Looking Back to Look Forward

••Workout units can provide a wealth of information for those who analyze credit quality and the effectiveness of credit risk management.

BY DAVID D. GIBBONS

IF YOU WANT to determine the quality of what goes into the credit pipeline, an effective (and mostly underappreciated) method is to closely examine what comes out of it.

Too often, banks fail to make the most of their problem-asset and workout units, taking the narrow view that credit workout is merely a way to minimize losses on loans already extended. If a bank's workout unit does little other than collect, repair, or charge off broken credits, its limited mandate will restrict its usefulness.

With appropriate direction, however, problem-asset and workout units can serve as an excellent early-warning system for credit officers and risk managers. And with some relatively basic reporting, these back-end functions can offer valuable insights into problems looming on the front end.

The key is to break down and categorize loan inflows to the workout units, determine the conditions that drove them there, and analyze whether those conditions represent one-time events or potentially larger issues. Inflows can be categorized by lending unit, borrower industry, geographic area, loan type, loan purpose, or some other grouping. Once these inflows are arranged in the appropriate taxonomy, the analysis can begin.

Look for Flow Patterns

Risk managers should look for discrete flow patterns among the groups of loans, both in absolute numbers and in dollars, and determine whether any meaningful patterns are emerging that require further inquiry. This simple analysis commonly reveals a unit, loan type, or geographic area that

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is causing a disproportionate amount of problems, leading risk managers to think more carefully about expectations for the geographic area or industry and whether lending policies should be adjusted accordingly.

Often, however, the data must be tracked and analyzed a bit more finely. For example, a particular cut of the data might reveal a high level of workout inflows from loans in a particular region or city. The initial presumption might be that loans in this geographic area need to be underwritten more carefully, re-priced to reflect their risk, or avoided altogether. But a deeper analysis might turn up a particular office within the area, or even a particular lending team or person, responsible for the problems.

Check for Problems in the Credit File

The condition in which the credits arrive in workout is another important forward-looking tool. Are the problems with the credit documented honestly and in a timely fashion? Was the risk rating accurate, and does the collectibility analysis reflect impairment and reserve requirements? Does the credit file itself reflect proper administration? A well-maintained file includes current financial information and analysis, recent reviews and approvals, and evidence that the customer was properly notified of any breaches to the lending agreement or covenants.

The documentation should be sufficient to allow a third party to easily assume administration and relationship responsibilities. Similarly, the contents of the collateral file should support the bank's position. Shoddy files frequently indicate poor credit administration, which in and of itself can portend trouble.

Poll the Workout Units

Polling the workout units is another good way to gather information. The asset managers have the best sense of the credits when they come in the door and whether they have been handled properly and identified soon enough to maximize the odds of collection. As a general rule, loans should be given a "substandard" classification and receive attention from the workout group—and possibly be placed under its direct control—at least six to nine months prior to default or nonperforming status.

It may be during the workout stage that the shortcomings of the initial risk selection and underwriting limit become most obvious, and certainly it is at this stage when documentation shortcomings come home to roost. Too often, workout personnel are hamstrung by problems as fundamental as locating and verifying the bank's legal standing in the form of perfected lending, collateral, and guarantor documents.

Conduct a Postmortem

The workout function also provides value when performing the look-back or lessons-learned analysis on credits that caused large and unexpected losses. These postmortems can be done early in the workout process. Samples of loans that have recently defaulted (that is, those that have not yet caused loss recognition) can be analyzed to determine when signs of risk were first in evidence, whether actions taken prior to default were appropriate, and whether protective measures (consulting with workout specialists, reviewing legal positions and documentation, and negotiating enhanced collateral or guarantee protections) were employed.

The results of these analyses provide significant insight into risk selection, underwriting, and credit risk management, and they should be used regularly to measure and inform performance and training for lending officers.

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Conclusion

Using the workout function as a forward-looking tool for portfolio risk management is much like using a car's rearview mirror to ensure safe forward progress. Properly mandated—and armed with supporting information systems, analyses, and a formal feedback loop—workout areas can and should provide a wealth of information for those who analyze credit quality and the effectiveness of credit risk management.

After all, workout areas are entrusted with protecting the bank's interests by resolving problems and maximizing collections. Problem-loan and workout specialists are some of the best credit minds in the bank, and their expertise should be leveraged. ❖

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