Credit approvers often do not scrutinize spreadsheets and tables of data put together by an underwriter in support of a loan recommendation—even when there may be evidence suggesting that the data is flawed.

The approvers tend to believe the numbers set before them. Frequently, they are driven by the same forces that influence lenders: limited time for careful review and the desire to continually increase the loan portfolio. Very rarely do they recompute data for their own enlightenment or to prove to themselves that the underwriter provided correct information.

More often than not, these issues are relatively minor, and the loan turns out to be a satisfactory investment. Nevertheless, these oversight failings sometimes lead to a poor credit decision. The following story is such a case.

The Cash-out Request

Once upon a time, three brothers owned, in equal shares, a granite-quar-rying company called Rock Is Us, having inherited it from their father. Two of the brothers actually operated the business, while the third brother served as a silent partner with no real interest in the day-to-day operations of the company.

The silent-partner brother wanted to cash out his investment in the business and pursue other opportunities. The two brothers who actually ran the business favored the buyout, especially since the third brother did not contribute in any meaningful way to the company, but received a small salary and dividend checks from time to time.
The economy was falling into recession, so the overall market for the company's products was declining. But the three brothers still figured that one-third of the business was worth $500,000 and agreed that the retiring brother's share be purchased for this amount.

The request for the new $500,000 loan came in November, but the most recent financial statements that Local Community Bank had for the company were for the year ended the previous December.

with this business, including lines of credit and term loans totaling several million dollars. All were supported by corporate assets, including accounts, inventory, equipment, and the real estate from which the granite was quarried.

Financial Statement Missteps
The request for the new $500,000 loan came in November, but the most recent financial statements that Local Community Bank had for the company were for the year ended the previous December. Although it always provided annual audited financial statements accompanied by an unqualified opinion from its accountants, Rock Is Us had consistently refused to provide interim statements, citing the difficulties in pulling together the required information.

Local Community had acquiesced to this practice, based on the long and satisfactory relationship with the borrower, even though the bank’s policy required interim statements for credit exposures of Rock’s size. Despite the weak economy and its inevitable negative impact on the borrower, Local Community Bank still did not ask for an interim statement to assist the underwriters tasked with considering the new loan request.

The financing request was handed to the underwriter who had been analyzing the company’s statements for several years. In analyzing the new request, the underwriter took the principal and interest payments due under the company’s existing debt to Local Community and added that to the projected principal and interest payments for the new $500,000 accommodation. This new total was then compared to historical cash flow for the past three years. It was determined that the debt service coverage (DSC) ratio, even in a declining market for the company’s products, would not have been less than 1.23 to 1.00 in any of the three years ending the previous December.

Even though the bank’s officers strongly suspected that times had gotten worse for this borrower in the intervening months since last December, the lender and his approving officers decided to go ahead with the transaction. They did this before the current year’s statements were received, based on the supposedly favorable DSC ratio and, again, on the satisfactory relationship that had existed for many years.

At about this time, the lending officer and the underwriter primarily responsible for the Rock Is Us relationship left Local Community Bank, having been wooed away by a competitor, Nearby Savings Trust. A new lender and a new underwriter were hired to replace them.

Signs of Trouble Begin
The new $500,000 loan was funded in December, and payments began to be made in January. Payments continued satisfactorily for the next few months, although some modest slowness was noted. In due course, Local Community Bank received the audited statements for the year ended in December of the year in which the loan had been made.

Upon reviewing the statements, the replacement underwriter discovered that operations for that year had not produced favorable results and that cash flow had been strained. The company had been able to reduce inventory levels, and accounts receivable levels had also contracted with the decline in economic activity. There were funds to keep payments reasonably current, but those unsustainable sources of cash were running out. Interim statements, finally provided at the bank’s insistence, confirmed that performance had worsened subsequent to the latest fiscal-year-end financials.

New Underwriter Takes Over
Local Community Bank’s management downgraded the credit risk rating of Rock Is Us, and the new underwriter began to produce internal problem-loan reports on the company. In her review, the new underwriter recreated the cash flow coverage tables used by the previous underwriter in an attempt to confirm that historical cash flow had in fact provided the coverage indicated in the original write-up.

She first reviewed the company’s audited financial statements and the spreadsheets prepared from them for the previous three years. To determine historical cash flow coverage, she added the previous year’s current portion of long-term debt, determined by the accountants, to the current year’s interest expense. Then she compared this total to the most recent year’s cash flow. (While such a calculation may not be an exact measure of debt service coverage, it’s often a reasonable proxy if more precise data is unavailable.)

From this information, she determined that actual debt service coverage had been considerably less than 1.0:1 in each of the previous three years. She also noted that this
method of computing DSC was already part of the ratio tables provided by the statement spreading software used by Local Community Bank. The evidence of inadequate historical cash flow had been available to the credit approvers who had blessed the lending relationship for several years.

Puzzled by the previous underwriter’s satisfactory cash flow coverage calculations in the loan approval documents, the new underwriter took a closer look at the statements and determined that Rock Is Us had borrowing relations with not only Local Community Bank but with other institutions as well, primarily leasing companies and companies engaged in long-term commercial equipment financing.

But the cash flow summaries produced by the old underwriter in evaluating previous loan requests and the more recent $500,000 request did not consider the outside debt service— it included only the debt owed to Local Community Bank. When the debt service to be paid to other institutions was added, the DSC ratio fell well below even 1.0:1. In fact, it was closer to 0.8:1, not anywhere close to the minimum 1.23:1 ratio cited in the most recent credit approval form.

What the New Analysis Revealed

So a basic underwriting error and the erroneous cash flow tables produced by that error had caused Community Bank’s credit approvers to feel comfortable that cash flow was adequate to meet debt service when, in fact, that had not been the case for several years.

Further dissection of the numbers revealed that the company had been able to keep payments reasonably current despite the unsatisfactory DSC ratio by:

- Drawing down on previously accumulated cash balances.
- Reducing inventory levels.
- Slow payments due on accounts payable and accrued liabilities, including payroll taxes.
- Periodically refinancing and increasing the balances of maturing term debt.
- Being granted modest increases in its short-term line of credit from time to time.

A more careful review of the spreadsheets derived from the company’s statements, including the detailed cash flow summaries and historical DSC calculations, would have revealed these facts. And it should have raised questions in the minds of the previous underwriter and the credit approvers about the soundness of the credit being extended, even though the underwriter-prepared summaries had revealed a different, much more favorable picture.

These miscalculations and omissions were duly noted in the problem-loan reports prepared by the new underwriter. Not having been involved with the previous loan approval write-ups, she could comment only that the unsatisfactory loan situation could be traced in no small part to the underwriting errors and the lack of loan approval oversight in previous years.

Were these errors a deliberate attempt by the old lending team to present a better-than-actual picture, or were they simply unintended computational errors? No one who was still with the bank could really say. While chagrined, the credit approvers could only agree that their oversight had been less than optimal. Management was not pleased.

In view of all the issues uncovered by the new lending team, the loans were downgraded further and transferred to the bank’s special assets department in an effort to minimize the damage. Negotiations with the client began in earnest to seek ways to work the company out of its unfortunate situation.

Help Arrives

About this time, help arrived from an unexpected source. Nearby Savings Trust, the bank to which the former lender and underwriter had fled, was seeking to increase its own loan portfolio and made an offer to Rock Is Us to take over the account and lending relationships that had existed with Local Community Bank for so many years. This effort culminated in a formal commitment letter, and a short time later the relationship was transferred to the new lender.

In due time, Rock Is Us, still reeling from the poor economy, unsatisfactory operating results, and inadequate cash flow, filed for bankruptcy. According to rumors in the banking community, Nearby Savings Trust sustained a substantial loss on the relationship.

Local Community Bank’s management was left to wonder if the lending team that had left to work for Nearby Savings Trust had committed the same errors in underwriting and credit approval that had caused a near disaster at Local Community. Management vowed to be more vigilant in the enforcement of policies dealing with the timeliness of financial statements, and the credit approvers promised to take the extra time needed to verify debt service computations and other summarized financial data.

Still, human nature being what it is, and lenders and credit approvers being under continual pressure from management to produce new loan volume, the reader is invited to guess how long those vows and promises were kept.

Kyle Nye is a former vice president and senior underwriter at Bank of America. He can be reached at nm.k2nye@gmail.com.

November 2012 The RMA Journal 57
About RMA
The Risk Management Association (RMA) is a not-for-profit, member-driven professional association serving the financial services industry. Its sole purpose is to advance the use of sound risk principles in the financial services industry. RMA promotes an enterprise approach to risk management that focuses on credit risk, market risk, operational risk, securities lending, and regulatory issues.

Founded in 1914, RMA was originally called the Robert Morris Associates, named after American patriot Robert Morris, a signer of the Declaration of Independence. Morris, the principal financier of the Revolutionary War, helped establish our country’s banking system.

Today, RMA has approximately 2,500 institutional members. These include banks of all sizes as well as nonbank financial institutions. RMA is proud of the leadership role its member institutions take in the financial services industry. Relationship managers, credit officers, risk managers, and other financial services professionals in these organizations with responsibilities related to the risk management function represent these institutions within RMA. Known as RMA Associates, these 18,000 individuals are located throughout North America and financial centers in Europe, Australia, and Asia.

RMA University
In today’s rapidly changing financial services industry, you need practical, day-to-day knowledge that will help you excel in your profession. RMA provides quality education to advance sound risk principles in the financial services industry. Traditional classroom training and online learning resources are available as open enrollments or in-bank training. Visit http://www.rmahq.org/events-training/rma-university/rma-university to learn more.

eStatement Studies
RMA’s eStatement StudiesSM is the only source of comparative data that comes directly from the financial statements of small and medium-size business customers of RMA’s member institutions. Round-the-clock online access gives you the ease and flexibility to use this wealth of information at your convenience. Visit http://www.rmahq.org/tools-publications/tools/esteematement-studies to learn more.

Are you an RMA member?
An RMA membership provides many benefits. In addition to a free subscription to The RMA Journal® and discounts on RMA events, products, services, and training, membership also provides countless networking opportunities and exposure to the industry’s key decision makers and manager. RMA’s local and national events keep you up to date on industry trends and issues while allowing you to meet new people and swap successes with peers. Visit http://www.rmahq.org/joinrma to learn more about membership.