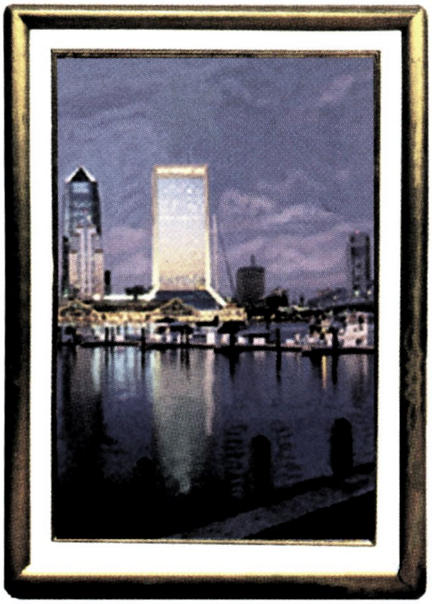

Partners

in community and economic development

Federal Reserve Bank of Atlanta
Volume 6, Number 4

Community Development Lending Requires a Structured Approach

By definition, virtually every community development loan or investment activity will have a social mission, such as providing affordable housing for low- and moderate-income persons, revitalizing distressed commercial or residential areas, or providing loans to small businesses. Social work has become an integral part of the development activity, and many new projects combine health care, day care, technical assistance or education programs as part of the project requirements. Most experts would argue that without these programs, community development projects will never meet their full potential. However, by its very nature community development lending and investment activity is financial, not social. Indeed, without a sharp pencil and attention to the financing details, very few projects will make it off the ground or sustain themselves over the long run.

While recognizing that the social aspects of community development activity are critical to a project's long-term success, this issue of *Partners* takes a look at the financial angle of community development activities. Beginning with information on how to make community development loans and investments, the newsletter also provides insight into why some loans are not made, and why other loans go bad. Hopefully, the discussion presented will encourage safe, sound and profitable community development lending.

An Introduction to Doing the Undoable Deal

The project almost works - but not quite. With just a few more dollars, a new business can get started or an existing one can expand, new housing can be built or older housing can be renovated. It may be a business owner who is looking for a way to make a deal work, or community leaders looking for ways to provide new jobs, additional goods and services, or more affordable housing. The bottom line is, the dollars, the collateral, or the expertise are not quite there and other alternatives are needed to make the deal work.

This article offers a map for finding your way through the maze of those alternatives. A sampling of federal financial and technical enhancements is included, but those programs - both public and private - will change as our communities change and our beliefs evolve regarding how to best balance individual and societal responsibilities. What is needed is a method to locate possibilities, not just a listing of currently available programs. A step-by-step guide begins on the next page.

In This Issue

Doing the Undoable Deal

The following article is an excerpt from a guide prepared by Dr. Larry Meeker, vice president at the Federal Reserve Bank of Kansas City. In his article, Dr. Meeker discusses the tools and techniques of community development lending, which includes the effective use of grants and subsidies. It may be helpful to review the flow chart in our centerfold before reading the article..

Community development lending is complex and evolutionary by its very nature. Gap financing that was formerly available through federal programs may instead be available through a state or local government, through nonprofit agencies, or privately funded foundations. Or it may not be available at all; some projects that were doable in the past may not get done in the future. Other "undoable" deals will get done, however, by partners who have found creative new ways to make projects work. What will not change is the need for community leaders, lenders, and development resource people to form partnerships and work together to improve their communities.

Regional, state, and local programs, as well as those of private foundations and involved corporations can also be added to the map. As the appropriate role of government in community and economic development is reconsidered, enhancement programs will change accordingly. The necessity of analyzing financing gaps in projects and finding alternatives for filling those gaps, however, will not change.

Lenders are facing increasing pressure to participate in community and economic development projects. Part of the pressure is in response to Community Reinvestment Act (CRA) responsibilities. But the interest often goes beyond that. Like other community members, lenders too are adversely affected by urban decay, economic disinvestment, and the lack of a diversified economy. The problems are often easy to identify. The difficulty is in finding widely acceptable solutions. A frequent suggestion is to undertake more community and economic development projects. This is the question facing lenders: Is it good business?

No Term for Marginal Projects

The financial literature is replete with terms describing different types of financing - consumer finance, real estate finance, and commercial lending to name just a few. There is no term, however, that describes the financing of marginal projects and borrowers.

Proposals with insufficient or uncertain cash flows, too little collateral, or that pose excessive interest rate risk or overhead costs are simply not done. For most lenders, their obligations to protect depositors' funds and earn profits for shareholders preclude excessive risk taking and inadequate profit margins. Indeed, these tenets of lending are basic, and lenders and their regulators pursue them vigorously.

Agencies Providing Assistance

Despite these perceived difficulties, many undoable deals may be doable because of their eligibility for financial and managerial assistance. Various government and philanthropic entities provide assistance to projects that aid economically disadvantaged individuals and communities. The basis for that assistance ranges from job creation and support for minority businesses to housing low-income individuals.

Many of the federal agencies providing this assistance are well known - the Small Business Administration (SBA), Rural Development (RD), and the Department of Housing and Urban Development (HUD). The state and local government programs, along with the philanthropic programs, are less familiar but are often as supportive as the federal programs. The process of using these program enhancements to make undoable deals bankable is termed *development finance*.

Article Objectives

This article has two objectives: (1) to examine the structuring of devel-

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Doing the Undoable

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opment finance deals, and (2) to address the problems associated with institutionalizing development finance lending. In both cases, the prevalent issues are the same as in conventional lending. Standard credit analysis principles guide the structuring of individual deals; overhead costs and interest rate risk considerations guide the decision to institutionalize the activity.

The Development Finance Process

The starting point to understanding development finance lending is not the alphabet/numbers soup of government and philanthropic programs - CDBG, HUD, NHS, EDA, LISC, UDAG, GNMA, SBA, 221(d)(2), 235, 504, 312, and so forth. These programs are the caulking that fill the financial and managerial gaps in individual projects and mitigate the internal costs and risks associated with development finance lending. They are resources that can make deals work, but only after a thorough project analysis.

The critical issues and decisions associated with development finance lending are easily understood when analyzed sequentially (see chart on pages 6-7). The upper portion of the chart, the project analysis, addresses credit issues associated with structuring individual projects. The lower portion (highlighted in beige) addresses internal or organizational issues associated with development finance lending.

The project analysis section of the chart (upper portion) begins with credit analysis. Development finance projects are treated like any other project the lender considers and are subject to the same underwriting criteria. Projects that initially pass the credit test without enhancements are eligible for conventional financing. By definition, development finance projects will fail the test until enhancements are used.

For projects that fail the credit analysis, weaknesses or gaps are identified and matched with appropriate enhancements. Since the enhancements usually produce additional financial support, the project cash flows change. This change requires another credit analysis.

Projects often cycle through this process several times to obtain the optimal combination of enhancements. It is a discovery process which the Hungarian chemist, Albert con Scent-Gyorgyi, once described as "seeing what everybody has seen and thinking what nobody has thought." If the project can be made creditworthy, however, there is no guarantee it will be funded by a lender. Much depends on the lender's motivations and business constraints.

The following sections explore the credit and institutional analyses individually.

Credit Analysis Issues

The credit analysis part of the development finance process focuses on protecting the lender's funds. Lenders, in contrast to equity investors, demand a high probability of repayment and use the credit analysis process to obtain that assurance. Projects that pass a variety of credit tests are financed; those that do not are not financed.

Operating Expenses and Net Operating Income

From expected cash flow, operating expenses must be met first. These expenses include the daily costs of operations, utilities, and management; property taxes; insurance; maintenance and repairs; and a reserve for replacing capital items. Deducting operating expenses from gross income leaves net operating income.

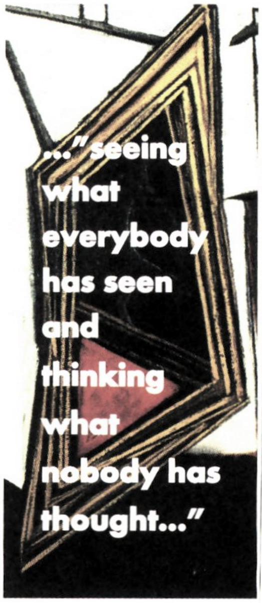
Net operating income is the primary source of loan repayment. A measure often used to evaluate this source is the debt coverage ratio (net operating income divided by debt service expense). Projects with a value greater than 1.0 can service debt from operations.

Collateral

If cash flow fails to service debt, lenders seek a secondary source of repayment in the form of collateral - typically the asset being financed. Loan to value ratios are a common collateral measure, comparing the value of the property to the loan against it. These ratios are usually less than 80 percent and vary according to the nature of the collateral.

Acceptable ratios are lower with specialized properties such as single-use manufacturing facilities and with properties in disadvantaged locations. Whatever the property, the appropriate measure of its value is its market value, not the amount invested. In the case of many community development projects, collateral value is considerably less than the construction simply because of the property's location.

Ownership Incentive



Another factor lenders consider in evaluating a project is ownership incentive. Even if a project produces sufficient cash flow to service debt, owners should get a sufficient return on their investment to ensure their continued interest.

A common measure of ownership incentive is the cash flow rate (cash flow divided by the owner's investment). With many development finance projects, these rates are far below the typical 15-20 percent minimums often required by investors. However, this deficiency need not pose problems. Equity investors in development finance projects are often satisfied with other incentives such as tax benefits or even the fulfillment of community service objectives.

While credit decisions are largely financial in nature, other factors are also important. Perhaps most important is the borrower's character. An

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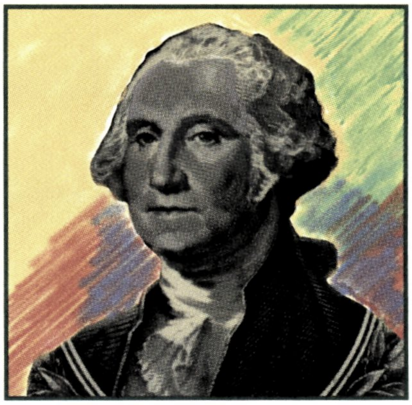
Why Banks Don't Make Every Loan You Think They Should Make



The following article is excerpted from a paper prepared by Ron Zimmerman entitled, "Banking for Nonbankers: Why Banks Don't Make Every Loan You Think They Should Make". The paper, originally written in September 1989, was updated in December 1995 and presents a simple discussion of important banking concepts that help explain why below market rate loans and higher default rates are difficult for banks to absorb. For a copy of the paper in its entirety, please contact this Reserve Bank.

The key to understanding how banks work is in knowing that banking is a highly leveraged, low margin, high volume business and gaining an appreciation for the constraints that these characteristics place on banks. In addition, to truly understand banking one must realize that banks are regulated entities and face keen competition from both within and outside the industry.

Leverage

When a bank loan officer lends money, he or she must be mindful that most of the money belongs not to the owners, but primarily to depositors. As a rule of thumb, a bank in sound condition would be considered to be adequately capitalized if its capital amounted to about 7 percent of the bank's total assets. This means that for each dollar loaned out, only 7 cents is the bank owners' money and the remaining 93 cents belongs to someone else.

While federal deposit insurance has eliminated many concerns, the high leverage in banking continues to be both the boon and the bane of bank investors. On the one hand, leverage can mean that a seemingly insignificant profit on the bank's assets can yield a nice return on the amount the bank owner has invested. On the other hand, even a small loss on the bank's assets can mean a sizeable loss to the bank stockholder.

For instance, assume a one dollar loan. If only 7 cents of that dollar belongs to the bank investor, then even if the bank nets only a 1 cent return on that dollar, the investor's return is slightly in excess of 14.25 percent (i.e. \$.01 divided by \$.07 times 100). By the same token, if the bank loses 1 cent of the dollar, the investor's loss is 14.25 percent. Note that depositors do not share in the profits or losses because they do not share in the risk of the investments. In effect the depositor has opted for the comparative safety of an insured but lower yielding deposit account rather than an equity investment which brings the possibility of a higher return but also a greater risk of loss.

Profitability

Bankers use two primary measures of bank profitability: return on assets (ROA) and return on equity (ROE). ROA is net income divided by total bank assets expressed as percentage. ROE is net income divided by total stockholders' equity expressed as a percentage.

ROA and ROE have different uses, but both are important. ROA is used to compare one bank with another. ROE allows analysts and investors to compare a bank's performance to not only other banks but to companies operating in other industries as well. One must realize that a bank's ROA and ROE has to be competitive in the marketplace. Otherwise, the bank cannot attract the investment capital it needs to grow.

A bank is regarded as doing reasonably well if its ROA is 1 percent or better. In 1995, the average ROA for all banks in the U.S. was 1.3 percent. Large money center banks in particular would be very pleased with a 1 percent rate of return, since competition is so keen among these banks and with other competitors in the nonbank financial service industries.

Low Margin

One might reasonably ask why banks cannot make much more than 1 cent on each dollar of assets. The answer is because banking is a low margin business. Banks' costs greatly offset the gross yields received on their investments.

Earning and Nonearning Assets

Bank assets may be divided into two broad categories: earning and nonearning. Earning assets for the most part consist of loans and securities. Nonearning assets might include actual cash on hand, the bank building, other real estate owned (which primarily consists of properties acquired through foreclosure) and loans that are not being repaid. One would logically conclude that the higher the percentage of earning assets, the more income a bank might expect to generate. For this reason, banks monitor the relationship between earning assets and

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Why Banks Don't Make Every Loan

Continued from previous page

nonearning assets very closely.

Hence, the volume of foreclosed properties is particularly critical since, not only are these assets not earning interest but the bank typically incurs costs to maintain and sometimes improve the property until it can be sold. In addition, the bank must pay interest on the deposits used to fund a foreclosed asset despite the fact that the bank is receiving no income. This is why one often hears bankers say they do not lend solely based on collateral value. Absent a borrower's reasonably reliable source of cash flow, a bank generally will not make a loan no matter how much the collateral is worth in relation to the requested loan amount.

Competitive Pressure on Earnings

If a bank were able to earn an average 8 percent on its assets and paid an average 4 percent for deposits, its net interest income would be 4 percent. Net interest income (NII) is the difference between the interest earned by banks on their loans and other assets, and the interest paid by banks for the use of depositors' funds. NII is the largest component of a bank's earnings. Other sources of revenue, called noninterest income, includes earnings from bank services such as fees for safekeeping services and trust accounts, and service charges on deposit accounts.

Overall, a bank averages about 1 cent in noninterest income for each dollar of assets on its books. In our example, if we add this amount to the 4 cents in NII, the bank's earnings before expenses amounts to about a nickel on the dollar of assets. Out of this, the bank must pay for its losses on loans that are not repaid, and pay its overhead expenses and taxes.

Overhead

A bank's overhead expenses typically include salaries and employee benefits, rent on the bank buildings, furniture and equipment, data processing systems, marketing expenses, insurance, federal assessment for deposit insurance, stationery, postage, telephone, etc. Because of the high volume of transactions banks complete, large staffs and correspondingly large amounts of office space, equipment and supplies are needed. In addition, its "back office" functions (e.g. bookkeeping, data processing, marketing, and the like) are not readily apparent to the public. However, these functions along with the more obvious expenditures result in a large overhead expense relative to many other industries. A representative figure might be around 3 cents on each dollar of assets, although inflation, salary competition to attract and retain good employees, and other factors are constantly straining overhead costs.

If we subtract the 3 cents from our nickel above, we are left with 2 cents before taxes and loan losses. Overall, a bank will be doing reasonably well if it is netting about 1 cent on each dollar of assets after taxes.

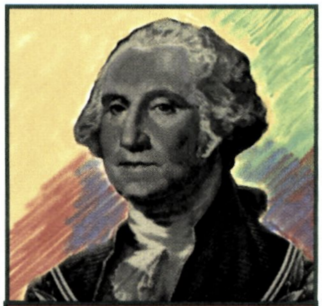
That concludes a simplified description of how banks make money and how much money they make. In reality, the process is enormously complex with little room for errors in judgment or faulty execution. The example above used whole percentage points for illustration. In actuality, bankers measure success or failure in fractions of a percentage point, or so-called "basis points" (100 basis points equal 1 percent). A few basis points swing in cost or income can mean a lot of money to a bank. For this reason, bankers are known to have some of the "sharpest pencils" around, figuring their costs to the fraction of a penny.

Losses

What constitutes high risk in a credit decision is a matter of opinion. However, perhaps it can be put into perspective by examining in a general sense how much a bank can afford to lose on loans. Let's take our $1 in assets again, remembering that the bank has about 7 cents in capital and nets about 1 cent on the $1 in assets.

Assume, for example, that earning assets average 75 percent of total assets or 75 cents in loans. If only 1 percent of our loans are lost, that's 75 percent of the 1 cent in net income the bank would have made. If the bank netted 1 percent on the remaining 74.25 cents in loans (75 cents minus .75 cents lost), the actual "profit" would amount to .7425 cents in interest (74.25 cents times .01) less .75 cents in loan losses or a net loss of .0075 cents. So losing 1 percent of loans in this example equates to an overall loss of .0075 cents.

As a practical matter, a bank may be able to absorb more in loan losses, perhaps as much as 2 percent, before the bank sustains an overall loss. This is because some banks' cost structures allow them to net a higher amount of interest income and some generate more noninterest income. However, losses of 1 percent on loans would surely have the stockholders howling since the return on their investment would in any case be below normal for the bank (if not negative). Of course, even 2 percent is not much of a margin for error. It should also be apparent from these calculations that a 10 percent loan loss would render the bank insolvent! This helps explain why the highly leveraged nature of banking compels bankers to be so conservative in their credit judgments.



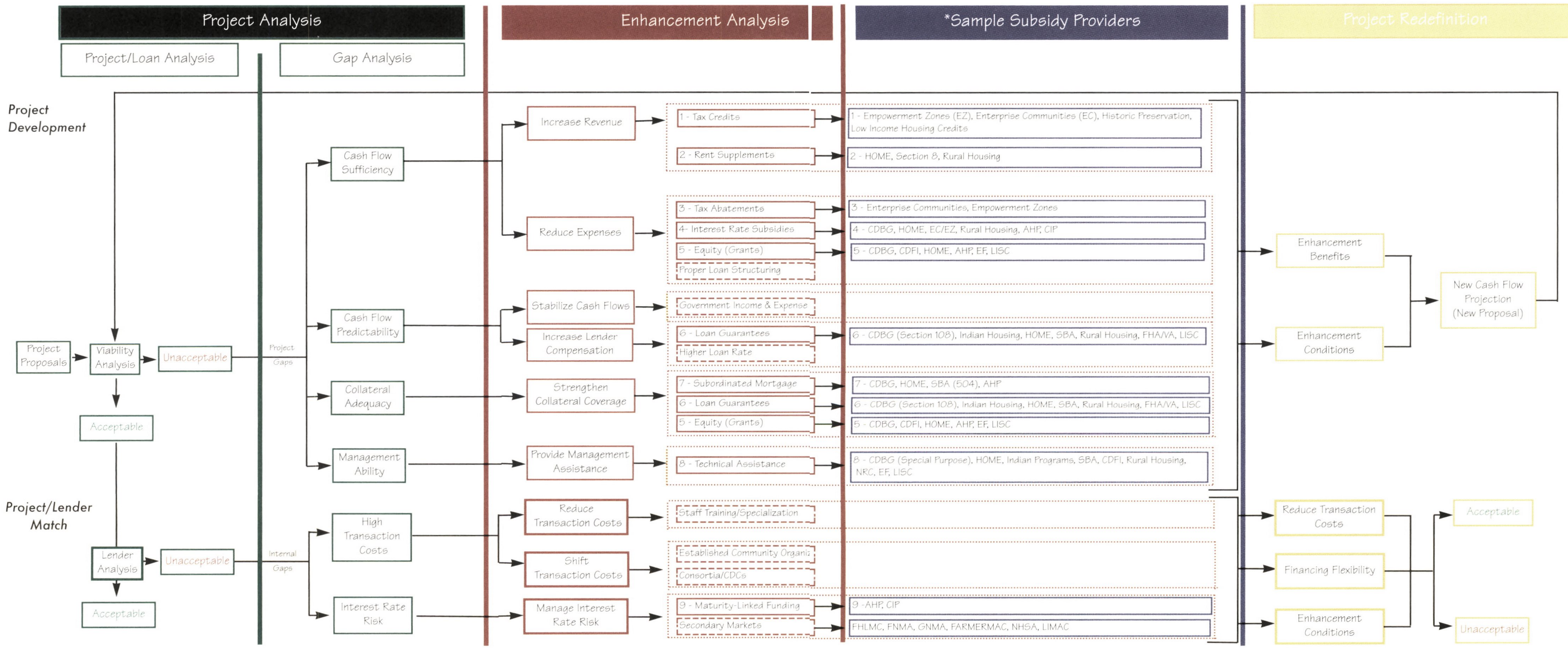
"...Banking is a high volume, low margin, highly leveraged business..."

Conclusion

In conclusion, it should be noted that the inherent nature of banking severely restricts how conventional

See Why Banks Don't Make Every Loan on page 8

Doing the Udoable Deal



* See following page

The ABCs of Subsidy Providers

Low-income Housing Tax Credit (LIHTC) - a dollar for dollar tax credit that reduces federal income tax liability for investors in low- to moderate-income rental housing developments.

HOME Program (HOME) - a federal grant program provided to local governments for the development of affordable housing; usually leveraged with private funding sources.

Section 8 - a federal rent supplement program for low-income renters that pays the property owner the difference between the amount the tenant pays for rent and the market or contract amount.

Rural Housing Loans - direct loans, guaranteed loans, and credit towards interest rate buy-downs available through the U.S. Department of Agriculture's Rural Development program for housing in rural areas.

Enterprise Communities(EC)/ Empowerment Zones (EZ) - federal grant programs administered through the Department of Housing and Urban Development.

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Community Development Block Grants (CDBG) - grants allocated to state (non-entitlement) and local (entitlement) jurisdictions to engage in a variety of community development activities.

Affordable Housing Program (AHP) - a Federal Home Loan Bank program that provides grants or loans to its member institutions, which then make the funds available to grantees or borrowers for housing development activity.

Community Investment Program (CIP) - a Federal Home Loan Bank program that provides advance funds to its member banks who in turn provide maturity-linked, subsidized loan assistance for a variety of housing and small business development activities.

Community Development Financial Institution (CDFI) - a financial institution established with the sole purpose of promoting community and economic development.

Bureau of Indian Affairs (BIA) - provides management, technical assistance, and loan guarantees for housing developments owned or occupied by Native Americans on trust land or in Indian or Alaska Native areas.

Historic Preservation Tax Credits - a program administered by the U.S. Department of the Interior that provides tax credits for rehabilitation of historic structures to property owners and long-term lessees.

Veterans Administration(VA)/ Federal Housing Administration (FHA) - insures loans made by private lenders that make lower interest rate or more favorable term loans to borrowers.

Small Business Administration (SBA) -offers a variety of special loan and guarantee programs for small business start-up and expansion efforts.

Local Initiatives Support Corporation (LISC) - a large, national, non-profit community development finance intermediary that also administers LIMAC, a secondary market provider that invests in loans made by LISC non-profit affiliates.

Neighborhood Reinvestment Corporation (NRC) - a federally chartered community development finance and technical assistance intermediary that works with non-profit community development organizations through its NeighborWorks network. NRC also operates a secondary market provider, NHSA, that invests in home mortgages made by NeighborWorks affiliates.

Federal Home Loan Mortgage Corporation (Freddie Mac) - secondary market provider that purchases mortgages and resells them in the form of guaranteed mortgage securities.

Federal Agricultural Mortgage Corporation (Farmer Mac) - provides a secondary market for agricultural real estate and rural housing loans by allowing the loans to be packaged and sold into loan pools that serve as collateral for investors.

Federal National Mortgage Association (FannieMae/FNMA) - a publicly owned secondary market provider that is chartered by Congress to invest in home mortgages originated by private lending institutions.

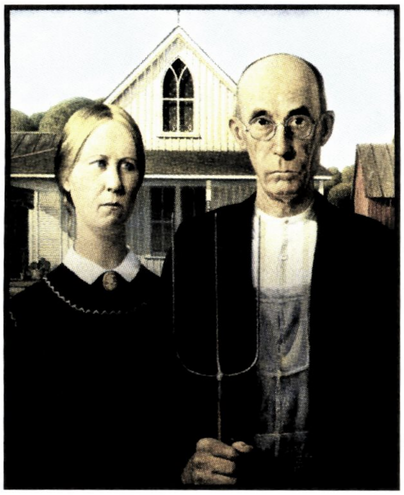
Government National Mortgage Association (GinnieMae/GNMA) - provides a secondary market for private lenders by purchasing mortgages generated by subsidized programs to support the construction and purchase of low- to moderate-income housing. ♦

Why Banks Don't Make Every Loan

Continued from page 5

banking products, in the absence of public or private enhancements, can be modified to make them more affordable for low- and moderate-income people. The fundamentals cannot be altered long term without undermining the competitiveness of the banking industry and seriously jeopardizing banks' safety and soundness. There is a limit to the concessions that banks alone can make. That limit is far below the level needed to make long-term progress in addressing the needs of low- and moderate-income people. If one falls to recognize this fact, one will be forever trying to pound a square peg into a round hole.

Fortunately, there is better way: the public/private partnership. Government, charities, and private corporations can work with the banks to leverage their funds in ways that are affordable and effective. In this way, each party can play to its strengths and through enlightened self interest, everyone involved can "win" ♦



Why Loans Go Bad

by
John Campbell

Conventional loans don't always perform as agreed. In this article, a senior bank examiner reviews some of the reasons loans go bad, and offers several suggestions to prevent problems before they arise.

Why do some loans, originated as apparently sound credits, deteriorate as they age? Over the years, I have heard literally hundreds of "why's". Often a loan officer who originates a loan that ends up on a bank's watch list, on a delinquency report, or in the workout department, points to external factors outside his or her control.

Problem credits are frequently attributed to a personal tragedy experienced by the borrower, an unpredictable reversal in a borrower's financial condition, fraud or misrepresentations by borrowers, borrowers that become uncooperative after the loan is made, a downturn in the local or national economy, natural disasters, and other events that some lenders feel were not foreseeable or controllable.

I think there is a more basic reason for loans going bad than the various "why's" discussed above. Although many unexpected events contribute to loans going bad, most loan problems that I have seen resulted primarily because lenders did not closely adhere to fundamental underwriting practices. Lenders need to anticipate a wide range of possibilities. Adhering to time honored lending practices will protect the organization when the unexpected occurs. Lenders who do not closely evaluate a customer's ability to repay in various scenarios - including adverse circumstances - and structure loans accordingly, often find the obligations they have booked end up in the charge-off records. Underwriting should include consideration of the "what if's" and provide for repayment if things don't go as anticipated.

A type of loan that I have routinely seen in South Florida, the undeveloped land loan, often provides an example of faulty underwriting. All too often a lender violates fundamental underwriting rules when he or she makes a vacant land loan. In most cases, the repayment of these loans is dependent on resale of the collateral property and typically there are no other reliable backup repayment sources. Generally borrowings made on the undeveloped land are to borrowers with limited cash flow to service the obligation. If the borrower does not or cannot sell the property in a relatively short period of time, the lender is often faced with deciding between either foreclosing on the property or deferring payments for extended periods.

Underwriting standards are sometimes sacrificed because of market competition. In rare cases, it is appropriate for a bank or other lending organization to approve loans that are exceptions to standard guidelines. However, the pressure to compete often drives an organization to approve too many loans that do not conform to the institution's or industry lending guidelines. The current banking and general business environments seem to be stimulating growth initiatives and strong competition in a saturated market. Those influences may negatively affect adherence to prudent lending standards.

One loan officer I recently spoke to alluded to pressure on lending standards. He referred to the "hope factor" as one significant deterrent to sound underwriting. A lender, he explained, often hopes a marginal loan presented for approval at an institution will improve based on some future event. Loan committees may also overlook shortcomings in a loan presentation and approve a loan because of promises a borrower has made, other unrealized expectations, and the competitive push to book loans.

A borrowing applicant, for example, may indicate that even though the historical cash flow from an income producing property being pledged as collateral does not provide adequate debt service coverage, a new lease being negotiated will provide the necessary coverage. Or a borrowing entity may provide very positive earnings projections despite losses in previous years. In order to make a deal work, the lender and committee may be tempted to stretch loan to value guidelines without thoroughly assessing anticipated cash flows or fail to closely evaluate projections.

Excerpts from the Robert Morris Associates annual fall conference held October 20-22, 1996, and comments of local lenders evidence a general industry concern that nationwide lending standards may be under stress. The principal concern

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Why Loans Go Bad

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expressed was that there is extremely heavy competition among lending institutions that is putting pressure on underwriting standards. In his keynote address at the RMA conference, David A. Daberko, Chairman and Chief Executive Officer, National City Corporation, Cleveland, Ohio, said "... the most compelling issue in corporate banking today can be put very simply: There are too many dollars chasing too few deals, creating an undesirable underwriting environment." He noted that "... the signs are there to be read by all of us: slowing asset growth, narrowing margins, more lenient terms."

The current strong business cycle has lasted longer than many have expected. The stock markets are at record highs, retail sales remain strong, and corporate profits are generally solid. Some economists feel that economic growth will continue unabated for several more years. However, some analysts feel that with increasing numbers of personal bankruptcies and increased levels of consumer debt delinquencies, an economic downturn may not be far off. Lenders who do not factor the possibility of a weakening general economy into loan decisions and who fail to maintain tight underwriting standards, may be booking loans today that will be tomorrow's problems.

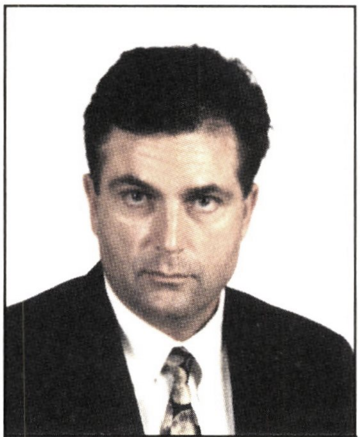
Underwriting Standards

Sound loan underwriting standards should ensure that a thorough analysis of loan purpose, repayment source, and collateral are being performed. Analysis of financial information, projections, and cash flows are critical for maintaining credit quality. Loan structure, terms, and covenants must be consistent with the above analysis. The borrowing history and background of the borrower, and industry and economic outlooks, generally need to be reviewed in detail as well.

The size and complexity of debt dictates the extent of financial analysis. Questions to consider are :

- Does the analysis contain appropriate financial ratios, trends, and cash flow history and projections to determine the financing needs and repayment capacity of the borrower?

- Are important items like salaries, fees, dividends, notes receivable and payable to insiders evaluated?



John Campbell is a senior examiner with the Miami Branch of the Federal Reserve Bank of Atlanta.

- Are significant balance sheet and income statement changes properly explained and are financial statement footnotes reviewed?

- Does the lender properly identify and review contingent liabilities?

- Is the quality of financial information submitted by the borrower commensurate with the size and complexity of the loan?

- Is the funds flow statement (source and use of funds) evaluated?

The following controls should be in place to ensure that the lending organization initially and routinely thereafter verifies the existence of, inspects the condition of, determines the value of, and perfects its interest in the collateral:

- The value of significant collateral should be assessed by independent parties and reviewed for reasonableness by in-house staff.

- An environmental assessment also should be performed by independent parties for real estate collateral.

- Lien and litigation searches need to be performed.

- For receivable financing, current agings should be reviewed for trends, concentrations, ineligible accounts, and compliance with any borrowing base formula.

- Inventory collateral schedules should be received and reviewed on a regular basis and adjustments made for obsolete or ineligible items.

- Listings of equipment held as collateral should also be routinely evaluated considering "in place", "orderly liquidation" and "fire sale" values.

- Routine visits to the borrower's place of business should be made to determine the condition of business operations, and the existence and condition of tangible collateral.

- Frequent repricing of liquid and readily marketable collateral should be undertaken to ensure that proper margins are maintained.

- Intangible assets should be evaluated using discounted current value of cash flows, multiples of net income, commissions or sales, recent market sales or franchise values.

- On-going reviews of compliance with loan agreement covenants should be conducted and events of non-compliance tracked until cured or waived.

Underwriting should provide a clear understanding of the lender's and borrower's responsibilities under the borrowing arrangement. All pertinent details relating to the loan should be documented in writing, including secondary and tertiary repayment sources, requirements for borrower's submission of financial information, detailed collateral descriptions, and default provisions.

While all good lenders take risk, and sometimes the best laid plans go wrong, *an ounce of prevention*, as the saying goes, *is worth a pound of cure*. ♦

Doing the Undoable

Continued from page 3

honest, committed borrower with the knowledge and experience to succeed with a project is essential. Also, knowledge of the community and the local economy is essential to making sound lending decisions. If a project involves the leasing of commercial space, the creditworthiness of the lessors is also important. Factors such as these must be considered and may be cause for denial.

If the project passes the credit tests, it can be funded with conventional resources. If it fails, however, a decision must be made about pursuing credit enhancements. This decision will depend on the project's eligibility for credit assistance and the willingness of the project sponsor to expend the effort to undertake further analysis. Assuming the decision is to proceed with further analysis, the next task is to identify project gaps and enhancements.

Gap and Enhancement Analysis

Lenders and investors have numerous reasons for not funding projects - such as weak sales projections, high overhead, inadequate management experience, insufficient collateral, and newness of a business. These deficiencies can be broadly classified as return, risk, and management gaps. Each represents a sound basis for not supporting a project.

Marginal Debt Coverage

Low return is perhaps the most common project deficiency. Simply stated, income does not exceed operating expenses by a wide enough margin to justify either debt or equity funding. The debt coverage and cash flow ratios may be too low. A variety of enhancements are available to augment return by increasing project income or lowering expenses.

Today, income supplements fall into two basic categories - rent subsidies and tax credits. The Section 8 housing certificate and voucher programs administered by the U.S. Department of Housing and Urban Development are the nation's rent subsidy programs. Under these programs, HUD helps low-income households obtain adequate housing by issuing certificates or vouchers for the difference between the cost of adequate housing in the market area and the renter's ability to pay. These payments thus enhance the landlord's revenues.

Unlike rent subsidies that enhance operating revenues, tax credits do not alter a project's financial statements. However, they are integral to the financial analysis of a project because they produce important returns to investors that emulate project income supplements.

At the federal level, for example, tax credits exist for low-income housing and the preservation of historic buildings. Both allow investors to obtain federal tax credits for contributions of goods, services, and cash to approved organizations, including venture capital funds.

Expense Reduction Measures

A wide range of programs are available for reducing expenses. Local governments often use real estate tax abatements to reduce operating expenses and augment cash flow available for debt service and equity holders. Tax increment financing is another form of tax abatement that uses taxes for property improvements. Interest rate subsidies can be provided in the form of below market rate funds provided by local bond issues. A direct rate buydown in which a third party helps make interest payments is another form of subsidy. Compensating balances and blended rate financing can also serve to subsidize interest payments.

Equity grants, in the form of property or cash may be available to reduce expenses by lowering the amount of debt that will be required.

Corporate and foundation grants to project sponsors are also popular, as are investments by national and local community development organizations. Community Development Corporations (CDCs) are equity investment vehicles for national banks, state member banks, and for bank holding companies.

A conventional technique often used to lessen the debt service burden is to extend debt maturities. A final means of reducing operating expenses is the use of small business incubators. Incubators allow small businesses to share common facilities and office personnel and many incubator tenants can access technical expertise from nearby colleges.

Risk Gaps

Cash flow, collateral and management also present potential risk gaps. Cash flow risk can be mitigated by stabilizing income and expenses through the various subsidies. Collateral risk can be offset through the use of loan guarantees or equity financing, for example. Management depth and expertise is a final project-related concern. Two significant resources are incubators and management consultants.

All of the enhancements bring constraints along with subsidies. These constraints may include job creation requirements or housing disadvantaged people. All the constraints must be satisfied.

Successful completion of the credit analysis process does not guarantee project financing. The lower portion of the chart depicts the institutional issues that must be addressed before the funding decision is made. However, a well-packaged deal taken to the appropriate financial institution can become "doable ".♦

For a full reprint of the guide, Doing the Undoable Deal, *please contact the Federal Reserve Bank of Atlanta.*

OUR MASTHEAD

Our masthead painting is of Jacksonville Landing, the downtown waterfront development in Florida's largest city. The temperate Florida climate makes this Rouse Development a very popular outdoor gathering place for residents as well as visitors to the city.

CALENDAR

Information provided on upcoming events of other organizations should be viewed as strictly informational and not as an endorsement of their activities.

JANUARY

American Bankers Association, January 22-25. Security Sales Management Forum, Palm Beach, FL. Contact: (800) 338-0626

The National Council for Urban Economic Development, January 23-25. Redevelopment Finance, Tempe, AZ. Contact: (202) 223-4735

American Bankers Association, January 26-29. ACB/ABA National Mortgage Markets Conference and Super Marketplace, Tucson, AZ. Contact: (800) 338-0626

American Bankers Association, January 26-29. National Security, Audit and Risk Management Conference, Atlanta, GA. Contact: (800) 338-0626

American Bankers Association, January 26-29. National Trust and Private Banking Conference, Washington, DC. Contact: (800) 338-0626

FEBRUARY

Neighborhood Reinvestment Corporation, February 17-21. Neighborhood Reinvestment Training Institute, Atlanta, GA. Contact: (800) 438-5547

Amercian Bankers Association, February 23-26. ABA/BMA National Conference for Community Bankers, Orlando, FL. Contact: (800) 338-0626

The National Council for Urban Economic Development, February 24-26. Introduction to Economic Development, Washington, DC. Contact: (202) 223-4735

The National Council for Urban Economic Development, February 26-28. Financing Economic Development and Attracting Jobs, Washington, DC. Contact: (202) 223-4735

MARCH

Amercian Bankers Association, March 2-5. National Fiduciary and Securities Operations Conference (NFSOC), Orlando, FL. Contact: (800) 338-0626

VICE PRESIDENT
Ron Zimmerman

EDITOR
Courtney Dufries

ASSOCIATE EDITOR
Marie Easley

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