Chapter 16

Providing Loans to Businesses and Consumers

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Contents from the textbook Peter & Sylvia

Agenda

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- Types of Loans
- Factors affecting the Mix of Loans
- Regulation of Lending
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- Steps in the Lending Process
- Loan Review and Loan Workouts

Introduction

- Lending to businesses, governments, and individuals is one of the most important services banks and their competitors provide, and it is also among the riskiest as the recent global credit crisis has demonstrated.

Basic concepts

- External factors:

  Changes in the economy, natural disaster, regulations imposed by government.

Basic concepts

- Internal factors:

  They affect loan risks, and include management errors, illegal manipulation, and ineffective lending policies

Basic concepts

- A loan workout specialist:

  the person who investigate the cause of problem loans during the loan review process, and work with the borrower to find a solution that maximizes chances for recovery

Basic concepts

- Criticized loans:

  Loans performing well but have minor weaknesses because lender not followed its own loan policy or failed to get full documentation from borrowers

Basic concepts

- Scheduled loans:

  Loans appear to contain significant weaknesses or dangerous concentration of credit in one borrower or in one industry

Basic concepts

- Adversely classified credits:

  Loans that carry an immediate risk of not paying out as planned

Types of Loans

- Real estate loans (secured by land, buildings), include ST loans for construction and land development and LT loans for the purchase of farmland, homes
- Financial institution loans : include credit to banks, insurance firms
- Agricultural loans: extended to farms to assist in planting and harvesting crops

Types of Loans

- Commercial and industrial loans : cover purchasing inventories, paying taxes
- Loans to individuals: credit for the purchase of automobiles, appliances, repairing home
- Miscellaneous loans: securities' loans
- Lease financing receivables: the lenders buy equipment and leases them to its customers

Factors determine the growth and mix of loans

- The profile of characteristics of the market area -> affect loan portfolio
- Lender size : the volume of capital held by a depository institution determines its legal lending limit to a single borrower (wholesale banks, retail banks)

Factors determine the growth and mix of loans

- Experience and expertise of management in making different types of loans
- Loan policy: prohibits making some loans
- Expected yield: each loan offers, compared to the yields on all other assets

Elements to Establish a Good Written Loan Policy

- A goal statement for the entire loan portfolio
- Specification of the lending authority given to each loan officer
- Lines of responsibility
- Operating procedures for evaluating and making decision on customer loan applications
- Documents and files

Elements to Establish a Good Written Loan Policy

- Guidelines for taking, evaluating loan collateral
- Procedures for setting loan rates
- A statement of quality standards applicable to loans
- The maximum ratio of total loans to total assets
- Procedures for detecting problem loan situations

Regulation of Lending

- Each banking firm assigned a numerical rating based on the quality of its asset portfolio, including its loans:
- 1 – strong performance
- 2 – satisfactory performance
- 3 – fair performance
- 4 – marginal performance
- 5 – unsatisfactory performance

Regulation of Lending

- Numerical ratings assigned based on 6 dimensions of performance, referred to as the CAMELS rating:
- Capital adequacy
- Asset quality
- Management quality

-Earnings record
-Liquidity position
-Sensitivity to market risk

Adversely classified credits

- Substandard loans (Weakness in collateral or in borrowers' repayment abilities) x0,2
- Doubtful loans (strong probability of an uncollectible loss to the lenders) x0,5
- Loss loans (uncollectible) x 1,0
- Sum the weighted amounts, if too > loan-loss allowances and equity capital -> require new loan policies or additions to loan-loss allowances and capital.

The Lending Process

- Finding Prospective Loan Customers
- Evaluating a Customer’s Character and Sincerity of Purpose
- Making Site Visits and Evaluating a Customer’s Credit Record
- Evaluating a Customer’s Financial Record
- Assessing Possible Loan Collateral and Signing the Loan Agreement
- Monitoring Compliance with the Loan Agreement and Other Customer Service Needs

Credit analysis: What makes a Good Loan

- Is the borrower creditworthy? How do you know?
- Credit depart. Has to analyzes the Six Cs (must be satisfactory)

6C principle approving a loan

- Character : including loan purpose and borrower honesty
- Capacity : esp., the legal authority of the borrower to sign a loan agreement
- Cash : consisting the adequacy of income or cash flow

6C principle approving a loan

- Collateral : including the quality and quantity of assets to backstop a loan
- Conditions : including the state of the economy
- Control : including compliance with the lender's loan policy and regulations

Credit analysis: What makes a Good Loan

- Can the Loan Agreement be properly structured and documented?

+ The loan officer responsible not only to the borrowing customer but also to depositors/creditors/stockholders

Credit analysis: What makes a Good Loan

- Can the Lender Perfect Its Claim against the Borrower's Earnings and Any Assets That May be Pledged as Collateral?

+ Common types of Loan collateral

++Accounts receivable (40-90% of A/R as security interest)

++Inventory (lend 30-80% of MV of inventory)

++Real property (land,..)

Credit analysis: What makes a Good Loan

- Can the Lender Perfect Its Claim against the Borrower's Earnings and Any Assets That May be Pledged as Collateral?

+ Common types of Loan collateral

++ Factoring (lender buy a borrower's A/R)

++ Personal property (automobiles,…)

++ Personal guarantees (deposits, stocks held by the major owners of a firm may be required as collateral to secure a business loan)

Credit analysis: What makes a Good Loan

- Other Safety Devices to Protect a Loan

+ The primary safety zone is income and cash flow

+ The second consists of strength on the customer's balance sheet, in the form of assets that can be pledged as collateral or liquid assets that can be sold for cash

Discussion

- Advantages /Disadvantages of lending process

Loan Review

- Review all types of loans every 30, 60 or 90 days
- Checking each loan on:
- The record of borrower payments
- The quality and condition of collateral
- The completeness of loan documentation
- Evaluation of borrower's financial forecast
- …

Loan Review

- Review the largest loans most frequently
- Conduct more frequent reviews of troubled loans
- Conduct it if the economy slows down

Loan Workouts

Indicators of a troubled loan	Indicators of Inadequate or Poor Lending Policies
-Irregular loan payments	-Poor selection of risks among borrowing customers
-Poor quality collateral	-Incomplete credit files
-Unusually high loan rates	-Failure to specify a plan for loan liquidation
-Absence of CF statement or projection	-High proportion of loans outside the lender's trade territory
……..	

Steps of recovering funds from a problem loan situation

- Maximize the chances for fund recovery
- Rapid reporting loan problems
- The loan workout responsibility separate from the lending function to avoid conflicts of interest for the loan officer

Steps of recovering funds from a problem loan situation

- Cutting expenses, increasing CF, problem analysis and causes, a plan of action
- What resources available to collect the troubled loan, including the liquidation values of assets and deposits
- For business borrowers, loan personnel must evaluate the quality, competence of current management
- Can make a new, temporary agreement, or find additional collateral, merging or liquidating the firm

Exercise 1

- With below data:

Source's of Funds	
Capital and surplus	250.000.000
Demand Deposits	200.000.000
Time and savings deposits	775.000.000
Subordinated debt	200.000.000

- Estimate:

Output Area:
Maximum $ amount of real estate loans
Maximum $ amount of loans to one customer

Exercise 2

- A corporation has below data:

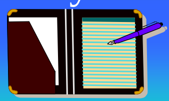
	20x1	20x2	20x3	20x4	20x5
Cost of goods sold	5,1	5,5	5,7	6,0	6,4
Selling and administrative expenses	8,0	8,2	8,3	8,6	8,9
Sales revenues	7,9	8,4	8,8	9,5	9,9
Depreciation and other noncash expenses	11,2	11,2	11,1	11,0	10,9
Taxes paid in cash	4,4	4,6	4,9	4,1	3,6

- Calculate cash flows:

Output Area:					
	20x1	20x2	20x3	20x4	20x5
Cashflows					

Summary

- Lending is risky and affected by external (disasters, economic changes) and internal (mgt errors, illegal manipulation) factors
- A 5-point CAMELS rating used to evaluate risk exposure of lenders
- Credit risk controlled by written policies on loan types, collateral, pricing and authority lines



Multiple Choice Question

1. Factors in approving or denying each loan include character, capacity, and conditions:

a. True

b. False

Multiple Choice Question

2. A sound lending program must make provision for the periodic review of all outstanding loans.

a. True

b. False

MCQ-Answers

1. A
2. A

Terminologies

- Pledge (v,n):