



Loan Fund Tip Sheet

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Loan Servicing Policies and Procedures

Sound underwriting is only half of the lending challenge. No matter how solid a loan appears when initially made, effective servicing is required to ensure that the borrower stays compliant with loan covenants; to respond to borrower problems early in order to prevent defaults; and, in the event of a default, to protect the lender's ability to recoup its investment. According to the policies and procedures manual for the Philadelphia Industrial Development Corporation (PIDC) in Pennsylvania, servicing tracks loan repayment, insurance maintenance, the borrower's financial health, and how well the company is meeting employment objectives.

Including servicing standards in a loan fund's policies and procedures manual is an important part of fund management. The manual is helpful for new staff and loan review committee members and is a guide for applying annual review, collection, and other standards to all loans in the portfolio.

Servicing Files

Servicing files provide a complete history of the life of a loan. They should be both detailed and easy to navigate so that the loan officer, the lender's finance officer, auditors, federal agency overseers, and others can quickly learn the loan's status. Dana Sumner, of Development Finance Training and Consulting (DFTC), suggests that files include the following sections:

Section 1

- Loan information;
- Jobs impact data;
- Collateral information;
- Year-end business financial statements;
- Interim financial statements;
- Business tax returns;

- Projections;
- Personal financial statements; and
- Personal tax returns.

Section 2

- Account information; and
- Contact information.

Section 3

- Information about the loan presented to loan review committee over the years.

Section 4

- Running memos and analysis.

Section 5

- Correspondence.

Section 6

- Insurance; and
- Other

East Central Regional Development Commission in Mora, Minnesota, recommends also including a summary sheet for each loan. It should include general information about the loan, such as business contact information, federal identification number, loan structure, other lending sources, payment dates, job creation, North American Industry Classification System (NAICS) number, Uniform Commercial Code (UCC) continuation filing reminder, and dates to request financial statements.

The Annual Review

Loan fund staff should conduct formal visits of their borrowers at least once a year (unscheduled and informal visits at other times are also recommended) for a variety of reasons, including getting an update about the

business' market, discussing problems faced by the borrower, checking the condition of loan collateral, and finding out if the company is still compliant with loan requirements. A site visit form can be used to document these findings. This form, as well as a memo summarizing the visit (including such sections as site review, interview with borrower, financial review, and action needed), are submitted to the loan review committee and filed.

Impact Data

Federal agencies and usually require periodic reports from the loan funds they capitalize. As time-consuming as these reports can be to prepare, their ultimate value is in demonstrating the important role played by loan funds in economic development. Borrowers are an indispensable source of employment and other impact data included in these reports.

The Rural Electric Economic Development, Inc. (REED) Fund in Madison, South Dakota, has its borrowers complete an annual business impact survey to evaluate the social and economic impact of its loan portfolio. It collects and keeps confidential information such as the number of full- and part-time employees, benefits provided, total amount of payroll withholding taxes, total wages and salaries paid, taxes paid, and sales activity by geographic area. PIDC annually asks for the number of employees by position to track the borrower's compliance with mutually agreed upon employment goals set prior to loan closing.

Insurance

Loan funds also are responsible for making sure that tangible assets in which they have a security interest are insured. According to PIDC, borrowers are required to provide liability and property insurance for the asset on an ongoing basis until the loan has been fully repaid. They also need to annually submit an insurance binder that specifies the following information:

- Nature of the insurance provided;
- Appropriate insurance limits;
- Expiration date;
- Correct identity of named insured; and
- Correct identification of PIDC as loss payee and/or mortgagee.

Financial Statements

Good portfolio management practices necessitate that borrowers submit financial statements on an annual basis (new companies should submit quarterly financials). Submission requirements are detailed in the commitment letter.

While certified public accountant (CPA)-audited financial statements are preferred, loan fund professionals accept CPA-reviewed statements, CPA-compiled statements, and tax returns. PIDC uses the following submission requirements:

- Borrowers with less than \$1 million in annual revenues have to submit at least corporate and personal tax returns;
- Borrowers with between \$1 million and \$2 million in revenues have to submit at least CPA-compiled statements and corporate and personal tax returns;
- Borrowers with between \$2 million and \$10 million in revenues have to submit at least CPA-reviewed statements and corporate and personal tax returns; and
- Borrowers with more than \$10 million in revenues have to submit CPA-audited statements.

Borrower Information to Check on Annual Basis

- Additions/improvements/changes to collateral;
- Changes in ownership or control of business;
- Proof that property taxes are current;
- Proof that liability, property, auto, worker's compensation, and life insurance policies are current and paid promptly;
- UCC dates verified for renewal; and
- Annual financial statements and tax returns received.

Tips from Dana Sumner, DFTC.

The purpose of requesting financial statements is to determine the borrower's ability to continue servicing their debt. Variances,

discrepancies, and trends can be identified by comparing current year financial statements to projections and previous years' financials. Loan fund professionals should not hesitate to ask questions about such red flags as fast growth, decreasing net worth, increasing officer compensation, and new debt.

To improve borrowers' compliance with submitting documents, some loan funds incorporate into the commitment letter and promissory note language about penalties that go into effect when documents that are required annually are not received. To induce borrowers to be more punctual, loan funds can impose an interest penalty of, say, 5 percent on each monthly payment during the period that information is not received.

Risk Rating Update

Once a borrower's financial statements have been reviewed, their risk rating is updated as part of the loan fund's portfolio management. The Southeast Alaska Revolving Loan Fund (RLF) in Juneau, Alaska, assigns risk ratings that range from 1 (exceptional -- loans with strong primary and secondary sources of repayment) to 3 (satisfactory -- loans with moderate primary and secondary sources of repayment or weak primary and strong secondary sources of repayment) to 5 (substandard -- loans for which repayment is inadequately protected by the capacity of the borrower or the collateral pledged) to 7 (loss -- loans which have been partially or completely written off). To reduce the risk of delinquency and default, technical assistance and increased attention should be provided to borrowers with higher and worsening risk ratings.

Changes in risk ratings are communicated to the loan review committee. It is policy at the Southeast Alaska RLF that a problem loan report is completed within 30 days of a rating downgrade and updated quarterly. The report includes a description of the problem and the loan's status, an evaluation of primary and secondary sources of repayment, a description of appropriate upgrade and downgrade triggers, and a strategy and action plan for rectifying the problem.

Changes in Collateral and Owners/Guarantors

Occasionally, a loan's collateral, owners, and/or guarantors change during the life of the loan. If so, the loan should be re-analyzed to determine the impact of such changes on the viability of the loan. If needed, additional collateral is taken. The loan file should include documentation of the board's approval of the change.

Collection Policies

Collection procedures should be explicit about the following:

- When and how payments will be made;
- When the fund manager will review files for late payments;
- Notification procedures in the event of delinquency and default;
- Penalties to be charged; and
- The role of attorneys and/or third-party collection agencies.

Payment Schedule and Method

Loan fund professionals use various systems for collecting payments:

- Borrowers can be given an amortization schedule at the loan closing so they know payment amounts and due dates.

The Importance of Using Loan Servicing Software

A growing number of loan funds are turning to loan servicing software packages to track loans, generate reports, and increase the efficiency of their operations. While EDFS does not advocate any one program, it does urge loan fund professionals who do not currently have a program to consider the benefits of investing in one.

Loan servicing software programs facilitate the work of loan fund professionals in such ways as compiling and tracking information on loans in the portfolio, preparing a variety of necessary forms and reports, and linking loan fund financial data with the parent organization's accounting system. In a broader sense, purchasing a software program is one of a number of strategies for raising the standards of professionalism of the loan fund community.

For more information, visit www.nado.org/edfs for a copy of *Loan Servicing Software: A Buyer's Guide*, free for EDFS members, \$10 for nonmembers.

- Some loan funds mail monthly invoices prior to the due date, while others provide a payment coupon booklet at the loan closing.
- The most effective and reliable means of collecting is by debiting a borrower's bank account on a particular date each month with electronic funds transfers (EFTs) through the Federal Reserve's Automated Clearing House (ACH). This approach reduces paperwork for the loan fund and borrower and improves the cash flow of the fund. According to EDFS members, ACH/EFT software is available at a reasonable cost.

Reviewing Files for Late Payments

To be sure late payments are identified on a timely basis, loan officers print a payment history on a regular basis; weekly or bi-weekly on a set day is preferred. Loan servicing software can automatically prepare these aging reports.

Late Payment Procedures

Loan funds usually offer a grace period of 10-15 days.

Once this period has passed, a loan fund staff member calls the borrower to determine why the payment is past due and to request the payment. For legal purposes, calls should be documented and a letter sent to the borrower detailing the conversation.

Others send a letter informing the borrower their payment is late, that the lender could demand full payment of the loan if the monthly payment is not made, and that the borrower risks legal action if no payment is received. Penalty fees are sometimes added as soon as the grace period ends.

If the delinquency persists, additional letters are sent, usually at the 30- and 60-day late points; at least one EDFS member declares the entire unpaid loan balance immediately due and payable 11 days past the grace period. Meetings with the borrower can be held during this period to discuss the possibility of restructuring the loan to ensure repayment and providing technical assistance as needed. Also during this period, the loan fund manager can bring the matter before the loan review committee to discuss options.

After 90 days without payment, the loan is declared in default, and the fund can refer the case to a third party collection agency and/or an attorney for legal action, which could include foreclosure and auction of assets. Borrowers are liable for the lender's legal fees.

Regardless of the timetable a loan fund uses to notify past due borrowers, it is important that the timetable be applied consistently in all cases so there is no hint of partiality on the part of the fund. In addition, loan fund borrowers could one day be eligible for a bank loan, so they need to be familiar with collections procedures that approximate those used by banks. Finally, sound collection procedures safeguard the loan fund's assets; low delinquency and default rates mean the loan fund can make more loans faster.

Penalties

Penalties are usually applied as soon as the grace period expires. These can take the form of late fees (a set dollar amount or percentage of the amount due), or an increased interest rate until the borrower pays, such as raising a rate that is normally 5 percent up to 18 percent.

Delinquencies can impact risk ratings. ACEnet Ventures, Inc. in Athens, Ohio, has a policy that borrowers who are more than 30 days late will be reviewed and considered for a lower rating; those over 60 days delinquent will be classified with a lower rating. A lack of response results in the lowest rating and potential legal actions.

Reports

Loan funds are obligated to provide the following reports to their borrowers and funding agencies:

Borrower

- 1098 report of interest paid;
- Report of annual servicing fees; and
- Outstanding principal balance.

Funding Agency

- Annual and other periodic reports;
- Problem loans report; and
- Report of violations of programmatic requirements.

For More Information

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