

PREVENTING & RESOLVING PROBLEM LOANS

A PRACTICAL APPROACH FOR BANKS ON HOW
TO LIMIT COST OF NON-PERFORMING LOANS

LONDON

WASHINGTON DC

SINGAPORE

GLOBAL EXPERIENCE, PRACTICAL EXPERTISE

INTRODUCTION

- ➔ **If you make loans, you will have Problem Loans:** while no lender intends to make a Problem Loan, lending institutions (should) anticipate having some level of Problem Loans and loan losses. Problem Loans are simply a by-product of the business of lending.
- ➔ **It boils down to cash flow:** while there are different strategies for managing and resolving corporate and retail Problem Loans, the underlying problem is the same – a lack of cash flow to pay their creditors and costs
- ➔ **Resolving problems is expensive and difficult:** managing Problem Loans properly is a complex, time-consuming task, which frequently requires specialized knowledge and expertise in, credit analysis, bankruptcy and security laws, as well as negotiating.
- ➔ **The objective:** The overriding objective in managing Problem Loans is to enhance or improve the position of the lending institution.

Goal of Problem Loan Management is to
obtain maximum recovery in minimum time

RULE 1: PREVENTION IS ALWAYS CHEAPER THAN CURE

- ➔ **Credit Policies:** Issued by the Board of Directors. Credit Policies are detailed statements designed to guide and control the direction and activities of the lending function. They are standardised to prevent as far as possible potentially problematic lending.
- ➔ **Risk Rating System:** This helps quantify the inherent risk of lending either to a borrower, or within a loan portfolio. A systemic Risk Rating System attempts to measure the probability that a borrower will be able to repay both principal and interest as agreed.
- ➔ **Independent Risk Management Division:** There has to be body within the bank that looks at every risk from the point of view of the bank and not the customer. The customer is not always “king” in a bank. Risk Management second guess lending and treasury divisions
- ➔ **Lending authorities:** A key decision for every Board of Directors is the allocation of decision making authority, how much, to whom and what checks on their authority.
- ➔ **Review system:** Every risk must be reviewed at least once a year as if it is a new facility, even if it is a term loan.

RULE 2: DETECT PROBLEM LOANS EARLY

- ➔ To identify, monitor and manage problem loans they must first be found.
- ➔ Early detection of a looming problem is central to an institution's ability to defend against and limit the impact of Non –Performing Loans. Institutions should not rely solely on lagging indicators, such as past due payments, which as it is much later in the process leaves the lender with fewer options to correct the situation and help the borrower.
- ➔ Institutions must focus on leading indicators of problems e.g. increased use of overdraft, seeking new credit lines, slow payment of trade creditors, late supply of information. These tend to indicate a growing need for cash. Lenders who act only after being directly affected e.g., past due payments, are not acting in the best interest of their institution.
- ➔ Since the key objective in managing Problem Loans is to detect the problem early GBRW's initial focus is on Problem Loans and then on Non-Performing Loans (NPLs). Banks need to see the signs of "cash crisis" at the borrower and take action.
- ➔ A Problem Loan becomes a Non-Performing Loan on default and if that default is not corrected within a set number of days, usually 45 days in developing economies.

CAUSES OF PROBLEM LOANS

Factors that can result in a good loan turning into a bad loan can be categorized into three broad groups:

- ➔ **External Causes:** Included are factors outside the control of the company's management and/or the lender. Examples include negative economic events such as high interest rates, recession, technological advances making the company's products obsolete, “Acts of God” such as floods and fire.
- ➔ **Internal Causes:** Factors brought on by the company's management. Generally attributed to management deficiencies such as lack of managerial, operational, and/or financial controls; product deterioration; loss of market share; not keeping up with the competition and fraud.
- ➔ **Lender Causes:** Factors brought on by the lender. These causes generally include improper loan structuring, an inadequate or excessive loan amount, failure to adequately monitor a loan, improper statement analysis, insufficient collateral, poor documentation, an inexperienced lender, and fraud.

RULE 3: IT IS BETTER TO HAVE A PROBLEM LOAN THAN A NPL

- ➔ It is far better if the lending department can work with the customer to resolve the problem rather than the customer go into default and after 45 days be transferred to the loan Workout Department.
- ➔ The methodology for recovery will be similar but the Workout Department are likely to be harsher “hatchet persons”. They are dedicated to getting back the bank’s money as quickly as possible (and their bonus will depend upon the resolution of the NPL).
- ➔ The level of provisioning for a Problem Loan will be lower than for a NPL. If the customer is still paying principal and interest, albeit on deferred terms .
- ➔ **A word of warning:** it is natural for lending departments to extend the maturity and reduce the margin of customers who are experiencing cash flow difficulties. This can only happen once. If loans are continually restructured it just hides the problem.

RULE 4: TRANSFER OF RESPONSIBILITY?

- ➔ **Are the people who made the loan the best people to collect it if it becomes a problem?**

Probably not as they will naturally be sympathetic to their customer and maybe less concerned about the overall interests of the bank. However, if they cannot resolve the issue of late payment by a customer within 45 days it should be taken out of their hands

- ➔ **Need for an independent loan Workout Department**

This would be part of the Risk Management Division which doesn't report to any Front Office Division.

- ➔ **Independent Restructuring Credit Committee**

Is the committee that approved the loan the best place to approve its restructuring? Probably not and it may have too many influences on its decision making. Better to have a wholly objective and independent committee whose decisions cannot be overturned by anybody in the bank.

RULE 5: MANAGING DIFFERENT PROBLEM LOAN PORTFOLIOS

Similar Goal but Different Approaches: While the objectives of managing commercial and retail Problem Loans are the same; i.e., obtaining Maximum Recovery in the Shortest Possible Time, the approaches and business models used are different.

- ➔ **Retail defaults:** Given the relative size of individual retail loans and the number and diversity of the retail customer base, establishing a retail workout department consisting of account officers responsible for recovering individual loans is not cost effective. Instead the recommended business model emphasizes monitoring concentration risk and investing in communication systems that automatically send past-due loan notices containing escalating intensity, base on the length of payment default.
- ➔ **Corporate defaults:** The potential impact of a credit loss associated with a commercial customers is greater than that of a retail customer. Given the greater probability of loss associated with commercial loans a larger investment in monitoring and managing (on a customer by customer basis) is justified. For this reason financial institutions with substantial commercial loan portfolios dedicate resources (financial and human) in managing corporate Problem Loans and Non-Performing Loans.

RULE 6: SPEED IS OF THE ESSENCE

➔ **There is nothing more expensive than a problem loan.**

It is not just the cost of carrying the Non Performing Loan, it is the management time and effort, the expense of using lawyers and other professionals.

➔ **Put timelines into the methodology**

After 90 days a Game Plan has to be presented to the Restructuring Credit Committee. If after 180 days the NPL is still unresolved it has to be resubmitted to the Restructuring Credit Committee and every 90 days thereafter.

➔ **Avoid going to court**

It will delay matters further, it will be expensive and you might not get the result you want. This is a last resort.

RULE 7: NEVER RELY ON SECURITY

Security is never worth what you think it is

- First you have to be sure that the collateral is protected and will not deteriorate, this costs the bank money.
- Then you have to be sure that you have legal title to the collateral and are entitled to sell it (and this usually results in a few nasty surprises).
- Then you have to get title and sell the collateral. All the buyers will know that the bank is a forced seller and will under-bid.
- If you add up all the costs, the collateral may only be worth 10% of what you originally thought it was worth.
- Selling the security is the action to be taken if all other avenues have been explored and failed.

RESOLVING COMMERCIAL PROBLEM LOANS – PART 1

Resolving commercial Problem Loans involves an analysis of the borrower's management, financial statements and cash flow

- **Management Analysis:** A thorough analysis of management must be conducted after the problem has been detected; notwithstanding any prior analysis that might have been performed. Assessing management involves a review of:
 - ⇒ General Management Capabilities;
 - ⇒ Crisis Management Capabilities;
 - ⇒ Management Integrity (are they honest?); and
 - ⇒ Turnaround Management Capabilities.

RESOLVING COMMERCIAL PROBLEM LOANS – PART 2

- ➔ **Financial (Statement) Analysis:** This attempts to evaluate, from a financial perspective, the company's performance in the light of the causes, viability of the core businesses, and the solvability of the Problem Loan. The viability of a company's core business is driven by:
 - ⇒ Overall demand for the company's product or service;
 - ⇒ The company's ability to generate sales in excess of its "break-even";
 - ⇒ The company's ability to consistently generate positive cash flow; and
 - ⇒ The ability of the company to cut costs sufficiently to make the business viable again.

RESOLVING COMMERCIAL PROBLEM LOANS – PART 3

➔ **Cash Flow Analysis**

⇒ This analysis attempts to understand and evaluate the cash sources and cash uses of the company; i.e., how the company generates cash and how the company uses cash. This information is not apparent by an analysis of the financial statements.

➔ **Cash Flow Analysis – Using the Cash Budget Model**

⇒ Cash Budget model (next slide) is a simple yet effective tool. It is easy to explain to the entrepreneur and easy for them to understand.

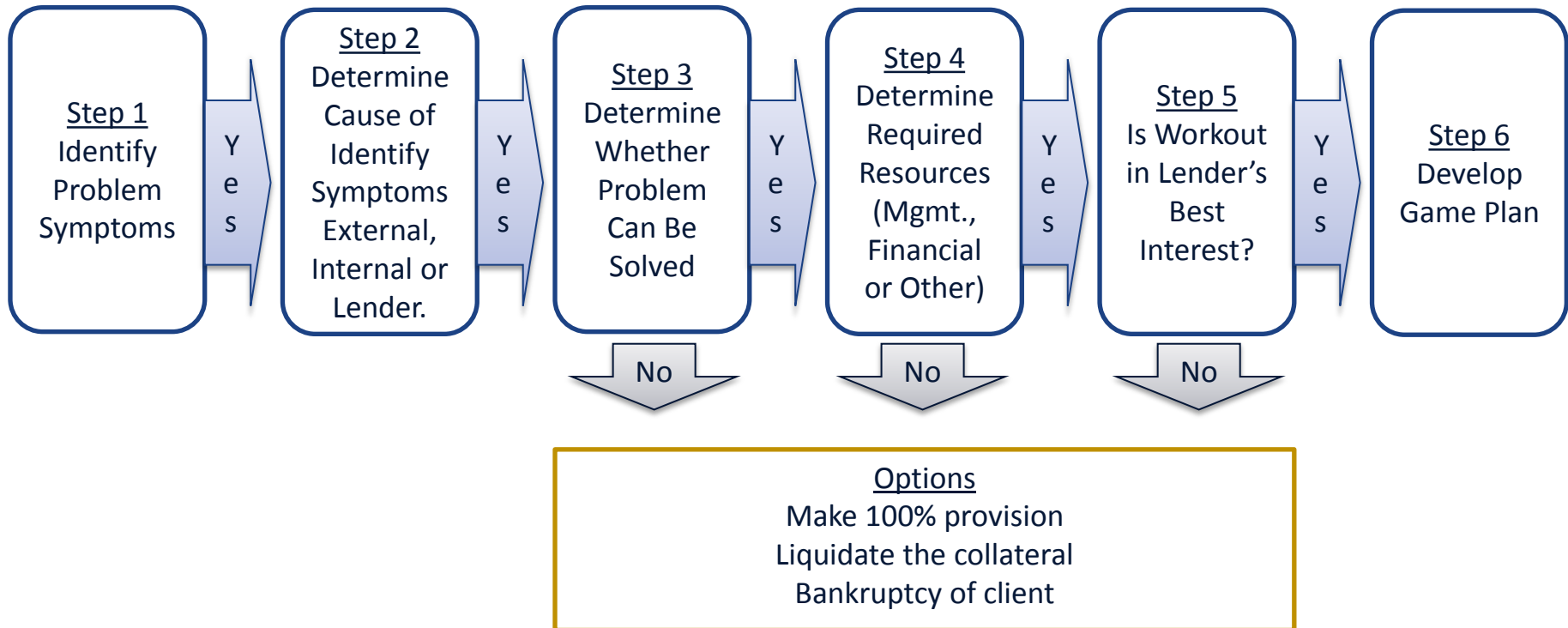
⇒ The Cash Budget model can be use to forecast and monitor a company's cash flow, as well as to understand variances in cash generated and cash used by a borrower.

⇒ The Cash Budget can be prepared on a quarterly, monthly or weekly basis.

CASH BUDGET MODEL

CASH BUDGET MODEL	Period 1	Period 2	Period 3	Period 4
Cash on Hand (<i>beginning of month</i>)				
+ Cash Receipts				
+ Total Cash Receipts				
Cash Available (before cash paid out)				
- Cash Paid Out				
- Total Cash Paid Out				
-/+ Cash Surplus (Deficit)				
+ Borrowing (new loans)				
- Loan Principal Payment (new loans)				
Total Principal Outstanding (new loans)				
- Interest Expense (new loans)				
Cash On Hand (end of month)				

DECISION PROCESS STEPS 1 - 6



DEVELOPING THE GAME PLAN

- ➔ If the analysis indicates that a workout is in the best interests of the lending institution, then the next step is to develop a “Game Plan.” Remember:
 - ⇒ The Game Plan is developed for the benefit of the lender — not the borrower.
 - ⇒ The first objective of the Game Plan is to obtain the maximum recovery warranted by the situation, the secondary objective is to rehabilitate the borrower
- ➔ The other options that the available to the lender are:
 - ⇒ Doing nothing; in other words just write off the loan 100%
 - ⇒ Liquidating collateral (which will cost money and deliver less than anticipated)
 - ⇒ Petitioning for the borrower to be placed in (involuntary) bankruptcy. Let the courts sort it out which at least means the bank doesn't have to spend any more money.

DEVELOPING THE GAME PLAN

- ➔ **Refinance the loan with another bank:** If the lender has identified the problem early and quietly enough, it may be possible that another lender (who wishes to increase loan production) may make a loan that repays the original loan. In many ways the ideal solution.
- ➔ **Customers tolerance for resolving the problem:** is the customer willing to work hand in hand with the bank and take the necessary steps to put themselves on a viable business footing, this usually means a significant reduction in operating costs including a cut in their own salaries?
- ➔ **Back to the Cash Budget:** the company will now be run, and monitored, according to the Cash Budget prepared by the bank and accepted by the customer.
- ➔ **Restructure the loans to the bank:** the bank will no doubt have to extend the period of its loans and possibly reduce its margins to enable the Cash Budget to work. In some cases it may have to write off part of the principal amount, known as a “haircut”.
- ➔ **Other lenders and creditors:** the bank is unlikely to be the only creditor. Those creditors may be unequally unhappy. Who gets paid and who is asked to take a “haircut”?
- ➔ **The Game Plan:** a written agreement between the customer and the bank (and other creditors) which sets out the steps and timetable to rehabilitate the business of the customer.

ESTABLISHING A WORKOUT DEPARTMENT

➔ Should Your Institution Have a Workout Department?

- ➔ Problem loans should be administered by experienced lenders who can provide objectivity. Resolving problem loans involves highly specialized and time-consuming tasks, requiring skills not possessed by many loan officers. Consequently, most banks benefit from the existence of a specialised Workout Department .

➔ Workout – A Special Department

- ➔ Large banks or banks with a significant amount (number and/or size) of commercial loans benefit from establishing an independent Workout Department containing specialists available to handle problem loans with no prior relationship with the customer
- ➔ Staffing the Workout Department involves engaging specialists (possibly including lawyers) and lending bankers with good analytical and negotiation skills.
- ➔ Establishing a Workout Department allows the original department to continue to function normally without spending a huge amount of time trying to resolve problems. They can get on with what they do best, marketing bank products to customers.
- ➔ They are a profit centre as Problem Loans are transferred to them after provisions so any recovery of the provision is their profit . Once the NPL has been restructured it is transferred back to the lending division, quite often with an equity kicker as the bank needs to benefit from all the cost of restructuring the borrower.

NOT QUITE BLACK AND WHITE

- ➔ In the majority of cases a customer will have defaulted through no major fault of their own. If the loan officer cannot resolve the position within 45 days responsibility is transferred to the Workout Department.
- ➔ The mandate of the Workout Department is to “Obtain maximum recovery in the shortest possible time”. This makes them a “hatchet person” with a very different relationship with the customer.
- ➔ This means that the existing working relationship and goodwill of the client is usually lost (unless the Workout Department have a real skill in building a Game Plan to restructure the business of the customer).
- ➔ The Restructuring Credit Committee should have the flexibility to decide what is in the best interests of the bank and maintain the relationship with the lending department.
- ➔ It may also be that the number of Non Performing Loans is such that the Loan Workout Department cannot handle them all.

HOW CAN GBRW SUPPORT IN MANAGING PROBLEM LOANS?

- ➔ GBRW can review, assess and recommend enhancements to the system of Lending Authorities in the bank.
- ➔ Written Credit Policies are very important and GBRW would be happy to review or indeed draft new policies and procedures
- ➔ A Risk Rating System is a valuable tool and needed in every bank
- ➔ GBRW can draft a charter for the Loan Workout Department and the Restructuring Credit Committee
- ➔ Training and assistance with the development of templates of the Cash Budget Model and the Game Plan
- ➔ Mentoring and training of the staff of the Loan Workout Department by working with them on individual NPLs

SUMMARY

- ➔ Successfully managing Problem Loans and NPLs involves strengthening key aspects of the bank's lending procedures and developing a standardised recovery methodology.
- ➔ A bank with limited experience in effectively managing Problem Loans and NPLs should develop or acquire the specialized expertise needed to administer the problem loans and NPLs.
- ➔ GBRW would welcome the opportunity to better understand your interests and/or needs relating to the management of Problem Loans and NPLs, as well as to discuss in greater detail any of the services presented within this document.

CONTACT DETAILS AND FURTHER INFORMATION

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