COMMERCIAL LOAN PACKAGES AND CREDIT WRITE UP

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Commercial Loan Package

- Before submitting a loan request for approval, the business banker reviews the customer's credit file and evaluates the information in notes, e-mails, credit reports, financial spreadsheets, and other materials according to basic measures of creditworthiness.
- This gives the lender a chance to discover unanswered questions.
- A review of the findings during the business development call and credit investigation helps answer questions about character, the first of the "Five Cs of Credit".
- Financial analysis helps answer questions about capacity and capital.
- Business development calls, credit investigation and financial analysis help resolve questions about conditions and collateral.
- it is important to list the financial strengths and weaknesses of the borrower and determine if the margin between the two is sufficient to outweigh the uncertainties posed by the loan.
- All these analysis and support documents submitted for approval of the loan comprise of the commercial loan package.

Functions of a Loan Package

- **Evidence and date of approval**—Even if a committee is involved in the loan approval and the committee has a secretary that takes minutes, the loan package usually serves as the evidence of loan approval by the committee. The committee minutes reference the loan package for complete details beyond the brief summary provided by the secretary. In direct sign-off situations, it usually is the only evidence of approval.
- **Details about the terms and conditions approved**—The written package provides information about the request and any terms or conditions of approval. This document becomes the basis for a commitment letter to the customer, instructions for bank staff involved in loan documentation, plus directions for monitoring the credit relationship beyond the approval of this request.

Functions of a Loan Package

- **Summary of the entire borrowing relationship and total aggregate credit exposure to the borrowing entity and any legally related entities**—Banks generally have two limits regarding the amount of credit exposure they can have to any single entity or group of legally-related entities—a "regulatory limit" and a "house limit."
  - The *regulatory limit* is established by law and is based on a bank's capital; sometimes called the "legal lending limit" of the bank
  - The *house limit* is established by the bank's board of directors and is always lower than the regulatory limit

The loan package establishes compliance with these two lending restrictions by providing a summary of the entire credit relationship of the lending bank with the borrower, any legally related businesses and any guarantors.

Functions of a Loan Package

- **Analysis of quantitative and qualitative factors, along with a risk rating assignment**—For loan monitoring and loan portfolio management purposes, most banks assign a risk rating on a loan-by-loan basis to commercial loans. Using a checklist/grid or written narrative, the loan package provides the basis for assigning the risk rating, which can be confirmed or changed during the approval process.

Components of a Commercial Loan Package

- **Cover pages or loan request summary**—Usually one or two pages of fill-in-the-blanks or various grids, cover pages summarize the terms and details of the borrower, loan(s) requested, plus the banking relationship.

  Example Loan Request Summary.docx

- **Credit application or credit memorandum**— This is the main body of loan package where all the analyses and recommendations are made. Because most memorandum formats require some of the loan terms and conditions to be repeated from the cover pages, it is important for the relationship manager to use the memorandum to explain the basis for any unusual terms, or terms that are not entirely explained within the cover pages.
  - However, avoiding repeated information from the cover pages is a key objective to keep in mind when writing the loan memorandum.
  - The memorandum length and the items it covers depend on the size and complexity of the credit request.

Components of a Commercial Loan Package

- **Financial spreads and other attachments**—The third major component of a commercial loan package is the financial information needed for the approval. Most banks seek to avoid having so many attachments that the loan package becomes too large and hinders the decision-making process.
- To achieve balance between providing too much or too little information, most banks limit attachments to spreads of business financial data plus summaries of any relevant pro forma statements. The key objective is to provide summary data and to avoid attaching the raw financial data to the loan package. In some situations, an actual financial statement or a portion may need to be attached, but this should be very infrequent.

General Memorandum Guidelines

Beyond the outline of suggested topics or issues to cover, a business banker should also follow these general guidelines for composing a loan memorandum:

- Focus more time on items not discussed or clearly shown on the cover pages or loan request summary
- Clearly indicate the key risks in the proposed lending arrangement, including known policy exceptions, unusual issues with the credit, or deviations from prudent lending
- Beyond citing the repayment plan and primary sources of repayment, discuss why the repayment plan is realistic
- Beyond citing collateral and collateral values, tell why the bank is properly and adequately secured

General Memorandum Guidelines

- Discuss specific items that help to mitigate the known policy exceptions or key risks
- If loan terms are being modified, provide the existing terms
- If the credit has experienced problems and may not meet lending guidelines, clearly note any improvements in the borrower's financial condition or the bank's collateral position that justify continuing the relationship
- When communicating financial information:
  - **No naked numbers**—Where numerals are used, they should always be accompanied by the following:

Rs.	Rs.1,000 use commas	
%	14.5%	one decimal point is usually enough
d	43d	days
x	1.75x	times, same as 1.75:1.00
m	25m	million
bp	35 bp	basis points, same as 0.35%
sf	500 sf	square feet

General Memorandum Guidelines

When communicating financial information:

- **Keep comparisons parallel**—In discussing financial trends, a business banker often will need to compare between time periods. changing the order around when making such lists or comparisons confuses the readers and slows down the decision-making process. Consider the following examples:
  - Mr. Hari built three homes in 2016, and in 2017 he built five
  - Mr. Hari built three homes in 2016 and increased to five homes in 2017 (*better)*
  - Accounts receivable turnover was 43d at 15/07/2016, and at 15/07/2017 it was 55d
  - Accounts receivable turnover was 43d at 15/07/2016, and 55d at 15/07/2017 (*better*)

While there is nothing wrong with the first sentence of both comparisons, the second sentence does a better job of allowing the reader to make the comparison.

General Memorandum Guidelines

When communicating financial information:

- **Keep rounding consistent**—The size of a loan request and magnitude of the financial data may warrant rounding of rupees amounts within both the loan request summary and the loan memorandum. A lender should use the style preferred by the bank, and also be careful to be consistent throughout the loan package, such as the following examples:
  - Rental income for 2016 was Rs.1.05m while net operating income was Rs.53k
  - Rental income for 2016 was Rs.1,051k while net operating income was Rs.53k (*better*)
  - Rental income for 2016 was Rs.1,051,000 while net operating income was Rs.53,000 (*takes the M/K confusion away*)

General Memorandum Guidelines

When communicating financial information:

- **Distinguish points in time versus periods of time**—Some financial ratios compare rupee amounts as of a specific date, while others use amounts representing a period of time. In general, the various liquidity ratios and financial leverage ratios are for a point in time. Profitability ratios and debt service coverage ratios a period of time. Efficiency ratios use both balance sheet and income statement accounts and are usually treated as a point in time, such as the following example:
- Rental income for 15/07/2016 was Rs.1,051,000 (*Boy, what a day!*)
- Rental income for 2016 was Rs.1,051,000 (*better*)
- Rental income for FY 2016 was Rs.1,051,000. For the fiscal quarter ended 15/10/2017, rental income was Rs.313,000. (*for an odd fiscal period, using "FY" for fiscal year*)

General Memorandum Guidelines

When communicating financial information:

- **Efficiency and other ratios: clarify what is “good” and what is “bad”—** For some ratios, a higher value can indicate improvement, while for others a lower value can indicate improvement.

  For example, in general, a higher current ratio indicates improved liquidity of the business. However, in general, lower leverage is an improvement. A business banker should try to use words like "improve" or "more/less efficient" when discussing many ratios.

- **Avoid “elevator” prose—**This is perhaps the most common issue. Simply talking in terms of financial amounts and ratios “going up” or “going down” invokes visions of an elevator. The business banker’s job is to find out and discuss in the loan package the reasons, or “drivers,” for an increase and decrease, and to relate the various financial amounts and ratios to the qualitative factors.

Writing a Credit memorandum

- Borrower:…………………. Date…………………………….

(Identify the borrowing entity by its exact legal name. Further identify the borrower with an abbreviation, short name or initial to be used in remainder of memo, if needed)

Transaction summary

- Describe the amount, type, terms, repayment agreement, interest rate and fees, collateral and purpose. If these items are need further explanation, be brief and focus on why these items are being proposed
- Identify any guarantors and the extent of guarantees (usually unconditional and unlimited—otherwise, describe any limitations)
- If a renewal and any terms are being changed, identify the existing terms
- If a renewal, identify the original amount and date of the loan. For lines of credit, provide a chart or identify usage levels (high, low and average balance)
- If a new customer relationship, identify how we obtained the opportunity

Writing a Credit Memorandum

Transaction summary contd.

- Outline any conditions precedent to funding or closing
- Identify any loan policy waivers or exceptions to be approved
- Identify any deviations (that may not be actual policy exceptions) from normal lending practices
- Outline any loan covenants or other forms of monitoring that are being proposed, as well as financial reporting (business and personal) to be required, such as tax returns, financial statements, and level of auditors required.
- *Overall, this section summarizes the credit request in a <u>brief</u> format. A separate paragraph is suggested for each credit; however, common features of each credit [such as guarantor(s) or financial reporting requirements] can be identified in one paragraph. It is important to identify key issues and save explanations for other sections of the memo. Bullet points are acceptable.*

Writing a Credit Memorandum

Background/Sponsorship

- Provide a brief history of the borrower and its line of business, products and services
- Identify the entity's legal structure (partnership, partnership, private company etc.)
- Identify the owner(s) and the percentage(s) of ownership
- Provide brief background(s) of owner(s), with attention to experience directly applicable to the loan request
- Identify key employees, managers, and professional advisors (auditors, attorney, etc.)
- Draw conclusions about integrity, competency, adequacy, depth and succession plan of management

Writing a Credit Memorandum

Banking relationship

Describe the deposit relationship and all significant credits with a summary of your bank's payment experience, plus comments on adequacy of collateral (LTV, DSC), plus utilization of credit facilities, account conduct, group relationship, reports submission, covenants compliance and banks past and projected profitability from this relationship. etc.

This is not intended to be a duplication of the information on the loan approval form. Instead, it is a narrative description of the extent and type relationship that the borrower has with your bank—including the length of time—in order to convey the relative importance of the customer to your bank.

Exposure and relationship with other banks

- Discuss if the borrower has borrowing or deposit relationship with other banks and its effect on our relationship. If for a new borrower, explain how the relationship started.

Facility Structure

- Discuss how the proposed facility/ies are a correct match for the customer's needs.

Writing a Credit Memorandum

Industry and market analysis

- Summarize the type of industry the borrower is in
- Identify unique industry risks or trends
- Discuss competitive issues that affect the borrower

Writing a Credit Memorandum

- **Financial Analysis**
- Provide a full discussion of the strengths, weaknesses, and trends of the following financial statements:
  - Income statement
  - Balance sheet
  - Cash flow
- Include partial information or tables derived from the financial statement spreads (that are attached to the memorandum) for significant items that directly affect the proposed loan or overall financial performance, such as accounts receivable and inventory turnover, margins, sales growth, working capital, balance sheet leverage, asset quality and financing mismatch
- If financial covenants are proposed, discuss the historical values for these ratios or measures

Writing a Credit Memorandum

Financial Analysis contd.

- Focus on the ability of the borrower to repay existing obligations from internally generated cash flow. This includes fully detailing significant obligations, including principal amounts due each year, pending balloon maturities, drawn and undrawn lines of credit, and any outstanding guarantees, L/Cs etc.
- Address usual or recurring capital expenditures and the ability of the borrower to fund them from internally generated cash flow.
- Discuss any related party transactions, eg. dividend distribution.
- *You should obtain full financial information on any <u>materially</u> related businesses and briefly summarize the financial condition.*

Writing a Credit Memorandum

Pro Forma Debt Service Coverage (or Primary Source of Repayment Analysis)

- Analyze "pro forma" or projected debt service coverage (DSC) based on funding and repayment of new debt and reasonable projection of cash flow available for debt service
- Use historical operating results or analyze projected financial results. The purpose of this section is to clearly demonstrate the capacity of the borrower to repay the loan under normal or expected conditions with reasonable range. Discuss key assumptions made and why do you think they are realistic.
- Stress test the projections to determine the extent to which the projections may fall below expectations while allowing the borrower to continue to meet its financial obligations

Writing a Credit Memorandum

Collateral or Project Analysis

- Provide a detailed description of the collateral, its location and value
- Describe the valuation method and source
- Establish a most likely value of the collateral at the time of default as opposed to at the time the loan is granted. Discuss how the bank will be protected if the realistic realizable value is less than the loan.
- Outline any potential difficulties associated with monitoring, obtaining control or possession of the collateral or with liquidating the collateral
- Discuss why and how the collateral adequately secures the loan.

Security Risk Assessment.docx

Writing a Credit Memorandum

Guarantor Analysis

- Discuss the following overall financial condition of any guarantors and relate this to their existing debt and the proposed new loan(s), including amounts, composition, and trends of:
  - Liquid assets
  - Non-marketable securities or ownership in related businesses

    (We should obtain full financial information on any material, related businesses and briefly summarize the financial condition)
  - Real estate assets, including personal residence
  - Other significant assets
  - Amount and type of significant liabilities
  - Any material contingent liabilities
  - Income, and cash flow items
- Compute and discuss the net worth of each guarantor

Writing a Credit Memorandum

Key Risks and Mitigating Factors

- List the most important risks that could prevent orderly repayment of the loan and describe the mitigating factors that apply to each risk. Show how the risks are made acceptable by these factors or other elements of the loan structure or proposed pre- conditions, covenants, monitoring, and/or financial requirements. The following can be key risks:
- Comment on reasons for approving policy exceptions noted in the Transaction Summary
- Comment on the overall adequacy of any of the following proposed factors:
  - Pre-conditions
  - Covenants or monitoring
  - Financial reporting requirements

Writing a Credit Memorandum

Risk Rating Conclusion

- Discuss the risk rating that you are recommending, including the key issues that influenced your recommendation. This should be consistent with your financial analysis and the important credit issues itemized in the appropriate Risk Grade Worksheet.
- If applicable, discuss reasons for recommended upgrade or downgrade

Summary and Recommendation

- Summarize the specific reasons why you are willing to recommend the loan for approval.
- These reasons or key points should have been fully discussed or analyzed in the previous sections of the memo

Relationship Manager's Signature

Intellectual Discipline and Ethics in Write ups

Business bankers face several challenges to maintaining an objective and balanced analysis and recommendation when writing a loan memorandum for new loan or for conducting an annual review. The following are examples of the intellectual discipline and ethical issues they face.

- **Provide all the facts**
  A business banker is in a position to "steer" the reader toward a conclusion by including or not including various facts about the borrower, the industry, and potential guarantors. The written package must also provide all the pertinent facts, both positive and negative, in order to properly identify the key risks.
- **Be objective**
  While the business banker usually is recommending a loan for approval, or a particular risk rating for an existing credit, this recommendation must be based on a solid analysis of both strengths and weaknesses. Another way to accomplish this is to focus on the issue of positives and negatives, as mentioned in the topic above. A best practice is to clearly identify the major weaknesses and risks as early as possible in the write-up format.

Intellectual Discipline and Ethics in Write ups

- **Interpret the facts for the reader**
  Similar to the goal of avoiding "elevator language," a business banker should tell what the facts mean in terms of risk. A business banker should be in a position to make connections within the financial statements and ratios, plus qualitative factors within the credit.
- **Do not jump to conclusions**
  Interpreting facts does not mean reaching for or jumping to conclusions. For instance, a business may have experienced a significant increase in inventory levels from one year to the next, resulting in increase in the inventory turnover ratio (in days). These facts can be cited in a write-up, and even noted as an area of increased risk, but do not conclude that the business "is obviously having trouble managing inventory"—unless this business banker is an expert on inventory management, or can cite a resource that has reached a similar conclusion about this business.

Intellectual Discipline and Ethics in Write ups

- **State sources of information**
  Especially with industry, market, and management risk factors, a business banker should be careful to cite sources of information. While most banks do not require formal footnotes, some means of listing references at the end of a write-up, or noting sources parenthetically within the narrative should be used.
- **Differentiate between fact and opinion**
  If a business banker properly cites sources and avoids jumping to conclusions, the reader should be able to distinguish between facts and opinions. Sometimes the financial data and ratios are the clear source of facts and lead to solid conclusions about risk that do not involve an opinion. The key issue is for a business banker to make observations, offer opinions, and make recommendations where necessary, and in a manner that makes it clear that these are the observations and opinions of the writer.

Credit File Maintenance

- Credit files, both electronic and physical, are an essential tool in loan origination and monitoring, and provide written documentation of the relationships between the bank and its borrowers.
- During litigation or to research and clarify legal concerns, legal advisor turns to credit files.
- When investigating a borrowing relationship, bank auditors and examiners rely on credit files as their primary sources of information.
  - Source of facts concerning the lending relationship and how it has evolved over time
  - Source for internal credit checks and exchanging credit information with other creditors
  - Record of the customer's total relationship for cross-selling bank products and services
  - Source of financial data and analysis of business performance over time

Credit File Maintenance

- Without a complete credit file loan cannot be monitored properly.
- A comprehensive and well organized credit file helps to reply promptly to information requests from regulatory bodies, credit agencies, in-bank personnel, loan review staff, auditors, and customers.
- Although many bank employees contribute to and use the information in business credit files, the business banker usually has ultimate responsibility for the content and organization.
- Every bank has its own style for organizing credit files—some use electronic means more than others. Whatever the arrangement, the business banker should be consistent in following the same format. If one business banker files copies of corporate resolutions under collateral records, another business banker should not be filing them under miscellaneous.
- Contents and Organization of Credit Files.docx

Annual Reviews

- Commercial loans should be evaluated on an annual basis, at a minimum, either through renewals and loan originations involving a particular loan or borrower, or a related loan that is adequately analyzed as part of the credit decision and loan package.
- The purpose of the review is to get updated on any changes in the various risk components underlying the loan.
- For “large” credit relationships that require an annual review, a format very similar to the bank’s loan package is utilized. For smaller credit relationships banks may allow the annual review to follow a simpler format than a normal loan package.

Annual Reviews

Allowance for a simpler format

- In addition to being a “small” loan, to use the simpler format, the following conditions must also apply:
  - All financial reporting has been provided as agreed
  - No past dues loan payments of 30 days or more within the last 12 months
  - Existing “pass” risk grade, (excluding watch list)
  - No event of default (or loan covenant violation) within the last 12 months
  - Current financial data does not reveal material adverse trends that would cause a risk rating downgrade

Annual Reviews

Allowance for a simpler format

- The abbreviated format of an annual review package would include updated financial spreads, including cash flow worksheets, along with a brief memorandum covering the following:
  - Major financial trends
  - Continued viability of primary source of repayment
  - Continued viability of secondary source of repayment
  - Summary of financial condition of guarantors
  - Opinion of ongoing relevance or “correctness” of current risk rating

Timing and administration

- Ideally, an annual review should be timed to the receipt of the primary financial data provided by the borrower, as it relates to the primary source of repayment. This can be a business financial statement. The annual review should be completed within 60 to 90 days of receipt of this primary financial data.
- The goal is to keep the risk ratings for all commercial lending relationships “fresh” within about a 12-month time window.

Thank you