



## DEVELOPMENT OF THE LOAN PORTFOLIO IN 1993 – 2000

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*In the previous part, the development of the loan portfolio between 1993 – 2000 was analysed mainly from the point of view of its risk structure by industrial sector. The general degree of credit risk is the decisive factor as regards the continuous decrease of the aggregated credit exposure of the banking sector. Therefore, one of its tasks is not fulfilled – participation in the reproduction of sound financial flows within the company sector. In this volume, we will focus on an analysis of the performance of the debt burdened company sector and factors causing distortions in the reproduction of loans.*

Table 1

Indicator/Years	1993	1994	1995	1996	1997	1998	1999
Number of entities	18 248	24 702	28 985	34 833	39 521	38 203	41 637
Assets (Sk milion)	1 329 667	1 414 858	1 426 020	1 642 119	1 931 069	1 692 861	1 724 838
Total Loans I	238 524	249 414	276 734	322 053	322 640	330 843	339 101
Total Loans II	210 245	193 785	239 003	305 851	294 000	283 837	329 839
Loans II/loans I (in %)	88.14	77.70	86.37	94.97	91.12	85.79	97.27

The value of loans I = the total value of bank loans provided to the company sector except banks and insurance companies

The value of loans II = the total value of loans provided to the analysed sample of the company sector

Loans II/loans I = the proportion of loans provided to the analysed sample of total loans within the economy

The analysis is focused on the parameters of the financial stability of borrowers that are the main cause of distortions in lending flows. In the beginning the entity affected is the banking sector as creditor. But subsequently the company sector is also affected due to the lack of lending resources provided on acceptable terms, i.e. such terms that respect the real turnover of revenues and the capability to finance the reproduction of the operations cycle of companies.

The data in Table 1 show that this is a statistically significant sample not only from the point of view of the company sector as a whole but, above all, from the viewpoint of the debt burdened company sector. In 1999, 97.27% of all loans were allocated to the analysed sample of companies which had a total asset value of Sk 1.72 billion.<sup>1</sup> The performance of this sample explains the continuing decrease of the credit exposure of the banking sector in 2000. After the recovery of the loan portfolio (the development of credit exposure was analysed in the previous part) the banking sector has been prudent. The reason for this is the continuing high proportion of loans with a low rate of return.

As a consequence, this article contains an analysis of selected performance parameters with a decisive influence on the general rate of credit risk. It focuses on entities dependent on domestic lending resources. A knowledge of their real economic position and the specification of the reproduction of in-

dustry financial flows is one of the assumptions for a decrease of the general degree of credit risk. The basic principle of the analysis is to search for reciprocal relationships between the development of indicators achieved by borrowers in year “x” and the development of losses reported by the banking sector in year “x+1”. This approach allows, among other things, a consideration of whether the modification of the general degree of the credit risk provides a real picture of the development of the performance of the debt burdened company sector or whether it is more influenced by the intensity of refinancing the previously provided loans.

One of the decisive factors of the ability to repay debts is the level of sustainable growth. The basic principle of sustainable growth is given by the following equation:

$$A = K + P$$

(A = assets, K = own funds, P = external resources)

This equation enables an assessment of the sources for financing asset growth. Under conditions currently prevalent in Slovakia, under which the relationship between the profitability of borrowers and the interest rate applied for many lending operations does not allow a leverage effect (the price of external resources is higher than the return), the financing of the increase of mainly circulating assets through loans with a low return represents a risk. The risk results from the development of a reciprocal relationship between the operational and financial leverage (dependency):

<sup>1</sup> The author would like to thank the BZCS, a.s. (clearing centre) which provided the data for this analysis and processed the statistical data for the sample.

**Operational leverage** = fixed costs/revenues  
**Financial leverage** = debt (external resources)/  
 capital (own funds).

The credit risk increases if the value of both leverages increases simultaneously and/or if the decrease of the operational leverage is lower than the increase of the financial leverage. The diagrams illustrate one of the causes of the high risk inherent in short-term loans (STL) and long-term loans (LTL), mentioned in the previous section. An important part of the fixed costs of the corporate sector is comprised by the depreciation of movable and immovable assets and interest paid on bank loans.

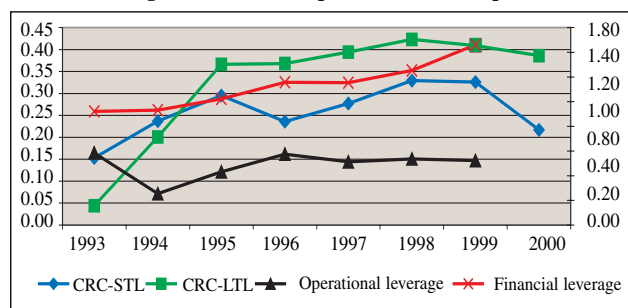
assets in revenues causes their resulting low profitability. Moreover, if these low turnover assets are financed by loans, a higher amount of interest relates to Sk 1 of revenues. These are a part of fixed costs. Subsequently, the proportion of interest from operational loans within the structure of fixed costs increases. The operational leverage also increases. Table 2 shows the development of the turnover of borrowers' assets. The result is a decrease of capital availability caused by a decrease of corporate assets profitability (Table 3).

An insufficient appreciation of investment assets in revenues with the subsequent increase of operational leverage, documented by the development of long-term loan risks is even mo-

Table 2 (in days)

Industry/Year	1993	1994	1995	1996	1997	1998	1999
Agriculture, hunting, fishing (1)	676.46	860.04	778.13	726.09	629.69	613.32	620.30
Mining (3)	881.44	789.03	733.71	809.92	778.33	872.48	942.05
Food industry (4)	369.91	341.53	343.15	301.69	263.39	276.44	282.42
Chemical and pharmaceutical industry (5)	437.82	405.74	369.70	356.99	353.86	406.24	376.30
Metallurgy and mech. engineering (6)	548.92	487.46	428.02	385.95	361.42	267.73	248.54
Electro-technical and electronic industry (7)	940.70	514.18	420.96	397.50	1644.52	242.15	246.53
Textile, clothing and leather industry (8)	429.91	408.65	417.33	397.73	380.41	303.55	287.22
Other industry (9)	523.86	461.12	498.73	430.95	371.24	415.92	366.16
Production and distribution of electricity, gas and water (10)	692.58	1040.12	734.04	760.91	734.57	749.80	777.79
Construction and building (11)	442.58	396.84	371.57	323.10	296.13	242.19	259.36
Trade, marketing, restaurant and accommodation (12)	238.57	186.83	193.95	197.73	214.85	212.16	211.33
Transport, warehousing, tourism and communications (13)	491.99	530.58	497.22	613.25	561.75	520.43	439.24
Other activities (14)	955.99	1075.26	954.82	632.13	745.67	630.96	773.82
Average	497.98	431.61	425.13	400.69	404.04	366.08	361.07

Diagram 1 Comparison of the development of operational and financial leverage with the development of the loan portfolio



The risk inherent in short-term loans in the period 1996-1999 has continuously increased (except for the expansion of credit risk exposure in 1996). The cause was, and still is, the low assets turnover in revenues. Its consequence is a high increase of the overall financial, and within this, the lending dependency. The carrier of profit is revenues and the carrier of revenues is circulating assets. An insufficient turnover of these

Table 3 (capital/assets in hallers/Sk 1)

Year	1993	1994	1995	1996	1997	1998	1999
Value	52.07	51.77	49.46	46.35	46.43	44.37	40.65

re significant. Even after two stages of claim assignment the decrease of the actual risk inherent in long-term claims is minimal. The reason is that the value of depreciation as a part of price calculation is not collected in the assumed actual revenues. The low fixed assets turnover in revenues has the consequence that booked depreciation is not a source of real cash flow. The year-on-year rate of operational leverage decrease is negligible. In contrast, financial leverage has increased significantly. In 1995, 1996 and 1998, both leverages even increased concurrently, while the financial dependency of borrowers increased continuously. That period was also the period with the highest year-on-year increase of uncollected interest. In the face of an insufficient ability to ensure the financial coverage of fixed costs by the accumulation of own funds, the provision of a loan for interest repayment was not exceptional.

The low efficiency of fixed and also total assets stimulates the effort to replace the rate of profit by the volume of profit. If the carrier of the profit and the appreciation of fixed assets are, through revenues, circulating assets, from the point of view of loan risk the decisive factor is the nature of the source of financing for the circulating assets. This is expressed by the parameter of sustainable growth, which is not widely used in Slovakia. This has a very close connection to the mentioned

balance sheet equation and to the development of operational but, above all, financial leverage. Its basic form is:

$$\text{Sustainable growth} = \frac{NP/A \cdot (1 - Di)}{K/A - [(NP/A) \cdot (1 - Di)]}$$

(NP – net profit, A – assets, K = capital, Di – dividends)

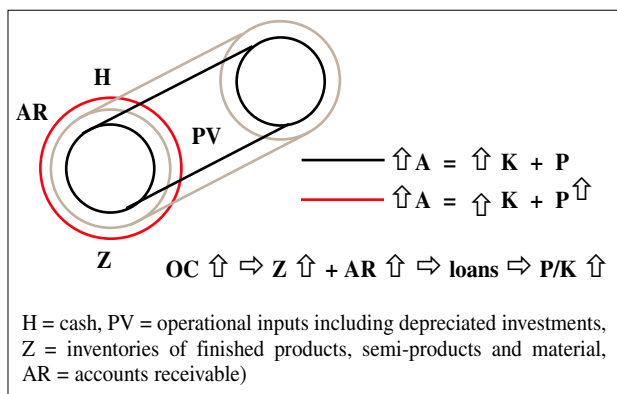
The principle of sustainable growth can be explained by the following example:

A business entity assumes the following increase of revenues for the basic balance sheet structure:

Balance sheet structure	Revenues
Assets = 3 000 000 Sk	1. year = 5 000 000 Sk
Capital = 1 500 000 Sk	2. year = 5 700 000 Sk
Net profit = 200 000 Sk	3. year = 6 400 000 Sk
Dividends = 20 %	4. year = 7 100 000 Sk

$$\text{Sustainable growth} = \frac{0.0667 \cdot 0.8}{0.5 - (0.0667 \cdot 0.8)} = \frac{0.0534}{0.4466} = 12\% \Rightarrow \Rightarrow \text{Sk } 600,000$$

This example clearly shows that the year-on-year increase of revenues of Sk 700,000 is economically unsustainable. The achieved level of ROA of 6.67% is lower than the price of external resources. One part of the increase in revenues, and therefore of circulating assets (in this case at the level of Sk 100,000) is dependent on an increase of external resources. The extended reproduction of the operations cycle (OC) is higher than the accumulation of own capital by the creation of profit. This increases the likelihood of the future growth of financial leverage. This is illustrated by the following diagram:



The inner circle represents the simple reproduction of the operations cycle. The valve represents the assets that ensure this reproduction. The middle circle represents an increase of assets financed by the increase of own capital by the generation of mass of profit. This represents sustainable growth of assets, which does not increase the financial dependency or the risk of liabilities repayment. The outer circle expresses the increase of assets dependent on external resources. It is above the

level of profitability and is the result of the mentioned effort to replace the profit rate by the mass of profit. Given an unchanged structure and turnover of circulating assets, the turnover of those assets that enter into the liquidity of the second degree (accounts receivable) and third degree, including the depreciation amortized therein is increased. The reproduction of the

	1 <sup>st</sup> year of production	2 <sup>nd</sup> year of production
Revenues	1 000 000 Sk	1 500 000 Sk
Costs	900 000 Sk	1 300 000 Sk
Profit	100 000 Sk	200 000 Sk
Profit margin		
= profit/revenues	10 %	13,3 %
External resources	450 000 Sk	750 000 Sk
Own funds	450 000 Sk	550 000 Sk
<b>Financial leverage</b>	<b>1.00</b>	<b>1.36</b>

operations cycle is linked to the requirements of external resources. Financial leverage increases which is confirmed by the following model example:

- Profitability allows the accumulation of own capital at the level of Sk 100,000. If the amount of circulating assets increased by the level of generated profit, the financial leverage would decrease (450,000/550,000 = 0.82). The credit risk decreases, and the profit margin rises thanks to the decrease in fixed costs used for the calculation unit of production, both the financial and operational leverage decreases.
- In the event of unchanged financial leverage and the bank's willingness to accept this, there is room for increasing the operations cycle to the level of Sk 1,100,000 of inputs (550,000/550,000). However, it is necessary to realize that interest rates paid on loans are still generally higher than the profitability of most borrowers. High lending dependency which does not decrease in the long-term can, therefore, be a risk factor.
- In the above case circulating assets increased beyond sustainable growth. The year-on-year increase of extended reproduction of the operations cycle at the level of Sk 400,000 is financed by external resources worth Sk 300,000. The volume mass of profit as well as the profit rate increase but in the current year it is not possible to repay a short-term loan provided in such a manner.

The unsustainable growth of circulating assets financed in the long-term by bank loans is an important factor as regards the already mentioned high risk of short-term loans. Sustainable growth is one of the significant characteristics expressing the profitability of corporate assets and the performance of the company sector. At the same time, it expresses the ability of borrowers to ensure an increase of circulating assets by means of own funds. Table 4 shows its development by industrial sector.

The performance of the analysed pattern of the debt burdened company sector does not allow sustainable growth. During the observed period the value of aggregated capital levels fell from 52.07% to 40.65%. This means that the increase of circulating assets beyond sustainable growth is financed exclusively by an increase of external funds. The negative value of this indicator

Table 4 (sustainable growth – coefficient)

Industry/Yea	1993	1994	1995	1996	1997	1998	1999
Agriculture, hunting, and fishing (1)	-7.683	- 8.644	-9.294	-9.898	-10.679	-9.765	-10.797
Forestry and timber (2)	0.228	- 0.084	-0.205	-0.433	- 0.329	-0.538	-0.087
Mining (3)	0.390	2.401	4.189	0.584	1.366	- 2.675	-9.862
Food industry (4)	- 4.153	-7.862	-12.004	-14.650	-14.956	-15.838	-18.855
Chemical and pharmaceutical industry (5)	-0.616	2.460	3.321	-0.395	0.893	-1.139	-12.514
Metallurgy and mech. engineering (6)	-14.982	-12.597	-15.967	-25.421	-27.421	-27.148	-34.429
Electro-technical and electronic industry (7)	-16.851	-14.386	-16.809	-18.218	-2.006	-12.418	-26.240
Textile, clothing and leather industry (8)	-2.703	-13.022	-20.482	-25.329	-38.711	-26.895	-36.905
Other industry (9)	-6.145	-4.762	-7.671	-7.084	-7.977	-11.490	-15.530
Production and distribution of electricity, gas and water (10)	11.158	10.366	13.265	9.980	5.341	2.455	1.381
Construction and building (11)	15.942	3.478	17.190	-0.563	-13.822	-11.635	-7.755
Trade, marketing, restaurant and accommodation (12)	-14.310	-8.123	-2.016	0.822	-1.042	-18.474	-22.717
Transport, warehousing, tourism and communications (13)	2.390	8.115	6.689	0.830	-4.827	-11.514	-13.219
Other activities (14)	7.383	3.978	3.876	1.455	-0.581	-7.166	-31.787
Average	-1.114	-0.530	0.467	-1.679	-3.902	-7.934	-14.915

Table 5

Ratio/year	1993	1994	1995	1996	1997	1998	1999
TL/CA	1.20	1.14	1.31	1.36	1.42	1.45	1.47
STL/CA	0.76	0.77	0.81	0.87	0.99	0.99	1.00

TL = Total liabilities, STL = Short-term liabilities, CA = Circulating assets

means that a significant part of loans, unsustainable for the banking sector, enter into loss making corporate financial flows. Financial dependency increases, which is confirmed by Table 5.

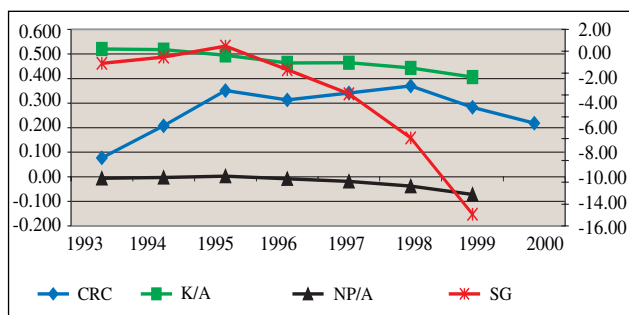
The growth of the overall financial dependency of circulating assets need not be assessed negatively if it had been the result of investment development impulses of borrowers with an expected gradual “sticking” of circulating assets to fixed assets as a part of sustainable growth (SG). However, the performance of the key part of the debt burdened portfolio does not attain the level of sustainable growth, not only due to the low ratio of circulating assets to fixed assets but also due to their resulting losses. The weight of causes leading to a higher financial burden of circulating assets by external resources is gradually transferred from secondary to primary insolvency. The development of the return of assets (profit/assets) confirms this tendency (Table 6).

One of the decisive causes of the absorption of disturbances in companies’ financial flows through a high degree of credit risk into the balance sheet imbalance of the banking sector is documented in Diagram 2. This is the synergy effect of the conjoint decrease of capital levels and borrowers’ profitability (left axis – level of CRC, right axis – sustainable growth; the development of capital levels and the return on assets is documented as a trend). The result is a strong decrease in the value of sustaina-

Table 6 (v %)

Ratio/Year	1993	1994	1995	1996	1997	1998	1999
Value	-0.59	-0.28	-0.23	-0.79	-1.89	-3.82	-7.13

Diagram 2 Development of parameters pertaining to sustainable growth and CRC



ble growth while its aggregated level is negative over the long-term. The diagram shows the development of the three basic parameters of financial and capital stability of the financed company sector and their impact on loan rate return. Until 1988, the development of sustainable growth had a relatively adequate transposition into the general degree of credit risk. Capital levels decreased, aggregated profitability level was negative, credit risk increased due to the previously mentioned financial leverage (Diagram 1). In the previous article, the development of the credit exposure was assessed as a credit crunch, however, its determining cause is the influence of the development of the debt burdened company sector’s sustainable growth on the general degree of credit risk. The continuing relative decrease in the level of credit exposure has two basic inter-linked causes:

- On the one hand the opinions of credit analysts are confirmed that if the standard parameters of companies dependent on loans are strictly observed, it is a problem to find a client that meets the credit risk criteria accepted as standard by banks.
- On the other hand, the impact of loan losses on balance sheet imbalance within the banking sector does not create sufficient internal potential for a marked increase of the acceptable credit risk threshold. Even after claims assignment loan



portfolios contain such a degree of credit risk, which draws on internal potential and its extended reproduction.

**It is necessary to state that: claims assignment was a significant part of the moderating process as regards the balance sheet imbalance in the banking sector. However, it has resolved the consequences, not the causes. All relationships between the parameters of company sector performance and the degree of credit risk expressed by the level of CRC, analyzed so far, confirm that its decrease in 1999 and 2000 was the result of claims assignment.**

All the indicators analyzed so far were based mainly on risk. Nevertheless, within rows for different indicators, profit is one of the most variable, and most vulnerable but, above all, the most easily influenced parameter used to express performance. In other words, the reported rate and mass of profit can be (reasons are not essential) adapted at a given time. This makes it even more difficult to assess the assumed credit risk and the return of the loan.

As a starting point for determining the position of risk within the structure of indicators, the following equation can be used:

$$p \cdot AV(R - C) - [(1 - p) \cdot AV(C)]$$

(p = probability, AV = actual value, R = revenues, C = costs)

The advantage of this indicator is that it allows an assessment of the probability of making profit. That is an actual profit achieved in revenues, which are a real source of loan repayment. As to an assessment of the risk inherent in a credit transaction, profit is not an objective but a result of the development of the parameters achieved by the borrower which influence it. The task is, therefore, to determine the probability of achieving profit and match the company's loan repayment ability with the lending terms.

#### Example:

Revenues: = Sk 12,000,000  
 Costs: = Sk 10,500,000  
 Probability: = 80% (calculated on the basis of a set of selected indicators applied by the bank in evaluating the risk of a client. For example, if according to the established weights of the different indicators their maximum is assigned is "100" points, the achievement of 80 points means an 80% probability that the client will reach the profit set.)  
 Calculation: =  $0.8 \cdot (12,000,000 - 10,500,000) - (0.2 \cdot 10,500,000) = -900,000$

This negative value means that the indicated profit will not be reached. By a simple adjustment to this profit, it is possible to establish the probability of making a profit at which the credit risk will be minimized:

$$p(12,000,000 - 10,500,000) - (1 - p) \cdot 10,500,000 = 0$$

$$p = 87.5\%$$

Indicators based on profit (ROA, ROE, profitability of revenues as a part of Altman's formula, etc.) have a significant weight within the structure of client assessment. However, first of all, it is necessary to determine the probability that the client will achieve the assumed profit. At a lower probability of its achievement, the mentioned indicators distort the actual quality. The cause of a high general degree of credit risk, analysed in the previous article, is not only the low level of financial stability parameters pertaining to borrowers, but also the acceptance of unrealistic profit due to the low probability of its achievement. Only after this becomes known is it possible to assess, not only the economic position of the borrower based on actual indicators of profitability, but also to maximise the degree of harmony between the reproduction of the borrower's financial flows and lending conditions. This is the key assumption for minimising the credit risk on the basis of an, in principle, two-step assessment of the client's loan repayment ability.

The achievement of the mass of profit necessary to satisfy liabilities depends on the turnover of assets in revenues. It indicates which of the following indicators is decisive for determining the risk of a lending transaction:

a) **profit/revenues**  $\Rightarrow$  how many hallers of profit will Sk 1 of real revenues contribute; the resulting profitability of revenues expresses what proportion of them is available after the reproduction of a production cycle either for its extended reproduction or for decreasing the financial leverage has been ensured (this represents a degree of harmony between price and resulting calculations)

b) **profit/assets**  $\Rightarrow$  how many hallers of profit will Sk 1 of assets contribute; the resulting return on assets expresses the internal potential of accumulating own capital

The following model example clearly shows that the risk of a loan is higher at the second company, despite the fact that it attained a higher level of return from revenues. In comparison with the first company, it is not possible to produce the mass of profit necessary to repay the principal. The cause of this development is an overlap of these indicators.

#### Model example

Indicator (Sk thousand)	1 <sup>st</sup> company	2 <sup>nd</sup> company
Profit	1,000	1,500
Revenues	10,000	10,000
Assets	10,000	15,000
Profit/revenues	10 %	15 %
Profit/assets	10 %	10 %
Own capital	2,000	2,000
External funds	8,000	13,000
of loans thereof*	5,000	10,000

\* e.g. a 5-year loan with a linear repayment mode, i.e. the first company pays an annual principal instalment of Sk 1,000,000, and the second company repays Sk 2,000,000.

Its importance from the point of view of credit risk is still not sufficiently respected. The overlap is represented by the ratio "revenues/assets". This ratio expresses the turnover of

Table 7

Industry/Year	Profit/rev. (in hal. 1999)	Profit/assets (in hal. 1999)	Rev./assets (in Sk 1999)	CRC – STL (coeff. 2000)	Total CRC (coeff. 2000))
Agriculture, hunting, fishing (1)	-11.72	-6.90	0.59	0.859	0.842
Forestry and timber (2)	-1.18	-0.08	0.07	0.038	0.050
Mining (3)	-18.55	-7.19	0.39	0.515	0.486
Food industry (4)	-5.94	-7.67	1.29	0.173	0.307
Chemical and pharmaceutical industry (5)	-6.75	-6.55	0.97	0.097	0.113
Metallurgy and mech. engineering (6)	-8.21	-12.06	1.47	0.324	0.530
Electro-technical and electronic industry (7)	-4.62	-6.83	1.48	0.221	0.426
Textile, clothing and leather industry (8)	-9.03	-11.47	1.27	0.391	0.578
Other industry (9)	-6.23	-6.21	1.00	0.358	0.361
Production and distribution of electricity, gas and water (10)	2.18	1.02	0.47	0.014	0.048
Construction and building (11)	-1.40	1.97	1.41	0.429	0.457
Trade, marketing, restaurant and accommodation (12)	-3.72	-6.52	1.75	0.292	0.416
Transport, warehousing, tourism and communications (13)	-10.07	-8.37	0.83	0.103	0.227
Other activities (14)	-30.97	-14.61	0.47	0.055	0.043
Total	-7.05	-7.13	1.01	0.217	0.219

assets in revenues. In the first company its level is 1.0, for the second 0.67. The ability to repay liabilities depends on the generation of profit mass, which depends on the turnover of assets in revenues – this is the already frequently mentioned assessment of fixed assets. If the value of this ratio is higher than 1.0, it is likely that actual funds for the repayment of current liabilities will be generated. An integral part of such liabilities is the proportional part of long-term liabilities payable in the current year. Only in such a case will the value of depreciation contained in the price calculation be realised in revenues. This represents the achievement of the assumed operational leverage. The risk of a loan has a direct relationship to the return on assets, which follows from an analysis of the following ratio:

$$\text{profit/ assets} = (\text{revenues/assets}) \cdot (\text{profit/revenues})$$

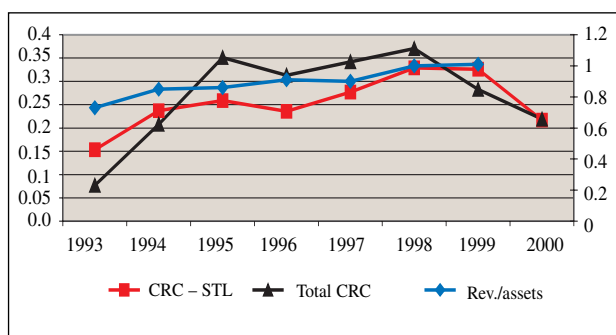
The profitability of revenues is only one side of profitability, it does not have a direct linkage to liabilities, nor does it provide any objective information on the ability to repay them. This indicator is used for client assessment, however, it is not assessed in relationship to the already mentioned asset turnover in revenues. The influence of this relationship on credit risk is shown in Table 7.

If both the above indicators of return are used within the set of indicators used to evaluate the risk of a lending transaction and they are analysed separately, the credit risk assessment may be distorted. The credit risk will be increased if the growth of the return on assets is slower than the increase of the

Table 8

Indicator/Year	1993	1994	1995	1996	1997	1998	1999	2000
Rev./assets	0.73	0.85	0.86	0.91	0.90	1.00	1.01	–
CRC – STL	0.153	0.237	0.259	0.236	0.277	0.329	0.326	0.217
Total CRC	0.077	0.208	0.351	0.313	0.342	0.370	0.283	0.219

Diagram 3 Comparison of the development of credit risk and assets turnover in revenues



profitability of revenues<sup>2</sup>. This means that the value of assets is growing faster than revenues. It expresses an increased financial dependency. In the event that the return on assets is even lower than the profitability of revenues, given even simple reproduction of the operations cycle, the repayment of liabilities becomes gradually a risk, including profits. Their refinancing is also inefficient. That is to say that if the value of revenues is lower than the value of assets, the probability of meeting liabilities payable in the current year, used to finance such assets, decreases. The data in Table 8 and Diagram 3 en-

<sup>2</sup> It is understandable that in the event of a negative value of these indicators due to loss, the relationship should be construed differently. A lower negative value does not express a positive development as it is the result of the



capsulate the development of the relationship between credit risk and the turnover of borrowers' assets.

They confirm that the decrease of CRC value is to a major degree the result of claim assignment.

The actual risk inherent in loans influences the determination of lending conditions (loan amount, interest rates, repayment mode, etc.) that are matched with borrowers' actual financial flows. One of the decisive indicators allowing the assessment not only of the financial stability of the borrower, but also the impact of the loan on its achievement, is the development of working capital. This is a parameter which ensures the reproduction of the operations cycle. Its structure is characterised by the following simplified scheme.

The development of working capital and its impact on the risk of mainly short-term loans is not paid sufficient attention. A short-term loan provided to an entity with a lack of working capital and a long turnover of circulating assets represents a risk in advance. On the one hand, it enters into the structure of unpaid short-term liabilities, on the other hand it is not allocated into actual circulating assets. Real circulating assets can be considered as those assets that are realised in revenues within one year. Up to 69.93% of short term loans provided to the company sector are allocated into industry assets with a turnover period longer than one year. None of the industrial sectors

<b>Fixed assets</b> 3,000,000	<b>Working capital</b> 3,000,000	<b>Own capital</b> 4,000,000
<b>Circulating assets</b> 7,000,000		<b>Long-term external funds</b> 2,000,000
		<b>Short-term external funds</b> 4,000,000

Working capital is defined by two relationships:

"circulating assets – short-term liabilities" (defines the value of realised revenues available for the operations cycle reproduction, and is not absorbed by the repayment of short-term liabilities,

"own capital" + long-term funds – fixed assets" (expresses the value of long-term funds allowing the financing of circulating assets and/or their increase.

have an assets turnover period shorter than seven months. The result is a continuing high degree of credit risk.

This article also contains only a brief summary of some of the analyses made by IMFS focused on the assessment of industry credit risks. Nevertheless, it is clear that the generally undercapitalised part of the company sector dependent on loans and the insufficient reproduction of lending flows requires an increase in the efficiency of their allocation. The next article will, therefore, deal with the position of loans within company financial flows.

*To be continued in volume 3/2002*