



Staying Informed

Monitoring Loan Covenants

by Darren D. Lydting *Bankers are advised to know the status of their loan portfolio, today and every day, by initiating and maintaining assessment procedures tailored to their institution's objectives. This "evergreen," which appeared in the December 2000–January 2001 issue, outlines a process undertaken successfully at several banks.*

Commercial lending is populated with such diverse loan types as large corporate, middle market, small business, Small Business Administration, acquisition and development, income-producing and investment real estate, and venture capital—to name a few! As such, and especially when compared with other banking products, commercial lending has always required unique attention. Senior officers convene in loan committee meetings to debate specific transactions, and midsize to large banks not only maintain commercial credit analysis departments but often invest in costly credit-training programs. Policies and procedures abound.

Institutions go to battle to lure commercial loan officers with strong networks. Flexibility and creativity in regard to

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lending parameters and operational procedures are essential for commercial borrowers.

Commercial loan officers cultivate and nurture relationships with potential borrowers well before a loan request comes through the door.

Once the request is in-house, the officer focuses on beating competitors' terms, pressuring the credit analyst for turnaround, and guiding the approval authorities "to see the light." Given the frequency of turnaround time pressure, the credit staff tends to keep all eyes on Joe Loanofficer's latest applicant. Senior management dictates the guidelines to lend within and steers the bank by tweaking its goals and objectives, while continuously marketing the bank among their professional and social networks. The closing department ensures appropriate documentation to best protect the bank in any case of default or fraudulent activity. Financial officers watch the investment and syndication markets to enhance fee income through loan sales. Then, seemingly overnight, the legal and collections department inherits a loan that is 90 days past due.

What Happened?

"What happened? That was such a good deal!" everyone gasps. The key word is "was."

That *was* such a good deal—under those conditions, for that fiscal year, given specific assumptions, and yesterday's state of the economy, technology, and the industry. Get the point? Yes, all parties involved performed their required jobs, but something went wrong. The dynamics changed, and then it was too late. Been there? Probably, because many banks operate under the departmental structure just discussed. Five out of these six departments focus on the front-end of a loan, with only one focusing on the back end.

The key is to prepare the bank by identifying red flags throughout the term of the loan—whether payments are timely or not. How? The answer starts with the commercial loan agreement. Yes, the document that outlines conditions deliberated over for hours (and often days) at all levels of management.

Monitoring Covenants

Why is it necessary to monitor loan covenants throughout the term of the loan? There are several reasons:

- It gives the loan officers and credit staff a current idea of the financial statements on file.
- It facilitates the bank's awareness of the financial conditions and operations of

its borrowers and guarantors on a continual basis.

- It allows for periodic contact with the borrowers to convey the bank's commitment to their banking needs.
- It minimizes bank exposure through monitoring standard and loan-specific covenants by allowing room for those red flags to wave vigorously.

Covenants should be assessed per the specific loan agreement and approval conditions. Ideally, the process monitors financial statement submission, financial covenant and loan restriction adherence, annual review and future compliance assessment, follow-up, and any other situation that requires extra attention. (See Figure 1.) A summary report (of all current assessments) will identify follow-up dates in addition to informing senior officers of noncompliant loans. (See Figure 2.)

A minimum total credit exposure should be determined by senior management to monitor a relationship's loan conditions. Each loan that qualifies for ongoing covenant assessment should have its own monitor, unless all terms and conditions are identical.

When to monitor. An initial loan assessment monitor should be created just prior to closing. The reason is twofold:

1. To verify that the loan's pre-

Figure 1

Loan Agreement Compliance Monitor

Compliant? *No*

Borrower(s):	<u>Dynamic Flooring, Inc.</u>	Account No.:	<u>123-45678-432</u>
Guarantor(s):	<u>C.J. & Carly Alyse</u>	Lender:	<u>Joe Commercial Lender</u>
Loan Type:	<u>Commercial, Revolving, Line of Credit</u>	Compliance FAJ:	<u>4/15/99</u>
Note Date:	<u>3/5/98</u>	Loan Amount:	<u>\$ 250,000</u>
Maturity Date:	<u>3/5/00</u>	Total Credit Exposure:	<u>\$ 363,000</u>
		Annual Review:	<u>4/30/99</u>
		Fiscal Year End:	<u>December 31</u>

Financial Statement Tracking

Statement/Reporting Entity	Statement Quality	Due	Assessments		
			FY97	FY98	FY99
<i>(annually)</i>					
FYE Financial Statement/Borrower	Compiled	within 90 days	12/31/97	12/31/98	
Corporate Tax Return/Borrower	n/a	upon filing	1997	1998	
Personal Financial Statement/Guarantor	Individual-Prepared	every 12 mon.	n/a	1/31/98	2/28/99
Personal Tax Return/Guarantor	n/a	upon filing	1997	Extension*	
<i>(quarterly)</i>					
YTD Financial Statement/Borrower	Company-Prepared	within 30 days	<u>3/31/98</u>	<u>6/30/98</u>	<u>9/30/98</u>
Contracts-in-Progress/Borrower	Company-Prepared	within 30 days	3/31/98	6/30/98	9/30/98
<i>(monthly)</i>					
Accounts Receivable Aging/Borrower	Company-Prepared	within 15 days	<u>12/31/98</u>	<u>1/31/99</u>	<u>2/28/99</u>
Accounts Payable Aging/Borrower	Company-Prepared	within 15 days	12/31/98	1/31/99	2/28/99
Inventory Report/Borrower	Company-Prepared	within 15 days	12/31/98	1/31/99	noncompliant

Financial Covenants

Covenant Type	Requirement	Assessed	6/30/98	9/30/98	12/31/98
Minimum Current Ratio	1.25:1	Quarter-End	1.29:1	1.43:1	1.29:1
Minimum Tangible Net Worth**	\$500M	Quarter-End	\$531M	\$589M	\$570M
Dividend/Distribution Limitation***	\$50M maximum	FYI	n/a	n/a	waived/\$42M

Other Covenants

Covenant Type	Requirement	Assessment
Real Estate Tax Liability	Current	Current
Insurance Coverage	Current	Current
Principal Clean-Up Requirement	30 Consecutive Days	10/17-11/30/98

Signatures

Analyst/Date: Joanne Credit Analyst 3/16/99
 Reviewed by: Tricia Credit Manager
 Lender: Joe Commercial Lender
 Waiver Type: One-Time (2/28/99)
 Waiver Approval: Gregg Senior Lender

Notes

*Copy of extension in file, which expires 9/15/99.

**Additional allowance for personal tax liability for respective year, as an S-Corp.

***Calculated as book net worth plus stockholder debt, less intangibles.

Waiver Comments: Waiver for FY98 dividends.
Total of \$92M was distributed; \$30M for personal taxes & \$62M to the Alyses for down payment on home. 2nd mortgage pledged as additional collateral for waiver consideration.

Figure 2

Loan Agreement Compliance and Annual Review Tracker

Updated: 3/16/99

Borrower	Account Number	Lender	Latest Assessment	Loan Compliant?	Total Credit Exposure	Compliance Follow-Up	Annual Review	Loan Maturity
Dynamic Flooring, Inc.	123-45678-432	Joe	3/16/99	No	\$ 363,000	4/15/99	4/30/99	3/5/00

closing conditions have been, or will be, met.

- To ensure a timely follow-up system for each qualifying loan.

Existing monitors should be updated during the loan renewal process to recognize changes in the loan's terms and conditions. It's important to hard-copy the credit file with the original and revised monitors to document a proper chain of events. Significant changes should be footnoted for future reference and ease of understanding.

Reasons to discontinue monitoring of a specific loan include:

- The loan is paid in full and offers no future ability to draw additional funds.
- The related relationship's total credit exposure drops below the minimum dollar amount required for loan monitoring.
- The loan becomes part of the bank's classified list, presenting minimal chance of collecting current and future financial statements.

The reason for discontinuation of a loan's monitoring should be documented on the final monitor for future reference.

How to monitor. The monitoring requirements and procedures can be a function of the bank's asset size, loan loss reserves, or senior officers' management style. Covenant compliance assessment should become part of the

bank's written loan policy. Figure 1 is an assessment sample for a commercial line of credit. The template can be created within a word processor or spreadsheet program, with all completed forms held in a central directory. The next portion of this article is structured as a guide to complete the Loan Agreement Compliance Monitor, using Figure 1 as the subject loan.

Using the Loan Agreement Compliance Monitor—Section 1

Loan identification—borrowers(s) and guarantor(s). List all borrowers as stated on the loan agreement. Lines should be inserted, as necessary, to provide a comprehensive picture. List all loan guarantees, including such government agency guarantees as the SBA. Guaranty percentages or limitations should be stated.

Loan type. Categorize the loan according to its documents. Types include any combination of the following: commercial, consumer, personal, (non)revolving, term/time loan, 7(a), 504, line of credit, letter of credit, mortgage, guidance facility, bridge facility, and loan document assignment.

Note date. State the loan's closing date.

Maturity date. State the loan's maturity, per the promissory note. The previous two dates will assist in setting the beginning and ending assessment dates.

Loan amount. State the current balance on the loan. If the facility is revolving, state the maximum availability per the note.

Total credit exposure. State the aggregate outstanding for the borrower and its related entities.

Account No. State the bank's internal account number for ease of identification.

Lender. Identify the relationship's responsible loan officer, to whom correspondence, questions, or concerns should be directed.

Compliance F/U. Each monitor must state the next compliance assessment date. This date will be when the next financial statements are due or financial covenants must be assessed. The follow-up date should not surpass maturity or the scheduled annual review date (if any).

Annual review. Set the date by which the entire relationship should be reviewed. Typically, relationships are reviewed annually and coincide with loan renewal dates (ideally to minimize the number of times a given relationship is analyzed during a 12-month period). If there are no annually maturing/renewing loans, the annual review date should coincide with completion of FYE financials (with a 30-day window for collection and credit review).

At a time when problem loans are on the rise, can a bank afford not to have a formal process in place to track covenants and borrower compliance?

Fiscal YE. Identify the month and day of the borrower's fiscal year-end, to help categorize financial statements upon submission.

Using the Loan Agreement Compliance Monitor—Section 2

This section, Financial Statement Tracking, is divided into time periods, which are dictated by the loan's reporting requirements (annually, semiannually, quarterly, or monthly, as appropriate). Each section lists the statements required, the reporting entity, quality of the statement, and the allowable grace period for submission. When tracking tax returns, the quality is not applicable. Tax returns on extension should be noted and the expiration date considered when setting the compliance follow-up date. When tracking personal financial statements the as-of date is important, since individuals typically do not complete PFSs on a rigid schedule. Most loan agreements require the submission of an individual's personal statement annually.

Upon receipt of required statements, insert the statement date in the grid, as shown in Figure 1. Financial statements are identified as "noncompliant" once the grace period has passed. Historical financial statements for

new entities should be identified in the grid as "start-up," "new entity," or "n/a." Refrain from using "not required," as this phrase can be misleading to others.

Using the Loan Agreement Compliance Monitor—Section 3

Identify each financial covenant emphasized in the loan agreement, and reference minimum/maximum requirements and assessment periods. These covenants are a reflection of the borrower's balance sheet and income statement. It is helpful to insert actual financial results in the grid, to provide a ruler for calculation. Any noncompliant covenants should yield a "violation," in addition to its numeric result.

Using the Loan Agreement Compliance Monitor—Section 4

Identify other covenants that the bank considers significant enough to monitor. These covenants are generally nonfinancial in nature and relate directly to the subject transaction. Assessment dates are not vital, since the covenants must be compliant at all times. Given the depth of today's loan agreements, a bank's senior management may want to predetermine which covenant categories are critical to monitor. Those not monitored closely are commonly referred to

as "boilerplate language." Other covenants commonly monitored are as follows: principal balance clean-up requirements, insurance coverage maintenance, current status for real estate tax liabilities, and assignment of collateral accounts or leases.

Using the Loan Agreement Compliance Monitor—Section 5

In the Signatures section, analyst, reviewer, and lender are self-explanatory. Often the lender is not required to sign, but keep in mind that it is one method to ensure that he or she is kept informed of the loan's status.

Waiver type. There are two types of waivers. A "one-time" waiver allows a specific covenant's noncompliance for a specified date; a "permanent" waiver terminates a specific covenant's assessment for the remaining loan term.

Waiver approval. This is the signature of the authorized officer, waiving the itemized violations. Authority is typically reserved for members of the loan committee.

Waiver comments. Full identification of the intended waiver should be disclosed, along with the reasoning for its approval.

Compliant? Yes or No

At the top right of Figure 1 is

the space to note borrower compliance. In reality, a loan is not in compliance if any loan agreement conditions are not met. If this were applied in the monitoring process, the result is dysfunctional. The lender should create a matrix for assessing a loan's compliance status. Certain situations can negate noncompliance. For instance, receiving a semiannual financial statement can negate the concern over not receiving the first-quarter results. Since the statements are year-to-date and the bank now has current information, the borrower's financial condition can be assessed. A "no" should be a red flag to management, even if the loan is current. An effective matrix will consider the types of covenant violations (and their potential consequences), payment history, collateral position, and guarantor capacity.

Tracking Active Compliance

Figure 2 is a sample report for summarizing the compliance status and follow-up dates for active loans. The report's columns should be customized to the bank's objectives. Periodically, the report should be distributed to senior management for review (monthly, or possibly quarterly).

Most Essential & Often Neglected

Loan covenants and their monitoring are considered Lending 101; everyone knows about it. The problem is, however, that not everyone does it properly. And at a time when problem loans are on the rise, can a bank afford not to have a formal process in place to track covenants and borrower compliance?

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2007 Author Update

Since the New Year's Eve countdown that led us into 2007, there have been many question marks surrounding the U.S. economy and the path it will take throughout 2008 and 2009. Headline news is dominated by fluctuations in security markets, "corrections" to real estate values, rising debt levels and lower saving rates, struggling industries, and increased costs of basic necessities such as utilities, gas, health care, and insurance. All of these issues directly affect our borrowers and potentially our bank portfolios. Staying informed is key to proper portfolio management.

Keep in mind that other than the two quarters following the attacks of 9/11, the U.S. economy has not seen a significant downturn since the early 1990s. Economic prosperity has often carried borrowers through "blips in the road," which today could be more like roadblocks.

Loan covenants inform the bank of potential concerns in a timely manner. Set covenants by recognizing the strengths of each transaction and identifying the most appropriate (and least cumbersome) way to assess their continued strength. For example, if debt service coverage is five times, a debt-service-coverage ratio minimum requirement in the range of two times would provide an early warning that something has changed significantly.

It is important to proceed with caution when modifying or waiving covenants. Ask the following questions:

- Is the existing covenant requirement still appropriate?
- Is a one-time or permanent waiver warranted?
- Does the modification or waiver make good underwriting sense?
- If a covenant cannot be met today, can a target date be set?

Ultimately, the file should contain well-documented explanations and justifications, and the borrower should understand the reasoning behind our decisions.

Final note: Licensed software products are now readily available to automate this process. Many of the products interface with other software widely used to spread financial statements, pull credit bureau reports, and standardize underwriting processes.

—Darren Lydting

