

Credit's Far-Reaching Impact

Inaccurate credit reports and financials could ultimately hurt the commercial industry

By **Adele Pool**, regional manager, Sterling Bank & Trust

WE CAN'T PICK UP THE NEWS-paper or listen to the news today without hearing about the problems in the nonprime market. Nonprime mortgage lenders find themselves under pressure to tighten standards for credit-impaired borrowers. Recently, federal bank regulators announced a crackdown on loose lending standards as some major lenders struggled to cope with losses and regulatory problems.

Nonprime concerns continue to crop up across the residential and commercial sides of the mortgage industry as we hear news of hedge funds near collapse because of overexposure in the market.

As a commercial mortgage professional, you might be asking yourself what this has to do with your business. Well, when one part of the market falters, other parts of the industry eventually will feel it. We are all about to experience ever-tighter credit — commercial mortgage industry players included.

It's becoming evident that credit standards and requirements are going to be more strenuous on borrowers. As a result, you need to tell clients the importance of understanding credit and explain their right to know what's in their credit report. Also, let them know about regulations for fair credit reporting.

This is the time to use all of your resources to ensure that borrowers present the best-possible credit picture available. It's in your best interest to explain to them how, in many cases, every point on their credit report can make a difference.

The 5 C's

Although commercial lenders traditionally place more emphasis on the strength of the property than the strength of the borrower, that's

not universally the case. Many small-balance lenders take the borrowers' credit into consideration. They want to confirm that there's sufficient evidence that a person can and will pay back a loan.

Lenders are increasingly considering the five C's of credit analysis each time they make a loan. Explain to your borrowers how lenders will review their credit, capacity, character, collateral and capital.

When reviewing credit, lenders evaluate borrowers' abilities to meet financial obligations. They also attempt to determine how well borrowers live within their means.

Of the five C's, possibly the most critical is capacity to repay the loan. As such, the lender will almost always still consider the property's cash flow. In addition, payment history on existing credit relationships is considered an indicator of future performance. Lenders also want to know about the borrowers' secondary sources of repayment, including other incomes.

Character can be described as the general impression borrowers make on a potential lender. Some lenders look at educational backgrounds as well as experience in development and property management.

If for some reason the borrowers cannot repay the mortgage, the lender wants to know that the real estate (i.e., collateral) secured by the mortgage is marketable. A real estate appraisal will indicate the property's value.

Capital, otherwise known as cash equity, is the money borrowers invest, or have invested, in the project. The higher the percentage of capital to total cost, the more likely the lender will finance the project. Capital also reflects borrowers' ability and willingness to save money and accumulate assets. The higher their net worth

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and liquidity, the more cushion for repayment in the event of a financial setback.

Risks

The Fair Credit Reporting Act (FCRA) became law in 1971 and is intended to ensure that consumer-reporting agencies — and users of consumer-reporting-agency reports (such as financial institutions) — adopt reasonable procedures for the accurate and confidential handling of information relating to consumer credit.

In 2003, the Fair and Accurate Credit Transactions Act amended the FCRA mostly to give consumers added protection against identity theft. Nevertheless, identity theft and information security remain ongoing concerns for borrowers. When talking to clients about their credit, discuss these risks. If credit-reporting agencies aren't advised of identity theft in a timely fashion, the result will be higher borrowing costs.

Although many commercial mortgage professionals may not give a lot of thought to such credit issues, they should. An individual's credit report is like a litmus test. Impurities lead to lower ratings. This can result in the denial of loans.

Another credit issue that directly affects brokers is when borrowers lie about their financials. In the past several years, members of the residential industry have allowed risky transactions such as stated-income, no-documentation loans and similar loan types. Unfortunately, some of these loans were based on false information and contributed to the nonprime meltdown.

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Credit's Impact

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When seeking financing for commercial real estate, you must not only know your borrowers' credit, but you must also be aware of their overall financial background. Concealment of facts about the property, its income or the history of the borrowers is fraud. Such fraud ultimately can be detrimental to the entire industry.

While you're having clients go through credit checks, you should also run investigative and legal checks on them. These types of reports


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unveil criminal history, possible personal disputes, and past or pending litigation. They also give the borrowers the opportunity to explain the situations upfront rather than have the lender discover them later.

Lenders are getting back to the tenor of: “Know your borrower.” Rather than surprises, they want demonstrable data.



News about the nonprime meltdown spreading to the top of the food chain continues to concern all of us. It now appears the market may be softening and will likely get worse before it gets better.

Tightening and changing credit policies and attitudes affect both our commercial clients and us. With a better understanding of credit and other financials, you can provide the tools to maneuver through these difficult and sometimes treacherous waters. 

5 C's of Credit Analysis

- **Credit:** Borrowers' background meeting credit obligations
- **Capacity:** Ability to repay the loan
- **Character:** The general impression borrowers make on the lender
- **Collateral:** Real estate security
- **Capital:** Money invested in the property