Keeping on your bank's good side means more than just making your payments on time.

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Commercial mortgage borrowers often assume that once their loan closes, all they need to do is make the monthly payments, and so long as they pay, they can't get into trouble with their lender. However, that couldn't be farther from the truth, especially if the lender is an FDIC-insured bank.

When a lender looks at a mortgage loan, it is not relying on one source of repayment. The lender always wants at least two sources to repay the loan, and usually three or more. First, there is the regular cash flow from the building, such as rent or maintenance payments from the tenants or unit owners. If those dry up for any reason, then the second source to repay the loan is the building itself. If the building has a fire or flood, then the third source is insurance proceeds. If it's a mixed use building with a commercial component, then lenders frequently require personal guaranties as a fourth source of repayment.

Once the loan is made, the lender monitors your loan to make sure that the sources of repayment are still there and supportable. Why do they do this when you are paying every month? First of all, because it's good lending practice to know what's going on so that problems can be avoided or addressed before they get serious. Second, when the lender is a bank, there are government regulators who are looking over their shoulder to make sure they are managing their loans well.

Federal bank regulators, like the FDIC and the Federal Reserve, conduct detailed on site examinations of every bank at least once every two years, and usually more often. For even a small bank, that means six weeks with bank regulators sitting in the conference room reading files, especially loan files. The regulators want to make sure that the bank knows everything there is to know about its loans. Regulators spot check loan files and make sure that the bank analyzes whether the sources of repayment are still there. Woe to the borrower if the loan is past due. It's no longer a spot check. The regulators read the significant past due loan files to verify that the bank is "convincing" the borrower to clean up its act and, if the borrower can't do that, make sure that the bank is enforcing the loan documents.

If the loan department is not collecting current financials, not checking to make sure that insurance is in effect; or not verifying that the building is being maintained, why does that affect you if you are paying your loan? Each bank gets a rating from its regulator, known as a CAMELS rating, which stands for: **C**apital **A**ssets **M**anagement **E**arnings **L**iquidity and **S**ensitivity to interest rates. Loans are assets, and if too many loans look bad, even though they are not actually bad, then a regulator downgrades **A** - Assets. If assets are weak, management is not doing a good job, so the regulators downgrade **M**. If loans are in default, earnings are down, so they downgrade **E**. If **A**, **M** and **E** are all downgraded, it means the bank should have extra capital, and if it doesn't, they downgrade **C**. So four out of six categories are downgraded because of loan problems, and that could mean an overall downgrade. An overall downgrade costs money - higher FDIC premiums, consultant costs, legal fees, etc.

It also means that the government bank regulators will complain to the bank's Board of Directors, the Board of Directors will complain to senior officers, the senior officers will complain to the junior officer in charge of your loan, and the officers will be miserable, even if you are making your monthly payments. To avoid being miserable, banks review loans annually to make sure that you are doing what you are supposed to do – paying your insurance and taxes; providing financial statements that the bank can analyze to see if there is sufficient income to pay; and maintaining the property so it is in good condition without depreciation in value.

What happens if the bank's monitoring discloses that you are not up to snuff? The bank keeps a list, known politely as the "Watch List," for all significant loans with weaknesses. Even borrowers who make every payment can get on the Watch List. You do not want to be on the Watch List. Not only will it mean greater scrutiny, but when it is time to refinance or get a new loan, you will not be considered a top quality borrower, meaning the possibility of a higher interest rate and perhaps even a loan denial. I have one client with a board committee that gets a monthly list of every commercial mortgage loan showing whether the borrower is current on insurance, financial statements, taxes, etc. There is a pink box if the borrower has not provided current financials. One director counts the number of pink boxes every month and reports the count to the committee. When the number goes up, woe is to the borrowers who are the cause of the increase.

There are different types of defaults you need to avoid. Obviously, nonpayment is the most serious. Next is anything that risks a decline in the value of collateral, like failing to keep insurance or pay taxes. Then there is anything that portends future default and anything, like the failure to provide current financials, that makes it harder for bank to evaluate your ability to pay in the future.

Unfortunately, regulatory review suffers from a "Flavor of the Month" problem. In 2008 and 2009, the Flavor of the Month was subprime residential loans. What was the flavor of the month in 2013? Flood insurance! After Hurricane Sandy, bank regulators have been reviewing flood insurance requirements more closely, and borrowers who have been lax in maintaining flood insurance because they thought it wasn't important are being criticized. Banks must force place expensive flood insurance. Flood maps are being re-drawn by FEMA and banks have been told to watch for the new maps. Flood insurance will be required on any mortgaged property that is in a new flood zone and if the borrower doesn't provide it, the bank will have to place it, and bank-placed insurance usually costs more than borrower-placed insurance, even though it normally provides less coverage.

What will be the next flavor of the month? Hard to tell. When the economy gets better, the regulators usually tilt away from whether the bank is in sound financial condition towards consumer quality of life issues. What does that mean for you as a building owner or manager? You should focus on issues like maintenance, violations, bed bugs and mold contamination, and green energy. Converting away from #6 fuel oil and keeping your fuel oil and burner permits current will be important. Provide a top quality environment in your building. Make your building the type of property that your lender wants to photograph and highlight in its annual report. Doing so will ultimately cause less aggravation and save you money by making you a desirable borrower when you need to refinance.

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