Changing times

How renewing a business line of credit has gotten more complicated **Interviewed by Adam Burroughs**

Borrowers often assume that because they have made all their payments in a timely manner, renewing their line of credit will be as easy as it has been in the past. However, this is not the case, says Kenneth R. Cookson, attorney with Kegler, Brown, Hill & Ritter.

"The lending environment is different now and the conditions that allowed some borrowers to run the lines up to the maximum amount and simply pay the interest have passed," says Cookson. "While in earlier years, it was almost automatic that timely payment of the monthly interest alone would make renewal easy, today, being a 'loyal customer' is nearly irrelevant to the renewal process."

Smart Business spoke with Cookson about the lending environment and how changing conditions have affected it.

Kenneth R. Cookson
Attorney
Kegler, Brown, Hill & Ritter

What challenges are banks currently facing?

In the post-Great Recession regulatory environment, banks are facing a combination of focused regulations and declining values in real estate portfolios and borrowers. They have pressure on their capital requirements and reserve requirements. When a loan is classified as less than perfect, there has to be a reserve established from a bank's capital to offset the portion of the loan that is in jeopardy, which can eat into capital reserves quickly.

Banks are being subjected to a loan-by-loan analysis by regulators and they are trying to get ahead of that by going through their own portfolios to figure out which loans are speculative and which are not.

Further, a bank may feel regulatory pressure when it has a high concentration of loans in one industry with similar borrowers, so it may hedge its risk. The borrower may be surprised that the line of credit is not extended because the business has made payments on time, but the bank may feel that it is too exposed in that particular area.

How are banks coping with these regulatory requirements?

They are certainly increasing their lending standards. The ratio of loan-to-value has come down, particularly in the real estate market, where a 70 percent loan-to-value ratio is not an unusual request. When you couple that with a decline in real estate values, it really amplifies the state of the conditions and the difficulties for both lenders and borrowers.

What is happening to borrowers?

Borrowers, in many cases, are being caught unaware. They have had a line of credit with a bank for many years and don't deal with a commercial banker very often. They will send in financial statements annually, the revolver is generally renewed and the rate goes up or down according to market conditions.

Now, bankers are having trouble renewing those lines of credit and are reducing them, or imposing other requirements that have not been enforced previously, such as not allowing borrowers to take out the maximum on their line and just pay the interest for a full year. The borrowers express surprise, asking, 'Why shouldn't making timely payments make the renewal of that loan automatic?'

The answer begins with the regulatory requirements on banks and concentration issues, the value of the portfolio of the collateral supporting the loan, an increase in loan-to-value ratios and cash flows.

If it is a real estate loan or one backed by accounts receivable, and the value of either or both has gone down, leading to the appropriate ratios established in the loan document to not be in line, the loan could be classified downward. Borrowers need to understand a bank's regulation reviews, internal reviews and lending policies, and be prepared for that.

What can borrowers do to help themselves through this?

Borrowers should make sure that their financial statements are current, accurate and complete. Look at your internal records and make sure that your accounts receivable are all good, and if they are not, work to discover the problems before the bank does.

Also, know your business plan and what your five or 10 largest customers are doing. If you learn that of your two lines of business, only one is profitable, you should shift your resources to the more profitable of the two.

Companies can get weighed down by the history of their operations and not take a critical look at their business model, business plan, customer array and pricing policies. Examine your business model as if you were starting fresh.

There is no shortage of examples of businesses that hypothetically have grown but their profits have not gone up proportionally. Increasing sales doesn't necessarily mean higher profits because of other factors, such as margins and collectability issues. You have to scrub the numbers to see what you are doing right. You may have to cut back sales to better serve customers at higher margins in order to make more money.

How can banks and borrowers each adjust during this period of transition?

You have to assume that we are going to come out of this Great Recession and that the economy will be back in growth mode. This takes patience and understanding from both lenders and borrowers.

Lenders want to make loans. They need to lend money because that is how they get a return on the capital that has been invested. And borrowers need to be granted loans in order to make that happen. <<

KENNETH R. COOKSON is an attorney at Kegler, Brown, Hill & Ritter. Reach him at (614) 462-5445 or kcookson@keglerbrown.com.

Insights Legal Affairs is brought to you by Kegler, Brown, Hill & Ritter Co., LPA