Loan Workout

2016

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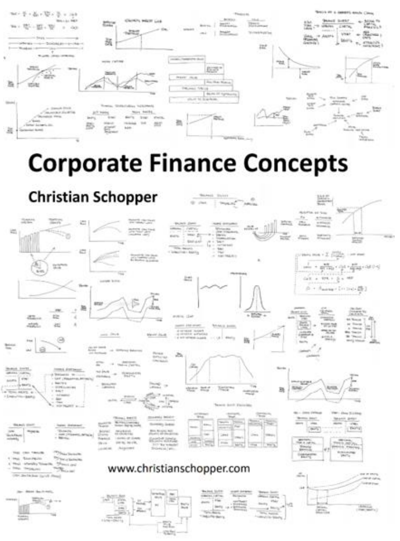

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Before Loans Become Non-Performing

Portfolio Level

Loan classification systems

- The health of a financial institution largely depends on the quality of its assets – including the loans it extends
- Loans typically involve credit extended on the basis of a contract that is held by the originating institution until maturity

- **Acceptable** – a loan with no detectable problems, in which the associated risks are unlikely to materialize over time.
- **Special Mention** – a loan with **material weakness** that nonetheless does not warrant the expectation of a loss or a substandard classification.
- **Substandard** – a loan for which **neither** the borrower's **financial condition nor** the security or **collateral** package backing the loan would be **adequate** to protect the lender from loss.
- **Doubtful** – a substandard loan with the **added risk** that any attempts to **liquidate** value **and** to **collect** on it are **unlikely** to generate enough **to recover** the lender's **capital**.
- **Loss** – a loan deemed **uncollectible**, because any assets backing the loan are gone or have lost their original value, and the borrower's means to repay the loan are impaired. The loan may still have salvage value, but the effort required to realize that value is beyond that considered reasonable, which justifies the lender writing off the remaining outstanding balance.

Signs of distress in the borrower

- **The process of accurately diagnosing a borrower's financial condition involves identification of groups of warning signs that validate one another**
- **Taken alone, most warning signs are too ambiguous to signal financial distress**

- **Declines in profit margins** – might signify that the higher sales were achieved from prices that are too low, overly generous discounts or rebates, higher selling costs, or some combination thereof.
- **Pronounced increases in product returns** – might indicate that higher sales resulted from lapses in quality control, which would have a negative impact on profits, with a time lag as dissatisfied customers return their purchases. It could even involve government-enforced product safety recalls.
- **Pronounced increases in the aging of accounts receivable** – might identify additional sales achieved by extending store or company credit without adequate credit scrutiny or safeguards. The additional costs of collection and losses on extended credit could have a negative impact on company profits with a time lag.

Signs of distress in the borrower (cont´d)

Warning Signs

Operations

1. Steady decline or rapid increase in sales
2. Frequent cash shortages
3. Significant changes in net working capital
4. Unexpected changes in strategy or business
5. Shrinking cash margins and unexpected losses
6. Unrealistic pricing/discount policy
7. Frequent revenue/earnings shortfalls
8. Increasing dependence on fewer customers
9. Negative operational cash flow with net profits
10. Deteriorating accounts receivable
11. Increased credit to affiliated companies
12. Lengthening terms of settlement for payables
13. Repeated changes in suppliers
14. Insufficient cash to take trade discounts
15. Inventory buildup with turnover slowing
16. Outmoded production or distribution system
17. Inadequate spending on critical activities
18. Failure to pay taxes
19. Non-renewal or cancellation of insurance
20. Billing practices are deficient

Management and Behavior

1. Poor or deteriorating sponsor reputation
2. A lack of management/sponsor vision
3. Increasingly authoritarian management/board style
4. Senior executives not providing financial information
5. Incompetent finance director or CFO
6. Management experience/skill deficiencies
7. Management and shareholder contentiousness
8. Frequent changes in ownership and key positions
9. Sponsors'/managers' unexplained new wealth
10. Quarrels between company and its auditors
11. Notable shabbiness/loss of pride in company
12. Personal issues constraining management team

Reporting

1. Worsening delays in financial reporting
2. Poor quality of, or inconsistencies in, reports
3. Qualified audit opinions and/or audit disclaimers
4. Unexpected and/or untimely changes in auditors
5. Many unusual items in financial statements
6. Revaluation of assets without convincing explanations
7. Padding of financial statements (mainly on the Balance Sheet)
8. Increasingly changing interim financials with surprises
9. Major unexplained planned vs. reported results gaps
10. A deterioration in ratings by external analysts
11. Regular breaches of financial covenants
12. Increasing incidence of waiver requests

Investing

1. Non-current assets increase faster than revenue/profit
2. Major procurement without proper rationale/financing
3. Working capital needs funded by asset sales
4. Inventory build-up without sound inventory controls
5. Seemingly speculative inventory purchases
6. Inadequate maintenance of plant and equipment

Financing

1. High or increasing levels of financial leverage
2. Increased short-term funding for long-term liabilities
3. Difficulties in accessing financing
4. Excessive lending to related individuals/affiliates
5. Obligations to creditors not fully met each cycle
6. Increasing customer/creditor complaints/ legal action
7. Funding secured on less favorable terms

Loan and loan portfolio reporting requirements and frequency

Portfolio staff should be given clear instructions regarding the frequency and topical coverage of portfolio supervision or monitoring reports

- **Loan terms, loan and interest payment history, borrower attributes, security profile** – Addresses who was intended to use the credit and why, relating the borrower's main characteristics to the nature of the business or project
- **Credit risk review** – The review is an analysis of the risks affecting the borrower's ability to repay. It includes industry risk, country risk, legal risk, operational risk, etc., along with factors that might influence willingness to repay the loan
- **Liquidity risk review** – For borrower company's assets and liabilities, with particular attention focused on the actual liquidity of those shorter term assets on which the borrower will likely depend to meet his regular cash requirements
- **Market risk review** – Pertains to the risks inherent in the markets for the company's obligations (debt) and other claims on its cash (equity)
- **Security/collateral adequacy review**
- **Adequacy of the information systems** – Provides regular information on the above points

Portfolio-level actions

- The lender should ensure that its information systems have the right balance between entity-level (borrower, loan, property) information and portfolio-level information
- On the right side are summarized five actions that management should take while business conditions are relatively calm; these can be modified to apply to lending institutions

Action	Description
Look for the warning signs	Develop both formal and informal information sources in connection with warning signs. Learn to spot sources of value destruction, build-up in short-term borrowing, likely formation of asset bubbles, and other sources of financial imbalances.
Develop a crisis management mind-set	Develop a coordinated crisis response through training, especially workshops and simulations.
Reduce financial mis-matches and strengthen funding sources	To ensure a stronger cash flow position, identify ways to ensure sustain-able levels of financial leverage and strengthen funding sources. Other actions include lengthening funding maturities, hedging major financial gaps, tracking financial health of creditors and borrowers, diversifying funding sources, and lining up additional credit.
Ensure that borrowers safeguard the supply chain	Give special attention to supply chain discontinuities or problems. For key and particularly crucial inputs, arrangements for securing alternative sources or substitutes should be in place.
Put alternative scenario and contingency planning processes in place	Preparing for crises by setting up a framework within which a variety of macro and micro alternative events and parameters are examined in light of their potential impact on the lending institution and potential mitigation strategies.

Establishing transfer criteria

There are **multiple organizational possibilities for handling problem loans**. Most lending institutions handle extreme cases of jeopardy in one of three ways:

- 1. The loans are **sold**;
- 2. The associated **loan collateral is liquidated** and the loan is paid from proceeds; or
- 3. Loans are **worked out** (usually involving some type of loan rescheduling or restructuring)

- The table below offers examples of some of the considerations regarding criteria for NPL transfers:

Conditions for triggering a transfer could include a loan with an outstanding balance above the threshold and any of the following:

1. A loan classification of "substandard" (or worse);
2. A loan classification of "special mention" if syndication is involved and/or reputational/legal issues are at stake;
3. Actual payment default to the lender of above some "prudent" default threshold (set to avoid very small payment irregularities) that has been in effect for a minimum time (often 60 or 90 days). Financial institutions should have a much shorter period as assets can disappear much more rapidly;
4. Evidence or reliable knowledge of significant payment default to other creditors (with similar thresholds as above);
5. A request made by a client to the lender or to any of the client's other creditors for a standstill agreement, a rescheduling, or a restructuring of the client's debt;
6. A failure of a previous rescheduling or restructuring;
7. An indication of an imminent major default or materially adverse event, including government intervention or nationalization, notice of termination of operating license or concession, significant external rating downgrade of client or guarantor, sudden plant closure, etc.;
8. Transfer of the loan by co-lenders or other members of a lending syndicate to their loan resolution or recovery unit, or sale of exposure to a distressed asset fund;
9. Bankruptcy or liquidation proceedings begun against the borrower or guarantor;
10. Litigation, arbitration, mediation, or other dispute resolution mechanism involving or affecting the lender; or
11. Evidence or strong suspicion of corruption or illegal activity involving the borrower or the borrower's other stakeholders

Warning signs for systemic distress

- When systemic distress reaches the equivalent of a financial flash point, it gives rise to a financial crisis, and the usual treatment of financial obligations as a collection of contracts subject to contract law breaks down

Some of the ***most common macro-economic warning signs for a country*** include:

1. Chronic and growing public sector deficits;
2. Chronic and growing public sector indebtedness;
3. Weakening external debt-servicing capacity;
4. Rapid and sustained depletion of foreign exchange reserves;
5. Adverse changes in terms of trade; and
6. Signs of asset price bubbles.

Warning signs within a country's financial sector** can signal a **future financial crisis:

1. Evidence of growing non-performing loans within the banking system;
2. Foreign exchange /maturity mismatches on bank balance sheets;
3. Significant deviations from Basel II guide-lines evident within many of a country's banks;
4. Relaxation of banking regulations; and
5. Increase in numbers of insolvent banks.

Systemic distress vs isolated (or ad hoc) distress

When the markets in which lenders' clients normally operate are marked by financial crisis, lenders may consider modifying their responses in the following areas:

- Loan **collateral loses protective value** as **widespread illiquidity** affects asset markets
- **Counterparty risk** becomes more important, as even strong institutions can fail during a financial crisis
- **Widespread uncertainty** and prospects of government debt forgiveness can cause good borrowers to stop servicing their debt obligations as they build up a cash war chest and avoid making payments that they believe might forestall some benefits of anticipated debt relief
- Borrower companies should consider the financial health of key suppliers and customers during widespread financial crisis differently from borrower distress that occurs as an isolated event

Portfolio-level actions during a financial crisis

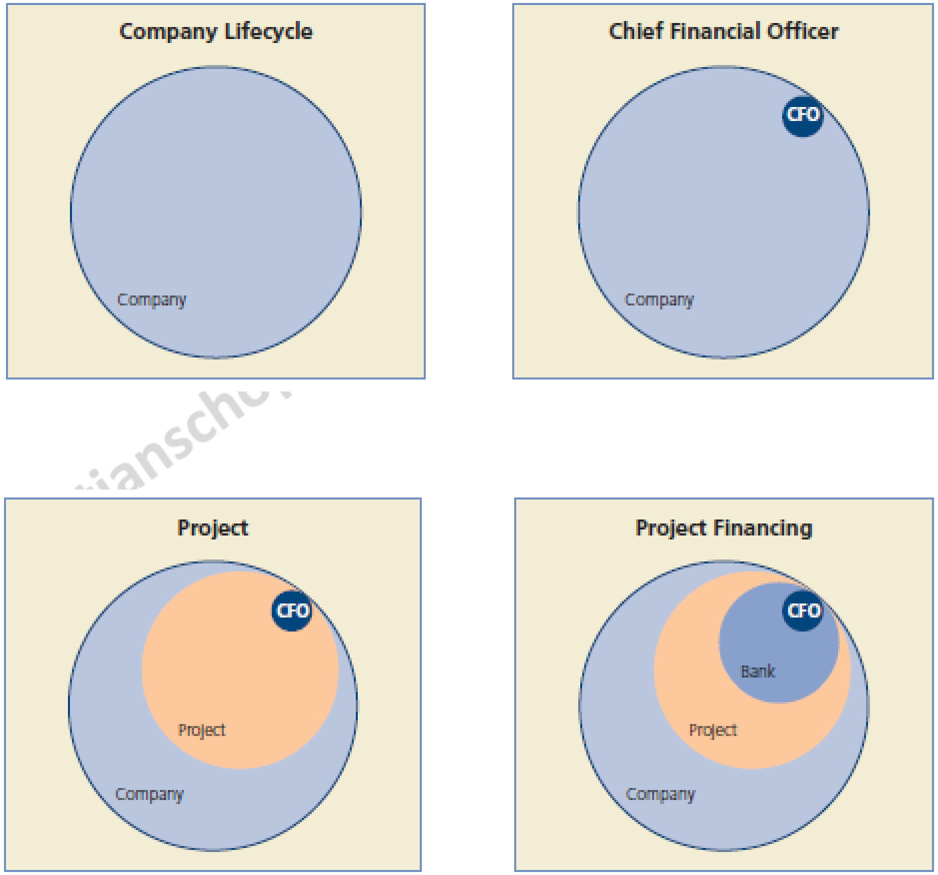
During widespread financial distress, several actions are recommended at the portfolio level

- The lender's **legal department** should **review** all loan collateral for "**enforceability**"
- **Portfolio staff** should **update collateral valuation**, taking into account changes in asset markets brought on by the crisis with particular regard to the current state of liquidity in those markets
- The lender's **financial operations unit** or accounting department should provide all portfolio staff with **up-to-date breakdowns of all loan amounts** outstanding and falling due, including accrued interest, penalty interest, loan amounts in arrears, arrears broken down by number of days outstanding, reimbursable expenses related to loan recovery, and any other amounts owing.

Level of the Individual Loan

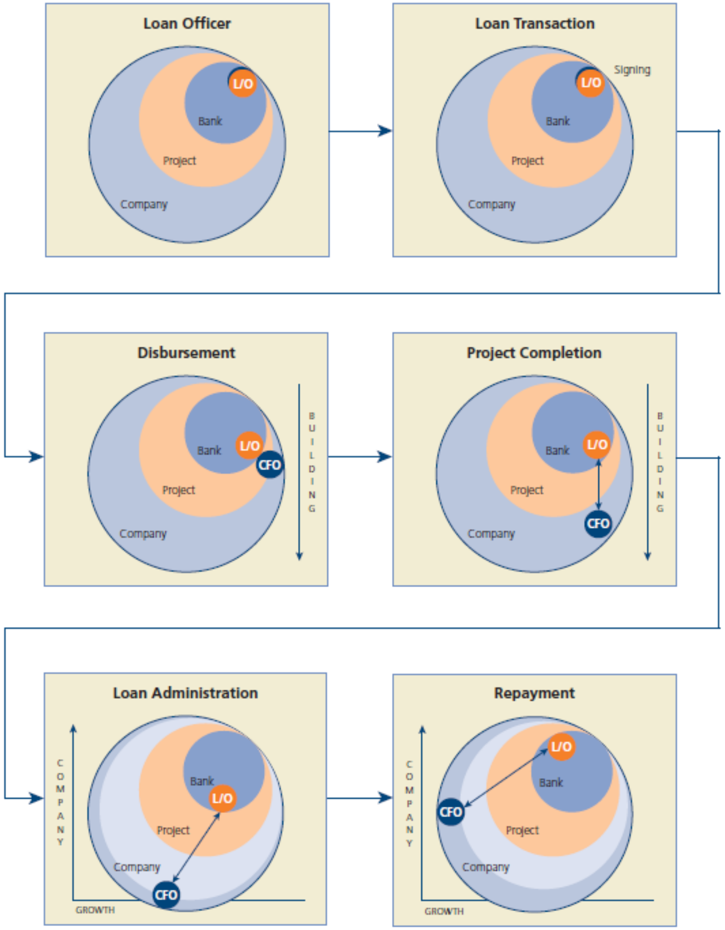
Project / loan cycles and the dynamics of divergence

- A major complication in a financial workout is the fact that relationships evolve
- At the financial heart of a larger enterprise will be the financial decision maker – the owner, the bookkeeper, a professional financial director, or the Chief Financial Officer (CFO)
- At some stage, the enterprise will need additional money to pursue a project, with financial aspects taken into consideration
- The relationship with the prospective lender has its own life cycle



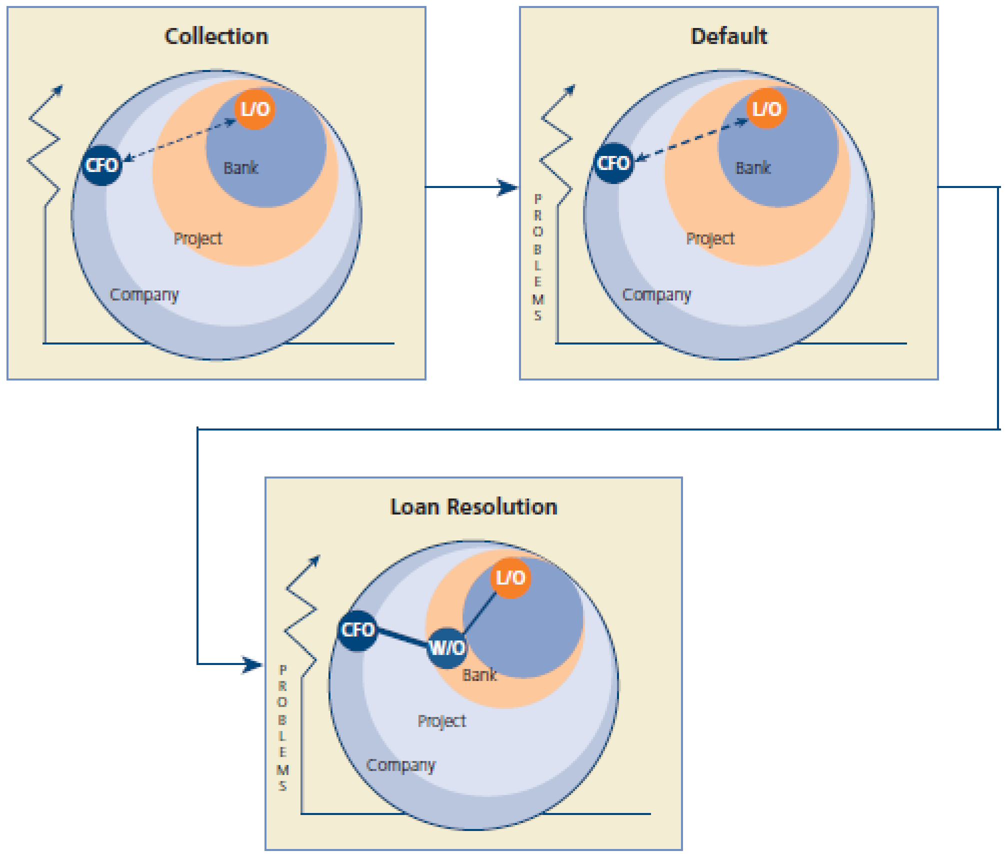
Project / loan cycles and the dynamics of divergence (cont´d)

- **At the lending institution, the financial decision will first lie with the liaison with the client, usually a Loan Officer**



Project / loan cycles and the dynamics of divergence (cont´d)

- Should the enterprise eventually suffer a financial set-back, the CFO will have to revive the relationship with the bank, this time under far less pleasant circumstances
- Initially, the bank is forgiving and prepared to accommodate
- After the first payment default, an early attempt is made to reschedule the loan
- However, there may be circumstances in which the situation deteriorates to where the bank has to call in its workout team
- In this situation, contacts are more frequent, but the circumstances have changed dramatically …



Documentation deficiencies and flaws

Errors

1. Failure to register security or registering the wrong security
2. Failure to notarize documents as required
3. Failure to perfect a security interest in the pledged collateral
4. Failure to detect prior encumbrances on assets offered as collateral for a loan transaction
5. Failure to include in the legal documentation adequate triggers that may be tripped as a result of deterioration in loan-servicing performance and in connection with the financial health of the borrower, as well as possible actions taken by the borrower
6. Failure to name the lender as a beneficiary on the borrower's insurance policies
7. Failure to hold motor vehicle title where vehicles represent collateral
8. Failure to notify absolute guarantors of major documentation changes, dollar limits, or special notice provisions in connection with guarantees
9. Failure to include covenants requiring the obtaining and updating of key financial or net worth information on guarantors
10. Failure to have key documents signed by all of the proper authorized persons required by local company law or the borrower's own articles of incorporation
11. Failure to obtain rent assignments or verification of borrower's right to occupy real estate collateral
12. Failure to include covenants obligating the borrower to keep appraisal information up-to-date and to bear the costs of appraisal

Documentation deficiencies and flaws (cont´d)

Deficiencies

1. Filing deficiencies related to legally required information, such as name changes, relocation, etc.
2. Weaknesses in the legal documentation of the lender's agent
3. Lack of clear cut events or conditions supporting loan acceleration, or unrealistic event or condition thresholds
4. Inadequate provision for cross-default and cross-collateral situations
5. Missing signing authorities and related powers in connection with marketable securities held as collateral
6. Problems in connection with letters of credit
7. Inconsistencies between documents with no provision of language guiding reconciliation or which document should prevail
8. Missing original documents
9. Lack of verification of the borrower's legal existence/incorporation in the documentation
10. Excessive or vague non-recourse provisions in the loan documents, which limit the lender's rights to collect on deficiencies
11. Weak or vague stand-off provisions in connection with subordinated debt instruments
12. Trust or fiduciary limitations imposed on collateral

Notice letters

- It is not enough for lenders to originate a loan to a corporate or SME borrower and then rely on the language in the loan agreement
- Lenders must also exercise discipline, caution, and equanimity in their communications with borrowers, both oral and written

Dunning letters

- Normally associated with lenders' **demands for payment**, these should also be applied to any of the following areas in which the lender considers the borrower's action or performance to be unsatisfactory:
  - Failure to pay **principal** and **interest** on a timely basis
  - Failure to pay as contractually agreed outstanding **penalty fees** and/or interest
  - Failure to **provide** contractually agreed **information** on a timely basis; and
  - Failure to pay on a timely basis such obligations as property **taxes**, **insurance** premiums, etc.

Acceleration letters

- Acceleration is a **formal action** and should conform to the institution's established procedures
- The acceleration letter should **reflect the specific requirements** of the lender-borrower relationship and should be handled with care

Demand letters

- … to co-signers, **guarantors**, or other such counterparties

Set-off letters

- A lender experiencing payment default should apply those **assets of the borrower subject to set-off** to outstanding debt in a way that conforms with local legal requirements

Guarantees, completion agreements, and comfort letters

Guarantees

- Guarantees are a type of loan enhancement in that they reduce the impact of non-payment of a particular loan, providing an alternative means for the lender to seek loan repayment
  - **Demand guarantees** do **not require proof of default** to be initially called
  - **Surety guarantees**, in which the **beneficiary of the guarantee must prove** that **default** has occurred before calling the guarantee

Completion agreements

- The **borrower pledges to provide additional financial resources in the event of any project cost overruns**
- Generally the beneficiary of a project completion agreement is the borrower company, which therefore must make the call

Comfort letters

- These letters are a way of **recording intent** but tend to "lack teeth" from a legal perspective

Understanding priority of claims

Liquidation in most jurisdictions is guided by law regarding how the proceeds of borrower payments are to be applied in a particular sequence of priority

Typical Waterfall

1. Administrative expenses
2. Super-priority items
3. Claims that are not extinguished against specific assets and contra accounts subject to set-off
4. Expenses granted priority
5. Fully-perfected security interests (in the order of the date at which perfection was completed)
6. Taxes
7. Pre-petition unsecured claims
8. Subordinated debt/claims
9. Preferred equity interests
10. Common equity interests

Seeking cash conservation before new lending

- **Raising funds in the continuing presence of financial sloppiness or profligacy only reinforces such behavior and amounts to tacit approval**
- **Therefore, before any decisions are made to secure additional funding, the lender will want to review the borrower company's operations to help identify areas in which savings can be achieved and which would free up cash from its current uses**

If a company shows signs of financial distress and is also hemorrhaging cash because of an absence of financial controls and questionable spending patterns, its efforts to raise additional funding to alleviate the distress will be misdirected.

1. Make a stronger effort in the collection of receivables
2. Delay those payments that can be delayed without adverse consequences
3. Look for innovative ways of reducing operating costs
4. Eliminate non-profitable product lines or units
5. Sell non-essential or non-core assets
6. Sale and lease-back of larger core assets
7. Reduce wages and salaries, the number of employees, bonuses, perks, etc. The key is to generate the most cash for the least adverse consequences –cut fat, not muscle
8. Raise equity or junior debt

Additional actions in connection with the borrower

- To the extent that the **borrower lacks** the means or **ability to control** its **cash**, **lenders** with the right to do so might **consider taking control** of the borrower company's accounts receivable
- This can be done through a "**lock box**" **with a cash sweep** that can be administered by the lender's staff, a specialist consultant, or an outside trustee
- Particular attention is to be paid on **invoicing** and the process of **collecting receivables** through daily monitoring
- The lender must both ensure that adequate controls are implemented and avoid being fully in control of the borrower's business, due to the risk of lender liability

Identifying conflicts of interest among stakeholders

Company stakeholders are often in situations in which they have a conflict of interest

- All of the company's stakeholders;
- Their representative bodies;
- A full description of the nature of each of their "stakes" and, with those who may have multiple stakes, which stake is likely to most affect their decision making;
- The payoff relationship inherent in each stakeholder's interest in the company; and
- A description of the nature of any major conflicts of interest that the company might have

Possible Stakeholders

1. Common active majority and minority shareholders
2. Common passive minority shareholders
3. Preferred shareholders
4. Secured long-term creditors
5. Senior long-term and short-term creditors
6. Subordinated creditors
7. Management and employees
8. Suppliers
9. Customers
10. The lending institution, its syndication partner banks, and other lending institutions
11. Government and affected citizens
12. Competitors

Preparing for Workouts

Taking Stock

Taking Stock

Determining the extent and main causes of distress

- Many expressions in the workout business reflect the world of medicine: a company is *sick* or *dying*; a company is *bleeding* and its management is trying to staunch the *bloodletting;* a division may have to be *amputated* because the market is *anemic;* wholesale *surgery* will be required, etc. …
- Similarly, prevention is superior to the cure, and a borrower should deal with problems before they become life-threatening
  - But bad judgment and bad luck may cause even the best-run corporation, let alone the small business borrower, to run into trouble
  - What is important is the cause of the problems

Understanding bankruptcy and the broader consequences of bankruptcy law

- Bankruptcy is the condition of a legal entity that does not have the financial means to pay their incurred debts as they come due. In countries with bankruptcy laws, this status is usually established through legal procedures involving a petition by the bankrupt (voluntary bankruptcy) or by its creditors (involuntary bankruptcy)
- The workout officer must become familiar with the particulars of the relevant bankruptcy framework through the institution's legal department or local counsel

Best Practice Organizational Arrangements

for Handling a Sizeable NPL Portfolio

Structuring an NPL Organization

- **An overwhelming majority of large lending institutions on several continents have reported that their banks decided against the profit-center model in favor of a more manageable cost-center model**

Most lending institutions generally and commercial banks in particular will have a unit dedicated to dealing with problem or non-performing loans (NPLs)

The unit's size and complexity will depend on several factors such as

- The **size**, **nature**, and **diversity** of the loan portfolio;
- The **percentage** of the loan portfolio that is problematic (however defined);
- The main **sources of financial distress** causing the non-performance of the loan portfolio (such as whether most of the problems can be considered ad hoc or are considered the result of a broader financial crisis) and
- The local **laws** as they affect and circumscribe what can be done in the area of asset resolution

- Decide on whether to make the NPL Unit a profit center within the lending institution

Bank records and systems support

A lender's *data processing system* should be able to accomplish the following:

1. Make accurate interest calculations for a broad number of loan types and/or debt-instruments without having to resort to major software programming
2. Account for penalty charges and other assessed fees
3. Apply payments correctly in accordance with a payments waterfall that may include more components when a loan is in arrears or is being worked out than when it has always been in full compliance
4. Track equity interests resulting from payment in the form of shares, stock options, or debt-equity swaps
5. Track "new money" in any and all of its possible forms
6. Show the impact of proposed workout or restructuring terms and conditions for each creditor for purposes of assessing the extent to which such proposals adhere to agreed notions of "fair burden sharing"
7. Store several sets of target payment and loan balance schedules as well as actual performance in order to allow tracking of loan recovery as conditions evolve
8. Calculate, report, and invoice loan "payout amounts" on demand with minimal delay
9. Report loans by team and team member, by obligor, by currency, and possibly a few other key fields in order to track progress within the NPL Unit
10. Employ a sub-system or linkages to a separate information system for loan collateral and various forms of security, particularly with respect to periodic valuation updates, status of such key aspects as security registration and perfection, and including details regarding options with valuations and time to expiration. This component should also provide information regarding guarantees, stand-by letters of credit, surety bonds, etc., and their expiration dates and associated collateral maintenance information.

Applying Triage in Managing an NPL Portfolio

Applying Triage in Managing an NPL Portfolio

- Analyze, diagnose, and **separate NPLs** into groups
- **Criteria** utilized in performing triage
- **Managing** bank loan portfolios during widespread financial crisis
  - Take stock from the **outset**
    - This is the time for honesty in assessing the extent of the damage to the portfolio and applying conservatism to estimates throughout the diagnosis, keeping in mind that relying on hope is not a valid coping strategy
  - Devise broad **strategies for** loan portfolio **recoveries**
  - **Strengthen organizational arrangements** for managing NPLs in order to staff, form teams, equip, and provide systems support to a best-practice NPL Recovery Unit
    - However, NPLs have a tendency to deteriorate quickly so do not waste time on perfecting the organizational structure
  - Make sure that the right **people** are assigned to loan recovery work throughout the lender's hierarchy, even if it means reassigning senior and middle management
  - Introduce **performance-based incentives** to attract and retain the best workout specialists

Taking Charge of the Workout:

Workout Tools and Workouts

Strategy Options

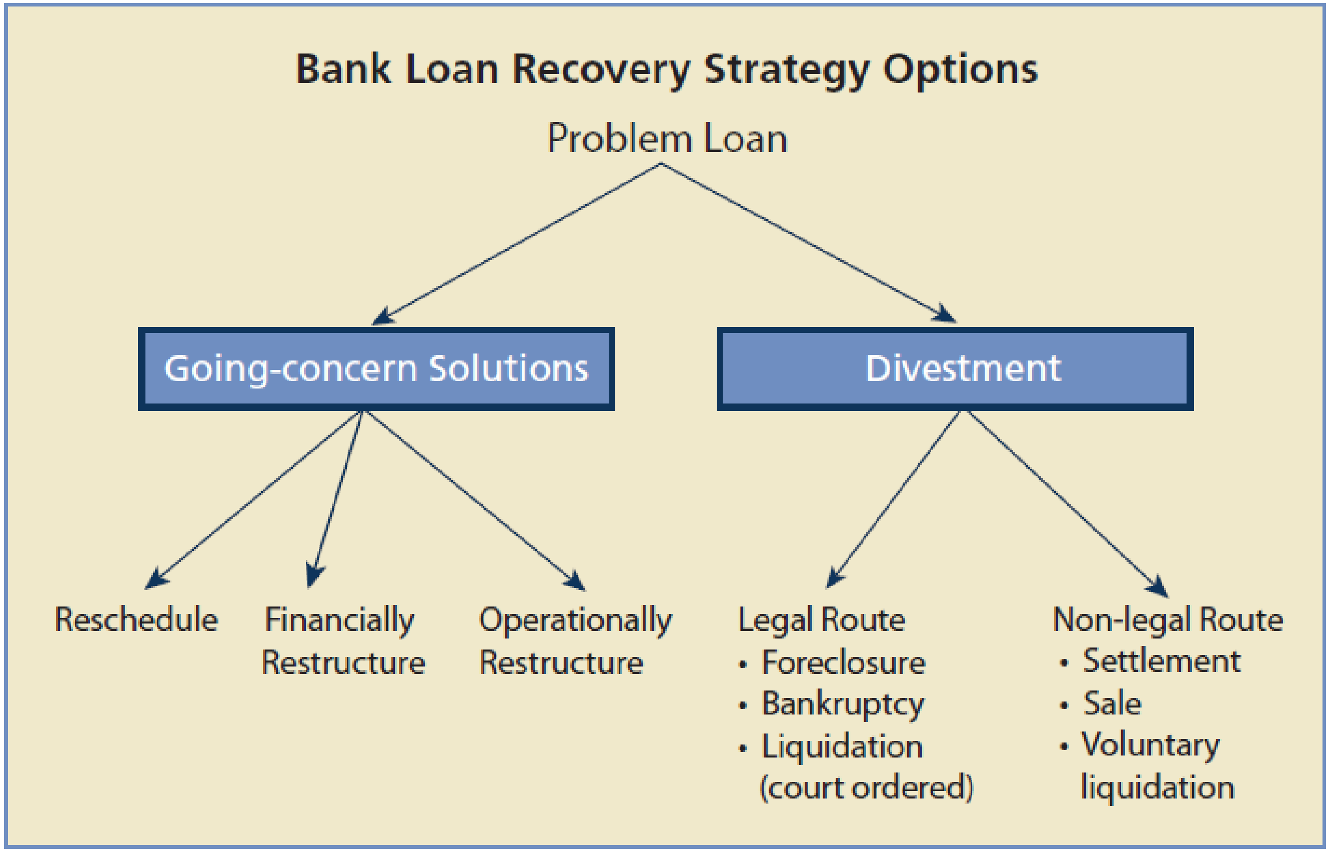
Workout Options

- **Discount** the loan
- **Acceleration** of maturity and right of set-off
- Voluntary **liquidation** of business or collateral
- **Move** debt to another bank
- **Renew** the loan
- Provide **additional funds**
- **Restructure** the debt

Restructuring of a Credit

- **Amending** the credit terms & conditions …
- … usually the repayment term, principal amount, or interest rate
- … due to customer's difficulties in repaying according to the initial terms

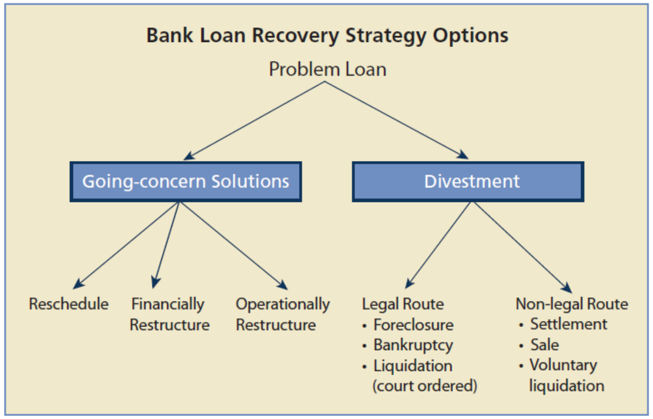
Bank Loan Recovery Strategy Options



Going-concern solutions

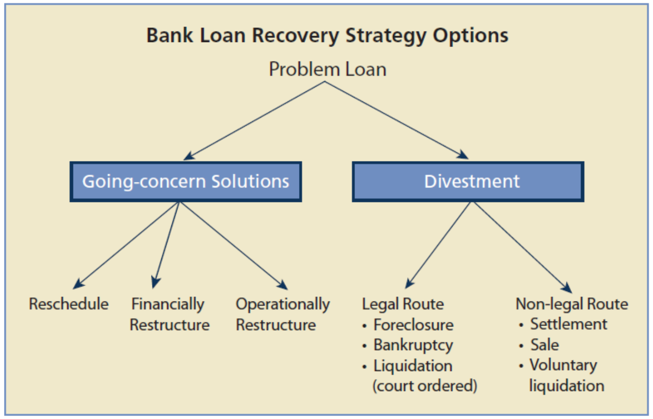
- So-called “going-concern” solutions are preferred solutions if an enterprise is worth more than the sum of the parts
  - Price that a used asset, or an asset that is sold under duress, can fetch is typically less than its book value, let alone its replacement value

- The going concern solutions may leave the borrower in charge …
- … nevertheless, the lender may insist upon some changes
  - Rescheduling
  - Financial Restructuring
  - Operational Restructuring



Divestment

- The lender can divest its position with the borrower via the legal route or the extra-legal route
- The extra-legal route is always preferred, as it allows the lender to retain a measure of control
- There are three ways in which the lender can extra-legally dispose of his position with the borrower:
  - Settle with the borrower or a closely related party;
  - Sell his position to a third party that has a greater appetite for the risk involved in the exposure to the borrower; and
  - Persuade the borrower to liquidate the asset(s) and repay all or most of the loan from the proceeds



The case for new money and recommended safeguards

There are cases where it may be much better to keep the enterprise going even when it has run out of cash

- As in most “going-concern” cases, the assets of such a venture will be worth less on their own than they are in combination …
  - … and / or they are when their sale is hastened by the liquidation of the enterprise …
  - … and / or than they are when third parties are aware of the borrower’s difficulties

- A critical issue is whether the **lender**, in agreeing to provide new money, can **make sure that he can be treated more senior to the already existing creditors**
  - This is an important reason for making sure that all of those with an exposure chip in and that there is some framework agreement among these parties
  - Likewise, the lender will probably seek some additional security but runs the risk that his security rights will not be recognized if the operation fails and the borrower or the enterprise still fails.

Strategy Selection

Assessing the loan quality

Assessing the quality and adequacy of loan security, and assessing borrower viability and potential viability

- The lender will have to consider **whether**, **when the collateral is sold**, the **proceeds** will be **enough** to cover the outstanding principle and any interest and penalties due

- In doing so, the lender will have to consider a number of factors:
  - **How easy** will it be to **foreclose** on the security?
  - Can the lender, upon foreclosure, **take ownership** of the asset and sell it to a third party **or** will the asset **have to be sold through an auction**?
  - **If** the asset has to be sold through an **auction**, **can** the **lender bid himself** and, better yet, **use the loan** to pay?
  - Will any **other parties share in the proceeds** of the sale of the asset?;
  - How much will the **procedure cost**?
  - How much **time** will be **involved** in the entire procedure?

Restructure Credit

- Gather **Information**
  - Credit File
  - Collateral File
    - Analysis of Problem
  - Title Search
  - Appraisals
    - Review of the collateral
  - Current Financial Statements
    - Conduct a financial analysis
  - Borrower's Business Plan

- Thorough **Analysis** …
  - What is the Problem?
    - Cause
    - Magnitude
  - Did the Bank cause the Problem?
  - Did the Bank have adequate controls?
  - Did you know all the pertinent facts?
  - Loan Documentation
  - Repayment Sources
  - General Business Analysis of the Company

- …. and more: Thorough **Analysis**
  - Inspect the collateral
  - Is there other collateral?
  - Projected financial statements
  - Collateral evaluation
    - Going Concern vs. Liquidation
    - Real Estate or Receivables???
  - Are there other lenders?
  - Borrower's or principal's character and management ability
    - Strengths
    - Weaknesses
    - Is Management the Problem?

- Analyse **Repayment Sources**
  - Borrower
  - Co-signer
  - Guarantor
  - Collateral

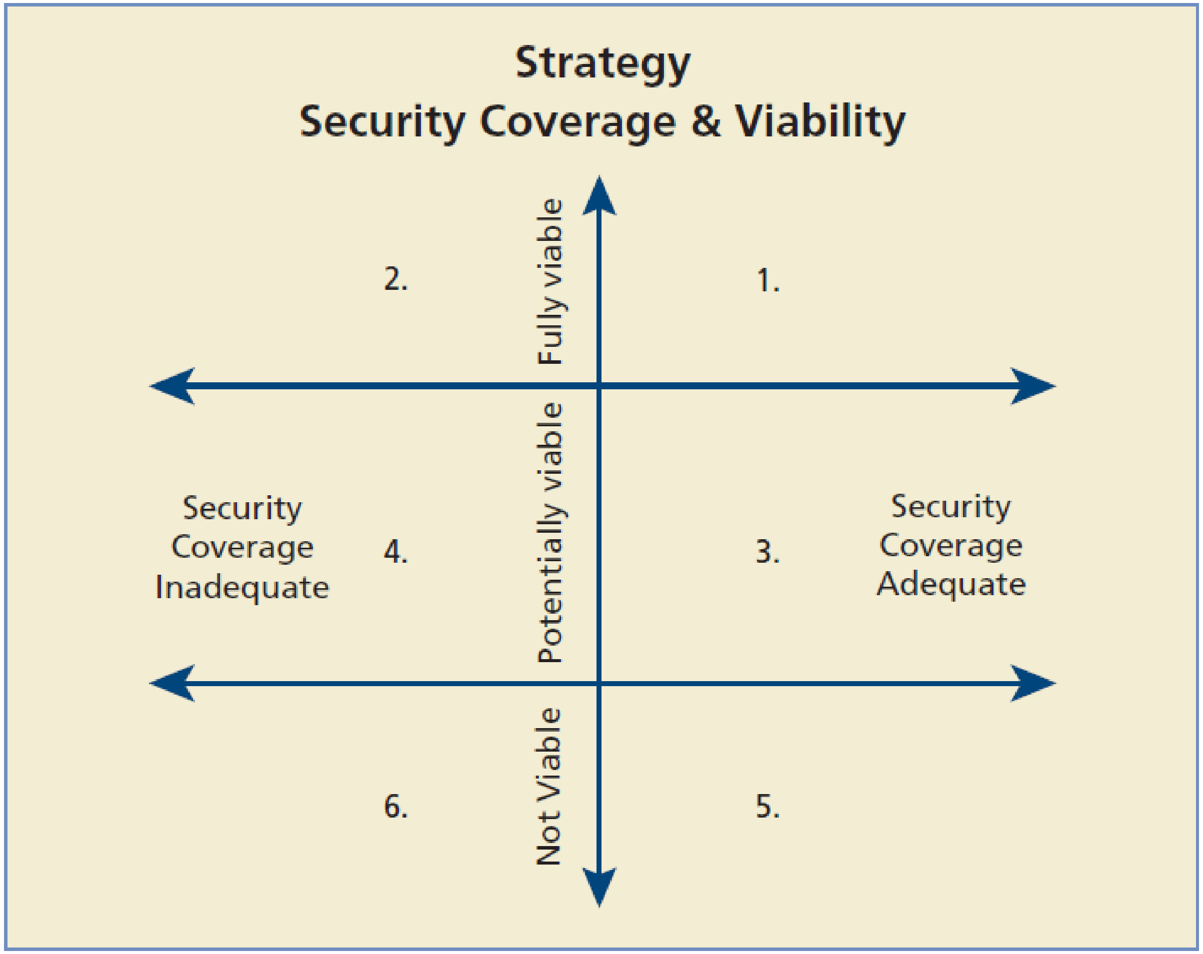
Action Plan and Options

- Develop an **Action Plan**
  - Meet with the borrower and discuss situation
  - Don't meet alone
  - Retain borrower's cooperation, if possible
  - Anticipate reactions
  - Protect your guarantors
  - What are your options?
  - Develop primary and secondary action plans

- **Options**
  - Do Nothing
    - Risk outweighs the benefits
  - Rehabilitate
  - Exit
  - Agreements should be signed
  - Sell Assets?
    - Other sources of repayment?
  - Cross default arrangements

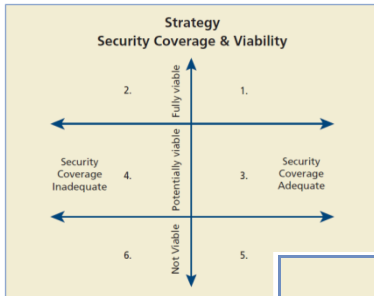
Loan Workout Strategy

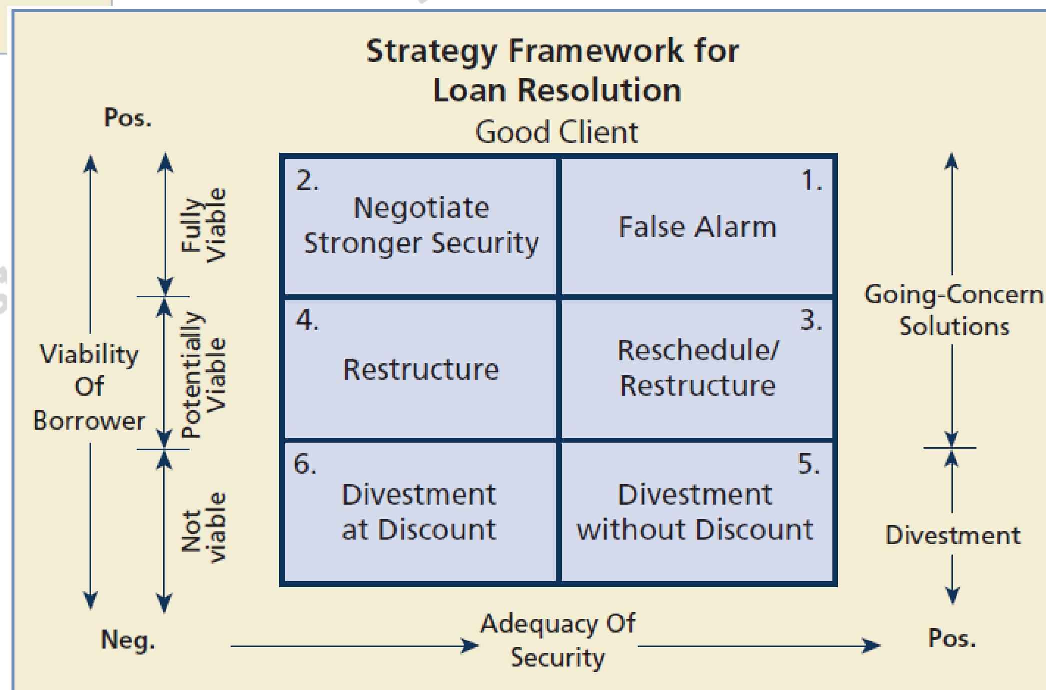
- Questions as to whether the lender's security (collateral) is sufficient and whether the borrower's business is viable can be pictured in the two-dimensional graph, with relative security coverage (collateral over exposure) being measured along the horizontal axis, and the borrower's viability along the vertical.



Loan resolution strategy selection

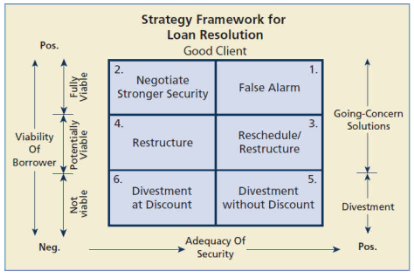
- The matrix indicates six scenarios each having distinct features, e.g. section 1 indicates the client being viable and the bank holding more than adequate security, while section 6 indicates the complete opposite





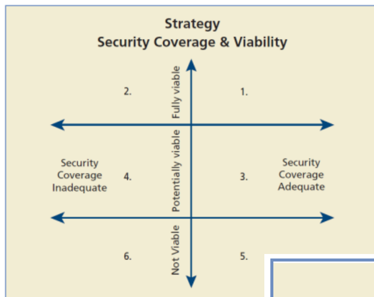
Loan resolution strategy selection (cont´d)

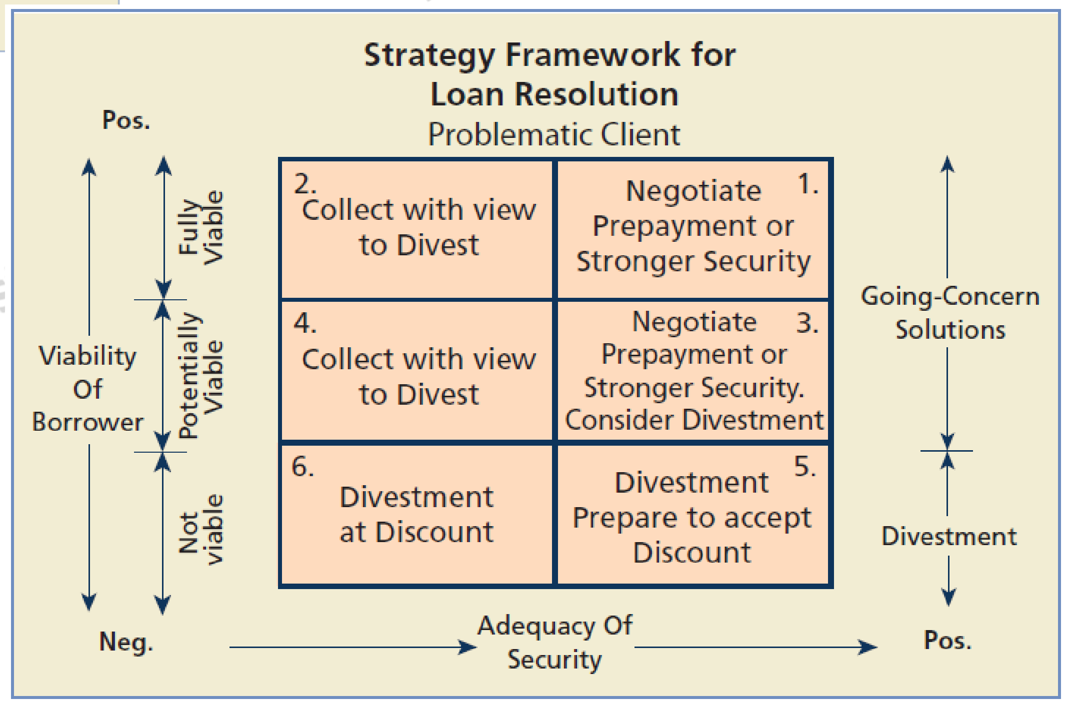
- **Each of the scenarios of the matrix represents a strategy that the bank may wish to pursue when commencing a workout**



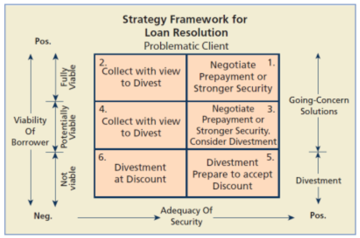
STRATEGY	IMPLICATION
1. False Alarm	Essentially, the default was an aberration due to a temporary problem with the enterprise, which is in good shape with good security. The client will be asked to pay as soon as possible and likely get off with a warning.
2. Negotiate Stronger Security	The client enterprise is, in principle, in good shape. However, to the extent that this may not be the case in the future, the lender may want to use this default as an opportunity to seek stronger security.
3. Reschedule/ Restructure	The client enterprise is suffering some setbacks and its present cash flow is not sufficient to service its debt. To the extent that the client enterprise is potentially viable, this may change for the better in the future. Meanwhile, the security is sufficient should matters not improve. The lender could therefore reschedule its loan for maturities to better match anticipated cash flows. In the event that projected cash flows are not sufficient to pay all of the agreed debt service, the lender may consider to reduce the principal of the loan and convert the balance into some form of equity.
4. Restructure	The client enterprise is potentially viable. To the extent that security is not sufficient, the lender should not only reschedule the loan, but also recognize that security is not enough and therefore should reduce the principal of the loan and convert the remainder into some form of equity to assure that if the client enterprise does better, the lender will share in the upside potential.
5. Divestment without Discount	The client enterprise must be considered unlikely to ever generate enough cash for it to be able to repay the loan. In fact, continuing the enterprise may be a misuse of resources in an economic sense. The lender may want to liquidate its position through some form of divestment. Given that the security is supposedly worth more than the value of the loan, the lender should hold out for a full recovery.
6. Divestment with Discount	Here, too, the client enterprise is unlikely to ever generate enough cash for it to be able to repay the loan. Here, too, the lender should consider liquidating its position, but it should be realistic enough not to seek a full recovery of its loan as the value of the asset(s) securing the loan is below that of the outstanding balance of the loan.

Modified loan resolution strategy selection



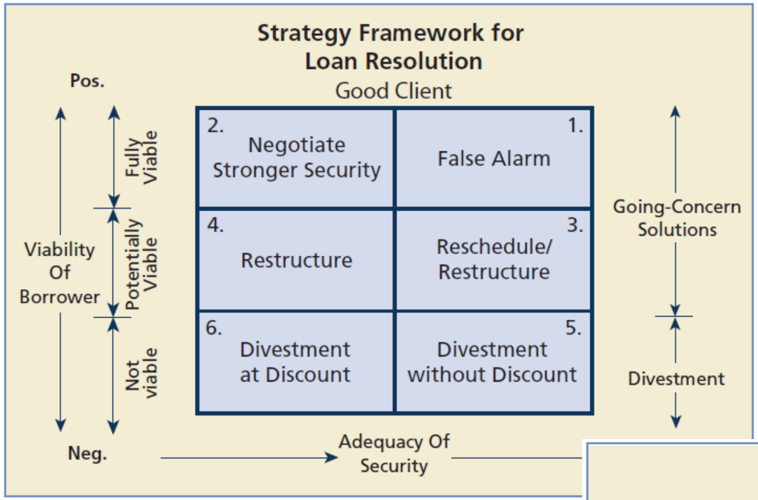


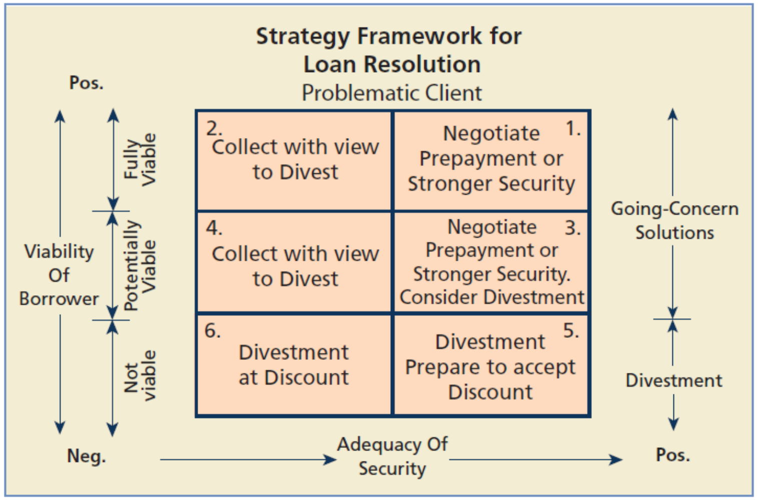
Modified loan resolution strategy selection (cont´d)



STRATEGY	IMPLICATION
1. Negotiate prepayment or stronger security	While it can be anticipated that eventually the client will repay the loan, chances are that there will be a re-occurrence and that the lender will not be so lucky. A hostile client can seek to block, or at least delay, the execution of the security. This time, the bank will either use the pretext of the one-time default to seek a prepayment of the loan but at the least will want to strengthen its security.
2. Collect with view to dives	The client enterprise is doing well, has a clear positive enterprise value, and should be able to repay its loan. But the atmosphere is unpleasant and should the situation deteriorate, the lender will not enjoy the goodwill of the client enterprise in finding common ground while it will not have enough security to cover the loan. Maybe the client enterprise's owner(s) can be persuaded to buy out the lender or there are parties around who are better able to deal with this situation. While there is no reason to sell out at a loss, the prudent lender will seek an exit.
3. Negotiate prepayment or stronger security. Consider divestment	The client enterprise is *potentially* viable *and* hostile. It will depend on the circumstances whether the lender will give the client enterprise the benefit of the doubt, while still negotiating a prepayment or stronger security. At he same time, the negotiations may become so difficult that the lender is better off selling the loan to a third party that is in a better position to recover the outstanding loan.
4. Collect with a view to divest	While in this scenario the client enterprise is *potentially* viable, suggesting that matters may improve, the hostility means that converting part of the loan into equity – assuming that the borrower is agreed – will make little sense. Future income is uncertain and the security is not sufficient so the lender will want to reduce its exposure no matter what, even at a discount.
5. Divestment but be prepared to accept a discount	The lender will want to liquidate its position for as long as it has some hope of recovery through the sale of assets. Although the security is supposedly worth more than the value of the loan, the client enterprise is hostile and may take action to prevent the lender from exercising its rights. While the lender should clearly hold out for a full recovery, it should for this reason be prepared to incur a small loss. To the extent that the underlying security apparently has value, the lender may take its time and not go for a fire sale.
6. Divestment at discount	This is much the same as in scenario 5, except that little is gained by further delay. A deep discount from the value of the loan is likely in realizing the sale of the underlying security.

Loan Workout Strategy (cont´d)





Equity Investments

Equity investments

- **Lenders to corporate entities may resort to the use of equity warrants, i.e., a derivative security that gives the holder the right to purchase securities (usually equity) from the issuer at a specific price within a certain time frame**

- Considerations regarding debt-to-equity conversions
  - When a **borrower is in principle viable** or even potentially viable, but servicing his debt in full has become difficult or impossible, the lender will **probably opt for a going concern solution**
  - To keep the borrower or the enterprise going will **require adequate working capital** and net cash flow, which may not be compatible with keeping the full loan in place
  - The **lender may opt to receive an "equity kicker**" as compensation for lowering the face amount of the loan to an amount that the borrower/enterprise will be able to service

- Advantages for the borrower
  - Provide the borrower with an **improved free cash flow**
  - With the lender(s) now being among the shareholders, the borrower will eventually enjoy **improved access to additional funding**
  - The lender(s) have an equity stake demonstrates that they **believe in the future of the borrower**, which will give the latter **improved credibility**

- The lender must recognize that it will have limited in-house expertise in the borrower's business and therefore cannot play an active role

Concessions

What can the Bank give?

- Forgive principal and / or interest
- Extend amortization period
- Lower the interest rate
- Lend more money
- Guarantees can be modified
- Release some of the collateral

What can the Borrower give?

- Updated financial information
  - No credit restructuring without it
- Additional collateral
- Additional capital for the business
  - Unlikely
- A new guarantor
- Sell something to reduce the principal
  - Part or all of the business, collateral or non-collateral
- Pledge of cash flows
  - From collection of accounts receivable, from sale of inventory, from another business…

Executing the Workout

Workout Agreement and Action Plan

Workout Agreement

- In writing to avoid conflict
- Have all parties sign
- Replaces existing agreements
- Date
- Reason
- Clarification
- Purpose
- Re-list collateral
- Repayment terms / Payment schedule
- Restrictions on borrower
- Financial requirements
- Cross collateralization
- Maintain collateral
- Contact if financial condition changes
- Any other litigation

Action Plan

- **Monitor Progress**
  - Track payment performance closely
  - Stay on top of financial information
  - Utilize "watch lists" and
  - Quarterly Action Plans
    - In writing
- Patience
- Impatience
- Pro-Active
- Re-Active
- Everyone must be on the same page
- *Don't change direction without notice*
- *Be Truthful*
- *Honor Commitments*
- *Avoid running the borrower's business*
- *What to do when the press calls*

Preparing for the workout

- **Establish the workout team**
- **Assess the problems**
  - Try to identify the underlying causes of the borrower company's problems, especially whether the main problems stem from external or internal factors
- **Analyze the business model**
  - **F**ocus on the dynamics of the industry and sector to understand trends, the company's performance relative to competitors and representative firms; understand how cash is generated, used, managed, and reported

How to Choose a Recovery Strategy

1. I dentify all lawful recovery actions and their pros and cons
2. Estimates the cost and time involved in executing each of the main options
3. Choose primary and secondary recovery strategies based on an assessment of risk, return, and uncertainties; interim strategies may also be necessary
4. If syndication is involved or a coalition among lenders is deemed essential, make sure that other lenders are kept well informed

Steps to Take in Preparing for Negotiations

1. Review all legal documents to identify your institution's rights and remedies
2. Check the status of your institution's security in connection with all loans affected by the workout
3. List all covenants that have been breached as well as any events of default and/or potential events of default that have occurred and are still in effect
4. Determine stakeholders' agendas, needs, and issues in order to identify both potential allies and coalitions with opposing interests
5. Assess principal owner commitment to the company or project and corresponding willingness to help find a solution
6. Determine your institution's leverage and bargaining power
7. Prepare a balance sheet for the liquidation scenario
8. Pay special attention to any terms involving or affecting the release of security
9. Identify all other lending within your institution that could be affected by the loan that is the object of the workout
10. Understand the level of insurance coverage
11. Obtain all necessary internal authorities for conducting the workout

The case for or against a moratorium and standstill agreements

- A moratorium **may be declared unilaterally by the lender or the borrower**, who is then in **default**
- Or the lender and borrower may sign an **agreement to delay or suspend any activities** under the loan agreement. This is referred to as a "**standstill agreement**."

- **Actions characterized as "not forbearance**," which the lenders might agree to undertake collectively **in connection with a standstill** or moratorium, include:
  - **Extend** new loan facilities;
  - Call for **additional security**;
  - Negotiate an **increased pricing** of the loans with the customer

During a *typical standstill*, each participating lender or trade creditor will agree not to:

1. Declare an event of default (EOD), present a notice of demand, or accelerate;
2. Demand additional collateral or credit enhancements;
3. Materially alter the nature of outstanding credit facilities;
4. Charge penalty interest;
5. Pursue ongoing legal action or other enforcement or recovery activities against the borrower.

Mediation

In response to numerous company failures following the systemic financial distress of the **1970s**, the **Bank of England** developed a framework for how to approach individual workouts of corporate borrowers in distress during a systemic crisis

This framework, called “the London Approach,” is a **system of mediation** and incorporates:

- A **preference for out-of-court** debt restructurings
- **Independent due diligence** review
- An **agreed standstill** period or debt moratorium
- The formation of a **lenders’ steering committee** and chair
- The **provision of new money**
- The need for **fair burden sharing** and **pari passu** treatment of creditors

Limitations of the London Approach

- The need for unanimity;
- The lack of an automatic stay;
- The lack of sanctions for failure to cooperate or to implement.

The principle of fair burden sharing

In order to convince a diverse group of lenders to join in a stay and subsequent restructuring, there must be a **clearly shared view of how gains and losses will be treated going forward**, guided by the "principle of fair burden sharing," which provides that:

- **Participants** are to be **treated equally** (within a single class of claimant)
- Participants are **not to seek unilaterally to improve their relative positions** going forward
- Going forward, participants are to **share additional risks and windfalls** on a **pro rata** basis

Practical issues in applying fair burden sharing and loss sharing arrangements

1. **Equalization** – the process of adjusting participant exposures to reflect their relative exposures to that of the day on which the parties agree the workout has started.
2. **Priorities** – in the case of new financing to a company the subject of a workout, the explicit treatment of priorities, particularly where such financing has not been provided by all of the original lenders on a pari passu basis
3. **Ringfencing** – arrangements to partition or treat risk differently where loans or credit have been extended to other companies in a group that are determined to deserve somewhat different treatment than the borrower company that is the subject of the workout
4. **Distributions** – arrangements for proceeds of any asset realizations to be distributed on a pro rata basis to the participants
5. **Indemnities** – arrangements to take care of essential contractors involved in the workout to receive payment from eventual liquidation proceeds on a pro rata basis in the event of shortfalls

Launching the workout

Workout arrangements within the lending institution

In preparing for a workout, the workout leader will need to move quickly to ascertain such issues as:

1. Involvement of institution's legal department
2. Extent of involvement of origination team and account managers
3. Involvement of credit function (department or committee)
4. Involvement of risk management function
5. Involvement of syndications department
6. Internal sign-offs and approvals

Principal Security Matters

1. Essential points to cover in the loan agreements regarding security
2. Monitoring compliance
3. Monitoring rights, remedies, and actions of other creditors
4. Monitoring factors affecting the value of collateral including changes in the nature and condition of pledged assets as well as in the market's direction and liquidity for pledged assets
5. Managing waiver requests
6. Use of cash sweeps and lock-boxes

Protecting security interest throughout the workout

- Be careful in what you say
- Watch what you put in writing
- Be aware that inaction can be as damaging as wrong action
- Gain a reputation for being “firm but forthright” rather than being “too clever”
- Understand the company’s structure and where it stands within a group of related companies
- Understand the company’s business model in terms of a SWOT analysis and update this knowledge periodically
- Know all of your legal documents inside out
- Try to at least meet all the main stakeholders prior to firming up the workout strategy
- Avoid being seen to “take sides” or to make alliances too soon
- Avoid attempts of others to undermine your credibility
- Involve your bank’s legal department regularly, even if you are a lawyer or know the law

Liquidation Balance Sheet

- The item **cash** and banks will likely not have to be re-adjusted

- **Accounts receivable** will most probably have to be adjusted
  - Experience shows that trade debtors tend to delay payment of outstanding invoices as they suspect that the receiver or administrator will take his time in pursuing the claims
  - Also, trade debtors may apply some discount for anticipated counter-claims under warranties and, to the extent that they have to turn to other suppliers in the future, for “trade interruption”

- **Inventories** will have to be adjusted for the prices that they might reach in a liquidation sale
  - Raw materials will be worth more than semi-finished products
  - The value of finished products will depend on whether these are custom-designed or whether there is a ready market for them

- A more difficult category of assets to value is **fixed assets**, particularly in the event of a rapid sale
  - The first question is how the assets may be disposed of, which is largely a legal question that varies by country
    - The holder of the security may drive the process and even take ownership of the assets
    - The receiver may be in charge of asset disposal and subtract funds from any proceeds for preferential creditors
    - Many countries demand that an auction be held for the sale of pledged assets

- An almost impossible category of assets is that of the so-called **intangible assets**

Business plan

Business model	The way the company runs its business, i.e., a broad range of informal and formal descriptions to represent core aspects of the business, including purpose, offerings, strategies, infrastructure, organizational structures, trading practices, and operational processes and policies.
Business plan	Statement of the business goals and a description and quantification of the activities required to achieve these goals.
Marketing plan	Description of the market, statement of goals in the market and measures, both qualitative and quantitative, to be taken to achieve these goals
Strategic plan	Process of defining a company's longer-term strategy or direction and preparing for decisions on the allocation of its resources, including capital and people, to pursue this strategy.
Budget	Periodical summary of targeted sales revenues and expenditures and capital investments to be incurred to achieve these sales.

Financial Projections

***Preparing financial projections* involves the following tasks:**

1. Determine on the basis of the sales and marketing plan how much can be sold
2. Identify the types of resources needed to achieve these sales
3. Quantify the amounts required of each resource
4. Calculate the total cost per unit of each type of resource
5. Summarize the costs to create a budget
6. Identify any risks and issues with the budget and, if possible, run a series of sensitivity tests for the more critical of these risks.

With the projections based on an acceptable and realistic business plan in hand, the lender can easily determine the sustainable cash flow

- Take most likely scenario for future business and related financial projections
- By assuming – at that stage – no debt service, compute excess cash = sustainable cash flows
- Determine appropriate discount factor = risk free rate of interest plus margin for risk taken
- Compute net present value of sustainable cash flows utilizing discount factor

Negotiations

To ***prepare for negotiations***:

1. Know your own loans and security position
2. Know the mindset or mental state of each negotiation counterparty.
3. Have a realistic assessment of counterparties' other personal or psychological attributes.
4. Know the main negotiating points critical to the success of the workout, and how each negotiating point is likely to be perceived by the counterparty.
5. Determine the overall posture best to adopt in conducting the negotiations.
6. Detail the relative merits of your chosen "posture" in terms of flexibility.
7. Separate the counterparties and their representatives from the problems caused by differences in positions.
8. Focus on each counterparty's needs and interests rather than their stated or presumed position.
9. Look for solutions with mutual benefits (win-win strategies).
10. Push for objectivity in judging proposals.

Pricing the workout

After all the analysis, the lender will have to determine the terms on which it is prepared to continue the financial relationship with the borrower

- Even where the one-time default proved to be exceptional, it is still likely that the risk profile of the borrower will have changed and will need to be reflected in new terms
- When more drastic action is required, the risk profile will have changed even more and the lender will need to seek compensation for this

- Determine additional security
- Determine change in risk profile
- Determine shortest possible repayment schedule
- Determine sustainable cash flow
- Determine average level of discount among all lenders
- Determine sustainable debt, i.e., “size of cake”
- Negotiate among lenders who will take what discount based on strength of security only
- Determine compensation for discount

Maintaining fall-back strategies

Fall-back strategies are extremely important because of the potential fluidity of any workout. The following are worth keeping in mind as strategy is being developed

- Be prepared for your best strategy to become abruptly obsolete as new information comes to light

- The importance of comparing options carefully during initial strategy selection
  - While occasionally some solutions will so clearly dominate all others as to not require deep discussion of alternatives, more often the best course of action is not so immediately obvious.

- Playing your cards “close to the chest” regarding fall-back strategies

- Often the greatest strength of legal recourse is the threat of using it
  - Deterrence can be a highly effective control device, deriving strength from the knowledge that a particular course of action available to an adversary carries with it the possibility of adverse consequences.

- Avoid making idle threats

- Avoid making things personal

Money-laundering or other criminal action

- Be aware of International tightening of scrutiny of fraud and other criminal actions
- Prepare list of safeguards when first signs or suspicions of fraud or other criminal activity first arise

When you suspect illegal activity:

1. Notify your institution's legal department as soon as illegal activity is suspected or detected or when notice of litigation proceedings against your institution has been served
2. Make sure senior management is regularly and appropriately apprised of developments
3. Use caution in approaching other stakeholders with suspicions or evidence
4. Document all future dealing with the borrower
5. Minimize one-on-one encounters with those suspected of illegal activity or who have initiated litigation against your institution
6. Involve legal counsel more frequently than under normal circumstances and especially in connection with notifying the relevant authorities
7. Channel all external communications through a designated spokesperson or unit
8. Do not continue with "highest-NPV recovery" strategies if these will materially compromise the institution

Loan Resolution Implementation and Follow-up

Restructuring documentation (cont´d)

- Establish parties to be part of the workout transaction
- Establish what minimum terms acceptable to parties other than the borrower
- Prepare draft term-sheet
- Negotiate draft term-sheet among parties other than borrower and reach tentative agreement
- Submit draft term-sheet to borrower
- Negotiate, agree, and initial term-sheet
- Have lawyers prepare draft legal documents for workout, including new or amendatory loan agreement and security documents, based on initialed term-sheet
- Negotiate, agree, and sign legal documents for workout
- Determine when conditions of effectiveness have been met and workout is complete

Restructuring documentation

The proposal should contain the following elements:

1. Full description of the borrower
2. Amount(s) of the loan(s) to be restructured
3. Restructuring fees and expenses, if any
4. Name(s) of the lender(s)
5. Anticipated date of closing
6. Representations and warranties
7. Repayment schedule(s)
8. Mandatory repayment(s), if any
9. Cash sweep mechanism, if any
10. Interest rate(s) and applicable margin(s) if floating rate
11. Default interest
12. Interest payment dates
13. (Revised) events of default
14. (Additional) security
15. List of documentation
16. Taxes
17. Governing law

Tracking financial obligations and managing cash flow

When cash continues to be managed within the borrower company, make sure of the following:

- Establish **expenditure thresholds** for different levels of review and control
- For expenditures **over a certain threshold**, ensure that **double signatures** are required to authorize payment
- Depending on the nature of the business, either **centralize approvals and handling of expenditures**, or set regular budgetary guidance and spending “envelopes” for unit or department managers with appropriate procedures for enforcing spending/budgeting reconciliation and accountability
- Rationalize approvals and payments system
- Use a third-party consultant or auditor to perform **monthly operational audits** as part of an ongoing monitoring process tailored to the key aspects of the workout and distinct from other audit and financial reporting functions

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For more concepts click on: