BANKING JUDGMENT LAB · THE IN-TRAY · THE GROUNDWORK · WORKSHEET

The Loan

Ten files on the contract: capacity, protection, price, hedges.

Ten one-minute files. Each gives a short setup, a few numbers and four possible calls. Make the call on paper; the reads are on the last pages — each names the senior banker's call and shows the working, with no score. Most files have more than one defensible call; the read says how far each sits from the senior's.

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THE FILES

FILE 1 OF 10 · THE LOAN · CAPACITY

A company asks to refinance. Its year in four numbers:

EBITDA	CAPEX + TAX	INTEREST	PRINCIPAL DUE
US$6m	US$2m	US$1m	US$2m

What is its debt service cover, on cash available after capital spending and tax?

[A] About 1.3 times.

[B] 2.0 times, on EBITDA.

[C] 6.0 times.

[D] 4.0 times.

FILE 2 OF 10 · THE LOAN · CAPACITY

Two borrowers each carry debt of three times EBITDA. One sells software on three-year contracts; the other builds new houses for sale.

Is three times the same risk for both?

[A] Yes, if their interest cover is the same.

[B] Yes. The multiple already adjusts for size.

[C] No. The builder is safer because it owns land.

[D] No. The same multiple sits on very different earnings stability.

FILE 3 OF 10 · THE LOAN · PROTECTION

A company with a US$25m senior secured bank loan and US$20m of unsecured notes fails. After the costs of the process, its assets realise US$30m.

Who gets what?

[A] It depends on what the administrators charge.

[B] The bank is repaid in full; noteholders share US$5m.

[C] Everyone recovers about two-thirds.

[D] Noteholders first, because they invested.

FILE 4 OF 10 · THE LOAN · PRICE

A US$10m loan. The bank estimates a 2% chance the borrower defaults within a year, and expects to lose 40% of what is owed if it does.

What is the expected annual loss?

[A] US$200,000.

[B] US$80,000.

[C] US$4,000,000.

[D] Nothing, unless it defaults.

FILE 5 OF 10 · THE LOAN · CAPACITY

A property investor collects US$2.4m of rent a year and spends US$0.4m running the building. Interest and principal on its loan come to US$1.6m a year.

What is its debt service cover?

[A] Can't tell without knowing the leases.

[B] 1.5 times.

[C] 0.8 times.

[D] 1.25 times.

FILE 6 OF 10 · THE LOAN · PRICE

A US$20m loan. The bank expects to lose 0.5% of it a year on average. It must hold capital equal to 10% of the loan, and its shareholders expect 12% a year on that capital. Funding and running costs are priced separately.

What margin covers expected loss and the return on capital?

[A] About 1.7% a year.

[B] About 1.2% a year.

[C] About 0.5% a year.

[D] Whatever the market will bear.

FILE 7 OF 10 · THE LOAN · CAPACITY

A US$2m machine is expected to save US$400k of cash a year. The borrower asks for a three-year loan to buy it.

How long does the machine take to pay for itself?

[A] Five years, before interest.

[B] Five years, longer than the loan.

[C] Three years, the loan term.

[D] It pays for itself; it returns 20% a year.

FILE 8 OF 10 · THE LOAN · PRICE

A company borrows at 8% a year. Its interest is deductible, and it pays tax at 25%.

What is its after-tax cost of this debt?

[A] 6%.

[B] 6%, if it has the profit to deduct the interest against.

[C] 8%.

[D] 2%.

FILE 9 OF 10 · THE LOAN · PROTECTION

A company fails. One lender is secured over the plant; the other is unsecured. The receiver's realisations, after costs, are below. There are no preferential claims.

SECURED LENDER OWED	UNSECURED LENDER OWED	REALISED FROM THE PLANT
US$10m	US$5m	US$9m

REALISED FROM EVERYTHING ELSE
US$2m

What does the unsecured lender recover?

[A] US$2m. The plant was the secured lender's; the rest is theirs.

[B] Nothing until the secured lender is paid in full.

[C] About US$1.7m.

[D] About US$1m, allowing for costs still to come.

FILE 10 OF 10 · THE LOAN · HEDGES

A borrower pays a floating rate on a five-year term loan: the base rate plus a margin. It enters a swap with the bank, paying a fixed rate and receiving the base rate.

LENDING MARGIN	SWAP FIXED RATE	BASE RATE TODAY
2.50	4.00	3.50

What does it pay all-in, and what if the base rate falls to 3.00?

[A] 6.50 either way.

[B] 4.00 — the swap replaces the loan's rate.

[C] 6.50 now; 5.50 if the base rate falls.

[D] 6.50, plus whatever the bank charges for the swap's credit risk.

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THE READS

FILE 1 · THE LOAN · CAPACITY

The senior read: A. About 1.3 times.

Debt service is interest and principal together: US$3m. Cash left to pay it, after capital spending and tax, is US$4m. Four over three is about 1.3 times; interest cover alone would have said six. This is debt service coverage.

FILE 2 · THE LOAN · CAPACITY

The senior read: D. No. The same multiple sits on very different earnings stability.

A leverage multiple divides debt by one year's earnings. How far that year can be trusted depends on the business: contracted income holds, house sales swing with the cycle. This is leverage read against earnings volatility.

FILE 3 · THE LOAN · PROTECTION

The senior read: B. The bank is repaid in full; noteholders share US$5m.

Priority decides recovery. Secured senior debt is paid from the assets before unsecured creditors see anything, so the bank recovers its US$25m and the noteholders share what is left. This is seniority and recovery.

FILE 4 · THE LOAN · PRICE

The senior read: B. US$80,000.

Expected loss multiplies three things: the chance of default, the share lost if it happens, and the amount owed. 2% × 40% × US$10m is US$80,000 a year on average, and the margin has to cover it before anything else. This is expected loss.

FILE 5 · THE LOAN · CAPACITY

The senior read: D. 1.25 times.

Debt service cover divides what is left after running costs by what the loan demands each year: US$2.0m over US$1.6m is 1.25 times. Gross rent would have flattered it. This is debt service cover on an investment property.

FILE 6 · THE LOAN · PRICE

The senior read: A. About 1.7% a year.

A margin must cover the losses the bank expects, 0.5%, and pay for the capital it holds against the loan: 10% of the loan at 12% is 1.2%. Together, about 1.7% before costs and tax. This is risk-based pricing.

FILE 7 · THE LOAN · CAPACITY

The senior read: B. Five years, longer than the loan.

US$2m at US$400k a year takes five years to recover, so a three-year loan has to be repaid partly from somewhere else. The tenor should follow the cash, or the rest of the business must carry the gap. This is payback against loan tenor.

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FILE 8 · THE LOAN · PRICE

The senior read: A. 6%.

Interest deducted against taxable profit saves tax at 25%, so 8% costs the company about 6% after tax, as long as it has the profit to deduct it against. This is the after-tax cost of debt.

FILE 9 · THE LOAN · PROTECTION

The senior read: C. About US$1.7m.

The secured lender takes the US$9m its plant fetched and, for the US$1m still owed, ranks alongside the unsecured lender. The US$2m left is shared in proportion to those claims: five-sixths to the unsecured lender, about US$1.7m, a third of what it lent. This is the recovery waterfall.

FILE 10 · THE LOAN · HEDGES

The senior read: A. 6.50 either way.

The swap cancels the base rate: the borrower receives it and pays 4.00 fixed instead, and the lending margin of 2.50 stays on top — 6.50 all-in. A fall in the base rate is the bank's gain under the swap, not the borrower's, which is the point of fixing. This is the all-in cost of a swapped loan.

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