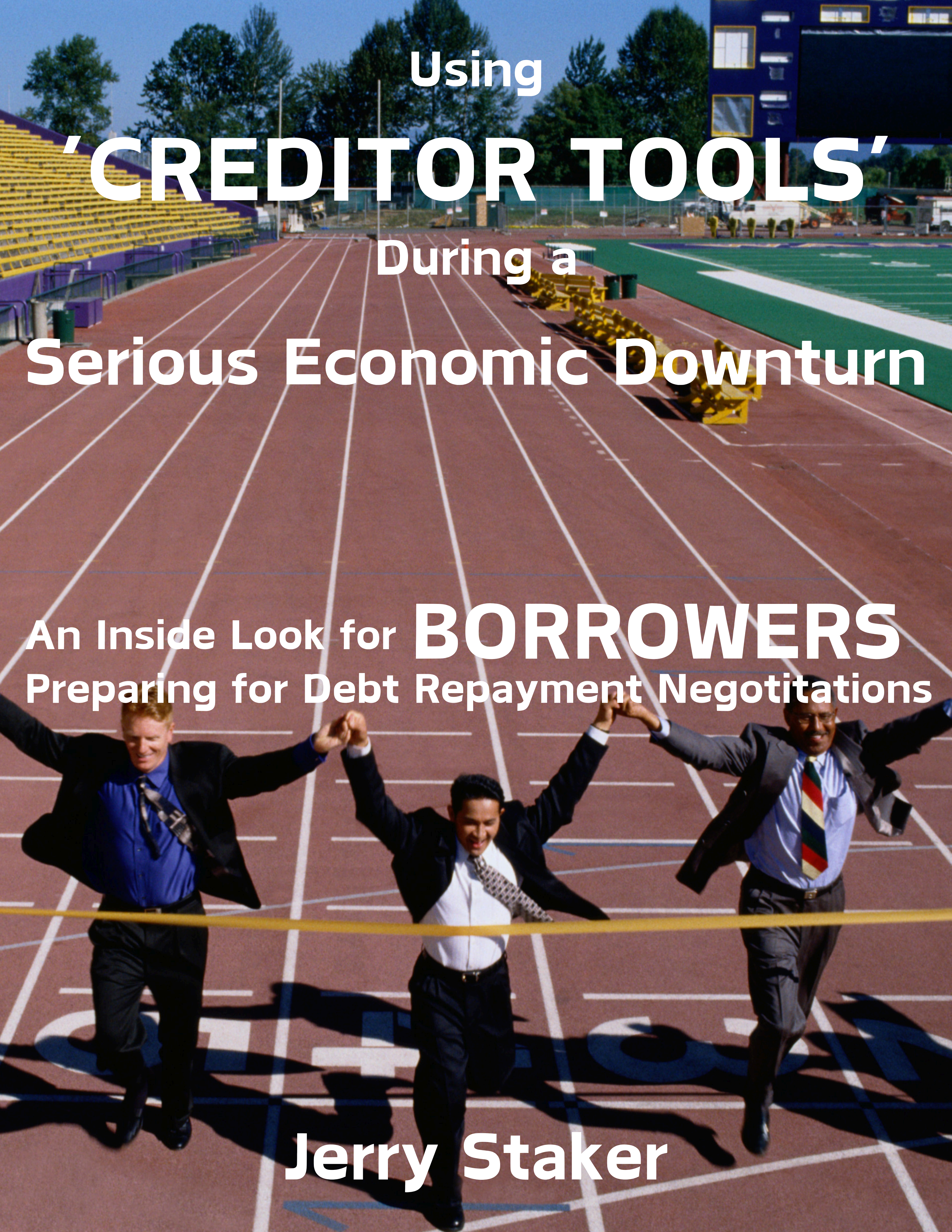

Using 'CREDITOR TOOLS' During a Serious Economic Downturn

An Inside Look for BORROWERS Preparing for Debt Repayment Negotitations

Jerry Staker

National Credit Awareness and Resolution Association, Inc.

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INTRODUCTION

Gain An Inside Awareness of Credit Risk Tools Used by Creditors

Building a Bridge Between Debtor and Creditor with the Right Tools – I have experience, lots of it. I started my commercial banking career during recessionary periods back in the early 1980's, 'working on the front lines' primarily in commercial loan workouts. I fought just as hard for the borrower as I did the creditors I worked for. And I was very successful in bridging both the borrower and the creditor together for optimal success. The career climaxed in 2009 (Great Recession), with 12 more years as a Commissioned Bank Examiner at the Federal Reserve Bank of San Francisco. I have been there and done that, from Wall Street in New York City to Honolulu, Hawaii. I know what I'm talking about. I also know what's coming, a debt crisis. I know what will be needed, for you, the small business owner (annual revenues <$10 million). I truly care about you, as you'll find most creditors care about themselves before they care about you. And, for the most part, nobody else out there is even talking to you, unless they are in it too, for themselves; just look at how they make money. Many, if not most of you, could use some 'inside-baseball' tips on how the creditor views credit risk in the administration of problem loans during an economic downturn. That's why I created these Credit Risk Memos (CRMs) and other publications. The CRMs will help you see and understand what the credit tools are and the purposes they serve. Best of all, each CRM has a section that addresses the 'why' these tools are important for you. The CRMs are divided into six sections and a number of subsections:

- Obligor (7), Credit Facilities (4), Creditor Protection (6), Financial Analysis (8), Management (11), and Loan Types (18)

You should be able to capture in your own mind what the creditor is thinking, and then be in a stronger position to respond as pressures build up during an economic downturn. You can use these credit risk tools to your advantage, or maybe even your survival. After all, there will be a debt crisis, and you and the creditor, will both be looking for fast, effective, and the right repayment solutions. Ultimately, there will be a paradigm shift from the creditor crafting up repayment solutions for you, the borrower. You'll soon be doing that role yourself, and bring those recommendations to the creditor. Due to the overwhelming volume of problem loans in seasons of default and restructuring, the borrower will become responsible to develop its own repayment solutions. The better prepared you are, the better chance you'll have to survive. The jaws of justice in each Promissory Note and Loan Agreement are powerful and can be crushing. But creditors and debtors must do this right, work closely together, maximize results, and minimize losses. Both stakeholders need to stay in business. Both sides are dependent upon each other. These CRM tools will help in building a strong bridge between debtor and creditor. Both have a lot to learn, so let's get going. As a reminder, the CRMs are select topics to enable you to gain an inside awareness of credit risk in the eyes of the creditor, followed by 'importance to you' statements, the 'why' these tools are important to you. These statements offer careful insights for you to use in developing your own repayment solutions during a serious economic downturn. Key public sources used throughout this publication include:

- RMS Manual of Examination Policies, Section 3.2 Loans, Federal Deposit Insurance Corporation (FDIC)
- Commercial Bank Examination Manual, Federal Reserve Board (FRB)

Credit Risk Memos (CRMs) – Obligor

Abundance of Caution

CRM #1) Abundance of Caution – Creditors will take liens against, but not lend money for, certain probable collateral (i.e., reserves, real estate, blanket lien on all assets, etc.) because of some type of uncertainty or its speculative nature. The inclusion as collateral is usually as an abundance of caution with little or no value assigned to it. In other words, for example, the real estate taken as collateral is not the reason or purpose for making the loan. Therefore, the loan terms may be unlike those of a real estate loan with a lower interest rate and longer term or maturity. But there must be some value in the (real estate) collateral taken as an abundance of caution. Creditors are required to get appraisals or evaluations on certain real estate unless it can be shown that the real estate collateral taken was used only as an abundance of caution. The creditor would have to clearly document and verify that repayment sources (i.e., cash flow) were well supported other than any reliance on the real estate collateral, and no appraisal would be required by the creditor, accordingly. Abundance of caution lending will have to be very thoroughly documented in the credit approval memo. The creditor will still secure its intended lien priority position, and insure the same with an ALTA title policy and hazard insurance.

Importance To You –

- *An opportunity to save some money* – It's possible your financial performance has declined, but is still acceptable. A creditor may very well wish to 'secure' your loans with additional collateral to protect its interests, and you may have, for example, real estate that could be pledged to your loan as collateral; but the new collateral could possibly be taken on an abundance of caution basis only. The good part is that you would likely save the cost of an expensive appraisal if it can be shown that your primary repayment source is still sufficient.

Bankruptcy

CRM #2) Bankruptcy – In bankruptcy, when a petition is filed, an 'automatic stay' prohibits creditors from taking any further action to collect on their debts. The 'stay' will remain in place until the debtor's assets are released from the estate, the bankruptcy case is dismissed, is discharged by the court, or the court approves lifting the stay. Debts owed to creditors are assigned to classes; the first class of creditors are priority creditors – they are to receive payment prior to other creditors. If there's no equity in the debtor's assets, the court is likely to terminate the automatic stay, allowing the creditors to seek repayment and liquidate collateral. A Trustee will be assigned to administer the affairs of the debtor's estate. He will control the disposition of asset sales, payments, and ensure there are no preferential transfers to creditors (taking a security interest in an asset) who may have taken certain actions 90 days prior to a bankruptcy filing (or one year for an insider). Bankruptcy petitions are also either voluntarily filed (by the debtor) or involuntarily filed (by creditors). Involuntary filings are filed where the debtor is

considered to be insolvent by the creditors, and where there's an expectation the assets will be sold to repay creditors. While still under the bankruptcy petition, a debtor could 'reaffirm' certain debts with creditors and resume payment (i.e., a mortgage or auto loan).

Chapter 7 Bankruptcy – A plan where the debtor's assets will be liquidated. It involves a trustee who will sell nonexempt property and utilize the cash proceeds for payment among the debtor's creditors. Once the debtor is 'discharged' he is no longer legally responsible, or liable for the debts listed at the time of the bankruptcy petition was filed with the court. Consumers and businesses both file Chapter 7 petitions. It's possible their other chapter petition filings to restructure their debts will be converted to a Chapter 7 filing for non-payment.

Chapter 11 Bankruptcy – A plan that is intended not for liquidating assets, but to reorganize debts and repay them from future cash flows. The restructuring results in there being an approved Plan of Reorganization, voted and accepted by the creditors, that will outline how each creditor will be repaid. Chapter 11 petitions are generally utilized by business entities.

Chapter 12 Bankruptcy – A plan that is designated for family farmer debtors who have regular stable annual income tied to the farm operation. Its primary objective is to reorganize farm debt that aligns up with the value of the collateral, and there's an expectation that the farmer debtor will be able to make regular payments under the repayment plan.

Chapter 13 Bankruptcy – A plan that is generally filed by individuals whose wages are used to satisfy unsecured and secured debts. The repayment plan is a new contract between debtors and creditors, where secured creditors are entitled to vote. A majority vote will bind the minority creditors to the plan. Repayment is expected to be at least three years, and possibly up to five years. In a Chapter 13 petition, creditors are expected to receive more than they would if the debtor's assets were sold and the proceeds were paid to the creditors.

Importance To You –

- *Bankruptcy is an expensive and time-consuming 'pain in the rear end'* – for all the stakeholders. It seems to be a measure, or should be, of last resort, or an emergency undertaking, where there are no better alternatives. A bankruptcy petition should be a rare occurrence, and only for clean-up purposes. Bankruptcy is the ultimate failure of the debtors and creditors to come to a suitable resolution in restructuring debt repayment. 'Hard heads' may have prevailed in repayment negotiations where the creditor was unwilling to work with the debtor because of bad feelings between the two parties. It's like any situation between two people who can't stand each other because of some offense given by one or the other, and then the other being able, but unwilling, to make any sort of concession to satisfy the other and come to an agreeable solution. It's where creditors will gladly spend 'good money, after bad' and put or force a debtor into bankruptcy, and not care otherwise. This is too often, just nonsense, and ridiculous

- *Debtors can offend too* – It may very well be that a debtor has offended the creditor by being unwilling to provide certain financial reporting when it was due. Why, because the debtor is fearful and doesn't know what he's doing? To a creditor, this is terribly offensive, as it shouts out to the creditor that the debtor has no integrity, lost his character, and is even dishonest. For why wouldn't

a debtor be honest and provide detailed financial reporting when it was due (as promised in the signed Promissory Note and Loan Agreement)? Maybe the creditor is right. The debtor should have complied with his promised end of the agreement, and been better prepared to negotiate and even propose his own repayment strategies short of having to file an expensive bankruptcy petition

- *Creditors can be jerks too* – Well, for one thing, it may be that the debtor perceives the creditor as one who is a completely hard-headed, unreasonable, an 'ugly jerk.' You get the picture. Perhaps the creditor has been insensitive to the debtor's financial circumstances, won't listen, is offensive, demanding, and only wants his money back, like yesterday. The creditor's demands may have been threatening to the debtor, so who in their right mind would want to even talk to that guy? Maybe the debtor is right. The creditor should have stopped treating the debtor as a 'number' and more like a human being

- *A workout modification is generally much better* – By now, you should start to see and appreciate what can happen in a 'work-out' situation. If nothing is done, each stakeholder will be constantly fighting and becoming more frustrated with the other. And they'll end up with an unwarranted expensive bankruptcy proceeding

- *An accelerated default can be a death knell* – Keep in mind that loan documentation will generally include that, upon default, the entire loan balance can be accelerated, where the full balance is due and payable. It would be like the loan maturity date was moved up to the present time. Upon default, there is also usually a default interest rate, which can be as much as three percent higher than the normal interest rate, or much more. If you had intention of trying to cure the default, say, by making up the missed payments, it is possible that because the entire loan balance was accelerated, the full payoff would be due and payable to cure the default, not just the missed payments. Bankruptcy is likely in that event, unless you can sweeten the negotiations

- *Feel the burden on the debtor* – The name of your business is on the Promissory Note, along with your signature. You likely signed an unlimited personal guarantee. You are the one who promised to repay, not the creditor. The creditor was the one who took the chance and lent you the money in good faith. He just wants it back. So, you, the debtor will do something new and different, starting today. You will take a little time and pay close attention, in other words, take full responsibility for your debt repayments if you haven't already. You will come up with debt repayment solutions that enable you to repay your debt 'as best you can.' That means being completely honest and forthright in all your negotiations with the creditor. This will include accurate and timely financial and other required and requested information. Not only can bankruptcy be avoided altogether, but the 'best repayment plan' will likely be realized. We live in a period where that's all anyone can ask, right? Fight for your best repayment plan, and if all else fails, then do what you must do

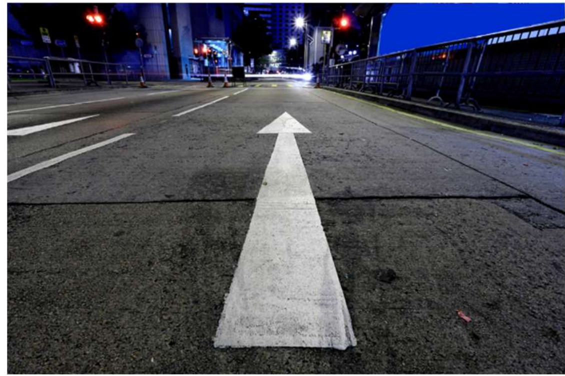
- *Build a bridge with your creditor or fall off the bankruptcy cliff?* – Bankruptcy is very expensive and you should avoid this ruinous experience. The creditor will likely recover most if not all his money over a reasonable time period as your financial condition warrants. You must fight for what is in your best interest too, in terms of repayment timing, terms, and conditions. This is your moment, and you need to do your homework. You need to understand what the creditor understands about your financial condition and situation. You have to stop, take some time, and learn to appreciate, see, and speak the way creditors approach workout loans. Imagine yourself in financial trouble. How does the creditor see its interests in your company compared to your point of view? Does the creditor have more debt capital invested in the company than you do via your smaller equity position? What is the debt-to-equity ratio? If it's >1:1, the creditor has a bigger stake in the company than you do – dollars financing the assets. Be a little more sensitive and cut out any fighting back and forth. It's never too late to apologize for your behavior, if necessary. You have to go into this realizing that you may need to build a stronger bridge across a 'grand-canyon' that may exist between you and your creditor. Make certain you're well-prepared and understand how to use the right tools so you don't stumble, or even fall off a cliff. So, what steps do you take? Conferring with legal counsel is always something to consider.

- *Know you cash position and forecast asap* – Assuming you will take some time and understand the creditor's perspectives and positions, the most effective tool you can use in crafting a repayment solution, besides all the required reporting, is the pro forma cash flow statement. Google up 'pro forma cash flow statement' for yourself; talk to your accountant and get to work on preparing your own. You, or your CPA, need to prepare a pro forma cash flow through the rest of the current year, and all of the following year, month by month, to show how you intend to stay in business. Show what cash flows will be generated and used to repay your debts as much as possible. Refresh the statement every quarter if necessary, or each month if warranted.

- *Be honest, and do your best* – All anyone wants, any creditor, any bankruptcy judge, any attorney, is for you to be honest and do the 'best you can' in repaying your debts as soon as is reasonably possible. What more can be done or asked of you? So, with overloaded bankruptcy courts, and asset quality in the tank for many creditors, you must step up. This is your time to step up big time. Avoid any contentious situation with your creditor(s), and use your pro forma cash flow statement to show the creditor exactly how and when you will repay your debts. If you find yourself getting heated or frustrated, step back and take a breath, and don't go there again. Ask questions, listen carefully, and re-work your pro forma if possible. You will likely be very successful and will likely avoid having to go bankrupt.

Borrowing Cause, Loan Purpose

CRM #3) Borrowing Cause, Loan Purpose – Creditors will carefully underwrite the actual reason the loan funding is needed, as small businesses need to borrow money for several different reasons. This is critical in helping ensure the proper repayment structure is put into place, at origination, and as closely as possible in a workout situation. Primary reasons for borrowing money will be for either temporary or permanent needs, and corresponding loan terms will be applied. Borrowing causes or purposes may include asset inefficiencies, growth in sales, purchases of fixed assets or equipment, trade credit mix, and decreased retained earnings. The financing repayment term will be longer for fixed assets such as the set-up and installation of new equipment, moving to a new building, etc. Other typical borrowing causes and purposes include:



Fund Increased Sales Growth (short or long term) – Working capital loan to fund an increase in accounts receivable (A/R) and inventory in the short term due to a seasonal spike. May finance the increase in trading assets not financed by accounts payable during high growth over a long period of time (permanent). There may be a term loan to amortize the permanent or core levels of working capital in a revolving line of credit

Fund Inventory Purchases – Fund a structural change in the business' products, or simply taking more time to unload inventory. Possible changes in terms offered by trade creditors, or to take discounts from trade creditors

Fund A/R – Fund accounts receivable during a period of slow collections from the normal time to collect on an account once invoiced

Fund Fixed Asset Purchases (new or replacements) – Longer term financing for new fixed assets to replace older assets, or to purchase new fixed assets. Long-term financing for purchasing a building, or a business acquisition

Refinance Existing Debt – Replacement financing with a different creditor to get better pricing and terms, etc.

Fund Poor Financial Performance – Renewal existing debt, or new debt, to provide liquidity for business operations under stress

Finance Disbursements to Owners – Used to fund payouts or owner draws. Replacing net worth with debt will increase leverage which will weaken the creditor's overall protection for repayment (less retained earnings)

Pay Unexpected Expenses – Pay warranty expenses that were not expected

Importance To You –

- *Reasonableness test; you still must be reasonable in what you're asking for* – When you are experiencing a financial set-back, it's likely that you and the creditor will not be worrying too much about identifying borrowing causes or purposes for borrowing the original funds. When you can't repay your debt as agreed, who cares about the original borrowing cause anymore, right? It's likely that the existing terms and conditions will have to now change and will no longer reflect the true

purpose of borrowing the money since the loan may be in default. Fair enough. But, it's important to recognize that while you're trying to get an extension or loan renewal, or even a workout or loan modification deal, you have to be reasonable in what you're asking for. The creditor expects you to be reasonable. For example, you can't expect a creditor to accept minimal payments (i.e., a 25-year amortization, 25-year maturity, and a low fixed rate) on a piece of financed equipment that should have been paid off in five years. But, if that's what your pro form cash flow statement says you need, that you now need a 25-year deal (or amortization), you're going to have to get creative and look at something different. Maybe a formal "A" and "B" note restructure, or getting some other creditor concession is more appropriate.

- *Documenting your plan; reasonable plans still need ongoing documented support* – Maybe your plan or conditions isn't that serious, and you just need help for the next three to six months. Why? Because, if that's the case, that is exactly the truth. You need a very small payment amount, or just interest-only payments for the next three to six months – and that's all. Roll up your sleeves then, and make your case, loud and clear. If that's what it is now, and you expect that your repayment capacity will improve significantly after six months (per your pro forma cash flow statement), then make that case. Promise the creditor that you will refresh your repayment plan before the six-month period expires. Refresh your pro forma cash flow statement for the next year or so on a quarterly basis or whatever it takes. On your next renewal, perhaps you will be able to make a normal payment amount; and then again, maybe you won't. But whatever it is, articulate your ability to repay each time you revisit your plan. You and your creditor will begin to see eye-to-eye, and will come up with a strategy that makes sense to both of you.

- *If your needs are unreasonable, document your case anyway* – Still, in more extreme situations, don't panic. See what the lender will do for you with your well-documented repayment plan. When you think of the original borrowing purpose or borrowing cause, be prepared to 'stay in the correct lane' as best you can; but, it is what it is, which is okay. Be as prudent and reasonable as you can. Document your pro forma cash flow statement. Support it with written assumptions. Sign it. Stand up and defend it. That's the bait creditors like to bite. Propose a repayment plan that makes sense for what you are financing, and don't try to take advantage of the creditor. Again, creditors will work with you if your proposals are prudent, even if that means needing more time or some other concession, maybe a lot more time. But to be unreasonable, to go 'way outside your lane,' is not being reasonable. It's not dealing in good faith either. So, don't hesitate to present 'reality' to your creditor, even if it first appears to be way 'outside the lane.' If you need some real forbearance and covenant waivers, then ask for them with a well-prepared repayment plan. If you can show you are taking responsibility of your plan, that you know you can effectuate it, and stand behind it, the creditor will have increasing confidence in you. Refresh your pro forma cash flow statement as often as is needed, even if its mid-stream. Stay in business. Work it out. Repay your debts. If you're willing to 'get back up on horse' each morning, any creditor worth his salt will work with you to help you stay in business. These times demand that. But you, the debtor, have to take the lead for this to work. You see that, don't you?

Borrowing Entity

CRM #4 – Borrowing Entity, Ownership – Small business lending will include loans made to any number of legal entities. These entities have varying degrees of the following: ownership liability, continuity of business operations, management control or authority for decision making, the ability to raise capital, implications for being taxed, and the cost of establishing the business, etc. Refresh your understanding of the various forms of legal entities or business organizations, their general characteristics, and personal liability structures; they include the following:

Sole Proprietorship – One-person ownership of all assets and control of the business, unlimited personal liability, taxed at the individual rate on net income.

Limited Liability Company – A business whose one or more member owners actively manage the business, and personal liability is limited. Income is passed directly to the members to avoid double taxation. The members are then taxed on the income distributed to each.

Limited Partnership – One or more general partners and at least one limited partner who share ownership. The general partner has management authority and unlimited liability. Limited partners only participate with their capital investment.

Limited Liability Partnership – Functions like a general partnership in form, but provides each of its individual partners protection against personal liability for certain partnership liabilities. Management by the majority, with each partner paying taxes on his own share of the net income.

General Partnership – Two or more people ownership, with unlimited personal liability, shared control and authority, profits not taxed prior to distribution to the partners.

C-Corporation – Ownership is via purchased shares. C-Corporations legally separate shareholder assets from the corporation's assets, with liability limited to the amount invested. Annual shareholder meetings to elect board of directors who hire senior management to manage the company under their direction. Taxes paid at the corporate rate.

S-Corporation – Ownership with 100 shareholders or less, with liability limited to the amount invested. Income is passed directly to the shareholders to avoid double taxation. The shareholders are then taxed on the income distributed to each.

Professional Corporation – Ownership by one or more licensed professionals (i.e., doctors, lawyers, accountants, dentists, consultants, real estate brokers, engineers, architects), unlimited personal liability for professional actions and limited liability for debts. Professional corporations pay taxes directly, but can deduct cost of salaries and benefits paid to the employee-owners. Most professionals are paid out all their earnings in salaries, etc.

Nonprofit Corporation – Formed by incorporators, has a board of directors and officers, but no shareholders who receive no distributions from profits, but rather receive reasonable salaries. For contributions to the nonprofit corporation to be deductible as charitable gifts on federal income taxes, the corporation must apply to the IRS to show it was established for an IRS-approved nonprofit purpose.

Importance To You –

- *The 20% ownership rule may result in a full unlimited personal guarantee* – Keep in mind that while there are certain limitations of liability depending on the type of business you have, the creditor may require a personal individual unlimited (or limited) guarantee, or a legal entity guarantee from a related business enterprise. If you own, say 20% of the business or more, you will likely be required to sign a personal unconditional and unlimited guarantee to repay a loan to a given legal entity. In other words, just because you might have a 20%+ ownership interest in the company, you may be liable for 100% of the outstanding debt. While you're likely aware of your personal guarantee liability, if there's any doubt, be sure to re-read the loan documentation to confirm your liability for repayment before you begin to negotiate a work-out or loan modification with your creditor

Credit Approval Memo

CRM #5 – Credit Approval Memo – Underwriting a new or existing credit relationship is a complex undertaking. After an initial loan screening where the lender wants to do the deal, they will gather a complete underwriting package. The underwriting will be summarized in a comprehensive credit approval memo, or presentation (called by various names). The credit approval memo will be prepared by credit analysts, a primary relationship officer, and presented to a credit administrator or Loan Committee (depending on the size) for approval. Similarly, where there are credit actions to be taken throughout the repayment period, other documented credit approvals are also prepared. The original credit approval memo will be a summary of the underwriting and may include: loan amount, borrowing cause, loan purpose, legal entity ownership, management, business operations (products, services, tenure, marketplace, competition), guarantors, interest rate and fees, primary and secondary repayment sources, maturity date, collateral, individual credit reports, financial statement and tax return analysis (balance sheet, income statement, cash flow, global and pro forma cash flows, trend and industry ratio comparisons), risk rating or loan grade, covenants, and environmental risk. These data will be gathered from business-pertinent financial statements and tax returns, generally, for the last three years, plus year-to-date interim financial statements (including any legal entity guarantors), and personal financial statement(s) and tax returns for each of the individual personal guarantors. It's a very big deal.

Putting Together a Good Deal – A credit analyst may be responsible for performing the detailed financial statement and tax return analyses using the three years of financial records. Understanding these reports will enable the creditor to clearly see the financial condition and trends of the business, and the prospect for funding a loan request that will get repaid. Each component of underwriting is important, and the cash flow (and global cash flow) analysis will be used to confirm the ability to repay the loan. Additional detailed financial reports may be required, including accounts receivable (A/R), accounts payable (A/P) aging reports, inventory reports, etc. The analysts will recommend the loan structure, including any covenants to obtain future financial statement information and targeted financial performance benchmarks. The loan pricing and fees will also be determined. This information will be assessed and analyzed so those with delegated loan approval authority can make an informed decision to grant the loan. Most creditors are subject to certain regulatory and supervisory guidance to conduct safe and sound lending practices. Prudent

underwriting and loan structural are critical to the creditor's long-term success. Creditors are also required to conform to applicable laws and regulations in the application or granting of credit process, and there should be no discrimination of any applicant.

Delegated Lending Authority, Exceptions to Policy, and Renewal Timing – Lenders routinely give specifically delegated loan approval authorities to their lending officers. The larger and more complex the credit relationship, the higher authority levels are required. This may include a loan review committee comprised by members of the board of directors, who will also review certain loans made since their last meeting. Active oversight is a key function of the directors. Depending on the size of the lender, lending authority may be delegated to the Chief Risk Officer (CRO), Chief Credit Officer (CCO), Chief Lending Officer (CLO), Credit Administrators, Relationship Managers, and individual lending officers. The latter will have primarily responsibility for the preparation of the credit approval memo or presentation, together with the assistance of a credit analyst. Should the underwriting include terms and conditions that don't conform to the lending policy, those items will be listed as 'exceptions to policy,' together with the documented reasons that mitigate the increased risk. Loan covenants can be installed to control certain risks. The credit decision process will include enough time to allow the approval authorities to make an informed credit decision and close the deal before the loan commitment expires. On existing loans set for renewal with a pending maturity date, like those with large balloon payments or revolving lines of credit, the underwriting for these deals will take place about two months before those loans mature. Approvals may have a commitment period, like 30 days to fund. Funds will not be disbursed until the creditor's collateral liens have been properly recorded, or 'perfected.'

Importance To You –

- *Build on your exiting experience with your lender* – Your business' financial condition is what it is, and hopefully you expect its performance to improve. Maybe it is greatly underperforming compared to what it was at the time of the original loan, but that's okay. If you have a 'history' with the creditor, the creditor will know and understand, generally, why things are the way they are during a financial downturn. If you've been forthright and have a trusted relationship, you are likely to be inclined to continue to 'tell it like it is.' You will provide timely financial reporting that the creditor will use in addressing your workout loan or loan modification. By the time you provide any requested information, the creditor should clearly understand the root causes for your specific financial deterioration and be sympathetic to your plan to repay. Ask the creditor if it has any questions or needs further information

- *It's natural to avoid a creditor, or get frustrated when there's been a downturn* – It may even feel like a 'grand-canyon' has suddenly split between the two of you. But, if you've taken real ownership of your business, figured out how you intend to repay your loans, you should be eager to provide the creditor any requested information so it can complete its underwriting. The more communication, display of good faith and good will, the better. Expect the lender to negotiate similarly with you, with respect and good faith. You can only do what you can do, and being completely forthright and honest about it, there's a better chance than not, that the creditor will agree to your repayment proposal. Maybe it will or maybe it won't. So, negotiate if you need to. That's perfectly

acceptable. Whatever you do, don't lose your temper, no contention, as you'll quickly be branded as being an uncooperative borrower. When that happens, the lender will likely turn to their legal remedies and not want to do further business with you. Better be prepared to whip out the checkbook if the relationship gets too bad and legal fees appear. In the end, you and the creditor should be on the same page, and an agreeable solution will be well-documented on a credit approval memo. Prepare for the lender thorough documented responses to each component listed in the credit approval memo. Once approved, you can put your focus and attention on making the plan a reality. You are more empowered to come up with your own repayment solutions to repay your own debts. It's not just the lender that has a say in this. An open communicative relationship with the creditor is essential. Let there be no 'grand-canyon' of misunderstanding between you and your creditor(s). May each creditor clearly understand their borrower's best-effort repayment solutions, and work with each as much as possible

Industry And Business Risk Analysis

CRM #6 – Industry and Business Risk Analysis – Creditors generally are aware of key industry and business risks as part of the underwriting process. Creditors also have ongoing credit risk management practices that include close monitoring, and will understand the risks facing their customers and most businesses in the industries they lend money in. They know how well business owners can and should manage those risks. Creditors constantly seek to see how their clients distinguish themselves from the 'competition.' After all, customers acquisition is limited and keen, especially in an economic downturn. A close look at the products and services will be made to see whether there are any advantages a company has in the marketplace. Other business risks include a company's suppliers, the production and distribution processes, as well as the sales process. How big is the company in terms of sales, assets, profits, and market share, and what stage of maturity is it at currently? Every business has a life to it, just like the natural person who is born and later dies. Key risks include the maturity of the industry itself, technology advancements, where the industry sits in the current economic cycle, the cost of products, competition, operating conditions, regulatory oversight or burden, and how profitable companies have been in the past as well as projections for the future. The words 'dynamic and fragile' easily come to mind. No wonder lenders have ongoing credit risk management controls for its loans (asset quality). One major business risk factor is the company's management team/key leadership, and whether there is a reputation of integrity out in the marketplace. Does management have the experience, knowledge, and back-ground to steer the company at the present time during an economic downturn? Is there a strategic plan in place that is performing to plan? These are all questions that the creditor will seek to understand to determine the overall viability of a given company.

Importance To You –

- *Pay attention to keep passing upstream your business and industry risks* – Whether you're talking loan origination, or a loan modification of a seasoned lending relationship, you have an important responsibility in shaping the creditor's understanding of the business and industry risks you are experiencing. This is part of you, taking primary responsibility for creating your own debt repayment solutions, especially if you're experiencing financial trouble. So, this is not a scenario where you assume the creditor truly understands your business risks or industry. The creditor is supposed to know your business and industry, but assumptions are not where you want to go with this, especially in an economic downturn with financial difficulties. Creditors are represented by

individual people, people who are aways in learning-mode themselves. There is also turnover, needed training, lack of training, personnel shortages, and inexperienced workout officers. Of course, there are people who may have expertise in the industry but those people may be far removed from the actual primary relationship officer responsible for working out a repayment plan for your business. So, what do you do? Whatever you do, don't assume.

- *First, you level-set the playing field* – The creditor wants and needs to understand your points of view, the business risks you are experiencing or will soon experience. The same goes for the industry risks too. Again, do not assume the creditor already knows what is happening to you, specifically, or what you may be talking about. It is possible, even likely, he may be less knowledgeable and prepared to represent your interest at the bank than you think. Don't take it for granted. When business and industry risks change, this is new territory and you need to fully explain the risks. If you're experiencing material underperformance, your account relationship may be transferred to an officer in the Special Assets Department (SAD) or workout department. Approach any new credit officer, probably a workout specialist, from the start, by supposing this individual is not all that familiar with the business or industry risks. Be patient. Prepare a well-documented analysis and summary of the business and industry risks you face and how it's affecting your operations. Remember, the new credit officer may not have anywhere close of an understanding as would others in the institution

- *Second, you should literally present, in writing, your 'business risks,' and 'industry risks'* – How do you convey business and industry risks? – Besides documenting the risks, be sure to ask questions to the credit officer to make sure he knows what you're trying to convey. Have a real two-way discussion. There can be no misunderstanding. Spell it all out and give plenty of context. You need to give your credit officer the 'why' behind your repayment plan, and the understanding of what you're experiencing that affects your operations and cash flow. You need to know that he 'gets it.' Persist until he does. This is your business you're fighting for, so be clear. You will not regret it. Aside from making poor management decisions, if you can convey these risks, they will serve as the backdrop, the foundation, the 'why,' to any proposed workout plan. You will recommend, as evidenced by your financial statements, and especially the pro form cash flow statement, a solution to your own debt repayment plan, and these risks are part of that plan. The primary focus will be on the pro forma cash flow statement showing the lender what repayments he can expect to receive over the next year or so. The written explanation of your current business and industry risks will support the forecasted repayment numbers

- *Finally, give the creditor the 'answers to the test' before he prepares the credit approval memo* – The picture you paint of your business and industry risks will be used by the credit officer as part of the credit approval memo to approve your workout plan. If your information is well-prepared and credible, you will make the job so much easier. If it makes sense to you or to an independent 3rd party, it will make sense to the creditor too. If you can stand behind the risks, if you understand them, put it all in writing and expect that your risk explanations will be acceptable. Creditors put a lot of weight on the information you will provide them. If the creditor doesn't ask for these risks, give them anyway so his understanding is genuine and up-to-date. When circumstances change, let the creditor know those changes too

CRM #7 – Management (Debtor) – From a business risk perspective, effective (debtor) management is key to a successful borrowing relationship. Essential elements of management include a reputation of unquestioned integrity in their business relations, tenure, experience, expertise, ability to execute the business plan and strategy, management information systems, controls, reliance on third parties, active board of directors, and personal decisions and consequences. 'Tone at the top' is an important symbolic representation of management's integrity. Not only will it set an example (i.e., tone) to all other managers and employees, it will also be reflected in the company's reputation in the marketplace. For example, how well can matters of confidentiality be kept, and certain private information be maintained? Management is expected to be honest and consistent in having moral and ethical principles. Resources need to be utilized appropriately, and employees need to have trust and respect for the management team. Of course, employees also need to be truly valued and appreciated for there to be an excellent working environment.

Just How Deep is the Management Team? – A seasoned management team, or manager is key – Who has experience working through multiple business cycles, through recessionary periods, and in a serious economic downturn? Managers must have proven skills over an extended period to help ensure future performance. Creditors will take note of and seek to obtain confidence in management, and its ability to manage operations, financing, sales, and overall management. Is there reliance on one or more key people, and who makes the decisions? What if that person were no longer at the company, and is there a management succession plan in place? Other points for consideration are the information and control systems in the business, and how well they function. This may include how well the accounting function supports management and if outside third-party service providers are used. It's entirely possible that 'personal matters' may arise and have a negative impact on management and its decision-making process.

Importance To You –

- *Integrity is paramount* – Come what may, management must maintain the utmost integrity and character in the repayment of debts even during times of poor financial performance. Maybe you feel justified in no longer cooperating with a creditor because he has made 'rash' decisions, demanded too much too soon, won't listen to you, treated you like a 'loan number,' for just like a name listed on a report. Anything but not who you really are. You feel a certain sense of frustration like you've never felt toward a creditor before, right? After all, this is your business, and the creditor "doesn't have a clue what's going on." So, what about that? How easy could it be for you, the business owner(s), or guarantor(s), to 'turn' on a creditor during difficult times, and do things that will cause the lender to suffer an unwarranted loss – to take an unfair advantage of the creditor. At the end of the day, the business is either going to 'make it' or it isn't, and it will be what it will be, and hopefully it will succeed. Think about this for a minute. Frankly, if there's an opportunity to get away with something that you really shouldn't do, there's no excuse or reason to 'shaft' a creditor because you think you can 'get away with it.' There is no moral or ethical way to justify you being anything less

than totally honorable in dealing with all your creditors. You simply need to offer and do your very best, and let come, what may

- *Don't go there, even if you 'could.' Do you want that on your conscience forever? No* – For example, if you wanted to hurt a secured creditor by violating the terms and conditions of your Promissory Note and Loan Agreement (which would trigger a default), you still could. You'd be in default, and subject to any repercussions, and go out of business, get sued, etc., but you could do damage. You 'could' quickly call, discount, and quickly collect all the accounts receivable and build a secret war-chest to cover pending legal fees, pay certain other creditors or suppliers who are not entitled to those funds, use business cash for a new gambling addiction, or squirrel away funds for your own well-being, etc. You 'could' liquidate inventory 'on the side' after hours, and not account for it under the ordinary course. Essentially you would be taking possession of funds that you control but really belong to trade suppliers, or first to a secured creditor. You 'could' sell an asset to a friend or associate that is subject to the lien interests of a creditor, and hope the creditor never finds it. You 'could' paint the place your favorite color, like red. There are several things you 'could' do to hurt a creditor, and you may even get away with it. And yes, it will cost the creditor additional monies it will never recover to go after you for collection purposes, not to mention the costs to liquidate the collateral once it's in a condition to sell. But, is that what you really want on your conscience at the end of the day? Creditors have been known to spend 'good money to go after bad money' because a debtor has clearly taken money belonging to the creditor through his shenanigans. Frankly, it's not worth it. Don't ever go there

- *Use your utmost integrity and negotiate in good faith* – Rather, first empower yourself by learning to understand how creditors think, and how and why they operate the way they do. Second, you will need to prepare financial reporting, especially your fully documented and supported pro forma cash flow statement, and negotiate a repayment plan on a best-efforts basis. There is absolutely no need whatsoever to exhibit anything less than the utmost integrity in doing your best work, and negotiate in good faith. This does not mean, specifically, that you offer a repayment plan that is too optimistic and something you think the creditor wants or must see. It doesn't work that way. Be real, show what it is. Negotiate in good faith. It will show well

- *Don't give a repayment plan based on what you think the creditor wants to see* – As the owner of your business, as it's manager, you know what it will take for your business to survive and eventually thrive. This is why you'll present the outright truth, not falsified numbers that match up with what you think the creditor needs to see, or some 'fudged' numbers to meet a covenant requirement. If you don't fully understand the ratios, or your own numbers, then ask questions and figure it out until you do know. We're talking full transparency and integrity. That's what you're going to present to the lender. Your management and negotiating skills are everything when it comes to being empowered to get the creditor repaid, as appropriate. Creditors need to make prudent lending decisions and they need to see the whole picture. Show him why and how prudent your new repayment plan is as of now. As an effective manager/owner, please do not forget that you are empowered to take the lead in your workout proposals. Document it well. Communicate, communicate, communicate. Make certain that you understand that the creditor understands what you understand. If you're not certain he does understand (everything), then start over if you have to, until you are certain he gets it. That's what effective management is. You are in

full control to make sure your repayment plan has integrity, and not ‘made up’ numbers

Credit Risk Memos (CRMs) – Credit Facilities

Interest Accrual, Nonaccrual

CRM #8 – Accrual, Nonaccrual – This is the accounting treatment of the daily interest that accrues on your loans. Accrued but unpaid interest amounts will be recognized as income to the creditor as interest is paid by you and if the lender expects your loans to be repaid according to the terms. Nonaccrual status is applied to your loan, in part, if the creditor determines that (1) principal or interest has been in default (i.e., non-payment) for 90 days or more, unless the loan is both well-secured and in the process of collection; (2) payment in full of principal or interest is not expected. Nonaccrual means the creditor is not getting any income from your loan – you can see why the lender wants to get your loan performing again quickly (to restart the interest income), or to move your loan out altogether. Once on nonaccrual, any accrued but unpaid interest by you would require the creditor to reverse any such interest not yet recognized as interest income, and essentially stop accounting for further accrued interest into their income each month. Well-secured means there is collateral in an amount sufficient to repay the debt and any interest in full, or a guarantee by a party that also supports repayment. In the process of collection means that there is ongoing legal action to pursue collection or collateral liquidation, or some other collection activity that also ensures repayment, or a return to a Pass credit risk rating. Loans are often restructured, in the best interests of both the debtor and creditor, to help ensure the prospects of repayment. With a properly restructured loan, it need not remain in nonaccrual status forever. Generally, sufficient time is given, for example at least six months, to document the receipt of payments being paid as agreed to support the decision to return the loan to accrual status. The key is to show repayment is 'sustainable.' After half a year, that's pretty good evidence there's an ability to repay on the new terms, therefore, the bank can start to accrue interest (into earnings) again. To restore a credit to accrual status, the principal and interest payments need to be current, and the creditor needs documented support to show it fully expects the loan to be repaid under the current terms. It can also apply to when the loan becomes well-secured and in the process of collection.

Importance To You –

- *Interest on your loans, that you owe, will keep accruing – forever, until it's paid* – Keep in mind if your loan is 90 days past due, and while the lender isn't posting accrued but unpaid interest to its income (your loan is on nonaccrual), the 'system' continues to calculate the interest payable that you'll be required to pay anyway (interest never sleeps). It is just that the creditor isn't taking accrued interest into income while your loan is in nonaccrual status, but the system will keep track of all the interest you owe on your side of the table

- *Nonaccrual status is a very big deal* – Lenders don't like nonperforming assets, loans where they are not making any money because they've stopped taking accrued interest from your loan into income. Again, if your loan is 90 days past due or if the lender has any doubt about eventually collecting the entire balance, the loan will stop accruing interest on the lender's books. But your loan will continue to accrue interest forever until it is repaid in full. By this stage, lenders will have made every effort to bring the loan to a $0 balance, unless you have been able to restore the

financial performance to acceptable levels (i.e., sufficient cash flow coverage). A creditor does not want to have any nonperforming loans laying around, as a concentration of nonaccrual loans will bring regulatory scrutiny very quickly

- *Returning a nonaccrual loan back to accrual status* – It is entirely possible that a workout loan repayment plan may require a loan to be placed on nonaccrual. There may be part of the loan that is deemed to be uncollectable (loss), where the loss portion is 'written or charged off' (see Restructuring; 'A' and 'B' Notes). The charged off portion (loan B) no longer accrues interest taken into income for the creditor. It can still be repaid with all interest due, once loan "A" is repaid. Despite charging off part of the loan ("B"), and having loan "A" initially still on nonaccrual, loan "A" could, eventually, be restored back to accrual status after sustained repayment performance. So, if you've formally restructured your loan to ensure repayment and performance on Loan A, it need not remain in nonaccrual status forever. The creditor will need to decide when to return the loans to accrual status based on your successful payment performance over a sustained period, like six months of regular payments under the new terms. Lenders need to have performing or accruing loans. Do everything you can to keep your loans on accrual status, but realize that a workout loan may have to be placed on nonaccrual and restructured

Loan Structuring

CRM #9 – Loan Structuring – Loan structuring is designed to help ensure a successful borrowing relationship, with appropriate measures that serve the debtor's needs in the short and long term, and in good and bad economic times. Workout loans may alter the traditional repayment terms and structure, however. Elements of loan structure may include: interest rate pricing and fees, maturity date, payment amount and frequency, secured or unsecured, lien position, collateral type, guarantors, seasonal funding, loan covenants, financial reporting, and down payment. With multiple credit facilities, the creditor should have maturity dates that support the respective loan purposes, along with their own repayment terms. The key for the creditor is to thoroughly understand the debtor and his business, the loan purpose and borrowing cause. The creditor will have credit policies and procedures to ensure the loan request is structured to conform to policy requirements, and anything outside of policy is an exception to policy (which are closely monitored). Most financial institutions are regulated entities and their underwriting standards, including loan structure, have similar characteristics. Competitive pressures and regulatory changes can affect the elements of loan structure. Loan structure helps ensure the creditor is lending in a safe and sound manner.

Importance To You –

- *Irresponsible swinging back and forth of loan structuring, lack of consistency* – Loan structure during economic expansion periods can result in laxed credit underwriting standards. For example, creditors offer 'light' covenants with excessive 'head room' before the covenant is violated (aka 'cov. light'), non-recourse, limited guarantees, no guarantors, extended maturities, unsecured or no collateral, crazy low fixed interest rates, and minimal fees. Thank goodness for competition, right? However, during an economic downturn, all bets are off. The creditor is going to get you back to a

performing status, or take whatever measures he can to ensure your loan is repaid as soon as possible. Interest rates and fees are likely to be increased, rightfully so. Lenders should price for credit risk, and if your loan is subject to higher credit risk, the lender should charge a higher interest rate. This may sound counter-intuitive because a disclosable loan modification may result in a lower interest rate. Yes, that is correct. Your workout could also result in a, not higher, but lower interest rate. So, don't discount out a lower rate (which you should ask for, if 100% needed), even though the deal's credit risk is higher and the lender is supposed to charge a higher interest rate. It does not have to be that way. Overall, the entire structure will become 'tighter' and more controlled by the creditor

- *It's too bad lenders, and borrowers are not more consistent* – You definitely have a much bigger voice in negotiating the loan structuring process than you realize, both at loan origination or loan workout. Yes, it's the creditor's business to know you and your business. But take a close look at the loan structure and step back a minute. Look at it from the lender's perspective, and how it might view it thinks how you view it. Who has the stronger negotiation position? If, for example, a guarantor only has a 50% limited guarantee, what does that mean? 50% limited guarantee of what, 50% of a potential loss after the liquidation of assets? Once you know for sure what you are supposed to guarantee, why not negotiate the guarantee amount? Make your case. Your case needs to be reasonable and work with in terms of an acceptable loan structure. It is not as if the patient is telling the doctor what treatment is needed. But if the patient, borrower, is aware of and familiar with treatment options, and knows what works best for his needs, why wouldn't he step forward and make a solid recommendation to the doctor, or repayment plan to the creditor? While a new loan may have more flexibility, in a workout deal, expect to have 100% unlimited guarantees in force

Pricing: Interest Rates, Fees

CRM #10 – Pricing: Interest Rates, Fees – The interest rate offered should be based on the credit risk in the deal. All things considered, the stronger the financial statement, the better the interest rate and fees. Competition will make sure of that. What goes into determining the interest rate? The established rate will need to be sufficient to cover the creditor's 'cost of funds' used to fund the subject loan, the overhead, or the cost to service the loan, potential losses that may incur, and a reasonable level of profit. Lenders operate on a very thin margin. Management will have internal pricing criteria, and experienced lenders who know the necessary pricing and fee objectives for each loan. Pricing can change as competition and other risk factors are realized. Unless you live in a closed market, creditors will not likely seek to offer the lowest interest rates, and may be willing to lose a deal due to underpricing from a competitor. Creditors will also consider the monetary value of 'compensating balances,' the deposits a loan customer will bring to the relationship, and adjust down the pricing accordingly. Many loans are granted on a variable interest rate basis, where a certain margin is tied to the prime rate (i.e., base rate), for example, as quoted in the Wall Street Journal. The pricing structure may also have a 'floor' rate or a 'ceiling' rate that reflects how low or high the interest rate may be adjusted in a given period. As the base rate changes, so will the rate on the loan change when adding the margin percentage. Consumer loans will frequently have a fixed rate structure for the entire loan term, as well as some longer-term commercial loans (i.e., interest rate to be adjusted

every five years, or upon maturity/renewal). Creditors can face strong pricing competition, but will try to win over deals with excellent service.

Importance To You –

- *Are you subject to higher interest rate risk, including refinance risk?* –Small business owners like you need to immediately and seriously reassess the level of debt on your balance sheets for the sake of your own survival. In too many cases, heavy debt rules the day, and most of the debt is accruing interest on a variable rate basis. We are now in a high interest rate environment. It isn't as high as prior decades, but as a percentage of increase over the low interest rate environment of the past ten years or so, the jump in rates is huge. It's huge especially with the high debt loads in the marketplace that are subject to higher interest rates upon renewal. There have been mixed signals, 2024 being an election year and all, of lower interest rates, but still pressure on keeping the higher rates high for a longer period due to high inflation. Talk of any lower interest rates is now being pushed into 2025. What if there are more shock events (you can almost count on them happening these days), that make interest rates increase even more than you might have expected, and possibly more sharply than you could have imagined? What then? If you're having a hard time making interest-only payments, or minimal amortizing payments, like much of the world is doing, how well would your business fair if your new interest rate was 100, 200, 300 or 400 basis points (one to four percent) higher, or more? How would that impact the interest expense on your income statement, and what would that do to your bottom line? Have your accountant or Chief Financial Officer stress test your balance sheet and income statement, and see what happens for yourself. Run different scenarios like those higher interest rates, a 10% reduction in sales revenue, a 5% increase in salary expense, etc.). What is your break-even point where interest expense eats up most of your budget? Seriously though, you can project what the next 12 months will look like on a monthly basis. If interest rates increased more suddenly and sharply than you expected, starting today, what effect would those economic conditions have on your operating margins, the value of your assets, and your ability to repay? Do it before it hits you, and the creditor. Know before you go

- *We've not paid enough attention to interest rate risk* – Look, we live in fragile times, and small business owners have paid too little, or no attention, to the levels of debt they maintain. Soon, small business will find themselves in serious jeopardy. Think of the words 'modest,' and 'controlled,' and consider adjusting your strategic plan accordingly. As you might guess in a workout situation, the creditor is going to offer an interest rate regimen that makes sense for the creditor – think higher credit risk equals higher interest rates. If you don't like it, and you're able to do something about it, take your business to another lender, sell assets, or retire the debt. If you're 'stuck' with the creditor, or if the creditor is stuck with you, there's no reason that you cannot address the interest rate treatment straight up. Look at your monthly pro forma cash flow statement and install the interest expense amount your creditor may be expecting you to pay over the next 12 plus months. If you feel the interest rate is fair and equitable, then fine, pay it. If you don't believe it is fair, equitable, or manageable for your business, then discuss the rate with the creditor and request an interest rate structure that will meet your needs. But don't do the latter, 'just because.' The creditor is a business just like yours, and you know what you need to charge to stay in business too. There should be a valid reason and financial need or you'll not likely to succeed

in getting a low rate (i.e., see disclosable loan modification). It is doubtful anyone can pull the wool over the eyes of an astute creditor. But a wise creditor will listen to a well-prepared borrower

- *Prepare a well-supported, assumptions-documented pro forma cash flow statement with the right interest rate* – You know your business operation better than anyone. Footnote material sources and uses of cash, as well as interest expense. Use different interest rates, a base case, a stressed case, even a break-even case. A lower interest rate is a variable expense option, but you will only get the right rate if you push for it because you need it to survive. Lenders can make concessions under disclosable loan modification terms, but only if it's necessary for your survival. Look at the interest rate through the eyes of the creditor, as creditors are businesses just like you. They still need to be properly compensated like you do for your products and services. Be careful. Be thoughtful. Justify your positions. It is what it is, good or bad. Think full disclosure. This includes having a variable or fixed rate. The creditor may be willing to discuss both options, and in a potentially rising interest rate environment, perhaps your interest expense can be locked in at a lower rate even if it is at the low end of a higher interest rate range. The creditor will, obviously, push for the rate it needs to cover all his costs and make a profit

Repayment Sources: Primary, Secondary, Tertiary

CRM #11 – Repayment Sources: Primary, Secondary, Tertiary – A well-structured loan comes with repayment terms and conditions that satisfy the loan's original lending purpose and based on a specific borrowing cause. Creditors require there to be well-defined repayment sources to help ensure full repayment. Ideally, there would be three sources for repayment to begin with since it is possible the primary repayment source might fail to materialize. The primary repayment source, generally cash flow, will be different depending on the type of loan being underwritten. Secondary sources will likely include the sale or liquidation of collateral or a refinance of the loan. Tertiary sources will often be the financial support from guarantees by legal entity(ies) or individual owners(s). Guarantors must have received 'consideration' from the loan transaction in order for the guarantee to be valid (received a direct or indirect benefit)

Primary Source of Repayment (PSOR) – The PSOR will be directly related to the loan type. For example, for a construction loan, the PSOR will be the take-out or permanent financing, and not rental income or the sale of the property. For an asset-based line of credit, the PSOR will be the conversion of trading assets (accounts receivable and inventory) to cash. The PSOR for a long-term equipment or an owner-occupied commercial real estate (CRE) loan will be the cash flow from business operations generated over multiple operating cycles. For a non-owner occupied CRE investment property, the PSOR would be the tenant rents.

Secondary Source of Repayment (SSOR) – The SSOR will serve as an alternative source of repayment should the PSOR fail to materialize. In most cases, the underlying collateral, a properly documented and pledged lien, or interest, will be foreclosed or liquidated and the proceeds will be applied to the remaining outstanding balance.

Tertiary Source of Repayment (TSOR) – The TSOR is typically the final layer of protection to help ensure repayment should the prior sources fail to pay off the outstanding balance. It's possible the guarantor(s) may, or may not, have the ability or willingness to further support and serve as a repayment source. Guarantors will often step in earlier to shore up any cash flow deficiencies, but often can become fatigued

through the workout process.

Importance To You –

- *Call it like it is* – You need to better understand repayment sources in the eyes of the creditor. Be candid and realistic about the repayment sources available to you when you're experiencing a serious financial setback. The repayment sources are either there or they're not. There is also the willingness to repay, and the ability to repay considerations. It is what it is. And your job is to be completely honest and candid as to what is there and what is not. All your financial reporting should be complete and accurate. Your root cause analysis, to determine the reasons for your financial difficulties, regardless of what they may be (i.e., the result of your decisions), together with the assumptions that support your resolution plan, need to be fully documented. As you do so, the repayment sources will have to take care of themselves. They are what they are, but call them out for what they are

- *It's true. The creditor does not want to hear any 'bad news'* – The lender wants to avoid any downgrades, and, especially, any losses. It wants to avoid having to spend good money trying to pursue liquidation of the collateral, or chasing you down as a guarantor in getting a judgment against you. It wants this to be over quickly, the sooner the better. Because of your integrity and good will, it expects you to keep your end of the bargain and comply with the actual promises and commitments you made when it gave you the money in the first place. The Promissory Note and Loan Agreement speak for themselves. But, you're right, the creditor wants to hear only good news. So, why not just give it want it wants to hear? Or, maybe, why not give it false hope and the numbers that it wants to see? And, you'll just hope to survive and live another day, right? Is that what the lender wants, and is that what you will give him? You're sure the credit officer's bonus is at risk if you have bad news, right?

- *If repayment sources are in jeopardy, why cooperate?* – You've probably been thinking about this for some time already, or maybe you've already had a bad experience. Maybe your initial reaction was to fight the creditor at all costs. After all you now have to protect your assets because 'the creditor is coming to seize them,' right? So, you're wanting to fight back with every tooth and nail. That, indeed, may be your natural reaction when your business and personal assets, and livelihood, are threatened. If that's what you think you're probably in good company. It may be that way because, as noted, the creditor wants it all, and it wants all it yesterday. And if you give it all that transparent information, it will then know how and where to come and get everything too, right? You'd be giving the lender the 'keys to the vault,' you say. Why on earth would you do something like that?

- *Making the best of the 'easy way, or the hard way'* – Well, first off, if you're financially in trouble, you have a choice to make. You can do it the easy way or the hard way. Take the hard way, for example. If you fail to live up to the promises you made when you signed it all away anyway, in your loan documents, you will have breached your promises if you default. You will have, in a sense, failed to meet the terms and conditions you promised. But you need to be honest about any repayment sources subject to the promises you've made. Creditors, just like you when you're trying to collect one of your accounts receivable, can sense any bad-faith. It's ugly. It's frustrating. How could they do that? Right? Well, you're an account debtor too, an account receivable on someone else's books. What does your creditor think of you today? Does he think of you the same way you think of your account debtors? Are you going to fail in your promises to come to the table? What if your account debtors treated you the way you're treating your creditor? What should you be doing? Are you going to acknowledge your problem, and then empower yourself, and fix your problem? It's not the creditor's problem. It's your problem. It's your responsibility, and you should hold yourself to account. Isn't this the approach you want people to assume who owe you money? So, why in the world don't you come up with your own debt repayment solution, since you own this? Do you see how you need to empower yourself? Make the hard way, into an easy way – yours

- *You're the one who signed the Promissory Note and Loan Agreement* – Which leads to the easy choice. Empowerment. Yes, empowerment. You know this is your deal. Study up on any knowledge gaps to prepare and present your own debt repayment solutions. Top it all off with a pro forma cash flow statement that shows what changes you're making in your business and how that will translate into cash flow for satisfying your debt repayment plan. Sure, it's not going to be what the creditor wants to see, but it will be your best shot, and what you expect will honestly be the case. Stress the repayment sources by discounting, increasing the interest rate, etc. Make a real case that's supportable. It is what it is, so give the bad news and your own solution to solve your problem. When conditions improve, you'll come back to the table and reset or modify the loan once again

- *Seriously, can't you turn the hard approach into the easy approach?* – Update and show the creditor exactly what the repayment sources are at this stressed time. Use and speak his language by using the credit risk memos in this publication. Do everything you can to step up to your obligations, making necessary sacrifices. If you're out of gas, or the sacrifices are too heavy for you, then consider handing the keys to the creditor and file bankruptcy. That's the last approach, a clean-up when all else has failed. But avoid the contentious approach at all costs, as it turns the repayment sources into 'the hard way.' If you choose that ugly approach, it could have a material negative impact on your overall well-being. There have been a lot of debtors who have lost everything meaningful in their lives and are left with a broken-down business, that smell. It is not worth that. Do you want to stink? Creditors, if they don't have options, can and will take appropriate measures to collect and force debt repayment anyway. It's called justice. It's their right, and they will exercise it. They have the resources to force their hand. On the other hand, if you do your very best to live up to your agreements, how can you be any less ahead at the end of the game? Remember, it is prudent lending for lenders to make, where necessary, disclosable loan modifications (principal

forgiveness, interest rate reduction, other than insignificant payment delays, term extensions) so these are options for your use too. Do this your way, whatever way you choose, with legal counsel support. But, be empowered and find solutions to your own debt repayment plan. While this may seem hard to believe for some borrowers, creditors are human beings too. They know how to listen, and they're reasonable people. You may be very surprised how well you fair, especially if you use these credit risk tools. But, seriously, do you really want to do this the hard way? No, you don't. You want to do this the easy way, your way. Your spouse and family will thank you in the end. No alimony and no child support payments here. You can do this

Credit Risk Memos (CRMs) – Creditor Protection

Appraisals, Evaluations

CRM #12 – Appraisals, Evaluations – Certified or licensed professionals render their appraisal opinions as to fair market value of real property (i.e., commercial real estate, CRE). Certain smaller transactions and renewals or refinancing do not require appraisals, and less formal (and less expensive) Evaluations, or even Validations of prior appraisals, may be used in their stead (conditions apply). Appraisals are performed as either a Complete or Limited appraisal. Both assignments may be prepared in three formats – a Self-Contained report, a Summary report, or a Restricted report. The degree of detail separates the three report types. The Self-Contained report is the most comprehensive. A Complete appraisal must conform to the Uniform Standards of Professional Appraisal Practice (USPAP), and a Limited appraisal allows for certain departures of those standards under certain circumstances. The appraisal and evaluation process must be independent from the loan production function at institutions, and the person performing the appraisal certifies that he has no interest in the property. This process of independence also includes the appraisal engagement and selection of an appraiser. Appraisers use three valuation approaches: Cost approach, Sales Comparison approach, and the Income approach. The appraiser will reconcile the three approaches to value to arrive at the as-is fair market value of the property.

Cost Approach – Used to estimate the reproduction cost of the improvements less depreciation, plus the land value. Older properties make this approach more difficult to use, and is also not used in a troubled market as construction costs will exceed market value of existing properties.

Sales Comparison Approach – Uses selling prices of similar recently sold comparable properties in the local marketplace to estimate the value of the subject property. The approach is more suitable for similar owner-occupied single-family properties, and will add support for commercial properties.

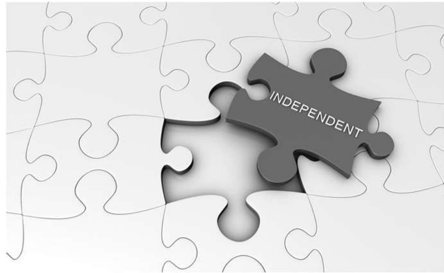
Income Approach – Mostly weighted for income-producing CRE. It is based on the discounted value (present value) of future net operating income, and should reflect the sales price of the subject property.

Importance To You –

- *A few things to be aware of that can impact the collateral* – The chances are pretty good that the creditor will be very familiar with the collateral risks securing the loan, especially CRE. Be aware of relevant market conditions: declining real estate valuations, inflation, increasing interest rates, employment rates, borrowing costs, increasing vacancy rates, decreased lease (rental) rates, increased operating expenses, decreased demand, lack of available financing, and less economic growth. Use these to build your case

- *Read the prior appraisal and get familiarized with these key elements of the appraisal* – Key elements include: extraordinary assumptions, hypothetical conditions, leases/rental rates, vacancy, operating expenses, CAP rates, discount rates, absorption rates, leasehold interest, and tenant improvements (TIs). Each of these elements will impact the appraised value. Determine what has

changed since the prior appraisal to get an idea as to whether there is downward pressure on the as-is market value of the collateral. Based on relevant/material changes in market conditions, project performance, geographic conditions, variances from original appraisal assumptions, change in project specs, loss of lease or takeout, high pre-lease fallout, and especially as your financial condition deteriorates, a new updated valuation will be procured, likely at your expense



- *A couple of reminders to consider* – If market conditions are distressed, and income properties are generating insufficient cash flow, it may be difficult to obtain sufficient financial information on comparable property sales. Financing may be difficult to obtain, and the marketplace may have numerous distressed properties for sale. The appraiser will have to use his best judgment in projecting future net operating income over time based on historical levels and trends, and current market data. As a debtor, you will have to stay clear of the appraisal function. Any appraisal you may engage, or appraiser you recommend for selection, will not be permitted, or used in the appraisal process

Collateral

CRM #13 – Collateral – Real or personal property pledged as security as a secondary repayment source for a term loan. The collateral is subject to being forfeited should the loan go into default. A secured loan is a loan with collateral usually sufficient to repay some or all the outstanding loan balance should the primary repayment source, cash flow, fail. The creditor may exercise his right to seize the collateral upon default. Generally, the type of collateral used will match up with the purpose of the loan.

Importance To You –

- *Collateral is an important part of the underwriting process* – Take real property for example. The value of the collateral will need to exceed the value of the loan amount, probably by 25% or more. Astute borrowers will finance as little as possible anyway, so it’s not uncommon to see loans with 50% equity cushion, or 50% loan-to-value. There needs to be a minimum equity cushion appropriate for the collateral type and the duration of the loan term, per regulatory guidance. Creditors often will install a loan covenant that is designed to ensure the loan balance maintains a certain equity cushion throughout the life of the loan. Should the collateral value fall below a measured ‘loan-to-value’ ratio, the debtor may be required to reduce the principal balance to return to a compliant ratio. Regardless, the debtor’s loan documents will generally state that you are required to maintain the collateral in good condition while the loan balance is outstanding. Market values often increase but they often decrease too. The equity cushion will help ensure the creditor will be repaid if the collateral becomes the only repayment source for the loan

- *Real estate collateral may not be worth as much as everyone thinks* – Keep in mind that there’s a big difference between you, the debtor, owning the asset, and the creditor owning the same asset. You will do what you will do with the collateral, but if the creditor forecloses or otherwise acquires the title to the collateral it’s another story altogether. A creditor, usually a financial institution, will need to sell the collateral, an asset that is not part of the creditor’s regular business model. Lending institutions lend money. They don’t operate construction equipment or use office/warehouse buildings as an industrial enterprise. The marketplace instinctively understands the difference, and when a creditor owns collateral that it desires to sell (must sell), the creditor may encounter a steep discount, and possibly material expenses relating to the disposition of the collateral. It’s possible that discounts, based on collective bids or offers from the marketplace, may be 10 to 20 percent

lower than what the collateral is worth. And, add that discount on top of depressed prices in the market, and you begin to see the value of the collateral from the creditor's perspective. It's very possible that by the time the creditor sells the foreclosed collateral, there could be a substantial deficiency that still needs to be repaid. In some States, the lender gets either the collateral, with no deficiency, or it can go after the owners to collect, and abandon its interests in the collateral. Lenders will often sue to collect on any deficiencies once collateral is sold

- *Personal property* – Personal property, consisting of inventory, equipment, unlike real property, the creditor will perfect a lien interest by filing a recorded UCC financing statement, and you'll also sign a Security Agreement. Rolling stock like vehicles, will be titled and the creditor's lien interest will be recorded on the titles. Creditors will pull new UCC searches to confirm whether other creditors also have a (junior) lien interest in the collateral, but the most senior lien position will be the first to be paid from the liquidation proceeds

- *What is the real cost of going too far to save a business?* – Now, before you and your creditor even think about talking about a cooperative or forced liquidation of the collateral, please keep a few things in mind. This is your business. It's serious business when you're experiencing financial setbacks. If you don't know already, you may know all too soon, the stress of insufficient cash flow, the burden of heavy debt, and the toll it takes on you and your family, employees, and other stakeholders. It's a big deal. So, if your debt load is too heavy for you and your business, realize that it is possible that you may lose your business and all the equity you put into it. Yes, you can and should do everything you can to maintain your business, but give yourself some time to really think about the real cost of going too far to save the business if it's nearing life support already. Why in the world would this make sense?

- *Frankly, here is a good reason why saving a business on 'life support' may not be the right decision* – Come along on a little journey a few years from now. Put yourself in the shoes of a business owner that took his business way 'too far' in trying to save it. What cost did he really pay in the end? Did there not enter his mind any warnings? Did pride get in the way, and at what expense? There are way too many business owner's tax returns filed each year that have alimony and child support; how sick, how sad. Behind the scenes of some of those businesses sits an owner by himself, with a half defunct business, where the fun of operating such a business is long gone. Many are the reasons why this is so. In most cases, the personal failures should not have happened. Maybe the owner gave away too much time and resources to save the collateral: metal, sheetrock, wood, nails, screws, paint, rubber, plastic, tile, asphalt, cement, inventory, shingles, carpet, glass, and the list goes on and on. Look at that owner, and ask yourself if saving such 'collateral stuff' was worth the price he really paid. Oh and now gambling losses show up in his tax return. Some life, right? In the meantime, he lost relationships with his wife, his children, his future grandchildren, and so forth. No business is worth that cost, whatsoever. A new business, under different circumstances, can be formed later. There may come a time to hand over the keys to the creditor and tell him you are taking your wife out to dinner. Think about it. Where do you sit today?

Covenants: Financial, Performance, Reporting

CRM #14 – Covenants: Financial, Performance, Reporting – Loan covenants are conditions that a borrower must comply with as specified in a Loan Agreement. Covenants involve reporting requirements, financial performance thresholds, affirmative and negative actions. If a debtor fails to adhere to the covenant requirements, it will result in there being a violation, and a technical default on the subject loan, enabling the creditor to call a 'time out.' Its purpose is to enable the creditor a way to mitigate the increasing credit risk. It is common for creditors to formally altogether waive or temporarily forbear covenant violations for a variety of reasons. Doing so, will not affect the remaining terms and conditions of the loan, or for compliance to the upcoming covenant requirements.

Take the Time to Read and Understand All Required Loan Covenants – Creditors usually install the appropriate covenants (i.e., the number of covenants, and how often they are to be measured) as part of a solid loan structure. They just want to get repaid, and are not out to sabotage a debtor. Else why would they lend the money in the first place? And besides, debtors agreed with these terms in the Loan Agreement, or they at least signed the document whether they understand what they're signing. Few probably take the time to read and understand it. That said, covenants protect the creditor's interests by requiring the debtor to achieve certain performance financial ratios or benchmarks, and to also submit financial reporting on a regular basis (i.e., monthly, quarterly, annually). See CRM entitled: Ratios, Financial.

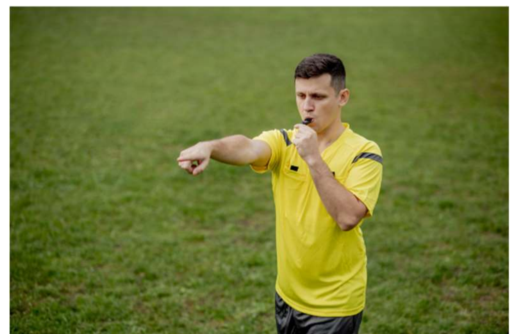
Loan Covenants Serve Various Purposes – Performance ratios may involve metrics for debt service coverage, profitability, efficiency, leverage, and liquidity. The creditor is seeking to preserve asset quality (i.e., cash, accounts receivable and inventory), maintain cash flow and net worth, and control growth. Other purposes include ensuring proper financial disclosure, and making sure management quality is maintained. Covenants will also protect the creditor by ensuring the business continues to operate. There are also affirmative covenants which require the debtor to 'do' certain things. For example, they may include: paying all payments when due, maintaining insurance, paying taxes, providing financial reporting, meeting minimum or maximum financial ratios, maintaining certain levels of working capital and net worth, following certain accounting procedures, permitting inspections, advising on litigation, and maintaining fixed assets. On the other hand, negative covenants will limit and prohibit the debtor from doing certain things. For example, the covenants may limit: new debt, sale of assets, capital expenditures, lease payments, officer salaries, and dividends. Covenants can prohibit certain types of investments, loans to certain parties, mergers, acquisitions, and changes in management. For longer-term loans, all loan covenants will be fully described in a formal Loan Agreement and are binding. Alternatively, where there is no Loan Agreement it may be more likely the loan has a short-term maturity with a balloon payment. This will allow management to make an appropriate review at maturity, which is pretty much what covenants do in long-term loans.

Covenants That Are Not Too Tight or Too Loose – Creditors are expected to prepare appropriate covenants to not have them too tight or too liberal (too much 'headroom') before they trigger a default. If they are too restrictive, it will be more likely that the company will frequently trigger unwarranted violations. At the other extreme, if they are too trivial with too much headroom, the borrower might be insolvent before a financial covenant is triggered, which does nobody any good either. Again, covenant violations are serious and can result in the acceleration of the debt's maturity date, or trigger the application of a default interest rate until the violation is cured.

Importance To You –

- *Study and understand what your loan covenants are* – Read and understand what covenants you are committed to, whether they are based on credit metric performance, financial reporting, affirmative and negative actions. How much cushion is there in measuring up to your covenants, and what is the trend line looking like over the past year? Where will the trend go, and will there be future covenant violations based on the trend analysis? It's doubtful most debtors ever read them all, but if you're in a serious economic downturn environment, they become increasingly more important. Covenant limits are more likely to be violated or triggered, and the 'fine print' in the Loan Agreement could come back to bite you if you're not prepared. As noted earlier, covenant violations are serious business, and it's entirely possible that if not corrected, the creditor could demand payment in full – in 10 days. The 'gloves could come off' and you may not have a clue what's happening before it's too late. So, pull out the Loan Agreement, read it, research any questions, talk with legal counsel, whatever it takes until you understand what it's saying regarding all the covenants. If you don't have a copy of your Promissory Note, or Loan Agreement, ask for a new copy from the creditor. It's okay to ask the creditor what the loan covenants mean, how they're calculated, and so on – if you need to. Not everyone is conversant with such covenants. No question is a dumb question. After all, if you have loans outstanding, you're already 'in bed' with the creditor so you may as well get to know what you've got yourself into, if necessary

- *Pay extra close attention the financial performance covenants* – Assuming you are compliant with the reporting requirements (i.e., you submit all your financial statements, certifications, etc., on time), focus your attention on the ratio requirements in the performance covenants. As poor economic conditions play out, it's likely that you will trigger a violation for not performing as agreed. Based on the 'new normal' of trends, does that mean the covenants themselves need to be adjusted higher or lower so as not trigger more violations that everyone can see will be coming? Maybe. If the covenants become unreasonable, then maybe it's time to have them adjusted so violations don't happen, assuming the lender wants the relationship to continue. But perhaps the covenants metrics are appropriate and still attainable. You and the lender both agree that you can, should and will quickly perform to the existing covenant expectations in the near term. If that's the case, the creditor will recognize such violations, but just issue a waiver letter for any specific violation. He will wait to see what happens next quarter, for example, when the covenants are tested again. If the creditor doesn't like what's happening, he



may temporarily forbear (not waive) the violation for a short period and remeasure the results to determine if a default has occurred

- *Make your voice heard when it comes to loan structure and covenants* – Creditors need to be realistic and recognize that your financial condition has, in fact, deteriorated, and that will affect your covenants accordingly. So, for you, it is important to understand the covenants, what they are, what they mean, and how they're measured. It tells you how much 'head room' you have to operate before a violation is triggered. You need to speak up if they are too restrictive. You have a say in the negotiations. It is your business. How can you possibly sign a Loan Agreement and essentially enter into 'covenants' if you don't agree with them, or understand them, in the first place? Remember, creditors didn't have to lend you the money at origination, or when there's a covenant violation. A condition of default could easily lead to a demand for payment in full. But that doesn't mean you shouldn't have a clear understanding of what they are, and have a voice in how covenants are structured in the Loan Agreement each time you sign one

Environmental Risk

CRM #15 – Environmental Risk – Lenders, absence adequate due diligence, can face potential environmental liability with the real estate they hold as collateral if they were to foreclose and take ownership – even if the creditor was not originally responsible for causing the contamination. Creditors would need to prove they are innocent landowners if they foreclosed on real property contaminated with hazardous waste. Many businesses produce waste as part of their operations, be it technology firms, service stations, waste disposal companies, machine shops, and other manufacturers. Some waste, however, may be hazardous which requires special handling and disposal. If those processes are not done correctly, for whatever reason, environmental risk will increase not only to the debtor, but potentially to the creditor. If the creditor determines there is too much environmental risk on a property, it may decide to not foreclose after all. Perhaps a financial institution may acquire, via a merger or acquisition, a loan with contaminated real property. They do not want to become liable for any cleanup costs for hazardous substance contamination that may have occurred on the collateral property.

Environmental Due Diligence is a Must – Beginning with the environmental underwriting due diligence process at origination, the creditor is (hopefully) going to determine its degree of environmental risk. The debtor will be required to confirm via certain environmental disclosures or questionnaires, that environmental due diligence was completed at the time of acquisition. The measures will also likely include due diligence on the prior owners and operators of the subject property. These disclosures will help protect the creditor as well as the purchasing debtor. This due diligence will put the debtor and the creditor in a position of being an 'innocent landowner,' and therefore not responsible for environmental clean-up. It also affirms that the creditor acted prudently should it ever have to foreclose on the real estate. More specifically, this due diligence process may include: an onsite lender inspection; the debtor's completion of environmental questionnaire; an environmental indemnification with provisions where the borrower agrees to indemnify the lender against any losses, liabilities, or costs arising from environmental contamination or cleanup related to the property; and online government record searches. If necessary, depending on the initial due diligence results, additional diligence may be required, including environmental audit testing by trained environmental professionals such as the following:

Phase One Testing – Site visit, historical records, regulatory review, geological and hydro-geologic review,

summary report.

Phase Two Testing – Investigation on Phase One findings, physical sampling of subsurface soils and ground water.

Phase Three Testing – An approved remedial action of contaminated area, subject to regulatory and licensed oversight.

Examples of Environmental Risk – Knowing the environmental risk upfront, and later, if necessary, protects the creditor because environmental contamination on the collateral property can have an adverse impact on its value. The debtor may not have the resources to remediate the contamination as well. If that were to happen, it would further aggravate the prospects of repayment from both the primary and secondary sources, as clean-up costs can ultimately be cost prohibitive for all stakeholders. Examples of environmental hazards include contamination and toxic substances from chemicals and waste products, fuels, cleaning solvents, leaking underground (fuel) storage tanks, building materials, asbestos, etc. These substances can travel underground to neighboring properties and increase the potential costs of cleanup. Again, if the original repayment source ceases because the company's operation fails, the creditor may be left with contaminated collateral as its only repayment source, and the value of the property may be substantially impaired.

Importance To You –

- *The potential liability for the environmental cleanup costs* – There's an old saying by the lender: 'Once you make the loan, you just bought the collateral property.' Indeed, once the loan is disbursed, the creditor's interest in the property becomes very real if not personal, as the property may become the loan's ultimate repayment source. But, if the collateral property is contaminated, and depending on the severity, it's entirely possible that the creditor might have to abandon its interests to the collateral (i.e., not pursue liquidation of the collateral, or foreclosure). If a lender acquired such a property, and it ended up being contaminated, the creditor would have to defend against being held liable for the environmental cleanup. In fact, the cleanup cost could end up being much more than the amount of the loan secured by the property in the first place. Creditors pretty much know how to ensure they understand the environmental risk and take the necessary precautions to avoid unwarranted environmental risk. You should also understand environmental risk too. Why would you not want or need to know everything about the potential environmental risk on the property you propose to purchase, or on an existing property you already own, just like your creditor needs to know? Think about it. You too could bear such liability for the environmental cleanup costs, and that expense may threaten the solvency of you and your business as well. It's not recommended that you or anyone run away from full disclosure of environmental risks

Guarantors

CRM #16 – Guarantors – Loans are underwritten based on the primary repayment (cash flow), and secondary repayment (collateral) sources, and a tertiary source may be the financial strength of any guarantor(s). Loans are not to be made based only on the strength of the guarantor. Guarantors, or interested/benefited third parties, are often included in the loan structure to help repay the loan should the debtor default on the payments. This generally includes guarantees for general partners, 20% plus owners of a closely held corporation, owners of a startup company, or on U.S. Small Business Administration (SBA) loans.

Recourse or Nonrecourse? – When guarantees are in place it's considered that there's 'recourse' to the principles. Guarantors generally are expected to sign fully unconditional or unlimited guarantees. If there are no personal or other legal entity guarantors on the loan, which has become common in the past few years (probably due to increased competition and lax underwriting standards), then the loan would be considered as 'non-recourse.' In most cases, where there are guarantees in place, the amount of the guarantee will be unconditionally 100% of the full unpaid balance, a joint and several obligation where every individual or legal entity that signs the guarantee is fully responsible for 100% of the loan amount, not just a certain percentage of the loan amount. Other guarantees may have limited recourse to the guarantor.

A Properly Written and Signed Guarantee, with 'Consideration' Given to the Guarantor – An owner/guarantor will realize that should the business fail, the creditor will come looking for full repayment. If a guarantee is executed, the owner/shareholder of the corporate borrower will be fully liable for debt repayment, and will know of a certain philosophical commitment. For the guaranty to be legally enforceable, and worth anything to the creditor, the guarantee will need to be properly written and signed, and 'consideration' given to the guarantor. An actual guarantee is a very complex and detailed document and ensures that the guarantor must repay the loan if necessary. Creditors will be sensitive to those assets owned in and subject to the rights allowed in a community-property state, or in a trust. If they want such-and-such assets to be part of the guarantee, they will ensure the documentation includes the appropriate language and signatures from the appropriate parties and trusts.

Importance To You –

- *Lenders expect both 'ability and willingness' on your guarantee* – Creditors will look to you, the guarantor, for financial support particularly when and if the loan becomes a 'problem or classified' loan, when there are deficiencies with the repayment sources. You can expect to see a concerted effort to obtain current detailed financial statements from you and any other guarantor(s), and determine your ability to provide adequate cash flow support. This includes information about your income, assets, liquidity, and contingent liabilities. These measures, however, are only going to document your ability to repay. Furthermore, to get any real repayment support, the creditors will have to assess your 'willingness' to repay. Willingness is 'all talk' until you write a check or offer additional collateral, etc. The lender doesn't know if you're willing until you do something about the problem. The creditor expects there will be

both, an ability and willingness to repay on the part of each guarantor. Willingness is manifested by performance, making payment when required or asked to do something. It's not just saying: "Sure, I'm happy to pay." Rather, it's actual payment or maybe a 'rightsizing' of a loan at renewal. That, is demonstrated ability and willingness

- *Getting a case of 'guarantor fatigue'?* – Imagine for a moment, a protracted workout loan scenario that involved default conditions and several negotiations with and payments paid by the guarantor, you. Have you ever heard of 'guarantor fatigue'? When you guarantee a loan that has a troubled primary repayment source, cash flow, and it is either insufficient or heading that way, the creditor is going to come 'knocking on your door.' At that early stage, you will probably be doing all you can to support repayment of what you hope and expect will be a short-term period of financial difficulty. So, for several months or quarters, you provide back-up support in supplementing cash flow deficiencies to keep the loan current. You've demonstrated both an ability and a willingness to honor your guarantee. Maybe you burn through your liquidity on hand, and then start to draw down on other lines of credit to come up with the necessary cash each month. Are you starting to get tired yet? You start to wonder how far this is going to last? The stakeholders all know that your personal financial statement has a considerable net worth. And, now that you're burning through liquid assets, you question whether this is going to 'cut to the bone' if you have to start liquidating personal assets to help support the commercial loan you guarantee. Do you see where this is going? Fast forward a year, and the business isn't able to keep up the payments and solve the reasons for there being insufficient cash flow. It doesn't look good. What are you going to do now? You clearly have a solid case of 'guarantor fatigue' at this stage. You've burned through your liquidity sources, and now it's getting painful. You've been carrying the loan for a year or so and you're getting worn out financially. To stand behind the loan you promised to pay as a last resort, you'd have to start selling assets. How does that feel? You were willing to do so when you borrowed and guaranteed the loan, but is that how you feel now? Why not? What's changed? What 'should' you do?

- *You have a choice* – You need to be honest and stand up to your guarantee at whatever financial cost it requires. Do yourself a favor and read each word of the guarantee you signed before you make the choice as to whether you will honor it. Is that your signature or not? After reading it, what would you choose to do? Sadly, and probably in most cases, the guarantor is going to do anything and everything he can to avoid making arrangements to pay the remaining loan balance, even after the collateral assets have been liquidated. These guarantors would even spend 'good money' to hire an attorney, and look to make every excuse to 'wiggle off the hook.' Is that what you'd do too? Is that who you've become? Is this what you really want? Would you like your accounts receivable debtors to do that to you? What's the difference? You do have integrity and honesty, correct?

- *Here's what an honest person, with integrity, would do* – Or, would you do the right thing and honor your guarantee? An honest person, a guarantor who was obligated to repay an unpaid debt, would approach his creditor with a fully prepared current personal financial statement with supporting documents, and sit down and work out an arrangement whereby certain assets could be sold and the proceeds be applied towards the unpaid balance until paid in full. What if doing so meant that it would 'cut to the bone,' and there was real loss of assets and financial pain? Well, that's precisely what you gave your unconditional promise to do if the business loan went unpaid. Guarantors need to be honest to the core and fully stand behind the obligations they promised to repay. Don't sign a personal unconditional and unlimited guarantee unless you're prepared to fully pay up with

everything that's on your personal financial statement at origination, and now

Insurance: Title, Hazard, Flood, General Liability

CRM #17 – Insurance: Title, Hazard, Flood, General Liability – To protect the creditor's interests (i.e., the loan commitment amount), the debtor will be required to have, and maintain, adequate and appropriate insurance coverage always.

Title Insurance – For real estate financing, this insurance will be required to verify and protect the creditor's intended lien position on the property. Most creditors will structure the loan to be in a first lien interest, and will require that position be insured via an ALTA Lender's title insurance policy. Such a policy is designed to protect the creditor against possible claims or other issues on the title to the real property, namely: correct ownership vesting, title defects, lien priority, unrecorded mechanic liens, assessments, encumbrances, encroachments, easements, water rights, mining claims, patent reservations, and conflicts of boundary lines. The policy is designed to insure the creditor against any loss for the entire length of the loan. Prior to booking the loan, the creditor will receive a Commitment for title insurance showing the status of the property so the creditor's documentation and interest will be properly prepared for recording.

Hazard Insurance – Insurance that covers property damage caused by fire, wind, severe storms, hail/sleet, and other natural events – to the extent those things are covered in the policy. Creditors will require an annual policy premium to be paid, or in place, always. The creditor will be listed as the loss-payee in the event of a claim.

Flood Insurance – Where applicable (i.e., the real property is in a 'flood zone'), flood insurance is required on all loans that are secured by real property. The creditor has procedures in place to verify whether the subject property is in a flood zone (per flood zone maps) and requires flood insurance, or not, accordingly. If so, the debtor will promptly be notified, as the loan won't be closed without flood insurance.

General Liability Insurance – The creditor will be named as an additional-payee for this insurance coverage, to be protected from a variety of various lawsuits and similar claims. Such claims may include bodily injury, property damage, personal injury and others that can arise from the debtor's business operations that involve visiting customers or vendors. Builders risk insurance coverage will also be required for in-the-course-of-construction building and renovation projects. This insurance indemnifies against damage from physical loss, or to buildings while under construction.

Importance To You –

- *Updated title insurance prior to foreclosure* – In a distressed problem loan scenario potentially involving foreclosure of the collateral, the creditor is going to do a credit file review to determine the status of its collateral. Current insurance coverage is part of that review. The creditor is expecting there to be an original title insurance policy with its endorsements. This confirms his insured interests as a creditor in the real property at the time the loan was originated. Now,

however, a new updated title report will be necessary to verify who the current vested owner is, and whether there are any newly recorded exceptions or liens against the property. The creditor needs to ensure his lien interests are what they were expected to be. Unpaid taxes and mechanics liens may pose a challenge to the creditor's interests, and will have to be researched and addressed

- *Forced-placed insurance coverage* – It is possible that you may not have the funds to maintain adequate hazard or flood insurance coverage. It happens. Creditors, however, by virtue of your signed loan documents, may find and apply some type of forced-placed insurance coverage, and add the premium costs to your loan balance. You may or may not be able to care about it, depending on your financial condition, but you should always care about it. If you can repay over the long-term, know that it will be very expensive to you. If you will not be able to hold on to the collateral property, it will likely be part of an unpaid deficiency balance that you may be responsible for

- *Always keep appropriate insurance coverage in place* – Debtors, you, need to honor the terms and conditions of the loan documents. In those times where it's not possible to service the debt, and maintain operations, the debtors should always keep appropriate insurance coverage in place. If you must make adjustments to your pro forma cash flow that lower the net available cash flow to service debt to cover for adequate insurance, then so be it. With detailed financial statements, and a well-prepared pro forma cash flow statement, the insurance costs can be identified and reconciled with the remaining cash flow to service debt. The creditor will realize that the insurance coverage will be paid for under the ordinary course of business, and there will likely be less available for debt service. It is expected that corrective actions will be taken to improve the cash flow to normal and improved levels over time. Meanwhile, the insurance policies designed to protect the interests of all parties remain viable and in place

Credit Risk Memos (CRMs) – Financial Analysis

Cash Flow Analysis

CRM #18 – Cash Flow – Like water in a slide, business cash flow, cash transferred into and out of a business, is generally the primary source of repayment (PSOR) for most loans, and therefore, is very important to the stakeholders. Loans are underwritten with a comprehensive credit analysis to determine the strength and trend of the PSOR. 'Positive cash flow' indicates that a company as the ability to repay future debt payments. Negative cash flow suggests there's too much spending. Cash flow originates from business activities, including its operations (main activities of the company), investing (investments, capital asset purchases) and financing (debt, equity infusions). Operating activities include direct cash receipts from customers, and the collection of accounts receivable. Disbursements will include inventory purchases, general operating and administrative expenses, wage expenses, interest expense, and income taxes. Adding the receipts, less the disbursements, will show the net cash flow available from operations. Investing activities include cash receipts from the sale of property and equipment, the collection of principals on Notes Receivable, or the sale of any investment securities. Disbursements will include cash paid for the purchase of property or equipment, loans made to others, and the purchasing of securities. The difference in receipts and disbursements will be your net cash flow from investments. Finally, financing activities include cash receipts from any stock issuances or new borrowings, and cash disbursements from any stock repurchases, dividends or loan repayments. The difference in receipts and disbursements will be your net cash flow from financing activities. Cash flow is analyzed using several methods, including the traditional method, uniform cash analysis, direct and indirect, and free cash flow. Following are two examples:

Traditional Method – Earnings before interest, taxes, depreciation, and amortization, or EBITDA, to cover debt service requirements. The traditional method is often used because the needed information is easier to obtain and calculate, and when statements are insufficiently detailed. However, it does not recognize growth in accounts receivable or inventory, a slow-down in accounts payable, capital expenditures, or additional borrowings.

Net Income (Amount of net income reported on most recent annual income statement before taxes)
(+) Interest Expense (Add the total amount of interest expense for the period)
(+) Depreciation/ Amortization (Add all noncash depreciation and principal amortization on outstanding debt)
= Cash Flow Before Debt Service (Indicates net Earnings Before Interest, Taxes, Depreciation, and Amortization, or EBITDA Amortization should include both principal and interest payments required on debt)
(-) Debt Service (Subtract scheduled principal and interest payments)
= Excess (Deficit) Cash Flow (Total amount of excess or deficit cash flow for the period after debt service)
= Coverage Ratio (Cash flow before debt service/principal and interest debt service)

The Direct Cash Flow Method – Over a given period, the cash flow statement will show the sources of cash which ultimately are used to repay a loan. Basically, it serves as a reconciliation of the company's balance sheet and income statement by showing the net amount of net increases and decreases of activities in these areas:

Cash Flow from Operating Activities:

- (+) Cash from customers

- (-) Cash paid to suppliers
- (-) Cash paid to employees
- (-) Cash for prepaid assets
- (-) Interest expense
- (-) Income taxes
- (+) Interest income

= Net cash from operations

Cash Flow from Investing Activities

- (-) Purchase for PPE
- (+) Cash from equipment sales
- Change in investments, intangibles

= Net cash from investments

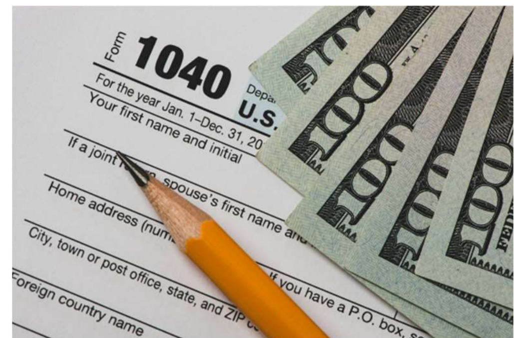
Cash Flow from Financing Activities

- Change in short-term liabilities
- Change in long-term liabilities
- (+) Common stock issuance
- (-) Dividends paid

= Net cash used in financing activities

Net increase/decrease in cash
Cash at beginning of period
Cash at end of period

Individual Cash Flow – Personal cash flow for individuals who guarantee commercial loans will be determined by analyzing individual federal tax returns. To calculate the cash flow and debt service coverage using individual tax returns, the actual cash received will need to be determined, together with all debt service requirements paid by the individual(s), taxes and living expenses. For example, using a federal tax return:



Wages
(+) Interest Expense
(+) Dividends
(+) Net Income/Loss + Interest + Depreciation from: Schedule C (Profit or Loss from Business); Schedule E (Supplemental Income and Loss); Schedule F (Profit or Loss from Farming)
= Beginning Cash Flow
(-) Less Taxes (Federal and State Taxes)
(-) Less Living Expenses (Consider reasonable annual living expense amount)
= Cash Flow Before Debt Service
(-) Individual Debt Service: (Subtract individual's scheduled principal and interest payments)
= Excess (Deficit) Cash Flow (Represents cash available after debt service)
= Coverage Ratio (Cash flow before debt service divided by individual's principal and interest debt service)

Importance To You –

- *Get on the same page with the creditor; convey you're doing your best* – During a serious economic downturn, it's entirely possible there will be conditions of default, everywhere. Some loans may need to be materially restructured altogether. Until and when those conditions are present, you need to just do your best. That's it. Your ability to repay, and the root causes for your current situation, will need to be effectively documented and communicated. Chances are, you're very familiar with your financial statements, as well as the type of cash flow statements you're used to providing the lender. If you're not well-versed in cash flow and need additional clarification, utilize your CPA, or google up and review the numerous examples of cash flow statements. Determine the root cause behind any deteriorated financial performance. Show the lender you're doing your best, even though the numbers are underperforming. Talk about the numbers until there is a mutual understanding of the same. Also, when you report to the lender be sure your statements are from consistent periods (i.e., annually, quarterly, monthly) year over year, etc. Year-to-date financial

reporting for the interim period is also important. Consistent financial reporting makes it possible to observe trends and help eliminate any misinterpretation of cash flow for any given business cycle or reporting period. You should request a copy of the 'financial spreads' from the creditor showing all your analyzed financial statements. The closer the stakeholders are on the same page, the better

- *The more debt service coverage cushion, the better* – When the creditor originated your 'long-term' loan, he no doubt installed a debt service coverage (DSC) covenant. The minimum coverage was likely a DSC ratio of 1.25x. They want $1.25 of available cash flow to service every $1.00 of debt. There needs to be some cushion in there, because if it's less than 1.00x, you may potentially fall short on being able to repay. Depending on the level of deficit cash flow, it doesn't necessarily mean that you have a serious financial condition that you can't work-out of. It may be an indication that your business is in a growth stage and you just need some working capital financing to assist with the growth in assets (i.e., accounts receivable, inventory). But if you are experiencing losses, don't expect the creditor to fund those losses with additional borrowings. If you understand what's causing the losses, you should be able to make certain decisions to remediate the same while renegotiating your existing debt

- *Know, thoroughly know, the root cause of any cash flow deficiencies* – Again, assume there are structural long-term issues affecting your cash flow, like a sustained decline in sales revenues, or other increases in operating expenses. In a severe case, this will likely end up being a modified loan work-out situation if performance doesn't improve in the short-term. Therefore, you have to absolutely know and understand the root cause of there being deficient cash flow. If you understand the root cause, you'll know the solution and about how long it will take to remedy. Don't just assume the lender knows and sees what you do. But, if you don't fully understand the actual reason(s) you can't properly fix the problem, and you'll lose or frustrate your credibility and relationship with the lender. So, you have to be well-prepared, make a repayment plan to fix the problem that caused the stressed cash flow. There's nothing wrong with communicating with the lender either. Maybe the stakeholders could use a few minutes visiting and discussing performance. Again, you have to know the root cause so you can fix it, knowing how you will do it, when you will do it, how much it will cost, etc. Ask questions, talk to your CPA, the creditor, or read on. But, don't stop digging until you know you understand your cash flow picture, how it came about, how it will be resolved, and document your assumptions, or your way out of it. You need to present a repayment plan to your creditor and convince them to accept it, or otherwise reach the best possible win-win arrangement. If you really 'get it' and are totally convinced you can and will bring the plan to fruition, getting to that level of commitment is called 'ownership.' This will come through 'loud and clear' to the creditor. He needs to see that you own this

- *You're the captain of your ship, but…* – The creditor needs to feel secure enough that if he decides to 'jump into the boat' and do a work-out loan with you, as you 'head out to sea,' he will be okay and make it to the intended destination. You need to see and appreciate the position it and the other creditors are in as you address your cash flow dilemma. Take a fresh look at your current balance sheet. What's the relationship of debt (creditor) to equity (you)? You thought you owned all your assets, right? That is the case, but how much of those assets does the lender have a senior priority interest in, vs. your interest? It's likely the lender has a larger stake in the assets than you do. If the leverage is 2:1, the lender has 2x more debt capital than you have equity capital. If it's higher than 3:1x or even in the 5:1 plus range, well, you pretty much had better be well-prepared in

presenting your repayment plan. Why? Because the creditors have 3x or 5x plus more interest in the business assets than you do, that's why

- *How to get to being 'prudent' by your 'best efforts'* – When you ask creditors to get in your boat and go out to sea with you, depending on the leverage, they have a lot more to lose in the business than you do. Yes, the creditors (generally) have much more to lose than you do. So, before you think this is all about you, do your homework and be well-prepared to have a legitimate and compelling conversation. You are certainly empowered to do this because you're the one who signed the Promissory Note, Loan Agreement, not to mention a personal guarantee. When there's an economic downturn, it can get 'beyond difficult,' because if the money isn't there, it isn't there. What do you do? You do your homework and let your documented debt resolution plan be based on a 'best efforts' basis. Sometimes that's hard to reconcile in one's mind because they know they must meet or exceed their covenanted financial performance thresholds. But it's just not possible sometimes, so you must go to 'best efforts' mode. The pro forma cash flow statement will have to project that. The creditor will recognize your ownership and effort, although the cash flow will probably not be what he expected (will likely be much less), but it is your best-efforts plan. Therefore, your plan should be considered a prudent plan that both can agree upon. It will be a 'win-win.' Lenders are supposed to be prudent lenders. That's how you get to being 'prudent'

- *This is not a 'one and done' repayment pitch* – When you are 'out to sea' for a few months with your repayment plan, update your financials and send them to the creditor(s), regardless if there is a financial reporting requirement to do so or not. Take ownership, and show the creditor if you're performing to plan or not. Be proactive, and defend your financial performance. If you're ahead of schedule, explain why. Communicate. Overly communicate. Build a relationship of trust, clarity, and understanding. You may need the creditor's assistance soon, possibly more than once or twice, which is perfectly fine. This isn't a 'one and done' situation. You're going to stay with this until the issues or problems are resolved, and your loans are repaid

- *Don't take any of your creditors for granted* – Creditors will likely have more into your business than you do, and it may always be that way for most small businesses during the growth years. So, don't take any of your creditors for granted, be they the vendor suppliers, or the long-term lenders for your office/warehouse. They granted you credit in good faith that you will repay pursuant to the underlying terms and conditions, and likely have charged you a competitive and reasonable market rate of interest and fees. So, when your cash flow is deficient, that's not the creditor's fault. If you see yourself blaming your creditors for your problems, then please think again. Based on experience, you'd be mistaken to not demonstrate full ownership for your business, and therefore well-advised to reconsider your relationships with each creditor. Seriously, who is responsible for, and regardless for the reason that caused you to experience financial difficulties, the deficient cash flows? If you're the owner, then you are responsible. Your decisions may not have led to the deficient cash flow, but you still own this business and you are responsible for it. So, act like it, especially if you made decisions that negatively impacted your cash flows. And negotiate in good faith. You should and will be expected to live up to all the terms and conditions of your Promissory Note and Loan Agreement

CRM #19 – Cash Flow Analysis: Global – The primary repayment source for most loans are the cash flows generated from the debtor's business operation over time. The secondary source of repayment is generally the collateral that secures the loan. The third or tertiary source of repayment is often the guarantor(s), be they individuals or other affiliate legal entities, or both. Over time, the guarantor(s) may, or may not, add additional cash flow or collateral support. The collateral aside, unless it is income producing CRE, one way to determine the global financial support beyond the primary cash flow source, is to conduct a global cash flow analysis of all cash flow sources and all debt service requirements. This global cash flow analysis will include all direct obligors of all related loans, and all the guarantors pertaining to the loans. The result will be a consolidated global cash flow and debt service analysis of the legal entity debtor and any all guarantors. When all global cash flows and debt service are analyzed together, this will confirm the overall repayment ability in each consolidated loan relationship. A global debt service coverage ratio will be determined, together with a trend analysis from prior financial statement reporting periods. The coverage trend will either be stable, improving, or declining. Determine the reasons for those changes, and whether they are systemic, and how soon any issues can be resolved.

Creditors Want to See the Big Picture – The purpose of the global cash flow analysis is to determine the overall direct and indirect repayment capacity of the given loans in a credit and deposit relationship. It considers all cash flows from all borrowers, legal entities, and their guarantors. Even when a given loan begins to deteriorate, the creditor will seek to understand the entire cash flow picture, those expected cash flow sources which would be available to support repayment of the problem loan. Indeed, the creditor may have legal recourse to enforce repayment for all such obligated parties. The credit analyst will need to also dig for potential contingent liabilities too, like co-signed debt, or general partnership debts that the individual guarantor, or legal entity guarantor, may be liable for. Therefore, it would be necessary to obtain tax returns and their supporting schedules to identify all cash flow sources as well as any required and discretionary cash outflows from all activities. This includes IRS Profit and Loss forms for businesses and properties for obligated individuals and legal entities, as well as IRS form K-1 that show distributions and contributions to individual guarantors.

Getting to a Global Cash Flow Coverage Ratio – Generally speaking, the debt service coverage (DSC) ratio can be determined by starting with the net profit/loss, adding interest and dividends, capital gains or losses, cash flow from rental properties, partnerships, and S-Corps, adding depreciation expense and interest expense, to get the cash available for debt service. Then, subtract federal and state taxes, FICA, other deductions, and reasonable annual living expenses, to arrive at the net cash flow available to service debt. The underlying debt service payment requirements are totaled and then subtracted from the available net cash for debt service, to determine the debt repayment margin. Dividing the cash available for debt service by the debt service requirement amount will produce a DSC ratio. Each one of the related entities owned by the obligors and guarantors of the subject loans in the relationship, will have their assets, liabilities, and cash flows analyzed, and the cash flows will be consolidated into one global cash flow analysis, and a global DSC ratio. In a global cash flow analysis, the result will be all the multiple sources of combined cash flow to determine the global cash available to service debt, global debt service payment requirements, global debt repayment margin, and a global debt service coverage ratio.

Importance To You –

- *Construct a bridge across any 'grand-canyon' that exists between the parties* – For several good reasons, creditors may have a hard time getting sufficient documentation from you so they can perform an accurate global cash flow analysis. It will likely not be because they don't understand how to do the analysis. The primary reason will likely be because you have not submitted sufficient financial documentation. And why might that be? Maybe it is due to the lack of mutual respect and trust between you and the creditor. Stressed relationships mean less transparency, but it doesn't have to be that way. Fast forward. It is incumbent on you to step up and take the lead in finding, preparing, and presenting your best-efforts repayment solutions to your creditors. Ask the creditor for a copy of its global cash flow analysis for your credit relationship. Follow through until you get a copy. Open the lanes of communication, or restore them if needed. Construct a bridge across any 'grand-canyon' that exists between the parties, especially during stressed economic times. There needs to be, and in fact will be, a paradigm shift that empowers debtors to own up to figuring out their own repayment solutions on a best-efforts basis. Creditors are expected to be prudent in their lending and work deals that are in the everyone's best interest. So, there is space and room for you to be forthright with the creditor and provide all the necessary current, accurate, and complete financial statements, pro forma cash flow statements, and copies of Federal tax returns. Let the creditor perform a global cash flow analysis and share the results with you. It's your season to be forthcoming

- *A cooperative workout situation is best* – Hopefully you appreciate how a solid global cash flow statement can be used to come up with a viable repayment plan. All the obligated sources of cash flow are 'on the hook' anyway should the creditor need to pursue a forced global liquidation and recovery solution. And, if you are honest and willing to abide by the loan documents you promised to follow, you will happily accept the documented financial reporting you're required to submit to the creditor. So, partner up and give all the required financial information on or before the requested date, and be sure each is signed and dated by you, the owner. Ask to see the creditor's financial analysis. Sit down with him and ask him to go through it with you, and answer his questions. At the end of the day, wouldn't it be nice to be on the 'same page' and have a mutual understanding of the resources that are subject to getting the loan repaid? And you have your own proposal for utilizing your cash flow as you best see fit, because you want to repay. You want to cooperate. You need the creditor's help to do a loan modification, forbearance, etc. And, if you think and know your repayment ability is weak at best, that's okay. It is what it is, right? It's your very best efforts. You and the creditor want to see and understand together your global cash flow picture, and overall ability to repay. Surely you will have a greater sense of peace of mind, not to mention the wherewithal to negotiate the best deal you might recommend. Creditors can be tough, but they are also reasonable people with well supported and document global repayment solutions that come from a well-prepared debtor

Cash Flow Analysis: Pro Forma Projections

CRM #20 – Cash Flow Analysis: Pro Forma Projections – A pro forma cash flow statement is a hypothetical projection of your future cash flows, based on certain business activity assumptions for operations, investing, and financing. Assuming a deteriorated financial condition, the cash flow statement will be used in your negotiations with the creditor by showing the cash flow levels you absolutely expect to generate over the next year to repay debt. It is expected that you and the creditor will come to a consensus on loan

repayment terms that align with your projections, especially as you articulate your assumptions that drive the numbers, getting to a win-win agreement. This will help meet the 'prudent lending' standard most lenders are required to abide by. There's nothing quite like a well-supported, documented, repayment plan that is originated, presented, and sold to the creditor by the debtor.

Importance To You –

- *Think reasonable, supportable, documented assumptions and conclusions* – At the end of the day, a well-prepared business cash flow pro forma statement is one of the best tools to use when negotiating a workout situation, loan modification, extension, or payment deferral. Special attention must be paid to your actual and expected cash flows in a potential workout situation. If you're in a deteriorating financial condition, analyze your financial statements and identify precisely why and for what reason the deterioration has happened. If you can identify the actual reason, you can apply the appropriate corrective action to fix the problem. You may have to make material adjustments to these activities, and those changes will be reflected in your pro forma cash flow statement as documented assumptions. Remember full transparency, and be reasonable. You will show the creditor the availability of cash flow, and when he can expect to receive loan repayments. You will have documented, perhaps not what the creditor expected to see, but your best-estimated or most accurately estimated cash position for the next 12 months, month by month, quarter by quarter. Make sure, again, it is reasonable and that, barring any unforeseen emergency, you will hit those numbers even if they're bad. Be detailed, and explain, specifically, the material assumptions behind achieving the projected numbers. There needs to be a thorough mutual understanding of your assumptions, between you and the creditor. If they're deemed to be reasonable and supportable, the documented plan should materialize, right?

- *Just tell the truth, regardless of how bad the numbers are* – Again, depending on the severity of your financial condition, you may need to prepare the cash flow statement to include amounts, by month, for the next 12 months, quarterly, semi-annually, or annually. If there's risk of imminent failure, cash flow statements may be prepared daily as well (daily reporting on accounts receivable collections). Cash flow statements will show the stakeholders your estimated cash position, but be sure to not just appease the creditor by showing the cash position you think the creditor wants or expects to see. Rather, make sure you estimate precisely the numbers you are very confident you can produce, regardless of how bad or good that may be. If the numbers are not good, then so be it. That's why it's called a 'workout,' meaning that there will need to be modifications to your loan documents that reflect your ability to repay. The cash flow statements can and should be regularly refreshed and additional modifications be made as well. Make sure you clearly understand that the cash flow statement reflects what you are comfortable with, because lenders are not all that forgiving (i.e., if you fudge and put numbers you think they expect to see there, and you know you can't achieve that), especially when there's a downturn. Their job is to ensure your loans are returned to an acceptable "Pass" risk grade as soon as possible, or to a $0 balance. You get the picture. There's going to be pressure coming from their end, and thus upon you. Doing this wrong, by overestimating your cash position, will likely result in a stressed relationship, if not worse. So, tell it like it is

- *Simplify and report the cash flow statement, as needed* – For smaller, less complex small businesses,

it's reasonable to simply prepare, say a single cash flow statement, by month, for each of the next 12 months (plus the 12-month total), and simply list all cash receipts (inflows) together: Cash sales/collections from accounts or notes receivable, sales proceeds from property and equipment, sale of investment securities, issuance of stock, proceeds from new borrowings, and cash from other sources. The same holds true for the cash disbursements (outflows): property and equipment purchases, investment securities purchases, inventory purchases, general operating and administrative expenses, wage expenses, interest expense, principal payments, and income taxes. When modifications or loans are restructured, it is imperative to repay the enhanced contractual terms on a timely basis. Refreshed financial reporting is warranted anytime there are material changes to your operations, favorable or otherwise. The level of detail (i.e., monthly, or quarterly reporting) will likely depend on the level or severity of credit risk and size of the loans, and will either increase or decrease as conditions merit. It's acceptable to revisit or revise already modified repayment terms, if necessary, with refreshed financial reporting. You own this, and your candor will hopefully payoff in your favor. Again, debtors should repay their obligations in full, as this is not an exercise to see what debt you can get out of paying. Liquidation strategies are a different story. But remember that you should have the opportunity to make your case on a best-effort basis, getting to a win-win solution, including terms you propose

Contingent Liabilities

CRM #21 – Contingent Liabilities – In the traditional sense, contingent liabilities are the potential liability of uncertain events in a future period. For example, a small business may have product warranties, or a pending lawsuit, whose outcome is uncertain. Depending on the probability of the event happening, the liability may be recorded as an accrued but unpaid expense, or listed as a footnote in the financial statements. Another important way to view contingent liabilities is those unknown, underestimated, or misunderstood liabilities a debtor has that may affect his relationship with a given creditor. Creditors can fail to fully understand a debtor's actual liability profile, and debtors may fail to fully disclose their actual liability profile. Creditors can be surprised to learn about other debts the debtor has that he was not fully unaware of at loan origination – call that a contingent liability too. Debtors don't always disclose their full financial picture in their financial statements.

Nondisclosure or Incomplete Disclosure of Contingent Liabilities is a Major No-No – An individual debtor may be a general partner/investor in a certain unrelated large commercial real estate (CRE) development in another State. Assume that he, personally, has joint and several unconditional liability, or 100% liability for 100% of the entire underlying $10 million debt, even though he only owns 40% of the asset being financed. Intentionally or not, the debtor may disclose to a given creditor his '40%' interest, or $4 million of the CRE liability, and not disclose his actual 100%, or $10 million liability for the entire debt. He may only disclose a 40% interest in the net profit too, and the creditor may think there is only a 40% liability interest. But he fails to understand that he is 100% personally liable on a very large mortgage debt. If that large CRE project fails, and there's a material short-fall after the collateral is liquidated, that creditor will likely pursue a deficiency judgement against the debtor. That pending litigation, and eventual judgment, could be considered to be a contingent liability that none of the parties gave enough attention to. In an economic downturn, things like this can bankrupt the stakeholders, and other lenders may not even be fully aware of these risks. Finally, maybe a debtor is a co-signer on another loan not listed on his personal financial statement (PFS) with another creditor. If the loan goes into default, the creditor may pursue collection against the cosigner debtor, perhaps coming as another surprise to the original creditor.

Importance To You –

- *Surprise, surprise, surprise; a contingent liability can sink a perfectly sound ship* – A perfectly good lending relationship can be upended when a debtor walks into the creditor's office and drops the keys on the desk and says he effectively bankrupt. The creditor may be surprised and asks how could that be? The credit file shows a strong financial statement, abundant liquidity, and even strong cash flow for debt service coverage. Yes, and now the debtor is essentially bankrupt? The creditor thought he had a customer who was a well-seasoned investor, so what could possibly have gone wrong? Answer? Imagine a borrower told the lender that he was a party to a large medical center building in a neighboring state and the project failed. The underlying mortgage went into default earlier in the year. The creditor sued the partners for very large sums, and was awarded a $2 million judgment against the debtor. The debtor would be unable to 'hide' or shield his liquidity and assets, and if he did, the preferential treatment of those asset transfers would be unwound by a bankruptcy trustee anyway. The debtor's liquidity was effectively wiped-out on account of the recorded judgment and now the current creditor is sitting there in a state of disbelief, realizing that the collateral on the debtor's loans was the only remaining viable repayment source. Maybe the creditor could exercise the right of off-set on deposits with the creditor, but that too, may be subject to further review and recapture, if bankruptcy were filed. Such surprises happen

- *None of the stakeholders should be 'surprised.' That's not good lending* – The key take-away here is the fact that when financial deterioration occurs, the financial status of the debtor may take on unexpected changes. The business and personal financial statements on file may, in reality, take on a whole other look when push comes to shove, and unknown contingent liabilities are identified. You need to be exceptionally clear with your creditors as to your full debt profile and be sure to explain all legal obligations in sufficient detail so there's no misunderstanding, including any contingent liabilities. Even if the creditor doesn't require or ask for full copies of every legal entity you have an interest in, you should still provide the same to the creditor so it can see the entire financial picture

Financial Statements, Tax Returns: Analysis

CRM #22 – Financial Statements, Tax Returns: Analysis – Creditors expect to review typical financial information such as an income statement, balance sheet, reconciliation of equity, cash-flow statement, and any applicable notes to financial statements. Other documentation will include current personal financial statements for individual guarantors, along with copies of business and individual Federal and State income tax filings for all obligated legal entities and individuals. Supplemental statements such as detailed accounts receivable and payable reports, and inventory reports may be necessary. At loan origination, it is customary to request the last three fiscal year-end business financial statements and business and individual Federal and State tax returns. These financial reports will need to be signed and dated by the obligors, often with a stamp that states the signatures affirm the data therein are true and accurate. A comprehensive analysis will measure the business' operating performance from the income statement, as well as how well the assets and liabilities were managed from the balance sheet. The cash flow analysis will be critical because it determines the debtor's ability to repay debt now and the prospect for future repayment.

A Deep Dive Credit Repayment Analysis – A determination will be made to identify recurring vs. non-recurring cash flow. A thorough analysis will help identify other sources of repayment for the creditor, if need be. Documentation supporting valuations for commercial real estate would consist of operating statements for each operating entity, plus tax return filings, and current rent rolls. For cash deposits, bank statements can be obtained, and for public stocks there can be online quotes. Individual credit reports will be used to verify information on individual (guarantor) personal financial statements. Pending or actual legal action or litigation must also be disclosed, together with the potential outcome and impact on the business. Furthermore, with three years' worth of financial statements and tax returns, a credit analyst will prepare a 'spread sheet' analysis showing the year-over-year trend analysis, and how the performance matches up with industry peers. A ratio analysis will determine the level and trend of profitability, operational efficiency, leverage financing, and liquidity. Weight will be applied to the financial statements with support coming from the tax returns. The analyst will be able to understand the differences between the results of the financial statements and tax returns. Financial statement 'spreads' will be common-sized, where each line item on an income statement, for example, is expressed as a percentage of the value for sales. This will show performance over several periods (i.e., years, quarters), and can be used to compare to peers or competitors in the same industry.

Typical Observations of Credit Analysis – Financial analysis, over time, will often identify weaknesses which may affect the internally assigned credit risk rating. Current assets such as accounts receivable may experience a slowdown in the collection period due to account debtors failing to pay on time, or from the easing of collection periods beyond the original terms, or even a loosening of credit standards. Inventory can also experience increasing levels in both the dollar amount or as a percentage of assets. This can be problematic if inventory isn't selling as expected, as the accounts payable due the trade suppliers still need to be paid on time too. Perhaps the inventory levels or materials are too excessive for certain products due to overbuying, or it's becoming obsolete; hence, liquidity may suffer too to maintain profit margins. A company may also use secondary financing to finance operations as evidenced by junior lien holders; this is likely an indication that the debtor is now unable to obtain conventional financing. The level of long-term debt may also increase indicating an increasing reliance on recurring cash flow over the long-term for repayment. Analysts will also measure the costs and expenses on the income statement to determine if the cost of goods sold is increasing, and if other overhead expenses are increasing as a percentage of sales.

Importance To You –

- *If you don't know, ask; share and fill in the gaps for mutual understanding* – Does it come as a surprise to you that the creditor does such an in-depth credit analysis of your financial statements and tax returns? Creditors really do attempt to understand the root causes for your financial performance, and can readily determine the prospect of repayment. Creditors are required to risk-rate or assign the appropriate loan grade to match the credit risk for your loans. You should find out what your current risk grade is, and ask to be notified when that grade changes. It helps to know what the creditor is possibly thinking when economic conditions have deteriorated and are negatively impacting your business. The creditor should not be the only one who understands the 'why' behind the numbers on the financial statements. You too, probably already know exactly why performance is lagging, and you know what needs to be done to remediate or correct the problems. If there's any doubt as to what is negatively impacting your financial performance, rest assured the creditor is 99% confident of what's happening. He may not fully appreciate the reasons why, like

you do, so be sure to fill in any gaps to have a mutual understanding. Ask questions of the creditor. You own half this relationship anyway

Financial Statements: Interim, Stale

CRM #23 – Financial Statements: Interim, Stale – Interim financial statements, usually less than one year, are used by creditors until a full annual financial statement is issued. It will provide valuable information that allows the credit analyst to compare performance during similar prior interim periods, and thus be able to identify any positive or negative trends. A good lender will ask you why the trends are happening. For example, the 1Q sales of the current year are compared to the 1Q sales of the prior year. The same holds true for the gross, operating, and net profit margins, not to mention working capital, cash flow, leverage, and debt service capacity. Current personal financial statements of the principals of the company will also be used by the creditor to assess the level of combined liquidity there is to sustain repayment, if needed. Unlike the typical three years of required financial statements and tax returns due at loan origination, current financial information reporting will be required throughout the lending term. When the debtor fails to submit signed and dated financial reports when required, the financial information on file will be considered 'stale.' Financial reporting may be due, for example, each month, or quarterly, semi-annually, or annually usually within 30 days of each period-end. Annual reporting may be due within 90 days of the fiscal year end, and tax returns within 30 days after being filed.

Lenders Like Lending with the Lights On – As part of the creditor's credit risk management practices, it will likely ensure the debtors receive notice of any pending reporting due dates, and will certainly send notices when the debtor has failed to remit required financial reporting, as per the reporting covenants. Not submitting financial reporting when due would constitute, not a payment default, but a technical 'event of default' under most Loan Agreement's terms, even if the loan payments are current. Stale financial information is unacceptable to the creditor as no creditor appreciates 'lending with the lights off,' unless, perhaps, the loan is secured by cash. Without current information, there is a material lack of communication, and the creditor may feel like there may be a character issue, or a breach of trust. Without the 'lights being on,' the creditor has no way of 'seeing clearly' what is happening. Loans subject to renewal will require current and timely financial statements, tax returns, credit reports, etc., and won't be underwritten on stale financial information if possible.

Importance To You –

- *You must know what financial reporting requirements are expected* – Right now, do you know what financial reporting is due, and when? Are you current on that reporting, or are you shying away from submitting current interim financial statements because you don't want the creditor to know what's happening? Do you know what your Loan Agreement specifically states, covenant-wise, as it relates to what financial statements and other documents are due, and when? You can rest assured that the creditor will read the Loan Agreement and clearly understand what constitutes an event of default. When is the last time you read the 'events of default' on your Loan Agreement, and does it state that not remitting such documents is an event of default? If so, what are the stated remedies available to the creditor to cure the default? Does the Loan Agreement also state that the underlying interest rate on your loan can be increased to the 'default rate' if you fail to submit financial statements? If so, what would that interest rate be? Could you afford it? Indeed, creditors

are both able and willing to declare a default and increase the interest rate accordingly. If paying the default rate doesn't get your attention, what will? To pay unnecessarily hundreds and possibly thousands more dollars in interest expense at the default rate is clearly a waste of resources. If you're not fully aware, today of what events trigger an event of default, you should take 20 minutes and read the Loan Agreement again. Notice the 'covenant' section, specifically

- *Is there any doubt that you really don't know what's going on, or expected?* – Better yet, keep in mind the word 'ownership' when it comes to dealing with your creditor. For example, while you have your Loan Agreement in hand, spend another 20 minutes or so reading it. Take it all in. Besides reading the events of default, look at all the covenants, including those agreements for financial reporting, financial performance ratios, affirmative and negative covenants. If any subject doesn't make sense to you, look it up, talk it up, and satisfy yourself of the expectations set forth in the loan documentation. If you will understand and recommit to the commitments you've knowingly (or unknowingly) entered into, it's more likely than not that any 'grand-canyon' size misunderstandings with your creditor will be minimized. In periods of economic downturn, there is every expectation that you will comply with all the terms and conditions of your loan documentation. Obviously, there will be times when you cannot do so, regardless of your best intentions. But it's not as though you wouldn't be in default if you could have avoided it. That is when you will want to take charge and be empowered to repay your debt obligations as best you can. Make sure you lead out with current and accurate financial reporting that states the facts. Build a relationship of trust and make sure all your financial statement information is submitted on time and that your credit file is never stale. Finally, never inflate or underestimate the values of assets or liabilities on your personal financial statement. The creditor has tools and methods available to help confirm the veracity of the amounts listed therein. He will look to see if there are assets that might be available to help shore up credit risk by having you pledge unencumbered assets to secure the loan, which you may be perfectly willing to do

Financial Statements, Tax Returns: Requirements

CRM #24 – Financial Statements, Tax Returns: Requirements – Creditors will require both a certain type or quality of financial statement reporting, together with the frequency of such reporting. These include company-prepared financial statements all the way to CPA-prepared audited financial statements. Financial statement quality reflects the level of 'assurance' needed by the creditor. Financial statements that require a level of assurance will be prepared by an independent Certified Public Accountant (CPA) according to a required accounting framework (i.e., Generally Accepted Accounting Principles, or GAAP). The financial reporting frequency can be monthly, quarterly, or annually, and will typically include at least the balance sheet, income statement, reconciliation of equity, and cash flow statement. The required type of financial statement, and tax return submission, is often matched up with the loan amount and consideration of the corresponding collateral – as follows:

Company-Prepared Financial Statements / Tax Returns (Loans up to $1 million) – Management-prepared

financial statements carry the highest degree of risk in terms of the creditor not being able to rely on the accuracy and completeness of the financial statements. The quality of the financial statements can vary significantly. For very small companies, if a CPA assists in the preparation of company-prepared financial statements, there will be no verification of accuracy or completeness of any of the information. Nor will there be any assurances provided by the CPA. Typically, CPAs will perform this service in conjunction with other bookkeeping, accounting, tax, or transaction processing services he might also be providing the small business owner. Company-prepared financial statements may not be worth much more than the paper they're written on if the creditor does not have confidence and trust in the debtor. Tax returns will serve as documented support for such statements.

CPA-Compiled Financial Statements / Tax Returns (Loans from $1 million to $3 million) – Compiled statements are based on the amounts provided by the business owner. They also offer no assurances or opinion from the CPA because there is no verification needed for this statement type. That said, the CPA is required to read the statements and consider whether the format is appropriate, and that there are no obvious material misstatements. Small businesses generally use accounting software to generate their internal financial statement reporting, but creditors will generally require these small companies (smaller loans) to have their statements compiled by a CPA. Naturally, a compiled financial statement is less expensive than a 'reviewed' financial statement.

CPA-Reviewed Financial Statements / Tax Returns (Loans from $3 million to $5 million) – Creditors will often require CPA-reviewed financial statements where there are certain limited assurances provided by the CPA as to the accuracy of the information, and that there are no material modifications needed to bring them into compliance with the applicable financial reporting framework. CPAs will perform analytical procedures and inquiries to verify information in accordance with accounting principles generally used in the business, and have a sufficient level of knowledge of the business' industry. A reviewed financial statement is less expensive than an audited financial statement.

CPA-Audited Financial Statements (Loans over $5 million) – Creditors who require the highest level of assurances will require audited financial statements and their accompanying disclosures. Audited financial statements add credibility to the reported financial condition of the debtor. The CPA will issue an opinion as to if the information was prepared, in all material aspects, with applicable financial reporting requirements. It offers reasonable assurance that the information is free from material misstatements. The CPA will perform internal controls testing (safeguarding assets, segregation of duties), and get confirmation and evidence of the amounts and disclosure listed in the statements (i.e., cash, securities, accounts receivable, inventory, fixed assets, accounts payable, debts, revenues, and expenses) based on procedures for inquiry, inspection, 3rd party verifications, and analytical analysis. Audited statements take the most time and are the most expensive.

Common Financial Statement Protocols – Financial statements should be prepared on an accrual basis, unless the statements are for a single entity commercial real estate holding company, or for small commercial loans. Schedules for accounts receivable, payable, and inventory should also be made available, if applicable. The schedules and the financial statement dates should all match. Most financial statement packages will include pro forma projections or budgets for the upcoming year, and year-to-date interim financial statements. Asset-based lines of credit may necessitate a correspondingly higher quality financial statement than what appears above as pertaining to loan sizes. All business financial statements and

business tax returns, including personal financial statements, will need to be signed and dated. A creditor will usually affix a signature stamp on the documents for the owner to certify the statements are true and accurate for the purposes of the creditor lending the debtor the money.

Personal Financial Statements (PFS) – PFS' are required for all 'individual' obligors or guarantors. Such debtor guarantors will be asked to complete creditor-provided PFS forms as they contain certain affirmative attestations which will bind the debtor. For new loan requests, the PFS should be 'current,' although a PFS that is dated within the last 30 plus days would likely be acceptable. PFS' are expected to be thorough, and detail all assets with the dates of acquisition, original cost, market value, underlying debts, etc. Liabilities should clearly state all contingent liabilities of any general partnership liabilities, and other personal guarantees. Personal tax returns need to be current as well and include the most recent three years of filings. Federal tax returns should include the various schedules (i.e., Schedule C, E, F) for other income and losses. The tax returns should include Schedule K-1 as well, unless ownership in each business is 25% or more, then the entire tax return for said business would likely be requested.

Importance To You –

- *The creditor is relying on your complete and accurate financial reporting* – A reminder may be in order. Financial statements, the language of business used to determine whether you are financially sound or not, are fully relied upon by the creditor as being complete and correct in all material respects. Anything else is fraudulent. Your required signature, usually in the form of an attestation that the information is valid, gives the creditor your good faith assurance that its lending decision is based on the truth, the facts. The creditor will be making its lending decisions, whether in a workout mode or not, based on the information it has received from you. In most instances, the creditor will require verification documentation to support the cash or near cash liquidity listed on the financial statements, and other valuations of the assets. Of course, audited financial statements are subjected to certain testing procedures, and are not as likely to be confronted by the creditor

- *Misleading or inaccurate financial statements and tax returns* – Now, fast forward to a very difficult and financially challenging time where your business is in serious financial jeopardy. How easy would it be to provide financial statements that you know are not accurate or are otherwise misleading as to their preparation date and the amounts listed? While creditors are not 'perfect,' debtors may become less than forthright when 'push comes to shove.' Don't go there. Debtors have purposely delayed submitting requested financial statements, as it happens all the time. But that does not mean it's right, because it's not. Some borrowers may even 're-age' the accounts receivable (A/R) on the detailed A/R aging report. They show otherwise materially past due A/R to be 'current.' Or a debtor can list inventory that is not actually there (i.e., sold). That's why an asset-based lending creditor will order an A/R and inventory audit regularly, to ensure the actual A/R are accurately portrayed on the books, with actual inventory in the boxes on the shelves, and not just empty boxes (which happens). A debtor might be willing to skim inventory on a regular basis and hide it in a neighboring storage unit and claim it was employee theft. Other asset values may be inflated. All this can be done on 'company-prepared' financial statements. Is that fair, or right? Is it not fraud? Of course it is fraud. While creditors usually trust their borrowers, do you think it's a good for a creditor to trust borrowers who only

have (potentially worthless) company-prepared financial statements, especially considering what a fraudster might do? What makes the difference? Creditors can easily spot inconsistencies, and will question anything that doesn't make sense. This is why your financial statements and tax returns can't be misleading or inaccurate. Debtors and creditors do stupid things when they are in financial trouble, and it needs to stop

Ratios: Financial

CRM #25 – Ratios: Financial – Analyzed financial ratios are widely used tools to assess the performance status of borrowers. Ratios are the numerical or quantitative relationship between certain variables. The ratios will help determine, in this case, the credit repayment risk of a debtor's business, and comparable performance from similar-sized peers in the same industry. Ratios can be influenced by certain adjustments, and decisions by management. Examples of key financial ratios, their general meaning, and how they are calculated include the following:

Profitability Ratios – These ratios indicate a company's financial health, and to assess a company's ability to efficiently manage its sales revenue and profits, control its operating costs or expenses, and generate return on investment over time. Examples of these ratios include gross profit margin, operating profit margin, net profit margin, profit to total assets ratio (ROA), and direct cost and expense ratios (expense/net sales).

Gross Profit Margin – The spread between the sales prices and the cost of the goods sold:
- Gross profit/net sales x 100

Operating Profit Margin – The profit percentage after the cost of goods sold, and selling/general and administrative (SG&A) expenses:
- Operating profit/net sales x 100

Net Profit Margin – The net profit from each dollar of sales:
- Net profit/net sales x 100

Return on Assets (ROA) – Shows the rate of return on average assets. Use the earnings before interest and taxes (EBIT) to total average assets; this is also an efficiency ratio:
- Net profit before interest and taxes/total average assets x 100

Note – EBIT is used instead of net profit to keep the metric focused on operating earnings without the influence of tax or financing differences when compared to similar companies. The average assets amount is determined by adding the beginning total assets plus the ending total assets and dividing by two.

Efficiency Ratios – These ratios are used by creditors to measure a company's current performance in generating income from the use of its assets. They measure management's ability to manage and control its assets, include sales to assets, inventory days on hand, accounts receivable days on hand, accounts payable days on hand, sales to net fixed assets, and return on equity. These ratios can be compared with peers in the same industry.

Sales to Assets (also known as the Asset Turnover ratio) – Shows the dollar amount of sales generated by each dollar invested in assets:
- Net sales/total assets

Inventory Days on Hand (INVDOH) – Shows the average number of days of holding inventory:
- Inventory/cost of goods sold x 365

Accounts Receivable Days on Hand (ARDOH) – Shows the average number of days in the receivables collection period:
- Net accounts receivable/net sales x 365

Accounts Payable Days on Hand (APDOH) – Shows the average number of days to pay payables (suppliers):

- Net accounts payable/cost of goods sold x 365

Sales to Net Fixed Assets – The dollar amount of sales generated for each dollar invested in fixed assets:
- Net sales/net fixed assets

Return on Equity (ROE) – Measures the rate of return on the owner's equity:
- Net profit before taxes/tangible net worth x 100

Operating Cycle – The number of days financing is needed:
- INVDOH + ARDOH - APDOH = Operating cycle

Leverage Ratios – These ratios provide insight into how the company's assets and business operations are financed, either by debt or equity. They compare the funds supplied by business owners with the financing supplied by creditors, and will be used to measure debt capacity and the ability to meet obligations. These ratios may include debt to total assets, debt to net worth, debt to tangible net worth, debt to EBITDA, and interest coverage.

Debt to Total Assets – Represents the how much external debt is used to fund assets:
- Total liabilities/total assets x 100

Debt to Net Worth – The relationship between outside debt vs. owner's equity:
- Total liabilities/net worth

Debt to Tangible Net Worth – A more accurate leverage analysis due to the elimination of intangible assets:
- Total liabilities/tangible net worth

Debt to EBITDA – Compares total obligations (and debt) to generated cash; the capability of making payments; earnings before interest, taxes, depreciation, and amortization (EBITDA):
- Total liabilities/EBITDA

Interest Coverage – Determines how easily a company can pay interest on outstanding debt:
- EBIT/interest expense

Liquidity Ratios – These ratios are used to measure a company's ability to payoff current debt obligations (without raising external capital). They show current liabilities in relation to liquid current assets and the coverage that exists to cover short-term debts, if needed. These ratios include the current ratio, quick ratio, and working capital ratio.

Current Ratio – The ability of the current assets to pay current liabilities:
- Current assets/current liabilities

Quick Ratio – The ability of the current assets, less inventory, to pay current liabilities:
- Cash + marketable securities + account receivables/current liabilities

Working Capital – The dollar amount of current assets over current liabilities:
- Current assets - current liabilities

Importance To You –

- *It is imperative that you understand what the creditor is understanding* – Facing a loan modification or workout with your creditors requires that you understand what the creditor is understanding. Ultimately, you have to think 'root causes' too. Of course, you understand what is happening in your business (i.e., declining sales, margins), but what are the reasons behind the same? Are there more reasons for 'that' happening, something more core or fundamental? Do you see any trends? The creditor is using financial ratios to understanding what trends are developing as they compare the ratios period over period. The creditors may analyze dozens of financial performance ratios from your last three year-end financial statements. The analysis will also include the most recent quarter

compared to the same quarter from the prior year, based on your most recent interim financial statements. These ratios will allow the creditor to determine how well, or if you have or will likely have, the ability to repay your loans. Your financial performance, using ratios, will also be used in the creditor's credit risk rating of your loans.

- *Working capital is like fuel for your plane* – The strategic decisions you make for your business may be compared to the many instruments in an airplane cockpit. You're the pilot and you own the controls, all the buttons, and dials. How you use them equates to the decisions you make every day. They will result in how you successfully navigate and fly the plane. If you fail to get enough speed, or altitude, well, you know what will happen. Some debtors are flying their planes straight into the side of a mountain, as fast as they can go. They hardly have a clue that they're doing so. And, guess what? Creditors are not perfect either. They too can make bad lending decisions that can cause their financial institutions to fail too, right? That said, your company's working capital is critical to your flying experience, as without sufficient cash reserves to meet current payment obligations, the plane won't make it and will run out of gas, even if you're profitable. If you sell your products to clients that can't really pay you on account, while you look profitable on paper, it won't be long before your working capital takes a hit. What would happen if you purchased some company's obsolete inventory, inventory that you got at a hefty discount, but couldn't sell yourself, but at a loss? There are numerous examples of where your plane's dials and controls, your decisions, might be misused or abused whether you realize it at the time or not. But that's the beauty of owning your own plane. You get to fly it. And the lender, it is flying its plane too, and is comprised of many passengers just like you. So, the stakeholders are interconnected. The lender's success depends on you being successful too. In the end, if you're having financial difficulties, you must make the creditor willing to get on board with you. The same analogy could be made for a boat too. You must know how much fuel, or working capital is there, why it's there, how to preserve it, or increase it. It all shows up in the financial ratios. Know them too.

- *No excuses; you must know your ratios and what they mean* – Especially in an economic downturn, is there any excuse for you not to know and understand key ratios and the root causes behind your company's performance? Do you think your creditor will sit down, give you a copy of the credit analyst's 'financial statement spread,' and discuss your financial performance? Of course, you'd think. If things are bad, you may feel that your lender is looking for a parachute, or a life rescue boat if you're not doubtful and unprepared to answer its questions (exit strategy). To the extent you're unfamiliar with certain ratios, could you not conduct additional research online and become conversant, as needed? Credit related ratios are going to be used in the analysis of your financial condition; such may be required in Loan Agreement in the form of financial performance covenant requirements. Creditors will use them by setting benchmarks, minimum or maximum levels of performance, so that they can 'call a time-out,' a technical violation, and address the performance issues with you. You absolutely must understand what and how financial ratios and trends work so you can use them to your advantage when offering debt repayment solutions.

Credit Risk Memos (CRMs) – Management

(Creditor)

Annual Term Loan Reviews

8

CRM #26 – Annual Term Loan Reviews – Long-term loans will be subjected to the annual term loan review function. These loans are generally secured by real estate, but may also include annually renewed lines of credit. Reporting covenants are generally prescribed in Loan Agreements and will require certain financial information corresponding to the loan type and collateral. The loan covenants will be closely monitored to ensure the debtor always remains in compliance. Creditors may have certain size thresholds under which such reviews will be conducted, like $500,000 plus, or smaller loans with higher loan-to-value ratios. For example, if a loan is secured by investor-owned or non-owner-occupied commercial real estate (NOO-CRE), the creditor is going to want to see a current rent roll showing all the current tenants and rental terms and conditions. The most recent year-end operating statement will be reviewed to determine the net operating income (NOI) to service the debt repayments. If multiple NOO-CRE properties are owned, a Schedule of Real Estate Owned would be requested. The most recent year-end business and guarantor tax returns and financial statements will also be required to help verify the accuracy of the assets and the financial performance of the operating statements. Material assets will also likely be verified, especially the liquidity position. The annual review will likely include a sensitivity analysis for NOO-CRE properties, where the analyst will stress certain factors to reflect how much debt service capacity there might be under various stressors. These factors may include determining full occupancy upon stabilization, current occupancy, and a breakeven analysis. A decent stress test will 'break' the breakeven metrics to show how far cash flow will fall to become insufficient, and stress the variables under a severe economic downturn.

A Site Inspection is Likely – Larger loans will likely require a lending officer to perform a site visit to inspect the collateral property. He will also be ascertaining whether the property has any adverse environmental conditions, and if it is being used in conformity with the Deed of Trust or Mortgage (or other Loan Agreement documentation) requirements, and not being used contrary to those terms (i.e., a marijuana related business, or MRB). Similarly, an owner-occupied CRE property will also require regular financial reporting on an annual basis, if not more frequently when there has been financial deterioration. The same holds true for other term loans secured by equipment. For loans secured by current assets, like accounts receivable and inventory, similar inspections and field audits will be made, together with all the other reporting.

Importance To You –

- *Expect stepped up creditor monitoring when there is deteriorating financial performance* – As part of prudent credit risk management practices, creditors strive to be always informed about the asset quality of their loan portfolios. Annual reviews are for ordinary times. Therefore, you can expect there to be, at a minimum, formal annual reviews conducted on your term debt. If you're experiencing financial difficulties, the level of review will become more frequent. It is likely that you will have triggered a technical default on loan covenants that will allow the creditor to require more

formal financial reporting, and problem loan administration measures will ensue. If there are multiple NOO-CRE properties in your portfolio, be sure to give a detailed real estate schedule that includes: entity name that owns the property, address, property type, percentage ownership, acquisition date, cost or basis, outstanding loan balance, creditor name, annual rent and income, operating expenses, net operating income, interest expense, principal paid, capital expenditures, net cash flow, depreciation and amortization expense, and the current estimated market value. The creditor will be able to quickly assess the financial condition of the NOO-CRE. In short, when a review of your credit file is underway, take this as an opportunity to be transparent and to work with the creditor. As a business owner, you have an ownership responsibility to not only prepare your financial disclosure documents, but to prepare them in detail and accurately. This is all part of building a relationship of trust. You will need trust when presenting repayment solutions if you require a work-out or loan modification at some point.

Loan Documentation

CRM #27 – Loan Documentation – Loan policies will define the necessary documentation and information (i.e., type and frequency) that will be required at loan origination and throughout the life of the credit. Appropriate and accurate loan documentation will help ensure the creditor is lending in a safe and sound manner. The creditor will maintain the original loan documents, their exhibits, and required original signatures. The information is used by the lending officer, loan committee, as well as auditors and other external parties (i.e., regulators). Information is used to verify the identity of the borrower and signers, their historical and current financial condition, the purpose of the loan(s), primary and secondary sources of repayment, and the collateral used to secure the loan. This includes financial statements, credit reports, appraisals, etc. Files will also include the on-going receipt of financial statement reporting, creditor analysis, collateral inspections and field visits, and loan covenant monitoring. These data will serve as a basis for establishing the borrower's credit worthiness and serve as a paper trail for external auditors and regulatory examiners to review.

Loan Documentation Will Be Used to Service the Loan – The credit file will also include documentation for collateral lien perfection and collateral monitoring. If there are third-party contractual agreements with contractors or franchisors, the creditor will have taken as assignment of those contracts in the event the debtor defaults on the loan. With proper documentation and internal controls, the creditor will be able to ensure that any collateral is released back to the borrower at the appropriate time. Negotiable collateral, like a Certificate of Deposit, will be maintained under dual control by individuals that are independent of the loan function. A well-managed credit risk management function will also enable the creditor to service the debtor adequately, even when the debtor's loan officer is no longer at the financial institution. Besides the Promissory Note, a risk-based Loan Agreement is used to control the borrower's financial performance, often including performance-based covenants, reporting, affirmative measures, and negative restrictions. Performance covenants should be adequately structured (hopefully) to give the debtor sufficient 'appropriate room' to operate his business before a violation is triggered as economic conditions deteriorate. The close monitoring puts the creditor in a position to accelerate or demand full loan repayment, if necessary.

Importance To You –

- *Take the time to read, discuss, and understand the loan documents* – Creditors need appropriate file

documentation not only at origination, but throughout the lending relationship. They are required to operate in a safe and sound manner, and understanding your financial condition while the loan remains unpaid is critical. Your loan documentation will likely require you to provide more ongoing reporting than you may think is reasonable or necessary, especially if you're experiencing financial difficulties. After all, the money has been advanced, "so why doesn't the creditor just leave me alone"? Maybe you're wondering why a residential mortgage lender, for a loan booked years ago, doesn't need additional documentation, but your creditor does? As you know, consumer loans have their own underwriting requirements, but your business loan has a much higher risk profile. The loan documents will ensure the creditor gets what it wants. It may feel like you're trapped in a corner, and someone telling you: 'If you don't like it, you don't have to borrower the money and just pay it off,' right? Financial institutions are required to lend money in a safe and sound manner, as most of them have similar lending and underwriting requirements. You may just need to spend some more time reading the loan documents, so see what they really mean. Non-regulated creditors may have different standards, but their interest rates and fees may be much higher because of the increased credit risk they're willing to take. That said, when you sign any loan documents, give yourself sufficient time to read, discuss, and understand what it is that you're signing. A serious business owner will do this and conform to any requirements. Not so astute business owners will just 'sign away,' and run the risk of mismanaging the business itself. The latter approach will likely result in a headache for the creditor should there be a decline in financial performance. How sharp is your pencil? How serious are you as a business owner?

- *In the end, you will get what you want and deserve* – Be judicious and smart when it comes to comprehending what your loan documents say, and what's required. At loan origination, or 'loan closing,' don't be rushed. It's your business, so take better care and ownership of it – whatever it takes, by carefully understanding your loan documents. Ask whatever questions you think you should, regardless of how much time it takes. Make sure you literally know what the creditor's expectations are, what the due dates are, what the covenants mean, and everything else. Chances are, you'll be much more successful, because when difficult economic periods come, as they surely will, you will have established a relationship of trust, respect, and mutual confidence with the creditor. Bottom line, you're going to need that relationship when your financial performance is less than both parties expect

Foreclosure

CRM #28 – Foreclosure – Foreclosure occurs when the underlying collateral is liquidated due to there being an event of default on a loan. The collateral serves as a secondary repayment source, and when there's a default, there's a legal foreclosure process which a creditor can pursue to help satisfy repayment of a defaulted debt. With real estate collateral in a Deed of Trust State, there will be a recorded Mortgage or Deed of Trust, giving the Trustee thereunder the right to take title of the real property at a non-judicial foreclosure or Trustee's sale. Other States may require a judicial action (i.e., court proceeding, expensive, time consuming) to recover the collateral. Foreclosure on a commercial real estate property or a single-family residence would indicate that there is no other option left to the creditor to satisfy debt repayment. Of course, prior to the Trustee' sale, the debtor will be given a prescribed amount of time to redeem the real property (i.e., payment in full), like 90 days. Then, if not paid off, the property will be noticed up for public sale or auction, within 30 days.

Getting to the Auction Bid – It's possible during this time that a bankruptcy petition could be filed to 'stay' the foreclosure process until the bankruptcy court authorizes the legal action at a future date. Once the bankruptcy court has abandoned the real property, the creditor will pick up where he left off and proceed with the foreclose process. After the collateral property is noticed up for a Trustee's sale on a specific date, the real property will be sold (i.e., public auction) to the highest bidder, possibly on the steps of the courthouse. The Trustee will read the Trustee's Sale (i.e., foreclosure action) and then open to the public a live bidding process to purchase the real property, sold as-is, to the highest bidder. The creditor will likely 'credit bid' an amount equal to the full outstanding balance owed on the loan, including all the unpaid interest, legal fees, and costs. However, the credit bid amount will not likely exceed the current appraised fair market value of the collateral property, less the estimated costs to sell (called the net realizable value) recently obtained by the creditor. Obviously, before the creditor bids on the property, a determination will have been made as to any potential environmental risk associated with the property, as the creditor does not want to inherent any potential environmental liability. Whomever the highest bidder is will immediately owe (i.e., same day) the Trustee the purchase price in certified funds. If someone bids higher than the creditor's bid, the purchase funds, less costs, and fees, will ultimately be forwarded to the creditor to help satisfy the underlying debt. If no one out bids the creditor's bid, the creditor will own the real property for the amount he bid, and that amount will be credited against the outstanding balance. The real estate loan will no longer be a loan. It will have been paid, depending on the bid amount (capped at the current appraised fair market value), equal to the amount of the creditor's bid and the remaining charged-down balance.

Real Estate Collateral Will Become 'Other Real Estate Owned,' or OREO – The creditor will now have another asset on its books, but no longer the original underlying loan. It is now called Other Real Estate Owned, or OREO. If there's a deficiency balance after the amount bid at the Trustee's sale, and depending on the State in which the property is located, the creditor may or may not be able to seek a deficiency judgment of any unpaid amount on the original loan. The creditor will need to decide if it is even worth trying to collect on any deficiency or unpaid balance. Creditors usually don't spend 'good' or new money after 'bad' money, or money it can't collect. The OREO will be valued on the books at the appraised as-is current market value of the real property, less the costs to sell it.

Personal Property Collateral Will Be Liquidated – Regarding personal property collateral, like equipment or inventory, once the creditor sues the debtor and possession is granted to the creditor, the creditor will arrange to have a Sherriff's sale of the collateral. A Sherriff will arrive at an appointed hour and similarly conduct a public sale of the collateral. Usually the creditor will credit-bid its unpaid balance or current market value amount, take possession of the collateral, and proceed to arrange for it to be privately sold. One way a creditor can dispose of fixed assets, including inventory, is to arrange for competitors to come and place private bids to purchase the same, usually in bulk. The creditor may expect that the prospective buyers will bid amounts that are materially discounted. The buyers know the creditors must sell the personal property, as the fixed assets are 'not part of the creditor's business, but are assets that 'must' be sold. Such property is only worth what people will pay for it.

Market Bids are Still Market Bids – The bids to purchase the property will likely be lower than expected, while the creditor may feel like it is being held hostage. But market bids are still market bids. It all goes to the highest bidder, and if all the bidders are bidding low, that's the way it goes. Keep in mind, the standard is to have a commercially reasonable sale. If the right conditions are not present, the creditor can sale it another day. Also, depending on the volume of the personal property, a creditor may have to hire another

firm or professional who specializes in selling such assets at the highest price possible. On occasion, depending on the volume, creditors may want to place the inventory in the services of a professional auctioneer company who will arrange a public auction.

Importance To You –

- *Liquidation of collateral is a big, very big deal, but what's the real cost?* – By the time your borrowing relationship has reached this point, all sorts of feelings will be happening. After all, your business is now being liquidated through the sale of its assets. Maybe you've sunk your life's fortune into it. Maybe you've fought hard to keep the assets in this life-changing event. That said, debtors have been known to try too hard to hang on to it, even at the expense of their own spouses and families. Is there not a time and place to 'let it go' before you lose out on family relationships due to the enormous stresses that come? If you are worried about the toll a forced liquidation is taking on you and your family, assuming you have one, take the needed time to really think this through, as only you can make that decision. Look at this through the lens of an outsider. Collateral, whether it's real estate or other personal property, it's just dirt, glass, rubber, metal, etc. Is the stress from trying to hold on to that more important than one's family? Maybe you are thinking that you have to fight for 'what is right,' at any cost, right? There's certainly merit there, of course. But maybe you must draw the line, and as a family, determine what's in the best interest of the family. Take that consensus and run with it. Hopefully, however, not everyone in the family with such a voice, are willing to sacrifice themselves too, to win the battle with the creditor. To the extent the creditor has a legal path to recover the proceeds for liquidated collateral, why would he stop? He likely has more resources to win the battle, right?

- *Forced or cooperative liquidation?* – Assuming the days of negotiating repayment are long gone, and you're facing a collateral liquidation scenario, you have a choice to make. You can do it cooperatively, or not. A cooperative self-liquidation can involve an orderly disposition of assets using a liquidation budget, where certain costs are identified to cover the entire process over time. In rare cases, it is possible the creditor will help compensate to cover liquidation costs if cash flows resources are exhausted. In such a liquidation, the creditor will want your help so the maximum recovery can be realized. While it's possible the market will perceive a distressed seller (you), it is still much better than what the market will pay to a creditor that's has to dispose of the collateral. After all, who else knows the collateral as well as you? Who knows the accounts receivable better than you? As you consider a potential liquidation, look at these strategies and pull them in as part of the negotiating process in repaying your loans. Can you see why it is important to build and develop a strong creditor-debtor relationship on integrity, trust, and good will? Speaking of the collateral during a workout process, you need to 'stay with it,' safeguard it from theft or loss, even if you know the proceeds from its sale will be going not to you but to the creditor to satisfy your debt. Don't just dump it in the creditor's lap and walk away. Be instrumental in finding the right buyers who will pay the highest prices, and in the most reasonable amount of time. Make the best of a bad situation, right?

- *Making the best of a bad situation* – As for not being cooperative, you could choose to be quite deceptive and hurt the creditor. But you do have a choice. And, hopefully that's not you and your decision. As the recovery/liquidation process heat up, especially when negotiations have failed, you

could easily take the attitude that you will do everything you can to hurt the creditor's prospects of being repaid. You may even want to cause as much financial pain on the creditor as possible. This should never happen or be the case, regardless of what may have transpired between you and the creditor – never. Why? Because when the 'dust settles,' and it surely will someday, you do not want to look back and see that you intentionally caused a creditor to whom you owed money, to incur more loss than was necessary. You do not want to look back and recall where, you were deceptive, even if the creditor didn't pursue legal action against you

- *Don't be deceptive, even if you are angry with the creditor* – For example, if the creditor wanted to force the collection of your accounts receivable. Suppose you know that the creditor is ready to send each account debtor a notice to immediately pay the creditor directly and not you. But, 48 hours before you expected the creditor would send the notices, you contacted all of them and offered a 15% discount if they paid you now, like right now. Then, the next day, the creditor tries to collect the receivables and there are none. All the (collectible) receivables would have been wired to you the day before. This would be a clear and dishonest violation of the loan covenants you signed onto at loan origination. That is deception, and it is wrong. The creditor will have to launch a (bitter) defense of its interests with new monies, that you caused them to incur, for which you're also responsible to repay. Another example might be where the creditor was preparing to go in and take possession of your inventory. But when the creditor arrived to the warehouse, it discovers that you've already cleared out the good inventory and hid it in other locations before the creditor could take possession. This would be another clear violation of your loan covenants. And, the list goes on and on

- *There is a better way to resolve any dispute* – From the beginning, go all in with good-faith efforts. If you've screwed it up somewhere along the way, even now, and you have poor relations with the creditor, stop, go back in, and fix it. 'Lay down some cards,' and seek a quick solution or remedy, and stop the fighting, if necessary. You do not want to ruin your personal and family life over material objects or dirt. Contention, anger, and deception are not the right course to take. They will gladly follow you right back into your own home each night. Your spouse and family will pick up the 'vibes' from the moment you pull into the driveway, or get out of the car. You can always start up another business again, but, if you're not careful and end up losing your precious family, you can't get your family back. Don't ruin your life over collateral, it is just not worth it. Period. It never will be either. Do what you can to assist the creditor to dispose of 'their' collateral, and move on with your life. Do it in a way that you and the creditor could both go out and have lunch together after it was all over, even if that may not realistically happen

Inspections, Field Visits

CRM #29 – Inspections, Field Visits – Depending on the size of the credit relationship, creditors will conduct field visits and collateral inspections, say over $500,000. Creditors will go onsite at loan origination and on an annual basis (if the loan is secured by commercial real estate). If the debtor is out of the creditor's market area, a third-party creditor-approved inspector will be engaged to do the inspection. The physical inspection is part of an ongoing due diligence or credit risk management monitoring process. If an inspection reveals unwarranted risks (i.e., adverse environmental hazards, a marijuana-related business tenant, etc.) a new loan request may be terminated, or for an existing loan, there may be an event of

default. The inspection may help determine if the proposed collateral is acceptable or not. Real property may be impacted by having either functional or physical obsolescence, or both, or deferred maintenance. If the collateral is acceptable, 'knowing' the collateral, its use and condition, may help the creditor in understanding and obtaining a more appropriate and accurate valuation and loan structure. The creditor will be cautious to ensure the maturity or loan term will be much less than the remaining useful life of the collateral property. An inspection helps the creditor to better understand the debtor's operation and character. It will enable him to verify statements made by the debtor, and hopefully strengthen the lending relationship. Inspections are also the time when environmental questionnaires are given to the debtor for completion. Creditors will have formal inspection worksheets, include interior and exterior photos, written narrative describing the condition of the assets, tenants occupying the building, deferred maintenance, noting any potential environmental or hazardous waste or other required remediation or monitoring, marijuana related business tenants (MRBs), etc. The inspection will also enable the creditor to confirm whether any collateral issues may result in a condition of default, if such constituted an event of default.

Importance To You –

- *Collateral is what it is. Relax* – Creditors have 'seen it all,' so don't be worried about trying to impress anyone. The most important part of any inspection or field visit is for you to build trust and mutual respect with the creditor. When the creditor or inspector shows up, block out enough time to complete the inspection. Ask upfront what the creditor's objectives and procedures are so that you can make every effort to accommodate his request. Remember that premise or collateral inspections rights are generally included in the Loan Agreement. Inspections can generally be performed at any time with reasonable notice to you. The inspection, depending on the type, may consist of a collateral field audit of the accounts receivable and inventory, or of the real property. The latter may take only 45 minutes or less. The field audit may take part or most of the day. Regardless of the type, stay focused on the purpose of the visit and respect the agreed upon amount of time. Hopefully the creditor will be sensitive of your time. That said, having the creditor onsite may have additional advantages. It's not often that the creditor will visit your business, especially if a workout officer has been assigned. At the inspection stage, it is an opportunity to open the creditor's understanding of your operation at a whole new level. If time permits, and it's agreeable to both parties (you may as well ask for it), take the time to give the creditor a 'walk-through' of your operations. Show the creditor how your business functions and consider introducing him to key personnel. If you've got something that you're proud of, shine a light on it. Build a basis to support your plan of repayment. There's no time like the present. Make sure the creditor leaves on good terms, and had positive experience

Loan-To-Value (LTV): Minimum, Maximum

CRM #30 – Loan-to-Value (LTV): Minimum, Maximum – Creditors have loan policies that reflect the level of credit risk established by the institution's board of directors. These board-approved credit policies should address the maximum loan amount by property type, maximum loan maturities, amortization schedules, pricing for interest rates and fees, and well-established maximum LTV limits. Exceeding the maximum LTV limits would result in there being an 'exception to policy.' Such exceptions could be approved subject to well-documented support and mitigating factors to offset the increased credit risk. As for the LTV ratio itself, it is relatively simple to calculate: outstanding loan balance (commitment amount)/current appraised value.

The Effects of LTV in a Declining Market – The LTV ratios of loans secured by real estate are closely monitored by the creditor, as this ratio represents the equity 'cushion' to protect the creditor should the primary source of repayment, cash flow, fail to materialize. Commercial real estate loans often have five, 10, 15, 20, 25, and 30-year maturities, a very long time. Anything can happen to a business' cash flow, along with changing property values in any given year. A five-year loan, with a 25-year amortization, will have a balloon payment at the 5-year maturity. It will have to be underwritten at the then market conditions and interest rates. If the loan was originated with a maximum 70% LTV, and market conditions have deteriorated to where the new collateral value had dropped by 20%, the loan balance would need to be paid down to reach the new 70% LTV requirement. Regulated creditors have structured maximum LTV requirements. Typical LTV requirements for various real estate collateral types, based upon the current fair market valuations, include:

50% to 65% LTV for Raw Land – Commercial Investment: Agriculture land, commercial and residential land acquisition and development, non-owner occupied commercial and industrial, commercial speculative, hotel, mini-storage units, retirement/assisted living, faith-based, auto dealership, gas station (i.e., special use properties).

75% LTV for Land Development – Single-family residential development (SFR), owner-occupied SFR, owner-occupied industrial (i.e., warehouse, manufacturing), owner-occupied office/medical/retail.

75-80% LTV for Commercial – Multi-family, apartments, and other non-residential construction.

85% LTV for Construction – 1-to-4 single family residence, improved property

The Higher the LTV, the Higher the Risk – Loans originated with collateral having high LTVs are often considered to be higher risk loans. It's unlikely the creditor will finance a loan amount more than the internally set LTV limits similar to those noted. As market conditions change, as they regularly do, the LTV position could deteriorate (increase), or substantially improve (decrease). Generally, the higher the LTV, especially in an economic downturn, the greater chance of the loan going into default. The debtor has less interest or equity in the property. Additionally, the less equity there is in a property as evidenced by a high LTV ratio, the more difficult it may be to sell, for the debtor or the creditor. Further, the higher the risk, the higher the interest rate may need be, to compensate for the increased risk and the potential for loss. The lower the LTV, the more likely the debtor will step-up and protect its interest or equity in the property, and thus the interests of the creditor too.

Junior Liens in a Secondary Position Behind the Senior Lien – In those cases where the lender might also have a junior lien (i.e., 2nd Mortgage or Deed of Trust recorded on the same property), the creditor will measure the combined loans to the current market value and come up with a combined LTV, or CLTV. The CLTV will still need to conform to internal loan policy limits. However, if the 2nd lien is from another lender, it's possible that it may work to the senior lien holder's advantage. If the sale or liquidation of the collateral is necessary, and if the current CLTV position is low enough, the junior lien holder may payoff, or 'take out' the senior lien holder to protect his interest. But, if market valuations are depressed, the interests of the junior lien holder will likely be 'foreclosed' or lost, when the senior lien holder takes back the property.

Importance To You –

- *Give Consideration Where Consideration is Due* – Think of the LTV as the risk the creditor has taken in the collateral you pledged. If there's a 75% LTV, it means that the creditor has a 75% stake in the financing of the collateral, which leaves you financing the remaining 25% stake, even though you technically own 100% of the asset. Go up to 30,000' and look at your balance sheet, how much equity do you have in financing the assets vs. the debt capital provided by the creditors. If the creditors have a 75% stake (or LTV), to your 25% stake, this leverage ratio of 3:1, means the creditor has a 3:1 stake in the assets. Keep that in mind when they ask for current financial statements, etc. You need to appreciate who has more of a stake in the business from a capital perspective. Even if you technically own all of the assets, 75% of them are at risk and subject to the interests of the creditors. So, don't get too comfortable, right? This should give you a better sense of why it is so important to deal with the creditor in good-faith. It matters not that the creditor may take in millions more than you and your business do. It's about the fact that the creditor stepped up and financed your business' assets 3:1 in this example. Those loans were given to you in good-faith, and you needed these creditors to have a shot at being successful

- *What goes up, often comes down* – 'Cash out re-financings' are commonplace, especially during periods of economic expansion. Business cash flows are supposed to become more seasoned over time, along with increasing property values, resulting in a decreasing LTV ratio. With a low LTV level, business owners often will pull equity (or cash) out of their real estate collateral properties to use for a myriad of reasons or purposes. The creditor will want to advance 'new money' because there is abundant seasoned cash flow to support repayment, as the new loan is still well-collateralized with an acceptable LTV position, and sufficient cash flow support to make everyone happy. But what goes up, often comes down. And when real estate values decrease, especially after a cash-out refinance, it's possible the maximum LTV position will be compromised. That in and of itself is not a reason for the creditor to be overly concerned, if the documented cash flows still support repayment. After all, the collateral is not the primary repayment source, as it is only the secondary repayment source in case the primary source fails. When it does fail, then there's a problem and reason to be concerned. Suddenly, loans may become impaired, subject to regulatory scrutiny, a potential shift in the interest accrual vs. nonaccrual status, a sale or liquidation of the collateral, etc. The debtor must understand the position and thinking of the creditor when it comes to the collateral, and maintain open lines of communication

- *As pressures build* – In a serious economic downturn, both the creditor and you may need to think more carefully about each other's position and give each other more respect, maybe a lot more respect. Too many such relationships become strained and ruined when stresses increase. On the one hand, creditors simply want all their money back. You are just trying to survive with a high collateral LTV. But between the time they loaned you the money and when they get repaid, you have an opportunity to become very engaged, show actual ownership of your responsibility to repay, regardless of the high LTV position. Lenders can work with you under a higher-than-normal LTV, but you'll need to empower your voice in what happens down this journey, as to how and when those debts are repaid. You too have much to lose, perhaps everything. That's precisely why you must be empowered to repay your debts, as best you can. Understanding the current LTV position and any potential loss the creditor may face, will help in coming to a mutually acceptable repayment solution. Creditors need to remember that you are a human being and not just a 'number' or a name on a report. The better-prepared you are, the better chance you will have to come up with a prudent repayment solution the creditor will agree to, and avoid problems

Other Real Estate Owned (Oreo)

CRM #31 – Other Real Estate Owned (OREO) – Creditors often have some OREO on their books, real estate owned that is 'other' than the real estate the creditor uses for its current premises, for its own operations. Most often, OREO is acquired real estate through the real property collateral foreclosure process for such secured loans. When the primary source of repayment (i.e., cash flow) is no longer there, the secondary source of repayment, the sale or liquidation of the real estate, may become the only remaining repayment source. Such a loan is called a 'collateral-dependent' loan, and the real estate is acquired by the creditor through the foreclosure process. Once a property is foreclosed by a senior lien holder, for example, the action will clear off any junior liens from the title to the property. The net proceeds from the (Trustee's) sale will be applied to the outstanding loan balance. Instances do occur where it makes economic sense for the creditor to accept a 'deed in lieu of foreclosure' to help satisfy an outstanding loan balance. If a creditor takes possession of real estate collateral (but not title), this is called an 'in-substance foreclosure.'

The Acquisition, Holding, and Disposition of OREO – Financial institutions manage the OREO portfolio, which can increase substantially during an economic downturn, in three phases: acquisition, holding, and disposition of real estate. The acquisition phase is when the creditor obtains title to the real estate and it is transferred as an OREO asset at an amount that reflects the newly appraised value, less selling and disposition costs. At a foreclosure sale, the senior lien holder will usually 'credit bid' this amount, an amount that is known to represent the 'fair value,' less the estimated cost to sell the real estate. Fair value is used for a sales price that a willing buyer and a willing seller would agree to. It is not a 'liquidation' or quick-sale value, but a fair value. The creditor will carry or hold the asset on its books at the fair value as periodically determined via the appraisal process, less estimated selling costs. If the creditor holds the assets for several years in a declining market, it is possible new appraisal valuations will be needed from time to time, and may result in the creditor having to 'write down' the OREO book balance to reflect the current market value.

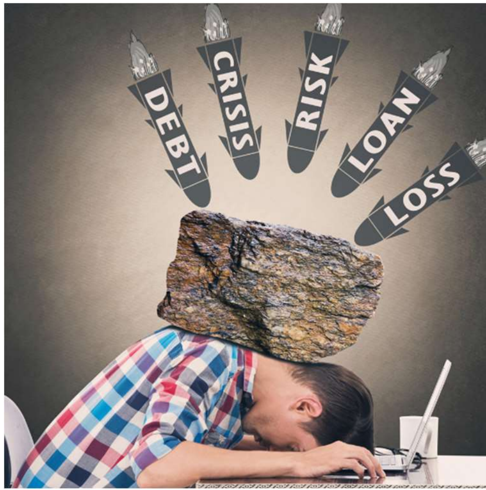
If the real estate market is increasing, the creditor may have a gain on sale to reflect the increase in value; however, the creditor will likely not increase the OREO balance, but take a 'gain on sale' when the property is sold. When disposing the asset in a flat or declining marketplace, creditors may have to take a discount to get the non-earning asset sold, especially if the OREO portfolio is large. The reduced sale amount may result on a 'loss on sale.' OREO is generally sold 'as-is' with 'no warranties whatsoever.' The timing for selling OREO is to be within any State mandated holding periods, but is to be done in a prudent and reasonable manner. It is typical for a creditor to place the asset into the hands of a real estate agent to have it professionally sold in the market. The carrying value would have already accounted for disposition costs so the net proceeds would likely payoff the OREO balance on the books.

Importance To You –

- *Disposal of OREO* – The collateral liquidation process should be a very rare event, and only necessary when all other alternatives have been explored and exhausted by you and the creditor. And that includes the filing of bankruptcy too. Obviously, if your defaulted loan made it all the way through the foreclosure process and into OREO, there's no longer any interest in the collateral on your part. Creditors will have taken full possession and will dispose of their OREO assets at some point. Upon selling the property, the creditor will generally require payment from external sources and won't finance the purchase itself. If the creditor does finance the sale of its OREO, it will conduct abundant due diligence and underwriting to show it was done in a commercially reasonable manner. The buyer would have to be fully qualified for any financing. The creditor would not likely be inclined to offer special concessions, terms, interest rate, and fees in disposing of an OREO property, lest the sale transaction be criticized by supervisory authorities.

- *Do You Have a 'zombie' or evergreen loan that will never be repaid?* – Keep in mind, if your business is a 'zombie' business limping along but essentially dead for all intents and purposes, is it fair to the stakeholders to continue the relationship and not liquidate? Do you have a forever 'evergreen' loan? Where, when, or how do you become a zombie company? Perhaps a zombie business is one that cannot survive expect for some major outside support to keep the heart beating or the doors open, or one that can only pay interest payments forever, but will never be able to repay the actual outstanding loan balance. If that's you, then rethink if you're wasting everyone's time and make a recommendation to look seriously at the real estate collateral as the only remaining repayment source. If you haven't already sought for a disclosable loan modification (principal forgiveness, interest rate reduction, other-than-insignificant payment delays, or term extensions), maybe that will make more sense. But if that is not the answer, maybe you can sell the collateral and get out of the loan that way. Maybe it's time to be done with it, right? It's a decision you will have to make, if the creditor hasn't already made it for you.

Problem Loan Administration



CRM #32 – Problem Loan Administration – For any variety of reasons or circumstances, there will always be 'problem, criticized, or classified' loans. The root cause for credit deterioration may come from the debtor's operations, market conditions, competition, or management's decisions. Maybe the issues were exasperated by weak (creditor) credit risk management practices. Problem loans may be baked into when the loans were first originated, such as: new start-up businesses, speculative ventures, insufficient collateral margin or lack of equity in the property, dealing with borrowers who lack character, poor underwriting on the level of debt service repayment ability, failure to obtain adequate financial statements, not understanding the loan purpose or borrowing cause, failure to recognize market demand (i.e., building lot concentration and lot absorption rates), or, a favorite, too much focus on income and fees (the creditor 'needed the loan totals'). Problems happen, especially when there's an economic downturn. Loans that need such special attention will generally be transferred to a new Special Assets Department for resolution.

Credit Policies, Risk Ratings, Monitoring Reporting – Financial institutions have well-established credit and lending policies and procedures to identify early, and administer problem loans. If the creditor is paying close enough attention, it will be able to spot changes that need to be addressed. Management will have well-established policies to guide their expectations on how it intends to manage adversely risk rated or problem loans. Criticized loans are risk rated, and generally referred, to as Special Mention. Classified loans are risk rated Substandard, Doubtful, and Loss. Criticized and classified loans are also referred to as just criticized loans too. Creditors readily know when financial performance is off, including collateral values and other metrics. Creditors focus heavily on managing problem loans in a timely basis, including individually documented problem loan 'action plan' reports (i.e., updated monthly or quarterly) that detail the overall steps to get your loan upgraded to an acceptable or Pass risk rating, or to a zero balance (i.e., possible liquidation of the credit).

Disclosable Loan Modifications (DLM) – Regulatory guidance changed in December 2022 that changed the way regulated creditors reported and disclosed impaired loans (heretofore called Troubled Debt Restructurings or TDRs). The new disclosure requirement for certain loan modifications is called 'DLMs to borrowers experiencing financial difficulty.' These modifications include four criteria, or any combination thereof to be assigned as DLMs:

a) Principal forgiveness
b) Interest rate reduction
c) Other-than-insignificant payment delays
d) Term extensions

DLMs show the four ways a creditor can participate with the debtor in developing repayment strategies. Loan forgiveness may include a charge-down of the amount owed to a lower balance, which helps with the ability to repay on the remaining balance. The difference can be repaid after the first portion is repaid (Note 'A' and a Note 'B'). The interest rate, in a workout situation, could be reduced, or payments temporarily deferred, or the term extended. Keep this card in your back pocket.

Creditor Due Diligence, Workout and Forbearance Agreements, Liquidation, Bankruptcy – Creditors will search to verify whether there are recorded judgments against the company and its principles, including tax liens (especially Federal tax liens that may supersede the creditor's interests), and secured junior liens by other creditors. Generally, and especially if the debtor is cooperative and is submitting the required financial statement information, a creditor will be able to gauge how solvent the company and its owners are, and how much longer they will be able to remain in business before having to file bankruptcy. Beforehand, however, a creditor may enter into a workout agreement to repay the unpaid balance that summarizes certain negotiations, and will be binding on the creditor, debtor, and guarantor. The rights in the remaining loan documents, beyond the terms and conditions of the workout agreement, remain unchanged and are not waived. A creditor may also enter into a Forbearance Agreement where it will forbear taking further action in exchange for the debtors doing certain things. A creditor may exercise its rights to 'offset' money the debtor has on deposit at that institution. In rare instances, a creditor may discount the Promissory Note and sell it in the marketplace, and thus be repaid usually at a hefty discounted rate; the balance would be written-off. Of course, the creditor may have no choice but to turn to the collateral (i.e., foreclose on the real estate), or by taking back a Deed in Lieu of Foreclosure (for an agreed upon amount to satisfy the debt), pursue a regular non-judicial foreclosure in States that use Deeds of Trust, or a judicial foreclosure (court proceeding) against the property and the guarantors. If everything fails, a bankruptcy petition would likely ensue.

Self-Dealing – Once in a while there is 'self-dealing' where unsound credit is given to insiders, or credit granted by certain lending personnel with incompetencies for specialty lending. The board and senior management may also fail to provide effective oversight, all the while there are changing economic conditions. Lenders often rely on oral or written information from debtors instead of verifiable financial information. Competition may also pay a role, as creditors will be tempted to compromise their credit standards and loosen loan covenants, etc. Institutions have been known to implement aggressive loan growth strategies for what ends up being short-term growth in earnings, but ends up with a heavy portfolio of problem loans and charge-offs. It's like letting the kite string out so far that when the line is pulled, nothing happens; they can't even see the kite or control it anymore. Such risks are unwarranted, of course, but it happens all the time. Documentation errors have historically been the cause of material problem loans, but the quality of loan documents has improved greatly over the years.

Notice of Default – A Notice of Default, at some point in the problem loan process, may be recorded against the real estate collateral. The creditor will likely list all the conditions for which the default issues were based, and the debtor will be required to remediate each of the conditions before the default may be cured. For some conditions, the unpaid loan balance may even be accelerated, and a full payoff amount will be required, usually within 10 days, else the creditor may elect to pursue its legal remedies to collect the unpaid balance, including liquidation of the collateral. Prudent creditors are likely not going to ignore any conditions of default, because they realize that the sooner they address these problems the better chance they have in achieving their 'least loss,' if any. The longer they ignore these conditions, the more likely they are to incur more losses as the ability to repay, and the condition of the collateral, usually deteriorates.

Importance To You –

- *When it's too hot in the kitchen, people scatter, and the creditor will then calls the shots* – Examples of problem loan situations include payment delinquency, multiple renewals with unusual payments structure, evergreen loans (i.e., little principal reduction), declining credit metrics: minimal or deficient working capital, lower trends and high aging in account receivable and inventory trends, increase in accounts payable, declining revenues, increasing expenses, heavy debt/worth ratio, and most importantly, poor cash flow. When repayment problems are present, the required financial reporting is often generally lagging. Borrowers, just like you, may go into hiding. So, if you experience diminished cash flow, collateral issues, or your financial performance is 'off plan,' you can expect that the creditor will be formulating its own action plan to shore up the credit. It's been this way for decades. The creditor is going to call the shots, including fixing any structural issues like enhanced financial performance covenants, more reporting, and collateral, etc. However, is this the best solution?

- *Develop your workout plan* – Of course creditors will 'work with you' to find a prudent repayment solution, but this is where the paradigm shift takes place. You need to be the primary author of the so-called work-out plan with its own quantifiable measures and completion dates. Use your pro forma cash flow statement to show, even if the numbers are low, the available cash flow to keep you in business. Your efforts to find a solution with the creditor clearly demonstrates your willingness to remain committed to the financing. Use the DLM tools to your benefit, if need be. This is the new regulatory guidance for most regulated financial institutions. There are four measures for consideration or any combination thereof: principal forgiveness, interest rate reduction, other-than-insignificant payment delays, and term extensions. Using these tools is still safe and sound lending that is also prudent. Be wise as you prepare your recommendations, but these are tools for your use. Go through the 'front door' and communicate what help you need to stay in business. It will be apparent quite quickly that you are not committed to the loan if you avoid the creditor, or make any threats to the creditor. If legal threats are made, you can guarantee the creditor will turn the matter over to its attorney for legal action against you. Don't make such threats unless you intend to keep them. Creditors can tell where you are, commitment-wise, so there's no sense in trying to hide your real intentions. As you look for repayment solutions, be open to a workout plan. The lender will also offer loan modification terms and solutions. Consider what changes may need to be made via an extension of the loan terms, maturity date, interest rate, payment amount, collateral, guarantees, etc. When there's no viable source of repayment, a loan can be restructured into two notes, an 'A' and 'B' note. The 'A' note will remain on the books and the 'B' note will be charged off, and repaid after the 'A' note is repaid. Perhaps the 'B' note can be set at a 0% interest rate. You can ask and propose anything. Be sure to use the DLM tools to your benefit as you propose a debt repayment plan.

- *You should make every effort to repay you loans in good faith* – If in the end, it's entirely impossible to do a workout, then so be it. It can be a cooperative liquidation in good faith too, as this will keep everyone's time and costs down. Creditors have even paid their borrowers to help with the liquidation process to recover as much as possible for the creditor. A liquidation budget can be established, and you should be part of that process too. The cost savings means less will be owed to the creditor too. Don't be surprised if, when you approach your creditor, there are new people assigned for the administration of your loan relationship. All products and services you have with the creditor will likely be under the approval of a 'workout department' or assigned to a new team

in the Special Assets Department (SAD). SAD is comprised of workout specialists as opposed to the usual primary relationship officer or relationship manager on the loan production side. The latter may have a potential bias and be predisposed to taking actions that may not be in your best interest as opposed to the creditor's overall best interest. SAD officers are more independent and will have the creditor's interests first and foremost. Having a problem or classified loan in a primary loan officer's portfolio does not fit financially well with this officer. Transferring the credit to another party, like SAD where it makes most sense, this will increase the chance of a faster and more favorable outcome to the creditor. A new SAD officer should be more objective and have more time for you, so seek a mutually acceptable outcome by preparing your own debt repayment solutions. The SAD officer will likely engage with you in good faith and help you get the job done.

Refinance Risk

CRM #33 – Refinance Risk – Refinance risk is when or how likely a debtor is to default on its loan because it is unable to 'refinance' an outstanding balance when the loan comes due, or matures. Obviously, this means that there has been a serious material deterioration of its financial condition, and where other creditors may not be willing to accept the increased credit risk through a refinance. It can also mean that because of changes in interest rates (i.e. increases), and changes in underwriting criteria (i.e., more conservative), the borrower is unable to meet the new requirements upon maturity. The debtor can't refinance and is struggling to repay as it is. This could possibly lead to payment default and collateral liquidation, or high refinance risk. Also, the property's value may become reduced and make it even more difficult to refinance. Lenders will pay close attention to the earlier 'resizing opportunities' before refinance risk increases too far, including: closely monitoring interest rates and market conditions, borrower creditworthiness, upping guarantees, and taking additional collateral. Lenders will determine if outside financing is even possible, if the loan will need to be downgraded, extended with disclosable modification terms, or the collateral even be sold. The borrower may take measures to improve its creditworthiness and the property value, reduce debt levels, increase cash flow, obtain an additional interested guarantor, provide more collateral or guaranty percentage, or offer and negotiate a workout or loan modification. Specifically, these potential issues will have to be faced one way or another:

Higher Interest Rates – Higher interest rates result in likely higher borrowing costs, more difficulty for the borrower to repay or obtain replacement financing, and result in a higher likelihood of default and foreclosure. Possible mitigating strategies for managing interest rate risk is the use of interest rate swaps (exchanging a variable rate for a fixed rate). Interest rates can be capped to limit increases or maximize costs, or have floors that provide a minimum borrowing cost.

Resizing Opportunities – The lender will determine if a commercial real estate loan needs to be paid down or re-sized by considering various factors such as a higher interest rate environment, reduced net operating income due to decreased rents and higher operating expenses, declining economic market conditions, lower debt yield, weak forecast, poor liquidity, uncertain repayment ability, etc. The lender will document the case for a resizing opportunity by using repayment tools like debt service coverage ratio (DSCR), loan-to-value (LTV), debt yield (DY), stressed interest rate sensitivity (showing how a higher interest rate will affect repayment), and propose and document a resizing paydown recommendation. The lender will make it clear that it is putting its interests first, and the borrower's interest second.

Repricing Risk – The possibility a loan may need to be refinanced at a higher interest rate upon maturity. Especially in an economic downturn and high interest rate environment, rates should cover cost of funds, loan servicing, probable loss, as well as a reasonable profit margin. Lenders will also underwrite the borrower's creditworthiness, income, and how much the collateral property value has declined. The lender will confirm root causes behind any deteriorated financial performance, including if the borrower has lost a major client, supplier, employee, major contract, customer, or vendor, etc. The refinanced loan pricing will have to reflect these increased credit risks.

Importance To You –

- *Refinance risk is a big deal, and will likely result in a credit risk rating downgrade* – Your current financial condition, market conditions, the potential timing on a refinance, and other factors may or may not be in your favor for a refinance. Don't be surprised to find your loan risk rating has been downgraded to Special Mention (criticized rating) if refinancing is your only viable option for repayment. This is especially true if your cash flow is just nominal or marginal. Where there's no likelihood of reducing the principal balance, and your refinancing is or was your only option for repayment, your loan risk grade may be lowered to Substandard (classified rating)

- *A warning* – You, and every other borrower the world-over, should pay very close attention to high debt levels and refinance risk. If it almost sounds like a 'warning,' know that it is a warning. If markets were to freeze up, if interest rates jumped excessively, or any number of things, you may not be able to refinance your unpaid loans at maturity. Frankly, the world has way too much debt, it's not sustainable, and new record debt levels are here to stay as far as you can see. Not enough people are even willing to talk about this risk and how it could result in a debt crisis. For these and other reasons, you may find yourself trying to survive in seasons of default and restructuring everywhere, along with the millions of other borrowers that have high debt levels. Please don't ever say you were not warned

Renewals, Refinancing, Extensions, Modifications, Forbearance

CRM #34 – Renewals, Refinancing, Extensions, Modifications, Forbearance – When unpaid loans mature (i.e., balloon payment), the creditor may require a full payoff, renew, or extend the maturity date of the loan for another period of time. It's likely the credit file will be refreshed with current financial reporting, somewhat similar to the original underwriting process. Existing loans may also be refinanced, with or without new money. The debtor may apply for a new loan to pay off an existing loan at another institution (refinance). Perhaps the terms and conditions will be more favorable due to competitive pressures. Or, when a loan matures, a debtor will be fully prepared to simply repay the loan in full. On the other hand, in an economic downturn, a loan might be modified or restructured due to a debtor's temporary adverse financial condition, or possible default. After all, it may be in both the creditor's and debtor's best interest to come up with another repayment solution. Any such modification or forbearance agreement would still need to be prudent. Otherwise, the loan might be liquidated, with or without the cooperation of the debtor. Creditors will always be looking out to see any red-flags that shows the debtor may be experiencing trouble. For consumers, red flags may mean a job loss, the loss of a family member, or a medical or health setback. The loan modifications or workout measures may be installed if the debtor maintains both an ability and

willingness to make repayment. The creditor is supposed to be prudent such that these lending measures or decisions are safe and sound. Loans that are restructured can be have additional borrowers added or substituted, including additional collateral.

Strategies During Serious Economic Downturns, Red Flags – As repayment issues are identified, it's possible for the creditor to enter into a Change in Terms agreement. Or, some other forbearance, modification, or workout agreement can be used to provide temporary postponement of the creditor's remedies to cure a condition of default. The agreements will outline certain conditions the debtor is expected to follow, and if not followed, the agreement automatically terminates. The wording in the agreements will cause the debtor to acknowledge that a default has occurred (and not waived), and may include language that releases the creditor of any potential lender liability. During difficult times, in particular, debtors need special attention, but debtors also need to be empowered to come up with their own repayment solutions. Typical red flags facing stakeholders include the borrower and/or guarantor having insufficient (global) cash flow, delayed construction projects or those that are no longer viable, slow moving inventory and accounts receivable collections, lack of timely financial reporting, loan covenant violations, declining financial ratio trends, excessively high loan-to-value (LTV) ratios on collateral, more competitors, slowing sales and increased expenses, repayment that is dependent on the sale of the collateral, and other well-defined credit weaknesses, or worse.

Partial Charge Off – In other situations where there is reliance on the collateral's value, the portion of the loan that is insufficiently secured by the collateral, and that cannot be supported by the available cash flow, may ultimately be charged off (or charged down). The interest accrual will be placed or remain on nonaccrual status while payments are collected and applied to the principal balance (even though the lender will still show you the total balance and all accrued interest. The remaining portion of the loan balance still on the books will have to be well-supported by documented available cash flow, pro forma cash flow, and appropriate collateral coverage. There are several factors that must be in place before the remaining loan can be returned to interest accrual status. After successive loan repayments have been demonstrated (i.e., six months), it is possible the remaining loan could be placed back on interest accrual. Once the outstanding balance is repaid, payments will be applied as 'recovery' payments towards the unpaid balance of the charged off loan, and ultimately include unpaid interest. The creditor's accounting for the loans, including any charged off portions, is solely an internal accounting matter. As for the debtor, he will continue to get monthly payment statements as if nothing had ever changed. It will appear the same even though there may have been prior charged off amounts, changes to the interest accrual status, etc. Just the creditor will be required to conduct certain accounting procedures for reporting problem loans on the books.

Last Resort Options – In some scenarios, and as a possible last resort, it may prudent to restructure the loan using any necessary combination of 'disclosable loan modification' tools: principal forgiveness, interest rate reduction, other-than-insignificant payment delays and term extensions. A defaulted loan can also be split into two loans, one that's kept on the books, and the other charged off. The latter can be repaid once the active loan is repaid. Customary terminology for this arrangement is 'A' and 'B' loans. Again, the 'A' loan,

legally enforceable, would be that portion of the current outstanding loan that is reasonably assured of acceptable repayment performance per the new terms thereunder. It would be structured such that it would be sufficiently supported by the then current available cash flow. Of course, the 'B' loan is the rest of the original loan not included in loan 'A.' It would not be a bankable asset, and would be charged off the creditor's books. Once the 'A' loan is repaid, however, the debtor can start repayment of the 'B' loan on reasonable terms.

Importance To You –

- *Give yourself plenty of time. But it's time to get to work, now* – Note that timeliness is very important for entering into loan modification, forbearance, or workout arrangements. You know when your loan(s) mature, right? You also know how long it might take for you to prepare a workout plan to the creditor too. It means you having had sufficient time to prepare your financial statements, identify the root causes for the decline in financial performance, and more importantly, the preparation of your pro forma cash flow statement. The pro forma will have to be well-supported by assumptions, since this is future cash flow based on strategic decisions to remediate the weaknesses heretofore experienced. These corrective measures may take at least 30 days in some cases. It may take longer if you have collateral issues, and the creditor has a list of items that he wants or needs too. So, if you have an upcoming maturity and you know you will be having to prepare and present a repayment solution, it could conceivably take up to 45-60 days. So, be ready. What about the time the creditor needs to do its underwriting, approval, and documentation work? There may also need to be a meeting or two, and that could also take a few days. Or more documentation requests from the lender. Realistically, you need 45-60 days, and the creditor needs 30 days. So, you're looking up to 90 days in advance of the loan maturity. It's time to get to work. Do. Not. Put. This. Off

- *How would it feel to be fully prepared?* – We talk about 'empowerment,' you creating your own repayment solutions. In an economic downturn, your creditor may be swamped with deals that need urgent attention. Not to mention that unexpected events may come your way too. You know you're not going to get enough of the lender's time and attention you deserve or want anyway, right? Can you imagine if you, a prepared business owner, came in with a workout package that included the necessary items outlined in these Credit Risk Memos? Do you want to shock your creditor? Okay then. Just come forward with the solution to your own repayment plan. You go in with well-supported key assumptions in your pro forma cash flow statement, and with identified root causes behind the deficiencies recently experienced. And so much more. You present it all within 30-45 days of the maturity date. Talk about building credibility, trust, and transparency. How can you lose? You can't. See it happen in your mind's eye, now

Restructured 'A' And 'B' Notes

CRM #35 – Restructured 'A' and 'B' Notes – Depending on the circumstances, a creditor may seek to remediate a nonperforming loan in default through a formal restructuring. Disclosable modification terms are now available for regulated lenders. These tools, and any combination of which, include: principal forgiveness, interest rate reduction, other-than-insignificant payment delays, and term extensions. The 'A' and 'B' note split option could also utilized where there is a viable repayment source to repay some, but not all the outstanding loan balance. The whole idea for such a restructuring is to recover as much of the outstanding loan balance as possible. This structure may imply that there were extenuating circumstances beyond the debtor's control, or for some other reason, for the creditor to want to stay in the deal. This restructuring is a prudent and reasonable approach to getting repaid as much as possible. A nonperforming loan is formally restructured by taking the loan and dividing it into two separate notes, an 'A' note, and a 'B' note. The 'A' note would equal that part of the original loan that the creditor (and debtor) believes will be fully repaid at the then current market interest rate over the remaining term. In other words, the historical and especially the pro forma cash flow statement will show what ability there is to service debt at the prevailing interest rate, obviously resulting in a new lower principal amount. The debt service coverage ratio should be, say at least 1.2:1. The 'B' note represents the remaining portion of the original loan not included in the 'A' note, and that portion is uncollectible (regulatorily speaking) and must be charged off. The 'B' note would have to receive material concessions such as to not infringe on the repayment ability for the 'A' note. Maybe the 'B' note terms will include a low or even a 0% interest rate, and a deferral of all principal and interest payments until the 'A' note matures and is repaid in full.

Why a Restructured Loan Makes Sense – The goal of the creditor will be to return the 'A' note back to an acceptable risk rating, and to return the accrual status from nonaccrual back to accrual, just like a regular performing loan. This gets rid of, temporarily, the portion that cannot be repaid at this time. That way, there is a restoration of as much of the original loan amount as possible without having to liquidate the entire loan. Again, such a restructuring requires there to be an economically rationale, prudent, and documented basis for restructuring a loan into the two separate loans. If structured correctly, over time, the creditor may be able to return the 'A' note to accrual status as a normally performing 'Pass' risk rated loan, according to the demonstrated financial capacity of the debtor. To do so, the debtor would need to pay some six months of on-time monthly payments, or 12 months of quarterly payments. If the new structure includes too much principal in the 'A' note, it's possible the collectability may be questionable. The 'B' note is charged off due to its being deemed uncollectible, but the terms of its repayment would be such that it would not interfere with the prospects of repayment for the 'A' note.

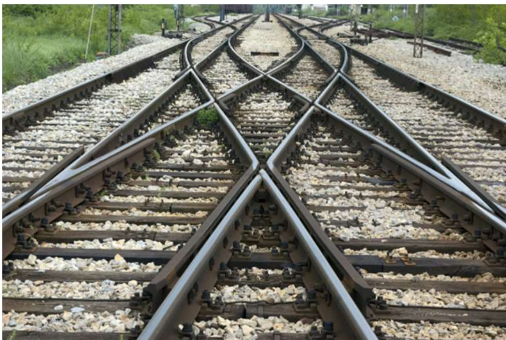
The Debtor is Liable for Both 'A' and 'B' Notes – The debtor is legally responsible for repayment of both notes notwithstanding the restructuring and the charging off of the 'B' note, including the non-accrued interest. Once the 'A' note is repaid, payments due under the 'B' note will commence (unless forgiven), and the creditor will apply the payments as 'recovery' income since it was previously charged off. The restructuring effectively allows the debtor to pay as much of the original note as possible, recognizing that his financial condition resulted in him not being able to adequately repay the entire debt over a reasonable period, but possibly later. Thus, the 'A' and 'B' note structure assisted the debtor by allowing him to remain in business and repay, hopefully, the full amount over an extended period. These actions should also be done to meet the best interests of the creditor.

Importance To You –

- *Formal restructurings will be commonplace* – The global economy is on increasingly on shaky ground and will experience seasons of default and restructuring over many years. Formal restructurings will be commonplace disclosable modification tools, along with 'A' and 'B' note restructurings will be regularly used to meet the adjusted debt service capacities of commercial borrowers. You should become acutely aware of how credit risk is managed by creditors so that you can create your own debt resolution proposals using these tools. You are certainly empowered to do so. By placing special emphasis on your pro forma cash flow statement, you will be able to articulate the projected cash flows to support the highest and most appropriate levels of debt service to also meet your needs. You must make certain the assumptions used in the pro forma are appropriate, well-founded, and fully documented. Again, you are empowered, and you must believe and understand why you're empowered, to negotiate your own repayment solutions with confidence. These tools, including the "A" and "B" note restructuring tool is an effective last resort tool in taking a loan out of its non-performing status and returning an appropriate amount to a performing status

Credit Risk Ratings, Loan Grades

CRM #36 – Credit Risk Ratings, Loan Grades – Regulated lenders apply credit risk ratings or loan grades to business loans as part of a credit risk management framework. The loans with acceptable risk of repayment are rated as Pass, and other ratings are made for loans that exhibit potential weaknesses, and those with well-defined weaknesses, or worse. Delinquency is one of the key credit risk metrics or indicators of a problem loan situation, but that usually comes after several red flag warnings well in advance. The credit risk ratings framework enables management to assign an appropriate 'reserve' amount from earnings against potential losses for a given loan. It is imperative that the credit risk rating system is effective in always assigning risk ratings accurately, and that any necessary changes in ratings are done on a timely basis. Pass ratings often range from, say, one to six, depending on the quality of the Pass rated credit; a loan secured by a Certificate of Deposit (i.e., cash secured) is perhaps the highest quality of a Pass rated credit (i.e., rated 1). Other Pass rated credits will have more credit risk, but are still acceptable (rated 2, 3, 4, 5, and 6). Creditors often include a 'Watch' (W) risk designation which is attached to any rating (i.e., 6W). This means there is an uncertainty that will be followed up on for resolution.



Criticized and Classified Risk Ratings Through Continuous Monitoring – Outside the Pass ratings (rated 1 through 6), is the 'criticized' rating called Special Mention, followed by the 'classified' ratings of Substandard, Doubtful, and Loss. All such loans may be called criticized loans. Primary lending officers have the first line-of-defense responsibility to identify emerging credit risks that might result in a downgrade from a Pass rating, with oversight support from management. Creditors often have an independent 'loan review' function, and outside consultants who will independently review loans to confirm the accuracy and timeliness of the risk ratings. Downgraded loans are regularly reported to senior management and the board of directors of a financial institution. Creditors need to assess the debtor's overall financial condition (i.e., credit quality) regularly. Key repayment sources include the debtor's current and stabilized cash flow capacity, credit report performance, management's character profile, the original loan purpose, current sources of repayment, collateral condition, guarantor support, and payment status. By the time credit weaknesses are identified, this usually results in a diminished ability to make the required payments and

the loan becomes delinquent. Creditors use standardized risk ratings definitions as defined by regulatory agencies (See: FDIC – Manual of Examination Policies):

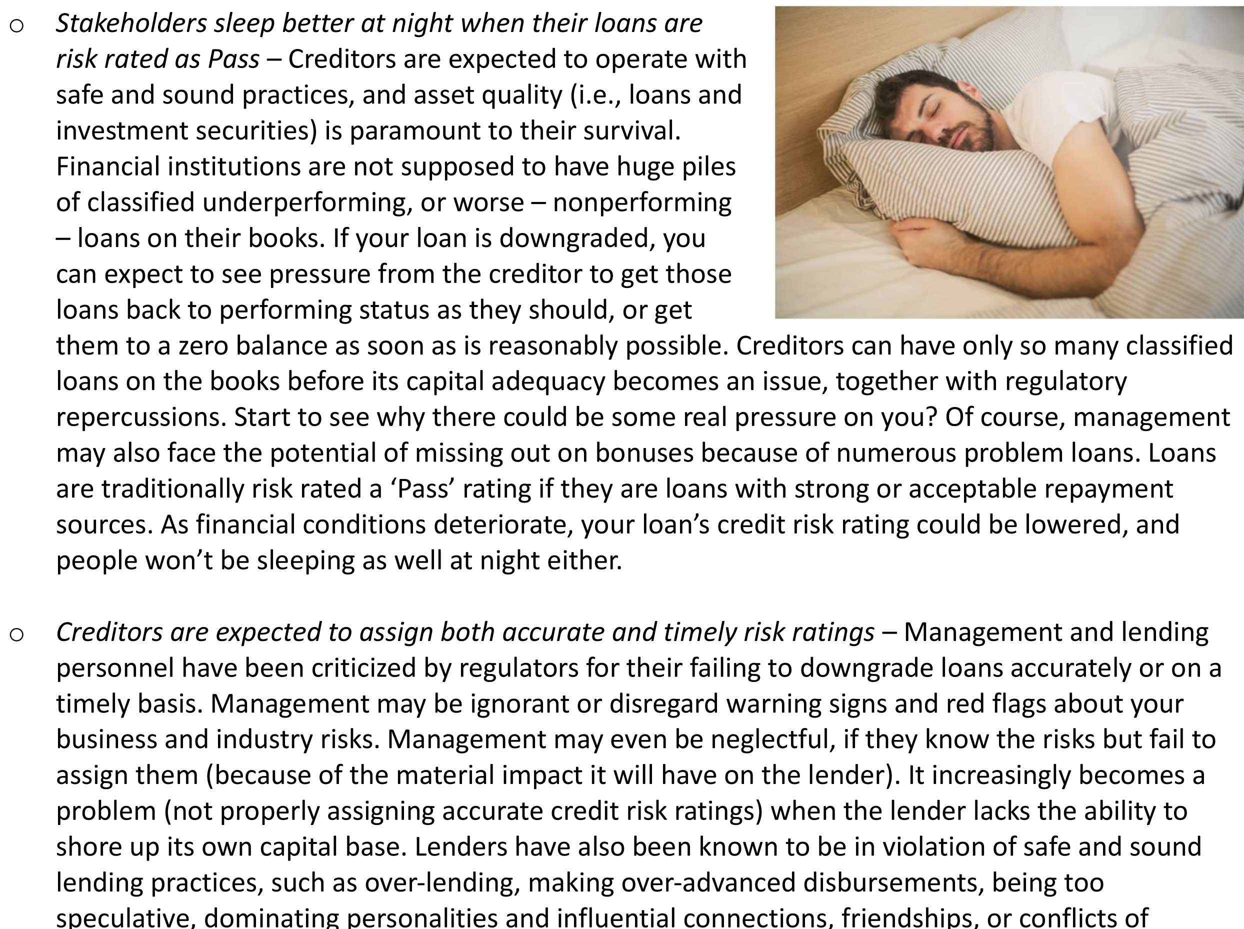
Special Mention – "A Special Mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification."

Substandard – "Substandard loans are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected."

Doubtful – "Loans classified Doubtful have all the weaknesses inherent in those classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions, and values, highly questionable and improbable."

Loss – "Loans classified Loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be affected in the future."

Importance To You –



- *Stakeholders sleep better at night when their loans are risk rated as Pass* – Creditors are expected to operate with safe and sound practices, and asset quality (i.e., loans and investment securities) is paramount to their survival. Financial institutions are not supposed to have huge piles of classified underperforming, or worse – nonperforming – loans on their books. If your loan is downgraded, you can expect to see pressure from the creditor to get those loans back to performing status as they should, or get them to a zero balance as soon as is reasonably possible. Creditors can have only so many classified loans on the books before its capital adequacy becomes an issue, together with regulatory repercussions. Start to see why there could be some real pressure on you? Of course, management may also face the potential of missing out on bonuses because of numerous problem loans. Loans are traditionally risk rated a 'Pass' rating if they are loans with strong or acceptable repayment sources. As financial conditions deteriorate, your loan's credit risk rating could be lowered, and people won't be sleeping as well at night either.

- *Creditors are expected to assign both accurate and timely risk ratings* – Management and lending personnel have been criticized by regulators for their failing to downgrade loans accurately or on a timely basis. Management may be ignorant or disregard warning signs and red flags about your business and industry risks. Management may even be neglectful, if they know the risks but fail to assign them (because of the material impact it will have on the lender). It increasingly becomes a problem (not properly assigning accurate credit risk ratings) when the lender lacks the ability to shore up its own capital base. Lenders have also been known to be in violation of safe and sound lending practices, such as over-lending, making over-advanced disbursements, being too speculative, dominating personalities and influential connections, friendships, or conflicts of

interest. Primary loan officers and others can lose their bonuses, or even their jobs if they have too many criticized loans in their portfolio. You can start to see why creditors may consciously make inaccurate or delayed risk rating calls. That approach does no one a favor, including you

- *When your loan is risk rated Special Mention (SM)* – Loans that are risk rated SM are 'criticized,' but not 'classified.' You should expect more attention and monitoring efforts. The expectation is that the SM rated borrower will return to a Pass rating in the very near future (i.e., months), or it will deteriorate further and become a classified loan (i.e., Substandard, or worse). But SM is really a transitory rating of sorts for a shorter period of time. The rating is expected to be upgraded to Pass or downgraded to SUB, but not endlessly sit as a SM rated loan. SM rated loans get management's special attention, as uncorrected credit risk may result in deterioration of repayment prospects. So, creditors are going to be asking more questions and for more financial information. They will review and adjust inadequate loan documentation, review the condition and/or control over collateral, declining economic or market conditions, or declining trends on your balance sheet and income statement. Are you going to cooperate or not?

- *When your loan is risk rated Substandard* – Loans that are risk rated Substandard (SUB) are 'classified' loans. This rating is another story altogether, and this is where it gets very serious. Insufficient cash flow is the standard reason for the SUB rating, and this underscores why you need to be armed with your pro forma cash flow statement, a month-by-month projection for 12 months showing what the available, though insufficient, cash flow will be for repayment purposes. The Promissory Note and Loan Agreement will likely need to be modified, or a Change in Terms Agreement negotiated and signed to reflect necessary adjusted terms. This may include a change in payment amount, the timing of payments, a reduced interest rate, payment deferral, or an extension of the maturity, etc. The negotiations may also include addressing violated loan covenants, taking additional collateral or any other type of agreement to shore up the creditor's repayment sources. Ideally, you will want to negotiate your repayment well before it (i.e., 45-90 days) becomes a SUB classified credit. Depending on the severity of the repayment sources, the accrual status may remain on accrual, or be changed to nonaccrual

- *When your loan is risk rated Doubtful* – Loans that are risk rated Doubtful indicate that the credit has deteriorated to the point there will be 'loss' in the repayment of the loan balance. The loan will be placed on nonaccrual and the creditor will no longer be taking interest income on the loan. This rating means that because of certain unknown factors that may strengthen the credit or work to its advantage, the amount of loss cannot readily be determined at that time. But, as soon as those factors are figured out (i.e., like a new appraisal, liquidation proceedings, capital injection, taking additional collateral, verification of environmental risk, or even a refinance at another institution), a loss amount can then be determined. Depending on the circumstances, it is possible a percentage of the loan can be risk rated SUB, another percentage as Doubtful, and the rest rated Loss

- *When you loan is risk rated Loss* – Loans that are risk rated Loss are uncollectible, are no longer 'bankable' assets. The loan balance must be written off in the period it is deemed to be uncollectable. That doesn't mean you no longer owe the money. It is to the contrary. Unless and until it is formally and legally discharged, or otherwise repaid, it is still owed, interest and all. Creditors will make every effort to collect as much of the loan as possible, even if it is internally

charged-off as a loss on its books. Creditors collect 'recoveries,' monies from loans previously charged off, all the time

- *Understand what these credit risk ratings really mean* – Here's the point. You need to understand what these risk ratings mean. You can ask the creditor what your loan is risk rated, or its loan grade. It will change from time to time as your credit risk changes. But, understanding these ratings will help you understand what is happening with the creditor. And regardless of the risk rating, Pass through Loss, your Promissory Note and unconditional and unlimited individual guarantee, will require full repayment regardless of the internal risk rating and accounting. The creditor's system will be able to produce a statement showing your loan payment status, including all interest, fees, and costs, owed, anytime

Credit Risk Memos (CRMs) – Loan Types

Agricultural (Ag) Loans

Agricultural (Ag) Loans – Ag loans finance the production of livestock, crops, fruits, and vegetables. They also are used to finance the farmland, machinery and equipment for its operations, and other improvements to the operations. Short-term loan types include production loans (seed to harvest and sale); they fund feeder livestock loans to purchase cattle, hogs, poultry, sheep, until they are mature, slaughtered, and sold. Intermediate term loans include breeder stock loans to fund purchases of beef and dairy cows, sheep and poultry, and repayment based on the offspring of the stock animals or their milk or egg production. Long-term loans are made to acquire the farm real estate and the permanent improvements for its operations.

Ag lending faces material risks that may result in the need for material modifications to effectuate repayment. These risks include the prices for commodities (i.e., dairy or beef prices), and weather conditions (too wet to plant or harvest, or drought). These risks do happen and there's little that can be done to stop it. Prudent restructurings will be necessary and should not be criticized by regulators. Carryover loans are made to satisfy short-terms loans that cannot be repaid as agreed, and are expected to be amortized over an intermediate period. Depending on the available collateral and the borrower's overall debt service capacity at the time, the ability to repay may be jeopardized. Workout plans are established to not only help the borrower, but to minimize loss to the creditor.

Asset-Based Loans – Accounts Receivable (A/R), Inventory

Asset-Based Loans - Accounts Receivable (A/R), Inventory – Asset-based lending is generally used to fund rapid growth, fund working capital needs, and take advantage of purchase discounts. The primary repayment source is the conversion of the pledged assets to cash, however, the lender expects the debtor's business to be performing well, as collateral liquidation is the last resort. Receivables and inventory are generally pledged as collateral ("blanket lien"), to protect the creditor's interest with predetermined collateral criteria outlined in a borrowing base. Creditors can get a higher-yield loan as to the perceived credit risk of the borrower, and generally includes a depository relationship too.

A/R financing is a specialized revolving line of credit, and structured such to represent the credit risk (repayment ability) of the cash flows. Financial reporting is paramount and includes borrowing base certification (BBC) of compliance, with operating and cash flow statements. The BBC is a detailed analysis of the accounts receivable and inventory to ensure there are sufficient quality assets to protect the outstanding balance and any advance requests. In other words, the line of credit balance fluctuates depending on the amount of available assets that secure the loan at any given time. Depending on the risk

profile, a BBC may be required quarterly, monthly, weekly, or even daily reporting (for funding). If a line of credit, having a BBC, is determined to be over-advanced, a principal payment will be required to return the outstanding line balance back to a conforming basis based on the eligible collateral. The creditor will also focus on the trends of working capital, and carefully analyze the turnover ratios of the accounts receivable and payable, as well as the inventory turnover ratios.

Creditors will quickly recognize deteriorating financial performance, and are prepared to begin liquidation of the collateral assets, if necessary. If future advances cease, the collection of accounts receivable, and the sale of the inventory will be used to paydown the subject loan until repaid (self-liquidate). Obviously, such actions will result in the business likely going out of business or filing a bankruptcy petition. When a debtor is in serious financial condition, it is possible the accounts receivable debtors will react with their own disputes, and collection in full may become more impaired. Before these measures take place, however, the creditor will have likely taken steps to remediate any problems before liquidation becomes necessary.

Creditors will be closely monitoring the 'excess availability' in the credit line, as the more margin there is, the better the chance of servicing the loan. The accounts receivable and inventory can generate only so much available borrowing on the line, and those trends will indicate the assigned rating and level of monitoring necessary to protect the creditor's interests or position. Financial performance covenants may be installed, which if violated, may result in a condition of default, and trigger remediation measures. The covenant structure will likely be made based on an initial credit analysis using projections. These projections will show the availability under the line at the creditor's loan policy advance rates, to satisfy working capital needs.

Creditors will also regularly review, or require an independent audit of the accounts receivable and inventory to ensure their authenticity and collectability. The audit scope will include verification that the information on the BBC is reconciled to the debtor's financial recordkeeping, and many other controls. Some of the standard criteria for determining acceptable collateral for the BBC include eligible accounts receivables that carry an acceptable degree of credit risk. Ineligible receivables may include delinquent accounts over 60 days past the invoice date with 30 days repayment terms, or 90 days past invoice date; government receivables (not assignable), foreign account debtors, retention amounts, contra accounts where the borrower sells to and purchases from the account debtor; affiliate accounts where sales are made to an affiliate company (i.e., common ownership); and concentration accounts where a large percentage of the receivables is sold to one, or to just a few accounts. Inventory advance rates on finished inventory will also be determined, typically from zero percent to as high as 50 percent or more, with an eye on its liquidation value. Audits of the inventory will confirm the degree of obsolescence (i.e., no longer in demand), seasonal goods, oversupply, or raw materials and finished goods that are difficult to get rid of.

Creditors and debtors want the line to function as per the Asset-Based Loan Agreement, else the financing may not be in place for the business to continue its operations. Should a loan covenant be violated, the creditor has the option to waive the violation or give the borrower more time to take appropriate action to cure the default. Creditors will likely inform the debtor in writing as to any violations. Failure to do so, and if the line is canceled without proper notice by the lender, the creditor be may inconsistent in its actions and potentially become subject to lender-liability.

For the lending relationship to be successful, the creditor will likely require monthly detailed accounts receivable aging reports to determine eligible receivables, and possibly a lockbox arrangement to control

the collection and receipt of the receivables paid directly to the creditor. If the receivables turnover slows down it could mean there's a deterioration in the quality of the accounts. Debtors will likely know the financial condition of account debtors through their own underwriting criteria to help ensure collectability and quality.

Commercial and Industrial Loans (C&I)

Commercial and Industrial Loans (C&I) – Commercial and industrial loans are made to legal entities and may be the most significant assets of a financial institution. They are often secured or unsecured and their maturities may be short or long term. They are not real estate or consumer installment loans, and their purposes cover a wide range of borrowing needs, including a business' short-term working capital (i.e., seasonal) needs to finance accounts receivable and inventory, manufacturing, retailing, etc. Term loans are granted to finance capital assets or equipment, and the assets are typically taken as collateral.

Commercial Real Estate (CRE) Loans

Commercial Real Estate (CRE) – Owner Occupied (OO-CRE), Non-Owner Occupied (NOO-CRE) – CRE financing is generally considered to be permanent financing generally for the purchase of the real property. This could mean a long-term mortgage loan to finance a commercial building, with financing terms having a 10-year maturity with a 20 to 30-year amortization, with a balloon payment due at maturity in 10 years. The interest rate may be variable or fixed, and possibly fixed but adjusted every five years. The primary repayment source will be the borrower's ability to repay (i.e., cash flow), and the secondary source of repayment will be the value of the underlying real estate collateral. If the real estate is owner occupied, the cash flow will come from the operating income of the owner's business onsite. If it is non-owner occupied, the tenant rental income will serve as the primary repayment source. The loan structure will specifically limit the advance rate (i.e., 75% loan-to-value) to protect the creditor's interest.

CRE loans may also comprise a major portion of the institution's loan portfolio in terms of dollar amount. One concern is whether real estate values have decreased from the original appraised value. Markets can become overbuilt, experience adverse economic conditions, or be subjected to a high interest rate environment. Creditors are also going to pay close attention to the number of building permits being issued for new construction, absorption rates, employment trends, vacancy rates, cost, and valuation trends in determining their appetite for CRE lending. Markets are sensitive and projects must make economic sense. Headaches can be caused by construction delays, rent concessions, slow sales of built out units, cost overruns, etc. Another concern may be where a creditor lends against an ill-conceived CRE project with a high loan-to-value (LTV) ratio.

Construction Loans: Residential, Commercial

Construction Loans: Residential, Commercial – Construction loans are short-term, and used to construct a project with specific time and cost constraints. The primary repayment source will be permanent financing, whether it's being provided by the construction lender. The lender will also underwrite not only the subject project, but the contractor too; essentially all parties to the project will be subjected to verifying their expertise, financial condition, as well as their character and reputation in the marketplace. A wide range of projects are traditionally financed including office buildings, condos, apartments, shopping centers, and hotels. The project will be underwritten to be successfully managed, constructed, marketed, and include a feasibility study and appraisal. The study will analyze the supply-and-demand factors that will affect the project's absorption rate. The subject property serves as collateral, secured by a first lien position.

A construction loan budget will itemize each of the direct/hard and indirect/soft costs, interest, and contingency reserves, for the proposed improvements. The interest reserve will be used to cover interest payments during the construction period and until the construction loan is repaid, project is sold, or reached stabilization. A contingency reserve will be a reserve to cover unforeseen costs. A contract for the improvements will be executed between the debtor and his General Contractor, which shows the start and completion dates, construction draw request schedule, third-party inspections, payment terms, and lien waivers for each draw request. The stakeholders execute a construction Loan Agreement and other documents to control the project, such as recorded Deed of Trust, title insurance, property survey, environmental impact, takeout commitment, completion, or performance bond, etc. It must be finished according to the construction plans, on time, on budget, with sufficient time for the permanent take-out financing.

Residential construction loans are made on a speculative basis, or for a specific buyer with a permanent take-out financing commitment. Construction loan administration will involve loan disbursement (i.e., progress payments), construction draw requests, inspections, inventory lists, lot release schedule, and interest reserves for interest-only payments.

Think 'on time, and on budget.' If it goes that way, fine. If it doesn't, there's going to be trouble. Only when the project is finished will the real estate become marketable; until then, the value is questionable. Strict controls for disbursements (payment) and collateral margins can be expected. Should default occur, the creditor will likely be in position to complete the project, and must deal with mechanic and materialmen liens, unpaid property taxes and possibly other judgments.

Consumer Loans

Consumer Loans – Installment loans, made to consumers for auto purchases, household appliances, home improvements, debt consolidation, are generally smaller loans with fixed or variable interest rates, and amortized for one to five years. These loans may be secured or unsecured. Such retail lending may result in there being an installment loan portfolio consisting of many small loans, or even loans purchased from retail merchants, and will require a loan application, credit check, and possibly collateral. Indirect installment loans are known as dealer loans or dealer paper (i.e., purchased indirectly from a car dealer). Such loans are either purchased with or without recourse to the dealer should the borrower default.

Underwriting considerations may include a maximum debt-to-income ratio, of say, 40% of a debtor's gross income for monthly recurring debt service. If a debtor needs a co-signer or co-maker to make the deal work, the loan becomes less attractive to the creditor. Usually there's a minimum personal credit score that is required, say 700 or so, to get the best interest rates. The lower the credit score, the higher the interest rate. Debtors usually need to have at least a couple of years on the job to qualify to help ensure the reliability of verified and sustained income. It helps to have lived in the community over the long-term, and have limited unsecured debt like credit cards. Certain consumer laws are also in place to help ensure fair lending and non-discrimination.

Home equity loans are typically junior lien secured loans whose credit limit is capped by the amount of equity the borrower has in its residence. The structure may be that of a closed-end second mortgage, fully disbursed at closing, and repaid over many years. It may also be structured as an open-end revolving line of credit. The interest rate is generally variable and the terms can be flexible (i.e., interest only or revolving feature for several years, followed by an amortization repayment period). Traditionally, such loans were extended for the purpose of making home improvements without a revolving feature. The proceeds of such loans are now used for nearly any purpose. Extended repayment terms and liberal loan structures can increase the risk of default. Changes happen that can jeopardize the prospect of repayment, including a depressed economic environment, a spike in interest rates, a loss of a job or a change in marital status. The initial underwriting may be that the combined loan balances of the first and second liens don't exceed 75% of the appraised value; this will leave a 25% equity cushion to protect the creditor's interests. A minimum threshold will also be set on total debt service coverage, and the debtor's debt to income ratio to qualify.

As credit risk increases, the creditor may be willing to offer extensions, renewals, and workout modifications. Debts not collected will be charged off once the collateral has been liquidated. If foreclosure were necessary, the junior lienholder would be responsible to payout or debt service the senior lienholder, which would increase the junior creditor's exposure. If there was insufficient equity, the junior loan would be in jeopardy of being foreclosed out of the picture.

Credit Cards

Credit Cards – Credit cards are used in lieu of cash for sales or services rendered. Amounts repaid in full each month generally don't incur a service charge, and unpaid balances are repaid with monthly payments with expensive service charges. Cash advances are also available at a high cost. Credit lines are supposed to be carefully managed and match the repayment capacity of borrowers using proven credit criteria. Creditors should carefully control 'authorizations' to ensure over-limit practices are properly managed. Minimum payments are offered as creditors seek to have debtors maintain outstanding balances. If payments are not paid timely, it's possible the total payments, including late charges and fees, will overwhelm the borrower's ability to repay, and result in delinquency. Debtors are expected to make payments sufficient to amortize the balances over a reasonable period. Workout plans will likely require full repayment within five years.

Desirable, Undesirable, Prohibited Loans

Desirable, Undesirable, Prohibited Loans – Often, depending on economic conditions (i.e., recessionary vs. expansionary), creditors will be prescriptive in outlining the types of deals that they want to grant, or prohibit. Creditors seek to lend in a safe and sound manner, not discriminate, and make prudent lending decisions on loan requests in their target or service marketplace. Desirable loans may include loans that are appropriately secured with collateral in a senior or first lien position. Some creditors seek real estate secured loans and others do not. Marketable securities are also used to secure loans, and even cash-secured loans. New vehicles loans are desirable, as well as home equity lines of credit. Asset-based lending and other short-term loans are also desirable.

Loans that are undesirable may include loans to start-up companies, and those with collateral that is older, and not readily marketable. If the primary source of repayment is the sale of the collateral, such loans are also discouraged. Creditors have been known to lend based on the strength of the guarantor, as opposed to the business, but those loans are also generally less desirable. Creditors may also want to have lending relationships that include depository accounts and may avoid 'transactional' only borrowings, loans that will be expensive to service, and those where the creditor can't reach certain debt yield requirements. Other loans less desirable would be those secured by a junior lien position, or where the debtor has a partial ownership in the collateral.

It may be obvious, but some creditors will not lend money under certain conditions. Character is usually atop the list, and if a client is deemed to be dishonest or lacks sufficient integrity, the lending decision will likely be negative. Speculative lending on stocks is not generally acceptable, or are loans secured by restricted stocks. The creditor may have a certain loan size limit due to capital constraints and therefore lending limits will apply. Clients that are in bankruptcy or have recently been in bankruptcy may also not be granted credit. It should go without saying, but loans for illegal purposes or transactions, including predatory lending, will likely be prohibited.

Equipment Loans

Equipment Loans – The general purpose of term loan financing is for the acquisition of long-term assets, with longer-term maturities of more than one year, with a fixed or variable interest rate. Term loans can be used to amortize the balance of unpaid revolving lines of credit too. Cash flow over multiple operating cycles is the generally the primary repayment source. Collateral, the secondary repayment source, is often required due to the long-term maturity. Interest is generally paid monthly or quarterly. The term of the loan will be less than the remaining useful life of the collateral. The loan structure will likely include certain loan covenants, measured regularly, and require the borrower to meet certain financial performance thresholds and financial reporting expectations.

Land Acquisition and Development Loans

Land Acquisition and Development Loans – These loans are generally made to investors and speculators, and are used to acquire the land for development (i.e., land preparation, utilities, road construction, building lots), for eventual construction, or to sell the property at a future time. Land development financing will include a development plan with cost budgets, legal expenses for permits, environmental studies, utilities installation, etc. The LTV will be such as to provide an adequate margin to account for unplanned expenses and protect the creditor. The value of the land will be based on its highest and best use, and on an ‘as-is’ basis, and possibly the ‘as completed’ basis. Repayment structure may follow the development and sale of the land. Normally, additional sources of repayment will be required due to the speculative nature of the transaction.

Letters of Credit

Letters of Credit – A letter of credit is provided by a financial institution acting as an intermediary, and used to facilitate a transaction between a buyer and seller of goods. It is used to facilitate the payment of those goods. Such letters of credit are often used for international trade as there are different legal and banking systems, etc. Essentially, a financial institution is committing to pay, typically on an irrevocable basis, for the goods on behalf of its customer, which gives the seller comfort that it will be paid for delivering the goods. Generally, the buyer and seller of goods are not that familiar with each other. The buyer’s financial institution will be used to guarantee payment to the seller once there is appropriate documentation showing the goods have been shipped and title has transferred. The buyer’s financial institution is then required to make payment to the seller, and the institution is reimbursed by the institution’s ‘buyer’ customer together with a fee.

Lines of Credit

Lines of Credit; Working Capital Loans – Working capital loans provide liquidity for seasonal operations on a short-term basis, and finance the business’ operating cycle. This starts with the acquisition of raw materials, the creation of products, sale of the inventory and the collection of any accounts receivable. Businesses will use these lines of credit when their operations are seasonal or there are peaks in current assets or current liabilities such as the holiday season, or manufacturing closing over a particular season. Lines of credit are structured on a revolving basis, mature, and subject to renewal each year.

Interest payments are generally due monthly or quarterly, with any unpaid interest and principal due at maturity. A ‘cleanup’ period to bring the balance to a zero balance at the low end of the operating cycle for a period (i.e., 30 days) is often required. ‘Resting’ the line of credit, unless the business is in a material growth phase, helps ensure the borrower is not dependent on the lender for permanent financing. Loan advances may have certain restrictions and repayment is usually based on the conversion of current assets

(inventory, accounts receivable). Hence, the repayment source is closely tied to the borrowing cause or purpose.

Working capital lines of credit can be misused too. Businesses that are experiencing losses may use the line of credit to finance operating expenses, debt service or other costs, and not use the line for its intended purposes. Another misuse would be to use the line to finance long-term assets, like equipment. A term loan facility is to be used for long-term assets. Trade creditors, or accounts payable, are also expected to be paid on a timely basis, and some debtors will use the line of credit to pay trade creditors who were not paid out as originally expected. If the value of inventory declines, or the accounts receivable are uncollectable, the borrowing base may be insufficient, and the outstanding balance may become over-extended. If an unpaid balance exists at maturity, the creditor may extend the loan to be amortized over a reasonable period, demand repayment in full (i.e., refinance at another lender), require an infusion of capital into the business (if possible), or liquidate the collateral if it can be determined that the business is no longer viable.

Overdrafts

Overdrafts – Overdrafts include a pre-established line of credit used as overdraft protection to cover a check that would otherwise cause the checking account to be overdrawn. Creditors also provide overdraft protection with discretionary coverage of a customer's overdrawn account for an overdraft fee; this fee is referred as an NSF fee, or non-sufficient fund fee. Creditors consider the NSF fee income as non-interest income, but such activity may not be encouraged as it may possibly set an unwarranted precedent. Such protection is an extension of unsecured credit to the account holder. Lending personnel closely monitor overdraft activity, as it may indicate that the customer or debtor may be experiencing financial difficulties.

Participation Loans: Sold, Purchased

Participation Loans: Sold or Purchased – A loan participation is where the ownership of a loan is split between the originating lead institution and another lender, or groups of financial institutions and entities. For example, take a 50% transferred interest; this means that there has been a 50% participation sold (agent institution selling that portion), and a 50% participation purchase (purchasing bank). The lead institution will be the agent institution and manage the loan relationship for the benefit of the parties who hold a participation interest. The lead institution is responsible for maintaining and keeping possession of the documentation in its own name, servicing the loan with all reporting, payments, contacting the borrower, and the receiving of financial data, etc. The information is communicated to the other parties who own a portion of the loan.

Such participation purchases are done where the buying institution needs to acquire loans when loan demand is slow. When a borrowing relationship exceeds the lending limits of a creditor and becomes too large, and to maintain a relationship, the lead institution will sell an interest in the loan to another lender as well. In any event, the purchasing institution is responsible for doing its own due diligence underwriting for

the deal as if they were originating the credit themselves. Such agreements are generally made on a non-recourse basis (can't collect from the lead institution if the borrower defaults), even though the lead is responsible for servicing the loan.

Single Family Residential (SFR) Real Estate Loans

Single Family Residential (SFR) Real Estate Loans – Residential lending for single family dwellings is long-term financing using the subject property as collateral. Underwriting includes an evaluation of the borrower's ability to pay the mortgage payments, taxes, insurance, and all other loan obligations and home expenses in relation to its income. Private mortgage insurance may also be charged if the LTV structure is too high. The current market value of the collateral is usually based on an appraisal, or an 'evaluation' of the property if the loan transaction is less than $400,000.

Small Business Administration (SBA) Loans

Small Business Administration (SBA) – U.S. Small Business Administration (SBA) has lending guarantee programs for small businesses that are 50% to 85% guaranteed by the U.S. government in the event of default. Approved lenders can issue a variety of loans, including 7(a) loans (working capital loans), CDC/504 loans (owner-occupied commercial real estate loans), CAPLines (revolving lines of credit), export loans (exporters), and microloans (small working capital loans). The SBA also administered the recent COVID-19 relief loans (paycheck protection program loans, disaster loans). Absent the U.S. government guarantee, it is unlikely financial institutions would be able to lend to these debtors due to an insufficient down payment or collateral, low interest rate, and longer repayment periods. SBA loans are not set up with conventional underwriting terms and conditions. The paper-work and technical requirements must be strictly adhered to for the SBA to stand behind its guarantee. It is typical to take at least 30-90 days to close some SBA loans.

SBA 7(a) loans – Commonly extended to start-ups and established businesses needing to expand, but with experienced business ownership with excellent credit. The purpose may include working capital, refinance existing debt, leasehold improvements, business purchase, real estate, or equipment. Terms range from 10 to 25 years, and rates are generally variable. As little as a 10% to 20% down payment is required.

SBA 504 loans – Made to finance the purchase, construction, renovation of owner-occupied commercial real estate (CRE), or purchase of fixed assets. The loans involve two lenders, a Certified Development Company (CDC) and a financial institution. The lender's portion of the deal funds up to 50% of the loan, and the CDC lends up to 40%, and the debtor contributes just 10% - a 50/40/10 split. The debtor will need to occupy at least 51% of the CRE and the rest can be leased out. Repayment terms may extend up to 25 years.

Standby Letters of Credit

Standby Letters of Credit – A standby letter of credit is generally unsecured and is the lender's commitment to pay a certain amount to a beneficiary of one of the financial institution's customers upon certain performance requirements. A beneficiary may need to ensure that the lender's customer can deliver certain goods or services by a certain time, quality, etc., and will get from the lender's customer a standby letter of credit. If the lender's customer fails to deliver, payment will be paid from the standby letter of credit. Non-financial standby letters of credit are also issued as performance bonds to ensure payment for the completion of building or construction contracts in the event a contractor is unable to deliver on his contract.

Unsecured Loans

Unsecured Loans – Unsecured lending is based on the financial strength of the obligor, its strong credit history, character, earnings potential, and liquidity – the value of any collateral is not necessary or required. Certainly, the character or integrity of the debtor or owner guarantor will need to be paramount for unsecured lending. It is presumed that the debtor will be able to repay the unsecured loan on the prescribed terms and conditions, because if its financial condition deteriorates, credit risk, or the lack an ability to repay, increases. The creditor will require the debtor to maintain appropriate (i.e., current, accurate) financial information on file always to help ensure the prospect of repayment is maintained. This documentation may include financial statements, bank statements, tax returns, etc.

Creditors will expect an unsecured debtor to have adequate global cash flows as verified on its tax returns and bank statements. It must have the capacity to service all debts at a reasonable level. That capacity should show the ability to amortize the debt over just a few years, as well as cover living expenses and taxes. It's likely there will be a limit as to a borrowing amount as a percentage of the debtor's tangible net worth, say 20%. There may also be a 'resting' period of 30 days to clean-up a line of credit at a zero balance. Unsecured revolving lines of credit are granted to both individuals and businesses.

Addendum #1) The Debt Crisis Problem

20 Risks That Will Soon Fuel a Serious Economic Downturn

NCARA.org, and tunbudget.com believe there will be a debt crisis here in the US in the near term, for several reasons (see the 20 risk events below). These risks outline the reasons for this crisis because of never-ending deficit spending at every level, everywhere, including consumers, businesses, and governments. The spending (debt) for these risks will ensure large structural deficit spending leading to a debt crisis that 'no one' wants to talk about or do anything about. As a result, overall debt levels are at overwhelming levels and are certainly not sustainable. While these risks are depressing in nature, they still need to be transparently debated so informed decisions and debt repayment solutions can be prepared. Otherwise, we have no one to blame but ourselves. So, bear with me – this is just the 'downside' case being made. The Tunabudget Solution, and Debtor-Proposed Repayment Solutions, provide the right answer to mitigate the effects of the downside case. These tools will help address the needs for small business (see NCARA.org) and the consumer (tunabudget.com). Finally, 2024-25 will be the beginning of times the likes of which we the people will hardly recognize. Things are going to change – big time. In plain English, enjoy this summary of 20 risk events that will soon fuel a serious economic downturn and debt crisis.

#1 – National Debt Levels

USA (USdebtclock.org, Rounded, January 2024)	January 1990	January 2000	January 2004	January 2008	January 2012	January 2016	January 2020	January 2024	January 2028
Total Unfunded Debt (Trillions)	$14	$27	$38	$51	$57	$68	$82	$97	$109
Federal (National) Debt (Trillions)	$3	$6	$8	$11	$16	$20	$27	$34	$46
Personal Debt (Trillions)	$5	$9	$13	$17	$16	$18	$17	$25	$28
Mortgage Debt (Trillions)	$4	$7	$11	$15	$13	$15	$16	$21 (e)	$24 (e)
Credit Card Debt (Trillions)	$0.7	$0.7	$0.8	$1.0	$0.9	$1.0	$1.0	$1.3	$1.5 (e)

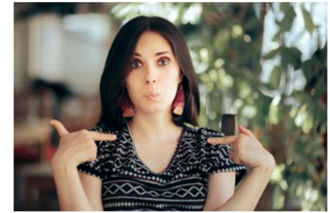
- America's collective debt burden will increase and become unsustainably burdensome. The recent debt metrics are alarming, especially when we add in the US Government's unfunded obligation of $97 trillion (soon to be $109 trillion) for entitlement spending

- 37% of Americans lack enough money to cover a $400 emergency expense; for non-emergency expenses, 18% of Americans said the largest expense they could cover using only their savings was under $100

- Just 24 years ago, in 2000, the total debt per tax payer was $53 thousand; it is now $264 thousand, and soon to be $332 thousand

- There will be other disruptive risk events that will be widely felt between now and sometime through 2025; the result will be a debt crisis

#2 – Consumer Debt Spending



- We the people have become less disciplined, more selfish, and have a plastic ‘buy it now, pay it later’ attitude. We have a ‘covetous’ desire for more wealth and possessions, especially for automobiles and larger homes. With that came large installment and mortgage debts, and a more and more, and a me, mine, myself, mindset has set in

- In 2000, mortgage debt totaled $7 trillion, and just $4 trillion 10 years earlier in 1990. Today, mortgage debt is $19 trillion, a 271% increase in just 23 years. Similarly, total personal debt, which includes mortgages, increased from $8 trillion in 2000, to $25 trillion in 2023, a 313% increase, expected to increase to $27 trillion in the next few years

#3 – Deficit Spending

2031 (e)	$2.3 trillion	2026 (e)	$1.7 trillion	2021	$2.8 trillion
2030 (e)	$2.1 trillion	2025 (e)	$1.8 trillion	2020	$3.1 trillion
2029 (e)	$1.9 trillion	2024 (e)	$1.6 trillion	2019	$984 billion
2028 (e)	$1.9 trillion	2023	$1.7 trillion	2018	$779 billion
2027 (e)	$1.7 trillion	2022	$1.4 trillion	2017	$665 billion
2027-31 (e)	$9.9 trillion	2022-26	$8.2 trillion	2017-21	$8.3 trillion

- The annual trillion-dollar plus deficit spending from 2020 through 2031 totals $24 trillion in new debt in just 11 short years

- One honest question to ask is how will the debt be funded, or at what cost? The US Treasury will need to issue new debt instruments to cover these deficits. But, unlike the past when interest rates were much lower, what interest rate will investors bid at the upcoming Treasury bond auctions, not if, but when they finally come to realize that such deficit spending is not sustainable?

- The US Government is going to have to print even more new monies to cover its gargantuan deficits, besides the rolling over of trillions of low interest rate bonds at higher interest rates. Interest rates will also continue to remain high for even a longer period, which will exasperate the cost of serving existing debt

- The deficit spending addiction the US is experiencing can only result in a debt crisis, because it has not been nor is it sustainable. Hardly no one is willing to talk about it, because most know that the fix is in. We the people cannot make it without relying on debt

#4 – Debt Crisis

- The debt load is too heavy. The pending debt crisis is probably the most predictable crisis event society has ever seen, but nobody can see it, or they do see it, but refuse to even talk about it

- A debt crisis could lead to a depression (severe economic downturn). Since 2000, the debt/GDP ratio has increased from 56% to 122% in 2024. That is an increase of 217%. It is increased two-fold in just 23 years. Does anyone believe that the US Government will cut its spending, ever? It cannot stop at this point without triggering an economic crisis

- The massive build-up in public debt is not sustainable. How in the world will any meaningful amount of the debt be repaid, or even serviced with interest-only payments, given higher interest rate environments that will come? Deficits can’t go on like this

- US Government leaders and officials, I believe, are not serving the interests of the people, but rather, are being political and even misleading America

- If you look back to the Great Recession in 2008, where were the economists arguing or pointing to a pending recession or even a depression; officials later confirmed a depression was averted?

- What are the chances we could be on the brink of another Great Recession or depression? After all, we have just been living off a giant credit card that is unsustainable, and a debt crisis is closer than ever

#5 – Inflation / Stagflation

- In response to the Covid19 pandemic, the US Government spent roughly $5 trillion which contributed to strong economic demand in a period of supply chain disruptions. This, and the tight labor markets created upward pressure on wages and prices, along with other events

- In the 2020-23 period, inflation gained traction at 4.2% in 04/2021, increasing to 9.1% in 06/2022, and falling to 3.4% in 12/2023. Interest rates were increased 15 times during this period to bring down inflation

- Taking the average inflation rate from the 2021-2023 timetable, you would have 4.7%, 8.0%, and 4.1%, respectively. For example, if you have $1 price in 2021 at an average 4.7% inflation rate, at the beginning of 2022 the higher price starts at $1.05. Adding another 8% for the second year pushes the price higher to $1.13 at the end of 2022. Adding another 4.1% inflation for the third year pushes the price higher to $1.18 at the end of 2023

- When the next event takes place, many more people will start to realize the US Government will just spend trillions more, and we would likely see more or heavy inflation

#6 – High Interest Rates

- The Fed Funds rate was kept purposely low at or near 0% from 12/2008 for the next 10 years, peaked again at around just 2% in 07/2019, and then dropped back to near 0% in 04/2020 at the time when the Covid19 pandemic picked up. In my opinion, the 10-year period of ultra-low interest rates was not warranted. The Federal Reserve Bank politicized its monetary policy by not raising rates sooner. I believe interest rates were intentionally kept low to stimulate the economy 'much longer' than was needed

- The Covid19 panic helped fuel an asset bubble in housing pricing, together with trillions of dollars in deficit spending and more stimulus. This created inflationary pressures, where in 06/2022, US inflation hit a 40-year high. I would argue that the Federal Reserve Bank juiced the economy much longer than was necessary, and thus had to raise interest rates sooner, higher, and longer than most people expected

- Where is the real voice of the Federal Reserve Bank? Why is it in a position where it had to raise interest rates so high, so fast? Why did not Congress and the Federal Reserve Bank scream and demand over the last 20 years the US Government get on a budget, stop the deficit spending, issue warnings, anything? They just always ask for and print more money. And, now we the people find ourselves in a predicament that will lead to a debt crisis

- It is estimated that the interest cost has now reached nearly $2 billion every day, clearly an unsustainable course that is more than likely to increase and get worse, which makes it increasingly unsustainable. Interest never even takes a nap, not for a single minute

- Anyone who argues that we can still afford the interest payments will go away silently some day when there is another massive interest rate shock (debt crisis) and we all go into default and restructure mode. The first question they need to be asked, should be: "where was your warning voice before we got into this mess?"

#7 – US Government Default

- When the musical chairs game stops, the US government will default on its debt repayments, and print and borrow even more money, leading to high inflation and higher interest rates

- Default will take the global economy to new low places, with global debt restructurings through seasons of financial forest fires

- The standard of living will shrink as people are forced to live within their means, including drastic cut-backs in government spending and services. Renegotiated debt repayment terms with its creditors will need to take place, everywhere

- We the people are in trouble if we do extend the debt limit, and in trouble if we do not. That is the point. We will be having a debt crisis in the near term. How can we not?

- The deficit spending and debt levels are not sustainable as default conditions are only increasing daily. If you do not increase the debt limit, you are just going to start the default period within weeks of the debt ceiling expiration date (freeway landing). If you increase and extend the debt limit, you are just postponing the inevitable (mountain side crash)

- We do not even want to have a real conversation and hold people accountable about repayment default risk, because it is time to 'get back to the football game and the grill.' Life is good until the party is suddenly disrupted and people are caught unprepared. That is what is coming, and frankly, we the people will get the consequences of our choices when it comes to the burden of overwhelming debt. The day of reckoning will come soon enough as a complete shock to most people

- Then comes the fighting, blaming, contention, and so forth. We the people, we who should have known better, will be 'naked when the tide goes out,' embarrassed and hopefully full of shame. Others will be wandering around, upset, confused, dazed, and perplexed because they did not see it coming. Most will likely panic, and some will act dumb or innocent for having been caught being heavily in debt.

#8 – Banking System

- When Silicon Valley Bank collapsed in 03/2023, as well as Signature Bank, US regulators took action to prevent a banking crisis by backing deposits above the $250,000 FDIC insured threshold at these banks. Noting the fragile banking system, US Treasury Secretary Janey Yellen took additional measures by saying the Government could step in to guarantee deposits at other banks if they posed a threat to the banking system

- Many bank stocks experienced a sharp decline at the time in 1Q2023. Assets at regional banks, in particular, lost value in the rising interest rate environment, as existing loans and bonds at low interest rates had embedded losses in them (if they had to be sold to raise liquidity to cover deposit withdrawals on bank runs) as investors were looking at assets subject to higher interest rates

- Interest rates remain high, which affect the value of bank assets. Banks have, in many cases, failed to adequately manage interest rate mismatches on their balance sheets. They did not sufficiently match fund their loans with the cost of their funds on deposits. A bank run will force the bank to sell its assets (low interest rate securities and loans) to have sufficient liquidity to cover the deposit outflows

- The Federal Government's intention to guarantee uninsured deposits indefinitely is unrealistic at best, which may result in low confidence from uninsured depositors (depositors with balances over $250,000 that are not insured or guaranteed by the US Government). How safe and reliable, really, is the $250,000 deposit insurance during such crises?

- $203 trillion In derivatives held by Goldman Sachs, JPMorgan and other top banks is like playing a game of musical chairs, where the risks become increasingly higher and higher. Even experienced professionals do not fully understand the risks involved with derivatives, future contracts on commodities, option trading on stocks, currency swaps in foreign exchange markets, mortgage-backed securities (MBS), interest rate swaps for banks, credit default swaps (CDS) on bonds, and more. Do not forget in the 2008 financial crisis there was widespread use of these extremely complex financial instruments, like derivatives, which contributed to the severity of the economic downturn. Just like in 2008, the music will stop some day

- The entire derivative market has potential risks, including complexity, lack of transparency, potential for speculation, leverage concerns, concentration risk, counterparty risk, historical precedent, and delayed crisis recognition (think 2008), regulatory challenges (gaps)

- Interest rates will be high, and likely be triggered even higher for any number of a host of reasons, at any time. What are the chances these risks will not trigger more government spending, higher inflation, and higher interest rates to combat the same?

- High interest rates will plague banks with their embedded losses on low interest rate loans and securities they hold. They will eventually have to pay (high) interest on their deposits for customers to not pull those deposits. So-called 'sticky deposits will become slippery (deposit flight) and money will quickly move out of some banks with all the online tools currently in place. This will create an

environment of more downward pressure on some banks and lead to more bank runs and failures in the near term

- Many banks will quietly raise their hands looking to sell

- Commercial real estate (CRE) loans will continue to come more into focus too, as such loans will experience higher interest carry costs when (and if they can) they are refinanced at higher rates, as well as increased operating expenses. Capitalization rates will increase and values will continue to be reduced, thus enabling vicious downward spiral cycles. Even heretofore safe bubble markets like those in Hawaii will not escape these risks and will also be materially impacted

- Credit repayment risk will increase for regular commercial loans, but especially the CRE office market where billions in loans are underwater. Such loans are subject to refinance risk at much higher interest rates, while experiencing high vacancy rates due to remote workers not being in the office

- Pricing for risk, in a higher refinance interest rate environment will further expose banks to potential impairments (losses). Kiss the dividends good bye, and downward pressure on bank stock valuations

- Banks will begin to sell CRE secured debt at discounts, demonstrating their own lack of faith in the CRE market. The higher the interest rates, the lower the collateral property values, and the higher repayment default risk

- The regulatory agencies will sharpen their pencils to ensure prudent credit risk management practices are accounting for all this action. All these forces will likely create a wave of merger and acquisition deals for acquiring banks to survive

#9 – Geopolitical Tension

- What are the far-reaching consequences and costs of geopolitical risk? Regional risks are everywhere. Where is there not political, social, economic, and now territorial issues that are ripping apart delicate international relationships? They include:

  > "confrontations, conflicts, crises, instabilities, civil wars, territorial disputes, and currently include Russia/Ukraine and NATO, Israel/Palestine, Taiwan/China, South China Sea, Myanmar, India/Pakistan, Afghanistan, Iran, Yemen, Iraq, Nagorno-Karabakh, Syria, Lebanon, North Korea, Somalia, Ethiopia, Sudan, South Sudan, Democratic Republic of Congo, Central African Republic, Libya, Western Sahara, Venezuela, Haiti, and Mexico" (Council on Foreign Relations, Global Conflict Tracker, 02/02/2024)

- International disputes on boundaries on the land and in the sea are emerging. Trade wars will increase tensions that include restrictions and tariffs on shipped goods

- Military conflicts will cause different countries to have to take sides, with possible sanctions and other diplomatic measures being set up to punish the so-called adversaries

- Uncertainties will increase in the North Atlantic Treaty Organization (aka NATO) relationship with Russia, and with the very complex relationships in the Middle East with countries like Iran and Israel as evidenced by recent missile strikes

- There will be nuclear tensions on the Korean Peninsula with North Korea's nuclear weapons program

- There will be disputes over control and access to energy resources like natural gas and oil reserves

- Cybersecurity risk will increase and become a major concern that will strain diplomatic relations between the US and China

- The cost of taking care of refugees fleeing from one country to another, including illegal migration, will only increase

#10 – Global Supply Chain

- We are just too used to there always being plenty of goods everywhere, always available, and at reasonable prices. Much of the world's shipped goods will be challenged due to hostile actors in the Red Sea and drought conditions in the Panama Canal. We will be found taking for granted the abundance of goods everywhere we look

- While the current global supply chain risk seems to be of some concern (i.e., moderate risk), the risk will, likely, escalate to high risk, and there be additional stresses added for the availability of goods. With high-risk geopolitical tensions, many will stare in disbelief at the bad actors who purposely disrupt lawful shipping with violent attacks

- Increases in US military action will stir the emotions in Congress in using war authorization powers with the US having to protect foreign shipping vessels at whatever cost it takes. All but about 3% of US imports and exports are shipped on foreign vessels. This will not only cost the US military budget to be overextended, it will contribute to higher inflation, especially when things get out of hand

#11 – Political Polarization

- It is not hard to estimate that political polarization will increase throughout the global community in the future, as well as in the US. In fact, likely, one must ask, how it could it not only increase?

- Political polarization will continue to build in 2024-25, resulting in extremism, intolerance, rejection of social order, new radical ideologies, possible revolution, political

violence, social unrest, disruption in global supply chains, and, of course, protests everywhere

- The atmosphere will become more divisive with a more confrontational social environment, values will be questioned, new ideologies will affect your personal freedoms and an individual's rights. The result will be more uncertainty, disruptions to daily life, heightened tensions, and large peaceful (and many violent) protests to effectuate change

- Nevertheless, we the people will stick with peaceful voting and activism to express our opinions, while a few will not, but the overwhelming majority will. There will be a strong sense of 'community,' to help ensure we honor and respect the rule of law, 'with justice and liberty for all.' Good people, everywhere, will step up and do the right thing

#12 – Terrorist Attacks

- Terrorism risk will increase, including lone-wolf terrorists

- Are hundreds or even thousands of terrorists-minded individuals illegally crossing into the USA each month in the 'ones-that-got-away groups? When push comes to shove and before they are arrested, will these people resist and commit acts of terrorism against the US and its citizens? Are any of them aligned with State-sponsored terrorist groups?

- No one can dismiss that with well-funded resources and advanced planning, well-coordinated and State-sponsored terrorist attacks will happen, regardless of how well anyone is prepared to counter these risks

#13 – Housing Insecurity

- Housing insecurity is already an increasingly high-risk matter, and will continue to be in the near-term for 2024-25

- The fundamentals of housing, say a mortgage or rent payment that equates to about 20-25% of one's gross income, will be stretched. Many people already have their 'housing ratio' much higher, and that may include two incomes combined. Pressures to increase rent will continue in 2024-25 until the market place says it is too much

- Housing affordability will continue to get out of hand, and many people will struggle to pay rent, and even those who have low interest mortgage payments. The cost of everything jumped since inflation started ramping up since the Covid19 pandemic and all the government spending. Most prices will remain high and budgets will be stretched for the consumer, the small business owner, and so on

- Homeowners with low fixed interest rates will not be inclined to sell their homes, which will help dry up housing inventory available for sale, keeping upward price pressure on inventory that does make it onto the market

- Distressed people/sellers (divorce, job losses, sick, etc.) who must sell, will be forced to sell. Distressed properties will also go on the market and likely sold as-is (fixer uppers)

- People will demand the US Government to step in and help make housing more affordable. There will be more subsidizing vouchers, along with rent controls installed. More low-income housing subsidized by the local tax payers, will be funded

- People will be resigned to becoming long-term renters, with younger generations most willing to rent and work remotely in areas with lower costs of living

- When homes do become available, corporate America will actively buy up homes and pool them into rental property investments, thus making it even harder for others to buy their own first home

- The US Government will have to step in and help solve the housing crisis already underway to find refuge for some 8,000,000 to 10,000,000 illegal aliens who have crossed over into the US in the past few years. Some of the States are bearing the burden of trying to make accommodations for these people, but are demanding help from the US Government

- Hawaii will be asked to shoulder its 'fair share' for housing and help take care of the millions of illegal immigrants

- With housing insecurity will come mental, emotional, physical, and even spiritual breakdowns. Such measures will (often) lead to more divorces, and the disruption of the family unit. More homelessness will ensue, which will lead to even more issues

#14 – Energy Security

- Using common sense, we live in a world where global interests are in conflict. The risks to energy security will continue to increase in 2024-25. Whether or not there will be oil shortages that increase inflation, bad actors are and will certainly try to perpetrate cyberattacks on the energy sector in the US. There's just too much geopolitical tension for there not to be such activities

- Extreme weather events will likely continue as Mother Nature never ceases to amaze anyone

- Supply chain disruptions from areas in the world that export energy resources, will increase and add pressure to price inflation of many other goods

- The transition to renewable energy sources will be a while before they are sustainable. Meanwhile the transition to those sources will be subject to political, and hopefully much public debate over the costs, who will own and regulate those resources, where they will be stored, and whether the US should rely on other countries to supply the underlying minerals needed for renewable energy. It will be a 'messy' fight

#15 – Natural Disasters

- Everything is becoming fragile, complex, and interconnected, from living organisms, plants, animals, soil, rocks, minerals, water, and the air

- There is a 99.99% chance of there being natural disasters in the near term, where we will see more human suffering and loss of life. The financial price tag will also be very large, in the billions

- When the stakes are high, everyone will band together and the best of humanity will do what it takes to alleviate human suffering

- The system of aiding victims of natural disasters will become increasingly stressed, including local and State agencies, State governments, Federal assistance, and even nonprofit organizations

- Due to the high cost of addressing natural disasters, eventually, we the people will step up and take care of each other and those most in need

#16 – Public Health, Well-Being

- We the people largely want drugs, regardless if they are unhealthy legal addictive drugs such as alcohol and nicotine (smoking), or illegal (Federal) drugs like marijuana or other drugs

- Pornography, another addictive habit, is also destroying people's souls and busting up their families and finances

- "Among people aged 12 or older in 2022, 59.8% (or 168.7 million people) used tobacco products, vaped nicotine, used alcohol, or used an illicit drug *in the past month*

  "In 2022, almost 1 in 4 adults aged 18 or older had any mental illness in the past year (59.3 million or 23.1%); 1 in 20 adults had serious thoughts of suicide in the past year (13.2 million or 5.2%), 1.5% (or 3.8 million people) made a suicide plan, and 0.6% (or 1.6 million people) attempted suicide in the past year

  "Among adolescents aged 12 to 17 in 2022, 19.5% (or 4.8 million people) had a past year major depressive episode; Over 1 in 8 adolescents had serious thoughts of suicide in the past year (13.4% or 3.4 million adolescents), 1 in 15 made any suicide plans (6.5% or 1.7 million adolescents), and nearly 1 in 25 (3.7% or 953,000 adolescents) attempted suicide in the past year"

  – (SAMHSA Announces National Survey on Drug Use and Health (NSDUH) Results Detailing Mental Illness and Substance Use Levels in 2022, US Department of Health and Human Services, 11/2023)

- Over the next couple of years, despite millions with excellent health, the overall health of society will continue its negative trends. So many of our families and neighbors need help. However, we

the people, largely, do not care anymore, and people won't speak up and opposed addictive substances. We are an increasingly addicted 'off to the next party' bunch to say the least

- Trillions of dollars will be spent throughout the world to address these health and well-being issues

#17 – Cybersecurity

- Cyber warfare, digital attacks on personal, business, and government computer systems and networks, will increase in 2024-25. This includes cyber tools, like bots, trolls, deep fakes, and the dark web. As geopolitical tensions rise, so will the cybersecurity threats, with more attacks

- As soon as cybersecurity defenses are in place, the bad actors will systematically work to penetrate these walls. If they cannot get through them, they will go above them, or around them, or below them, but they will not stop trying. Technological tools will be used for both good and evil purposes. Dark forces will seek to deceive, lie, and manipulate to impair the rule of law

- With billions of people participating in the global elections in 2024, people will demand transparency and accountability in the entire electoral process

- Cybersecurity risk with China will become an increasingly high threat risk to mitigate

#18 – Inequality in Wealth and Income

- "Americans said it takes an average net worth of $2.2 million to qualify a person as being wealthy. (Net worth is the sum of your assets minus your liabilities.) People with the top 1% of net worth in the U.S. in 2022 had $10,815,000 in net worth. The top 2% had a net worth of $2,472,000. The top 5% had $1,030,000. The top 10% had $854,900. The top 50% had $522,210." (Are You Rich? U.S. Wealth Percentiles Might Provide Answers; Kiplinger Personal Finance, Neale Godfrey, 06/16/2023)

- "The wealthiest Americans have never owned so much of the stock market, with the top 10% now holding a record 93% of US equities. Americans broadly have been participating in the stock market at a higher rate, with a record 58% of households owning stocks in 2023; the bottom 50% of Americans owned just 1% of all stocks and mutual fund shares in the third quarter." (The wealthiest 10% of Americans own 93% of stocks even with market participation at a record high; Jennifer Sor, 01/10/2024)

- It is doubtful that anyone would think that, throughout the world, the rich are not getting richer, and the poor are not getting poorer. What could possibly go wrong with something like this when the US experiences a debt crisis?

- In 2024-25, these asset classes, well-supported by asset bubbles from inflation, will take a hit, possibly the likes of which we have not seen in modern times. It is only a matter of time

- We the people will continue to believe that more and more stuff means more happiness, when it generally results in the loss of the most precious and important things in our lives. Money will give pleasure, but not happiness. Such will continue to be the trend in the near term

- Down the road a bit, there will come a time when those with wealth, the ones that understand what the highest and best use of it is, will use those resources to assist those who are poor and less fortunate. And for those who cannot take care of themselves at all, we the people will take care of them ourselves. Those that want none of that will simply build up their fortunes unto themselves, and when they die, they will leave it all here anyway

#19 – Labor Market

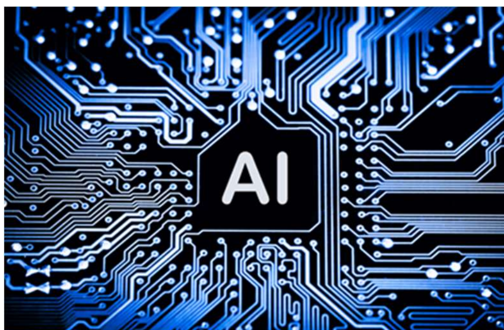
- On paper, the job market looks solid, strong, and surprisingly resilient. Under the cover in reality-land, however, unemployed people will find it increasingly difficult to find a good job, with only a handful of employer responses from dozens of applications. Burnout will increase in the near term

- The story of the low unemployment numbers will be questioned due to the low job numbers yet the difficulty finding good jobs becomes a concern. There will be a call for transparency when it comes to how many people are working more than one job, the number of government jobs and not private sector jobs used to pay for government jobs, retirees working longer to support their fixed incomes, the number of hours people are getting each week, jobs with any benefits, and the number of full-time vs. part-time jobs being offered

- High and now lower (but still) inflation has resulted in high costs or prices, which will continue in 2024-25. Wages will not keep up for the time being due to the so-called resilient job market

- The remote, or hybrid remote work environment will continue for the near term. The employee still has an advantage for the time being. Hopefully it will help strengthen work-life balance. Employers will push for more office time to build up fact-to-face knowledge sharing, collaboration, and mentoring other employees, to add long-term value to the enterprise

#20 – Artificial Intelligence (AI), New Technologies



- Concern over the impact of AI in disrupting election outcomes will be a very big risk for the 2024 global governmental elections for billions of people

- AI-powered solutions will be used to streamline operations and increase productivity in healthcare, transportation, manufacturing, retail, and finance

- AI and new technology risk will be disruptive for many good paying jobs in science, technology, engineering, and mathematics. The world is evolving and transforming with new technologies. It will change more quickly than most people realize

- AI may be coming after 300 million jobs globally. "The International Monetary Fund warned that nearly 40% of jobs across the globe could be affected by the rise of artificial intelligence, with high-income economies facing greater risks than emerging markets and low-income countries." (IMF warns AI to hit almost 40% of jobs worldwide and worsen overall inequality, Sam Meredith, 01/15/2024)

- Everybody knows that bad actors (individuals, groups, governments, etc.) will use these wonderful tools in evil and nefarious ways. They will use them to get power and control over others at any cost. Which means, most certainly, the US will spend countless billions of unbudgeted dollars to defend and protect its national security interests

- Military applications will obviously become more enhanced, thanks to the billions being spend on national defense

- How to govern AI will be a major undertaking, as policymakers and other organizations try to come up with guidelines, standards, and even regulations

- Upcoming technologies will include blockchain, quantum computing, and biotechnology

Addendum #2) Purpose

Dedication

To everyone, everywhere, who is experiencing (or may yet experience) the heavy burden of debt; those that are searching for debt repayment solutions, financial peace of mind, and well-being.

Mission Statement

To do good business, share good fruit, build true friendships

Principal / Founder

Jerry Staker founded the following companies:

- National Credit Awareness and Resolution Association, Inc. (NCARA.org) for small business, in 2020
- Tunabudget LLC (tunabudget.com) for individuals and families, in 2020
- Credit Risk Management Advisory, LLC (CreditRMA.com) for creditors, in 2023

The following points may be of interest:

- Birth: 1960
- Residency: Utah, Rhode Island, Arizona, Hawaii, Kentucky
- Family: Married, four children, five grandchildren
- 40+ Year Career: 28 years in commercial banking at community and regional banks: Workout Loans, Credit Review, Director/Credit Management Group; 12 years Creditor Supervision & Regulation (Commissioned Creditor Examiner – Federal Reserve Creditor of San Francisco
- Interests: Walking, traveling, gardening, writing, music, family, service, journal writing, family history work, fishing, feeding birds
- Hobbies: Earthquakes, volcanos, tornados, solar, water, wind, astronomy, consumer finance, politics, personal life histories, sunny beaches
- Ambitions: Sing, play Ukulele, under 200 lbs.