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Financial Lending Notes

A Newsletter for Commercial Lenders

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Term Sheet, Commitment Letter, Loan Agreement

Utilize the Continuum to Serve Borrowers Better

There tends to be some confusion among many community bankers when it comes to term sheets, commitment letters and loan agreements. For example, some bankers think they're basically all the same thing — but they're not.

When used properly, there is a continuum between the term sheet, commitment letter and loan agreement. By utilizing all three of them properly, you can minimize misunderstandings and disagreements with businesses and help both your bank and your borrowers better understand each other's expectations.

The Starting Point

The term sheet is the starting point in the continuum. It lists the different factors the bank will consider when reviewing a loan application. These typically include the business' financial statements, collateral requirements and minimum requirements for various ratios, such as debt service coverage.

In addition, the term sheet will outline the broad basis for the lending relationship and spell out the terms in detail, including the steps involved in loan underwriting, approval and documentation. In this way, it provides structure for negotiations with the borrower and borrower protection from arbitrary changes by the lender.

Also, the term sheet can serve as a basis for comparing competitive loan offers received by the borrower from another bank. For example, if a borrower tells you the bank down the street is offering a lower interest rate, you can look at the term sheet together to see if there are things like loan fees or appraisal or environmental impact fees that actually make that offer less competitive than yours.

Note that term sheets are for discussion purposes only and do not represent a commitment on the part of the bank to lend money.

The commitment letter is the next step in the continuum. It formalizes the details spelled out in the term sheet and is binding on the lender. Most importantly, a commitment letter will establish upfront expectations in specific areas, including:

- The lender and borrower
- Loan terms and interest rate
- Fees (e.g., loan, appraisal or environmental impact)
- Collateral requirements
- Loan guarantees
- Conditions for loan closing

Role of the Loan Agreement

Together, the term sheet and commitment letter will form the foundation for the creation of the loan agreement. A well-structured loan agreement serves several key roles — it can help preserve strengths, protect against weaknesses and uncertainties, and serve as a framework for loan monitoring.

Most loan agreements are comprised of the following components:

- Definitions
- Loan terms and conditions
- Representations and warranties
- Affirmative and negative covenants
- Conditions of lending
- Default events and remedies

Covenants are an especially important component of loan agreements. They serve several impor-

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Make Cultivating Risk Culture a Top Priority

The fake accounts scandal at Wells Fargo Bank has gotten a lot of attention since it first became public more than a year ago. Pundits and the press have reported on the details of how bank employees opened fraudulent customer accounts due largely to intense pressure they felt to meet aggressive sales goals.

This scandal brought to the forefront an issue that all banks, regardless of their size, should make a top priority: Cultivating the appropriate risk culture within the bank.

Risk Appetite + Risk Tolerance = Risk Culture

Risk culture is derived from a bank's risk appetite and risk tolerance. Banks can get in trouble when there's a disconnect in this risk continuum, as happened at Wells Fargo and among many subprime lenders before the financial crisis.

Banks often think of risk within the context of credit risk. However, the regulators view risk from a much broader perspective, including liquidity, market, compliance operations, and reputation risk.

Building the right kind of risk culture starts with drafting a risk appetite statement. This is a formal document that forms the foundation of your bank's risk management program. It should be closely integrated with your bank's overall strategy and clearly communicated to all bank employees, sensitizing them to their role in managing risk.

Regulators expect banks to draft a formal risk appetite statement that spells out their level of risk tolerance. Specifically, *Enhancements to the Basel II Framework* states that "it is the responsibility of the board of directors and senior management to define the institution's risk appetite and to ensure that the bank's risk management framework includes detailed policies that set specific firm-wide prudential limits on the bank's activities which are consistent with its risk-taking appetite and capacity."

Culture Trumps All

Your risk appetite statement will help you establish policies, procedures, systems and controls designed to manage risk within your defined parameters. But if your risk appetite and risk tolerance don't translate into a sound risk culture, all your efforts could be for naught — because culture usually trumps everything else.

For example, if a bank's risk culture encourages cutting corners to boost new account openings and sales, employees will likely find ways around policies, procedures and controls to accomplish this. Subcultures can also develop within banks that are extensions of one or more powerful managers who exert their influence upon those underneath them.

The Financial Accounting Standards Board (FASB) has specified several different indicators of a sound risk culture, including the following:

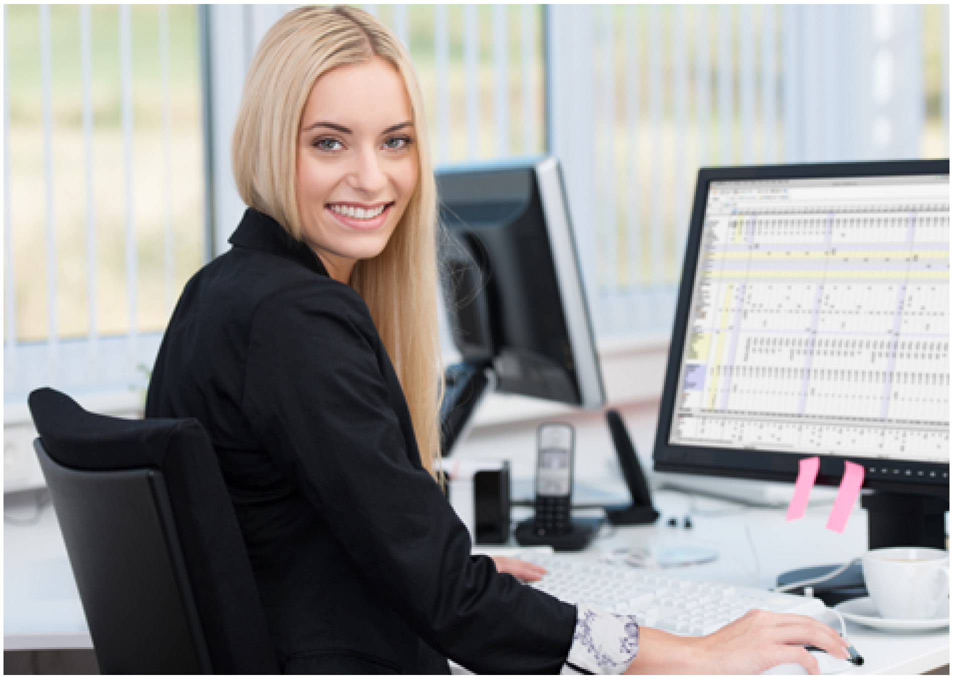
- It starts at the top with bank management and the board of directors and flows down from there.
- Employees are held accountable for understanding the risk culture and how their actions impact it.
- Challenges and feedback to the risk culture are welcome and encouraged from employees at all levels.
- Employees are incented financially for exhibiting desired risk behaviors.
- The risk culture message is continually reinforced, as are policy and portfolio limits designed to manage line of business growth prudently.

The "Do Right" Rule

As you strive to create the right kind of risk culture within your bank, try to remember the "do right" rule. Does your risk culture encourage and incent employees to do the right thing for stakeholders every time? Stakeholders include your customers, community, shareholders, vendors and other employees.

The "do right" rule should lie at the heart of how your bank conducts business. Make it the foundation of your risk culture as well.

Call us if you'd like to discuss cultivating the appropriate risk culture at your bank.



The Impact of Basel III on Lines of Credit

Traditionally, community banks structured business lines of credit to mature in one year or less, even if they knew there was a high likelihood that they would renew the line a year later. This reduced the amount of capital that banks had to maintain, since they only had to maintain capital against lines with maturities greater than one year.

However, Basel III changed the equation. These regulations require that banks now maintain minimum capital levels against *all* loan commitments, not just those with a maturity of greater than one year. So there is no longer a capital advantage to banks of structuring credit lines in this way.

Given this, it may make sense to begin structuring business credit lines with two and three-year commitments, instead of one year or less. There are significant administrative costs to underwriting and documenting these lines on an annual basis, not to mention hassles and inconveniences for small business borrowers.

If there's a high probability that you will renew a line of credit, consider structuring it for two or three years right from the start. Using covenants in a loan agreement, you can preserve the ability to step in and remediate before the line matures if you need to. Doing so will reduce your loan administrative costs and make things easier for your borrowers.

Similarly, your bank must maintain capital against your entire line of credit commitment, not just the amount that businesses borrow. So it might also make sense to start imposing non-usage fees on borrowers who aren't using much (or any) of their credit lines.

For example, if a business has a $500,000 line of credit but rarely borrows more than $100,000, you could impose a 1% non-usage fee on $400,000. Or you could simply reduce the line to more accurately reflect how much money the business is actually borrowing.

Capital is your bank's most expensive source of funds, so it makes sense to plan your capital requirements carefully.

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tant roles, including ensuring full and timely disclosure of information, maintenance of adequate cash flow and asset quality, preservation of net worth, orderly and manageable growth, limitations on leverage, and preservation of the core business as a going concern.

There are a number of broad categories of covenants, including financial, operating, reporting and disclosure, capital preservation, and other sources of financing. Most banks focus primarily on financial covenants, and debt covenants in particular. The most important debt covenants for most small business loans are the following:

- Minimum debt service coverage ratio
- Minimum current ratio
- Maximum debt to tangible net worth ratio
- Minimum working capital level with step ups (working capital is required to increase by defined amount each year)
- Minimum tangible net worth level with step ups (tangible net worth is required to increase by defined amount each year)
- A requirement to provide periodic financial statements

With these covenants in place, you will effectively limit the borrower's ability to grow too fast, as well as limit how much money the owner can take out of the business and how much additional debt the business can assume. You will also define the parameters for when you will term out a line of credit.

Some banks make the mistake of utilizing term sheets, commitment letters and loan agreements and then failing to monitor them. The fact is, having an unmonitored loan agreement is worse than having no loan agreement at all. If you were to try to exercise remedies due to default but haven't monitored the loan agreement, a court might rule that your right to assert a default has been waived.

Good for Everyone

Utilizing term sheets, commitment letters and loan agreements can be good for your borrowers and your bank. It imposes limitations on your borrowers that keep them from growing too fast or taking on too much debt.

In addition, it creates a monitoring structure that alerts your bank if the borrower may be getting in trouble. This way, you can step in and take corrective action while there's still a viable core business and you still have a reasonable collateral position.

Got more questions about term sheets, commitment letters and loan agreements? Call us to schedule a time when we can talk in more detail.

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The Clock is Ticking on Lease Accounting Standard

In less than one year, one of the most drastic changes ever to be made to public accounting standards will become effective.

Public companies must begin adopting the new lease accounting standard — ASU No. 2016-02 — for interim and annual periods beginning after Dec. 15, 2018. For private companies, the deadline is Dec. 15, 2019.

The new lease accounting standard will require borrowers that lease assets such as real estate, vehicles and equipment for more than one year to report lease obligations as liabilities on the balance sheet. Currently, operating lease obligations aren't listed on the balance sheet.

The current method tends to improve leverage, debt service coverage and liquidity ratios, which may increase a business's chances of obtaining a loan. The new standard will tend to have the opposite effect.

Businesses that lease their facilities could be impacted the most.

Businesses that prepare GAAP compliant financial statements will have to recognize assets and liabilities on the balance sheet for all leases longer than one year in duration. In addition, they will have to report a right-to-use asset and corresponding liability for the operating lease payment obligation discounted to present value.

This would adversely affect borrowers' leverage and liquidity ratios, since they must list a new liability on the balance sheet. The result could be fundamental changes to the underwriting of business loans and structuring of debt covenants. Retail businesses and professional service providers (like doctors and attorneys) that lease their facilities could be impacted the most.

For example, if lease obligations had not been previously included in the debt service coverage calculation and now will be treated as the functional equivalent of debt, loans for borrowers with significant lease obligations may have to be underwritten at a higher debt service coverage ratio, such 1.5-1 instead of 1.25-1.