



'Unexpected' Loan Losses Do Have Warning Signs

John E. Bourquard
BKD, LLP

It's heard all too often: "No one expected a loss on this loan." It is startling to see how many banks incur large, unexpected loan losses on their commercial credits.

Certainly unanticipated losses can occur, but most troubled borrowers exhibit warning signs well in advance. Learning to heed these signs is crucial to loss prevention. Here are seven ways to help avoid unanticipated loan losses:

1. Answer a key question.

If borrowers exhibit problems but continue to pay, answer the question, "How are they paying, and can payments be sustained?" Most troubled borrowers can pay you using other bank loans, balance sheet management techniques, equity injections or personal debt until such funding sources stop. Despite this, many banks rationalize not recognizing risk with the fact the loan has been paid as agreed. "Paid as agreed" does not always mean the loan is good. If you can determine how loan payments are

made, you will be able to more accurately assess credit risk.

2. Pay attention to balance sheet trends.

For borrowers and potential borrowers with strong profits and moderate levels of leverage, bankers sometimes overlook negative trends in the balance sheet. Examples of overlooked trends — those that can yield the biggest surprises — include slowing collections of accounts receivables, slowing inventory turns, advances to related entities, stretched payments to the trade and unpaid payroll taxes.

If you see signs of these, thoroughly investigate the causes.

3. Include distributions in the cash flow analysis.

If cash flow after distributions is short, go back to No. 1 above and address how the shortfall was covered. Some bankers will argue that all distributions out of the company are discretionary and should not be included in the cash flow analysis. But including them can actually enhance the analysis. For example if cash flow was short by \$100,000 due to a distribution, but leverage was acceptable, and the distribution was funded by sustainable improve-

ments in receivable collection practices, you have demonstrated that cash flow was adequate. If you conclude the borrower funded the shortfall by slowing payments to the trade and borrowing on your line, you have other issues to consider. Examine exactly how distributions were funded, rather than ignore or gloss over them, and your ability to assess risk will improve.

4. Lend with caution if you market to investors of lower-priced rental homes.

While reputable borrowers exist in this industry, so do those who will take advantage of weaknesses in a bank's underwriting and controls. Some owners may have had the properties for a short time, yet managed to borrow up to the purchase price or more based on inflated appraisals. When underwriting to this industry, look first at the last sale date and price of the property. Any recent sale should be reported on the appraisal. Review the title commitment to see how much the previous lender was willing to extend against the property, and when that loan

— See *Unexpected* page 16

originated. Most of these borrowers will maximize the amount financed, and the prior lender's loan commitments might be a good indicator of value. If it looks too good to be true, it probably is.

5. Monitor inventory carefully if you lend to auto dealers.

Make sure you have stringent controls and procedures for monitoring inventory. Many community banks create higher levels of risk in floor-plan lending by not tightening controls in this area. Without such controls and procedures in place, the community bank usually loses when a problem surfaces.

6. Beware of contractor lending.

If you lend to contractors, either become an expert, or exit the



John E. Bourquard is a principal with BKD, LLP, Indianapolis, a CPA and advisory firm. A member of BKD's risk management group, he leads the firm's loan review outsourcing practice. Bourquard has 22 years of experience practice. He earned a bachelor's degree from Salem State College, an MBA from Indiana University and is an alumnus of the Graduate School of Banking at the University of Wisconsin.

The author can be reached at 317-383-3783, e-mail: jbourquard@bkd.com. BKD, LLP is an associate member of the Indiana Bankers Association.

business. Lending to contractors, *eg*, commercial roofers and excavators, requires specialized experience. If you do not have thoroughly knowledgeable resource people in this area, it's best to forego this line of business. There is too much risk if you count on

accounts receivable related to progress billings to protect your loan, or if you are not thoroughly versed in the relevant accounting issues such as the concept of costs in excess of billings.

7. Revisit your appraisals. Compare the appraiser's original assumptions about net operating income and capitalization rates to the property's current cash flow. For many properties, such as some hotels and golf courses, the current net operating income levels are below those used in the original appraisals, implying the actual values might be lower today. Before you mitigate your borrower's inadequate cash flow with a low loan/value ratio, consider the potential impact of the diminished cash flow on the value. Also, in a rising rate environment, capitalization rates, which reflect the required return on the real estate investment, should rise. All else being equal, a rising capitalization rate will cause the value to decrease.

Losses are unavoidable, but there are abundant opportunities to reduce unexpected losses and improve operating performance. To increase your effectiveness, thoroughly analyze all credit information presented, revisit the industries you lend to, and establish appropriate controls and procedures.





BRINGING GREAT PEOPLE AND GREAT COMPANIES TOGETHER

Angott Search Group, a leader in the executive search industry for more than 25 years, can provide a full range of search capabilities for your Financial Services requirements.

Our practice can provide assistance in the following areas:

k Executive Management	k Retail banking
k Corporate Banking	k Mortgage
k Trust & Investment	k Insurance
k Operations	k Accounting / Finance

Mark Angott
President

Jill Small, CSAM <i>Vice President</i>	Brian Rhonemus <i>Vice President</i>	Megan Uphoff, CSAM <i>Director</i>	Kim Fous <i>Director</i>
Stephanie Stevenson <i>Account Manager</i>	Laura Mulvaney <i>Account Manager</i>	Charlie Tudor <i>Account Manager</i>	Gary Markell, CSAM <i>Account Manager</i>
Chuck Doherty <i>Account Manager</i>	Steven Roberts <i>Associate</i>	Wally Rutkowski <i>Associate</i>	

Angott Search Group
2530 S. Rochester Rd., Rochester Hills, MI 48307
(248)299-1900 info@ASGteam.com www.ASGteam.com