

Session 18: Examiner Evaluation of Bank Lending Activities

*SEACEN Course on
Banking Examiner Foundational Skills Development*

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Objectives

Interactive discussion of:

- Analyzing borrowers' financial statements
- Loan documentation
- Collateral protection
- Assessing debt service capacity
- Examination loan discussions
- Examination loan evaluations
- Dealing with problem loans

Bank Loan Documentation

- Basic legal documents for any loan:
 - Articles of Incorporation (if partnership, Partnership Agreement)
 - Bylaws of the Corporation
 - Corporate Borrowing Resolution
 - Promissory Note
 - Loan Agreement



Bank Loan Documentation

● Additional Legal Documents Depending on Circumstances:

- Security Agreement
- Pledge Agreement
- Guaranty
- Stock/Bond Powers
- Mortgage or Deed of Trust



Bank Loan Documentation

Credit Documentation:

- Credit application
- Commitment letter Current financial statements
- Credit analysis
- Credit checks
- Correspondence
- Inspections
- Appraisals
- Evidence of hazard insurance



Bank Loan Documentation

● Loan agreement:

- The purpose of this document is to give the bank an option to act if the risk in the loan changes (e.g., “material adverse change clause”)
- A well-constructed loan agreement establishes events of default that trigger opportunity for the bank to demand payment or restructure the loan to reduce its risk
- The *event of default* section of the LA defines the point at which the borrower will be outside the terms and conditions of the agreement

Bank Loan Documentation

Role of a Loan agreement:

- Preserve borrower's strengths
- Protect against identified weaknesses
- Framework for monitoring borrower performance
- Defense against borrower litigation

Bank Loan Documentation

🌐 Loan (Security) Agreement:

- Loan terms and conditions
- Representations and warranties
- Affirmative covenants
- Negative covenants
- Conditions of lending
- Events of default
- Remedies



Bank Loan Documentation

Objectives of Loan Covenants:

- Disclosure of information
- Preservation of net worth
- Maintenance of adequate cash flow
- Continuance of quality management
- Assurance of legal existence and “going concern” viability

Bank Loan Documentation

Financial Loan Covenants:

- Debt service coverage
- Minimum total net worth
- Debt to total net worth
- Borrowing base
- Clean-up period
- Capital expenditures
- Limitations on additional lines of credit
- Limitations on salary and/or dividends
- Limitations on employee and/or intercompany loans

Bank Loan Documentation

Non-financial Loan Covenants:

- Reporting requirements
- Litigation
- Bankruptcy
- Limitations on purchase/sale of assets
- Change in ownership
- Maintenance of insurance
- Negative pledge
- Material adverse change



Bank Loan Documentation

🌐 Guaranty:

❖ An agreement by a third party to repay a loan in the case of default or payment by the borrower.

The guaranty

- May be secured or unsecured
- Is only as reliable as the guarantor's willingness and ability to repay
- Serves a psychological purpose
- Some jurisdictions restrict creditors' ability to collect from guarantor

Bank Loan Documentation

Landlord's Waiver:

- ❖ Provides notice of the bank's security interest to the owner of the property on which the collateral is situated, serving the following purposes:
 - Provides the property owner's consent to the security interest
 - The property owner and/or lienholder give bank the right to enter the property and take control of the collateral
 - Property owner and/or lienholder subordinate(s) any lien or claim they may have in the collateral (e.g., past due rent)

Bank Loan Documentation

Security Agreement:

- ❖ Agreement in which the borrower grants the bank an interest in certain property of the borrower for the purpose of making that property available to the bank in the event that the borrower does not pay the loan. The security agreement must:
 - Be signed by the borrower or its authorized representative
 - Contain a description of the property in which the bank is given a security interest

Collateral

- ❖ An asset against which a bank takes a security interest. The security interest entitles the bank to the cash derived from the sale of the asset to repay a borrower's unpaid obligations.



Collateral Considerations

- Locate it
- Identify it
- Lay legal claim to it
- Sell it at sufficient net price to recover:
 - Principal
 - Interest
 - Liquidations costs
- Environmental risks



Collateral Quality

- Liquidity/marketability
- Dependability of value
- Controllability



Types of Collateral (in order of liquidity)

- Cash
- Marketable securities
- Accounts receivable
- Inventory
- Equipment
- Fixed assets



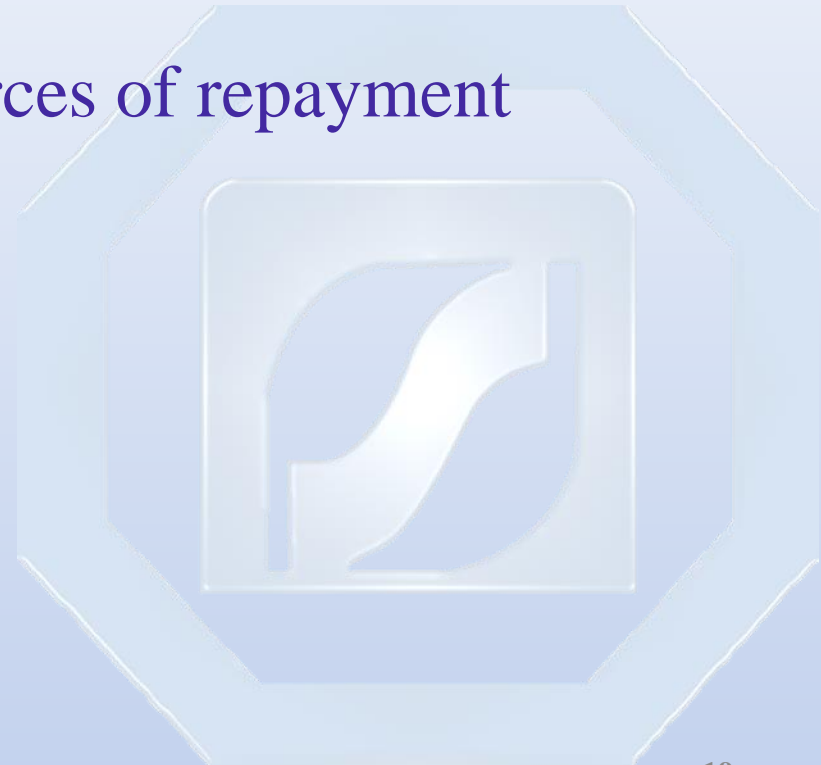
Valuing Collateral

- Cost
- Market
- Income
- Discounted cash flow (DCF)
- Liquidation



Assessing Repayment Capacity

- Cash is “king”
- Stable cash flow
- Primary and secondary sources of repayment



Purpose of Supervisory Loan Review

- Leading factor in assessing the asset quality component
 - ✚ Provides confirmation of bank compliance with approved lending policies and credit administration practices.
 - ✚ Provides an independent assessment of the quality of a bank's internal loan review process and internal risk rating systems.
 - ✚ Provides an independent measurement/quantification of risk in the bank's credit portfolios

Traditional Regulatory Rating Grades

No Significant Concerns Noted	Pass
Potential Problems – Management Attention Needed	Special Mention
Problem Credits – Adverse Classifications	Substandard Doubtful Loss

Special Mention

- A Special Mention asset has potential weaknesses that deserve management's close attention.
- *If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date.*
- Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

“Pass” Loans

- Reasonable credit risk
- Principal and interest current
- No evidence of adverse trends



Special Mention - Example

- A \$1 million construction loan for which management has been making regular advances but has not inspected the property to determine if the work has actually been completed.
- No title search was conducted to validate lien position or management is aware of technical deficiencies but has not implemented corrective action.
- Potential factors exist, which raise uncertainty as to the short-term debt service ability of the company (for example – potential litigation, possible employee strikes, short-term market events, etc.)

Substandard

- A Substandard asset is an asset that is *inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any.*
- Assets so classified must have a *well-defined weakness or weaknesses that jeopardize the liquidation of the debt.*
- They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.

“Well-Defined” Credit Weaknesses

- Cash-flow does not cover debt-service
- Obligor highly leveraged or illiquid
- Clear trend of operating losses
- Covenant waivers/defaults
- Weak exit strategy
- Marginal or non-liquid collateral support



Substandard - Example

- \$5 million loan to ABC Company
- Loan is collateral dependent
- Collateral is a shopping center with recent appraised value of \$5.25 million
- Local vacancy rates are increasing
- Borrower is 90 days past due



Doubtful

- An asset classified Doubtful has all the weaknesses inherent in one classified Substandard
- Added characteristic that the **weaknesses make collection or liquidation in full**, *on the basis of currently existing facts, conditions, and values*, **highly questionable and improbable.**

Doubtful - Example

- ✓ \$5 million loan to ABC Company
- ✓ Loan is collateral dependent
- ✓ Collateral is a shopping center with appraised value of \$5.25 million
- ✓ Local vacancy rates are increasing
- ✓ Borrower is 90 days past due
- ✓ Appraisal is 5 years old
- ✓ The area is overbuilt
- ✓ Real estate prices are dropping, with most prices dropping by at least one-third over the last 5 years
- ✓ Signs of deferred maintenance



Loss

- Assets classified Loss are considered **uncollectible** and of such little value that their continuance as bankable assets is not warranted.
- This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is **not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected** in the future.

Loss - Example

- ✓ \$5 million loan to ABC Company
- ✓ Loan is collateral dependent
- ✓ Collateral is a shopping center with appraised value of collateral is \$5.25 million
- ✓ Local economy vacancy rates are increasing
- ✓ Borrower is 90 days past due
- ✓ Appraisal is 5 years old
- ✓ The area is overbuilt
- ✓ Real estate prices are dropping
- ✓ Signs of deferred maintenance
- ✓ Fire consumed 50% of building
- ✓ Insurance has lapsed
- ✓ Title search revealed senior lien of \$1 million



Classification Summary

- Reasonable people can disagree on risk ratings
- Classifications should be based on facts available at time of review
- Support your decisions



Conclusion/Questions?

