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Financial Lending Notes

A Newsletter for Commercial Lenders

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Loan Agreements and Debt Covenants
Are You Using — and Monitoring — Them?

If asked about loan agreements and debt covenants, many community bankers will nod their head and agree that, yes, these are important tools for monitoring the status of loans and the activities of small business borrowers.

But ask them whether or not they are *using* these critical tools and you might get a different reaction. The fact is, loan agreements and debt covenants are woefully underutilized by community banks on small business loans. Worse yet, many community banks are failing to monitor the loan agreements they have put in place.

Why Banks Resist

There are several common reasons why community banks don't utilize loan agreements and debt covenants. One is that they don't want to assume the liability associated with monitoring them. Another is that they don't believe the loans are big enough to justify the cost and effort required to monitor them. Or, they see that other community banks aren't requiring them, so why should they?

Perhaps the biggest reason, though, is simply the fact that most community banks don't want to deal with pushback from borrowers over their perception that the bank is telling them how to run their business. But it's important to realize that loan agreements are good for both your bank *and* your borrowers — and to explain this to borrowers who resist them.

From your bank's perspective, loan agreements build a "fence" around your borrowers that they can safely run around in. They limit their ability to grow too fast and assume too much debt relative to equity, and they limit the ability of owners to take out too much money to support their lifestyle.

It's important to realize that loan agreements are good for both your bank and your borrowers — and to explain this to borrowers who resist them.

Perhaps most important, loan agreements establish upfront expectations with the borrower about the importance of providing ongoing financial information to the bank. This information will enable the bank to monitor their performance and spot potential problems before the business finds itself in serious financial trouble and on the verge of default.

From the borrower's perspective, loan agreements spell out the terms of the lending relationship in such a way that they are protected from things like new lenders coming in and arbitrarily making changes. Borrowers

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Compliance Strategies

The ABCs of TDRs

In the aftermath of the financial crisis and Great Recession, many community banks worked with borrowers to restructure troubled small business and commercial real estate loans by modifying loan terms and granting concessions. Often, these actions created troubled debt restructures, or TDRs, that community banks have to segregate on their financial statements, as well as note on their call reports.

As the financial crisis and recession fall further behind in the rearview mirror, many community banks are now focused on removing some of these loans from TDR status. Banks must perform additional reporting and tracking on TDRs, and TDRs are also subject to special accounting requirements.

To remove the TDR designation from a loan, you must demonstrate that the borrower has met the terms of the restructured debt for six to 12 months. If so, you can stop reporting the loan as a TDR on your call report.

From an accounting standpoint, however, once a loan is classified as a TDR, it remains a TDR until fully repaid. It must continue to be segregated on the bank's financial statements.

As the financial crisis and recession fall further behind in the rearview mirror, many community banks are now focused on removing some loans from TDR status.

What Constitutes a TDR?

A loan must meet two different criteria in order to be classified as a TDR:

1) The borrower has to be troubled (i.e., experiencing financial difficulty).

2) The bank has to offer modified terms or make concessions it wouldn't normally offer if not for the fact that the borrower is troubled.

Loan modifications and concessions could include a lower interest rate, forgiven principal or accrued interest, and an extended maturity date or longer amortization schedule. Banks must follow accounting procedures detailed in *ASC 310-40* for TDRs, including testing these loans for impairment. *ASC 310-40* specifies that impairment should be measured based on the present value of future cash flow, less the original loan's effective interest rate.

ASC 310-40 also includes specific examples of loan modifications that could create a TDR, such as:

- Absolute or contingent reduction of the stated interest rate, face or maturity amount of the loan, or accrued interest.
- An extended maturity date at an interest rate that's lower than a comparable loan's current market rate.
- Conversion of a principal-and-interest loan to an interest-only loan.

Some Regulatory Guidance

Note that these scenarios do not automatically necessitate that a loan be designated as a TDR. For example, if the modified terms of a loan are consistent with market conditions — or in other words, if the borrower could receive the same terms from another bank right now — a restructured loan would not be designated as a TDR.

FASB's *Accounting Standards Update (ASU) No. 2011-02* offers guidance to help community banks determine when a loan concession or modification does and does not result in a TDR. This guidance helps you determine what specifically qualifies as "financial difficulty" and whether or not a "concession" has been made.

A borrower experiencing financial difficulty could have declared bankruptcy or be behind on debt payments (either to your bank or another bank). Or, there could be substantial doubt as to whether or not the business will continue as a going concern, or a forecast of insufficient cash flow to service debt in the foreseeable future.

To remove the TDR designation from a loan, you must demonstrate that the borrower has met the terms of the restructured debt for six to 12 months.

Meanwhile, *ASU 2011-02* specifies that a concession may have been granted if the business could not borrow a similar amount of money now, using similar risk characteristics, at a market rate. If the bank is experiencing more than insignificant payment delays with the business, this could also signify a concession.

Reclassify with Caution

In light of current efforts by many banks to remove the TDR designation from some loans, financial regulators are now taking an especially close look at TDRs. So use caution as you consider which TDRs you can — and cannot — reclassify for regulatory reporting purposes. ■

Contact us if you have any questions when it comes to reclassifying TDRs.

Loan Agreements and Debt Covenants

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are also protected if the bank were to be acquired and the new bank has a restricted or prohibited industries list on which they just happen to be at the top.

Make it clear to borrowers that your bank's objective in requiring loan agreements isn't to put them out of business if they hit a rough spot. Rather, it's to identify problems early on so you can address them with the business owner before it's too late. From your perspective, meanwhile, a loan agreement should enable you to spot these problems while you still have a reasonably cooperative borrower, a viable core business and the opportunity to encourage the borrower to find another bank, if necessary.

Structuring Loan Agreements

When it comes to structuring loan agreements, err on the side of simplicity rather than complexity. If you try to over-engineer them to include every potential scenario that might arise, you will frustrate your borrowers and it will be impossible for you to monitor the agreements. In general, there are six debt covenants that should be included in a typical small business loan agreement:

1. A requirement to provide periodic financial information
2. Minimum debt service coverage ratio
3. Maximum debt to tangible net worth ratio
4. Minimum current ratio
5. Minimum working capital level (with step-ups)
6. Minimum tangible net worth level (with step-ups)

Loan agreements and debt covenants are woefully under-utilized by community banks on small business loans.

Most automated doc prep programs include templates for standard loan agreements that you can customize for each individual small business loan. Also be sure to clearly state your bank's definitions for the covenants in your loan agreements. If there is any ambiguity in your definitions, the borrower could use this as a legal defense. For example, there are several different ways that the debt service coverage ratio can be calculated (see sidebar below), so include your bank's specific definition and formula in the loan agreement.

It's also a good idea to establish a minimum loan size for which loan agreements and debt covenants will be required. For example, you might require them for small business loans larger than $250,000 with maturities over one year and a total bank exposure of more than $1 million.

The Importance of Active Monitoring

Finally, keep in mind the fact that an unmonitored loan agreement is worse than no loan agreement at all. If you try to exercise remedies against a borrower in a court of law but have not met your obligation to monitor the agreement, the borrower will likely assert that you acted in bad faith by not informing them they weren't in compliance.

In this scenario, a judge will likely rule that you have implicitly waived your right to default by virtue of your non-action. So if you are going to go through the process of creating and utilizing loan agreements and debt covenants, be sure to put in place a framework for actively monitoring them. ■

We can help answer your questions about loan agreements and debt covenants, as well as certify that your borrowers are in compliance. Call us to discuss this further.

Calculating Debt Service Coverage

It's important to be specific when defining debt covenants that will be included in your loan agreements. The debt service coverage ratio is a good example.

A minimum debt service coverage ratio (usually of 1:2 or 1:2.5) is one of the most common covenants included in small business loan agreements. But this ratio can be calculated in several different ways. Two of the most common formulas for calculating debt service coverage are:

1) $$\frac{\textbf{Net Income + Depreciation \& Other Non-Cash Charges}}{\textbf{Interest + Current Maturities of Long-Term Debt (Payments)}}$$

2) $$\frac{\textbf{EBITDA (Earnings Before Interest, Taxes, Depreciation \& Amortization)}}{\textbf{Interest + Current Maturities of Long-Term Debt (Payments)}}$$

Both of these formulas can legitimately be used to calculate debt service coverage, but they will produce different results. So be sure that your loan agreement specifies which formula will be used for that particular loan. ■

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Deferred Tax Assets and NOL Carryforwards

When examining loan applications of potential small business borrowers, it's important for lenders to consider the potential impact of deferred tax assets on a business' financial performance. That's because it's possible for businesses to use deferred tax assets to make their financial picture look better than it really is.

Many companies that have experienced recent losses are now utilizing deferred tax assets in the form of net operating loss (NOL) carryforwards. These can be carried forward for up to 20 years and back for up to two years.

Utilizing deferred tax assets and NOL carryforwards is a legitimate small business tax-reduction strategy. However, lenders should assess how reasonable it is that the business will be able to realize the benefit in the future. Or put another way, how realistic is it that the business will have future operating income that the NOL carryforward can offset? Also, deferred tax assets are usually deducted by lenders when calculating the tangible net worth of a borrower.

Another thing to keep in mind is that deferred tax assets and NOL carryforwards will not appear on the financial statements of S corps, partnerships and LLCs. Nor will they appear on compilations, though GAAP requires that they be included in the reviewed and audited financial statements of regular C corporations. They will appear on a separate schedule accompanying small business tax returns.

Here are two takeaways regarding deferred tax assets and NOL carryforwards:

1. If a borrower presents financial statements with significant deferred tax assets and NOL carryforwards, this might possibly raise a red flag. Dig a little deeper to determine how reasonable it is that they will be realized in the future.

2. Just because you don't see deferred tax assets and NOL carryforwards on a borrower's financial statements doesn't mean they're not there. If a borrower has experienced recent losses, ask about any possible NOL carryforwards that aren't disclosed. Considering them in your underwriting analysis could make the business a better credit risk. ■