Strategies for Dealing with Nonperforming Loans in Times of Economic Uncertainty

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Stay-at-home orders and social distancing measures aimed at slowing the spread of COVID-19 have caused severe economic hardships for many businesses, threatening their ability to meet their loan obligations.

In the early stages of the pandemic, the four federal agencies that supervise banks and credit unions (Federal Reserve, FDIC, OCC, and NCUA) with the state bank and credit union regulators (the “agencies”) issued an interagency statement on March 22 to address the disruption that was anticipated to be caused by the pandemic.

In the statement, the agencies encouraged banks to work with it borrowers to provide loan payment deferrals and other flexibility, describing the situation where a short-term loan modification granted to a borrower that was current in response to financial problems a borrower has due to COVID-19 would not be considered a troubled debt restructuring (TDR).

The key words being short-term, meaning the modification would be for a period of less than six months, and current, meaning the borrower was not 30 days or more past due prior to the modification. This gave banks and credit unions some assurance that they had some flexibility to work with performing borrowers who through no fault of their own, found themselves struggling due to the fallout from the pandemic.

While we all learned a new acronym, WFH (Work from Home, you could make another one, but decorum prevails), we hoped the curve would flatten, and the economy would reopen sooner rather than later.

Unfortunately, the Coronavirus is not cooperating. We are now four months past the agencies' March statement. Some borrowers who thought they needed three months for their deferment have come back for another deferment. Some areas of the country and many industries are not doing as well as we hoped. And while we wait for more sectors of the economy to reopen and people get back to work, examiners will come calling.

During this time, banks and credit unions should prepare by referring to the agencies' examiner guidance issued in June.

In this article, we will focus on one of the six areas covered in an institution's CAMELS rating, asset quality, and specifically a financial institution's loan portfolio

The Examiner Guidance makes it clear that the examiners are expected to continue to assess credits in line with the interagency credit classification standards, though they are to recognize the constraints posed by the pandemic. The Examiner Guidance lists 10 different areas the examiners are expected to review and with this in mind, below are some tips for dealing with nonperforming loans in light of the current economic uncertainty.

- Banks should be contacting their borrowers, talking to them about what financial recovery will look like for them. Use this time as an opportunity to find out what unique challenges a business is facing, how they are revising financial forecasts, and what steps they are taking to pivot in response to the pandemic.

- Consider whether the challenges a borrower is facing are unique to that business or are consistent with the difficulties that other members of the relevant industry are experiencing. Consider how other similar businesses are managing through the pandemic.

- Transparency and frequent communication with your borrowers are crucial. Make sure that borrowers know that if they're going to have trouble making loan payments, or are likely to be out of compliance with financial covenants in their loan documents, it is best to let the bank know as soon as possible, preferably ahead of time.

- Encourage borrowers to be realistic about the financial difficulties they expect to face in the coming weeks and months. The bank may be able to work with a borrower to modify the terms of its loan to prevent your loan from going into default. This may include modifying payment terms or temporarily relaxing financial covenants.

- If the borrower waits until the loan is in default, the bank's options for working with the borrower may be limited due to regulatory constraints.

- Most importantly, be proactive and check in with borrowers frequently, including visiting their place of business (as local COVID-19 restrictions allow); borrowers should not be allowed to ignore the situation or fail to respond to emails or phone calls from the bank. As we all know from experience that will only make the situation worse. Lack of communication, and failure to provide requested financial information in response to changed circumstances are often the primary reasons that banks initiate enforcement action on troubled loans.

- Re-familiarize yourself with your loan documents. The loan documents will typically include a loan agreement and one or more promissory notes. They may also include a security agreement, one or more real estate mortgages, deposit account control agreements, and other documents whereby the borrower has granted the bank a lien on certain assets as collateral for the loan. Make sure you understand the loan terms, including the maturity date, whether the borrower has additional borrowing capacity on lines of credit, whether the borrower has options in terms of selecting an interest rate, and what circumstances may trigger an event of default on the loan. Also, review what assets are pledged as collateral, which may include real estate and other fixed assets, accounts receivable, deposit accounts at other banks, or all of the above.

  - Run updated UCC searches to confirm that financing statements have been properly filed to the extent necessary to perfect the bank's security interest in collateral. If applicable, it is also advisable to run updated title searches on all real estate collateral to check for any mechanic's liens, tax liens, or other liens that may take priority over the bank's lien on the real estate.

  - Review any loan guaranties and understand how they tie into the overall loan structure. Owners of the business or affiliated companies may have given guaranties. Determine whether the guaranty is limited to a certain dollar amount, or whether liability under the guaranty may be triggered by certain events — for example, if the borrower breaches certain covenants in the loan documents.

- Review the conditions under which a borrower may obtain additional funds on existing lines of credit. For example, most loan documents prohibit additional borrowing if a borrower is in default or if any of the representations and warranties in the loan documents is no longer true. Often, a condition to funding is that no material adverse change shall have occurred in the borrower's business or is reasonably likely to occur.

- Review the circumstances that may trigger a default. In addition to failure to make a loan payment when due, events of default commonly include: a change in control, failure to maintain certain financial ratios, failure to continue operating the business in the ordinary course and failure to pay on other unrelated loans. Also, look at what cure rights are afforded in the loan documents. Often, loan documents contain grace periods for certain types of defaults.

- Review the bank's remedies in the event of a default. For example, does the bank have the right to appoint a receiver to take control of the borrower's business or assets?

- Understanding the bank's collateral position and its available remedies in case of a default is crucial to developing an effective loan workout strategy if the loan does go into default.

Optics matter. Undoubtedly, banks will be more willing to work with borrowers who are proactive, thoughtful and make prudent decisions in light of changes in circumstances.

Borrowers who are seen as sloppy (e.g. who let their qualification to do business lapse, change their business structure without informing the lender, or keep poor records), or are viewed as reactive rather than proactive, are likely to be more challenging to work with during this extended period of economic uncertainty.

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