COMMERCIAL LOAN STRUCTURING

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By

Kumar Lamsal

The Art of Loan Structuring

Balance between over and under lending

- The art of loan structuring is matching the purpose of the loan to the amount and repayment terms, based on the operating cycle of the business.
- It involves walking a fine line between lending too little or too much, and setting terms that may be too limiting or too liberal.
  - For example, if a customer's financing need is mistaken as Rs.2,000,000 when in fact Rs.5,000,000 is required, the business banker soon will be left with an unpaid Rs.2,000,000 loan and a business that needs another loan or more time to repay. Failure to grant further credit or to extend repayment terms may force a customer to liquidate assets.
  - On the other hand, lending a customer Rs.5,000,000 when only Rs.2,000,000 is needed has its pitfalls as well. The customer may use the excess cash to finance assets unrelated to the loan purpose and may be unable to generate the cash flow to repay the Rs.5,000,000 of principal plus interest that is accruing.
- Business bankers have a responsibility to lend in amounts that will be used properly and to lend to borrowers who need funding.

The Art of Loan Structuring

- By lending more than needed for the loan purpose, the lender is risking bank funds unnecessarily. The funds could be used to lend to other borrowers, enhancing further the bank's role in the community and market share, or the funds could be invested in securities through funds management.
- Overly strict repayment terms may leave the borrower without the cash flow needed to operate the business, with the result that the business does not perform as planned unless the borrower obtains more financing or longer repayment terms.
- Conversely, lenient terms may leave the business banker with little control over how funds are used by the business, including repayment of debt.
  - If a borrower receives in the first 60 days enough cash to repay a one-year loan, for example, the borrower may choose to use these funds for investment and growth, or to repay another creditor, rather than repaying the one-year loan.

The Art of Loan Structuring

Who establishes the loan structure?

- Bank cannot depend on the customer's judgment about what constitutes a proper loan structure and therefore, It is the business banker's responsibility to ensure the bank's funds are deployed properly against credit risk.
  - For example, an owner of a small business may request a short-term loan to finance an increase in inventory when a permanent working capital loan would be more appropriate.

Often, medium-sized and smaller business owners will negotiate price, collateral, guarantees, and loan agreement terms, but will look to their banker to define the length of the loan, repayment source, and overall loan structure.

Just as the business owner is focused on growing and protecting the business's assets, the lender should focused on growing and protecting the bank's assets.

The Art of Loan Structuring

Elements of loan structuring

- The first step in structuring a loan is deciding the appropriate financing arrangement and repayment terms.
- To structure a loan properly, a business banker must know the purpose and use of borrowed funds and the sources of repayment.
- Thorough loan interviews, credit investigations, and financial analysis are crucial to loan structuring.
- If these steps are properly performed, the business banker usually is in a good position to determine the possible loan structure, beginning with determining the reason for borrowing, then matching it to the appropriate type of borrowing arrangement and terms.
- Conclusion, if you have not analyzed the loan request properly, you can not structure the loan properly.

The Art of Loan Structuring

- **Borrowing need and repayment plan**
- In most cases, loans are repaid from cash generated by the assets financed by the loan.
- As current assets and fixed assets generate cash in different ways, the repayment plan of the loans provided to finance these assets must be made to match the amount and timing of cash generation.
- A loan to finance inventory (a current asset) should be planned to be repaid when the inventory is sold and converted into accounts receivable, which are then collected and converted to cash.
  - A loan that finances the inventory, therefore, generally is structured to be repaid within one year or less.
- Similarly, fixed assets generate cash by their repeated use in multiple operating cycles.
  - A loan that finances fixed assets must be planned to be repaid in multiple installments that may spread over many years depending upon the useful life of the fixed assets.

For the above reasons, it is a general tendency of commercial lending—increases in current assets normally are financed by short-term loans, and increases in noncurrent or fixed assets usually are financed by long-term loans. However, structuring loans is an “art” and should be flexible.

Borrowing Arrangements and Terms

When a business customer comes to you with a lending request, choosing the correct borrowing arrangement (Credit Facilities) requires matching the purpose of the loan, the source of repayment, the required loan amount, and the term of the loan.

- The bank's loan policy and available credit instruments, the loan's purpose, and the repayment source usually dictate the bank's choice of lending terms. Commercial loans generally are divided into the following three categories:
  - Loans to finance isolated increases in current assets or the special commitment loans
  - Operating lines of credit to finance ongoing needs to support current assets
  - Loans to finance fixed assets
  - Documentary Letter of Credit and/or Bank Guarantee
  - Term Loan

Borrowing Arrangements and Terms

Special commitment loan

- Such loans are needed for unusual or special circumstances to support increases in current assets.
- A business may request a special commitment loan to purchase additional inventory to fulfill an unusually large contract or finance a one-time purchase of close-out inventory. Special commitment loans are generally repaid within 30, 60, 90, or 120 days.
- These are single payment loans, repaid with cash generated by converting noncash current assets to cash. Determination of specific primary and secondary source of repayment required.
- Secondary source of repayment can be the liquidation of current assets outside of the normal operating cycle. Additional support can come from fixed assets and personal guarantees of the business owners.

Borrowing Arrangements and Terms

Operating lines of credit

- **Seasonal loans or lines of credit** are short-term and repaid from earnings at the end of a given season. Borrowers, in anticipation of a seasonal surge in sales volume, use seasonal financing to fund a periodic increase in accounts receivable and inventory.
  - Most retailers, for example, rely on a seasonal line of credit to stock up on inventory for Dashain when, in a period of one quarter, sales can account for over 30% of total sales.
  - The loan's maturity should be tied to the end of the seasonal operating cycle. eg. For agriculture business

Borrowing Arrangements and Terms

Operating lines of credit

- **General operating lines of credit** support general working capital needs of a business that tend to be temporary in nature, and not specifically tied to seasonal variations in sales.
- Because of even sales throughout, line usage truly is for temporary working capital needs.
- It is expected that bank may require the line of credit balance comes to some minimum level at multiple points during the year.
- The maturity or renewal point for an operating line of credit generally is one year.
- Repayment comes from the conversion of current assets into cash.

Borrowing Arrangements and Terms

Loans to finance fixed assets

- **Term loans** are scheduled to mature in more than one year, with repayment usually in quarterly installments. Term loans are used to purchase equipment, furniture, leasehold improvements, vehicles, and most other fixed assets.
- Down payment required, amount varies depending on the useful life of the fixed asset and the bank’s policies for fixed asset loans.
- Bullet or balloon payments are possible.
- The risks are higher because of longer term.
- Loan repayment schedule is matched to cash flow generated by operation.

Borrowing Arrangements and Terms

Bank Guarantee

A Bank Guarantee (BG) is where a bank guarantees payment by the underlying business upon declaration of non-payment. A BG is not expected to be drawn against; it simply represents a source of funds available if needed. Often, an BG is issued for a year. BGs usually are issued to a bank's most creditworthy customers because they can be called for payment, even if the customer's financial situation has deteriorated.

Borrowing Arrangements and Terms

Commercial or documentary letter of credit (DLOC)
A commercial or documentary letter of credit (DLOC) is issued to support international shipments of inventory. A DLOC usually is issued to the benefit of the seller, who draws upon the DLOC upon receipt of acceptable merchandise. The buyer and seller both typically engage large banks with international offices and relationships. The large banks may already handle the business of the buyer and seller, or if the buyer and seller use smaller banks, the smaller banks engage a larger bank to confirm the DLOC (for a small fee) and act as intermediaries. So, the underlying transaction creates an obligation from one of the banks to pay the other, called a banker's acceptance. While an BG is not expected to be drawn against, a DLOC is expected to become a funded obligation and a mechanism for international transactions.

A letter of credit may be revocable or irrevocable. The document guarantees payments of a customer's draft up to a specific amount over a certain time. With a letter of credit, a bank guarantees payment for goods or services purchased by a customer in a contract with a third party. By substituting the bank's credit for its own, the customer (the purchaser in the transaction) can avoid paying in advance, or provide partial support for an initial extension of trade credit by a new supplier.

COMMERCIAL LOAN SUPPORT

1/31/2018

By
Kumar Lamsal

Identifying Secondary and Tertiary sources of Repayment

Willingness and Capacity as the primary source

- A secured loan cannot be held to a different standard from other loans just because collateral can be taken and sold if the borrower fails to satisfy the debt.
- Assets pledged as collateral may be worth less than the balance outstanding on the loan, and foreclosure, collection, and other costs erode their value even further.
- Taking possession of and liquidating collateral is a lengthy and sometimes costly process, and the bank has no assurance it will recover all loan costs.
- Therefore, best protection of the loan is the PSOR.
- Collateral may offset some of the risk in making the loan by serving as a secondary or tertiary source of repayment.

Identifying Secondary and Tertiary sources of Repayment

Collateral security as a viable support

- Banks' loan policy requires collateral as a means of support for a loan. Due to the policy preference, regulatory encouragement and because loan is used to acquire assets, collateral is a ready source of support and is the secondary source of repayment (SSOR).
- Third party support or the personal guarantee is the tertiary source of repayment (TSOR).
- When a personal guarantee appears to have more financial strength than available collateral of the borrowing business, a business banker may designate the personal guarantee as the SSOR and the collateral as the TSOR.
- Regardless of this "ranking," the key issue for a lender is to determine the viability of any sources of loan support.

Factors Affecting Collateral Value

Liquidity

- *Liquidity* is how quickly an asset can be converted to cash. In general, the more liquid the asset, the greater the asset's collateral value as a percent of its nominal or face value. Eg. stocks, bonds, and other marketable securities.
- Accounts receivable also are fairly liquid, but their age, validity and concentrations to be looked into.
- Inventory is less liquid. Noncurrent assets, such as equipment, and land and buildings, are even less liquid.
- For example, repossessing and selling land is a lengthy process involving many people, and significant time likely will elapse before funds are received.

Factors Affecting Collateral Value

Dependability of value

- Some types of assets lose value more rapidly than others. Eg. Computers, fashion items etc.
- Real estate and certain other fixed assets, however, may increase in value over time and usually are more acceptable as collateral.

Marketability

- When evaluating collateral, a business banker considers the market available to purchase an asset obtained in a loan workout situation.
- General use inventory is more attractive than specific use inventory.
- A car or a truck can be sold far more easily and quickly than a crane or loader.
- For items that take longer to sell, until a buyer is found, storage and security costs are likely to be high.

Factors Affecting Collateral Value

Controllability

- Controllability refers to the ability of a bank to locate and hold collateral.
- Certificates of deposit pledged as collateral and held in a bank's vault are highly controllable.
- The controllability of accounts receivable and inventory is very weak.
- Repossessing a large, stationary piece of manufacturing equipment is contingent on the bank's access to the plant.

Costs to liquidate

- Beyond the collateral's existing value, there are costs for liquidation. Before any proceeds are realized from selling the collateral, the bank absorbs foreclosing costs, such as legal and appraisal fees, holding costs, such as taxes, rent and maintenance, and selling expenses, such as shipping and commission.
- The amount remaining is what the bank can expect to apply to the loan's principal, interest, and costs to liquidate.

Factors Affecting Collateral Value

Inadequate physical damage insurance

- To protect its interest in collateral securing a loan, most banks require that the customer maintain adequate physical damage insurance coverage.
- For example, loans secured by real estate, equipment, fixtures, or inventory require fire insurance on the property, with the bank as the payee.
- The customer must maintain a comprehensive insurance program throughout the life of the loan.

Assessing Collaterals

Marketable Securities

- Assess value before disbursing funds and then periodically thereafter. This is especially true of stocks and bonds, which may vary considerably in value over time..
- The following are marketable securities that lenders generally avoid:
  - Non-publicly traded securities and ownership interests in private companies as collateral because the value can be difficult to establish
  - Publicly traded securities that are thinly traded with exceptions
  - Restricted stock that may not be sold by anyone (including the bank or the borrower, even in foreclosure) unless a holding period has been met, and possibly other requirements

Assessing Collaterals

Accounts Receivables

- When taking accounts receivable as collateral for commercial loans, consider the following issues to be sure as the primary comfort:
  - Selling terms—When are accounts receivable expected to be paid? How do the credit terms compare to key competitors in the industry?
  - Credit procedures—How does the business approve and grant credit? A business banker should understand the typical industries and types of customers the business maintains, as well as the steps taken to determine the credit risk
  - Concentrations—What is the number and mix of the accounts receivable?
  - Internal controls—What systems are in place to assure proper approvals of credit limits and terms, plus compliance with concentration policies?
  - Invoicing—How promptly does the business send invoices? The accounting system used by the business should be both accurate and timely, with very few errors and adjusting transactions

Assessing Collaterals

Accounts Receivables

- Method of aging—From what date, such as the billing date or the due date, does the business age its accounts receivable? Is other information, such a customer contact person, provided on the aged listing?
- Reporting—How often are accounts receivable aged, billed, and reviewed?
- Ease of verification—How easy is it to verify the validity of the accounts receivable?
- Collection practices—What procedures are used to collect past due accounts receivable? The business should have the following policies in place to both monitor payment and avoid receivables that will be difficult to collect:
  - Bill and hold, Pre-bill, partial shipment

In addition to bill and hold, pre-bill, and partial shipment receivables, lenders generally exclude from a borrowing base the following types of receivables:

Related party receivable, Prepayments, Concentration (?), Consignment sale, Guaranteed sale, Contra accounts, Unbilled receivables, *Current receivables to past-due customers etc.*

Historical loss rate of bad debts, Discount practices, Allowances and returns, Warranty claims

Assessing Collaterals

Inventory

When taking inventory as collateral, the starting point is to determine the inventory mix. The value of inventory depends on many of the following factors:

- Brand name merchandise—What brands are carried? What is the brand reputation? How strong is national and local advertising and marketing support?
- Seasonal products—Are any products seasonal and what percentage do they represent? Can unsold merchandise be "rolled forward" to the next season?
- Components—What is the breakdown between raw materials, work in process, and finished goods?
- Each component may have significant variation in both book value and liquidation value.
- Shelf life—What is the average shelf life for perishable products? Are raw materials perishable? Are finished goods perishable?

Assessing Collaterals

Inventory

- Obsolete, highly customized, or incomplete goods—Is any inventory obsolete and no longer salable?
- Internal controls—How does the company track its inventory? A business banker should assess controls, accounting procedures, and management information systems such that inventory components, values, and locations as reported can be relied upon.
- Days on hand—What is the average day's supply by product line? Does this adequately cover shipping times or potential delays in receiving new inventory? Sales can be lost if inventory is not on hand when needed, or shipped promptly. Further, the days on hand should be in line with the borrower's industry.
- Method of valuation—Is last-in, first-out (LIFO), first-in, first-out (FIFO), weighted average cost, or another inventory valuation method used? How accurate is the carrying cost on the books versus market value?
- Ownership—Who owns the inventory? Is it on consignment from a supplier? Is it subject to a re-purchase agreement under a guaranteed sale contract? Do any suppliers have a purchase money security interest in portions of inventory?
- Location—Where is inventory located? If multiple locations, are any locations leased facilities?

Assessing Collaterals

Plant and equipment

A business banker considers the following when taking equipment as collateral:

- Special purpose—Is the equipment single purpose or multiple-purpose?
- Specialized or single purpose equipment may have a narrow market outside a borrower's industry, while general or multi-purpose equipment can be used and sold more broadly.
- Fixtures and leasehold improvements—Is the equipment attached to the building? Bankers tend to assign very low resale values to equipment that is permanently or partially attached to a building.
- Access—Does the bank have access to the equipment? If located within leased premises, special arrangements may need to be made with the landlord.
- Cost to dismantle and move—The portability of equipment deals with the costs to move and dismantle the equipment. Items that are permanently or partially attached to leased real estate will involve landlord rights. Further, some equipment is very expensive to transport, which can reduce the liquidation value

Assessing Collaterals

Plant and equipment

- Technical obsolescence—Is any equipment obsolete?
- Equipment with a high technological composition may lose value very quickly. Find out if the equipment has been phased out or even subject to regulation by a governmental unit.
- Age and condition—What is the age of each piece of equipment? Has its useful life already expired? Has the equipment been properly maintained? Do maintenance records exist?
- Observe the conditions under which the equipment is used. Hot and dusty environments can make it difficult to maintain.
- Identification—Many pieces of equipment have serial numbers or other unique means of identification. If a borrower pledges equipment to multiple lenders, it will be important to identify specific items pledged to your bank
- Similar to inventory, equipment in multiple locations can present logistical issues and costs in a liquidation. Lien searches become important if multiple lenders are involved, and clarity of the specific items pledged to each lender, or to multiple lenders, must be determined.

Assessing Collaterals

Plant and equipment

Consider the following characteristics when taking commercial real estate, including a manufacturing plant, office or warehouse, as collateral:

- Value— Did a professional valuator determined it? Was it done as per the set guidelines? Check for any specific comments about access road, High voltage line etc.
- Environmental issues—Are there environmental issues that need to be addressed?
- Type—Is the real estate single purpose? More general purpose or general use properties tend to have a broader market and more resale opportunities.
- Occupants—Do tenants occupy the real estate? If so, what are the terms of the lease?

Assessing Collaterals

- ***Collateral with second charge***
- ***Secured vs. Unsecured debt***

Guarantees and Sub-ordination Agreement

Guarantees

- A guarantee, another type of loan support, is a legal document obligating a third party, or *guarantor*, to repay the debt if the borrower defaults.
- A guarantee should never be the primary source of repayment for a commercial loan, nor a substitute for a business borrower's acceptable financial status.
- It is only as good as the guarantor's willingness and capacity to repay the debt if required.
- The most common types of guarantees are personal, corporate, and government agency guarantees.

Guarantees and Sub-ordination Agreement

Sub-ordination agreement

- A subordination agreement is an agreement between two creditors of a borrower in which one creditor grants to the other a priority position in the credit relationship. This priority position can be for debt repayment.
- If the debt is from the officers or owners of the business, and adequately subordinated, some banks add the amount to total equity when calculating tangible net worth.
- In lending to a privately held company, it is often required that any owner debts be subordinated, because the company's owners have the ability to pre-pay these loans, regardless of the written commitment in place between the owners and the business.

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KEY DOCUMENTS LOAN AGREEMENTS AND COVENANTS

1/31/2018

By

Kumar Lamsal

Loan Documentation

- Documenting the lending agreement is as important as the commercial lending process itself.
- One reason is that there are many types of borrowers. Another reason is that there are many types of borrowing arrangements—unsecured, secured by collateral, demand and single payment, installment, and term.
- The purpose of loan documentation is to have a written, legally enforceable understanding of the bank's and borrower's obligations under the lending arrangement.
- This written agreement assures that the bank can be repaid on time and in full from the borrower.
- Further, upon default of the borrower, any assigned collateral can be legally obtained, liquidated, and applied to the debt, without prior claims of other creditors.

Loan Documentation Requirements

When granting a commercial loan request, banks need the following loan documentation:

Evidence of authority to borrow

- In case of default and in the event of bank initiating its recovery action, borrower may challenge the bank in a court of law.
- To establish whether the bank has a legal right to take possession and sell the collateral, the court will want to establish several basic facts.
- First, it must determine if the loan was made, in fact, to the business and signed by a person authorized to represent the business.
- If the bank gave loan to someone unaffiliated with the business, and then they left town with the proceeds, then the bank made a mistake, and it may be without recourse in collecting the loan.
- A borrowing authority is established through Board Resolution, Partnership Agreement etc.

The bank will need written proof or evidence of the authority to borrow.

Loan Documentation Requirements

Evidence of debt

Second, the bank will need to document that it disbursed the loan amount to the business, that the business received it, and that the business promised to repay the amount with interest.

- In other words, there must be evidence of the borrower's indebtedness to the bank, such as a loan deed supported by Board resolution.

Without evidence, the bank cannot support its claim that the borrower owed the money, at a specified interest rate, and payable on specified date.

Loan Documentation Requirements

Evidence of collateral

Next, the bank must establish its right to the borrower's collateral. The court will want to know exactly what collateral secures the loan.

- Is the collateral all the stocks owned by the borrower or just the items purchased with loan proceeds? Is the collateral all the assets of the borrower, including furniture and fixture, land and building? Were owner's personal properties also pledged as claimed by the bank?
- Having answered these questions, other issues are addressed such as, "Does the bank have priority in taking possession of the collateral, or are there other creditors whose liens must be satisfied first?"

The court will turn to the loan documents for answers. Loan documents, therefore, must include evidence of collateral such as a Hypothecation deed, Pledge deed, Securitization documents, Mortgage deed etc.

Loan Documentation Requirements

Evidence of collateral

- Before a bank can take possession of property securing a loan, the bank or any other creditor must show that its right to the property is superior to the owner's right. This right is referred to as having a <u>security interest attched</u> in the property.
- if the bank wishes to establish a right to the property that takes precedence over other possible creditors, the security interest must be perfected.
  - This is generally done by either taking physical possession of the collateral, by taking control over the collateral, by filing a notice of the security interest through with the Secured Transaction Registrar or by creating mortgage.
  - For doing all this security agreement with the borrower is necessary.
- Ownership of the property to be verified through company records, title documents etc.

Loan Documentation Requirements

- **Evidence of the loan's terms and conditions**
  Finally, the bank will need to establish the rights of both parties. For example, the borrower may claim that the bank acted hastily in foreclosing the loan and that, if granted a few more months, the stock could be sold and the loan repaid.
- The bank can counter by saying it needs to sell the collateral now, before it decreases in value any further.
- The bank's legal position will be bolstered considerably if it has documentation showing the borrower agreed to the bank's right to demand repayment and sell the collateral.

Written evidence of the loan's terms and conditions is needed. Loan Agreement serves as the evidence of terms and conditions.

Loan Agreements

- By clearly defining the rights and obligations of the borrower and the bank, a loan agreement or an offer letter duly accepted by the borrower can limit a bank's exposure to credit risk.
- It sets forth the conditions under which the loan was granted and establishes the parameters within which the borrower must operate.
- Based on the financial strengths and weaknesses, future prospects, managerial capabilities, legal standing, and ability to provide reliable and accurate records, a loan agreement sets reasonable standards of performance and describes the options available to both the bank and the borrower if they are not met.
- Although the specific wording for a loan agreement varies, most agreements contain the following sections:

Loan Agreements

The Loan or Credit Facility

- This section describes the terms and conditions of the loan, including the type of loan, amount, interest rate, repayment schedule, and security.
- It also identifies all the parties to the loan and their roles, and may include definitions of the financial, legal, and accounting terminology used in the agreement.
- Reference often is made to the loan deed, security agreement (if there is one), and any other documents that may be a part of the loan package.

Borrower representation and warranties

- They attest that certain statements the borrower made are true. For example, the owners of Borrower will represent or warrant that it is a company, that it entered into the lending agreement legally, that the financial statements it supplied to the bank are accurate, that there is no existing or pending litigation against it, and that it owns its collateral assets.

Loan Agreements

Affirmative Covenants

They place certain restrictions on the borrower. Affirmative covenants state what the borrowing business proactively must do until the loan is paid in full. The following are some examples:

- Maintaining a certain rupee level of working capital or net worth
- Meeting certain ratio requirements (such as a current ratio of 1.5x or greater)
- Furnishing the bank with periodic financial statements, tax returns and other reports
- Reporting to the bank any adverse conditions or events
- Maintaining adequate levels of property and casualty insurance
- Maintaining legal, business existence in "good standing" with the appropriate laws
- Paying all taxes and other obligations that, if unpaid, might result in a lien
- Maintaining property, plant, and equipment in good repair
- Permitting bank personnel to inspect business records to verify authenticity of financial statements and physical condition of assets
- Informing the bank of any actual or probable litigation or changes in key contracts

Loan Agreements

Negative Covenants

They specify practices that, absent the bank's prior written consent, the borrower cannot engage in until the loan is paid in full. The following are some examples:

- Mortgaging, selling, or pledging assets to third parties, other than those required in the ordinary course of business
- Compensating owners or officers above a certain specified aggregate amount
- Paying dividends or distributions to owners above a certain specified amount
- Assuming liability of indebtedness of other entities through guarantees or other means
- Engaging in lines of business other than lines of business present at the time of the agreement
- Entering into a merger or consolidation or acquire the assets of another entity
- Incurring additional debt
- Allowing changes in management or ownership

Loan Agreements

Events of Default

- They occur when the borrower does not comply with the loan agreement.
- These can include failure to make a loan payment on time or in the amount due; misrepresentation on a loan document; violation of any affirmative or negative covenant; bankruptcy, insolvency, or liquidation proceedings; or death of one of the owners or guarantors.

Remedies

- They detail the bank's options if the borrower defaults on the loan, including the right to demand immediate payment of all that is owed, the right to demand more security or guarantees, and the right to set-off any amount owed by the borrower on the loan against any money held by the bank, such as deposits.
- A loan agreement, thus, defines the loan, outlines the obligations of the bank and borrower, sets minimum acceptable performance standards, and describes what will cause a default and the bank's remedies if default happens. The agreement is then signed by the bank, the borrower, and when applicable, the guarantor.

Other Documents

Hazard, fire, and other insurance policies

- To protect its interest in collateral securing a loan, the customer must maintain adequate insurance coverage.
- For example, loans secured by real estate, equipment, fixtures, or inventory require fire insurance on the property, with the bank named as the loss payee.
- Hazard, liability, malpractice, loss of profit, and other forms of insurance coverage also may be justified.
- The customer must maintain a comprehensive insurance program through the life of the loan.

Other Documents

Lessor's agreement

- A lessor's agreement, also called a landlord's waiver, is often justified when making a loan to a borrower who rents the space where the business is located.
- It allows the bank to assume the rent payments by the business so that it has the right to enter its premises and liquidate collateral, obtain business records, or take other actions to protect its security interest in the collateral.
- Without a lessor's agreement, the bank may find itself locked out and forced to go through lengthy and costly legal channels before it can gain entry.
- A lessor's agreement is especially important when the business owner also owns the building where the business is located and is more likely to lock out the bank.

Loan Closing

- Having completely and accurately prepared the loan documents, the lender is ready to close the loan.
- At this stage, most questions and problems have been resolved. Nonetheless, it is worthwhile to proceed in an orderly fashion and not overlook any important last minute details.
- Prepares and reviews a checklist of all records to be obtained from the borrower and of all documents to be signed and by whom. This ensures that no document or signature is overlooked.

Pre-loan closing meeting

- Consider a pre-loan closing with the customer in person or by telephone.
- A pre-loan closing meeting can resolve any misunderstandings or unfulfilled requests, and allow a borrower to ask relevant questions in advance.
- It is also a good time to review and reaffirm the terms of the loan, amount, rate, collateral, and guarantees.

Loan Closing

Loan signing and closing

- For the closing, first ensure that all necessary parties are in attendance.
- Next, the business banker reviews each loan document with the customer and points out key obligations, such as when payments are due, when financial statements are to be submitted, and under what circumstances the loan may be called.
- Once all parties are in agreement, the documents are signed and funds disbursed.
- After the closing, give the customer a copy of all loan documents and add another copy, along with any other records or notes, to the customer's credit files.
- The original loan documents usually are held in a separate collateral file and separate promissory note file.

LOAN MONITORING

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By

Kumar Lamsal

Loan Monitoring

Follow up after the loan closes

- Updating the customer's files is an important and ongoing step and should not be disregarded after the loan has been made.
- Regular comments to the credit file are added whenever interim statements are received or there has been contact with the customer whether by phone, e-mail, or a business development call.
- Loan disbursement is not the end but the beginning of the oversight process.
- The loan needs to be monitored continually to ensure that its terms and conditions are being fulfilled by both the customer and the bank.
- Again, an experienced business banker looks beyond the current credit arrangement to anticipate and meet the future financial needs of the customer.

Loan Monitoring

Objectives:

- Ensuring compliance of terms of pre-disbursement conditions,
- Keeping documents legally enforceable,
- Preventing diversion of bank funds,
- Ensuring security offered to the bank being physically and legally recoverable,
- Obtaining early warning signals of deterioration in financial health for undertaking preventive steps.

Loan Monitoring

- Pre-operation monitoring
- The project loans should be disbursed as per the periodical progress reports submitted by the borrower duly certified by a consultant, if any, and subsequent site inspection.
- The actual cost as per the certified statement submitted by the borrower should be compared with the projected statement of project cost to be incurred at each stage of the project to ensure the proper use of funds.
- Cost overrun, if noticed, must be addressed promptly to prevent the account from turning into a problem loan.
- In addition, site inspection of securities report is a very useful source to get early warning signals. Any erosion in the value of securities /negligence noticed on the part of the borrower to keep securities in order would be a matter of concern.

Loan Monitoring

Monitoring during the currency of the loan

- By obtaining periodical reports and statements from the borrowers and analyzing,
  - including stock statement, aged book debt statement and accounts payable statement at agreed frequency.
  - select operational data on a monthly basis
  - Statement on status of covenant, if any and due
  - half-yearly operating statement
  - Annual financial statements

Each of these statements need to be analyzed for the quality of the assets, drawing power to be recalculated and adjusted, and the analysis be circulated through credit chain. If any report is not received within expected time frame, or is there is other irregularity/ies, it should be recorded as irregularity and reported. Any irregularity/deviation to be reported. Compare the sales realization with account turnover.

Loan Monitoring

- By visiting business site

Onsite inspection assists to verify level of activity, capacity utilisation, present condition of assets charged to the bank, availability of raw material and spares, and power supply or any other issues that may affect the business activity/running of the unit.

  - Stock and book debt verification to be carried out at the prescribed frequency. Following items to be checked.
    - Verification of stocks and stock report against register
    - Storage condition
    - Goods condition
    - Rent payment status
    - Insurance adequate and in order
    - Check the plant and equipment as well for its orderly operation and efficiency.

Loan Monitoring

While calculating drawing power (DP) based on stock statement and stock inspection, we should ensure whether advances received against orders for goods are deducted to arrive at DP. Letters of Credit (LCs) should be deducted from the total inventory. More importantly, month-wise purchases and sales should reasonably be reflected in the borrower's statement of account to prevent diversion of funds.

- By analyzing internally available information
  - Statement of account of the borrower
  - Internal audit report long form audit report (LFAR)of the statutory auditor, NRB inspection report
- By observing and staying alert to direct or indirect signs supplied by third parties
- By keeping lines of communication open with the borrower via periodic telephone calls, correspondence, and site visits and gathering nonfinancial clues as well
- By monitoring the borrower’s total account relationship with the bank

Detecting Problem Loans

- Loans rarely become problem loans or losses overnight. Numerous warning signs usually precede a gradual deterioration in credit quality.
- The key to minimizing problem loans is to note the symptoms when they occur rather than wait for a major breakdown in repayment.
- Loan monitoring provides the business banker the opportunity to detect these problem loans at an early stage.
- When detected ignoring these signals or taking them casually and not acting promptly to take corrective measures may lead to problem loans.

Detecting Problem Loans

Financial Early warning signal

- Analyzing a borrower's financial statements often will reveal the symptoms of a potential credit problem.
- The major tools of financial analysis are the balance sheet, income statement, ratios, and cash flow statement.
- Comparing balance sheets and income statements from year to year (or period to period) or to the industry standard is useful in spotting trends that may lead to a problem loan.
- Ratio analysis, a look at the relationship between one or more balance sheet and income statement accounts, could reveal poor liquidity, high financial leverage, low debt service coverage, and poor profitability positions.
- Cash flow statements reveal problems the borrower might encounter when trying to obtain adequate cash to finance operations and repay debt.

Financial Early Warning Signals

- Failure to receive statements in a timely fashion may indicate insufficient assets
- Deterioration in customer's cash position
- Sharp increases in amounts or percentage of accounts receivable or slowness in collection period
- Evidence of stale inventory, large levels of inventory, or inappropriate inventory mix, stock report and inspection report mismatch, dual financing for the same stock
- Decline in current assets as a percentage of total assets or material changes in the asset mix
- Deterioration of the liquidity or working capital position
- Rapidly changing concentrations in fixed assets
- Poor maintenance of plant and equipment
- Deferred replacement of outmoded or inefficient plant and equipment
- Large increase in warranty reserves
- Significant increase in intangible assets
- Disproportionate increases in current or long-term debt

Financial Early Warning Signals

- High financial leverages or rapidly increasing financial leverages
- Significant changes in balance sheet structure
- Declining or rapidly expanding sales
- Major gap between gross and net sales
- Rising costs and narrowing profit margins or growing operating losses
- Disproportionate increases in overhead or operating expenses relative to sales
- Rising levels of total assets relative to sales or profits
- Poor financial performance in terms of declining sales and profits, cash losses, net losses, erosion in net worth, etc.
- Book debts remaining in the books for a long time.
- Shortage of working funds.
- Diversion of short-term funds for long-term use.
- Building up of unproductive assets.
- Evidence of misuse of funds

Non Financial Early Warning Signals

Borrower nonfinancial warning signals of problem loans

- Changes in behavior or personal habits of key people, including health or marital problems
- Failure to perform on personal obligations
- Changes in management, ownership, or key personnel
- Inability to meet commitments on schedule
- Inability to plan
- Fragmented operations
- Venturing into acquisitions, new business, new geographic area, or new product line
- Desire to or insistence on taking business gambles and unwarranted risk
- Routing transactions to other banks
- Major breakdown in plant and machinery

Non Financial Early Warning Signals

Borrower nonfinancial warning signals of problem loans

- Delay in reacting to declining markets or economic conditions
- Any erosion in the value of securities /negligence noticed on the part of the borrower to keep securities in order would be a matter of concern.
- Excessive growth that strains the capacity of the owner to manage and control
- Labor problems
- Change in the nature of the company's business
- Loss of key product lines, franchises, distribution rights, or supply sources
- Loss of any major and financially sound customers
- Transfer of assets to other companies or individuals
- Change of auditors
- Frequent turnover of internal accountant, bookkeeper, or Chief Financial Officer
- Sudden death/ illness of partner/director.
- Disputes among partners/directors.
- Frequent reconstitution of the firm/board.

Third Party Early Warning Signals

Business transactions or other personal contacts between the borrower and third parties often alert a business banker to potential problem loans.

The company's competitors, suppliers, customers, and regulators can alert the inquisitive business banker to an impending problem or provide some missing background information.

Periodic checks of public records and a daily review of newspapers, magazines, and trade publications via computer may reveal warning signs.

A newspaper or magazine article may be the first place to learn of a contract termination, plant closing, or some other event that may foretell a problem loan.

Third Party Early Warning Signals

Third-party early warning signals of problem loans

- Telephone calls from existing suppliers for additional credit information to evaluate requests for special terms
- Telephone calls from new suppliers requesting credit information to open new credit lines
- Changes in supplier credit terms
- Additional use of new financial institutions, especially collateralized lenders
- Non renewal of insurance
- Legal notices served against the borrower for tax liens, judgments etc.
- Sharp fall in prices
- Unfavorable changes in Government policies as regards imports, export, price mechanism, minimum wages etc.
- Recession effect in the industry

Bank Early Warning Signals

Although the borrower may be meeting the terms and conditions of all current loan obligations, signs of a deterioration of the account relationship with the bank still may exist.

- Declining bank balances
- Excessive or unanticipated STL renewals
- Heavy reliance on short-term debt
- Marked changes in the timing of seasonal loan requests
- Increases in the size or frequency of loan requests
- Loans where the purpose is vague or simply "working capital"
- Evidence of checks written against uncollected funds
- Poor turnover in an account indicates that either sale proceeds are being routed through the other bank or have, in fact, been dropped.

Bank Early Warning Signals

- Each time cheques are drawn for a large and round amount, post-dated cheques and cheques frequently issued in favour of those parties not related to business.
- Frequent invocation of bank guarantees (BGs)and non-payment within a reasonable period and non-payment of Letter of Credit liabilities within a reasonable period.
- Frequent returns of Bills for collection.
- Heavy withdrawal of cash

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 do 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