



## [Ask A Good Customer to Leave...](#)



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The event that has become known as the “Subprime Crisis” has in some way touched nearly every American household and now, many countries around the world. Behind the scenes, there are thousands of scenarios playing out that will shape how business is done in the future. In the past few months there has been considerable tightening for certain types of credit. Here is but one example:

Some traditional banks are being criticized by their regulators for making “stated income” residential construction loans, regardless of the performance history, financial strength of the borrower or equity in the real estate being financed. For as much as two decades, banks had been successful selectively making stated income construction loans to high net worth individuals, who would arrange take-out financing upon completion of construction. Because complete financials are not furnished for the stated income loan and the number of competing take-out lenders has recently diminished, coupled with the common lack of a well documented commitment to take out, regulators view the stated income loan as being high risk and have required banks to downgrade the loan(s). All bank loans are risk rated, based on numerous internal and external factors. Reserves must be set aside by the bank to allow for any loan losses. The amount of reserves is determined by the volume of loans in each risk grade and keyed to the bank’s loss experience. The higher risk loans have a higher reserve requirement. As a result of the downgraded loans, the bank’s criticized / classified loan totals may abruptly go up and the bank’s loan loss reserves many times become inadequate. One may have foreseen this, considering the stated income concept was widely misused in qualifying borrowers for all types of loans. But that is not the end of the story.

As the domino effect plays out in the marketplace, so it goes within the bank. Additional to the general allocation for loan loss, the bank must do a specific reserve (FAS114) calculation on most classified real estate loans. If the value of the collateral adequately secures the loan, no additional reserves are required. However, today the FAS 114 calculation for a classified real estate loan should have a lower loan advance rate. Additional allowance must be made for a declining real estate market and extended time to market the collateral, if the bank forecloses. This means a loan that was well secured a few months ago may now be inadequately secured and require a specific reserve in addition to the general reserve for loan loss. This could cause a significant draw on bank income.

In dealing with the problem, the bank has several options, including asking the customer to leave the bank. In analyzing that alternative, the bank may consider the lost opportunity on the additional reserves and the additional servicing and reporting costs to come up with a

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discounted payoff incentive to get the borrower to leave. Other choices may be to sell the loan to an investor (also at a discount) or simply make the construction advances and allow the project to complete as originally planned.

As the situation is now playing out, banks are being stretched to find good loans to generate profit on narrow margins and, at the same time, boost reserves to cover the increased risk in the current environment. The most prudent choice for the bank may be to ask the customer to leave. But, to a good customer who is performing as agreed, it may seem unusual and may not play out well at all.

Anytime a customer is asked to leave, the situation can become contentious. If the situation escalates to a lawsuit, thorough discovery and engagement of an expert can be very helpful.

For example, a business obtained and used a product from a vendor that, when used as prescribed on his plants, it would increase quality and thus increase income for the business. Instead, for this business, production declined and the business lost money. The bank financing the business felt it was no longer creditworthy and asked the borrower to pay off their loans. The business filed a lawsuit against the vendor alleging mislabeling and misrepresentation and, among other things, the failure forced him to involuntarily refinance at a higher cost than he previously had.

Through thorough discovery and assistance from an expert, it was determined:

1. The borrower's bank at the time of the failure unknowingly refinanced him out of a problem loan situation at his prior bank.
2. The borrower had been out of compliance on numerous loan covenants since near the beginning of his relationship with the current bank.
3. The borrower ranked in the lower ¼ of his industry, when compared to his peers.
4. The banking relationship was to be exclusive, per the loan agreement. In reality, the business financed over \$1 Million with a trade associate and did not disclose it to the bank or in any financial statement.
5. In the year of the failure, Borrower actually would have experienced a financial loss without having experienced damage from the product.

The conclusion was the bank would have asked the business to leave, even if there had not been issues with the enhancement product.

The author of this article, Expert Witness Number 2251, has over 35 years of experience in commercial banking and real estate finance, including management of special asset

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departments for community banks and Farm Credit. This Expert has been a Chapter 11 Bankruptcy Trustee. This Expert's licenses and certificates include a California Real Estate Broker's license, a California General Building Contractor's license and a Housing Counseling Certification from NeighborWorks America.

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