

Case 4: Bank loans and covenants

I came across this appalling case of bank mismanagement and customer naivety whilst visiting the business banking arm of a major bank operating in London. It is the sort of thing that makes banks unpopular and was in my mind entirely unnecessary. There is an argument that the bank's customer was at fault here and, technically, he was. However, I think the bank's action, whilst protecting its interest, was avoidable.

A small family-run business operated a successful camp site. It had plenty of spare land and decided that it would use this land to build cabins. The proprietor went to the bank to negotiate a loan to cover the building cost. A loan was offered for 60 per cent of the costs, with a first charge over the land and all buildings completed or partially completed and all materials on site. The bank also required the borrower to agree to certain covenants, which the borrower readily did, perhaps not realizing the significance of these. The covenants were many and varied, including things that the borrower must not do and things that he must do.

Among the things that the covenant required were to submit regular financial statements to the bank and to also maintain certain financial ratios, including liquidity and profitability. These must all have seemed easy enough to fulfil at the time.

Building works commenced in February and the proprietor expected to have at least five cabins completed by June and have them occupied by the time the school holidays commenced. This would have produced valuable income to assist with the rest of the building programme. Unfortunately, the builders (as is often the case) encountered delays in getting materials delivered and were hit by heavy rain that caused the whole programme to slip significantly. They would have several cabins completed by the school holidays, but what with other completions and ground work the site would not be suitable for residents. Then followed one of the wettest summers on record and people were just not camping. This meant that regular income from the site was down and that the business was running out of cash, with a delayed project and little chance of breaking even before the end of the season. This, you might think, must surely have been expected in such a seasonal business as camping. Why did the proprietor not allow for this and why did the bank not also factor it into their decision?

Of course, you can guess by now that when the borrower sent in the accounts to the bank, they did not show the required performance and he was in breach of covenant. The bank had headroom in its security and might have considered allowing the borrower a season to get things right. Perhaps it could have re-negotiated the loan and covenants. However, it was easier for the bank to simply pull the rug, load on penalty charges and clear its position.

So, what are the lessons learned here?

- Don't enter into any covenant lightly.
- Don't think you might not have to meet the terms of a covenant.
- Assume the bank will enforce the covenant.
- Understand the margin (the difference between its cost of borrowing and what it charges you) is often small in relation to the risk it is taking and that it will protect itself.
- A bank's principal responsibility is to its shareholders.