A Loan Analysis Case Study
Track the Lifecycle of a Commercial Loan

- Discuss and gain an understanding of the 5 P’s of Credit;
- Analyze a recently originated loan for potential weaknesses / red flags;
- Review and re-evaluate the loan a year later;
- Discuss any needed modifications and the implications associated with those modifications.
5 “P’s” OF CREDIT

- People
- Purpose
- Payment
- Protection
- Prospects
Who is the borrower and what do they do?

- Type of Business/Industry
- Organizational Structure
- Payment History with Your Institution
- Credit Report
- Information from Other Lenders/Parties
PURPOSE

What will the money be used for?

- Purchase of Specific Assets
- General Working Capital
- Asset-Based Lending
- Refinance Other Debt
- Consistency with People
What are the terms of the debt and the borrowers ability/willingness to pay?

- Terms of Debt
- Source of Repayment
- Income to Debt
- Service Requirements
- Living/Other Expenses
- Other Sources of Income
- Consistency with People and Purpose
PROTECTION

What is the collateral, can we get it, and what would it be worth if we have to sell it?

- Lien Perfection
- Lien Position
- Access/Control
- Marketability
- Market/Liquidation Value
PROSPECTS

What is the likelihood of the borrower continuing to pay?

- Company Trends/ Future Prospects
- Industry Trends/ Future Prospects
- Economic Forecasts
- Succession/ Continuation Plans
- New Developments
- New Laws and Legislation
PROBLEMS

What actual or potential concerns or weaknesses exist?
Case Study

- Borrower – Shopping Center Plaza, LLC
- First State Bank
- $300 million asset size
- 2-rated overall and 2-rated asset quality
- Most recent Strategic Plan targets 10% loan growth for this year.
- Policy requires loans OVER $1 million need full Board approval. This loan was approved at Loan/Security Committee.
Nonaccrual Definition

Loan should be placed on nonaccrual if:

- Bank decides to maintain a loan on a cash basis because of deterioration in a borrower’s financial condition, or
- Payment in full of principal or interest is not expected, or
- Principal or interest has been in default for 90 days or more – unless the loan is well secured and in process of collection
Requirements for Loans on Nonaccrual

- Handle in accordance with GAAP (i.e., evaluate collectibility)
  - On a loan with sufficient collateral protection to cover principal and accrued interest, reversal of previously accrued interest is not required

- Acceptable treatment includes reversing all previously accrued interest
  - Credit accrued interest receivable
  - Debit interest income for uncollected year-to-date accrued interest
  - Debit the ALLL for uncollected prior year accrued interest if ALLL methodology considers the collectibility of accrued interest
When Can a Nonaccrual Loan Be Restored to Accrual Status?

- No principal and interest is due and unpaid, and repayment of remaining contractual principal and interest is expected, or

- Loan becomes well-secured and in the process of collection, or

- Loan not yet current but the borrower has resumed paying full contractual principal and interest payments, and
  - All payments contractually due are reasonably assured of repayment within a reasonable period, and
  - Sustained cash repayment performance in accordance with contractual terms for at least six months

Certain other situations are described in the Call Report instructions
**Troubled Debt Restructurings (TDR)**

- **For a loan to be a TDR, bank must**
  - Have granted a material concession, and
  - Concession due to troubled borrower condition

- **Implications for bank**
  - Call Reporting
  - Management Reporting
  - Impairment analysis required
Loan Impairment Process

- Determine “universe” of loans to be reviewed for impairment
- Review all such loans to identify which are considered to be impaired
- Determine appropriate method to calculate impairment for each impaired loan, including all TDRs
  - For collateral-dependent loans, only Fair Value of collateral method allowed
  - For noncollateral-dependent loans, can use either Present Value of Cashflows or Observable Market Value methods
- Calculate amount of impairment
- Make appropriate adjustment to general ledger and/or ALLL analysis
A loan is impaired when, based on current information and events, it is probable that a creditor (bank) will be unable to collect all amounts due (principal and interest) according to the contractual terms of the loan agreement.
Impairment Measurement Methods—

- Present value of expected future cash flows, discounted at loan’s effective interest rate (if loan is not collateral-dependent)
- Fair value of collateral (for collateral-dependent loans only)
- Observable market price (if loan is not collateral-dependent)
Collateral-Dependent

“A loan is Collateral-Dependent if repayment of the loan is dependent on the sale of the collateral as well as cases where repayment is dependent only on the operation of the collateral.”
Fair Value of Collateral Method

- When the bank uses the fair value of the collateral to measure impairment of an impaired collateral-dependent loan and repayment or satisfaction of a loan is dependent on the sale of the collateral, the fair value of the collateral shall be adjusted to consider estimated costs to sell. (i.e., if repayment is dependent upon sale of collateral, then amount that book value exceeds Fair Value less Costs to Sell must be charged-off)

- If repayment or satisfaction of the impaired loan is dependent only on the operation of the collateral rather than the sale of the collateral, the measure of impairment shall not incorporate estimated costs to sell. (i.e., if repayment is dependent upon operation of the collateral, then any amount that book value exceeds Fair Value must be reserved for)
Banks are required to document—

- How fair value was determined, including use of appraisals or other evaluations; timing and reliability of appraisals or other evaluations; valuation assumptions; and calculations
- Supporting rationale for adjustments to appraised values, if any
- Determination of costs to sell
- Appraisal quality, and the expertise and independence of the appraiser
Present Value of Future Cash Flows Method

Bank should document and support:

- Best estimate of expected future cash flows, discounted at the loan’s effective interest rate
- All assumptions and projections
- Evaluation of all possible outcomes (if using scenarios), with most weight given to the extent the evidence can be verified objectively
- Amount and timing of projected cash flows
- Effective interest rate used to discount the cash flows
- Basis for the determination of cash flows
Observable Market Price Method

- Amount traded in the market for a loan or loans with identical terms and risk
- Source, and date of observable market price should be documented
- Infrequently used
Once management measures an individually impaired loan for impairment, they should—

- Include in the calculation of the ALLL account the amount allocated for the individual loan’s impairment amount
- Charge-off any amount deemed a “confirmed loss”
- Re-evaluate the loan periodically and adjust the allocation for the loan in the ALLL account, as needed
Questions?
Thanks for Your Attendance!!!