Problem Loans: Early Detection for Lenders

By Tommy M. Onich

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Years ago I trained as a commercial lender in the Canadian banking system. This was a conservative lending environment—the antithesis of what we have recently seen in the credit markets.

In this environment we "owned" the loans that we made. They were not sold or packaged and stayed as part of our individual portfolios even when they went bad. The issue of profitability was ubiquitous, and we were always cognizant of the fact that a small loan written off required a large and producing loan as an offset.

Our extensive training was supervised by crusty and seasoned lenders. Some of them had worked previously in a primitive version of asset-based lending. In this environment, they were sometimes required to collect payments from clients, even if it meant an evening visit. They had vast practical experience and a wealth of knowledge about our trade: the challenging task of lending money and making a profit.

From them, I learned the two elements of managing a loan portfolio for optimal profitability: origination and monitoring.

Step One: Origination

We were taught that the process of origination was the first step of good portfolio management. The rationale for origination was the most important indicator of future loan quality. Subsequent due diligence was an important but secondary issue.

The rationale for origination was based on three criteria: character, capacity and collateral, the three C's of loan origination. Some of these factors are quantifiable; some are more nuanced and require judgment:

- Character required judgment and included two components: integrity and competence. These were of equal importance. In our judgment, true quality of character required both.
- Capacity referred to the ability of the client to repay the loan from operations in the normal course of business. It required proof in the form of quality financial information that was relevant, reliable, timely and accurate.
- Collateral referred to the security taken for the loan. This included soft security such as guaranties and hard, or tangible, security such as real estate, inventory, equipment and accounts receivable.

Not all of these had to be present to justify an advance. They could be present in some mix or synthesis, or a loan could be made on the strength of one parameter alone. In terms of importance, character and capacity had great significance. On occasion, I declined fully secured loans because of poor character. I also advanced loans that were into seven figures that were totally unsecured. We always viewed capacity as being the primary source of loan repayment. This is very relevant today as we see security values drastically adjusted downward.

Most importantly, if none of the three Cs were present, then the loan would be declined.

Step Two: Monitoring

The second step of good portfolio management involved the early detection of problems, combined with prompt action. Our mantra involved two

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important concepts: A problem unattended never gets any better, and the first loss on a loan is usually the least loss.

Warning signs are varied and diverse. They may be quantitative and include specific measures such as working capital (WC). They may be more qualitative and nuanced, such as behavioral indicators. All warning signs are relevant, but they have different strengths as danger signals.

The warning signs of problem loans can be grouped into three areas: liquidity, financial and behavioral.

Liquidity Indicators

Liquidity is a symptom and not a cause of financial problems. Liquidity issues are a lagging indicator and the strongest signal of trouble. Unfortunately, liquidity issues are often the first apparent sign of trouble. This may be because other indicators have been ignored or because information provided by the borrower is lacking in relevance, timeliness or accuracy.

While liquidity can be quantified, you can learn a lot about liquidity from simple observation. A late loan payment or a sudden overdraft can be very revealing.

The symptoms of liquidity problems include the following:

- Increased credit inquiries about the client
- Increased need for guaranteed payment to creditors, such as certified check or letter of credit
- Credit reports, that is, information about the client
- Returned items from deposits made by the client
- Returned checks drawn on the client's account
- Operating loans fully utilized for extended periods
- Operating loans over their limit, for example, a sudden unrequested overdraft
- Increased litigation against the client
- Third-party claims such as those due to the government or health care providers
- Payroll delayed or missed (a very serious situation)
- Increased collection activity either by or against the client
- Frequent and sudden requests for a temporary bulge or loan accommodation
- Operating loan covenants squeezed or actually out of covenant
- Any inappropriate trend relative to events, for example, a fully used operating loan inconsistent with sales or credit policy
- Quantitative financial indicators (see below)

Financial Indicators

When I worked as a lender, we understood the quantitative expression of liquidity to be WC. We used two traditional tests:

- Accounts Receivable + Inventory/Accounts Payable
- Accounts Receivable/Accounts Payable

These simple models are useful but require refinement to establish a conservative and realistic picture of liquidity. Accounts receivable (A/R) should represent actual realizable value in the normal course of business. A conservative measure would be to deduct *all* of any account that is well beyond the normal terms of trade. For example, this would be over 90 days for accounts with 30-day terms. For inventory, obsolete, spoiled and recalled or unsalable items should be deducted.

Often, reported accounts payable (A/P) principally address trade debt and may exclude other amounts due. These may include such things as employee deductions for accrued insurance payments or other third-party liabilities. They also may include more exotic liabilities, such as amounts due for environmental or labor fines. It is important that A/P include all amounts that are due.

WC ratios should be tracked on a month-to-month basis to determine if any trend indicating deterioration exists. Should WC appear to be satisfactory but other warning signs appear, a thorough WC analysis should be completed.

Ultimately, the performance of the organization provides the capacity to repay debt. When I worked as a commercial lender, we viewed several components of performance to be the most important measure of capacity to repay. We did not concern ourselves with the nuances of corporate strategy but rather with the following income statement items: sales, cost of goods (COG), selling and general expense (SGA), gross margin (GM) and net profit.

Another important factor was the ability of the company to respond financially to difficulty or opportunity. This capacity could only be assured by retained earnings. Accordingly, we applied a debt-to-equity ratio of some choice and were particularly concerned when earnings were heavily withdrawn from the organization.

After 25 years as a lender and turnaround manager, I believe that these indicators are still central to lending decisions. In almost every distressed company, they reveal distress.

Behavioral Indicators

Behavioral warning signs give lenders clues into the integrity and competence of owners and managers. The management group will have the most influence upon the fortunes of the organization. (It is unlikely that any lender will have the time or access necessary to assess or measure the general staff of an organization.)

Competence is implicit in the financial performance of the organization. In the face of true misfortune or adversity, it can be measured by how quickly management reacts.

Integrity is difficult to measure, but there are indicators that lack of honesty could be a problem:

- Any deception, misrepresentation or lie (This is a clear and strong warning sign.)
- Any consistent delay in financial reporting requirements
- A reluctance or unwillingness to communicate
- Failure to respond to a specific question directly and entirely
- In an interview, answering a question with a question
- Providing evasive or unspecific information to a request
- Unreasonable and frequent delays in response to a request
- Any indication that records have been mislaid or inadvertently destroyed
- Absence of key personnel from crucial planning or strategic sessions

It is normal in a troubled company for management staff to feel stress. Occasionally, this causes a reluctance to communicate, fueled by fear and reinforced by denial. When observed behavior transcends or exceeds this tendency, it is often a sign of deeper problems.

Red Flags of Fraud

Occasionally, our commercial lending group encountered characters who were not merely weak but actually deeply flawed. This led to outright fraud, something we all have seen too much of these last few years.

Some signs that fraud may be occurring:

- A very rapid and significant decline in liquidity that does not seem to be supported or explained by business conditions or events
- Too much change in accounting personnel or procedure
- Changing external accounting firms too often
- The use of an accounting firm that does not seem to possess the depth and breadth of skill required for the business
- Excessive photocopies of invoices, particularly if they are out of sequence
- Excessive numbers of checks to cash or individuals (Look for second endorsements.)
- A disconnect between the number of employees relative to business volumes; also, false payroll using nonexistent employees
- Asset transfer without a sound business reason or at less than fair value
- A large number of business accounts inappropriate to business needs
- Any inappropriate trend relative to events
- Lapping, which is a misdirection of customer payments, such as a current payment used to pay older accounts
- The use of phony or shell entities to manipulate goods and services

Key Points for Lenders

- Know the client. This is essential in origination and flows through the process of monitoring the loan. Understanding the client is the first principle of loan monitoring.
- Communicate frequently with the client through site visits as much as possible. Meeting on-site has a host of benefits. A plant or operational tour can reveal a lot about ongoing operations, can bring out security issues and can create opportunities to interact with company employees. Site visits are also a prime selling opportunity for the lender.
- Meet key members of the internal accounting team and the external accounting firm. At some point, this should include a meeting at the offices of the accounting firm. It should be clear that the accounting firm has the depth and breadth of skill necessary for the needs of the company.

- Establish a monthly information package to be provided by the client. A good accounting department can easily provide profit and loss, A/R, A/P, inventory and any monthly budget or target. The accounting department should also confirm veracity.
- Use this information on a comparative basis to track performance in key areas such as sales, COG sold, GM and WC. Review any apparent deterioration with the borrower's management and the borrower's accounting department. Expect a clear explanation, including what occurred and how it will be corrected.
- Use the plant visits and monthly reporting as an opportunity to identify behavioral signals. Any deception or sign of fraud is a serious warning sign.
- Establish a minimum number of loan covenants that have maximum import. There is little point in creating many covenants, most of which will be breached and almost automatically waived. This is a waste of resources and can create an environment permissive to covenant breach.
- Heed warning signs with regard to their gravity. Indicators of liquidity problems or fraud have priority as strong warning signs. Financial indicators have less strength because they appear early. Strong indicators of fraud obviously reduce the reliability of financial indicators. This is one of the reasons that empirical indicators are important.
- Multiple warning signs from any quarter are an indication of distress. Too often, the reaction of the lender is simply to revise the loan covenant. Before any action is taken, a fundamental turnaround or liquidation analysis should be completed. The criteria for turnaround success are quality management, a viable core product and financial resources. If these are not present, then liquidation should be considered.