Understanding the Problem Loan Process in Banking

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Successful discovery and depositions require an understanding of the problem loan process in banking. Once a bank has designated a loan as a problem, it takes on a new set of regulatory and policy requirements. Problem loans are sometimes also designated as "Workout Loans." Virtually all problem loans have an adverse classification per regulatory guidelines. I will explain these adverse classifications as well as other banking terms and procedures associated with problem credits. Understanding these classifications may help in assessing how the bank is monitoring, reviewing, analyzing, collecting the loan, and approaching litigation. All of my discussion will pertain to larger loans of banks and not consumer type credit. Some banks, normally larger banks, transfer problem loans to specialized departments for handling. Typically these are designated with special names such as; "Problem Loan Departments," "Work-out Departments," "Special Assets," or "Credit Services."

Adversely Classified Loans and Loan Risk Rating

All banks attach a numerical risk rating or grade to each loan. These appear somewhere in the bank credit file documents or loan boarding information. The specific numerical risk rating system is usually detailed in the loan policy of each bank. Adversely classified loan designations (sometimes referred to as criticized loans) will always be part of the risk rating system of the bank. Loans that are not adversely classified are generally referred to as "pass credits" by the regulatory examiners. Pass credits usually have a numbering system such as 1, 2, 3, or 4, and sometimes are designated with much more detail such as; 1A, or 3W. The numbering system may vary from bank to bank but should be detailed in the bank loan policy. The federal bank and thrift regulatory agencies utilize the following definitions for assets (loans) adversely classified for supervisory purposes as well as those assets listed as special mention.

Special Mention: Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification. 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.

Substandard Assets: A Substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets 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 institution will sustain some loss if the deficiencies are not corrected.

Doubtful Assets: An asset classified doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weakness make collection or liquidation in full, on the basis of current existing facts, conditions, and values, highly questionable and improbable.

Loss Assets: Assets classified loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be affected in the future.

Based on the sample numerical system as outlined above, the pass credits and adversely classified loans would be designated as follows:

Pass Credits
1, 2, 3, and 4 (Pass Credits)
5 (Special Mention)

Adversely Classified Assets
6 (Substandard Assets)
7 (Doubtful Assets)
8 (Loss Assets)

The risk rating quality of the pass credits usually go from the best; 1 to the higher risk 4, before reaching the regulatory guidelines for problem credits. As an example, a risk rating of 1 might be a savings secured loan or loan of such a high quality that there is virtually no possibility of loss. A risk rating of 4 might be a loan that is on the banks "Watch List", meaning it is being highly monitored, and could become a problem but has not yet been downgraded to Special Mention or worse. Some banks designate a 5 (Special Mention) as their Watch List risk category. Loans are typically risk rated by the loan officer designated to handle the credit but the ratings are verified by the appropriate approving body. This could include an Officer Loan Committee, Chief Credit Officer, Board Loan Committee, or Board of Directors depending on how each bank has authorized loan approval/review authority. When regulators examine the bank's loan portfolios, they check the risk ratings of loans reviewed to make sure the appropriate risk rating has been assigned. At each credit examination by regulators, a random sampling of loans is reviewed, but all existing adversely classified loans are reviewed.

At a minimum, the adversely classified definitions, as outlined above, should appear in the bank's loan policy but may be expanded to include more detail. Such detail might suggest when a loan is to be charged off, placed on nonaccrual, or what corrective action may be required.

Allowance for Loan and Lease Loss (ALLL)

All banks are required to maintain an Allowance for Loan and Lease Loss (ALLL). There are key concepts in Generally Accepted Accounting Principles (GAAP) and ALLL supervisory guidance that must be followed. There are Statements of Policy by the regulatory agencies that go into great detail on this subject. I will only address the basic concept in this article. The principal source of guidance on accounting for impairment in a loan portfolio under GAAP are Statement of Financial Accounting Standard No. 5, *Accounting for Contingencies* (FAS 5), and Statement or Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan* (FAS 114). The ALLL is maintained by the bank for the total loan portfolio. Once a loan is

adversely classified, a specific impairment analysis and problem loan report is maintained on each credit relationship. The impairment analysis and problem loan report will be updated on a quarterly basis for regulatory reporting purposes. This information should be specifically requested during discovery, since most litigation involves loans that have been identified by the bank or regulators as problem credits.

Bank Expert Witnesses examine this information to determine the amount of impairment that has been calculated on each loan. This impairment calculation determines the ALLL dollar amount that has been allocated (reserved) on each loan. This information should be helpful in mediation or settlement negotiations.

Nonaccrual

Once a loan has been adversely classified, a determination is made by the bank as to whether the loan should be placed on nonaccrual. A nonaccrual loan is a loan on which a bank internally stops accruing interest. Standard banking regulations require that loans be placed on nonaccrual when certain thresholds are identified. Basically, a nonaccrual decision is made when there is doubt as to the full collection of principal and interest. Nonaccrual loans will almost always be classified. A bank places a loan on nonaccrual according to criteria in the call report instructions. The general rule is that an asset (loan) should be placed on nonaccrual when principal or interest is 90 days or more past due. There is no requirement that a loan must be delinquent for 90 days before it is placed on nonaccrual. Once reasonable doubt exists about a loan's collectability, the loan should be placed on nonaccrual. Continuing to accrue interest income on assets (loans) which are in default or there is doubt as to the full collection of principal and interest, overstates a bank's assets, earnings, and capital.

Once a bank places a loan on nonaccrual, all accrued unpaid interest is reversed from current earnings of the bank. The placing of a loan on nonaccrual has no affect on the balance or accrual of interest that is owed by the customer. Simply stated, the bank discontinues showing any interest income on its income statement until the loan is fully paid or reaches criteria for restoration to accrual status.

Early Involvement In The Case

There are a number of reasons why it is important to get an expert involved early in the case. It happens far too often that I receive a call and the attorney says, "I have to designate an expert by a certain date" which is only a couple of weeks away or less. As we get into the discussion and I start asking about discovery and specific documents, we find that discovery did not cover all of the documents like ALLL and problem loan reports, needed to evaluate the case and the deadline has passed to request the additional information. This is most prevalent when I represent clients against banks. I can understand the attorneys reasoning for waiting as long as possible to retain an expert, hoping the case will settle and save the cost of an expert; however, it would have probably been helpful to know what the bank's ALLL and impairment analysis determined prior to settlement or mediation negotiations.

Conclusion

In conclusion, optimizing the use of an expert in Understanding the Problem Loan Process in Banking can be extremely beneficial to the case. It can also benefit a case early on during settlement negotiations, especially if the attorney has identified what has been set aside for projected loss on the credit. If it is determined early in the case that an expert will be needed, there is no reason not to optimize his/her use in analyzing problem loan documents.