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FINANCIAL LENDING NOTES

BLOCKING AND TACKLING

Return to the Fundamentals of Commercial Lending

When a football team is struggling, coaches sometimes stress to players the importance of refocusing on the fundamentals of the sport — or as they put it, going back to “blocking and tackling.”

As the U.S. banking industry emerges from the worst of the financial and credit crisis of the past few years, some community banks are taking a similar approach to banking. In hindsight, it’s clear that losing sight of some of the basics of commercial lending is one of the factors that led to the crisis.

There are a number of time-tested commercial lending fundamentals that banks should be focusing on today. Here is a “top 10” list of some of the most important:

1. Make sure you put borrowers into the right loan product. What is the purpose of the loan? Loan purposes generally fall into three broad categories: 1) to purchase assets (such as inventory and equipment); 2) to rearrange liabilities (or in other words, refinance existing debt); or 3) to reduce owner’s equity (for example, to buy out a partner or fund operating losses).

One mistake sometimes made by bankers is failing to distinguish between a temporary and a permanent investment in current assets. To do so, you must determine two main things about the financing need: whether it’s recurring or non-recurring, and whether it’s short-term or long-term. Based on the answers, you can determine the appropriate loan product:

Short-Term

Recurring	*Non-Recurring*
Line of Credit	Bridge Loan

Long-Term

Recurring	*Non-Recurring*
Revolving Debt	Term Loan

2. Accurately identify cash flow that’s available for debt service. Only cash repays loans. This is a simple fact, but it’s sometimes easily forgotten.

So the most fundamental thing a lender must do is determine whether the borrower will be able to generate sufficient cash flow to repay the debt.

But all “cash flow” is not the same. An objective cash flow analysis will distinguish between personal and global cash flow and the core cash flow that is actually available to service debt. The calculation is:

Net Profit
+ Interest
+ Depreciation and Other Non-Cash Charges
– Replacement Capital Expenditures
– Scheduled Debt Service
– Distributions in Lieu of Taxes (for S corps/LLCs)
= Core Cash Flow

3. Look carefully at the business’ breakeven. It’s not hard for a lender to perform a basic breakeven analysis on a small business. But does the *owner* understand his or her breakeven? Does he or she know how much must be sold every month to meet fixed costs, or is the business just making (or losing) money accidentally?

4. Know when to say, “enough is enough.” Ten out of ten small businesses will probably answer, “Yes!” if you ask them if they want to grow. What many don’t realize, though, is that if they aren’t careful, they can grow themselves right out of business.

A well-structured loan provides the business with enough money to meet its financing need, but not too much so that it gets into trouble. And it enables the business to repay the loan out of core cash flow without undue strain. See the sidebar below for some benchmarks to help you determine when “enough is enough.”

5. Establish realistic expectations with the business. It’s up to the lender to communicate expectations to the borrower in terms of financial performance, the information that will be required to facilitate loan monitoring, and penalties to be

BLOCKING AND TACKLING

Return to the Fundamentals of Commercial Lending, cont'd.

assessed for non-performance. These should be detailed in loan covenants that clearly spell out the bank's expectations in these and other areas.

One strategy is to establish benchmarks that enable you to adjust loan pricing (or call loans) if the borrower's financial performance falters. Also be careful not to allow borrowers to assume more debt simply to repay interest, or to increase their lending facilities arbitrarily.

6. Assess the borrower's internal systems and controls. Does the business have adequate systems and procedures for generating timely financial information and monitoring costs and key performance indicators (KPIs) like inventory and receivable turns and critical financial ratios? Are there adequate internal controls and checks and balances to guard against fraud and embezzlement?

7. Carefully gauge the borrower's financial leverage. Debt-to-equity is obviously a key financial consideration, but you should dig a little deeper than just calculating the ratio. For example, what specifically constitutes the equity?

Also, what is the business' operational leverage? If the business has high fixed expenses, you want to ensure that it is able to consistently operate above this level — if so, a large percentage of profit will drop to the bottom line. But the opposite is also true: Losses are magnified if the business consistently operates below this level.

8. Pay special attention to concentrations. A high percentage of revenue (and profits) from one or two large customers should always be a red flag to lenders. But customer concentrations aren't the only thing to watch for.

Is the business heavily dependent on one large supplier? Does it have secondary suppliers lined up in case its primary supplier goes out of business or raises prices dramatically? And what about expense concentrations — is there a heavy concentration of expenses in potentially volatile areas like insurance and raw materials?

9. Don't rely too heavily on collateral and loan guarantees. These should always be considered secondary, not primary, sources of repayment. Liquidating collateral can be costly due to the difficulty in finding and taking possession of it and determining its value. There are also costs associated with foreclosing on and holding collateral.

Remember that a guarantee is nothing more than a promise to pay — and the reality is that guarantors do not willingly write checks. Therefore, a best banking practice is to always secure the guarantee — whether it's a pledge of commercial or personal real estate, securities, etc. — in order to provide leverage should it become necessary to collect.

10. Return to the 5 Cs of credit. Traditionally considered the bedrocks of commercial lending, the 5 Cs of credit kind of took a back seat at many banks during the "go-go" days leading up to the financial and credit crisis. However, a close look at any troubled loan will likely reveal that underwriting exceptions were made that started with the lender ignoring one or more of the 5 Cs: Character, Capacity, Collateral, Capital or Current market conditions.

How to Know When "Enough Is Enough"

Consider these benchmarks to help determine when enough is enough:

Multiple of Core Cash Flow	3-5 years
Minimum Acceptable Debt Service Coverage Ratio*	Greater than 1.25
Maximum Acceptable Debt/ Tangible Net Worth	Less than 3-1
Adequate Margin Collateral Coverage	Greater than 1.0
Acceptable Liquidity (i.e., Current Ratio)	Greater than 1.3

**Including assumed amortization of revolving debt*

Source: New Horizons Financial Group

REGULATORY UPDATE

How Might Basel III Affect Bank Capital Levels?

With the financial and credit crisis at its peak, the Basel Committee on Banking Supervision published the first version of the Basel III banking reform measures in late 2009. Building on Basel I and Basel II, Basel III is designed to strengthen bank transparency and bolster the ability of banks to deal with financial and economic stresses like those that caused the financial crisis.

According to the Basel Committee, Basel III is intended to foster greater resilience at the individual bank level in order to reduce the risk of system-wide shocks. The committee believes that this will be accomplished by improving regulation, supervision and risk management within the worldwide banking industry.

Basel III requires U.S. banks to maintain certain leverage ratios and meet minimum capital and equity requirements. All banks were given three years from the publication of Basel III in late 2009 to satisfy the leverage and capital requirements.

Standards Apply to All Banks

In June, the regulatory agencies approved three separate proposals for implementing the Basel III capital standards. These standards will apply to all banks, not just those with more than $500 million in assets, as some community banks mistakenly believe.

Banks were invited to comment on the proposed capital standards and how they would affect their capital levels, with the comment period ending on October 22. A number of concerns have been voiced about the standards, including the following areas:

Higher regulatory capital and common equity ratios – Many bankers are concerned that the Basel III requirements that banks maintain higher levels of capital and equity will limit their ability to make loans to qualified borrowers, thus further suppressing overall lending (and small business lending, in particular) in the U.S.

Higher risk-weighting of assets – The proposed new Basel III formulas for risk weighting are tied to loan-to-value, so they are likely to significantly increase the weight of residential mortgage loans (both first and second liens), HELOCs, and noncurrent and nonperforming loans. Residential real estate loans with balloons may be especially susceptible. These new risk-weighting formulas could prohibit some banks from making certain types of real estate loans.

Frequency of required loan-to-value ratio tracking – The standards are not clear in terms of how frequently banks will be required to track the LTV on residential and commercial real estate. It could be only at the time the loan is made, or perhaps quarterly or even daily. Some banks are concerned about how they will track LTV if this is required during the entire amortization period of the loan.

Capital calculations and minimum requirements – The standards will require banks to track 13 different categories of deductions and adjustments to capital and changes to risk-weighted assets, at least quarterly. Since loan limits are tied to capital, the timing of the calculation will be critical. In addition, the standards include three minimum capital requirements plus the new Capital Conservation Buffer, which must be maintained to avoid restrictions on capital distributions and discretionary payouts.

Trust Preferred securities – The Collins Amendment in Dodd-Frank allowed bank holding companies with less than $15 billion in assets to continue counting existing Trust Preferred securities as part of Tier One capital. But the proposed standards ignore this, calling for a phase-out of Tier One capital for all bank holding companies over a 10-year period beginning in 2013. Many community bankers are concerned that this could send their capital levels below the required minimum levels, thus decreasing overall lending.

Regulatory capital volatility – The standards call for unrealized gains and losses on Available for Sale securities to be included in regulatory capital. Some bankers are concerned that this creates the potential for capital volatility, as well as a significant reduction in regulatory capital in an inevitable future rising rate environment.

Stay Tuned

While the regulators are in the process of compiling the comments they have received from bankers, it's already clear that Basel III could fundamentally change how banks calculate their regulatory capital requirements. Therefore, you should keep a close eye on developments as Basel III is finalized in the coming months.

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Update on Lease Accounting

While International Financial Reporting Standards (IFRS) are used by at least 120 nations worldwide, public companies in the U.S. have traditionally followed Generally Accepted Accounting Principles (or GAAP) instead. In recent years, though, the Inter-national Accounting Standards Board (IASB) and the U.S.-based Financial Accounting Standards Board (FASB) have been working together toward the future convergence of IFRS and GAAP.

One particular area of focus when it comes to GAAP and IFRS convergence has been the accounting treatment of leases, since the standards treat leases very differently from an accounting standpoint. GAAP distinguishes between two different types of leases: capital leases and operating leases.

IFRS does not make this distinction — instead, substantially all leases under IFRS are treated in a manner similar to capital leases and placed on the balance sheet. This treatment reflects the accounting principles of IFRS that a “right to use” an asset requires capitalization treatment, as opposed to the “bright line rules” of GAAP.

In June, FASB and the IASB reached a compromise that appears to be a step back toward the rules-based accounting standards of GAAP. They agreed to include two types of leases in their upcoming overhaul of lease accounting rules: those to be treated like financings for accounting purposes, and those to be treated as straight-line expenses.

The standard setters had been hoping to do away with some of the rules necessary for companies to decide whether to treat a lease as a capital or operating lease. The move back to allowing two types of leases will require that new standards be created for each type.

A final version of the new lease accounting rules could be released by mid-2013, with the standards possibly going into effect by 2016.

Contact us at 314.862.2070 if you have more questions about lease accounting standards and how they may impact your borrowers.

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