BANK 402
COMMERCIAL LENDING

WEEK 1

ROSE (1999) CHP.16
BANK LENDING POLICIES AND PROCEDURES
Making loans is the principal economic function of banks. For most banks, loans account for half or more of their total assets and about half to two-thirds of their revenues.

Risk in banking tends to be concentrated in the loan portfolio. Uncollectable loans can cause serious financial problems for banks.
Types of Loans Made By Banks:

Bank loans can be grouped according to their purpose.

1. Real Estate Loans
2. Financial Institution Loans
3. Agricultural Loans
4. Commercial and Industrial Loans
5. Loans to Individuals
6. Miscellaneous Loans
7. Lease Financing Receivables
# Table 16.1 Loans Outstanding for US Banks

<table>
<thead>
<tr>
<th>1996 Loans by Purpose</th>
<th>All Banks</th>
<th>&lt; 100 Mill.</th>
<th>&gt; 1 Bill.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$</td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td>Real Estate Loans</td>
<td>1,140.0</td>
<td>40.5</td>
<td>55.8</td>
</tr>
<tr>
<td>Loans to Fin. Inst.</td>
<td>114.2</td>
<td>4.1</td>
<td>0.1</td>
</tr>
<tr>
<td>Agriculture Loans</td>
<td>41.3</td>
<td>1.5</td>
<td>10.9</td>
</tr>
<tr>
<td>Commercial loans</td>
<td>709.9</td>
<td>25.2</td>
<td>16.3</td>
</tr>
<tr>
<td>Loans to Individuals</td>
<td>560.9</td>
<td>19.9</td>
<td>15.4</td>
</tr>
<tr>
<td>Misc. Loans</td>
<td>171.7</td>
<td>6.1</td>
<td>1.0</td>
</tr>
<tr>
<td>Lease Finance Rec.</td>
<td>78.4</td>
<td>2.8</td>
<td>0.4</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>2,816.3</strong></td>
<td><strong>100.0</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>
Factors Determining the Growth and Mix of Bank Loans:

- Characteristics of Market Area Served
- Size of the Bank
- Experience and Expertise of Management
- Written Loan Policy
- Expected Yield of Each Type of Loan
- Regulations
Regulation of Lending

• The loan portfolio of any bank is influenced by regulation. For example, in the USA, real estate loans cannot exceed the banks capital, or 70% of its total time and savings deposits. Also, a loan to a single customer cannot exceed 15% of banks capital.

• The quality of a bank’s loan portfolio and the soundness of its lending policies are the areas bank examiners look at most closely when examining a bank. The possible examiner ratings are:
  1 = strong performance
  2 = satisfactory performance
  3 = fair performance
  4 = marginal performance
  5 = unsatisfactory performance
Asset Quality

• Criticized Loans
• Scheduled Loans
• Adversely Classified
  1. Substandard loans
  2. Doubtful loans
  3. Loss loans

Examiners compare the weighted averages of adversely classified loans with the bank’s sum of loan loss reserves and equity capital.

\[ \text{grand total} = 0.20 \times \text{Substandard loans} + 0.50 \times \text{Doubtful loans} + 1.0 \times \text{Loss loans} \]
CAMELS Rating System

- Capital adequacy
- Asset quality
- Management quality
- Earnings record
- Liquidity position
- Sensitivity to market risk

Banks whose overall CAMELS rating is toward the low, riskier end of the numerical scale (and overall rating of 4 or 5) are examined more frequently than the highest rated banks, those with ratings of 1, 2, or 3.
Bank’s Written Loan Policy

1. Goal Statement for the Bank’s Loan Portfolio
2. Specification of Lending Authority of Each Loan Officer and Committee
3. Lines of Responsibility for Making Assignments and Reporting Information
4. Operating Procedures for Reviewing, Evaluating and Making Loan Decisions
5. Required Documentation for All Loans
6. Lines of Authority for Maintaining and Reviewing Credit Files
Bank’s Written Loan Policy (cont.)

7. Guidelines for Taking and Perfecting Collateral

8. Policies and procedures for setting loan interest rates and fees and the terms for repayment of loans

9. Statement of Quality Standards

10. Statement of Upper Limit for Total Loans

11. Description of Principal Trade Area Where Loans Should Come From

12. Discussion of Preferred Procedure for Working Out Problem Loans
Steps in the Lending Process

• The customer fill out a loan application
• An interview with a loan officer usually follows right away
• If a business or mortgage loan is applied for, a site visit is usually made by an officer of the bank to assess the property
• The customer is asked to submit several crucial documents, such as financial statements
• The credit analysis division of the bank analyses the application and prepares a brief summary and recommendation
• Recommendation goes to the loan committee for approval
• If the loan is approved, the loan officer check on the property that is pledged as collateral in order to ensure that the bank has immediate access to the collateral if the loan agreement is defaulted. This is often referred to as perfecting the bank’s claim to collateral.
Credit Analysis:

The division of the bank responsible for analyzing and making recommendations about loan applications is the credit department.

Is the Borrower Creditworthy?
This usually involves a detailed study of six aspects of the loan application: character, capacity, cash, Collateral, conditions, and control.
The Six Basic C’s of Lending

1. Character—Specific Purpose For Loan and Serious Intent to Repay Loan

2. Capacity—Customer Has Legal Authority to Sign Binding Contract

3. Cash—Does the Borrower Have the Ability to Generate Enough Cash to Repay the Loan

4. Collateral—Does the Borrower Have Adequate Assets to Support the Loan

5. Conditions—Must Look At the Industry and Changing Economic Conditions to Assess Ability to Repay

6. Control—Does Loan Meet Written Loan Policy and How Would Changing Laws and Regulations Affect Loan
Common Types of Collateral

- Accounts Receivable
- Factoring
- Inventory
- Real Property
- Personal Property
- Personal Guarantees
Sources of Information About Loan Customers

• The bank relies principally on outside information to assess the character, financial position, and collateral of a loan customer.

• The bank may contact other lenders to determine their experience with this customer.

• The local or regional credit bureau may be contacted to ascertain the customer’s credit history (In the USA: Robert Morris Associates; Moody’s and Standard & Poor; Dun and Bradstreet)
Parts of a Typical Loan Agreement

The loan is given with a written contract that has several parts.

1. **The Note:** It is signed by the borrower and it specifies the principal amount, interest rate, and the term of repayment.

2. **Loan Commitment Agreement:** This is done for large loans and home mortgage loans. Bank promises to make credit available to the borrower over a certain period.

3. **Collateral:** Bank loans may be either secured or unsecured.
Parts of a Typical Loan Agreement (cont.)

4. **Covenants**: Most formal loan agreements contain restrictive covenants, which are usually one of two types:

   1. **affirmative**, or
   2. **negative**

**Affirmative Covenants**: Require the borrower to take certain actions, such as periodically filing financial statements with the bank, maintaining insurance coverage on the loan and on any collateral pledged.

**Negative Covenants**: Restrict the borrower from doing certain things without the bank’s approval, such as taking on new debt, acquiring additional fixed assets, participating mergers, and selling assets.
Parts of a Typical Loan Agreement (cont.)

5. Borrower Guaranties or Warranties: The borrower guarantees or warranties that the information supplied in the loan application is true and correct.

6. Events of Default: most loans contain a section listing events of default, specifying what actions or inactions by the borrower would represent a significant violation of the terms of the loan agreement, and what actions the bank is legally take in order to secure its funds.
Loan Review (Loan Monitoring)

• After the loan is granted, the loan department must periodically review all loans until they reach maturity. Loan review helps bank management to spot problem loans quickly. This increases the chance to recover the loans and reduce the bank losses.
Warning Signs of Problem Loans

• Unusual or Unexpected Delays in Receiving Financial Statements
• Changes in Accounting Methods
• Restructuring Debt or Eliminating Dividend Payments or Changes in Credit Rating
• Adverse Changes in Price of Stock
Warning Signs of Problem Loans (cont.)

- Net Earnings Losses in One or More Years
- Adverse Changes in Capital Structure
- Deviations in Actual from Predicted Sales Amounts
- Unexpected or Unexplained Changes in Deposit Balances
Loan Workouts

- Goal is to Maximize Full Recovery of Funds
- Rapid Detection and Reporting of Problems is Essential
- Loan Workout Should be Separate from Lending Function
- Should Consult with Customer Quickly on Possible Options
Loan Workouts (cont.)

• Estimate Resources Available to Collect the Troubled Loan
• Conduct Tax and Litigation Search
• Evaluate Quality and Competence of Current Management
• Consider All Reasonable Alternatives