Credit Risk Ready Podcast

Host Linda Keith CPA With Michael Wear

The Second 'R' of Triage Outcomes: Restructure When Your Borrower Needs Help to Recover

Hi, this is Linda Keith CPA with Credit Risk Ready, a podcast where we interview senior credit and lending professionals from community financial institutions across the United States, their regulators and banking advisors to better understand and mitigate credit risk.

Now, in the pandemic-induced recession there are borrowers who are just fine, borrowers who need some extra support, and borrowers for whom we need to restructure their loans to help them recover. Today we'll focus on our candidates for restructuring.

Our guide in this journey is Mike Wear, owner of 39 Acres Corporation, specializing in banker training and bank consulting services in credit risk underwriting and loan portfolio risk management. 41 years in banking. Mike retired as a senior analyst in the credit risk administration department of a $23 billion community bank. He developed and conducted credit training programs and he currently consults on customized credit analytics, effective prospecting, and loan portfolio risk management.

Thanks so much for being back with us, Mike.

Michael Wear:
My pleasure to be here, Linda.

Linda Keith:
So in your model of problem loan triage, there are three outcomes: rehab, restructure, or remove. How do we decide restructure is the best option, or even a viable option, to keep the relationship and protect our loan portfolio?

Michael Wear:
Absolutely. We talked initially about the triage and what to ask about. And depending on our diagnosis based on the capital position; liquidity position; details as to their current liabilities; current, both long-

term loans, as well as current from an accounting standpoint, short-term loans; all liabilities. And in the macro-level implications, in what we believe might be coming down the pipe at our borrowers, such as supply chain pressures and demand drivers. Based on our review and analysis of that, the liability side might need some restructuring to help the borrower.

And there's many different needs of borrowers. Typically, when they have cash crunch, they're looking for more short-term alternatives. And sometimes, to get a short-term benefit, you need to look at long-term lending. Not just new loans and long-term tenure, but also the structure of current long-term debt and the payment flow, the cash flow implications of that.

Linda Keith:
So, are you talking about looking at the long-term debt already on the books and saying, you know, we could either restructure this just to give them a little more breathing room? Or are there even people who have used up liquidity to buy long-term assets that those long-term assets really have enough value that we could restructure and actually rebalance from what they had?

Michael Wear:
Absolutely. You know, again, the cash flow statement will tell you if they use short-term money for long-term purposes. But as far as… That's where we do this after we look at the capital position and those assets comprising the equity in the business, and then the holistic look at the liability side of the balance sheet, and match it up. And you might have some opportunities.

I remember in the last recession, I had a borrower that was turned down by their existing bank for lack of cashflow and lack of collateral and they had me look at it. They were referred to me and I looked at it and there were two errors. One, the bank missed depreciation that was in cost of goods sold, so that helped the cashflow situation. Secondly, the bank did not really fully look at or value the assets that were on the books, but were very much depreciated down. They had off balance sheet equity in that equipment, if you did a little research on what the secondary market is for those type of pieces of equipment. $6.5-million-dollar relationship later, they were one of my very best, if not the best, customers.

Linda Keith:
One… Doesn't that sound like a bit of a, actually two, rookie mistakes? One, not discovering all appreciation, but the second, taking a business balance sheet, which is on a historical basis to start with, and then has assets that may have appreciated in value, depreciated on the books, and then thinking that relates to the value of the assets. That feels like that would be a rookie mistake, but maybe we've got too many rookie mistakes going on right now.

Michael Wear:
Right. And then knowing what you have presently, a restructure may also be just to improve your own monitoring. Let me give you an example of that. Let's say we have a revolving line of credit secured by accounts receivable. And in the past, we have been using what's called a forward-looking borrowing base. In other words, once a month, we'll get an account listing and aging and listing report from our borrower and then put it in our plan of collateral valuation and come up with a borrowing base. And we just use that for the next month. In other words, the past will dictate what's available for the future.

With decreasing revenues and decreasing receivables, you may have exposure over and above what that forward-looking borrowing base may support. So, therefore, you may want to do what's called a reverse borrowing base, and that is take the snapshot and then adjust your credit limit accordingly. And who's to say you can't do it more often than monthly? And this is where knowing your borrower comes into play. If they do billings twice a month, why can't you do twice-a-month borrowing base review and adjust your credit limit accordingly?

I had a situation where I had a staffing company that went from $15 million in revenues down below $3 million. And it was a rather fast decline. I went to a weekly borrowing base and actually verified receivables, too, along the way. So that just sometimes restructures our own structure and how we monitor our credits. And again, if you're only getting financials say, once a year, and if you're only relying upon tax returns that are pretty much always extended, you may be looking, you know, not just 12 months, but maybe 18 months in arrears. So that type of backward-looking financial support is just not beneficial for either the borrower relationship or the bank relationship when you have a lot of movement.

That's one example of just using a borrowing base, but we can go into other types of receivable, alternate financing, and also restructuring. And that is such as using factoring.

Linda Keith:
Right. Now do most banks do factoring themselves or do you have to end up outsourcing that?

Michael Wear:
Both. Some banks prefer not to do it and they outsource to vendors. And then others have gained expertise internally. To me, I think it's a very valid alternative to increase your control, to increase your monitoring, and protect the bank's downside risk. Because when things get tough, receivables tend to disappear in the liquidation.

Linda Keith:
Sure. Well, and so what we're looking at here is restructuring because they need it. Then it gives us this window or this opportunity to make changes in how often we monitor, what we get to monitor, so that we reduce our risk while the borrower is actually more flexible right now than they've been in years as to what they're willing to give us or how often they're willing to give us that information.

Michael Wear:
Yeah, bankers tend to get complacent in good times. Just like Esther George said, “Bad loans are made in good times.”

Linda Keith:
Yeah, yeah. And maybe they would have been good loans if we hadn't had, I don’t know, a pandemic recession or, yeah, in the case of ag lending, the trade wars, and the tariffs, and so forth. There's so many externals and, actually, as we interview, we now have record heat on the West Coast. We have fires up and down. In fact, this morning, I had smoke that I had to deal with outside of my house. Not that the fires are anywhere close, but that the weather systems are bringing smoke and bad weather in, and then you've got hurricanes going on.

So, if it weren't for COVID, there's still plenty of other things that can cause deep trouble for some of our borrowers. So, we need to be prepared to do what you and I are talking about, even when we're not in a pandemic-induced recession.

On another episode, I think we talked about how this recession is different. Yeah, it is, and no, it isn't. And by that I mean recessions happen and our whole credit process is designed to protect the bank in downturns. Well, here we are. And so it's time to not only make sure that the bank is set, but also then to pull out the tools we already have and we already know about that allow us to engage with our borrowers and help them through if possible, unwind, or remove.

Michael Wear:

Or to gain market share. Where there's adversity, there's opportunity. And I've used factoring of accounts receivable to launch three staffing companies and also save a construction contractor in a workout situation, because they had basically a spending problem. They like the shiny new iron and equipment and didn't have the revenues to support it. With proper structure and control, you can also help a borrower expand, such as needing more working capital for sustainable and manageable growth.

Linda Keith:

Wow. So restructure… I know that by the time we get to restructure the borrower, themselves, is really nervous because they feel they can't make the payments they agreed to. They're not living up to what they promised and so it's a real negative. But, depending on how the banker approaches it and how they carry it out, not only do we help save that borrower, but we strengthen that relationship and not only for future lending to them. But as you pointed out in another episode, often that borrower is connected to family members who are also borrowers, and others in their chain of influence that could be borrowers.

So, if you can handle a restructure with empathy, with strong solutions, with the kinds of questions that help them make better business decisions, you are solidifying a relationship that can really grow.

Michael Wear:

Absolutely. And a couple more examples, such as asset-based lending. Obviously, when the primary source of repayment, the business, recurring income or retained income, is weak or volatile, you may have to take a new look at your collateral, your secondary source of repayment. And the key here, I believe, is the expertise in determining your net exposure after liquidation costs of that collateral.

And then we have to watch demand trends for those pieces of equipment, let's say, and collateral inspections. And banks can charge fees for these collateral inspections, similar to what we do for car dealer floor plans. How about trucking and equipment dealer floor plans? Can you do the same thing with your non-dealer that has inventory reliance, let's say? Absolutely! Equipment reliance? Yes, we can value that. You can hire people to value equipment. So, this is the time to emphasize your secondary sources of repayment, and a little bit of lessons learned from asset-based lenders in the last big recession is something I carry with me every day. And I remember walking on some collateral for a small three-color press printer. And we looked at the door. We looked at the big presses. And we knew it was moving to digital and these were analog. And we looked at the door again. We said, "Thank you. We are not going to go after this collateral." We walked.

The lesson there was learned when I was about 25 years old and wet behind the ears. And that seasoned lender told me this. He goes, “You know why I walked on that?” And I go, “Well, it's just too hard to dismantle them and get them out the door?” He goes, “Yeah. Easily said, ‘It's the juice that’s not worth the squeeze.’” Sometimes you have to squeeze so hard for just a little bit of juice. Is that the really the best use of the bank's time, capital, and the most effective way to recover?

Some cases, looking hard at that secondary source of repayment, can help determine your restructure alternatives. And another alternative loan type, if that collateral position is not very conducive, is government guarantees: SBA, USDA. I've used them to literally restructure long-term debt when collateral coverage is short after we'd take a hard look at it. We amortize stale short-term debt and sometimes even reloading that line of credit to help the business grow.

I've also used USDA on a takeout basis on a construction loan of some pretty stinky collateral. It was a water and sewage treatment plan. So, they did a 40-year loan on that and that's okay by me. That was just some ways that I can take some risk off the table for my bank. And sometimes landing a new client in tough economic times. You don't have to do a full boat guarantee level. You can reduce the amount of guarantees, such as using SBA Express at 50%. They know where you just need to take the edge off a little bit of risk. That way you can retain the business of the business. If you're helping them in tough times, they're going to be a great marketing tool for you.

Linda Keith:
They're going to love you. So, as I'm listening to some of these really good ideas, I am also thinking some of them are pretty time consuming. Right now, we have to find the time to really look at collateral, to visit with the borrower. And I don't know whether we already are the same busy as before and this is an add-on, or are we able to say we don't need to do everything we did before so we can shift our focus as the lending or credit professional to do more of this loan portfolio review, individual loan review, spending time with your customers, going and looking at the collateral? Where's the time coming from to do this?

Michael Wear:
I know everybody's, you know, time sensitive, but imagine the time spent on a workout loan versus a borrower that is managed through the risks, and is communicating, and you're communicating with them. It is so much better for your personal time management as a lender and in credit risk management personnel to do this now as opposed to waiting. And then again, we talked about doing a disservice for our borrower. So, if we wait too long… So yeah, we're all busy. But what are the alternatives of waiting and not addressing this? Now, I think those outcomes are not the ones we want to have for either party.

Linda Keith:
Well, you know, some of our listeners are at the loan origination level so they've got to find or carve out the time or figure this out. Many of our listeners are at the loan management level. And the message I would think to them is you need to find the time for whoever it is that's going to do this, whether it's the originators, whoever needs to do this, needs management to make the priority and then give the incentive to do it. So that it does get done, because if management doesn't give them the time, then it doesn't get done because it can't get done.

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Michael Wear:
And everybody who's listening to this is welcome to email me. The link is on my LinkedIn profile. And I'd be happy to discuss some of these action plans that I've done in the past and maybe give some more detail that we didn't have time for with this podcast.

Linda Keith:
What an amazing resource. Last idea that just came to me as I'm listening to you is that it's time for the lending professionals to really up their knowledge base about what these alternatives actually are. So they got their toolbox and can grab something out that fits the scenario. And that's a call to arms, if you will, to our originators to say, "You know what you need to take responsibility for your own education in this area." And then also a call to action for our loan managers to come up with a way to communicate to your people, "Here are situations in which these different tools that we already have might be a good fit."

Because our younger folks, and I'm going to say folks in their 20s/30s, they're just getting into this business. They were in middle school for the last recession, for goodness sakes. They don't have those tools at their fingertips. And it is incumbent upon the folks like you and I who are involved in advising and training, as well as the people within their financial institution to say, "You know what? We need to find a digestible way for people that we're asking to do this to actually have the information. The tools in their tool belt."

Michael Wear:
Absolutely. We have this situation of experienced lenders that are retiring at a faster pace. And the next generation may not have had to go through workouts, may not have had to liquidate a borrower, may not have had, literally, problem loans in the last, you know, five-to-10 years. That experience gap, I call it, is one that it's on us as those near-retirees to pass on knowledge and work with the next generation and help them. We'd be doing them a disservice if we don't do that. We're going to do our employer a disservice if we don't do that.

So this is the time in using this launch pad and reason to talk about risk in a portfolio-wide basis, in a risk in the past, rated portfolio basis… is a topic that can bring everybody together and help those people that have not had as much experience in these areas with some lessons learned. Like I try to explain some of my examples. You know, they're sometimes painful lessons, and sometimes just good lessons to just carry with you throughout your career. But we have to keep the next generation up to speed. Just have to.

Linda Keith:
Yeah, well, I would encourage the listeners who are in those first 10 years of your service, of your work, when one of your more experienced folks says, "We could do this" or "We couldn't do that." Make sure you're asking, "Why? How did you decide that? What were you thinking what was the consideration?" You need to sort of suck their knowledge right out of their brain if you can, because you do need to capture it. They will be leaving. And right now is the perfect time. This is the school of hard knocks. This is the time to pull that information from those who have it and add it to your own arsenal.

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Well, Michael, thank you so much for looking at restructure, giving us some real specific examples, and some specific examples, not only of tools that we could use, but the circumstances in which they would be helpful to our borrowers. We do have in the show notes some of the additional information that Michael has provided. As well as his amazing offer: we have links to his LinkedIn profile. I would recommend that you follow Michael and read the things that he is writing elsewhere, because he is a font of knowledge. And he's one of these guys that has this information in his head that you've just got to absorb and be able to use whether you're the one who didn't know it yet, or whether you listen to Michael and go, “Gee, I know that too, but I don't think I've been saying that to my newer lending and credit professionals.”

Michael, thank you again for being with us today.

Michael Wear:
It's been my pleasure. Helping others helps me obtain and succeed at my goals and that is to help as many people as I can.

Linda Keith:
Absolutely.

Thanks for joining us on the Credit Risk Ready Podcast. Subscribe, comment or share on social media to stay connected and spread the word. Join me next time as we bring our bank, our customers, and our communities through the recession safe and sound.

Take care.

Resources

- LinkedIn:
  https://www.linkedin.com/in/michael-wear-crc-853b9828/
- Commercial Lending Alternative Financing PDF:
  https://lindakeithcpa.com/wp-content/uploads/2020/10/Credit-Risk-Ready-Michael-Wear-Alternative-Financing.pdf

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About Michael Wear

Mike Wear is owner of 39 Acres Corporation, specializing in banker training and bank consulting services in credit risk underwriting and loan portfolio risk management. *Less lecture—real business cases—more hands-on practice and more fun!*

Over his 41-year banking career, he previously served in commercial lending and senior credit management positions with Omaha-area community banks. Mike retired as a Senior Analyst in the Credit Risk Administration department of First National Bank of Omaha, a $23-billion community bank, specializing in underwriting larger ($10-100M) commercial real estate loans throughout the country. In addition, he developed curriculum and conducted multi-tier training programs in credit analytics on an enterprise-wide basis.

He is the Loan Portfolio Management Section Leader and serves as a member of the faculty at the Graduate School of Banking at the University of Wisconsin in Madison, as well as GSB's Sales & Marketing School and IT Management School. He is a former adjunct professor for the University of Nebraska-Omaha. He has authored articles for banking publications and has served as a textbook editor/reviewer for the American Bankers Association.

Mike is now expanding his advanced commercial and CRE lending workshops and teaches for several State Banking Associations. Bank consulting offerings include customized credit analytics, effective prospecting, and loan portfolio risk management strategies and tools to identify risk in the Pass-rated portfolio.

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About Linda Keith

Linda Keith, CPA, draws on her 30-plus years of experience consulting with and training lending institutions; background in public accounting; 15-plus years as CFO of the family residential construction company; and experience as an Examiner with the Washington State Auditor's Office and as adjunct faculty in Accounting Principles and Managerial Accounting to help lending and credit professionals say "yes" to good loans.

Of course, you know those are not consecutive years or she'd be over 100 by now!

Linda is known by her clients to be both practical and funny. In fact, there is a movement afoot to change the 'P' in CPA to stand for 'Playful'. The fact is, people absorb ideas and learn better when they are having a little bit of fun. So, Linda brings the fun along with her practical knowledge and depth of understanding to provide credit analysis training and presentations that make a difference.

She is the founder of Lenders Online Training, a virtual classroom approach to improving tax return and financial statement analysis capabilities; the host of the Credit Risk Ready Podcast; and a consultant/trainer on credit risk to banks and credit unions across the country.

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