How Do Examiners Assign Loan Classifications on Your Examination?

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Presentation Overview

- Loan Classifications – What are they?
- The Loan Evaluation and Classification Process
- Five (Six) P’s of Credit
- Case Study(s)
- What Can Your Institution Do to Limit Risks?
- Review and Conclusions
Loan Classifications
What are they?

- Loan classifications are expressions of different degrees of a common factor, risk of nonpayment.

- Loans not adversely classified
  - Pass
  - Special Mention

- Adversely classified loans
  - Substandard
  - Doubtful
  - Loss
Loan Classification Definitions

- **Substandard** – Loans classified Substandard are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.
Classification Definitions (continued)

- **Doubtful** – Loans classified Doubtful have all of the weaknesses inherent in those classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable.

- **Loss** – Loans classified Loss are uncollectible and of such little value that their continuance as a bankable asset is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value but rather that it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.
**Special Mention**

- **Defined:** A Special Mention asset has potential weaknesses that deserve management’s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution’s credit position at some future date. Special Mention assets are not adversely classified and do not expose the institution sufficient risk to warrant adverse classification.
The Loan Evaluation and Classification Process

- Examiner’s loan review sample may include:
  - Previously classified
  - Internally classified
  - Delinquent loans
  - Other significant loans which exhibit high degree of risk due to recent industry trends, or identified by the bank through audits, etc.
  - Insider loans

- Review loan files, discuss with officers, and assign appropriate classifications
- Assess loan underwriting and compliance with loan policy/procedures
- Evaluate adequacy of ALLL
Five (Six) “P’s” of Credit

When we review individual loans we evaluate the following to ascertain the current creditworthiness of a loan.

- People
- Purpose
- Protection
- Payment
- Problem
- Prospects
People

Who is the borrower?

- Type of business/industry
- Organizational structure
- Management quality and depth
- Payment history with your institution
- Information from other lenders/parties
Purpose

What will the money be used for?

- Underlying borrowing cause
  - Purchase specific assets
  - Fund working capital needs
  - Asset based lending
  - Refinance other debt

- Is the purpose legitimate?

- Does loan structure correlate with purpose?
Protection

What is the collateral and what is worth?

- If there is a lien, has it been perfected?
- What is the lien position?
- What is the liquidation value?
- Marketability of collateral?
- Access/Control issues?
Payment

Borrower’s ability to pay?

- Terms of the loan
- Sources of repayment
  - Cash flow from operations
  - Guarantor support
- Other sources and uses (global cash flow?)
- Delinquency status is only one indicator of repayment capacity
Problems

Are there well defined weaknesses that jeopardize loan repayment?

– If repayment concerns exist, what is the underlying cause?

– Are problems temporary or permanent?

– Have underwriting or credit administration weaknesses contributed to loan deterioration?
Prospects

*What steps is the bank or borrower planning to take to address the loan’s weaknesses?*

- What does borrower plan to do to resolve issues?
- If problem is temporary, will a loan restructuring improve prospects for repayment?
- What are the bank’s intentions going forward?
- Are the borrower’s problems permanent or are they correctable?
CASE STUDY
Loan Classifications

Now we will walk through a case study designed to give you an opportunity to assign a rating to a loan relationship.

- Pass, Special Mention, Substandard, Doubtful, Loss?

Refer to the handout titled “Loan Classification Case Study”

Review loan documentation and, applying the six “P’s” of credit, assign appropriate classifications.
What can you do to mitigate risk?

- Establish strong lending policies and procedures
  - Ensure loan officers adhere to established guidelines.
  - Establish loan policy exception and reporting
    - Are loan policy “exceptions” becoming the rule?
  - Establish independent credit review and audit coverage

- Respond to early warning signals through report monitoring
  - Delinquency trending up?
  - Watch list/internal classifications trending up?
  - Market characteristics changing?
  - Noticeable increase in requests for modifications?
Conclusions/Questions

- Questions????