CREDIT ANALYSIS
TECHNIQUES
ASSET QUALITY
CLASSIFICATION OF CREDITS

Classification of credits is according to the probability of repayment which estimates the amount of loss that will probably be suffered on deteriorating credits.
ASSESSMENT OF CREDIT QUALITY

The overall financial condition and resources of the borrower, including the current and stabilized cash flow.
ASSESSMENT OF CREDIT QUALITY

The credit history of the borrower
ASSESSMENT OF CREDIT QUALITY

The borrower’s or principal’s character
ASSESSMENT OF CREDIT QUALITY

The purpose of the credit relative to the source of repayment
ASSESSMENT OF CREDIT QUALITY

The types of secondary sources of repayment available:

– guarantor
– collateral
TREATMENT OF GUARANTEES

A guarantee should provide support for repayment of debt, in whole or in part, and be legally enforceable. It is predicated upon both the guarantor’s financial capacity and willingness to provide support for a debt.
TREATMENT OF GUARANTEES

• Degree to which guarantors have demonstrated their ability and willingness to fulfill previous guarantees

• Whether previous performance was voluntary or the result of legal action

• Economic incentives for guarantor performance

• Type of guarantee
ROLE OF COLLATERAL

Primary focus on a credit review is the borrower’s ability to repay without liquidation of collateral. However, in troubled loans, the assessment of collateral value should be used to support the credit.
ROLE OF COLLATERAL

- Whether bank has a legal claim to the assets
- Whether the bank can easily identify the collateral pledged by the borrower
- Maintenance of insurance
- Current valuation performed by an independent party
- Collateral inspections
KEY INDICATORS TO PROBLEM CREDITS
PROFILE OF A TROUBLED COMPANY

Stages of a Cash Crisis

– Cash Concern
– Cash Crunch
– Cash Crisis
CASH CONCERN

- Expenses reduced; salaries cut or raises delayed; bonuses cut or eliminated; overhead controls initiated
- Account receivable collections efforts strengthened; inventory levels reduced
- Capital expenditures reduced
- Prices cut to move stale inventory
CASH CRUNCH

- Expenses further reduced
- Employee layoffs
- Morale declines
- Nonessential assets sold
- Company seeks additional borrowings
- Assets are refinanced
- Product quality suffers
CASH CRISIS

- Additional assets sold
- Layoffs continue
- Key employee resign
- Plants closed
- Changes in top management
- Overdrawn accounts
- Loans past due
EARLY DETECTION

- Financial
- Nonfinancial
- Personal
FINANCIAL

• Performance compared with plans
• Performance compared with trends
• Performance compared with peer companies in the same industry
• Financial structure
NONFINANCIAL

- Change in product mix
- Change in market strategy
- Rapid expansion plans
- Management turnover or shuffling
- Change in accounting firms
- Change in structure of board of directors
PERSONAL

• Lifestyle
• Personal investments
• Personal behavior
• Relationship with banker
• Willingness to provide information
CLASSIFICATION CATEGORIES

- Substandard
- Doubtful
- Loss
Substandard credits are inadequately protected by the current sound worth and paying capacity of the borrower or of the collateral pledged. Substandard credits have well defined weaknesses that jeopardize the liquidation of the debt. If not corrected, these weaknesses expose the bank to loss.
DOUBTFUL

Have all the weaknesses of a substandard credit with the added characteristic that the liquidation in full, on the basis of existing facts, is highly questionable and improbable.
LOSS

Loss credits are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the credit has no recovery or salvage value, but it is not practical to defer writing off the bank’s books.
SPECIAL MENTION

Defined as a credit having potential weaknesses that deserve management’s close attention. If left uncorrected, these potential weaknesses may, at some future date, result in deterioration of repayment abilities.
SPECIAL MENTION SITUATIONS

• Lending officer may be unable to properly supervise the credit because of an inadequate loan agreement
• Questions exist over the condition/control of collateral
• Economic conditions may unfavorably affect the obligor