Effective Credit Risk Management
Getting Best Answers for Debt Repayment Solutions / Transcription

Objective

- *Getting to Yes* – Understanding the need for complete financial reporting, internal analysis and asking the right questions, identifying red flags and root causes
- *Getting Enough Data* – Key reminders for balance sheet, income statement, and other financial metrics

Expectations

- *Finish the Job* – Get the necessary financial reporting, thoroughly analyze, ask the necessary 'deep-dive' questions, and identify root causes

Getting Financial Statement Information

Financial Reporting Covenants

- *What's In Your Covenants?* – Having the appropriate financial statement reporting structure requirements in the Loan Agreement in the first place is paramount. This includes business and individual financial statements and corresponding tax returns. Most Loan Agreements obviously have adequate reporting requirements. However, some Loan Agreements may need to be adjusted for adequacy as credit risk increases, but generally have a provision for the Lender to reasonably request additional financial statement reporting from the obligated parties. The question is, how will the borrower and guarantors react when the bank requests financial reporting, especially for detailed financial reporting when that has not been the case in the past?

Let Us Get Something Straight

- *Stakeholders Need to Uphold Their End of the Agreement* – Subject to the terms of the signed and agreed upon Loan Agreement, the parties will have their various rights, responsibilities, and remedies when it comes to financial statement and tax return reporting covenants. From the inception, the bank should make it very clear that the required financial statement reporting is fully expected throughout the term of the loan relationship. And to also make it clear that the bank will enforce this provision, and carefully weigh any covenant defaults (forbear, waive) in the future. Additionally, a word to the borrower and guarantor: 'If you signed a Loan Agreement with financial reporting covenants, you must comply, regardless of whether you want to.' And, they should expect the bank to, as applicable, enforce its default remedies if an unwarranted default were to occur (generally an increase in the interest rate to the default rate). And, such remedies, where warranted, should be enforced. All requests for financial information should be specific, and communicated in writing with defined remittance or due dates

The Willing

- *When Things Go Right* – What is better than a cooperative and steadfast banking relationship through thick and thin? Many borrowers and guarantors will readily step up and take care of their responsibilities. Imagine that. And, a strong bank may be better able to assist a borrower with a problem loan by extending prudent workout or modification terms. The borrower and guarantor will gladly submit not only the necessary financial information on time, or as requested, but step up and offer the bank additional lender protection (higher or full guarantee amount, additional collateral, loan resizing, etc.). Borrowers should also prepare their own pro forma repayment solutions based on their own cash flow projections recommendations. This is the way it is supposed to be, right? However, do not be so sure this will be the case when push becomes shove. Pressures and stresses can change anyone

The Unwilling

- *When Things Go Wrong* – But what if the borrower and guarantor turn adversarial and become unwilling to provide the requested financial reporting? Their history of willingness is beginning to shift. Look at it this way. Perhaps the borrower needs to be aware that the bank may have loaned the borrower (and therefore have a greater interest in the company's assets) more than the guarantor/owner. From a leverage (bank's) perspective, it may be 1.5x, 2x, or even 3x more debt than equity. Therefore, the lender may feel disdain for the borrower if the borrower does not step up and comply with all the terms of the Note and Loan Agreement. The borrower may feel similarly about the lender by not fully understanding the borrower's needs either

- *Revisit the Given Expectations* – If a borrower is unwilling to provide the requested financial documentation in a reasonable period, the decision to retain or exit the relationship should be revisited. Using the utmost respect and good will, unless there is a well-documented and supported reason to the contrary to forbear the covenant default, the bank should quickly enforce its remedies and pursue getting the required financial reporting. The bank should never 'lend in the dark,' but bring the 'full necessary day light' to the table

Level of Financial Reporting Detail

- *Get Whatever Level of Detail is Necessary* – The bank will have a set of current financial reporting requirements. However, to get at the root cause of financial deterioration, additional financial information may be warranted. There are numerous financial documents that may be needed: detailed aging reports for accounts receivable and payable, inventory reports, copies of complete leases, detailed list of contingent liabilities, full tax returns, verification of deposits, and so on

Internal Analysis and Questions

- *This Can Be Tricky* – In order to save time and money in the long run, and assuming the proper financial reporting has been received, spread, and analyzed by analysts or underwriters, determine if the right questions have been asked. Stakeholders should review the analysis and be sure to ask challenging questions that may not have already been addressed. Look at the analysis through the eyes of an independent third-party (credit review, internal audit, regulatory supervisor). Another way to think about it is to ask if Credit Administration or Special Assets has any "deep dive" questions that they need answers to, so that the proper risk rating can be identified. Some credits are known to be 'hands off' to everyone except senior management, which can quickly become problematic. Too often in the asset quality monitoring process, gaps or weaknesses exist without a full understanding as to why. Insufficient curiosity and rigor become apparent, especially when it comes to finding the root cause of declining financial performance. There may also be a lack of experience by the PRO, CA, or other stakeholder (as serious economic downturns are not all that frequent). Such questions and answers should be documented, and the answers sought and obtained by the obligated parties in short order. Don't stop until you get all the answers, even if you have to keep going back and ask for more information

The Hard Part – Questions, Yellow / Red Flags

Zero-In on the Issues

○ *Flags or No Flags?* – Are there yellow or red flags, indicators of potential problems? Most C&I exposures, with increasing credit risk, will have red flag warning metrics before too long. The point is, that a conscious effort is given to confirm any red flags, and why deterioration is specifically happening. Zero in on the target by asking as many questions and getting verified answers as needed. You must understand what management intends to do to cure the negative performance

Following are Examples of Such Yellow and Red Flags, and Indicators of Potential Problems:[1]

- *Working-Capital Advances Used for Funding Losses* – A business uses advances from a revolving line of credit to fund business losses, including the funding of wages, business expenses, debt service, or any other cost not specifically associated with the intended purpose of the facility

- *Working-Capital Advances Funding Long-Term Assets* – A business will use working-capital funds to purchase capital assets that are normally associated with term business loans

- *Trade Creditors Not Paid Out at End of Business Cycle* – While the bank may be paid out, some trade creditors may not get full repayment. This can cause a strained relationship as unpaid trade creditors may be less willing to provide financing or offer favorable credit terms in the future. In turn, the business will become more reliant on the bank to support funding needs that were previously financed by trade creditors

- *Overextension of Collateral* – The business does not have the collateral to support the extension of credit, causing an out-of-borrowing-base situation. Review borrowing-base certificates to verify that coverage meets the prescribed limitations established by the bank's credit policy for the specific asset being financed

- *Value of Inventory Declines* – If a business does not pay back the bank after inventory is converted to cash or accounts receivable, the value of the inventory declines. Other causes of inventory devaluation include obsolescence; a general economic downturn; or, in the case of a commodity,

[1] Federal Reserve Bank – Commercial Bank Examination Manual, Section 2080.1

market volatility. Declines in inventory value will commonly put a working-capital facility in an out-of-borrowing-base situation and require the excess debt to be amortized and repaid through future profits of the business

- *Collectability of Accounts Receivable Declines* – The increasingly past-due status of accounts receivable, or deteriorating credit quality of account customers, both result in the non-collection of receivables. This can also cause an out-of-borrowing-base situation for the bank

- *Working-Capital Advances Used to Fund Long-Term Capital* – Funds may be inappropriately used to repurchase company stock, pay off subordinated debt holders, or even pay dividends on capital stock

- *Accounts Receivable* – A slowdown in the receivables collection period. This symptom often reveals that the borrower has become more liberal in establishing credit policies, has softened collection practices, or is encountering an increase in uncollected accounts

- *Inventory* – Noticeably rising inventory levels in both dollar amount and percentage of total assets. Increases in inventory levels are usually supported by trade suppliers, and financing these increases can be extremely risky, particularly if turnover ratios are declining. The increase in inventory levels or lower turnover ratios may also be related to the borrower's natural reluctance to liquidate excessive or obsolete goods at a reduced price. Many businesses are willing to sacrifice liquidity to maintain profit margins

- *Slowdown in Inventory Turnover* – This symptom may indicate overbuying or some other imbalance in the company's purchasing policies, and it may indicate that inventory is slow-moving. If the inventory is undervalued, the actual turnover is even slower than the calculated results

- *Existence of Heavy Liens on Assets* – Evidence of second and third mortgage holders is a sign of greater-than-average risk. The cost of junior money is high. Most borrowers are reluctant to use this source of funds unless conventional sources are unavailable

- *Concentrations of Noncurrent Assets Other Than Fixed Assets – A* company may put funds into affiliates or subsidiaries for which the bank may not have a ready source of information on operations

- *High Levels of Intangible Assets* – Intangible assets, which shrink or vanish much more quickly than hard assets, usually have very uncertain values in the marketplace. In some cases, however, intangible assets such as patents or trademarks have significant value and should be given considerable credit

- *Substantial Increases in Long-Term Debt* – This symptom causes increasing dependence on cash flow and long-term profits to support debt repayment

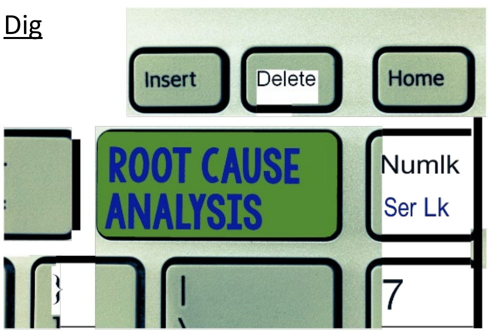
- *A Major Gap Between Gross and Net Sales* – This gap represents a rising level of returns and allowances, which could indicate lower quality or inferior product lines. Customer dissatisfaction can seriously affect future profitability

- *Rising Cost Percentages* – These percentages can indicate the business's inability or unwillingness to pass higher costs to the customer or its inability to control overhead expenses

- *A Rising Level of Total Assets in Relation to Sales* – If a company does more business, it will take more current assets in the form of inventory, receivables, and fixed assets. Be concerned when assets are increasing faster than sales growth

- *Significant Changes in the Balance-Sheet Structure* – These changes may not be the customary changes mentioned previously, but they are represented by marked changes spread across many balance-sheet items and may not be consistent with changes in the marketplace, profits or sales, product lines, or the general nature of the business

Document the Root Cause(s)



Dig Until You Get to the Bottom of the Root

- *Clearly Document the Root Cause* – If you are not 100% certain of the root cause(s) behind the financial deterioration, then keep digging until you find the reason(s). Why? Because to identify and apply the right risk rating, accrual status, covenant structure, workout repayment solution, and action plan, you must know what caused the deterioration or problem in the first place. Otherwise, there could be a missed opportunity to apply the optimal repayment plan, which could end up costing the bank more in time and money

- *Look Who Wins* – As analysts and underwriters help identify root causes as part of the ongoing monitoring processes, overall quality and efficiency will improve. Risks will have been better managed, including an understanding as to whether financial performance covenants should be waived or forborne. It is also less expensive to manage a credit in the long run when appropriate action is taken at the right time, the first time. Management and lending staff will also become more enabled through improved decision-making. Borrowers will also take comfort knowing the bank is aware of the issues, and build trust with the bank by keeping the bank informed on its remediation progress through better communication. As individuals and teams work together to identify root causes, they become more accountable, more engaged, and will contribute more to bank's success through job satisfaction too.

Key Reminders/Tips for Credit Metrics

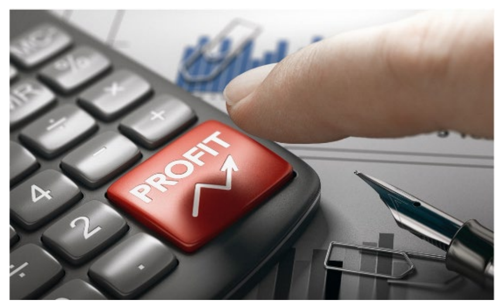
Cash Flow

- *Debt Service Coverage Ratio (DSCR - ability to repay); Global Cash Flow (individual and business); Interest Reserve (fund interest on construction loan)* – Monitor and know the adequacy of each borrower's ability to repay on a continuous basis. It is critical to evaluate the cash flow trends, particularly declining trends, including a comparison to industry peer performance. Make sure extensions are not just covering up repayment issues. Consider the level and trend of the DSCR in assigning a credit risk rating. In a downturn, the obligated parties may have increased demand from global cash flow sources which need to be carefully analyzed, not double-counting income, etc. Ensure complete business and personal tax returns are obtained from all obligated parties. Consider the financial strength of the obligated guarantors in the credit risk rating determination. Confirm the time the interest reserve is in place compared to the needed financing, and make sure any cash flows the property generates go to service the debt; continue monitoring the project lease-up. Ask any necessary questions until you fully understand the current and projected cash flows

Net Operating Income (NOI)

- *Stabilized NOI (fully leased with maximum rental income); Vacancy Impact (direct reduction of rental income); Operating Expenses (CRE maintenance); Debt Yield (DY: risk in deal, viability, stability)* – Determine why units are vacant, for how long, and exactly how the borrower intends on getting them leased. Carefully review key increasing expenses from an historical perspective and ask any necessary questions to understand extraordinary expenses. When monitoring a loan's performance, compare the current DY to that of the original loan underwriting and to policy underwriting thresholds for the same new loan today. A low DY will require additional analysis and questions should be generated around increasing a personal guarantee, offering additional collateral, or even resizing opportunities to properly increase the DY (regardless who the customer is, especially the high-profile borrower/depositor). Look at the deal as if the bank had to take back the property with the current DY

Profitability



- *Sales (top line performance), Expenses (controlling costs), Profits (benefit)* – Measures efficiency in sales and profit levels, controlling expenses and a return on investment. Evaluate trends in sales revenues, gross and net profit margins, and other notable cost and expense ratios. Determine the reason behind material changes in key metrics. Identify material expense trend increases as a percentage of sales. What is the outlook? Understand what is driving the profit margins and what needs to happen in the future to improve the same. Ask any necessary questions until satisfied

Efficiency

- *Inventory Days (days to sell average inventory); Receivables Days (A/R on hand); Payable Days (average time to pay trade suppliers)* – Detailed inventory reports can be used to conduct an inventory inspection by sample testing and ensuring accuracy (holding the borrower to account for discrepancies). If there are material differences in the DOH by comparison of values of similar, same industry companies, continue your inspection. Determine if and how much functional or technical obsolescent inventory is in stock. With detailed current A/R and Customer List reports on hand, carefully analyze ineligible A/R (past dues, concentrations, etc.), and determine their collectability. If necessary, ask the borrower "how much, and when" for all material A/Rs to get a clear idea of how much will be collected and by when. Suppliers obviously play a key role in the success of operations. Carefully analyze the DOH over time and determine if the borrower is operating efficiently, or is unable to pay its creditors on time. Similarly, get an AP Aging report and, if necessary, ask the borrower "how much, and when" for material past due payables as to when these will be paid

Leverage

- *Funding Sources and Capacity (financial resources: earnings, debt capital, equity capital, to meet obligations; ability to manage finances)* – Determine the viability of each funding source and if those sources of capital are available or sustainable. How possible is refinancing, and at what cost and on what terms? Is the sponsor or guarantor able or willing to inject additional capital? Is the projected period to de-lever to a sustainable level acceptable? Does the cash flow analysis rely on overly optimistic or unsubstantiated projections? Are the projections stressed-tested for a downside case? Determine the ability to meet obligations, and the extent of plan variances. Document poor structures and limited covenants, if applicable. How vulnerable is the borrower to sharp economic and business cycle swings?

Liquidity

- *Sources (cash on hand, short-term funds, cash flow management, secondary sources, cash burn)* – Review the liquidity needs of the borrower and if primary sources are sufficiently available, or if secondary sources need to be liquidated to meet current obligations. Carefully review current maturities, the size and timing of payments, interest rates, uncollected receivables, obsolete inventory. Determine root cause for liquidity problems. If (net) cash burn exists, confirm how much time is needed before returning to positive cash flow, and the sources to recapitalize. Carefully study the cash burn analysis as often as is needed, and adjust the credit risk rating when necessary. Ask the borrower how it intends to lower the cash burn rate

Performance to Plan

- *Budget vs. Actual Variance Analysis (performance evaluation, expectation review)* – Important to understand not only why the variance(s) occurred, but to determine if the bank has confidence in the borrower's budgets, and whether they need to be stressed for the bank's case. Do you have confidence in future forecasting based on historical variances, and what reasonable adjustments are necessary? Is the budget overly optimistic? If you do not know, ask. Monitor revisions to plan but get the level of understanding where the bank has confidence in borrower projections. Variance analysis can be performed monthly, quarterly, or annually as needed

Pro Forma Outlook

- *Outlook Realistic (forecast future financial performance); Assumptions (projections, educated guesses); Cash Budget (budget plan on debt repayment workouts)* – During times of economic downturn, use pro forma statements to structure workout or loan modification repayment solutions. Ensure the statements are conservative in both revenue and expenses, and include upcoming one-time expenses. Depending on how severe the current economic conditions are, have the borrower prepare its pro forma statements with its own recommended repayment plan. It should include, detailed, well-supported, foot-noted explanations on the assumptions used. Repayment terms can be temporarily used, with the frequency of updated pro forma statements adjusted as necessary. Risk ratings will similarly be adjusted according to regulatory guidance. Under extreme circumstances, a cash-in and cash-out monthly budget can be utilized to show possible debt repayment solutions

Management

- *Succession Plan (transition of leadership)* – Economic challenges must be successfully unmanaged by skilled leaders. Understand borrower's succession management planning for all key positions (not just at the most senior level). Are there recent or pending retirements, and how might those changes (and their tangible contributions) in staffing impact the borrower's competitiveness?

Competition

- *New or Pending Direct Competition (market share); Customers Lost to Competition (negative impact on borrower operations)* – New competition can affect a borrower's operations and ultimately its ability to repay its loans. The potential loss of market share could result to a decline in revenue and profits. Determine if increased price competition is likely as new competitors may enter the market with lower prices, affecting profit margins and impact repayment ability; this may affect or result in increased marketing and advertising expenses. Understand the strategies management uses to be proactive in mitigating competition risk, and how it differentiates themselves from their competitors