

Banking Industry Group

2100 Clearwater Drive
Oak Brook, IL 60523

630-545-4500

www.wolfcpa.com



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Timothy D. Johnson
630-545-4594
tim.johnson@wolfco-fs.com



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Wolf Financial Group

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A NEWSLETTER FOR THE BANKING INDUSTRY

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PORTFOLIO MANAGEMENT STRATEGIES

Managing and Mitigating Portfolio Risk



that have gotten into the most trouble have primarily been the ones that:

- Aggressively underwrote higher-risk types of lending, especially commercial real estate (CRE), and
- Allowed high portfolio concentrations among small groups of borrowers, or in certain types of lending (again, CRE was a primary culprit) and/or geographic areas.

What a difference time makes. Three years ago, most banks were enjoying low levels of past-due accounts, criticized/classified loans and losses in their small business portfolios. Then came the recession and the financial crisis, which led to record losses and the subsequent failure of many banks.

It's easy for bank management to point to the financial turmoil as the cause of their problems, and it has certainly been a major factor in banks' struggles. When looked at objectively, however, it's clear that many banks made some key mistakes and poor assumptions that resulted in making a bad situation much worse.

PAST DOESN'T EQUAL FUTURE

In an article published in the June 2010 issue of *The RMA Journal*, John R. Barrickman and Christine Corso note the primary mistaken assumption was simply this: that banks could base projections of future credit performance on past performance. Clearly, this was (and still is) not the case. The banks

In hindsight, it's clear that historical credit performance is not a very good indicator of portfolio risk if the history upon which the performance is based is, in essence, a best-of-all-worlds scenario. This is essentially the world in which most small businesses and banks lived prior to 2008.

Factors like the distribution of asset quality ratings (AQRs) in the portfolio, the mix of different business lines, and the degree of portfolio concentrations (as noted above) are better measures of portfolio risk and the potential for volatility.

THE LENDING ENVIRONMENT

Going forward, one of the most important things you can do to better manage portfolio risk and reduce the potential for problem loans and defaults is to take a hard look at the lending environment that exists in your institution. In other words, where does your bank fit in the framework for risk tolerance and potential

GOT GUARANTEES?

Monitoring Government Guaranteed Loans



A primary cause of concern among many banks today is the high rate of default on government agency guaranteed small business loans like Small Business Administration (SBA), Farm Services Administration (FSA) and Farmers Home Administration (FMHA) loans.

In the good 'ol days, when these loans hit 90 days past due, the bank simply filed a claim, sent the government agency the credit file and the agency took it from there.

Now, the agencies expect lenders to work out the credits themselves before filing claims. And for claims filed, the agencies expect documented evidence of lender due diligence in every aspect of loan origination and monitoring before they will honor their guarantee.

The fact is, guarantors have never rushed to write checks and, with federal budget deficits soaring, it's not a stretch to say that government agencies are looking for more reasons to say "no" to the payment of loan guaranties.

In this environment, lenders must make sure they are dotting every "i" and crossing every "t" when it comes to loan origination and monitoring procedures.

DUE DILIGENCE REQUIRED

Just because you have a loan guarantee doesn't mean you can book a loan and forget about it. Far from it. The agencies expect you to perform the same due diligence on government guaranteed loans that you perform on non-guaranteed loans.

Due diligence steps you can take to help ensure that guaranties are paid when government guaranteed loans go bad include:

- Obtain current and timely financial information from borrowers. You should be able to demonstrate that such information was obtained prior to underwriting the loan and periodically throughout the lending relationship, and that you appropriately monitored and analyzed the data.
- Conduct periodic site visits. When it comes to monitoring the true health of your borrowers, there's no substitute for sitting down across the desk from them eyeball-to-eyeball and walking through their facilities to see for yourself what's really going on.
- Monitor customer concentrations. A high concentration of sales (e.g., 50 percent or more) with one or a small group of customers should almost always be a cause for concern with small business borrowers. If this single customer is lost, the business' future will be in serious jeopardy.
- Monitor growth. Is the business growing at a rate that's sustainable over the long term? Is it adding

profitable new customers, as opposed to just adding more customers for the sake of growth?

- Stay current on the agencies' SOP manuals. Government agencies' standard operating procedure (SOP) manuals change periodically, and not being aware of key changes could jeopardize your loan guarantee.
- Be proactive. Small business loans rarely sour overnight – signs of distress are usually evident three to five years before a loan defaults. Agencies want to see indications that you recognized signs of deterioration and were proactive in dealing with them well before the loan went bad, rather than waiting until payments were past due and it was too late to salvage the credit.
- Track how loan proceeds are being used. If you loaned money to support receivables, the business shouldn't be using it to buy real estate, for example.

DOCUMENT EVERYTHING

The importance of thorough documentation cannot be overemphasized. As far as government agencies are concerned, if it's not in the file, it didn't happen.

Therefore, lenders should include written memos and other appropriate documentation in client files to support every substantive conversation or event related to the credit – and especially those that document specific due diligence steps like the ones noted here. ■

To learn more about monitoring government guaranteed loans, please contact our office.

for volatility that was first laid out in the classic book Strategic Credit Risk Management¹?

More specifically, what is your bank’s approach to maximizing shareholder value; what are the “unwritten” rules of behavior when it comes to underwriting loans; how does your bank view transaction, intrinsic and concentration risk; and what risk controls are in place when it comes to influencing, directing and controlling individual lender’s decisions?

The next step you should take is to identify the specific types of loans, industries and properties that may lead to problem loans in the future. Industries with high fixed costs and significant financial leverage, as well as those undergoing significant changes and those in which participants enjoy comfortable lifestyles, have historically been ones with a high percentage of problem loans. Some good examples have been agriculture in the 1970s, energy and CRE in the 1980s, healthcare in the 1990s, and telecommunications and technology near the end of the 20th century.

Once you’ve identified broad industries that may pose higher risk, narrow your

focus to look for specific borrowers in your portfolio who may pose problems in the future. Through diligent monitoring, you should be able to spot problem borrowers as early as four to five years before loans go bad.

The ability to service debt always comes down to one thing: cash flow. Therefore, it’s your job to identify and monitor the things which have the potential to cause cash flow problems, such as:

- Flat or declining sales
- Shrinking gross margins
- Rising overhead (especially if rising faster than sales)
- Slowing receivables and inventory turn and slowing trade payables
- Increasing financial leverage and over-reliance on short-term debt
- Rapid sales growth coinciding with strained management and systems

BREAK OUT THE SHEARS

Based on all of the above, your final step should be to continuously

prune your portfolio. This means making periodic portfolio adjustments to reflect changing conditions in the overall economy, as well as in the borrower’s specific industry and marketplace.

Implement systems that enable you to continuously monitor both individual and portfolio performance. Then summarize your findings and recommended course of action for the board of directors.

There are several different ways to prune borrowers from your portfolio, including raising their interest rate, obtaining agency guarantees and participations, using market instruments (like credit derivatives), and simply asking borrowers to move their relationship to another bank. ■

¹By John E. McKinley and John R. Barrickman
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We can help your bank devise and implement portfolio risk management strategies and systems. Please give us a call to learn more.

Wolf Banking Team Profiles

In the Spotlight



Jeff Conrad

Our banking team includes three partners who lead professional staff with a variety of expertise and skills. They are experienced in providing audit and tax services, as well as other business advisory services to banks. We would like you to get to know our team, so in select issues of our newsletter we will highlight one of our members.

Jeff Conrad is a senior manager in the Tax Practice at Wolf & Company LLP. He received his Bachelor of Science in Business from Indiana University – Bloomington, and a Juris Doctorate from the University of Louisville School of Law. Jeff has more than ten years experience in public accounting, and manages various types of tax planning and compliance engagements for the firm’s bank clientele.

Jeff is a member of the Illinois CPA Society, DuPage County Bar Association, and Chicago Estate Planning Council. He also participates and volunteers in a number of capacities with local charitable organizations as well as the Illinois High School Athletic Association.



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BANKING BRIEFS

Are Your Borrowers Testing for Goodwill Impairment?

When a company is sold for more than net book value, this results in an accounting concept known as goodwill. If you are relying on reviewed or audited financial statements from borrowers, you should be aware of their obligation to test for goodwill impairment.

Once a year, these companies are required to screen for potential impairment, measure the amount of impairment (if any exists), and adjust the value of intangible assets (like goodwill) to reflect current economic realities.

If testing reveals that the value of goodwill on the borrower's books has been impaired (or, in other words, has declined), the company

is required to write off this amount to its current fair market value. Note that the value of goodwill can only be written down, not up.

As a lender, you should be sensitive to things that are occurring in borrowers' businesses which might result in an annual test for impairment. Also, be proactive in recognizing when an adverse test is imminent, and the effect it may have on the company's future earnings and net worth.

Keep in mind, however, that while impairment will result in a charge to earnings and have an adverse effect on net worth, it will have no cash impact. Therefore, its practical impact on a borrower's ability to service debt will be negligible. It can be, however,

an indication of potential future cash flow problems if the acquired company is not going to perform as well as originally anticipated.

Another rule change impacting accounting for goodwill requires that acquisition-related costs like finder's fees, professional or consulting fees, and general administrative costs be expensed rather than capitalized.

These costs are then added to the fair value of the asset acquired. The result is a lower amount of goodwill that can be booked in the acquisition, thus potentially lowering the acquirer's bottom line. ■