South Carolina Bankers School Principles of Lending for Non-Lenders

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Session I

- Why Do We Lend And What Is The Process?

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Why Is Lending Important?

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Why Is Lending Important?

- Interest income from loans makes up the bulk of income for your bank.

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Why Is Lending Important?

- Interest income from loans makes up the bulk of income for your bank
- Providing credit is an important economic function for customers served by your bank.

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Major Loan Classes

- Commercial
- Consumer
- Mortgage

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Major Loan Classes

- Commercial – Paid back from cash flow generated by a business.
- Quick cash flow calculation:
  - Earnings before interest, tax, depreciation and amortization/debt service

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Major Loan Classes

- Commercial – Paid back from cash flow generated by a business.
- Consumer – Paid back from an individual's personal cash flow.
- Consumer Debt to income – Monthly Debt service/Monthly Income

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Major Loan Classes

- Commercial – Paid back from cash flow generated by a business.
- Consumer – Paid back from an individual's personal cash flow.
- Mortgage – Specific form of consumer lending used for real estate.
  - Debt to income ratios are important – monthly debt payments/monthly gross income

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Is There Much To It?

- Business development
- Information gathering
- Credit analysis
- Approval
- Commitment and negotiation
- Closing
- Set up and servicing
- Loan review

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Policies, Policies and More Policies

- Structure is important
  - Written lending policies
  - Written lending procedures
  - Well-trained lending personnel
  - Established portfolio monitoring and evaluation system

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Who Gets To Make a Loan Decision?

- Individual Authority
- Combination
- Committee

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Who Gets To Make a Loan Decision?

- Individual Authority
  - Ability of the lender
  - Secured vs. unsecured
  - Business vs. consumer
- Combination
  - Lender plus a concurring lender
  - Lender plus credit officer
- Committee

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How Do You Know It's Good?

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How Do You Know It's Good?

- We get paid back.

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How Do You Know It's Good?

- We get paid back.

- Economic conditions
- Existing vs. new venture
- Cash generation potential
- Fall Back position

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Will It Make Us Money?

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How Do You Know It Will Make Us Money?

- Interest income
- Fee income
- Cost of funds
- Cost of servicing

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Spread

- Interest income on loans minus the bank's cost of funds.

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How Do You Know It Will Make Us Money?

- Interest income
- Fee income
- Cost of funds
- Cost of servicing

- Deposit balances
- Additional Bank business
- Referrals

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Did We Do it Right?

- Regulatory Environment is changing daily
  - Dodd Frank
  - TRID
  - HMDA
  - CRA
  - CDD
  - Beneficial Ownership

- Consumer vs. Business Regulations

- It is up to the lender to comply

- Monetary penalties for non-compliance

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Is Our Glass Half Full or Half Empty?

- Quantity Considerations
  - Regulation
  - Concentration
  - Diversification
  - Risk Mitigation

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Report Card Time

- Loan Review
  - Address credit quality
  - Monitor lending activity
  - Keep lenders focused on bank's policies and procedures

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Session II

- How Do You Do It?

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Types of Loans

- Working Capital
- Term Loans
- Letters of Credit

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Types of Loans

- Working Capital
  - Short term loan for temporary cash needs.
  - Less than one year maturity
  - Can be revolving or non-revolving
  - Usually rely on asset conversion for repayment

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Types of Loans

- Working Capital
  - Short term loan for temporary cash needs.
  - Less than one year maturity
  - Can be revolving or non-revolving
  - Usually rely on asset conversion for repayment
- Term Loans
  - Finance permanent assets or long term growth
  - Usually longer than one year maturity
  - Can include capitalized leases
  - Repaid from cash flow

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Types of Loans

- Letters of Credit
  - Facilitate trade
  - Transfer risk
  - Standby or Documentary
  - Repaid by specific event

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Secured or Unsecured?

- Unsecured lending is only for the best risks
- Collateral is important
  - Often arises out of the transaction
  - Reduces risk of loss to the bank
  - Keeps the Borrower engaged

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Types of Collateral

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Types of Collateral

- Good Stuff
  - Cash and liquid assets
    - Certificates of Deposit
    - Brokerage accounts
    - Stock
  - Owner occupied real estate
  - Income producing real estate
  - Primary residence

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Types of Collateral

- Iffy Stuff
  - Accounts Receivable
  - Inventory
  - Specialized equipment
  - Non income producing real estate
  - Toys

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Types of Collateral

- Bad Stuff
  - Intangible assets
    - Contracts
    - Patents
    - Franchise rights
  - Closely held assets
  - Agricultural Products
    - Does it walk and eat?
    - Does it spoil?

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What Do Lenders Do Besides Play Golf and Take People to Lunch?

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What Do Lenders Do Besides Play Golf and Take People to Lunch?

- Develop Business
- Gather Information
- Analyze financials
- Make credit decisions
- Communicate with customers
- Prepare documents
- Follow up
- Monitor

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Is There A Lot To Think About When You Make A Loan Decision?

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Is There A Lot To Think About When You Make A Loan Decision?

- Amount of loan requested
- Purpose of loan funds
- Repayment source
- Term of the loan
- Collateral
- History of the borrower
- Financial condition
- Other Creditors
- Success in the marketplace
- Business Plan

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What Happens When You Sit On A Two Legged Stool?

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What Do A Three Legged Stool And 5 C's Have In Common?

- The Three Legged Stool of Lending

- Character/Credit
- Capacity/Cash Flow
- Collateral

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What Do A Three Legged Stool And 5 C's Have In Common?

- The 5 C's of Credit
  - **Character** – Credit Report, Payment History, Civil/Criminal history
  - **Capacity/Cash Flow** – Does the business or individual make enough money to pay back creditors?
  - **Capital** – Do they have skin in the game?
  - **Conditions/Cycle** – How will the outside world affect the borrower?
  - **Collateral** – What do we fall back on if they can't pay?

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What Do A Three Legged Stool And 5 C's Have In Common?

- Analyzing a borrower's ability to repay is the most important step in the loan process

Look at past, present, future

Utilize tools available

Shore up the deal

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What Do A Three Legged Stool And 5 C's Have In Common?

Tools lenders use

- Credit reports
  - Over 700 = good credit score
  - Quickest way to determine a decline
- Spread programs
  - Used with business requests
  - Compare with industry
- Credit Scoring models
  - Used with consumer requests
  - Determines probability of default

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What Do A Three Legged Stool And 5 C's Have In Common?

- Options to make a weak deal stronger
  - Federal loan guarantee programs
    - SBA
    - USDA
  - Homebuyer Assistance
    - FHA
    - VA

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It's A Risky Business

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It's A Risky Business

- Most Common Risks
  - Economic
  - Political
  - Management
  - Environmental
  - Operational
  - Liquidity
  - Counterparty
  - Disaster

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Talking To Potential Borrowers

- Approach
  - Ask open ended questions
  - Listen more than you speak
  - Speak plain English
- Discussion
  - Understand the business fully
  - Create a realistic expectation of response time
  - Explain that follow up info may be necessary

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Talking To Potential Borrowers

- General Principals
  - Be prepared
  - Ask for additional information in writing
- Follow Up
  - Make a site visit
  - Give them a timely answer – especially if it is "NO"

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Session III

- What Happens Next?

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Not Afraid of Commitment?

- What constitutes a commitment?
  - Verbal – Saying "Yep. We can do that"
  - Written – Wording is important
- Term sheet versus commitment letter
  - Term Sheet –Written outline of the terms and conditions
  - Commitment letter – Binds the Bank

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Not Afraid of Commitment?

- What should be in a commitment letter?
  - Specific terms and conditions
  - Lists documents necessary for closing
  - Tells Borrower what must happen in order to close
- Be sure borrower understands terms
  - Clear with simple language
  - Allow them to ask questions
  - Give them an expectation of how much it will cost

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Let's Seal The Deal

- Its all about the paperwork
  - Correct document preparation is crucial to the Bank's repayment.
  - Loan compliance is getting a lot of attention from regulators and politicians.

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Let's Seal The Deal

- Documents that may be used in a loan closing
  - Application
  - Disclosures
  - Waiver of appraisal rights
  - Notice of flood determination
  - Attorney/Insurance preference
  - Appraisal
  - Borrowing resolution
  - Note
  - Security agreement
  - Mortgage
  - Loan agreement
  - UCC – 1
  - Guarantee Agreement
  - Settlement Statement

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Keeping The Relationship Alive

- Portfolio Management is a critical function for any lender
  - Call on customer
  - Monitor payment progress
  - Collect regular financial information
  - Correct documentation exceptions
  - Look for other opportunities
  - Ask for referrals

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When A Breakup Is Inevitable

- Identify the problem
  - Past due
  - Collateral value deterioration
  - Problems with other Banks
- React to the problem
  - Communicate, communicate, communicate
  - Document your communications
  - Verify the value of your collateral
  - Make sure your paperwork is in order
- Work it out
  - Loan modifications
  - Additional collateral
  - Support from a third party
  - Make sure your paperwork is in order

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When A Breakup Is Inevitable

- Collection
  - Start early
  - Get in front of the customer
  - You made the mess. You clean it up.
  - Short term issues require temporary solutions
  - Be creative
  - Make sure your paperwork is in order

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