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CHAPTER SIXTEEN

Lending Policies and Procedures

Key Topics in This Chapter

- Types of Loans Banks Make
- Factors Affecting the Mix of Loans Made
- Regulation of Lending
- Creating a Written Loan Policy
- Steps in the Lending Process
- Loan Review and Loan Workouts

16–1 Introduction

J. Paul Getty, once the richest man in the world, observed: "If you owe the bank $100, that's your problem. If you owe the bank $100 million, that's the bank's problem." To be sure, 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.

However, risky or not, the principal reason many financial firms are issued charters of incorporation by state and national governments is to make loans to their customers.[1] Banks and other lenders are expected to support their local communities with an adequate supply of credit for all legitimate business and consumer financial needs and to price that credit reasonably in line with competitively determined market interest rates.

Indeed, making loans to fund consumption and investment spending is the principal economic function of banks and their closest competitors. How well a lender performs in fulfilling the lending function has a great deal to do with the economic health of its region, because loans support the growth of new businesses and jobs within the lender's trade territory. Moreover, loans frequently convey information to the marketplace about a borrower's credit quality, often enabling a borrower whose loan is approved to obtain more and somewhat cheaper funds from other sources as well.

Despite all the benefits of lending for both lenders and their customers, the lending process bears careful monitoring at all times. When a lender gets into serious financial trouble, its problems usually spring from loans that have become uncollectible due to mismanagement, illegal manipulation, misguided policies, or an unexpected economic downturn. No wonder, then, that when examiners appear at a regulated lending institution they conduct a thorough review of its loan portfolio. Usually this involves a detailed analysis of the documentation and collateral for the largest loans, a review of a sample of small loans, and an evaluation of loan policies to ensure they are sound and prudent in order to protect the public's funds.

[1]Portions of this chapter are based upon Peter S. Rose's article in *The Canadian Banker* [3] and are used with the permission of the publisher.

16–2 Types of Loans

What *types* of loans do banks and their closest competitors make? The answer, of course, is that banks make a wide variety of loans to a wide variety of customers for many different purposes—from purchasing automobiles and buying new furniture, taking dream vacations, or pursuing college educations to constructing homes and office buildings. Fortunately, we can bring some order to the diversity of lending by grouping loans according to their *purpose*—what customers plan to do with the proceeds of their loans. At least once each year, the Federal Reserve System, FDIC, and the Comptroller of the Currency require each U.S. bank to report the composition of its loan portfolio by purpose of loan on a report form known as Schedule A, attached to its balance sheet. Table 16–1 summarizes the major items reported on Schedule A for all U.S. banks as of June 30, 2005.

We note from Table 16–1 that loans may be divided into seven broad categories, delineated by their purposes:

Factoid
In the most recent years which financial institution has been the number one lender in the U.S. economy?
Answer: Commercial banks, followed by insurance companies, savings institutions, finance companies, and credit unions.

1. **Real estate loans** are secured by real property—land, buildings, and other structures—and include short-term loans for construction and land development and longer-term loans to finance the purchase of farmland, homes, apartments, commercial structures, and foreign properties.
2. **Financial institution loans** include credit to banks, insurance companies, finance companies, and other financial institutions.
3. **Agricultural loans** are extended to farms and ranches to assist in planting and harvesting crops and supporting the feeding and care of livestock.
4. **Commercial and industrial loans** are granted to businesses to cover purchasing inventories, paying taxes, and meeting payrolls.

TABLE 16–1
Loans Outstanding for All U.S.-Insured Banks as of June 30, 2005 (consolidated domestic and foreign offices)

Source: Federal Deposit Insurance Corporation.

Bank Loans Classified by Purpose	Amount for All FDIC-Insured U.S. Banks ($ billions)	Percentage of Loan Portfolio: Percentage of Total Loans for all FDIC-Insured U.S. Banks	Smallest U.S. Banks (less than $100 million in total assets)	Largest U.S. Banks (over $1 billion in total assets)
Real estate loans[a]	$2817.6	54.9%	62.8%	51.9%
Loans to depository institutions[b]	151.6	3.0	0.0*	3.5
Loans to finance agricultural production	48.2	0.1	10.3	0.4
Commercial and industrial loans[c]	980.3	19.1	16.0	19.7
Loans to individuals[d]	813.7	15.9	9.6	17.4
Miscellaneous loans[e]	231.4	4.5	0.9	4.0
Lease financing receivables	136.6	2.7	0.4	3.1
Total (gross) loans and leases shown on U.S. banks' balance sheet	$5132.1	100.0%	100.0%	100.0%

*Less than 0.05 percent.
[a]Construction and land development loans; loans to finance one- to four-family homes; multifamily residential property loans; nonfarm, nonresidential property loans; foreign real estate loans.
[b]Loans to commercial banks and other foreign and domestic depository institutions and acceptances of other banks.
[c]Credit to construct business plant and equipment; loans for business operating expenses; loans for other business uses, including international loans and acceptances.
[d]Loans to purchase automobiles; credit cards; mobile home loans; loans to purchase consumer goods; loans to repair and modernize residences; all other personal installment loans; single-payment loans; and other personal loans.
[e]Includes loans to foreign governments and state and local governments and acceptances of other banks. Columns may not add exactly to totals due to rounding error.

5. **Loans to individuals** include credit to finance the purchase of automobiles, mobile homes, appliances, and other retail goods, to repair and modernize homes, and to cover the cost of medical care and other personal expenses, and are either extended directly to individuals or indirectly through retail dealers.
6. *Miscellaneous loans* include all loans *not* listed above, including securities' loans.
7. *Lease financing receivables*, where the lender buys equipment or vehicles and leases them to its customers.

Of the loan categories shown, the largest in dollar volume is *real estate loans*, accounting for just over half of total bank loans. The next largest category is commercial and industrial (C&I) loans, representing about one-fifth of the total, followed by loans to individuals and families, accounting for about one-sixth of all loans federally insured banks make.

Factors Determining the Growth and Mix of Loans

While Table 16–1 indicates the relative amounts of different kinds of loans for the whole banking industry, the mix usually differs markedly from institution to institution. One of the key factors in shaping an individual lender's loan portfolio is the profile of *characteristics of the market area* it serves. Each lender must respond to the demands for credit arising from customers in its own market. For example, a lender serving a suburban community with large numbers of single-family homes and small retail stores will normally have mainly residential real estate loans, automobile loans, and credit for the purchase of home appliances and for meeting household expenses. In contrast, a lender situated in a central city surrounded by office buildings, department stores, and manufacturing establishments will typically devote the bulk of its loan portfolio to business loans designed to stock shelves with inventory, purchase equipment, and meet business payrolls.

Of course, lenders are not totally dependent on the local areas they serve for *all* the loans they acquire. They can purchase whole loans or pieces of loans from other lenders, share in loans with other lenders (known as *participations*), or even use credit derivatives to offset the economic volatility inherent in loans from their trade territory (as we saw in Chapter 9, for example). These steps can help reduce the risk of loss if the local areas served incur severe economic problems. However, most lenders are chartered to serve selected markets and, as a practical matter, most of their loan applications will come from these areas.

Lender size is also a key factor shaping the composition of a loan portfolio. For example, the volume of capital held by a depository institution determines its *legal lending limit* to a single borrower. Larger banks are often **wholesale lenders,** devoting the bulk of their credit portfolios to large-denomination loans to business firms. Smaller banks, on the other hand, tend to emphasize **retail credit,** in the form of smaller-denomination personal cash loans and home mortgage loans extended to individuals and families, as well as smaller business loans.

Table 16–1 reveals some of the differences between the largest and smallest U.S. banks in loan portfolio mix. The smallest banks (under $100 million in total assets) are more heavily committed to real estate and agricultural loans than the largest banking firms (over $1 billion in assets), which tend to be more heavily committed to commercial loans and loans to individuals. The *experience and expertise of management* in making different types of loans also shape the composition of a loan portfolio, as does the lending institution's *loan policy*, which prohibits loan officers from making certain kinds of loans.

We should also note that the composition of loans varies with the type of lending institution involved. For example, while commercial banks typically extend large numbers of commercial and industrial (business) loans, savings associations and credit unions tend to

emphasize home mortgage and personal installment loans. In contrast, finance companies favor business inventory and equipment loans and also grant large amounts of household credit to purchase appliances, furniture, and automobiles.

Finally, loan mix at any particular lending institution depends heavily upon the *expected yield* that each loan offers compared to the yields on all other assets the lender could acquire. Other factors held equal, a lender would generally prefer to make loans bearing the highest expected returns after all expenses and the risk of loan losses are taken into account. Recent research suggests that gross yields (i.e., total revenue received divided by loan volume) typically have been exceptionally high for credit card loans, installment loans (mainly to households and smaller businesses), and real estate loans. However, when *net yields* (with expenses and loss rates deducted from revenues received) are calculated, real estate and commercial loans generally rank high relative to other loan types, helping to explain their popularity among many lenders.

Concept Check

16–1. In what ways does the lending function affect the economy of its community or region?

16–2. What are the principal types of loans made by banks?

16–3. What factors appear to influence the growth and mix of loans held by a lending institution?

16–4. A lender's cost accounting system reveals that its losses on real estate loans average 0.45 percent of loan volume and its operating expenses from making these loans average 1.85 percent of loan volume. If the gross yield on real estate loans is currently 8.80 percent, what is this lender's net yield on these loans?

Lender size appears to have a significant influence on the net yield from different kinds of loans. Smaller banks, for example, seem to average higher net returns from granting real estate and commercial loans, whereas larger banks appear to have a net yield advantage in making credit card loans. Of course, *customer size* as well as lender size can affect relative loan yields. For example, the largest banks make loans to the largest corporations where loan rates are relatively low due to generally lower risk and the force of competition; in contrast, small institutions lend money primarily to the smallest-size businesses, whose loan rates tend to be much higher than those attached to large corporate loans. Thus, it is not too surprising that the net yields on commercial loans tend to be higher among the smallest lending institutions.

As a general rule, a lending institution should make those types of loans for which it is the *most efficient producer*. The largest banks appear to have a cost advantage in making nearly all types of real estate and installment loans. Medium-size and large lenders are generally the lowest-cost producers of credit card loans. While the smallest lenders appear to have few cost advantages relative to larger institutions for almost any type of loan, these smaller lenders are frequently among the most effective at controlling loan losses, perhaps because they often have better knowledge of their customers.

16–3 Regulation of Lending

Lending institutions are among the most closely regulated of all financial-service institutions. Not surprisingly, the mix, quality, and yield of the loan portfolio are heavily influenced by the character and depth of *regulation*. Any loans made are subject to examination and review and many are restricted or even prohibited by law.

Key URLs
To discover more facts about the rules and regulations of lending see, for example, the Federal Financial Institutions Examination Council at **www.ffiec.gov/press.htm**, the Federal Deposit Insurance Corporation at **www.fdic.gov**, and the Federal Reserve System at **www.federalreserve.gov**.

For example, banks are frequently prohibited from making loans collateralized by their own stock. Real estate loans granted by a U.S. national bank cannot exceed that bank's capital and surplus or 70 percent of its total time and savings deposits, whichever is greater. A loan to a single customer normally cannot exceed 15 percent of a national bank's unimpaired capital and surplus account. The lending limit may be further increased to 25 percent of unimpaired capital and surplus if the loan amount exceeding the 15 percent limit is fully secured by marketable securities.

Loans to a bank's officers extended for purposes other than funding education or the purchase of a home or that are not fully backed by U.S. government securities or deposits are limited to the greater of 2.5 percent of the bank's capital and unimpaired surplus or $25,000, but cannot be more than $100,000. State-chartered banks face similar restrictions on insider loans in their home states and from the Federal Deposit Insurance Corporation. The Sarbanes-Oxley Act of 2002 requires that loans to insiders be priced at market value rather than being subsidized by the lending institution.

The Community Reinvestment Act (1977) requires banks and selected other lenders to make "an affirmative effort" to meet the credit needs of individuals and businesses in their trade territories so that no areas of the local community are discriminated against in seeking access to credit. Moreover, under the Equal Credit Opportunity Act (1974), no individual can be denied credit because of race, sex, religious affiliation, age, or receipt of public assistance. Disclosure laws require that the borrower be quoted the "true cost" of a loan, as reflected in the annual percentage interest rate (APR) and all required charges and fees for obtaining credit, *before* the loan agreement is signed.[2]

In the field of international lending, special regulations have appeared in recent years in an effort to reduce the risk exposure associated with granting loans overseas. In this field lenders often face significant political risk from foreign governments passing restrictive laws or seizing foreign-owned property, and substantial business risk due to lack of knowledge concerning foreign markets. U.S. law in the form of the International Lending and Supervision Act requires U.S. banks to make public any credit exposures to a single country that exceed 15 percent of their primary capital or 0.75 percent of their total assets, whichever is smaller. This law also imposes restrictions on the fees lenders may charge a troubled international borrower to restructure a loan.

The quality of a loan portfolio and the soundness of its policies are the areas federal and state regulators look at most closely when examining a lending institution. Under the Uniform Financial Institutions Rating System used by federal examiners, each banking firm is assigned a numerical rating based on the quality of its asset portfolio, including its loans. The examiner assigns one of these ratings:

1 = strong performance
2 = satisfactory performance
3 = fair performance
4 = marginal performance
5 = unsatisfactory performance

The better a bank's asset-quality rating, the less frequently it will be subject to examination by banking agencies, other factors held equal.

Examiners generally look at all loans above a designated minimum size and at a random sample of small loans. Loans that are performing well but have minor weaknesses because the lender has not followed its own loan policy or has failed to get full documentation from

[2]See Chapter 18 for a more detailed discussion of antidiscrimination and disclosure laws applying to bank loans to individuals and families.

Key URLs
Information about the regulation of lending around the world can be gathered from such sources as the Bank for International Settlements at **www.bis.org** and the libraries of the World Bank and the International Monetary Fund at **jolis.worldbankimflib.org/external.htm**.

the borrower are called *criticized loans*. Loans that appear to contain significant weaknesses or that represent what the examiner regards as a dangerous concentration of credit in one borrower or in one industry are called *scheduled loans*. A scheduled loan is a warning to management to monitor that credit carefully and to work toward reducing the lender's risk exposure from it.

When an examiner finds loans that carry an immediate risk of not paying out as planned, these credits are *adversely classified*. Typically, examiners will place adversely classified loans into one of three groupings: (1) *substandard loans*, where the loans' margin of protection is inadequate due to weaknesses in collateral or in the borrower's repayment abilities; (2) *doubtful loans*, which carry a strong probability of an uncollectible loss to the lending institution; and (3) *loss loans*, regarded as uncollectible and not suitable to be called bankable assets. A common procedure for examiners is to multiply the total of all substandard loans by 0.20, the total of all doubtful loans by 0.50, and the total of all loss loans by 1.00, then sum these weighted amounts and compare their grand total with the lender's sum of loan-loss allowances and equity capital. If the weighted sum of all adversely classified loans appears too large relative to loan-loss allowances and equity capital, examiners will demand changes in the lender's policies and procedures or, possibly, require additions to loan-loss allowances and capital. Financial institutions that disagree with examiner classifications of their loans can appeal these rulings.

Of course, the quality of loans is only one dimension of a lender's performance that is rated under the Uniform Financial Institutions Rating System. Numerical ratings are also assigned based on examiner judgment about capital adequacy, management quality, earnings record, liquidity position, and sensitivity to market risk exposure. All five dimensions of performance are combined into one overall numerical rating, referred to as the **CAMELS rating.** The letters in CAMELS are derived from

Capital adequacy	**E**arnings record
Asset quality	**L**iquidity position
Management quality	**S**ensitivity to market risk

Depository institutions whose overall CAMELS rating is toward the low, riskier end of the numerical scale—an overall rating of 4 or 5—tend to be examined more frequently than the highest-rated institutions, those with ratings of 1, 2, or 3.

One final note on the examination process today: Rapidly changing technology and the emergence of very large financial institutions appear to have weakened the effectiveness of traditional examination procedures. An added problem is that examinations tend to occur no more frequently than once a year and the decay in the quality of examination information over time can be rapid, especially among weakly performing or poorly managed lending institutions. Accordingly, regulators are beginning to turn more toward *market forces* as a better long-run approach to monitoring behavior and encouraging lenders to manage their institutions prudently. The new emerging emphasis in examination is to rely more heavily upon "private market discipline" in which such factors as borrowing costs, stock prices, and other market values are used as "signals" as to how well a lender is performing and to help examiners determine if they need to take a close look at how a lending institution is managing its loans and protecting the public's funds.[3]

[3]In order to more closely monitor the condition of depository institutions between regular examinations the regulatory agencies today use *off-site monitoring* systems. For example, the FDIC employs SCOR—the Statistical CAMELS Off-Site Rating—which forecasts future CAMELS ratings quarterly, based on 12 key financial ratios tracking equity capital, loan loss exposure, earnings, liquid assets, and loan totals. See especially Collier et al. [7].

Key URL
For an interesting source of information about trends in lending and loan policies, see the Senior Loan Officer Opinion Survey at **www.federalreserve.gov/boarddocs/SnLoanSurvey**.

Establishing a Written Loan Policy

One of the most important ways a lending institution can make sure its loans meet regulatory standards and are profitable is to establish a *written loan policy*. Such a policy gives loan officers and management specific guidelines in making individual loan decisions and in shaping the overall loan portfolio. The actual makeup of a lender's loan portfolio should reflect what its loan policy says. Otherwise, the loan policy is not functioning effectively and should be either revised or more strongly enforced.

What should a written loan policy contain? The examinations manual, which the Federal Deposit Insurance Corporation gives to new examiners, suggests the most important elements of a well-written loan policy. These elements include:

1. A goal statement for the loan portfolio (i.e., statement of the characteristics of a good loan portfolio in terms of types, maturities, sizes, and quality of loans).
2. Specification of the lending authority given to each loan officer and loan committee (measuring the maximum amount and types of loan that each employee and committee can approve and what signatures of approval are required).
3. Lines of responsibility in making assignments and reporting information.
4. Operating procedures for soliciting, evaluating, and making decisions on customer loan applications.
5. The required documentation that is to accompany each loan application and what must be kept in the lender's files (financial statements, security agreements, etc.).
6. Lines of authority detailing who is responsible for maintaining and reviewing the institution's credit files.
7. Guidelines for taking, evaluating, and perfecting loan collateral.
8. Procedures for setting loan rates and fees and the terms for repayment of loans.
9. A statement of quality standards applicable to all loans.
10. A statement of the preferred upper limit for total loans outstanding (i.e., the maximum ratio of total loans to total assets allowed).
11. A description of the lending institution's principal trade area, from which most loans should come.
12. Procedures for detecting and working out problem loan situations.

Concept Check

16–5. Why is lending so closely regulated by state and federal authorities?

16–6. What is the CAMELS rating and how is it used?

16–7. What should a good written loan policy contain?

Key URLs
To learn more about how loan officers are educated see, for example, the Risk Management Association (RMA) at **www.rmahq.org**. If you are interested in a possible career in lending see especially **www.jobsinthemoney.com** and **www.bls.gov/oco/cg/cgs027.htm**.

Other authorities would add to this list such items as specifying what loans the lender would prefer *not* to make, such as loans to support the construction of speculative housing or loans to support leveraged buyouts (LBOs) of companies by a small group of insiders who typically make heavy use of debt to finance the purchase, as well as a list of preferred loans (such as short-term business inventory loans that are self-liquidating).

A written loan policy carries a number of advantages for the lending institution adopting it. It communicates to employees what procedures they must follow and what their responsibilities are. It helps the lender move toward a loan portfolio that can successfully blend *multiple objectives*, such as promoting profitability, controlling risk exposure, and satisfying regulatory requirements. Any exceptions to the loan policy should be fully documented, and the reasons why a variance from the loan policy was permitted should be

listed. While any loan policy must be flexible due to continuing changes in economic conditions and regulations, violations of loan policy should be infrequent events.

16–4 Steps in the Lending Process

1. Finding Prospective Loan Customers

Most loans to individuals arise from a direct request from a customer who approaches a member of the lender's staff and asks to fill out a loan application. Business loan requests, on the other hand, often arise from contacts the loan officers and sales representatives make as they solicit new accounts from firms operating in the lender's market area. Increasingly the lending game is becoming a *sales position*. Sometimes loan officers will call on the same company for months before the customer finally agrees to give the lending institution a try by filling out a loan application. Most loan department personnel fill out a customer contact report similar to the one shown in Table 16–2 when they visit a prospective customer's place of business. This report is updated after each subsequent visit, giving the next loan officer crucial information about a prospective client before any other personal contacts are made.

2. Evaluating a Prospective Customer's Character and Sincerity of Purpose

Once a customer decides to request a loan, an interview with a loan officer usually follows, giving the customer the opportunity to explain his or her credit needs. That interview is particularly important because it provides an opportunity for the loan officer to *assess the customer's character and sincerity of purpose*. If the customer appears to lack sincerity in acknowledging the need to adhere to the terms of a loan, this must be recorded as a strong factor weighing against approval of the loan request.

TABLE 16–2
Sample Customer Contact Report (results of previous calls on a customer)

Name of customer: _____

Address: _____ Telephone: ( ) _____

Lender personnel making most recent contact: _____

Names of employees making previous contacts with this customer: _____

Does this customer currently use any of our services? _____ Yes _____ No

Which ones? _____

Has the customer used any of our services in the past? _____

If a business firm, what officials with the customer's firm have we contacted?

_____

If an individual, what is the customer's occupation? _____

What line of business is the customer in? _____

Approximate annual sales: $ _____ Size of labor force: _____

Who provides financial services to this customer at present? _____

What problems does the customer have with his/her current financial service relationship?

_____

What financial services does this customer use at present? (Please check)

_____ Line of credit	_____ Funds transfers
_____ Term loan	_____ Cash management services
_____ Checkable deposits	_____ Other services

What services does this customer *not* use currently that might be useful to him or her?

_____

Describe the results of the most recent contact with this customer: _____

_____

Recommended steps to prepare for the next call (e.g., special information needed):

_____

3. *Making Site Visits and Evaluating a Prospective Customer's Credit Record*

If a business or mortgage loan is applied for, a loan officer often makes a *site visit* to assess the customer's location and the condition of the property and to ask clarifying questions. The loan officer may contact other creditors who have previously loaned money to this customer to see what their experience has been. Did the customer fully adhere to previous loan agreements and, where required, keep satisfactory deposit balances? A previous payment record often reveals much about the customer's character, sincerity of purpose, and sense of responsibility in making use of credit extended by a lending institution.

4. *Evaluating a Prospective Customer's Financial Condition*

If all is favorable to this point, the customer is asked to submit several crucial documents the lender needs in order to fully evaluate the loan request, including complete financial statements and, in the case of a corporation, board of directors' resolutions authorizing the negotiation of a loan with the lender. Once all documents are on file, the lender's credit analysis division conducts a thorough financial analysis of the applicant, aimed at determining whether the customer has sufficient cash flow and backup assets to repay the loan. The credit analysis division then prepares a brief summary and recommendation, which goes to the appropriate loan committee for approval. On larger loans, members of the credit analysis division may give an oral presentation and discussion will ensue between staff analysts and the loan committee over the strong and weak points of a loan request.

5. *Assessing Possible Loan Collateral and Signing the Loan Agreement*

If the loan committee approves the customer's request, the loan officer or the credit committee will usually check on the property or other assets to be pledged as collateral in order to ensure that the lending institution has immediate access to the collateral or can acquire title to the property involved if the loan agreement is defaulted. This is often referred to as *perfecting* the lender's claim to collateral. Once the loan officer and the loan committee are satisfied that both the loan and the proposed collateral are sound, the note and other documents that make up a loan agreement are prepared and signed by all parties to the agreement.

6. *Monitoring Compliance with the Loan Agreement and Other Customer Service Needs*

Is this the end of the process? Can the loan officer put the signed loan agreement on the shelf and forget about it? Hardly! The new agreement must be monitored continuously to ensure that the terms of the loan are being followed and that all required payments of principal and interest are being made as promised. For larger commercial credits, the loan officer will visit the customer's business periodically to check on the firm's progress and see what other services the customer may need. Usually a loan officer or other staff member enters information about a new loan customer in a computer file known as a *customer profile*. This file shows what services the customer is currently using and contains other information required by management to monitor a customer's progress and financial service needs.

16–5 Credit Analysis: What Makes a Good Loan?

The division or department responsible for analyzing and making recommendations on the fate of most loan applications is the *credit department*. Experience has shown that this department must satisfactorily answer three major questions regarding each loan application:

1. Is the borrower *creditworthy?* How do you know?
2. Can the loan agreement be properly *structured and documented* so the lending institution and those who supply it with funds are adequately protected and the borrower has a high probability of being able to service the loan without excessive strain?

3. Can the lender *perfect* its claim against the assets or earnings of the customer so that, in the event of default, the lender's funds can be recovered rapidly at low cost and with low risk?

Let's look at each of these three key issues in the "yes" or "no" decision a lending institution must make on every loan request.

1. Is the Borrower Creditworthy?

The question that must be dealt with before any other is whether or not the customer can *service the loan*—that is, pay out the credit when due, with a comfortable margin for error. This usually involves a detailed study of six aspects of a loan application: *character, capacity, cash, collateral, conditions*, and *control*. *All* must be satisfactory for the loan to be a good one from the lender's point of view. (See Table 16–3.)

Character

Filmtoid
What 1999 film, recounting the early days of Apple and Microsoft, finds a clean-shaven Steve Jobs in search of funding for Apple Computers and explaining the beard had to go, "Banks don't like beards"?
Answer: *Pirates of Silicon Valley*.

The loan officer must be convinced the customer has a well-defined *purpose* for requesting credit and a serious intention to repay. If the officer is not sure why the customer is requesting a loan, this purpose must be clarified to the lender's satisfaction. The loan officer must determine if the purpose is consistent with the lending institution's loan policy. Even with a good purpose, however, the loan officer must determine that the borrower has a responsible attitude toward using borrowed funds, is truthful in answering questions, and will make every effort to repay what is owed. Responsibility, truthfulness, serious purpose, and serious intention to repay all monies owed make up what a loan officer calls *character*. If the loan officer feels the customer is insincere in promising to use borrowed funds as planned and in repaying as agreed, the loan should *not* be made, for it will almost certainly become a problem credit.

Capacity

The loan officer must be sure that the customer has the authority to request a loan and the legal standing to sign a binding loan agreement. This customer characteristic is known as the *capacity* to borrow money. For example, in most areas a minor (e.g., under age 18 or 21) cannot legally be held responsible for a credit agreement; thus, the lender would have great difficulty collecting on such a loan. Similarly, the loan officer must be sure that the representative from a corporation asking for credit has proper authority from the company's board of directors to negotiate a loan and sign a credit agreement binding the company. Usually this can be determined by obtaining a copy of the resolution passed by a corporate customer's board of directors, authorizing the company to borrow money. Where a business partnership is involved, the loan officer must ask to see the firm's partnership agreement to determine which individuals are authorized to borrow for the firm. A loan agreement signed by unauthorized persons could prove to be uncollectible and, therefore, result in substantial losses for the lending institution.

Cash

This feature of any loan application centers on the question: Does the borrower have the ability to generate enough **cash**—in the form of *cash flow*—to repay the loan? In general, borrowing customers have only three sources to draw upon to repay their loans: *(a)* cash flows generated from sales or income, *(b)* the sale or liquidation of assets, or *(c)* funds raised by issuing debt or equity securities. Any of these sources may provide sufficient cash to repay a loan. However, lenders have a strong preference for *cash flow* as the principal source of loan repayment because asset sales can weaken a borrowing customer and make the lender's position as creditor less secure. Moreover, shortfalls in cash flow are common

Source: Peter S. Rose, "Loans in a Troubled Economy," *The Canadian Banker* 90, no. 3 (June 1983), p. 55.

Character	Capacity	Cash	Collateral	Conditions	Control
Customer's past payment record	Identity of customer and guarantors	Take-home pay for an individual; the past earnings, dividends, and sales record for a business firm	Ownership of assets	Customer's current position in industry and expected market share	Applicable laws and regulations regarding the character and quality of acceptable loans
Experience of other lenders with this customer	Copies of Social Security cards, driver's licenses, corporate charters, resolutions, partnership agreements, and other legal documents	Adequacy of past and projected cash flows	Vulnerability of assets to obsolescence	Customer's performance vis-à-vis comparable firms in the same industry	Adequate documentation for examiners who may review the loan
Purpose of loan	Description of history, legal structure, owners, nature of operations, products, and principal customers and suppliers for a business borrower	Availability of liquid reserves	Liquidation value of assets	Competitive climate for customer's product	Signed acknowledgments and correctly prepared loan documents
Customer's track record in forecasting business or personal income		Turnover of payables, accounts receivable, and inventory	Degree of specialization in assets	Sensitivity of customer and industry to business cycles and changes in technology	Consistency of loan request with lender's written loan policy
Credit rating		Capital structure and leverage	Liens, encumbrances, and restrictions against property held	Labor market conditions in customer's industry or market area	Inputs from noncredit personnel (such as economists or political experts) on the external factors affecting loan repayment
Presence of cosigners or guarantors of the proposed loan		Expense controls	Leases and mortgages issued against property and equipment	Impact of inflation on customer's balance sheet and cash flow	
		Coverage ratios	Insurance coverage	Long-run industry or job outlook	
		Recent performance of borrower's stock and price-earnings (P/E) ratio	Guarantees and warranties issued to others	Regulations, political and environmental factors affecting the customer and/or his or her job, business, and industry	
		Management quality	Lender's relative position as creditor in placing a claim against borrower's assets		
		Recent accounting changes	Probable future financing needs		

indicators of failing businesses and troubled loan relationships. This is one reason current banking regulations require that the lender document the cash flow basis for approving a loan.

What is **cash flow?** In an accounting sense, it is usually defined as

$$\text{Cash flow} = \begin{matrix}\text{Net Profits}\\ \text{(or total}\\ \text{revenues less}\\ \text{all expenses)}\end{matrix} + \begin{matrix}\text{Noncash Expenses}\\ \text{(especially}\\ \text{depreciation)}\end{matrix}$$

This is often called *traditional cash flow* and can be further broken down into:

$$\text{Cash flow} = \begin{matrix}\text{Sales Revenues} - \text{Cost of Goods Sold} - \text{Selling, General and}\\ \text{Administrative Expenses} - \text{Taxes Paid in Cash} + \text{Noncash Expenses}\end{matrix}$$

with all of the above items (except noncash expenses) figured on the basis of actual cash inflows and outflows instead of on an accrual basis.

For example, if a business firm has $100 million in annual sales revenue, reports $70 million in cost of goods sold, carries annual selling and administrative expenses of $15 million, pays annual taxes amounting to $5 million, and posts depreciation and other noncash expenses of $6 million, its projected annual cash flow would be $16 million. The lender must determine if this volume of annual cash flow will be sufficient to comfortably cover repayment of the loan as well as deal with any unexpected expenses.

In this slightly expanded format, traditional cash flow measures point to at least five major areas loan officers should look at carefully when lending money to business firms or other institutions. These are:

1. The level of and recent trends in sales revenue (which reflect the quality and public acceptance of products and services).
2. The level of and recent changes in cost of goods sold (including inventory costs).
3. The level of and recent trends in selling, general, and administrative expenses (including the compensation of management and employees).
4. Any tax payments made in cash.
5. The level of and recent trends in noncash expenses (led by depreciation expenses).

Adverse movements in *any* of these key sources and uses of cash demand inquiry and satisfactory resolution by a loan officer.

A more recent and, in some ways, more revealing approach to measuring cash flow is often called the *direct cash flow method* or sometimes *cash flow by origin*. It answers the simple but vital question: *Why* is cash changing over time? This method divides *cash flow* into its three principal sources:

1. *Net cash flow from operations* (the borrower's net income expressed on a cash rather than an accrual basis).
2. *Net cash flow from financing activity* (which tracks cash inflows and outflows associated with selling or repurchasing borrower-issued securities).
3. *Net cash flow from investing activities* (which examines outflows and inflows of cash resulting from the purchase and sale of the borrower's assets).

This method of figuring cash flow and its components can be extremely useful in ferreting out the recent sources of a borrower's cash flow. For example, most lenders would prefer that most incoming cash come from operations (sales of product or service). If, on the other hand, a substantial proportion of incoming cash arises instead from the sale of assets (investing activities) or from issuing debt (financing activities), the borrower may have even less opportunity to generate cash in the future, presenting any prospective lender with added risk exposure if a loan is granted.

Collateral

In assessing the *collateral* aspect of a loan request, the loan officer must ask, Does the borrower possess adequate net worth or own enough quality assets to provide adequate support for the loan? The loan officer is particularly sensitive to such features as the age, condition, and degree of specialization of the borrower's assets. Technology plays an important role here as well. If the borrower's assets are technologically obsolete, they will have limited value as collateral because of the difficulty of finding a buyer for those assets should the borrower's income falter.

Conditions

The loan officer and credit analyst must be aware of recent trends in the borrower's line of work or industry and how changing economic *conditions* might affect the loan. A loan can look very good on paper, only to have its value eroded by declining sales or income in a recession or by high interest rates occasioned by inflation. To assess industry and economic conditions, most lenders maintain files of information—newspaper clippings, magazine articles, and research reports—on the industries represented by their major borrowing customers.

Factoid
Who is the number one originator of loans to households (consumers) in the United States?
Answer: Commercial banks, followed by finance companies, credit unions, and savings institutions.

Control

The last factor in assessing a borrower's creditworthy status is *control*. This factor centers on such questions as whether changes in law and regulation could adversely affect the borrower and whether the loan request meets the lender's and the regulatory authorities' standards for loan quality.

2. Can the Loan Agreement Be Properly Structured and Documented?

The six Cs of credit aid the loan officer and the credit analyst in answering the broad question: Is the borrower creditworthy? Once that question is answered, however, a second issue must be faced: Can the proposed loan agreement be *structured* and *documented* to satisfy the needs of both borrower and lender?

The loan officer is responsible not only to the borrowing customer but also to the depositors or other creditors as well as the stockholders and must seek to satisfy the demands of *all*. This requires, first, the drafting of a loan agreement that meets the borrower's need for funds with a comfortable repayment schedule. The borrower must be able to comfortably handle any required loan payments, because the lender's success depends fundamentally on the success of its customers. If a major borrower gets into trouble because of an inability to service a loan, the lending institution may find itself in serious trouble as well. Proper accommodation of a customer may involve lending more or less money than requested (because many customers do not know their own financial needs), over a longer or shorter period than requested. Thus, a loan officer must be a financial counselor to customers as well as a conduit for loan applications.

A properly structured loan agreement must also protect the lender and those the lender represents—principally depositors, other creditors, and stockholders—by imposing certain restrictions (covenants) on the borrower's activities when these activities could threaten recovery of the lender's funds. The process of recovering the lender's funds—when and where the lender can take action to get its funds returned—also must be carefully spelled out in any loan agreement.

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

Reasons for Taking Collateral

While large corporations and other borrowers with impeccable credit ratings often borrow unsecured (with no specific collateral pledged behind their loans except their reputation and ability to generate earnings), most borrowers at one time or another will be asked to

pledge some of their assets or to personally guarantee the repayment of their loans. Getting a pledge of certain borrower assets as collateral behind a loan really serves two purposes for a lender. If the borrower cannot pay, the pledge of collateral gives the lender the right to seize and sell those assets designated as loan collateral, using the proceeds of the sale to cover what the borrower did not pay back. Secondly, collateralization gives the lender a psychological advantage over the borrower. Because specific assets may be at stake (such as the customer's automobile or home), a borrower feels more obligated to work hard to repay his or her loan and avoid losing valuable assets. Thus, the third key question faced with many loan applications is, Can the lender *perfect* its claim against the assets or earnings of a borrowing customer?

The goal of a lender taking collateral is to precisely *define* which borrower assets are subject to seizure and sale and to *document* for all other creditors to see that the lender has a legal claim to those assets in the event of nonperformance on a loan. When a lender holds a claim against a borrower's assets that stands superior to the claims of other lenders and to the borrower's own claim, we say that lender's claim to collateral has been *perfected*. Lending institutions have learned that the procedures necessary for establishing a perfected claim on someone else's property differ depending on the nature of the assets pledged by the borrower and depending on the laws of the state or nation where the assets reside. For example, a different set of steps is necessary to perfect a claim if the lender has actual possession of the assets pledged (e.g., if the borrower pledges a deposit already held in the bank or lets the lender hold some of the customer's stocks and bonds) as opposed to the case where the borrower retains possession of the pledged assets (e.g., an automobile). Yet another procedure must be followed if the property pledged is real estate—land and buildings.

Key URLs
For an overview of modern loan risk evaluation techniques see, for example, **www.riskmetrics.com/sitemap.html** and **www.defaultrisk.com**.

Common Types of Loan Collateral

Examples of the most popular assets pledged as collateral for loans include the following:

Accounts Receivable. The lender takes a security interest in the form of a stated percentage (usually somewhere between 40 and 90 percent) of the face amount of accounts receivable (sales on credit) shown on a business borrower's balance sheet. When the borrower's credit customers send in cash to retire their debts, these cash payments are applied to the balance of the borrower's loan. The lending institution may agree to lend still more money as new receivables arise from the borrower's subsequent sales to its customers, thus allowing the loan to continue as long as the borrower has need for credit and continues to generate an adequate volume of sales and credit repayments.

Factoring. A lender can purchase a borrower's accounts receivable based upon some percentage of their book value. The percentage figure used depends on the quality and age of the receivables. Moreover, because the lender takes over ownership of the receivables, it will inform the borrower's customers that they should send their payments to the purchasing institution. Usually the borrower promises to set aside funds in order to cover some or all of the losses that the lending institution may suffer from any unpaid receivables.

Inventory. In return for a loan, a lender may take a security interest against the current amount of inventory of goods or raw materials a business borrower owns. Usually a lending institution will advance only a percentage (30 to 80 percent is common) of the estimated market value of a borrower's inventory in order to leave a substantial cushion in case the inventory's value declines. The inventory pledged may be controlled completely by the borrower, using a so-called *floating lien* approach. Another option, often used for auto and truck dealers or sellers of home appliances, is

called *floor planning*, in which the lender takes temporary ownership of any goods placed in inventory and the borrower sends payments or sales contracts to the lender as goods are sold.[4]

Real Property. Following a title search, appraisal, and land survey, a lending institution may take a security interest in land and/or improvements on land owned by the borrower and record its claim—a *mortgage*—with a government agency in order to warn other lenders that the property has already been pledged (i.e., has a lien against it) and to help defend the original lender's position against claims by others.

Concept Check

16–8. What are the typical steps followed in receiving a loan request from a customer?

16–9. What three major questions or issues must a lender consider in evaluating nearly all loan requests?

16–10. Explain the following terms: character, capacity, cash, collateral, conditions, and control.

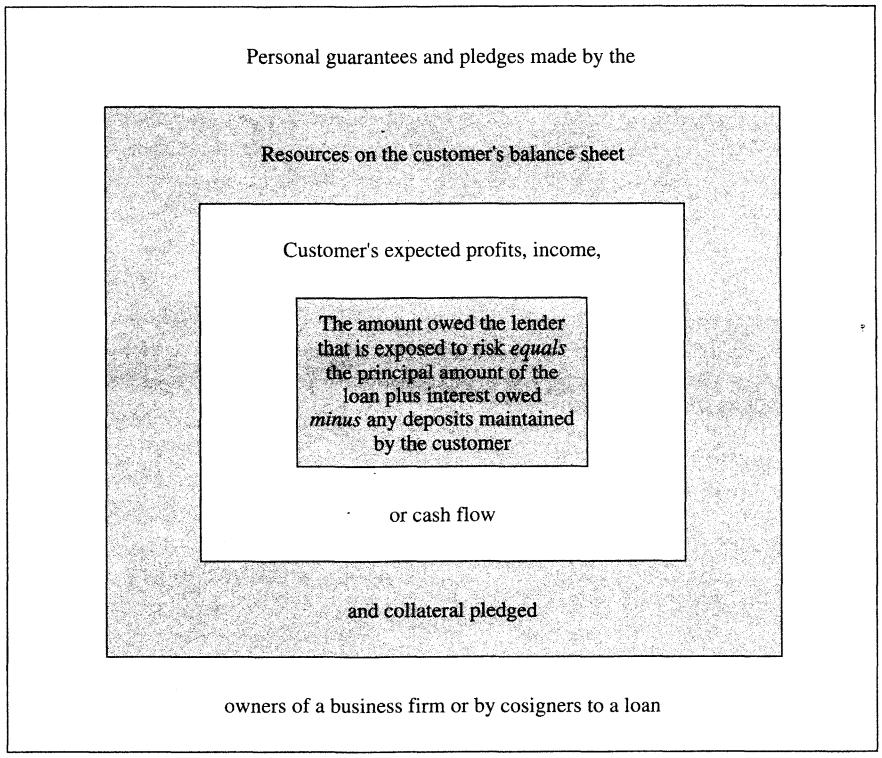
16–11. Suppose a business borrower projects that it will experience net profits of $2.1 million, compared to $2.7 million the previous year, and will record depreciation and other noncash expenses of $0.7 million this year versus $0.6 million last year. What is this firm's projected cash flow for this year? Is the firm's cash flow rising or falling? What are the implications for a lending institution thinking of loaning money to this firm? Suppose sales revenue rises by $0.5 million, cost of goods sold decreases by $0.3 million, while cash tax payments increase by $0.1 million and noncash expenses decrease by $0.2 million. What happens to the firm's cash flow? What would be the lender's likely reaction to these events?

For example, public notice of a mortgage against real estate may be filed with the county courthouse or tax assessor/collector in the county where the property resides. The lender may also take out title insurance and insist that the borrower purchase insurance to cover damage from floods and other hazards, with the lending institution receiving first claim on any insurance settlement made.

Personal Property. Lenders often take a security interest in automobiles, furniture and equipment, jewelry, securities and other forms of personal property a borrower owns. A *financing statement* may be filed with state or local government offices in those cases where the borrower keeps possession of any personal property pledged as collateral during the term of a loan. To be effective, the financing statement must be signed by both the borrower and an officer of the lending institution. On the other hand, a *pledge agreement* may be prepared (but will usually not be publicly filed) if the lender or its agent holds the pledged property, giving the lending institution the right to control that property until the loan is repaid in full. The various states in the United States have adopted the Uniform Commercial Code (UCC) which spells out how lenders can perfect liens and how borrowers should file collateral statements.

[4]Lenders seeking closer control over a borrower's inventory may employ *warehousing* in which the goods are stored and monitored by the lender or by an independent agent working to protect the lender's interest. (The warehouse site may be away from the borrower's place of business—a *field warehouse*.) As the inventory grows, warehouse receipts are issued to the lending institution, giving it a legal claim against the warehoused materials. The lender will make the borrower a loan equal to some agreed-upon percentage of the expected market value of the inventory covered by the warehouse receipts. When the public buys goods from the borrowing firm, the lender surrenders its claim so the company's product can be delivered to its customers. However, the customer's cash payments go straight to the lending institution to be applied to the loan's balance. Because of the potential for fraud or theft, loan officers may inspect a business borrower's inventory periodically to ensure the loan is well secured and that proper procedures for protecting and valuing inventory are being followed.

EXHIBIT 16–1
Safety Zones Surrounding Funds Loaned



Typically financial statements that detail collateral associated with a loan are filed in one location, such as the secretary of state's office in the debtor's home state.

Personal Guarantees. A pledge of the stock, deposits, or other personal assets held by the major stockholders or owners of a company may be required as collateral to secure a business loan. Guarantees are often sought in lending to smaller businesses or to firms that have fallen on difficult times. Then, too, getting pledges of personal assets from the owners of a business firm gives the owners an additional reason to want their firm to prosper and repay their loan.

Other Safety Devices to Protect a Loan

Many loan officers argue that the collateral a customer pledges behind a loan is just one of the safety zones that a lending institution must wrap around the funds it has loaned for adequate protection. As Exhibit 16–1 indicates, most loan officers prefer to have at least two safety zones—ideally, three—around the funds they have placed at risk with the customer. The primary safety zone is income or cash flow—the preferred source from which the customer will repay the loan. 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 in order to fill any gaps in the customer's cash flow. Finally, the outer safety zone consists of guarantees from a business firm's owners to support a loan to their firm or from third-party cosigners who pledge their personal assets to back another person's loan.

16–6 Sources of Information about Loan Customers

A lender often relies heavily on outside information to assess the character, financial position, and collateral of a loan customer (see Table 16–4). Such an analysis begins with a review of information the borrower supplies in the loan application. How much money is

TABLE 16–4
Sources of Information Frequently Used in Loan Analysis and Evaluation

Information about Consumers (Individuals and Families) Borrowing Money
Customer-supplied financial statements
Credit bureau reports on borrower credit history
Experience of other lenders with the borrower
Verification of employment with the consumer's employer
Verification of property ownership through local government records
The World Wide Web
Information about Businesses Borrowing Money
Financial reports supplied by the borrowing firm
Copies of boards of directors' resolutions or partnership agreements
Credit ratings supplied by Dun & Bradstreet, Moody's Investor Service, Standard & Poor's Corporation, Fitch, etc.
New York Times and *New York Times Index*
The Wall Street Journal, Fortune, and other business publications
Risk Management Associates (RMA) or Dun & Bradstreet industry averages
The World Wide Web
Information about Governments Borrowing Money
Governmental budget reports
Credit ratings assigned to government borrowers by Moody's, Standard & Poor's Corporation, etc.
The World Wide Web
Information about General Economic Conditions Affecting Borrowers
Local newspapers and the Chamber of Commerce
The Wall Street Journal, The Economist, and other general business publications
U.S. Department of Commerce
Central bank business data series (as in the *Federal Reserve Bulletin*)
The World Wide Web

being requested? For what purpose? What other obligations does the customer have? What assets might be used as collateral to back up the loan?

Key URLs
Among the most important Web sites for financial data and analysis of firms and industries of particular use to loan officers are Dun and Bradstreet at **www.dnb.com** and RMA at **www.rmahq.org/** (see Annual Statement Studies link).

The lending institution may contact other lenders to determine their experience with this customer. Were all scheduled payments in previous loan agreements made on time? Were deposit balances kept at high enough levels? In the case of a household borrower one or more *credit bureaus* will be contacted to ascertain the customer's credit history. How much was borrowed previously and how well were those earlier loans handled? Is there any evidence of slow or delinquent payments? Has the customer ever declared bankruptcy?

Most business borrowers of any size carry credit ratings on their bonds and other debt securities and on the firm's overall credit record. Moody's and Standard & Poor's assigned credit ratings reflect the probability of default on bonds and shorter-term notes. Dun & Bradstreet provides overall credit ratings for several thousand corporations. It and other firms and organizations provide benchmark operating and financial ratios for whole industries so that the borrower's particular operating and financial ratios in any given year can be compared to industry standards.

One of the most widely consulted sources of data on business firm performance is Risk Management Associates, founded as RMA in Philadelphia in 1914 to exchange credit information among business lending institutions and to organize conferences and publish educational materials to help train loan officers and credit analysts. While RMA began in the United States, its members have now spread over much of the globe with especially active groups in Canada, Great Britain and Western Europe, Hong Kong, and Mexico. RMA publishes several respected journals and studies, including *Creative Considerations*, *Lending to Different Industries*, and the *RMA Journal*, to help inform and train credit decision makers.

Another popular RMA publication is its *Annual Statement Studies: Financial Ratio Benchmarks*, which provides financial performance data on businesses grouped by industry type and by size category. Loan officers who are members of RMA submit financial performance information based on data supplied by their borrowing business customers. RMA

then groups this data and calculates average values for selected performance ratios. Among the ratios published by RMA and grouped by industry and firm size are

Current assets to current liabilities (the current ratio).

Current assets minus inventories to current liabilities (the quick ratio).

Sales to accounts receivable.

Cost of sales to inventory (the inventory turnover ratio).

Earnings before interest and taxes to total interest payments (the interest coverage ratio).

Fixed assets to net worth.

Total debt to net worth (the leverage ratio).

Profits before taxes to total assets and to tangible net worth.

Total sales to net fixed assets and to total assets.

RMA also calculates common-size balance sheets (with all major asset and liability items expressed as a percentage of total assets) and common-size income statements (with profits and operating expense items expressed as a percentage of total sales) for different size groups of firms within an industry. Recently the association began publishing a second volume of its statement studies series called *Annual Statement Studies: Industry Default Probabilities and Cash Flow Measures*, which reports on the risk exposure of about 450 different industries, estimates default probabilities for one- and five-year intervals, and tracks at least four different measures of cash flow—a key element in any lending decision.

Finally, RMA has offered lenders a Windows-based version of its statement studies series, called eCompare2, which permits a credit analyst or loan officer to do a *spreadsheet analysis*—arraying the loan customer's financial statements and key financial and operating ratios over time relative to industry averages based upon data from more than 150,000 financial statements. eCompare2 enables a loan officer to counsel his or her borrowing customer, pointing out any apparent weaknesses in the customer's financial or operating situation compared to industry standards. It also reports on recent developments in each of more than 600 different industries. This credit analysis routine is also available to business firms planning to submit a loan request to a lending institution so business owners can personally evaluate their firm's financial condition from the lender's perspective.

A similar array of industry data is provided by Dun & Bradstreet Credit Services. This credit-rating agency collects information on several million firms in more than 800 different business lines. D&B prepares detailed financial reports on individual borrowing companies for its subscribers. For each firm reviewed, the D&B *Business Information Reports* provide a credit rating, a financial and management history of the firm, a summary of recent balance sheet and income and expense statement trends, its terms of trade, and the location and condition of the firm's facilities. D&B calculates key ratios measuring efficiency, profitability, and solvency, as well as common-size balance sheets and income statements (with each entry expressed as a percent of total assets or total net sales) for the medium-size, or typical, firm and for the uppermost and lowest quartiles of firms in each industry.

In evaluating a credit application, the loan officer must look beyond the customer to the economy of the local area for smaller loan requests and to the national or international economy for larger credit requests. Many loan customers are especially sensitive to the fluctuations in economic activity known as the *business cycle*. For example, auto dealers, producers of farm and other commodities, home builders, and security dealers and brokers face cyclically sensitive markets for their goods and services. This does not mean that lending institutions should not lend to such firms. Rather, they must be aware of the vulnerability of some of their borrowers to cyclical changes and structure loan terms to take care

of such fluctuations in economic conditions. Moreover, for all business borrowers it is important to develop a forecast of future industry conditions. The loan officer must determine if the customer's projections for the future conform to the outlook for the industry as a whole. Any differences in outlook must be explained before a final decision is made about approving or denying a loan request.

16–7 Parts of a Typical Loan Agreement

The Note

When a lending institution grants a loan to one of its customers, such an extension of credit is accompanied by a *written contract* with several different parts. First, the **note,** signed by the borrower, specifies the principal amount of the loan. The face of the note will also indicate the interest rate attached to the principal amount and the terms under which repayment must take place (including the dates on which any installment payments are due).

Loan Commitment Agreement

In addition, larger business and home mortgage loans often are accompanied by **loan commitment agreements,** in which the lender promises to make credit available to the borrower over a designated future period up to a maximum amount in return for a commitment fee (usually expressed as a percentage—such as 0.5 percent—of the maximum amount of credit available). This practice is common in the extension of short-term business credit lines, where, for example, a business customer may draw against a maximum $1 million credit line as needed over a given period (such as six months).

Collateral

Loans may be either secured or unsecured. Secured loans contain a pledge of some of the borrower's property behind them (such as a home or an automobile) as **collateral** that may have to be sold if the borrower has no other way to repay the lender. Unsecured loans have no specific assets pledged behind them; these loans rest largely on the reputation and estimated earning power of the borrower. Secured loan agreements include a section describing any assets pledged as collateral to protect the lender's interest, along with an explanation of how and when the lending institution can take possession of the collateral in order to recover its funds. For example, an individual seeking an auto loan usually must sign a *chattel mortgage* agreement, which means that the borrower temporarily assigns the vehicle's title to the lender until the loan is paid off.

Covenants

Most formal loan agreements contain **restrictive covenants,** which are usually one of two types: *affirmative* or *negative*.

1. *Affirmative covenants* require the borrower to take certain actions, such as periodically filing financial statements with the lending institution, maintaining insurance coverage on the loan and on any collateral pledged, and maintaining specified levels of liquidity and equity.
2. *Negative covenants* restrict the borrower from doing certain things without the lender's approval, such as taking on new debt, acquiring additional fixed assets, participating in mergers, selling assets, or paying excessive dividends to stockholders.

Recently the use of loan covenants appears to be shrinking (especially for business loans), averaging only about 5 to 6 covenants per loan, due to intense competition among lenders, the sale of loans off lenders' balance sheets, and increased market volatility, making it harder for borrowers to meet performance targets.

Borrower Guaranties or Warranties

In most loan agreements, the borrower specifically *guarantees* or **warranties** that the information supplied in the loan application is true and correct. The borrower may also be required to pledge personal assets—a house, land, automobiles, and so on—behind a business loan or against a loan that is consigned by a third party. Whether collateral is posted or not, the loan agreement must identify who or what institution is responsible for the loan and obligated to make payment.

Key URL
For more information about loan accounting and disclosure of problem loans in an international setting, see especially **www.bis.org/publ**.

Events of Default

Finally, 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 lender is legally authorized to take in order to secure recovery of its funds. The events-of-default section also clarifies who is responsible for collection costs, court costs, and attorney's fees that may arise from litigation of the loan agreement.

16–8 Loan Review

What happens to a loan agreement after it has been endorsed by the borrower and the lending institution? Should it be filed away and forgotten until the loan falls due and the borrower makes the final payment? Obviously that would be a foolish thing for any lender to do because the conditions under which each loan is made are constantly changing, affecting the borrower's financial strength and his or her ability to repay . Fluctuations in the economy weaken some businesses and increase the credit needs of others, while individuals may lose their jobs or contract serious health problems, imperiling their ability to repay any outstanding loans. The loan department must be sensitive to these developments and periodically review *all* loans until they reach maturity.

While most lenders today use a variety of different **loan review** procedures, a few general principles are followed by nearly all lending institutions. These include:

1. Carrying out reviews of all types of loans on a periodic basis—for example, routinely examining the largest loans outstanding every 30, 60, or 90 days, along with a random sample of smaller loans.
2. Structuring the loan review process carefully to make sure the most important features of each loan are checked, including
   a. The record of borrower payments to ensure that the customer is not falling behind the planned repayment schedule.
   b. The quality and condition of any collateral pledged behind the loan.
   c. The completeness of loan documentation to make sure the lender has access to any collateral pledged and possesses the full legal authority to take action against the borrower in the courts if necessary.
   d. An evaluation of whether the borrower's financial condition and forecasts have changed, which may have increased or decreased the borrower's need for credit.
   e. An assessment of whether the loan conforms to the lender's loan policies and to the standards applied to its loan portfolio by examiners from the regulatory agencies.
3. Reviewing the largest loans most frequently because default on these credit agreements could seriously affect the lender's own financial condition.
4. Conducting more frequent reviews of troubled loans, with the frequency of review increasing as the problems surrounding any particular loan increase.

5. Accelerating the loan review schedule if the economy slows down or if the industries in which the lending institution has made a substantial portion of its loans develop significant problems (e.g., the appearance of new competitors or shifts in technology that will demand new products and delivery methods).

Loan review is *not* a luxury but a *necessity* for a sound lending program. It not only helps management spot problem loans more quickly but also acts as a continuing check on whether loan officers are adhering to their institution's own loan policy. For this reason, and to promote objectivity in the loan review process, many of the largest lenders separate their loan review personnel from the loan department itself. Loan reviews also aid senior management and the lender's board of directors in assessing the institution's overall exposure to risk and its possible need for more capital in the future.

16–9 Handling Problem Loan Situations

Inevitably, despite the safeguards most lenders build into their loan programs, some loans will become *problem loans*. Usually this means the borrower has missed one or more promised payments or the collateral pledged behind a loan has declined significantly in value. While each problem loan situation is somewhat different, several features common to most such situations should warn a lending institution that troubles have set in (see Table 16–5):

1. Unusual or unexplained delays in receiving promised financial reports and payments or in communicating with bank personnel.

TABLE 16–5
Warning Signs of Weak Loans and Poor Lending Policies

Source: Federal Deposit Insurance Corporation, *Bank Examination Policies*, Washington, D.C., selected years.

The manual given to bank and thrift examiners by the FDIC discusses several telltale indicators of problem loans and poor lending policies:

Indicators of a Weak or Troubled Loan	Indicators of Inadequate or Poor Lending Policies
Irregular or delinquent loan payments	Poor selection of risks among borrowing customers
Frequent alterations in loan terms	Lending money contingent on possible future events (such as a merger)
Poor loan renewal record (little reduction of principal when the loan is renewed)	Lending money because a customer promises a large deposit
Unusually high loan rate (perhaps an attempt to compensate the lender for a high-risk loan)	Failure to specify a plan for loan liquidation
Unusual or unexpected buildup of the borrowing customer's accounts receivable and/or inventories	High proportion of loans outside the lender's trade territory
Rising debt-to-net-worth (leverage) ratio	Incomplete credit files
Missing documentation (especially missing financial statements)	Substantial self-dealing credits (loans to insiders—employees, directors, or stockholders)
Poor-quality collateral	Tendency to overreact to competition (making poor loans to keep customers from going to competing lending institutions)
Reliance on reappraisals of assets to increase the borrowing customer's net worth	Lending money to support speculative purchases
Absence of cash flow statements or projections	Lack of sensitivity to changing economic conditions
Customer reliance on nonrecurring sources of funds to meet loan payments (e.g., selling buildings or equipment)	

2. For business loans, any sudden change in methods used by the borrowing firm to account for depreciation, make pension plan contributions, value inventories, account for taxes, or recognize income.
3. For business loans, restructuring outstanding debt or eliminating dividends, or experiencing a change in the customer's credit rating.
4. Adverse changes in the price of a borrowing customer's stock.
5. Losses in one or more years, especially as measured by returns on the borrower's assets (ROA), or equity capital (ROE), or earnings before interest and taxes (EBIT).
6. Adverse changes in the borrower's capital structure (equity/debt ratio), liquidity (current ratio), or activity levels (e.g., the ratio of sales to inventory).
7. Deviations of actual sales, cash flow, or income from those projected when the loan was requested.
8. Unexpected or unexplained changes in customer deposit balances.

Factoid
What are the principal causes of failure among banks and thrift institutions?
Answer: Bad loans, management error, criminal activity, and adverse economic conditions.

What should a lender do when a loan is in trouble? Experts in **loan workouts**—the process of recovering funds from a problem loan situation—suggest the following steps:

1. Lenders must always keep the *goal* of loan workouts firmly in mind: to maximize the chances for full recovery of funds.
2. Rapid detection and reporting of any problems with a loan are essential; delay often worsens a problem loan situation.
3. The loan workout responsibility should be separate from the lending function to avoid possible conflicts of interest for the loan officer.
4. Loan workout specialists should confer with the troubled customer *quickly* on possible options, especially for cutting expenses, increasing cash flow, and improving management control. Precede this meeting with a preliminary analysis of the problem and its possible causes, noting any special workout problems (including the presence of competing creditors). Develop a preliminary plan of action after determining the lending institution's risk exposure and the sufficiency of loan documents, especially any claims against the customer's collateral other than that held by the lender.
5. Estimate what resources are available to collect the troubled loan, including the estimated liquidation values of assets and deposits.
6. Loan workout personnel should conduct a tax and litigation search to see if the borrower has other unpaid obligations.
7. For business borrowers, loan personnel must evaluate the quality, competence, and integrity of current management and visit the site to assess the borrower's property and operations.
8. Loan workout professionals must consider all reasonable alternatives for cleaning up the troubled loan, including making a new, temporary agreement if loan problems appear to be short-term in nature or finding a way to help the customer strengthen cash flow (such as reducing expenses or entering new markets) or to infuse new capital into the business. Other possibilities include finding additional collateral; securing endorsements or guarantees; reorganizing, merging, or liquidating the firm; or filing a bankruptcy petition.

Of course, the preferred option nearly always is to seek a *revised loan agreement* that gives both the lending institution and its customer the chance to restore normal operations. Indeed, loan experts often argue that even when a loan agreement is in serious trouble, the customer may not be. This means that a properly structured loan agreement rarely runs into irreparable problems. However, an improperly structured loan agreement can contribute to a borrower's financial problems and be a cause of loan default.

Concept Check

16–12. What sources of information are available today that loan officers and credit analysts can use in evaluating a customer loan application?

16–13. What are the principal parts of a loan agreement? What is each part designed to do?

16–14. What is *loan review?* How should a loan review be conducted?

16–15. What are some warning signs to management that a problem loan may be developing?

16–16. What steps should a lender go through in trying to resolve a problem loan situation?

Summary

This chapter has focused on lending policies and procedures and the many different types of loans that lenders offer their customers. It makes these key points:

- Making loans is the principal *economic function* of banks and other lending institutions. Loans support communities and nations by providing credit to finance the development of new businesses, sustain existing activities, and create jobs for individuals so that living standards can grow over time.
- Lending is also *risky*, because loan quality is affected by both external and internal factors. *External factors* include changes in the economy, natural disasters, and regulations imposed by government. *Internal factors* affecting loan risk include management errors, illegal manipulation, and weak or ineffective lending policies.
- The risk of loss in the lending function is at least partially controlled by (*a*) *government regulation* and (*b*) *internal policies and procedures*. Regulatory agencies such as the FDIC send out teams of examiners to investigate the lending policies and procedures and the quality of loans within each lending institution. Among depository institutions today a five-point CAMELS rating system is used to evaluate the performance and risk exposure of lenders based upon the quantity and quality of their capital, assets, management, earnings, liquidity, and sensitivity to market risk.
- Risk is also controlled by creating and following written policies and procedures for processing each credit request. Written loan policies should describe the types of loans the lender will and will not make, the desired terms for each type of loan, the necessary documentation before approval is granted, how collateral is to be evaluated, desired pricing techniques, and lines of authority for loan approvals.
- Lenders consider multiple factors in approving or denying each loan request: (1) *character* (including loan purpose and borrower honesty); (2) *capacity* (especially the legal authority of the borrower to sign a loan agreement); (3) *cash* (including the adequacy of income or cash flow); (4) *collateral* (including the quality and quantity of assets to backstop a loan); (5) *conditions* (including the state of the economy); and (6) *control* (including compliance with the lender's loan policy and regulations).
- Most lending decisions center around three key issues: (1) Is the borrower creditworthy and how do you know? (2) Can the loan agreement be properly structured to protect the lender and the public's funds? (3) Can a claim against the borrower's assets or earnings be perfected in the event of loan default?
- Finally, a sound lending program must make provision for the periodic review of all outstanding loans. When this *loan review* process turns up problem loans, they may be turned over to a *loan workout* specialist who must investigate the causes of the problem and work with the borrower to find a solution that maximizes chances for recovery of funds.