

# COMMERCIAL BANKING

1<sup>st</sup> Year Class

2021

# Key Topics

- The Business of Banking & Leverage
- The Credit Process & Credit Risk
- Components of Financial Health  
Liquidity, Leverage, Asset Quality, Sales  
Growth, Profit Margins, Cash Flow
- Business Life Cycles
- Economic cycles impact on Banking
- Putting It All Together – The Credit  
Decision

# Session 1 - Overview

- Banking Industry Update
- Review Home Study Problem
- Why Do Businesses Borrow?
- Why Do Banks make Loans?
- Credit Losses
- Discuss Study Cases

# Banking Industry Update

# Home Study Problem

# Why Do Businesses Borrow?

- Leverage Works - To a Point

Investment = \$100,000

Earn = \$ 20,000

Return 20%

# Why Do Businesses Borrow?

- The Impact of a Loan

Borrow = \$80,000 (one year @ 10%)

Investment = \$20,000

Earn = \$12,000 (profit of \$20,000  
minus \$8,000 interest

cost)

Return = 60%

# Why Do Banks Make Loans?

- Primary Obligations are Deposits and Borrowed Funds
- Primary Earning Assets are:
  - Investments
  - Consumer Loans
  - Commercial Loans
  - Real Estate Loans

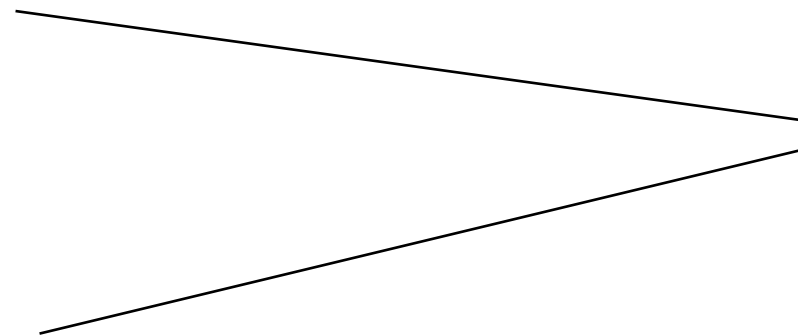


# The Bank as a Business

% Interest Earned

Net Interest Margin

Cost of Funds %



\*The Answer - Fees

\*The Other Answer - Credit Losses

# Credit Loss

# Credit Risk Classifications

- Transaction Risk  
Risk Rating
- Inherent Risk  
Industry - Line of Business
- Concentration Risk  
Borrower, Industry, Geographic

# Risk Tolerance Standards

- Past Due Loans
- Watch Loans
- Classified Assets
- Non-Performing Assets
- Losses

# Risk Tolerance Standards

## Examples\*

Past Due Loans	2.0 to 4.0%
Watch Loans	3.0 to 7.0%
Classified Assets	2.0 to 5.0%
Non-Performing Assets	1.0 to 2.5%
Losses	0.5 to 1.0%

\*Percent Loans Outstanding

# Session 2 - Overview

- The Lending Process
- Credit Analysis Considerations
- Loan Policy
- Financial Analysis
- Key Indicators of Financial Health
- The Balance Sheet
- The Income Statement

# The Lending Process

- Application or Solicitation
- Analysis
- Approval
- Documentation
- Monitoring
- Collection

# Credit Analysis Considerations

- Loan Policy
- Economic Climate
- Regulatory Environment
- Geographic Location
- Company Management
- Bank Resources



# Loan Policy

- Establish prudent credit concentrations & guidelines
- Establish effective concentration monitoring and reporting
- Require comprehensive analysis of repayment ability
- Specify the type of financial information and documentation necessary for each loan type
- Set requirements for property and other types of inspections
- Approach on timely identification and collection of problem assets

# Financial Analysis

- The primary purpose is to determine how and if the Bank will get repaid
  - Purpose of the Loan
  - Source of Repayment
  - Timing of Repayment
  - Secondary source of Repayment
  - Outside/Guarantor Support

# Views on Financial Performance

- The Borrower – Net Sales is the focus
  - “Sales are up! What do you mean I’m not making money?”
- The Banker – Profits & Cash Flow
  - “We need your company to evidence the capacity to repay our debt.”

# Components of Financial Health

- Liquidity
- Leverage
- Asset Quality
- Sales Growth
- Profit Margins
- Cash Flow

# Components of Financial Health

- Liquidity – Current Ratio
- Leverage – Debt to Worth Ratio
- Asset Quality - A/R, Inventory & A/P Turnover
- Sales Growth – Net Sales Growth
- Profit Margins – Gross, Operating & Net Margin
- Cash Flow – Cash After Debt Amortization

# Balance Sheet

# Income Statement

# Session 3 - Overview

- Financial Analysis – Continued
- Sources and Uses of Cash
- Cash Flow



# Sources & Uses of Cash

## Cash Budget

	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	To
Beginning cash balance	\$935	\$891	\$928	\$895	\$889	\$939	\$952	\$927	\$920	\$909	\$977	\$927	\$
Cash from operations	125	218	141	156	211	161	155	187	167	246	132	184	2
Total Available Cash	\$1,060	\$1,109	\$1,069	\$1,051	\$1,100	\$1,100	\$1,107	\$1,114	\$1,087	\$1,155	\$1,109	\$1,111	\$3
Less:													
Capital expenditures	\$113	\$123	\$113	\$106	\$102	\$94	\$114	\$126	\$133	\$126	\$119	\$123	\$1
Interest	20	26	24	25	21	22	27	29	20	27	23	29	
Dividends	2	4	3	5	0	2	1	2	3	2	4	5	
Debt retirement	50	31	40	32	48	39	46	41	34	30	40	42	
Other	0	0	0	0	0	0	0	0	0	2	0	0	
Total Disbursements	\$185	\$184	\$180	\$168	\$171	\$157	\$188	\$198	\$190	\$187	\$186	\$199	\$2
Cash Balance (Deficit)	\$875	\$925	\$889	\$883	\$929	\$943	\$919	\$916	\$897	\$968	\$923	\$912	\$
Add:													
Short-term loans	6	3	6	6	10	9	8	4	7	9	4	5	
Long-term loans	\$10	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$5	\$0	\$0	\$0	
Capital stock issues	0	0	0	0	0	0	0	0	0	0	0	0	
Total Additions	16	3	6	6	10	9	8	4	12	9	4	5	
Ending Cash Balance	\$891	\$928	\$895	\$889	\$939	\$952	\$927	\$920	\$909	\$977	\$927	\$917	\$

# Cash Flow

# Session 4 - Overview

- Financial Analysis – Completed
  - Cash Flow & Sources and Uses
- Components of Financial Health
- Company Growth – When is more the wrong answer for the borrower?
- The Business of Lending
- Class Questions & Review

# Components of Financial Health

- Liquidity – Current Ratio
- Leverage – Debt to Worth Ratio
- Asset Quality - A/R, Inventory & A/P Turnover
- Sales Growth – Net Sales Growth
- Profit Margins – Gross, Operating & Net Margin
- Cash Flow – Cash After Debt Amortization

# Company Growth

When is more the wrong answer?

# The Business of Lending

## Risk Ratings & Why Loan Quality is Critical?

# Session 5 – Overview

- Business Life Cycles of the Borrowers and the Impact on Portfolio Management
- The Economic Cycle
- Case Study #1 & #2
- Concentration Issues
- Warning Signs & Weaknesses
- Managing the Lending Function
- Review Home Study



# Business Life Cycles of the Borrowers and the Impact on Portfolio Management

# The Economic Cycle

# Cases Study #1 & #2

# Concentrations

- Large volume of economically related loans by collateral type, industry, or borrower
- Potentially created by factors such as location, economic environment or the bank's market niche
- Considerations should include growth plans, policies, inspection requirements, and prudent limitations
- Monitoring routines should be increased with more in-depth review - the greater the concentration, the greater the need for monitoring
- Management reporting should address the dollar volume of the exposure, industry status and direction, supply and demand trends for the type of property, and changes in underwriting standards

# Warning Signs & Weaknesses

- Loan documentation is poor as updated financial information is not being received, is weakly analysis and is a “routine” not a decision point
- Internal credit review is based solely on delinquency
- The “watch list” is inadequate, ineffective and not a “management tool”
- Process is reactive not proactive relative to financial health of the portfolio

# Managing The Lending Function

- Bank Management/Executives Should:
- Adopt effective policies prior to loan decisions
  - Send a clear message
  - Tailor policy to past events & experiences
- Inspect & Enforce policies as loans are decisioned
  - Documentation
  - Review Function - Targeting Process
- Enable adequate monitor activities after loan decisions
  - Management Reporting
  - Loan Review Systems
- Maintain adequate allowance for losses
  - Changes in lending policies, staff, nature and volume of loans, trends in past due and adversely classified credits, change in local and national economic conditions

# Commercial Banking Home Study

In Seven pages or *less*:

1. Discuss the composition (Loan types, Segments or Lines of Business) of the Commercial Loan Portfolio within your Institution. For each component of your portfolio, outline the placement within one of the four business lifecycles (Start-up, Growth, Mature and Decline).
2. Discuss your view on the economy's direction and the potential impact to your Institution's Commercial Loan Portfolio over the next 24 months.
3. Given your portfolio composition, placement of the components within the business life cycles and your thoughts on the direction of the economy, outline any recommended changes to your company's lending policies to ensure asset quality remains within established risk tolerance standards over the 24 months.

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