borrower's personality is examined and analyzed precisely; Honesty, integrity, good reputation, and commitment. The borrower's personal data are collected from the environment around him\her to identify level of living, financial problems, social level, business record, and previous transactions with the Bank.

2 -Capacity criterion.

This criterion identifies the borrower's capacity to achieve the income and then, to repay the loan and profits through examining the borrower's financial position and banking transactions.

3 -Capital criterion.

This criterion identifies the extent of the borrower's relevance and the ownership capacity to repay the granted loan. It is an extra warranty in case the borrower fails to repay.(6)

4 -The collateral criterion.

This criterion involves a number of assets which the borrower offers to the bank as a warranty to get the loan. The client cannot utilize the assets. The bank can utilize the assets if the borrower fails to repay. The collateral may be a person whose a considerable financial position or a company with a considerable financial position.

5 -Conditions criterion; It involves:

A- Public conditions, including:

1 -Public commercial conditions.

2 -Legal frames.

B- Private conditions, including:

1 -Market share of products of the project and the provided services.

2 -The form of the competition.

3 -The cycle of the product or the proposed service.

4 -The location of the project.(7)

It is normal not to adopt all these criteria; The weakness of any criterion can be alternated by the strength of the others.

Fifth; Lending policy; Concept, significance, and components.

1 -The concept; It is a number of concepts and principles determined by the bank's administration and followed by the lower administrations when planning for lending. These concepts and principles are the guide for the decision makers when lending applications are submitted. Borrowers are obliged to stick to them when examining their applications.

2 -Significance; The bank, like any other organization, has a number of goals to be achieved. Lending policy determines directions and ways of using the bank's money which are gained from depositors and capitalists. Hence, lending policy is effective in making the decisions for achieving the bank's goals to serve the society. Lending policy aims at:

A- Achieving the safety of granted loans.

B- Developing the bank's activities and achieving the highest incomes.

C- Ensuring continuous monitoring of loan granting operations at all stages.

3 -Components; Components of loan granting policy can be summarized as follows:(9).

1 -Determining the amount of borrowed money.

2 -Determining the warranties that the borrower should offer.

3 -Determining the period of the loan.

Levels of taking decision.

1 -Determining the maximum extent of granting.

2 -Determining the coasts of the granted loan.

3 -Determining the documents of the loan.

4 -Following up loans.

5 -The frame or the structure of the loan.

Section three; Current procedures of granting loans and the use of the proposed method.

First; Current procedures of granting loans.

These procedures can be classified into:

1 -General terms; Granting loans is the most important and risky bank operation as it involves risks of banking credit. Therefore, the bank adopts many criteria when deciding to grant the loan and its amount, including:

A- The borrower's personality؛

It is an important element of granting loans as it helps knowing the borrower's regularity in repaying his\her debts through the banks and suppliers with whom the borrower deals. It also helps knowing the borrower's financial position in the trade market and work experience.

B- The ability to repay.

C- Soundness؛

It helps knowing the ability of the borrower to use his\her money safely and timely repayment, which can be identified by measuring the borrower's efficiency through studying his\her own policy, pricing his\her products, his\her ability of competing, predicting changes in demand for goods, variety of products, and ability to maintain the capital.

D- Capital or financial position؛

The borrower's financial position helps the bank take back the granted money. The borrower's financial lists are analyzed in light of the proportion of ownership rights to the fixed assets, the proportion of trading, the proportion of financial abundance, the return of investment, and the rate of rotation of fixed assets.

D- Warranties;

A range of collateral is taken, in kind or in person, to improve the conditions of the loan provided by the Bank and to protect the Bank against certain risks.

E- General conditions؛

The above general conditions may be available for granting the loan, but they may not be sufficient to grant the loan due to a range of economic fluctuations that affect the repayment ability of the borrower, which requires studying the competition and the ease of entry of new producers, which makes it more difficult to dispose of products or sell at low prices.

Second; Procedures of granting loans.

Some detailed procedures may differ in the loan granting policy. The loan granting procedures can be summarized as follows:-(10)

1 .Examining the loan application. The initial validity of the loan application shall be ascertained in accordance with the bank's lending policy in terms of:

A- The purpose of the loan.

B- Time of eligibility.

C- Repayment method, including:

2- The borrower's credit analysis, including collecting data from various sources to make sure of the borrower's credit ability; reputation, personality, and repayment ability through analyzing the borrower's financial position and economic conditions.

3 -Negotiation with the borrower, including:

A- Determining the amount of the loan.

B- The purpose of the loan.

C- How to grant the loan.

D- How to repay the loan.

E- Sources of repaying the loan.

F- Required warranties, profit price, and commissions.

4 -Taking the decision of granting the loan.

In this stage, lending is either accepted or refused by the bank through a comprehensive estimation of the loan, credit conditions, financial position, the amount of the loan, repayment method, and submitting it to credit granting authorities to grant the loan. The contract of granting the loan is signed with the required warranties, fulfilling commitments and obligations, and then granting the loan to the borrower.

5 -Following up the loan and the borrower.

It should be made sure that there are no changes in the payment dates, which are specified for taking some legal measures to preserve the bank's money.

6 -Taking back the loan.

The bank takes back the loan and all legal procedures in order to grant the loan, postponed, or refurbished, in light of the view of the current policies of granting the loan; the general conditions, involving the documents that the borrower should have submitted, and examining documents of loan granting applications. To be granted the loan, the borrower should submit the following documents:

1 -Introductory documents concerning the applicant for the loan.(1)

2 -Accounting documents; budgets, estimated budgets, profits and losses statements.

3 -The other documents; the basic law, trade record, debtors, and parties.

4 -Presenting a number of studies, including:

A- Studying the humanitarian factors; efficiency, integrity, and commitments.

B- The period of the loan.

C- The economic and financial environment.

D- Examining the market.

In light of what has been mentioned earlier, it is obvious that these procedures take long time, causing both the bank and the borrower to loose time and efforts.

Second; Using the proposed method; points recording method for granting credit.

Points recording method is a modern quantitative method used for analyzing personal credit (consumer credit), through guessing the borrower's behavior in light of a number of some features adoptable by loan granters. A statistical survey list is used for counting each applicant's points. The sample draws on 9 major elements, as follows:(11).

1 -Age; A point is given for each year until 20 years. The maximum number of points for this criterion is 30.

2 -Gender; 0 points for male, 40 points for female.

3 -Residence stability; The applicant is given 4.2 points for each year at the same residence. The maximum number of points for this criterion is 42.

4 -Degree of job risk; The applicant is given 55 points for good jobs whose activity never affects the borrower's repayment ability, 0 points for risky jobs, and 16 points for other jobs.

5 -Activity and industry type; Workers at public projects, governmental projects, financial market, and banks are given 21 additional points

6 -Work stability; The applicant is given 5.9 points for each stable year at work. The maximum number of points for this criterion is 59.

7 -The borrower's property; The client is given the following points for:

a- A current bank account, 45 points.

b- Real estates and lands, 35 points.

c- The borrower's life Insurance, 19 points.

The figure below shows this sample.

Client's name:							
	Total points				none	عند الاقارب	At house
					Zero	1	5
address:	Residence						
	Total points	Rented room	Rented apartment	Lives with others	Rented house	Own house(installment)	Own house
		zero	Zero	1	2	3	6
Client's total credit points	Accounts with banks						
	Total points				More than an account	One account	none
					6	4	zero

Estimating client's points. Credit value from zero to 2,000,000 Dinars			Years of residence at the current address						
			Total points			More than 7 years	3-7-years	from 2 years	Less than half a year
						4	3	1	zero
22and more	19-21	18-0year	Number of client's family members						
				Total points		More than 7	6-3	2	1
Approval	Sending back to the main center	Refusal				Zero	3	4	2
The deferred value from 2000,000-5000،000			1- Monthly income						
					More than 170	1401-1700	110-1400	901-1100	Less than 900
					8	6	2	1	Zero
More than 25	22-24	0-21	Duration of current work) year						
						8 year	3-7	half- 2	Less than
Approval	ارجع الى المركز الرئيسي	رفض				4	2	1	Zero
Credit value is more than 5000			2- Percentage of deferred sales(%)						
						85-99	70-84	50-69	Less than 50%
						zero	1	3	5
			3- Optional points for credit analysis due to personal interviews+) 5-) – 5)						

27and more	24-27	0-32									
			4- Client's total points (the borrower)								
approval	Sending back to the main center	refusal									

By the researcher.

Client's total points are collected in light of this sample and compared to a predetermined score to help taking the decision; approval or refusal, credit risk score, which estimates each client's non-repayment(11). The standard score is 124 points; When a client scores 125 or more points, that client is considered a good borrower. But, when a client scores less than 125, that client is not a good borrower and credit application is refused. There are many steps to be followed when preparing the points recording sample for credit analysis:

1- Collecting historical data about the borrower for analysis.
2- Identifying the good features in credit applications, which help to predict the financial position of the applicant by specifying points for each feature to differentiate among borrowers as follows;
3-

(Credit Scoring System)

Points	Factors	ت	Points	Factors	ت
	Bank's transactions			residence (renter/ tenant)	
10	Current account and saving account	A	40	has /buyer	A
40	Current account	B	8	Renting	B
40	Saving account	C	8	Without renting	C
30	Saving account and a loan or current account and a loan	D	25	Others	D
10	A loan only	E-		Duration of residence in the current address	
10	None	F			
10	No reply	G	12	Less than 6 months	A
	A recommendation from financial companies or establishments		15	6 months –2 years	B

15	One recommendation letter	A	22	2 –6.5years	C
10	Two or more	B	35	More than 6.5 years	D
5	None	C	12	None	E-
10	No reply	D		Duration of working in the current job	
	Total annual income		12	Less than 1.5 years	A
5	zero – 1500	A	15	from 1.5 – 3 years	B
15	1500 – 3000	B	25	3 years – 5.5 years	C
30	3000 – 5000	C	48	on salary	D
50	5000 – 10000	D	25	Without a work and gets approved /spends on children's' living: gets governmental aids	E-
70	More than 10000	E-	48	More than 5.5 years	F
	Monthly commitments		25	Works at domestic industries	F
35	zero – 100	A	12	Without a work or governmental care	G
25	100 – 300	B	12	No reply	H
10	More than 300	C		The borrower's age	
	None	D	4	Less than 45 year	A
	No reply	E-	20	45years or more	B
	A point for the client's rank		4	No reply	C
Zero	No investigations about the client	A			
20	No previous transaction	B			
Zero	Two or more weakness points	C			
15	One weakness point	D			
	Positive rank) no weakness points)	E-			

Section Four:

Using the proposed method to analyze loans credit.

In this section, a sample of the research will be shown. It consists of four authorized banks for granting loans for all beneficiaries including

1- The agricultural bank/ Wassit.
2- The real estate bank/ Baghdad.
3- Al- Rasheed bank/ Wassit.
4- Al- Rafidain bank/ Baghdad.

The non- performed loans, taken from the financial supervision office's documents have been shown in details as follows;

Loans type	Non-performance period	period	The amounts of non- performed loans	The bank's name	ت
Profitability	5months	3-1years	4,481,000,000	The agricultural bank	1
Real estate loans	6years	10years	46,000,000	The real estate bank	2
Projects	5years	5-1years	1,026,000,000	Al- Rasheed bank	3
Trade loans	16 years	Unknown period	368,000,000	Al- Rafidain bank	4
The total amount of non-performed loans is				The total amount of non- performed loans is	

(5٬921000,0000٬(Dinars) (Five Billions nine hundred twenty one million Dinars). These amounts are stated in the financial supervision office's documents for the years 2013- 2016. That results in losses for banks by losing the alternative loan, non-investment of the banks' money, and appealing to the administrative bank to get back the loans. By using the proposed method with some modifications through assessing some borrowers who did not pay back in the real estate bank, it has been noticed that the borrowers did not score the 125 points, which means that they should not have been granted the loans.

The reasons of non- performance can be summarized as follows:

1- Borrowing from more than a bank at the same time which results in the client's inability to repay.
2- Invalid bales.
3- Loans credits are not commensurate with their amounts.
4- Other factors around the borrower; age, amount of monthly income, other potentials, and social conditions around the borrower according to the proposed model are not taken into account.
5- Lack of cross-sectional information among banks about the borrowers.
6- The reluctance of some departments to prove borrowers' repayment of loans, the actual statement of financial position of borrowers, or their entry into several loans to different banks.

A questioner, with limited number of questions about the reasons of non-performance, showed that:

1- Personal aspects, the client's ability to pay at the time of borrowing and beyond, as well as the guarantor are not taken into account.
2- Other social aspects of the borrower; quality of housing, rent or ownership, examining financial abundance and the ability to provide cash to repay loans are not taking into account.

3- The inaccurate estimation of some assets that are reserved for repayment of the loan in case of any delay by the client.

Reasons	The amounts	No
Incomplete small projects	296,050,000	1
Client's inability to repay	888,150,000	2
Guarantor's inability to repay	2,072,350,000	3
Random estimation of assets	1,184,200,000	4
Studying the financial position weakly, and providing fictitious projects	1,480,250,000	5

Section five:

Conclusions and recommendations.

First; Conclusions.

1- Adopting traditional methods when granting loans: Personal collateral, instead of scientific methods, studying client's personal details and his/her repayment ability.

2- Coasting the bank financial, administrative, and legal coasts because of non-payment despite the collateral, but long time causes the bank to loose the investment of alternative opportunity.

3- Exposing the bank to credit, marketing, and operational risks; therefore, more modern methods should be adopted when granting loans.

4- Adopting personal criteria more than adopting other criteria: repayment ability, capital, and surrounding conditions.

Second; Recommendations.

1- To avoid losses, banks should adopt modern methods like points recording.

2- Banks should adopt more criteria when granting loans like pers.

3- Personality and financial abundance of the borrower.

4- Banks should provide researchers with data that help solving the problems which face the banks like the present one.

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