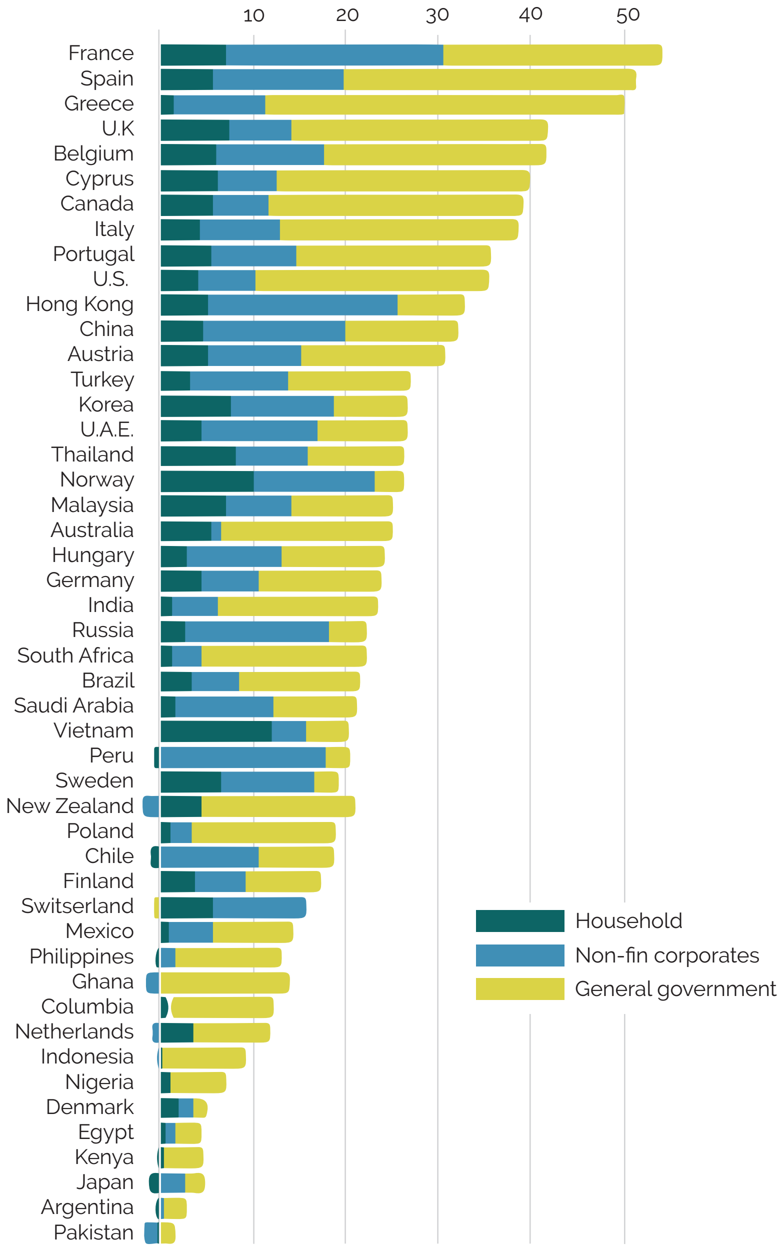
HEAVY WEATHER BANKING

“Banks expect a major financial setback due to the corona pandemic.” News headlines in the summer of 2020 said that the top three US banks had set aside some $28bn as loan loss provisions during the first half year of 2020. And although much less than their American counterparts, the main Dutch banks also saw material increases in their buffers for credit losses in the first three quarters.

It is clear that the COVID-19 crisis created heavy weather for everyone - individuals, businesses and governments alike – and on a global scale, also for the banking industry. At the time of finalising this book, it’s the second half of 2021, and the earlier expected avalanche of bankruptcies has not taken place, not yet at least, mainly thanks to the safety nets created by governments. The safety nets have increased government debt in many places, which debts may still be sustainable thanks to current mild interest rates.

The chart below shows the estimated increases in debt-to-GDP ratios, in percentage points, over 2020. Source IIF, BIS, IMF

After the economic benign interlude since the last financial economic crisis, the banks have been re-strengthening their Restructuring and Recovery teams, in anticipation of an avalanche of work with their most troubled credit relationships – both individuals and business clients. As said, early last summer, all economic analysts and other experts predicted a global economic crisis of unknown magnitude. However, so far, the



Source: IIF, BIS, IMF.

Image 01 - This chart shows the estimated increase in debt-to-GDP ratios, in percentage points, over 2020.

expected avalanche did not materialise. There was hardly any increase in the number of distressed corporates, resulting in a limited workload for the banks' restructuring officers, and in material releases of provisions for credit losses that were taken last year.

It makes one wonder: is economy a science? The 2008-2009 financial-economic crisis was not foreseen, and the last year widely predicted economic doom period has not materialised – so far. Pushed by banking supervisors and regulators, many bank officers are working hard to make new models, that are more predictive and can better calculate future credit losses than the old ones. Will they succeed?

One thing is certain: there will always be individuals, businesses, banks and even governments that run into financial problems. And many of them will opt for a (financial) restructuring, with the ultimate goal to reach a turn around to a healthy financial situation.

This book explains the "do's and don'ts" in international restructuring and recovery, based on lessons learned in earlier crisis situations. This book is meant to give some guidance to banks and bankers that are going through heavy weather. And to anyone else who is interested.

You only learn in bad times, not in good times.

Good Times - Bad Times: a big difference. In good times all banks are profitable and every credit relationship manager is a good banker. Your client, the company, makes enough money to pay all repayments, some fees and a decent interest margin on its loans. Apart from the mandatory annual review, the credit file stays in the closet. The client performs on its debt, and the bank will never notice that mistakes may have been made in the credit analysis at origination, in identifying and establishing the optimal collateral package, in the documentation and in subsequent monitoring after closing.

The client pays, so there is no need to actively check or correct anything. The credit file can remain in the closet, and nobody is harmed.
Bad times are different. When your client stops making enough money to meet all its obligations, the situation changes. Suddenly it will start to matter what position you're in, compared with the other creditors, whether you have collateral or other priority rights over other creditors. And the big question will be whether the company can turn around and survive, whether you as bank can or should support the company to survive, and whether you can still correct the earlier mistakes that your bank may have made. Only in bad times you will have to ask yourself whether your bank is still "in-the-money" or "out-of-the-money".
And my first intention with this book is to support you in making the right choices and doing the right things in any financial restructuring or loan workout.

Relationship, Return and Reputation are the key pillars for sustainable banking.

My second goal is to encourage relationship bankers to keep the interest of their client at heart, and not only because (in the Netherlands, at least) you have signed up to the Bankers' Oath. Question to answer first: who is your client? You have to realise that every corporate in distress will have many stakeholders, including their management, owners, employees, customers, suppliers and a variety of other creditors. And many of these stakeholders are clients of your bank as well. However, when dealing with a corporate client in crisis, we have to realise that the company is the client. The company and its future are at stake. And in that perspective, other stakeholders are not "the" client. Realise that e.g. management or even owners can be replaced. How to diligently deal with, and (financially) restructure a corporate in distress to help it turn around, is the subject of the second part of this book.

The “Lessons (re)Learned” department is often ignored in good times.

The third important goal is to once more record the many expensive lessons learned in corporate lending. The “Lessons Learned” department in any bank is one that is mostly closed in good times, and only occasionally reopens during bad times. Then, after the next crisis has been survived, the “Lessons Relearned” dept closes again, only to be reopened again as the “Crying Out Loud” dept in the new crisis.
Maybe it’s a bit cynical to say that bankers have memories like goldfish, but it is remarkable that the historical track record of the banking industry shows that the same mistakes have been repeatedly made.

THE BOOK OUTLINE – ACKNOWLEDGEMENTS & DISCLAIMER

The book starts with an introduction to restructuring by highlighting the ins and outs of an actual work out case that I have personally managed. When? In the beginning of this century. Where? In Poland. Which company? I have changed the name, as the company has never reacted to my request whether I could use its actual name.

After the Polish experience, the main body of the book will follow. It consists of two parts: lessons learned and restructuring. The first part of the book is about the inherent credit risks in lending, common mistakes that banks have made, sometimes more than once, and the lessons that should be learned from these mistakes. We will see that mistakes are not exclusive to corporate lending, but that mistakes are also made in consumer lending, and in lending to financial institutions and governments.

For easier reference, the various lending mistakes are classified in ten categories, as follows, in Book I: "Lessons Learned".

1. Early warning signals / Red Flags
2. Leverage / debt structural issues
3. Liquidity / cash flow issues

4. Documentation issues
5. Syndication / other lenders issues
6. Ownership / Management issues
7. Industry / Market specific issues
8. Collateral / Legal issues
9. Creative Accounting / Fraud
10. Other reasons for loan losses

When looking at the individual cases, we will see that there are many overlaps, that the root cause for a problem loan situation is not a single issue, but that there is often a combination of categories and factors in play.

The second part of the book is about how to deal with problem loan situations once they have arisen. This part is meant to be a Restructuring and Recovery handbook, a manual on work out situations, based on my personal experience. By the way, "Workout" is an often used synonym for both restructuring and recovery situations. And the restructuring and recovery function in ING Bank is called Global Credit Restructuring (GCR). In chapter 20, the last chapter of this book, I will provide my views on the strategy / purpose of the GCR function, and what I personally believe is its proper place and organisation within the bank organisation.
Neither the first, nor the second part of the book is a comprehensive manual. It simply can't be, given that every case is different, and because we can't predict how future cases will – literally - work out. However it is meant to give important guidelines on how to deal with work out situations. The second part of the book provides content, tools, techniques and some important restructuring principles, but surely also guidelines on "softer skills", on more or less efficient behaviour and communication when dealing with problem situations.

The layout of the book's second part, or Book II: "Restructuring" is as follows.

11. Causes of misfortune
12. Stakeholders – trust and liquidity
13. Customer centricity – but who is our client?
14. When to transfer to restructuring
15. Restructuring in three phases
16. Contents & behavior
17. Critical considerations for the bank
18. Critical considerations for the company
19. Sources of conflict and dealing with conflict
20. GCR function and place in the bank organization

In order to promote accessible reading, you will find important topics phrased in ***bold italics***. The book will conclude with a summary of some main lessons and takeaways.

As stated, I have changed the actual name of the Polish company, just as I changed the names of most other individuals and corporates, especially those relating to lesser-known private companies. Names of publicly listed, some other very well-known companies and their top managers, names that are well-known in the public domain, have not been changed. All examples are based on my personal observations and experience, and it is possible that not all information is accurate or complete, or that others may have different views on the situation and/or information that I have provided. In addition, I would like to emphasize that all ideas, statements and conclusions are based on my personal opinion and in no way reflect those of other individuals or institutions, including those of my former employer ING Bank.

At the end of this introduction, I want to express my sincere gratitude to all the people who have supported me in completing this book. A big "thank you" goes to the early reviewers of this book, including Jan Adriaanse, Rudi Deruytter, Jelle Hofland, Alexander Pisaruk and especially Adrian Grant for his enthusiasm and a great editing job - in case you still find language errors, it is because I made changes afterwards - and Keith McGregor for his valuable insights and suggestions. Another big "thank you" goes to my favourite cartoonist Hein de Kort, for his spot-on cover design.

I am also grateful to all GCR team members and other colleagues at ING Bank for their outstanding performance, tireless support and great sense of humour to deliver great results from our many adventures. Working with so many smart and talented men and women, from diverse cultural backgrounds who joined our teams in the early crisis years after 2008, will always be one of my fondest memories.

I also thank the bank's senior management for their deep support for and trust in our departments – they were always approachable, attended our team meetings on a regular basis, and without doubt helped us reposition the restructuring and recovery job "from the dark side of the bank to the spotlights" – which could have been an alternative subtitle for the book.

Rik Santegoets provided useful support on the initial graphs and illustrations, Jeroen Vos gave welcome legal advice, and Freekje Groenemans took a real good photo. Finally I would like to thank Geerhard and Angels at Haystack for their professional and creative support, which enormously helped bringing this book to market.

SECOND INTRODUCTION

WestConnect

Created in last century's roaring late eighties and nineties in Central and Eastern Europe, WestConnect succeeded in acquiring some high profile real estate properties and established retail businesses - department stores - in the country's main central city locations. The acquisition price was not excessive, but the transfer came with some strings attached, including the government withholding part of the shares. Taking over the old communist-style trained staff was part of the deal as well, and the acquired properties were completely outdated and poorly maintained. As an example, the Katowice based department store resembled an old, ill-lighted industrial shed rather than an attractive shopping place.

WestConnect was in the first place a real estate investor, but quickly developed some new department stores specialized in fashion, and added retail chain stores for cosmetics, music, movies, magazines and books. It also created some more or less successful joint ventures with established western brand names in photography, cosmetics and water.

In 1999, ING Bank – through its local subsidiary – put out a prospectus, aiming to provide a $99m investment loan A (for further development and refurbishment of the commercial real estate), tenor 6,5 years, and a $22m working capital facility loan B (mainly for stock financing), on a yearly roll over basis. On a side note, "stock" is meant as "inventory" here (European style), not as "shares". Both loans A and B were to be syndicated. The total $121m loan was real money, as in those days the $ was still valued above the Euro. ING Bank had a total "final take" participation of $55m, and the other syndicate participants were ABN AMRO, BPH PBK (Bank Austria), Bank Zachodni WBK (Allied Irish), Bank Handlowy (Citi), BRE (Commerz) and the German bank for small – and mid-corporates MHB.

The first observation is that there was a clear mismatch between the loan in foreign currency ($) and the company's source of income which was in Polish zloty (PLN). That the rents of the various properties were indexed against the US dollar was mentioned as a mitigant. This was not a real mitigant, because the tenants were fully dependent on zloty income as well.

This currency mismatch is one of the classical lending mistakes in banking and has often led to material credit losses

Despite a low initial capitalization, the financials showed a positive equity, thanks to a material revaluation of the commercial real estate properties acquired by WestConnect in the amount of PLN470m – well in excess of $100m.

While sales levels reached between $150-200m in the period 1998-2001, operational cash flows were negative already before financing costs, and came in at minus $10m (1998), minus $18m (1999), minus $12m (2000) and minus $5m (2001).

The usual "hockey stick" type of financial projections and ample collateral package led to a positive credit decision

As often happens, the financial projections were positive, thanks to aggressively forecasted sales increases and better margins. The assumed revenue increase was even more aggressive, taking into account the then negative economic sentiment leading to low consumer spending and increasing competition from many strategic newcomers (hypermarkets like Casino), booming shopping mall development, and the outdated department stores that weren't really attractive to shopping visitors. At credit origination, little or no attention was paid to the legal / ownership issues for some of the most material properties, or for the generally felt political sentiment that material state assets had been squandered away for a song to some crooked foreign investors…

There were some strong mitigants against those early warning signals. Yes, this was a start-up company with negative results, but it also was a market leader in a Polish economy that was turning around. Obviously, cross selling was an important consideration for house bank ING to finance WestConnect – a future IPO mandate was seen as a realistic proposition. Also, there was ample collateral value in the real estate properties that had an estimated market value of $160m. Another strong point was that the WestConnect CEO and CFO (a highly talented ex-ING banker) made a strong impression and did a convincing presentation to ING's Credit Committee ("CC"). The CC approval conditioned *inter alia* that the mortgage security rights would be perfect and legally enforceable.

The historic financials were pretty bad, and the CC approval came in only after two rebounds. And this was not the first, nor the last time, that a positive outlook and financial forecasts, enhanced by an overestimated collateral value, caused the hope factor to get the upper hand over the fear factor. And it wasn't the first time that a level of false comfort was created by conditioning something to be perfect in an imperfect world. Having a perfect enforceable security right on these - still partly state-owned - commercial properties in Poland was basically impossible, and both the commercial and the credit risk bankers should have been aware.

When WestConnect showed a historic record loss in its 1999 financial report, the local Credit Committee commented in her credit review that: "At present moment the best of evils is to continue the financing, especially in view of the security (key mortgage rights were not yet registered because of ownership issues), and to give them the chance to finally fulfill the forecasts". Further it was concluded: "The credit documentation remains strong and (so) we are committed". This was not correct given that most financial covenants - when properly calculated – had been broken and, in addition, the client's sales revenues didn't flow through the ING bank accounts as conditioned. No attention was paid to the company's announcement in the report that: "negative operational cash flows will require repayments to come from other sources – in particular, from the sale and lease back of real estate." The review was approved, conditional to a second opinion from GCR.

Transfer to the work out department, the first drill and initial talks

GCR immediately took over control of the file, since we felt there were simply too many red flags. During the "first drill" - desk top analysis including loan and security documentation check - we found that the syndicate's security package (both the 200 mortgage registrations and the pledges on stock) was far from perfect. In addition, a complete security overview was missing, conditions precedent before disbursement had not been met (inter alia there had been no control of uses of funds against the investment plan), basically all financial covenants were broken, the legal opinion about the enforceability of the mortgage rights was not received and also the formal approval from the shareholder to enter into the loan was missing.

After spending a few weeks in Warsaw for these first checks, we started to

arrange strategic meetings, first with the client and then with the syndicate and various advisers.
WestConnect main shareholder told us that he was committed to improve the operational results and to reduce debt by sale of real estate properties. Merrill Lynch was retained to attract outside investors and DTZ Zadelhoff was requested to revalue the properties. In preparation of a sale, the real estate properties were split from the retail business. In order to improve efficiency, responsibility, insights and financial results, the retail business was split in various business units (covering the various city centre department stores, children's toys shops, a few different fashion outlets – media retailer FRS had always been a separate business entity). Further, reorganization measures included staff reductions, limiting the number of suppliers, introducing private labels and promoting the stores in stores concept, where significant parts of the real estate space was to be rented out to third parties including boutiques, Albert supermarkets and H & M fashion.
Meanwhile it was late summer 2000, and the banks agreed to continue financing and not call the loans. Of course, we sent a letter, confirming the defaults, and reserved our rights in that respect. We wrote a Memorandum of Understanding (MoU) setting out the considerations, and all rights, principles and preliminary agreements between the company, loan A banks and loan B banks. No indefinite waivers were given, but rights were reserved, and – anticipating material sale proceeds from (some of) the real estate properties - the loans were extended for one and a half year until FYE01.
Although this MoU was only signed by all parties late 2001, a few months before the revised repayment date, in practice it did serve and would serve as a roadmap for the workout process, both in the beginning and going forward.

This book is a must-read for wholesale bankers and other professionals dealing with companies in financial distress.

Heavy Weather Banking provides a structured approach to the various lending mistakes and lessons learned from actual banking practice, and a relevant toolbox on restructuring do's and don'ts, both in terms of content and effective behaviour.

Quickly following the dotcom bubble burst of 2000, and the financial-economic crisis that started in 2008, we are currently experiencing the third major credit crisis of this century. The outcome remains uncertain, but it seems likely that many corporates will struggle to survive.

This textbook on distressed corporate debt restructuring is written from the bank's viewpoint, and concentrates on how the bank should best manage problematic loans, causing as little as possible financial and reputation damage to the bank.

Heavy Weather Banking is not an academic finance book, but rather a practical, easily accessible textbook that provides a comprehensive overview of the many topics, from early warning signals and lessons learned, to reaching a successful restructuring. The book includes many real-life examples.

"This is a valuable addition to the literature on distressed debt and one which I shall be recommending to all of my bank clients and trainees in this space."

Adrian Grant, Consultant and Trainer on loan origination & restructuring

Rob Wijman is one of Europe's leading loan workout and restructuring bankers with a deep and global experience in high profile cases. Wijman provides training, workshops and lectures on corporate crisis situations in addition to advising distressed businesses.

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