



Federal Reserve Bank of Atlanta

A Guide for Specialized Credit Activities

CONSUMER LENDING

According to the Federal Reserve Board of Governors, seasonally adjusted consumer credit outstanding including revolving and nonrevolving credit totaled \$2.8 trillion at the end of June 2013, up only slightly from \$2.5 trillion at the end of 2008. Despite that slight increase, household debt-burden service, which is an estimate of the ratio of debt payments to disposable personal income, fell as individuals deleveraged during the recovery to 10 percent—more traditional levels—from high norms of between 10 percent and 12 percent in the years before 2008.

Many community banks are consumer-focused in their efforts to meet customer needs. Yet increased debt levels among consumers and lower cash reserves have translated into serious financial hardship for many borrowers during the last five years. This in turn has caused banks' loan portfolios to deteriorate and their losses to increase. To mitigate and manage the risks in consumer lending, banks must incorporate in their lending program a thorough risk assessment of the retail lending function.

At a minimum, a sound lending program should incorporate a review of the bank's loan policy regarding consumer lending, as well as a review of the loans, borrowers' payment trends, and collection procedures.

Loan Policy

The consumer loan policy should have standards and guidelines for lending that include the following:

- Lending authorities
- Desirable types of consumer loans (including home equity loans, home equity lines of credit, direct loans and indirect loans).
- Ceilings for debt-to-income ratios for all consumer loan requests. Generally, a customer can handle payments if the debt-to-income ratio does not exceed 36–40 percent of gross income.
- Requirements for obtaining information from credit bureau agencies for all new loan requests. Generally, banks should establish floors for Beacon scores and have procedures in place requiring authorization from a senior officer if loans are granted to applicants with scores below the floor. Banks should pay close attention to borrowers with low credit scores.

- Reasonable loan-to-value ratios and repayment terms that do not expose the bank to undue risks for all consumer products
- Guidelines for unsecured loans. Unsecured loans should be reserved for borrowers with an adequate net worth and ample cash flow and liquidity. Generally, an unsecured consumer loan should not exceed 1.5 times an applicant's monthly net income. Another rule of thumb limits unsecured debt to the lesser of 10 percent of a borrower's net worth or 50 percent of the borrower's unencumbered liquid assets. Terms are generally limited to 12–18 months.

Loan Review

An effective loan review process should be in place that incorporates all loan types and includes an assessment of small consumer loans to ensure compliance with loan policy guidelines and sound underwriting practices. If concerns or problems are noted, a more in-depth review may be warranted.

Borrowers' Payment Trends

Banks should regularly review their borrowers' payment trends. A borrower who is late (at least 30 days) on the first loan payment may be a potential problem. Also, payments that are made well in advance could indicate that collateral was sold to pay down the loan, leaving the bank in an unsecured position.

Collection Procedures

A bank should formalize its collection procedures to ensure that losses are minimal. The collection process can either be centralized or be the responsibility of individual loan officers. Regardless of the structure, procedures should be in place detailing actions to take when a credit is 15 days, 30 days, or 60 days past due. Weekly or biweekly meetings should also be held to monitor collection efforts. Internal classifications should be in accordance with the Uniform Retail Credit Classification and Management Policy as outlined in SR Letter 00-8. Extensions of payment dates should be kept to a minimum since they can be used to mask potential loan problems.

Although individual consumer loans may be small-dollar amounts, collectively, they can result in significant losses for banks that do not have adequate systems in place for identifying, monitoring, and controlling consumer credit risk.

COMMERCIAL REAL ESTATE CONSTRUCTION LENDING

Commercial real estate construction lending (that is, non-owner-occupied and owner-occupied) is a major line of business at community banks. Bank management should ensure that appropriate procedures and controls are in place to minimize risk while enhancing profits. The following information provides basic guidelines for commercial real estate construction lending.

Risk Controls

Sound preplanning

Before making a loan, lenders should require building plans and specifications in hand. Additionally, qualified personnel should perform property surveys, environmental risk audits, and soil tests to ensure that construction is feasible on the selected development site, thereby reducing the risk of potential problems.

Construction loan agreement

This document sets forth the rights and obligations of the lender and borrower, conditions for advancing funds, and the events of default.

Effective onsite inspection

An appropriate inspection process ensures that the lender does not advance funds if the quality of work is less than satisfactory, which could lessen the property's sales potential and jeopardize repayment.

Disbursement procedures

Typically, a qualified, unaffiliated contractor, engineer, or architect should conduct inspections before each draw is made. Inspectors should sign and date the draw sheet or the form that the American Institute of Architects has created as evidence that work has been completed in accordance with plans and specifications.

Circumstances or transactions requiring title insurance policies versus title opinions

Title insurance is generally backed by the financial resources of long-standing entities and offers the bank enhanced protection against losses. A title opinion is backed by a sole legal practitioner who may or may not have the financial resources to protect the bank if title defects surface.

Terms for commercial real estate construction loans

Typically, these construction loans have terms between 12 and 18 months, with interest paid monthly or quarterly. It is not uncommon for lenders to extend loans for another 6 to 12 months after construction is finished to complete lease-up (non-owner occupied), depending on the facility size. Nevertheless, the policy should contain a provision that requires principal curtailments or amortization after a specific time (18–30 months from origination).

Draw sheets

Banks should pay close attention to draw sheets because they can indicate an over-advanced situation. An over-advanced situation occurs when current disbursements exceed the stage of completion.

Use of lien waivers

If contractors, suppliers, and subcontractors are not paid on time and they file liens, other lenders may be less prone to provide take-out financing. Ideally, contractors should execute lien waivers after each disbursement. However, at a minimum, lenders should conduct lien searches before the final advance.

Loan Policy: Underwriting Guidelines

The loan policy should address the following items.

Specific loan-to-value guidelines that correspond with the supervisory guidelines in Regulation H

Banks should report to their boards of directors at least quarterly on loans exceeding supervisory loan-to-value guidelines.

Circumstances requiring appraisals and evaluations

Appraisals are required for all transactions over \$250 million. When evaluations are allowed, the policy should specify the criteria necessary to arrive at a reasonable value for the property. Typically, lenders directly involved with originating the credit should not perform evaluations. SR Letter 10-16 provides guidance on the use of appraisals and evaluations.

The analysis of the deal should focus on the borrower's project (if non-owner-occupied, preleasing and leasing projections), business history and results (if owner-occupied, current financials), and the builder's previous construction experience. Analysis should

emphasize cash reserves, trends in profit margins, net income, and debt levels. Banks should closely scrutinize any real estate holdings, specifically noting existing speculative or unleased space. If the builder's cash level is marginal in relation to total debt, the builder's ability to make interest payments for an extended period is diminished. Analysis of information contained in builder trade credit reports is also essential with this type of underwriting. The reports must disclose the builder's payment records with suppliers, any existing liens and judgments, and debts with other lenders. Delinquent trade debt and judgments are often early warning signals of a builder's distress. Lenders should obtain builder trade reports along with financial statements at least semiannually, or more often if there are significant changes in the builder's payment patterns or borrowing frequency.

Basic Tenets

- Don't push the appraisal.
- Make sure the builder has the cash position to carry unleased space.
- Don't advance funds before inspection of work.
- Know a builder's market area.
- Always consider all of the builder's projects when assessing repayment capacity.

ASSET-BASED LENDING

This type of lending is financing that is secured by a company's balance sheet assets such as inventory, receivables, or collateral other than real estate. Companies typically use this type of financing to support growth in sales, receivables, and inventory. They may also use these funds to meet daily operating needs and to take advantage of discounts offered by suppliers, thereby decreasing their cost of goods.

Because of the inherent risk in asset-based lending, only the most skilled and seasoned lenders should administer this function.

The Basics

Repayment terms

The primary repayment source comes from the conversion of working assets to cash. Generally, these borrowing facilities have a revolving feature with a one-year term. Interest is usually due monthly, with principal and any accrued interest due at maturity.

Rate

Typical interest rates fall in the range of prime + 1.5% to prime + 3%. Some banks may also charge a monthly service fee to offset administrative expenses.

Collateral

Generally, collateral consists of a first lien on accounts receivable and possibly inventory (raw materials or finished goods). Supporting documents would include a note, a security agreement, and a UCC-1 filed in the county where the borrower is incorporated. Lenders should conduct a UCC-11 search to determine if other creditors including suppliers have liens on the proposed collateral.

Advance rates

Maximum advance rates usually equal 75 percent of eligible receivables and 50 percent of eligible inventory. Eligible receivables are normally defined as receivables less than 60 days past due. Receivables greater than 60 days past due, intercompany accounts, foreign accounts, and retainage are usually considered ineligible receivables.

Field Audits and Risk Controls

A field audit helps the lender determine if the borrower is maintaining accurate financial records and adequate risk controls. Lenders can perform audits as part of the underwriting process, or conduct them periodically once an accounting firm originates the loan. The audit should include an assessment of the following items:

- The quality of the borrower's financial records
- Collection procedures aided by a review of a current aging report
- The level of returns or credit memos. Excessive returns could indicate faulty product quality.
- The method used to write off bad debt (the direct write-off method or the charge-off method)
- The borrower's status with suppliers and taxing authorities
- The level of concentration risk. Concentrations are generally defined as borrower's clients who owe 10 percent or more of the borrower's outstanding receivables. Banks should consider obtaining Dunn & Bradstreet reports on these clients. If the reports contain adverse information, those clients should be excluded from the borrowing base.

Field audits should also include sending verifications to the borrower's clients to confirm outstanding balances, due dates, and terms. The confirmation process should occur at least annually, and the bank should consider doing this under the guise of a phantom company so debtors are not notified that receivables are being pledged. This process serves as a useful tool in detecting fraud by determining if the borrowing base contains fraudulent invoices, and it also tests the accuracy of the borrower's financial records.

Other Risk Controls

In addition to field audits, the following minimum risk controls should be in place for monitoring and administering asset-based loans:

- Review receivable agings at least monthly to determine if the firm's level of delinquent accounts is rising.
- At least monthly, prepare borrowing base calculations performed by the borrower and reviewed by the lender to determine if the borrower is within formula. The bank's risk is heightened if the borrower is in an over-advanced position.
- At least quarterly, review payable agings to determine if trade debt is current. Trade creditors can force bank customers into bankruptcy for nonpayment. They can also place slow-paying customers on a cash-on-delivery basis, which could be devastating for firms with cash flow problems.
- For large credit lines, banks should consider requiring the borrower's clients to send payments to a bank-owned lockbox.
- Conduct periodic lien searches to determine if state or federal tax authorities have filed liens on the borrower's assets for nonpayment of taxes.

Additionally, for large credit lines, lenders should put in place loan agreements with specific covenants and the frequency for submitting financial information on primary and secondary borrowers/guarantors. (These agreements should address the quality of the financial information.) The financial covenants may include at a minimum interest coverage, current and quick ratios, and caps on leverage and capital expenditures. The loan agreement may also require the borrower to submit monthly borrowing base certifications, receivables agings, and evidence that payroll taxes are current.

Financial Analysis

Analysis should focus on the borrower's cash level, changes in the level of receivables, inventory, payables, bank debt, and equity using the following ratios.

Leverage

Measures the percentage of funds that creditors have provided. Generally, creditors prefer a lower ratio because a lower ratio normally reduces their risk. Two commonly used leverage calculations are debt-to-total-assets and debt-to-net-worth. This ratio can vary significantly depending on the industry. A debt-to-net-worth ratio greater than 3:1 could indicate a problem.

Interest coverage

Measures the extent to which net income or net cash from operations covers interest. This measure may be computed as follows:

Net cash from operations/Interest expense or

$$\frac{\text{Net income} + \text{Depreciation expense} + \text{Interest expense}}{\text{Interest expense}}$$

A high ratio indicates that a firm can meet interest payments on short-term notes.

Current ratio

Measures a company's short-term solvency and the extent to which claims of short-term creditors are covered by assets to be converted to cash. This ratio is computed as current assets/current liabilities. Creditors prefer a ratio of 2:1 or higher.

Quick ratio

Measures a firm's ability to pay off short-term obligations without relying on the sale of inventory. This ratio is calculated as current assets less inventory/ current liabilities. Generally, creditors prefer a ratio of 1.2:1 or higher.

Efficiency ratios

Refer to "Key Financial Ratios for Asset-Based Lending" below.

If possible, compare these ratios with industry averages. Risk Management Association data are useful because they provide financial comparisons for companies in given industries.

A Bank's Involvement in Asset-Based Lending

Pros

- Attractive pricing
- Opportunity to establish a deposit relationship with the borrower
- Opportunity to cross-sell other services

Cons

- Proper monitoring practices are labor-intensive, and a commitment to an adequate infrastructure to support the activity is critical.
- Terms generally do not require periodic principal payments, heightening the possibility of the facility becoming permanent.
- When a default occurs, collateral often becomes subject to tremendous discounts because marketability is limited.
- Inventory could be sold out of trust, diminishing collateral protection.
- Under adverse conditions, the borrower may submit or include fraudulent accounts in the borrowing base.
- The loan policy may not adequately address underwriting and monitoring guidelines.
- More frequent loan review evaluations are necessary, and the use of lower pass grades is generally appropriate.

Key Financial Ratios for Asset-Based Lending

Efficiency ratios measure management's ability to manage and control assets.

Sales to assets

$$\frac{\text{Net sales}}{\text{Total assets}}$$

Indicates the dollar amount of sales generated by each dollar invested in assets. To understand changes in this ratio, the lender must conduct an analysis of how efficiently

management handles specific categories of assets—for example, receivables, inventory, and fixed.

Inventory days on hand (DOH)

$$\left(\frac{\text{Inventory}}{\text{Cost of goods sold}} \right) \times 365$$

Indicates level of efficiency in managing inventory. Generally, low or declining DOH means greater operating efficiency than high or increasing DOH. An increase may indicate a deliberate management decision to make a bulk purchase in anticipation of a sales surge or a disruption in the supply of raw materials. Raw materials and finished goods are easily liquidated. Work in process is more difficult to sell if liquidation becomes necessary.

Accounts receivable days on hand

$$\left(\frac{\text{Net accounts receivable}}{\text{Net sales}} \right) \times 365$$

Indicates collection and credit screening abilities. Generally, low or declining DOH means greater operating efficiency than high or increasing DOH. Lenders should review receivables for any concentrations, which represent a higher degree of risk. The receivables' aging schedule should also be reviewed for receivables past due 90 days or more, which present a greater likelihood of charge-off.

Accounts payable days on hand

$$\left(\frac{\text{Accounts payable}}{\text{Purchases}^*} \right) \times 365$$

* If unavailable, use cost of goods sold.

Measures trade creditor financing of inventory and indicates paying habits. Increasing DOH may be indicative of cash flow problems. Generally, a firm with cash flow problems leans on its trade creditors first.

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