Student Bank Loan Policy

PREFACE

This assignment is a combination of credit scoring *and* judgement. Many components in the answer sheet do not have one single answer, and your ability to make a judgement is part of the assessment. As long as you provide good arguments, you will receive marks.

Any omissions or inconsistencies in the loan application files are intentional and used to push you into a "judgement" mode. If you deem there are omissions or inconsistencies, it is prudent to follow up with the client in your answer sheet.

1. PURPOSE

The Board of Directors of Student Bank believes that sound loans are a desirable and profitable means of employing funds available for investment. The board recognizes that lending money necessarily includes reasonable business risks and thus formulates this policy to provide guidance and to control the quality of these major earning assets.

2. BASIC GUIDELINES FOR THE LOAN PORTFOLIO

- All loan decisions to be undertaken with sound credit analysis.
- Take loan documentation seriously.
- Aggressively seek good loan relationships.
- Interest rates and terms set in line with the market

Student Bank believes that a good loan relationship includes a good deposit relationship, so loan officers should strive to build a deposit relationship, as well as cross selling other bank services, with each loan customer.

3. EXTERNAL POLICY GOALS

Student Bank aims for a high level of public confidence. Each loan officer is responsible for doing everything possible to help maintain the Bank's reputation as a friendly and professional Bank that routinely delivers quality service to its customers and the communities it serves.

4. INTERNAL POLICY GOALS

Student Bank's objectives are to establish a sound loan portfolio that will consist of sound consumer, commercial, and real estate loans. These loans will be made on a non-discriminatory basis.

5. CONFIDENTIALITY

Student Bank considers the confidentiality and privacy of all customer information to be of prime importance. The cornerstone of Student Bank is the trust, confidence of its customers, and respect. To promote that trust, all information regarding the personal, business, and financial affairs of customers will be kept strictly confidential and not discussed with any outside parties.

6. EXCEPTIONS TO POLICY

Exceptions to loan policy are to be kept to a minimum and a request shall state the reason for the exception and loan officer's recommendation for handling the exception and rationale for granting the exception.

7. DEBT SERVICE COVERAGE

To ensure customers can repay their debt Student Bank has set a repayment condition known as the Debt Service Coverage. The Debt Service Coverage ratio stipulates that the total amount of monthly repayments (including the current loan application amount) cannot exceed a certain percentage of total monthly gross income. By default, the maximum level is 35% but there are exceptions listed further in this loan policy.

$$Debt\ Service\ Coverage\ ratio = \frac{Total\ amount\ of\ monthly\ repayments}{Total\ monthly\ gross\ income} < 35\%$$

$$Debt\ Service\ Coverage\ ratio = \frac{Existing\ monthly\ loan\ repayments + rent + monthly\ loan\ repayment\ on\ current\ loan}{Total\ monthly\ gross\ income}$$

where the “monthly loan repayment on current loan” is the monthly repayment on the loan listed in the loan application.

where total monthly gross income is the gross income from wages or income from self-employed activity and does not include investment income from shares and or rental properties. However, if the loan is for investment purposes, you need to include the potential new income from the investment in their total income to analyse the loan as well as existing investment income. Whenever there is a joint borrower or co-applicant the gross income is the sum of both individuals’ gross income.

The total amount of monthly loan repayments includes rental payments and 2.25% of credit card limits. A customer must not exceed 35% of their monthly gross income. In home mortgage loans where the Household Expenditure Measure justifies a higher loan amount, repayment can be 40% of total monthly gross income.

Loan repayments will be monthly for all loans and based upon either the loan term requested, or the maximum loan term, whichever is shorter. Consideration should be given to the life expectancy of the collateral.

8. HOUSEHOLD EXPENDITURE MEASURE (HEM)

This is the benchmark Student bank uses to estimate a loan applicant's annual expenses and becomes part of the calculation that determines borrowing capacity. The household expenditure estimate is based on a several things, including living in the state of NSW, the number of dependent children and their lifestyle across three categories: Basic, Moderate and, Lavish. This is a guide to help bank lending officers look at loan amounts. The Debt Service Coverage measure takes priority over this HEM measure except in home mortgage loans where the HEM justifies a higher loan amount, in which case repayment can be 40% of total monthly gross income. The basic lifestyle estimates the annual expenses of an individual at \$32,400. Families are in the moderate range with higher spending. In using these guidelines loan officers need to be careful in making assumptions about the borrower's spending.

$$HEM = gross\ income - tax - living\ expenses$$

To estimate the applicant's lifestyle the loan officer may take into account all information listed in the loan application, such as but not limited to the amount of outstanding credit card debt compared to the credit card limit and the value of their home and car compared to their income.

	Basic		Moderate		Lavish	
Gross income	**Living expenses**	**Borrowing limit**	**Living expenses**	**Borrowing limit**	**Living expenses**	**Borrowing limit**
<\$40,000	32,400	60,000	N/A	N/A	N/A	N/A
\$40,000	32,400	60,000	N/A	N/A	N/A	N/A
\$50,000	32,400	170,500	\$39,000	89,000	N/A	N/A
\$60,000	32,400	230,500	\$39,000	137,430	N/A	N/A
\$70,000	32,400	300,000	\$40,100	200,400	N/A	N/A
\$80,000	32,400	340,000	\$41,200	\$266,900	\$50,000	\$195,900
\$90,000	32,400	415,000	\$43,500	\$335,500	\$50,000	\$260,500
\$100,000	32,400	485,000	\$45,360	\$405,500	\$58,320	\$327,000
\$125,000	32,400	645,500	\$50,360	\$554,700	\$68,320	\$465,600
\$150,000	32,400	817,500	\$55,360	\$677,900	\$78,320	\$538,600
\$200,000	32,400	1,144,000	\$60,360	\$968,500	\$88,320	\$792,800
\$500,000	32,400	3,140,500	\$70,360	\$2,806,967	\$108,320	\$2,472,763

Table: Household Expenditure Measure

The borrowing limit may be interpolated using the lower and upper limit on gross income, or rounded down to the nearest gross income. The latter option is more prudent but in some cases, for example when the Debt Service Coverage ratio is low, interpolation may be used. Loan officers should clearly mention the use of interpolation in the loan application answer sheet. Note that linear interpolation is not a requirement but a choice.

The loan officer must evaluate the customers' ability to repay all their debts. The annual total loan repayment of a customer including the new loan and rental obligations should not be greater than 35% of the customer's total income except in the case of a home loan (Debt Service Coverage ratio).

The Household Expenditure Measure assumes standard tax rates and calculates the amount of money left over to serve a debt. Use personal income tax rates for residents in Australia.[1]

Example: A gross income of $80,000 less the tax payable of $16,467 and less the basic living expense of 32,400 leaves $31,133 per year to service repayments of loans. The HEM is $31,133.

Whenever there is a joint borrower or co-applicant the gross income is the sum of both individuals' gross income. Their net income is the sum of each individual's net income. The tax rate applies to the individual's gross income only.

Example: Individual 1 has gross income of $80,000 and individual 2 has gross income of $50,000. Their combined gross income is $130,000. To calculate their combined net income we use the following formula: [($80,000 X (1 – tax rate)) + ($50,000 X (1 – tax rate))].

Whenever there is a joint borrower or co-applicant we use the sum of both individuals' gross income to look up the corresponding expenses in the table. Let's call these expenses X. To calculate the HEM, loan officers would proceed as follows:

- Individual 1 net income = individual 1 gross income - individual 1 taxes - (1/2 X)
- Individual 2 net income = individual 2 gross income - individual 2 taxes - (1/2 X)
- HEM = individual 1 net income + individual 2 net income.

9. TYPES OF CREDIT AVAILABLE

A. Consumer mortgage-Instalment Loans

1. Loans for new and used vehicles/consumer mortgage

Deposit minimums:

- cars including small utilities and station wagons 10% deposit;
- motorcycles and boats 20% deposit;
- trucks and campers 25% deposit;
- caravans: a customer may borrow up to 75% of the purchase price or appraised value, whichever is lower.

When a customer has a trade-in on a purchase, the value of the trade-in can be counted as part of the deposit on the purchase (see also FAQ).

Interest rates

The applicable interest rate is to be worked out from the first sheet (Sb rate sheet) on the set of loan applications:

- Interest rate new: applies to new vehicles.
- Interest rate used: applies to used vehicles. Any vehicle older than 1 year can be assumed to be used.

[1] Available at https://www.ato.gov.au/rates/individual-income-tax-rates/

2. Personal/household items loans

Interest rates

The applicable interest rate is to be worked out from the first sheet (Sb rate sheet) on the set of loan applications:

- Interest rate new: applies to new personal/household items.
- Interest rate used: applies to used personal/household items. Any personal/household items older than 1 year can be assumed to be used.

3. Home equity and home improvement loans

Customers may borrow up to 70% of value of their home less the outstanding balance owed to the first lienholder. Where the loan is over 50% of the client's estimated value of the home the home must be valued. The customer must pay for an appraisal.

4. Unsecured loans (borrower doesn't provide collateral)

It is expected in certain situations that loans will be made by the bank on an unsecured basis. In this case the loan is issued without any collateral and is also based on the character of the borrower. Unsecured lending is appropriate only when a borrower's capital, liquidity, historical operating performance, indicate that such an extension of credit is proper. The repayment of an unsecured loan should be well identified. Generally, unsecured loans should be limited to 30% of the borrower's net worth with a maximum unsecured amount of $40,000.

A debt consolidation loan is used to pay back the balance on all other debt (loans and credit cards). Thus, if the debt consolidation loan is granted, all other debt (loans and credit cards) are cancelled.

Credit cards are unsecured lending. The maximum limit on a new credit card is $35,000. The regular monthly repayments on a credit card are calculated as monthly payments and are 2.25% of the credit limit (<u>not</u> the outstanding balance) or $25, whichever is greater. Credit cards do not have a maturity, i.e. we assume monthly repayments continue indefinitely.

For existing credit cards (client liabilities), regular monthly payments are calculated at 2.25% of the credit limit (<u>not</u> the outstanding balance) or $25, whichever is greater. The 2.25% applies to credit cards issued by any bank, and not limited to Student Bank credit cards.

5. Secured loans (borrower provides collateral)

In a secured loan the borrower pledges as security something of value greater than the loan amount. The collateral can be sold should the customer default on their loan obligation. First liens only will be accepted for car, truck, boat, motorcycle, camper, caravans and recreational vehicle loans plus required insurance coverage (collision and comprehensive) must be carried. In addition to the purpose of the loan and the anticipated source of repayment, secured extensions of credit must be structured in accordance with the nature and useful life of the collateral.

B. Residential Real Estate Loans

The bank should grant residential real estate loans with the ability to offer competitive, long-term, interest only (if requested), and fixed-rate for first 5 years of mortgage. An important aspect when assessing residential real estate loans is the loan-to-value ratio (LtV). The loan-to-value ratio (expressed in %) is the loan amount relative to the value of the residence:

$$Loan - to - Value = \frac{Loan\ amount}{Value\ of\ the\ residence}$$

For example, if the applicant requests a $150,000 loan for a house worth $250,000, then the LtV ratio is ($150,000/$250,000 =) 60%.

Loan to Value Ratios should not exceed 90%. Borrowers are required to provide their down payment (deposit) prior to the Bank extending loan advances. Mortgages will be made available with maturities up to 30 years.

- Loans for primary residences (owner occupiers) cannot exceed 90% of the sale price or the appraised value whichever is lower.
- Loans for secondary residences cannot exceed 80% of the sales price or appraised value whichever is lower. The amount borrowed for refinanced loans with the customer taking cash out cannot exceed 80% of the appraised value. The applicant's Debt Service Coverage ratio must be 40% or lower.
- Loans for investment purposes, (non-owner occupied) may not exceed 80% of the sales price or appraised value, whichever is lower. The minimum mortgage amount is $40,000.

<u>Interest rates</u>

The floor interest rate on all mortgages is set by the bank. Given the long maturity of residential real estate loans (up to 30 years), the loan officer must apply the “rate for loans” from the first sheet (Sb rate sheet) on the set of loan applications. The rate for loans is deliberately higher compared to the current interest rate to account for any future increases in benchmark interest rates.

10. CREDIT SCORING SYSTEM

Student bank uses its own credit score to determine the acceptability of loans and rates for loan products. Credit scoring is conducted using the *Student Bank Credit Scoring.pdf*. The calculated credit score is compared to the bank’s cut-off points for the classification of prime borrowers, subprime borrowers, and rejected loan applications. The cut-off points can be found in the Sb rate sheet in the loan application file.

Whenever there is a joint borrower or co-applicant, the credit score will be based on the higher of the two scores. When there is an applicant and co-signer or guarantor, the credit score will be based on the applicant's score only.

Any customer may be considered a risk if there is a court judgment, charge-off, or collection account against that person. This would have to be disclosed in the loan application. If the credit check confirms that a financial judgment, charge-off, or collection account exists, the loan should be rejected. Prime customers are rewarded with a prime interest rate. A sub-prime customer will be charged between 0.5 to 1 percentage point over the standard rate as assessed by the lending officer.

The lending officer has complete discretion over the surplus percentage point they apply in the 0.5-1 percentage point range, except in the case of rejected loan applications. If the loan application is rejected, loan officers must apply the 1 percentage point surplus.

The bank obtains credit scores on customers from external providers where possible but these may not generally fall within the same rating as Student Bank's segments.

11. LOAN CRITERIA AND TERMS

All loans should have a reasonably identified purpose.

For self-employed customers financial statements must be current financial statements and support loans for the borrower and/or guarantor. The statements must be signed by the borrower or shall be prepared by a well-regarded independent certified public accountant. Were payslips are provided original documents must be sighted or letter from employer stating pay for customer

A loan officer must review the following items when a loan application is requested: the loan amount, the security offered (if any), the total monthly amount of financial obligation, the monthly income (only include spouse's income if the spouse is a joint borrower or co-applicant), the credit history, if the application is filled out completely. Care needs to be exercised in lending to customers with short employment history, typically under 24 years of age and customers over 55 years of age depending on the loan product. Loan officers need to ensure the loan will be repaid before the customer turns 70.

12. CALCULATING MONTHLY REPAYMENTS

The loan officer must calculate the monthly repayments on the loan. The procedure involves the use of the "=PMT" formula in Microsoft Excel:

$$= PMT(\frac{A}{12}, (B * 12), -C)$$

where A = the yearly interest rate;

B = the number of years;

C = the loan amount.

This formula yields the monthly repayment. Loan officers may verify calculations with online loan repayment tools.

13. REPAYMENTS

Loans should be made only when a specific source of repayment can be identified and agreed upon by the bank and the borrower. The primary source should be the borrower's income and cash flow; the secondary source should be collateral liquidation; and a guarantor is best thought of as the source of last resort. It may be necessary to change the term to obtain satisfactory lower repayments.

14. COLLATERAL

In the event of non-payment, the loan's collateral becomes significant. The liquidity, marketability, and value of the collateral are all important considerations. Loans should be amortized so that adequate collateral value is maintained throughout the loan period.

15. GUARANTEES

Where the loan to the borrower will be strengthened by the use of a guarantee of a financially responsible party, then a guarantee may be used. In cases where a loan is made with heavy reliance on the strength of the guarantor, strong consideration should be given to the guarantor's ability to pay out of income and not on the liquidation of assets.

16. NON-DESIRABLE LOANS

Loans of the following types are non-desirable loans and should normally be denied:

1. Loans to a customer where the loan cannot be repaid within a reasonable period except by liquidating the assets or borrowing elsewhere.
2. Loans of purely speculative nature.
3. Loans that involve "self-dealing" or conflicts of interest.
4. Loans for illegal activities
5. Loans for used vehicles/boats over ten years old
6. Loans for personal or household items older than 4 years
7. Loans to customers aged over 70 years
8. Loans to customers aged under 18 years

17. FAQ

- **If the credit score is too low to accept the loan, does the loan officer still need to complete the loan application answer sheet?**
  Yes, the loan application answer sheet is an important document, regardless of whether the loan is accepted or rejected. The document needs to be completed as part of the bank's compliance requirements, and to justify the loan decision to the client.

- **If the loan term requested exceeds the maximum term allowed for this type of loan, which loan term is applied to calculate monthly loan repayments?**
  In this case, the loan application will be rejected. Loan officers need to apply the maximum term allowed by the Student Bank loan policy to calculate monthly repayments.

- **What happens if the applicant does not provide a deposit amount in the application sheet and the Loan Policy stipulates a minimum deposit percentage for this type of loan?**
  If no deposit is shown in the loan application, then it would be prudent to either
  - Make sure that a deposit will be provided. Write in the recommendation that the application will be approved (provided all other criteria are met) conditional on the client

providing the minimum deposit. You can verify whether they have sufficient cash/deposit reserves by looking at their list of assets.

And/or

- follow-up with the client. Write this in the recommendation.

- **Can you give an example of how a trade-in would work, and how that relates to the deposit amount and % of purchase price?**
  When a client applies for a loan to purchase, say, a vehicle, they can decide to trade in their existing (old) vehicle. The trade-in value of the existing vehicle will be added to the deposit amount the client provides.

  For example, the new vehicle costs $90,000. The old vehicle has a trade-in value of $30,000 and the client requests a $50,000 loan. The deposit listed in the application sheet is $10,000.

  Their total deposit adds up to (trade-in value + cash deposit) = $30,000 + $10,000 = $40,000.

- **I have doubts about the information a client has provided / The loan application seems to have insufficient information to make a fair judgment. What should I do?**
  In this case, make a note in the recommendation that you would need more information from the client, and be specific about the type of information you are looking for.

- **My applicant requests a debt consolidation loan for an amount that is smaller than the sum of their outstanding liabilities. Should this loan be rejected? On which amount do I base the monthly loan repayments?**
  It is unclear whether the loan would have to be rejected straightaway. If the deposit provided by the client makes up the difference between the debt consolidation loan and their outstanding debt, then there is no issue. If no deposit is provided in the loan application, then it would be prudent to
  - assume that a deposit will be provided if the client's assets allow it (write this in the recommendation).
  - follow-up with the client (write this in the recommendation).

  Monthly loan repayments would be based on the requested loan amount (if it fits within Student Bank's allowed limits).

- **My applicant applies for a second mortgage, i.e. they are buying a second property while still repaying their first mortgage. How should I treat their existing loan payments?**
  It depends on whether the applicant is selling their first home or not:
  - If the applicant sells their first home, the existing loan repayments will cease.
  - If the applicant doesn't sell their first home, the existing loan repayments will continue.

- **My applicant has dividend income and this is relevant for the loan application. How should I calculate the dollar amount?**
  You multiply the value of the shares by the listed percentage yield. For example, if the client's shares have a market value of $10,000, and the dividend yield is 2%, then their dividend income is $10,000 X 0.02 = $200 on an annual basis.

- **How can I know if a vehicle is new or used?**
  Some application files explicitly state that a vehicle is "used", while others do not explicitly mention the state of the vehicle. If there is no explicit mention of "used", then we can look at the build year of the vehicle. If the model year is 2018 or earlier, we can assume the car is used.

- **My applicant applies for a first mortgage and they are currently paying rent. Do I need to include the rental payments in the applicant's existing loan payments and rental obligations?**
  Yes.

- **My applicant applies for a first mortgage and they are currently paying rent. Do I need to include the rental payments in the applicant's total repayments of loans and rental obligations?**
  No. Going forward, the applicant moves to their own home and rental payments are no longer due.

18. CONTACT

If you have any further questions, you can contact me at wendy.zheng@uts.edu.au. Please observe the following:

- Make sure to mention your loan application file number and the customer number.
- In the context of the HEM calculation, no comments will be provided on the lifestyle of clients. All information and examples are included in the Student Bank Loan Policy.pdf. Remember: this assignment is a combination of credit scoring *and* judgement. As long as you provide good arguments, you will receive marks.
- In the context of the credit score calculation, no comments will be provided on the classification of individual professions into the bank's "customer occupation" categories. Remember: this assignment is a combination of credit scoring *and* judgement. As long as you provide good arguments, you will receive marks.