Risk Rating Definitions – Commercial & Institutional Loans

Applies to:

- Business Banking
- Small Business Lending (interim)
- Not-For-Profits and Institutions

Excellent (1)

New and renewed loans based on liquid collateral, with adequate margin or supported by strong financial statements, audited with an unqualified opinion from a Certified Public Accounting firm. The character and repayment ability of the borrowers are excellent and without question. High liquidity, minimum leverage, strong ratios, and minimal monitoring requirements are common to these loans. This classification will also include all loans secured by Certificates of Deposit ("CDs") or cash equivalents, margined in accordance with bank policy. In addition, an Excellent rating may be assigned to a publicly traded company that has a senior debt rating of AA or better.

DSCR	Leverage	Collateral Coverage	Liquidity	Profitability	Mgmt	Industry Outlook	Delinquency	Covenant Compliance	Debt Rating Equivalent
> 3.0x	Minimal	>2.5x, well-matched to loan type, or 100% cash-secured	Excellent	Consistently high, from core operations	Capable & deep	Favorable	None	Complies	AAA,AA

Good (2)

Desirable new and renewed loans of somewhat less stature than Excellent, but with strong financial statements containing an unqualified opinion from a CPA firm. Loans supported by un-audited financial statements containing strong balance sheets and five consecutive years of profits, combined with a five-year satisfactory relationship with the Bank. Loans secured by margined marketable securities, where there is no concentration or impairment to liquidation and the probability of serious financial deterioration is unlikely. Possessing a sound primary source of repayment and a secondary source, which will reasonably allow for repayment within a reasonable period of time. Individual loans backed by liquid personal assets, established history, and unquestionable character. May include unsecured loans to substantial publicly owned or privately owned businesses which for the most part meet the requirements of Excellent (1) above and are considered to be well above average financial strength but may be major players in cyclical industries that have experienced fluctuating earnings records. May also include secured or unsecured loans to publicly traded companies of very strong financial strength.

DSCR	Leverage	Collateral Coverage	Liquidity	Profitability	Mgmt	Industry Outlook	Delinquency	Covenant Compliance	Debt Rating Equivalent
> 1.75x	Minimal	>1.75x, well-matched to loan type.	Very Good	Consistently above average, from core operations	Capable & deep	Acceptable	None	Complies	A to BBB+/-

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Satisfactory (3)
Satisfactory loans of slightly better than average risk; having some deficiency or vulnerability to changing economic conditions, but still fully collectible. Projects/borrowers clearly demonstrate better than breakeven debt service coverage on a current basis. May exhibit some weaknesses, but with offsetting features of other support readily available. Loans that are meeting the terms of repayment, but may be susceptible to deterioration if adverse factors are encountered.

Loans may be rated Satisfactory when in-file financial information is older than two years and the following conditions apply:

- At inception, the loan was properly underwritten and did not possess an unwarranted level of credit risk—also the loan met the above criteria for a risk rating of Excellent, Good, or Satisfactory.
- At inception, the loan was secured with collateral possessing a loan-to-value adequate to protect the Bank from loss.
- The loan has exhibited two or more years of satisfactory repayment with (1) a reasonable reduction of the principal balance or (2) performance within asset-based remittance and reporting requirements.
- During the period that the loan has been outstanding, there has been no evidence of any material credit weakness. Some examples of weakness include slow payment, some lack of cooperation by the borrower, or the business is in an industry which is known to be experiencing problems. If any of these credit weaknesses are observed, a lower risk rating is warranted.
- May also include secure or unsecured loans to publicly traded companies that have exceptionally strong financial depth.

DSCR	Leverage	Collateral Coverage	Liquidity	Profitability	Mgmt	Industry Outlook	Delinquency (last 12 mos)	Covenant Compliance	Debt Rating Equivalent
> 1.5x	Acceptable	>1.5x, matched to loan type.	Good	Consistently average, largely from core operations	Capable	Generally Acceptable	1 X 30	Complies	BB+/BB

Acceptable (4)
This risk rating would be assigned to a loan considered satisfactory, but which is of only average or slightly below average credit risk due to financial weakness or uncertainty. Loans so categorized need a higher than average level of monitoring to ensure that weaknesses do not advance. Debt service coverage may be weaker than for a loan rated 3 and secondary repayment sources may be less secure.

Credit relationships falling into this category may include transitional credits such as:

- Stronger RE construction/renovation projects for commercial borrowers with strong NWs and/or liquidity, due to the inherent risk of construction lending; most RE construction/renovation project loans will be rated 5.
- Loans to franchisees where the primary collateral is a blanket lien on business assets, valued on an Enterprise Value basis.
- Loans to contractors with limited experience with the Bank under a Developer Line of Credit product.
- May also include secured or unsecured loans to publicly traded companies that have very good financial strength.

DSCR	Leverage	Collateral Coverage	Liquidity	Profitability	Mgmt	Industry Outlook	Delinquency (last 12 mos)	Covenant Compliance	Debt Rating Equivalent
>1.25x	Acceptable	>1.25x matched to loan type.	Acceptable	Average, with minor other income contribution	Capable, may be unproven	Generally Acceptable, may be vulnerable to bus. cyc.	1 X 30, or more	Infrequent waivers-non-financial in nature	BB / BB-

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Acceptable/Monitored (5)
Loans, which possess some credit deficiency or potential weakness, which deserve close attention but which do not yet appear to jeopardize repayment. The key distinctions of an Acceptable/Monitored classification are that the credit characteristics are those of a '4' rated credit that is performing normally, but there is an uncertain level of risk due to such factors as (1) a lack of information about the current condition of the borrower, and/or (2) a documentation defect that could ultimately jeopardize repayment of the loan in full. Examples of 5 rated borrowers are business start-ups and most RE construction/renovation projects.

The level of risk in an Acceptable/Monitored credit is considered non-criticized (i.e 6 or worse) and within normal underwriting guidelines as long as the loan is given the proper level of management supervision. Debt service coverage may be weaker than for category 4 credits and secondary repayment sources may less secure.

DSCR	Leverage	Collateral Coverage	Liquidity	Profitability	Mgmt	Industry Outlook	Delinquency (last 12 mos)	Covenant Compliance	Debt Rating Equivalent
>1.05x	High	>1.0x, collateral mis-match	Weak	Inconsistent w/ recent weakness(es)	Some weakness	Uncertain may be vulnerable to business cycle	Occasional 30 day	Infrequent waivers.	B

Special Mention (6) *[Criticized]*
Per the FDIC: *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.*

The Special Mention category is not to be used as a means of avoiding a clear decision to classify a loan or pass it without criticism. Neither should it include loans listed merely "for the record" when uncertainties and complexities, perhaps coupled with size, create some reservation about the loan.

Loans to new customers should not be approved with this loan rating. 6-rated credits generally reflect these characteristics:

DSCR	Leverage	Collateral Coverage	Liquidity	Profitability	Mgmt	Industry Outlook	Delinquency (last 12 mos)	Covenant Compliance	Debt Rating Equivalent
<1.00x	Very High	<1.0x to adequate; may be over-margined	Strained	Inconsistent w/ material loss, after previous profitability.	Potential weakness	Neutral to Unfavorable outlook and dynamics	Up to 45-60 days, frequent 30+ days	Frequent waivers.	CCC

Substandard (7) *[Classified]*
Per the FDIC: *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 bank will sustain some loss if the deficiencies are not corrected.*

One or more of the following characteristics may be exhibited in credits classified Substandard:

- Possess a defined credit weakness and the likelihood that a loan will be repaid from the primary source of repayment, are uncertain or nonexistent.
- Financial deterioration is under way and very close attention is warranted to minimize potential and probable losses.
- Loans are inadequately protected by the current net worth and paying capacity of the obligor.
- Unusual courses of action are needed to maintain a high probability of repayment.
- The borrower is not generating enough cash flow to repay loan principal (even if the in the interim the borrower continue to make interest payments by drawing on external but non-contractually obligated sources).
- The lender is forced into an inadequately protected position (e.g. subordinated or unsecured position due to flaws in documentation).
- Loans have been restructured so that payment schedules, terms, and collateral represent concessions to the borrower when compared to the normal loan terms.
- Initiation of legal action which would cause the bank to be inadequately protected based on the best judgment of the bank.
- Most if not all credits transferred to Other Real Estate Owned status will be classified 7-Substandard.

DSCR	Leverage	Collateral Coverage	Liquidity	Profitability	Mgmt	Industry Outlook	Delinquency (last 12 mos)	Covenant Compliance	Debt Rating Equivalent
Inade-quate	Very High	<1.0x to adequate; may be over-margined	Strained	Serious and/or consistent losses.	Incapable and/or ineffective	Highly unfavorable outlook and dynamics	Up to 90 days	Frequent violations	CC/C, or D if bankruptcy filing

Loans to new customers will not be approved with this loan rating. When a credit is 7-rated or worse, the loan officer should evaluate the loan's accrual status, and prepare an Impairment Analysis consistent with FAS 114 and bank policy. If impairment exists, the analysis should be forwarded to the Special Assets Group as well as Finance & Accounting, and the loan should be placed on non-accrual status.

Doubtful (8) *[Classified]*

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Per the FDIC: *Loans classified as Doubtful have all the weaknesses inherent in those classified Substandard with the added characteristic that the weaknesses make collection or liquidation if full, on the basis of known facts, conditions and values, highly questionable and improbable.*

DSCR	Leverage	Collateral Coverage	Liquidity	Profitability	Mgmt	Industry Outlook	Delinquency (last 12 mos)	Covenant Compliance	Debt Rating Equivalent
Inade-quate	Insolvent	<0.5x - 0.75x	Very Strained	Serious losses.	Incapable, not credible	N/A	> 91 days, non-accrual	Consistent violations	D

The loan officer should place an 8-rated credit on non-accrual status, and prepare a Credit Adverse Action Form, an ORE Transfer form (if applicable), and an Impairment Analysis consistent with FAS 114 and bank policy.

Loss (9) *[Classified]*

Per FDIC: *Loans classified Loss are considered uncollectible and of such little value that continuing to carry them as assets on the Bank's financial statements is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value, but rather it is not practical nor desirable to defer writing off this basically worthless asset, even though partial recovery may be affected in the future.*

General Risk Rating Guidelines

- Loan officers (relationship managers, salesoersons, and credit analysts involved in the credit decision) are ShoreBank's first line of defense when it comes to risk rating accuracy. Risk ratings dictate our level of earnings, loan loss reserves, capital, and reputation with our regulators and auditors. Ratings should be assigned and modified based on objectivity, not ego. Every loan officer needs to know and properly apply risk ratings in both underwriting and credit management.

- Risk ratings should be fully justified in each loan presentation memo, referencing the guidelines above for the rating assigned.

- ShoreBank's rules for modifying risk ratings:

  - Loan officers should revisit a risk rating and document/communicate with a credit file memo, any RR change within 30-45 days of receipt of adverse financial information either from the borrower or other source, but in no event past a calendar quarter end date.
  - A double-downgrade of a risk rating (i.e. more than one notch) within a short timeframe, and absent no new material information, is not indicative of proper risk management and communication. Disciplinary action may be taken in accordance with SBK's Human Resources policies and procedures.
  - Reasonable banking professionals may disagree on the difference between, say a 3-rated or 4-rated credit, but there should be little disagreement between a "Pass" credit and a "Criticized" credit.

- Loan Review (internal and external) are the final authority on risk ratings. However, in the event Loan Review and management do not reach agreement on the amount of impairment or charge-off, the final decision will rest with the Chief Credit Officer.