10 STEPS TO ANALYZE PROBLEM LOANS AND MINIMIZE LOSSES

To minimize losses on a problem loan, you must first analyse the loan by ensuring that all of the pertinent information is taken into consideration. The benefits of using a systematic approach to your analysis include 1) consistency, i.e., each individual in the decision-making process uses the same information, and 2) error minimization, i.e., it reduces your chances of missing an important issue or fact.

The following process will help you gather and understand the facts, analyse the problem, and enable you to make a recommendation to correct the problem. The process is not entirely sequential—some steps occur simultaneously and often overlap.

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Step 1: Review the Documentation

Operational or documentation risk is a critical area, which represents a major contribution to loan losses. Although most banks use some form of standardized documentation, it is not uncommon to incur deficiencies due to improper use of the forms, modifications to the forms, or improper completion of the forms. Over the years nearly 30% of commercial loan losses can be attributed to documentation deficiencies.

It is appropriate for you to use a professional for the review of the legal documents. Legal counsel, who would be representing the bank in the event of subsequent litigation, would be the best individual to complete this review. The use of an attorney may be expensive, so you need to weigh this selection against the size and complexity of the credit. If you do the review before the borrower falls into serious trouble, the borrower may be more cooperative in making your desired document changes.

Step 2: Perform a New Lien Search

Perform a new lien search. Then determine lien priorities. Generally, the first to file is the first in right. However, a few exceptions to this rule exist:

- Purchase money security interests (PMSI). Note that there is a difference between inventory and equipment claims. Inventory PMSI claims are effective for shipments after filing and notification. Equipment PMSI claims are effective up to 20 days after delivery and without notification.
- The 45-day Rule for judgment and tax claims provides these parities with a superior claim against new assets generated 45 days after filing.
- Bonding companies have the right of equitable subrogation on the assets of only the bonded job and are not required to file financing statements.

Subscribing to a continuous records search on the borrower with a licensed and bonded search firm will keep you informed (though it is not guaranteed); the cost is modest.

Step 3: Collateral Valuation and Constraints

Once you are satisfied that the documentation provides your bank with a solid first claim on the collateral, determine what the true value of the collateral is.

There are three critical aspects of collateral valuation:
1) Current asset valuation adjustments.
In determining the loan value of accounts receivable, you should be aware of:

- Aged invoices. Beyond a specified date (DOI).

  Contra accounts. Buying from and selling to the same party provides an automatic offset and is common in most businesses.
- Bonded accounts. The assets of the bonded job are subject to the prior claim of the bonding company and thus offer no value to the bank.
- Unbilled receivables. These assets are questionable because the borrower's customer is unaware of the obligation because the customer has received no invoice.
- Pre-billed receivables. The customer has billed before the work is done; yet it has already recorded the sales and earnings.
- Bill and hold receivables. Again the borrower's customer is unaware of any obligation because the invoice is retained by the borrower and not sent to the borrower's customer.
- Conditional receivables. These are payable only after conditions are met. These should be verified with the obligor, not the borrower. Hereto, revenue and earnings are recorded before the asset is a true receivable.
- Consigned receivables. These are not technically receivables, but inventory held at different locations for sale.
- Outstanding's over concentration limits.

Remember to obtain aging of accounts receivables by date of invoice, not due date. Other items to watch are concentrations, percentage of completion (used in the construction industry), retainages, partial shipments, the credit quality of the accounts, and rewrites and re-billings.

2. Collateral constraints

Troubled accounts often move (on average once per year) to reduce costs. They are also under pressure to protect (hide) assets.

- Lay legal claim to the collateral. This is where legal documentation comes into play. Without a blanket lien on the assets, the bank's documentation must clearly identify and distinguish its collateral from the other assets.

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- Take possession of the collateral. The repossession process must meet the legal requirements and may require the help of law enforcement.
- Verify the condition of the collateral. The condition of the collateral will have a significant impact on the value and scalability of the security. If the collateral is perishable, then further constraints affect the collectability from the disposal of those assets.
- Sell the asset for value. Your bank needs to sell the asset for value in a commercially reasonable way, as defined by the law.

3. Appraisals
At the first sign of trouble, you should reaffirm the value of equipment and real estate. You can best do this by obtaining an updated appraisal ordered from a qualified appraiser (a member of the Appraisal Institute [MAI]). There are a number of different values that can be obtained.

- Forced liquidation—what your bank can get.
- Orderly liquidation—what the borrower might get.
- Cost or book—what is on the balance sheet.
- Market—what a buyer would pay in good times.
- Enterprise value—what a going business might fetch.
- Value in use—what it means to the borrower.
- Replacement—what it will cost to replace.

Appraisals on equipment and inventory should contain the same level of detail and support typically provided in a real estate appraisal.

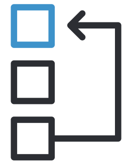
Step 4: Financial Analysis

The value of a financial analysis is predicated upon how current the borrower's and each of the guarantors' financial statements are, as well as the quality of the accounting. Obtain current information, ideally within a short time of the most recent period covered. If the statements are not audited, be sure the obligor signs them.
Focus your analysis on:

- Cash flow (operating, investment, and financial) to measure soundness and ability to meet obligations. Cash is king. You need to know the amount, the timing of funds flow, and its uses. In addition to principal and interest, capital expenditures need to be factored into the company's operation.
- Assets and leverage to help you evaluate safety and the collateral situation. Be sure to include lease obligations, which are often off balance sheet. Remember the rights of a lessor are often greater than the rights of a creditor.
- Short-term (maximum three months) budgets or forecasts to help you identify changes in safety and soundness in the near term. The emphasis here is on short. The bank needs to get to first base before it determines how it will score (collect).

A break-even analysis is often a useful tool to identify financial issues and possible corrective action.

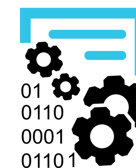
Step 5: Identification of All Related Debt



In order to make an intelligent decision, you need to be aware of all of the borrower's obligations. This step also uncovers valuable assets (deposits, trusts, etc.) that may affect the final course of action. The big picture of all related debt includes:

- Related entity debt. Parent, subsidiaries, affiliates, etc.
- Related guarantor debt. Mortgages, credit cards, auto loans, home equity credit, etc.
- Off-balance sheet obligations. Leases and other commitments. Most businesses lease assets (buildings, furniture, computers, vehicles etc.).
- Contingent obligations of the debtor and/or guarantor. Guarantees, contracts, etc.
- Search both inside and outside of the bank.

Step 6: Evaluation of Management



- Problem awareness. How engaged is management in the recognition of their problem(s) and have they taken action (right or wrong, have they moved)?
- Cooperativeness. No matter how resolvable the problem(s), unless you have the cooperation of the management team, ultimately, nothing will get resolved.
- Honesty. Without this "C" of credit (character), you need to exit the relationship as quickly as you can; you will never have a relationship that you will want to preserve. It may require a loss; however, remember, with a dishonest borrower, your first loss will likely be your least loss.

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7th Annual Distressed Debt Restructuring & Recovery Excellence 2016

3 Day Master Class

9th - 11th November 2016

Grand Millenium KL, Malaysia

OVERVIEW

The credit market in Asia and the Middle East has been growing rapidly in recent years, and the field is becoming increasingly competitive and complicated. Credit processes and assessment standards have been evolving in the two regions, and problem loans and default rates in several countries have been excessive. Regardless of the size and complexity of the transaction which determines the method used in resolving the problem loans, there are common areas of strategy, law and business skills which must be considered. The experiences of the Asian currency crisis and the enormous volume of non-performing loans that emerged from it have provided important lessons in the early recognition, control and proactive management of nonperforming loans.

This workshop will cover all aspects of the problem loan process, from recognizing the problem, minimizing legal risk, managing a portfolio of such loans and finally resolution of the problem. This interactive programme, based on real-life situations, will provide you with the opportunity to discuss and debate techniques and approaches to workouts, litigation and alternative approaches to handling problematic lending situations.

COURSE LEADER

Steven T. Kargman is an advisor on international insolvency, restructuring, distressed debt, nonper forming loan (NPL) and cross-border insolvency/ restructuring situations, with a special focus on the emerging markets to theWorld Bank, the United Nations and the US State Department.

Steve has worked on numerous high-profile and difficult restructuring transactions in the emerging markets, including among others the $13.9 billion Asia Pulp & Paper restructuring as well as two of the most significant project finance restructurings in Indonesia, the Paiton and Jawa power project restructurings.

He was also involved with the Dabhol power project and Jindal Steel restructuring in India, the $1.85 billion AHMSA steel company restructuring in Mexico, and Piltel telecom company and Mabuhay Satellite restructurings in Philippine. He has led high rated training workshops in China, Germany, India, Colombia, Uganda, Switzerland, Vietnam, Hong kong, Indonesia, Malaysia, Uganda, Nigeria, South Korea, Singapore. He has been frequently quoted on international restructuring issues in major news media outlets such as The Wall Street Journal and Bloomberg.

He is a Fellow of the American College of Bankruptcy, served as co-chair of the American Bar Association's Subcommittee on International Bankruptcy, and has been a member of the Board of Directors and a Founding Member of the International Insolvency Institute.

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