Loan Classification Case Study

BASE CASE:

- $15 million loan to buy an office building
- 20 year amortization, $13.6 million balloon at end of year 5
- 75% LTV ($20 million AV)
- DSC Ratio 1.30x
- Over the course of the five year, vacancy has increased due to market weakness of office space

SCENARIO 1: At maturity, the lender renewed the $13.6 million loan for one year at a market interest rate that provides for the incremental risk and payments based on amortizing the principal over the remaining 15 years. The borrower had not been delinquent on prior payments and has sufficient cash flow to service the loan at the market interest rate terms with a DSC ratio of 1.12x, based on updated financial information. A review of the leases reflects that most tenants are stable occupants, with long-term leases and sufficient cash flow to pay their rent. The major tenants have not adopted hybrid work-from-home arrangements for their employees given the nature of the businesses. Recent AV: $13.3 million, LTV of 102%.

SCENARIO 2: At maturity, the lender renewed the $13.6 million loan at a market interest rate that provides for the incremental risk and payments based on amortizing the principal over the remaining 15 years. The borrower had not been delinquent on prior payments. Current projections indicate the DSC ratio will not drop below 1.12x based on leases in place and letters of intent for vacant space. However, some leases are coming up for renewal, and additional rental concessions may be necessary to either retain those existing tenants or attract new tenants. The lender estimates the property's current "as stabilized" market value is $14.5 million, 94% LTV, but a current valuation has not been ordered. In addition, the lender has not asked the borrower or guarantors to provide current financial statements to assess their ability to support any cash flow shortfall.

SCENARIO 3: At maturity, the lender restructured the $13.6 million loan on a 12-month interest-only basis at a below market interest rate. The borrower has been sporadically delinquent on prior principal and interest payments. The borrower projects a DSC ratio of 1.10x based on the restructured interest-only terms. A review of the rent roll, which was available to the lender at the time of the restructuring, reflects the majority of tenants have short-term leases, with three leases expected to expire within the next three months. According to the lender, leasing has not improved since the restructuring as market conditions remain soft. Further, the borrower does not have an update as to whether the three expiring leases will renew at maturity; two of the tenants have moved to hybrid work-from-home arrangements. Recent AV: $14.5 million, 94% LTV.

Special Mention Loan Definition

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

Substandard Loan Definition

Substandard loans are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans 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.

Loss Loan Definition

Loans 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 loan 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 effected in the future.