Loan Terms and Process

A bank´s credit culture determines its lending activity as well as its risk management and processes related to it, such as: Business development, credit analysis, credit execution, monitoring and administration as well as loan workout and restructuring, should it be required.

Prior to issuing a loan to a client, extensive credit analysis is undertaken: This, in essence, assesses the likelihood or risk of a client´s default on a loan. Thereby, focus will be on the risks inherent in the operations of a business, the borrower´s abilities to address or mitigate such risks, and the lender´s alternatives to adequately structure and control its own exposure.

In this context, lenders usually refer to the 5 C´s to evaluate a borrower:

- Character: A borrower´s reputation or track record for repaying debts.
- Capacity: A borrower´s ability to repay a loan in view of debt vs income.
- Capital: The borrower´s contribution towards a potential investment.
- Collateral: Assurances that in the case of default the lender can repossess previously agreed upon borrower´s assets.
- Conditions: Terms, such as interest rate, amount of principal, payback schedule, currency or else.

The decision on issuing smaller loans may be made by an individual officer (increasingly supported by algorithms), whereas with volume and complexity rising, a credit committee will get involved.

A loan agreement is a legal document, comprising, among others:

- Type of credit facility: Secured (collateral in case of default) vs unsecured (no collateral).
- Amount
- Currency
- Purpose: Working capital, investment, acquisition, overdraft, credit line.
- Interest: Floating (benchmark) vs fixed, spread
- Payment terms: Interest (regular vs accrued), principal (term loan / regular, period payments vs balloon payment, revolving loan where principal can be spent, repaid and spent again).
- Maturity
- Other: Guarantors, recourse, reporting and documentation, representations and warranties, events of default.

Covenants are an essential part of a loan agreement: Financial covenants are restrictions based on specific balance sheet, income statement or cash flow items, whilst operating activity covenants dictate how to operate a business. Other covenants may refer to reporting, disclosures, maintenance of collateral, restrictions on investments or the payment of dividends, the sale of assets or divestitures.

Often, covenants are defined in the form of financial ratios, such as certain minimum standards to be maintained by the borrower, for example addressing liquidity (current or quick ratio), leverage (debt / equity, assets / equity), or profitability (frequently based on cash flow or EBITDA). Additional covenants are directed towards the loan as such, for instance interest coverage (EBIT / interest) or debt coverage (debt / EBITDA).

Covenants can also be distinguished into positive ones (affirmative, or what has to be achieved or done) and negative ones (what is not allowed to do). – Affirmative covenants may address maintaining credible / audited reporting or accounts, or upholding insurance coverage. Negative covenants may include restrictions on mergers, certain investments, divestitures or write-offs or in regards to dividend policy.

The loan review process is split into monitoring the performance of existing loans and the handling of problem loans, whereby the ongoing loan review should act separately and independently from loan officers. In the case of default (violation of covenants or failure to make agreed upon payments) a loan would be referred to a specialist workout and restructuring team. Together with the borrower, the team will attempt to change the terms of the loan, with a view that the lender has a more likely chance of recovering the loan principal and interest without foreclosure. – If that fails, liquidation of collateral may be pursued, in worst case bankruptcy procedures initiated.

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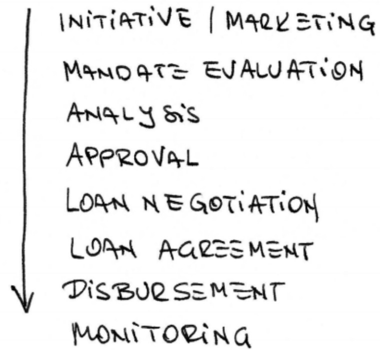
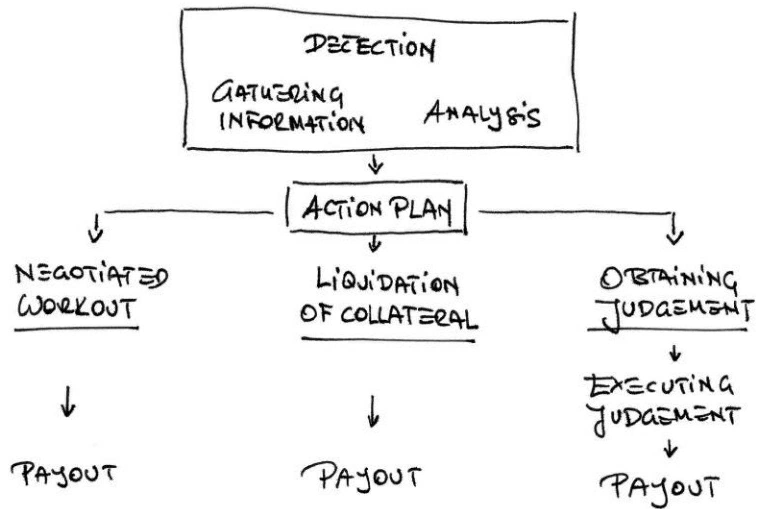
LOAN PROCESS



PROBLEM LOANS AND RECOVERY



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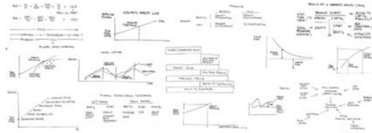

Corporate Finance Concepts

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