Problem Loan Management

Know the Red Flags and Move Quickly

- Find red flags by examining the firm’s financial statements, observing the company’s internal operations, and understanding the borrower’s industry.

BY KEVIN MCLAUGHLIN

Good management of problem loans requires a keen eye for detecting red flags in a borrower’s business and acting quickly to address concerns.

David Aloise, founder and principal of Aloise and Associates, offered some best loan-workout practices in a recent RMA audioconference for community bankers.

Finding and Responding to Red Flags

“Red flags almost always appear before there is a payment default,” Aloise said. “The critical thing is to get into the identification process early. The remedial-action window is finite and, if you wait too long, you lose options and so does the borrower.” (See Figure 1.)

Red flags—indicators that a business might be having problems—can be found by examining the firm’s financial statements, by observing the company’s internal operations, and by understanding the borrower’s industry.

Lenders should look for indicators that have the greatest...
impact on financial performance, such as cash flow, asset values, or collateral coverage, and connect the dots between them to get a full financial picture.

“Step back and identify the important red flags that suggest critical deficiencies that may threaten the company’s viability,” Aloise said. “Without viability, you can’t save the customer, you can’t do the turnaround, and you can’t save the loan.”

An attentive lender must factor in a business’s operational shortcomings and industry-wide struggles. These problems often lead to or can cause financial troubles for the borrower.

The lender also needs to fully understand the borrowing firm’s difficulties and work closely with its management. “In relation to remedial action, it’s important to get on the same page with management to address the issues behind the flags. As community bankers, we don’t want to overreact to our customers’ problems, but we need to be realistic. In our analysis of a firm, we need to stay fact-based and document our interactions with the company’s management,” he said.

**The V and C Framework**

Aloise uses what he calls the “V and C framework” to classify criticized loans. “V” stands for company viability. “C” stands for collateral and asset values. (See Table 1.) He places loans in one of four quadrants based on whether the firm’s viability and collateral/asset values are positive or negative:

- **Negative viability and positive collateral/asset values** generally suggest that an orderly sale or liquidation is likely.
- **Negative viability and negative collateral/asset values** often indicate a distressed sale or a liquidation, foreclosure, or wind-down scenario.
- **Positive viability and negative collateral/asset values** indicate the potential for a turnaround, workout, or restructuring.
- **Positive viability and positive collateral/asset values** suggest a likely false alarm. The firm is fundamentally healthy.

“Young job as the lender is to get at the truth. Sometimes a firm is not viable, but we want to work with the customer and believe what he says. But if the firm has negative viability and we give management too much time to turn it around, negative cash flow eats up the balance sheet, eats up value, and eats up our collateral...
coverage. This leaves the lender exposed to a possible loan loss,” Aloise warned.

The Workout Process
Aloise suggests five steps that lenders should take when confronting a problem loan:
1. Know the facts about the borrower and also the bank’s financial and legal position in relation to the loan.
2. Identify the company’s and the bank’s problems with the loan. Once you know the facts, you need to understand what’s broken. Are you happy with your loan? You need to look at pricing, terms, collateral reporting, and financial reporting. Obviously, loan-to-value (LTV) is critical.
3. Determine possible courses of action. The V and C framework can help you decide if a turnaround is possible or whether the firm should be sold or wound down.
4. Create a proactive, objective-based action plan. A good action plan must address the LTV, reduce your risk, and hopefully stabilize the borrower. It must be specific in terms of time and steps to be taken.
5. Establish a program to monitor the firm.
Aloise identified several general principles that guided him throughout his career. They include the following:
• Make sure the documentation is accurate and complete.
• Communicate clearly and effectively with your customer.
• Evaluate a firm’s management to determine if it needs help or should be replaced.
• Remember that the bank controls the loan, but it doesn’t control the borrower.
• Get value in return for loan waivers or amendments.
• Avoid putting new money into a lender with a troubled loan.
• Work closely with third parties: other lenders, guarantors, or equity holders.

A Successful Turnaround
A successful turnaround usually includes the following elements:
• A firm that is viable. There needs to be a good core business or you can’t do a turnaround.
• Management must be willing and able to change. If it can’t or won’t, new management might be the answer.
• The industry has to be viable and the macroeconomic outlook should be favorable.
• The firm has to be on a sound financial footing. It’s about right-sizing the company to the current economic environment and restoring soundness. Based on the current revenue line, what can the firm do to restore stability?
• The company must restore product and service competitiveness. There needs to be a product or service that customers want.
• The firm needs to restore credibility with customers and creditors.

Tips for Success
Aloise offered the following tips for success based on his 30 years in the industry:
• Stay close to the borrower. Make sure you understand the key issues and what’s going on. Refuse to be ignorant.
• Don’t let personal relationships cloud your judgment. You need to stay objective. You need to stay smart. And you need to communicate in a clear and honest way.
• Minimize bad publicity and be sensitive to lender liability and Community Reinvestment Act issues.
• Maintain attention to detail while keeping the overall action plan in view.
• Be vigilant for red flags that indicate borrower troubles.
• Stay up-to-date on industry-wide issues that affect your borrowers, as well as their internal operational and financial issues.
• Understand the legal issues.
• Make sure your action plan fits the facts and solves your problems and those of the borrower.
• Show a sense of urgency. Time can work against you, so you need to move quickly.
• Focus on better loan and collateral control and be mindful of your risks.
• Always be fair and professional with your customer.

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