How banks oversee their lending book and the implications for borrowers

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Introduction >>

Banks combine regular *monitoring* activities with a programme of internal *reviews* in order to oversee their lending books. In this article, we look at how banks do this, and consider the implications for borrowers.

It is important to appreciate that lending money to a business is not a one-off decision and that banks keep borrowers under constant scrutiny. This is the case for all types of borrowing - even term loans - but is especially true of working capital facilities, such as overdrafts.

How banks monitor borrowers >>

Think of this in terms of a bank's early warning systems. Banks have many different ways of monitoring borrowers, in order to check that they are complying with the terms of their finance agreements, and to help identify potential problems at an early stage, thereby avoiding losses.

If they identify any potential problems they might decide to carry out a more in-depth review, which might then lead them to renegotiate their arrangements with the borrower concerned. We look at how and when banks carry out these reviews in the next section.

As far as the monitoring of borrowers is concerned, the first thing to be aware of is that banks have numerous ways of doing this – for example:

- Their computers constantly analyse the trends on customers' bank accounts. This account activity data is one of the most valuable sources of information for a bank because it can give them advance warning of trading difficulties, or of cash flow problems. Their computers can report the following data over various time periods:

    - Best and worst account balances
    - Average balances
    - The monthly swing (the difference between the best and worst balance each month)
    - Diminishing swing (a deteriorating trend between the best and worst balance each month)
    - The total value of debits and credits passing through the account
    - The percentage utilisation of overdraft facilities (how many days the borrower is in overdraft for every month, and how much of the available facility they use)
    - The number and amount of any excesses above agreed overdraft limits

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- In addition, Lending Managers and their support staff will analyse the financial information that they receive from borrowers (profit & loss accounts, balance sheets, cash flows); again, they look at trends over time and will question anything that looks unusual.

- Similarly, the bank will receive and analyse a copy of each borrower's year-end accounts, which it will use to assess the overall quality of that borrower. They also use the accounts to monitor the borrower's compliance against any agreed lending covenants, such as asset cover, or profit and cash cover.

- Meetings are another vital way of monitoring borrowers. Most borrowers will have an annual meeting with their Manager, especially those businesses with working capital facilities: some will have additional meetings, typically those with complex needs, or those experiencing trading difficulties. Meetings are an opportunity for a bank to gauge the competence and capabilities of the people who are running the business and to assess their plans for the future. It is also an opportunity to visit the customer's trading premises to get a feel for how well things seem to be going.

- Centrally, banks monitor economic news and trends, as well as individual sectors of the economy, from which they will set their credit policies for lending to businesses operating in those sectors.

As previously mentioned, if their monitoring activity reveals any concerns about a borrower, then a bank will carry out a review of its arrangements with that borrower, and if necessary will renegotiate them.

We look at how and when banks carry out reviews in the next section.

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How and when banks review their existing lending >>

As we said at the start of this article, lending money is not a one-off decision and a bank will from time to time carry out a review of each existing lending. Depending on the outcome of its review, the bank may continue with the borrower's existing arrangements, or may decide to renegotiate them. However, if the bank thinks the situation is serious enough, it may request full repayment or even instigate recovery action.

A review typically involves the Lending Manager preparing an internal credit paper and, in conjunction with a Credit Manager acting in a supervisory capacity, re-evaluating the terms on which the bank will continue lending to the borrower. They will examine the borrower's current trading position, check it is complying with the agreed lending terms, review the security the bank holds, revisit the pricing and its own return on lending, and then consider the overall position. If they think it is necessary, the Lending Manager will then renegotiate with the borrower.

Reviews happen at different times and for different reasons. They can be pre planned, carried out on an 'ad-hoc' basis, or prompted by unexpected events. You may be surprised to know how frequently reviews can happen.

1. Pre-planned reviews

These are reviews carried out at predetermined intervals. For example:

- The most common pre-planned event is the borrower's annual review meeting with their Lending Manager. Those with working capital facilities will always have an annual review. Borrowers need to be careful because this is an opportunity for the bank to reassess their creditworthiness and its own return on lending, so it may therefore decide to renegotiate the price it charges, or the level of security it holds – or both.

- Banks will also carry out a review at predetermined points in the life of a facility, (for example term loans, which often have a review date after 3 or 5 years).

- When there is a change of Lending Manager, the incoming Manager may carry out a review of some borrowers and decide to recommend changes to some of their existing lending terms.

- Whenever a bank changes its lending policy to a particular sector, it will usually carry out a review of borrowers in that sector, where the impact on existing borrowers can be quite severe (lending to the property sector has been the most common example in recent years).

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2. 'Ad-hoc' reviews

These are reviews carried out following random selection.

- The way it generally works is that banks' Credit departments will randomly select a number of accounts to review, for which they will request an interim credit report from the relevant Lending Managers.

- Banks also have internal Audit Teams, who carry out unannounced visits to branch offices, during which one of their tasks will be to undertake a lending review of some of the branch customers.

- Banks will also carry out various sampling exercises. This is where personnel based in a remote location undertake a high-level review of a number of customer files selected by the bank's computers. If they find anything that they think requires further investigation, they will ask the Lending Manager to submit a more detailed interim credit report.

3. Reviews prompted by unexpected events

This is where a bank will carry out a review in response to something unexpected happening. It is when banks are most likely to overreact to situations, and when borrowers can quickly find themselves in a tight spot.

Running a business is rarely plain sailing, so the chances of borrowers suddenly finding themselves under even closer scrutiny are relatively high. Here is a list of the most common reasons why this happens:

- When borrowers send their financial information to the bank – such as their annual accounts, or management accounts – and the bank in its opinion concludes that the borrower's financial position has deteriorated

- If a borrower exceeds agreed funding limits without authority, or misses a loan repayment

- If the borrower breaches any borrowing covenants

- When a borrower unexpectedly requests an increase in facilities due to trading issues (for example; bad debts, or the loss of a large contract)

- If the value of the bank's security falls (for example; following a property revaluation, or maybe a reduction in the net worth of a guarantor)

- If the bank receives notice of County Court Judgements or insolvency proceedings (including any involving partners, company directors, or guarantors)

- If other things go awry, or a borrower's circumstances change (e.g. a change in key personnel, including the death or incapacity of key individuals)

- Where there are similar problems to those outlined above, but involving associated or connected businesses (such as holding companies and their subsidiaries)

- Sometimes a bank will review its lending to some borrowers if it has encountered problems with similar businesses, or with businesses operating in the same sector

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What are the potential implications for borrowers? >>

This depends on the scale of the problem identified by the bank, or on the nature of the transgression committed by the borrower. As you would expect, serious problems are more likely to prompt a bank to take swift action to protect its position, whilst repeat offenders are likely to face an escalating series of sanctions.

One important point to mention at this stage is that banks work on something called 'risk-adjusted pricing', which in very simple terms means their profit on lending is a combination of how much income they receive in interest rates and fees etc., and how much money they might lose in future if a borrower was to default.

A bank can therefore improve its return on lending by increasing its income; and/or it can reduce its lending risk – for example by taking more security, or cutting back the amount lent. Banks are businesses just like any other, so they will always keep a close eye on their returns, especially when things appear to be going wrong. To many borrowers this approach appears counterintuitive: "The bank took my umbrella away when it started raining!" is a common complaint.

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The consequences for a borrower could range from the relatively benign, to the extremely serious, as the following examples demonstrate:

- Increased costs in the form of interest rates and fees and other charges
- Replacing the borrower's facility with a different type that carries less risk for the bank – a common example would be moving them from overdraft onto Invoice Finance, which is generally more costly for the borrower, but much more profitable for a bank, with a much lower risk of loss
- The introduction of stricter lending covenants (such as loan to value ratios, and profit, asset or cash covenants), which tend to limit the amount of finance available to borrowers, or restrict how they can use it, thereby giving banks a greater level of control
- Calls for more security – such as charges over additional assets, or personal guarantees
- A restriction on future borrowing, which could hamper growth or make it harder for the business to ride out any downturn in trading
- A borrower could find themselves moved into the bank's 'intensive care' department where it will generally come under more intense scrutiny as the bank seeks to reduce its risk on lending as much as possible
- The bank may want to appoint an independent firm of accountants to undertake a business review, which can be very disruptive and expensive
- Borrowers may face requests for partial repayment, or even demands for immediate repayment in full
- In the worse cases, insolvency proceedings or legal action could ensue

You may already have experienced similar situations before and know just how problematic they can be for a business.

Of course, the issue for borrowers is that they are to some extent a sitting target because it can be disruptive for them to have to move to a new lender (assuming they are in a strong enough position for another lender to take them on). Directors who personally guarantee their company's borrowings are particularly exposed if things start going awry.

Business lending is also very technical and lending decisions are carried out behind closed doors, which means it is almost impossible for borrowers to know whether the bank has done its job properly. They will not be able to spot if the bank has misunderstood something and therefore made a mistake.

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What can increase the likelihood of things going wrong? >>

Unfortunately, many things can – some of which stem from the way in which banks make their lending decisions, where human nature, time pressures, inexperience and the need for Lending Managers to meet targets all have a part to play.

To understand more about how lending decisions are made and the common problems that occur, read the separate article on the Business Finance page entitled 'How and why lending decisions go wrong, and what to do about it.'

As far as borrowers are concerned, a lack of understanding, complacency, and poor communication are the main causes of things going wrong. Here are some examples:

- Making important decisions without having the right information about their business on which to base them – such as accepting new contracts without considering whether they will have sufficient working capital
- Not understanding the key metrics of their business, such as the gross profit margin, the sales breakeven figure, or its sensitivity to changes in interest rates
- Being disorganised and failing to supply financial information to the bank on time
- Using their borrowing facilities for the wrong reasons – such as using an overdraft facility to purchase fixed assets, where to do so will absorb vital working capital
- Not being sufficiently aware of the agreed lending terms (such as covenants and conditions) or of the 'small print' in loan agreements (such as events of default)
- Poor credit control so that cash reserves become stretched
- Insufficient or ineffective internal systems for their business – especially financial systems
- Poor control over other important tasks, such as reconciling their bank account on a regular basis so that they are aware of their cash position
- Not keeping the bank sufficiently informed about important matters relating to their business

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How Independent Banking Consultants can help >>

If uninterrupted access to finance is important for your business then call us for a confidential chat about how we might help you.

Everyone at IBC has many years experience of commercial banking – as Lending Managers and Credit Managers. We are experts in our field with valuable 'inside knowledge' of banks' monitoring systems, and of the lending review process.

We can therefore help you to avoid unnecessary problems, guide you safely through bank review meetings, and strengthen your ability to negotiate with the bank when difficulties arise.

It is easier for us to keep a watchful eye on things for you, and safer than leaving it to chance. We can work comfortably with your Lending Manager, save you both time, and help you to avoid misunderstandings that can lead to unnecessary problems and conflict. Dealing with the bank will be much easier and less stressful for you.

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