READING

COSTS OF PROBLEM LOANS TO BANKS

Damaged reputation

Banking is built on the foundation of trust. A bank can attract the funding it needs for loans and other investments only if its depositors and investors have confidence in the bank's ability to handle their money prudently. As a bank grows its loan portfolio, a few problem loans can be expected. An excessive number, however, damages the bank's reputation with its customers and investors. Once that happens, profitability declines, capital is difficult or more expensive to attract, and growth of the bank is hindered. When problem loans arise out of a push for growth rather than credit quality, a bank may develop a reputation for granting too much "easy credit." This growth strategy invites more high-risk borrowers and, consequently, loan problems compound. If growth is achieved by making several large dollar, high-risk loans, then a bank can suffer excessive losses from just a few problem loans.

Increased administrative expense

A problem loan, which may take several years to resolve, demands far more attention from bank personnel. A business banker has to devote more time meeting with the borrower and monitoring the loan. Other bank divisions, such as loan review and audit, spend more time monitoring problem loans than credits that are performing as agreed. The unproductive time spent monitoring a problem loan serves merely to protect the bank's assets. It does not generate additional revenue. Furthermore, additional costs will accrue if outside appraisers, consultants, and other specialists need to be hired.

Lowered employee morale

When a bank experiences an excessive number of problem loans or charge-offs, employee morale usually suffers. An unprofitable bank cannot reward its employees with salary increases and bonuses. If the loan situation is particularly bad, hiring freezes or layoffs may occur. As a result, the best business bankers and other key personnel may resign. The bank then either trains new employees or pays a premium to attract people as qualified as those who left.

To help alleviate the stress on staff assigned to problem loan management, many larger banks have separate workout or "special assets" departments. Smaller banks facing excessive problem loans may hire a consultant or assign these loans to one individual. Other lenders and employees then can focus on sales and operating the bank. Thus, problem loans affect not only the business banker, the lending department, and projected profits, but they also affect all bank operations and employees.

Increased regulatory expenses

A bank with an unusually high number of problem loans normally will find itself subject to increased oversight and control from regulatory authorities. Special reports may have to be filed with bank regulators, with the bank paying the extra cost to prepare the reports. In some instances, the bank has to establish special loan committees and institute more stringent loan approval processes. For example, loans that bank regulators have identified as substandard, such as advances or renewal lines of credit to adversely classified borrowers, may need special approval from the board of directors. When regulatory controls are imposed on a bank, the increased personnel commitment and added delays in getting required approvals may cause loan opportunities to be lost and bank profitability to be reduced.

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Increased legal expenses

A problem loan eventually may have to be resolved in a protracted lawsuit or bankruptcy case. If so, by the time litigation is over and a settlement rendered, the attorney fees and court costs may reduce the bank's debt recovery substantially. Sizable potential legal expenses may cause the bank to accept an early resolution of a problem loan at a discount to the principal amount borrowed.

A bank also may become the target of a lender liability lawsuit that can cost substantial sums in legal fees and jury awards. A lender liability lawsuit often arises when a problem loan is not resolved to the satisfaction of the borrower or another lender. In one such case, a lender was awarded millions of dollars in a lawsuit against another lender. The court ruled the original lender should have told the new lender everything known about the borrower. Although each lender should originate loans based on its own credit underwriting, a court may find the original lender potentially liable for fraud if full disclosure about the borrower is not made to the new lender.

The best defense against borrower-initiated lawsuits is for the business banker to perform in good faith the bank's stated obligations in the loan documents. Although a business banker may carefully consider plans to assist a borrower with a problem loan, the lender should never instruct the borrower to review an employee's performance, lower the price of merchandise, liquidate inventory, or otherwise become involved in the business's decisions. If the business eventually fails, the borrower not only may blame the bank, but also may claim improper interference in the company's affairs.

Fraud and misrepresentation—A business banker that knowingly or recklessly makes a false representation to a borrower may be liable for damages, particularly if the borrower acts on the false statement and suffers damages as a result. Business bankers who claim that the terms of a loan agreement allow them to decide who should head a company may face legal liability if the loan agreement does not grant such powers.

Duress—A business banker who threatens to take an action when no legal right to take action exists may be charged with duress. For example, a business banker who threatens to force a business into involuntary bankruptcy, in order to force the business to sell a profitable asset in order to pay a loan, may be in legal trouble. A business banker can avoid charges of unlawful coercion by refraining from "take-it-or-leave-it" demands.

Breach of good faith and fair dealing—The obligation a lender has to treat the borrower fairly and reasonably extends beyond the written terms of the loan documents. The implied obligation within the loan documents is an explicit element of contract law and the Uniform Commercial Code (UCC). A business banker may live up to the terms of the loan documents, but be found by a court to have exercised unreasonably the powers of the documents. For example, suppose a business banker, without notification, refuses to allow a borrower to draw on a line of credit. The business banker must have a valid reason for taking this action, such as the borrower currently being past due on loan repayment. If the action was taken because of a personality conflict, however, the business banker may expose the bank to legal damages if the refusal to extend credit resulted in damages to the business.

Interference with corporate governance—A business banker should avoid becoming too involved in a borrower's business decisions, even if the borrower solicits the banker's help. Advising a borrower on how to turn the business around is tempting. Although general advice may be warranted at times, a business banker who effectively participates in the day-to-day operational aspects of a borrower's business may be deemed as having effective control over the conduct of the borrower's business to the detriment of other creditors. If the business fails, the bank may lose the amount of its loan and be found primarily responsible for repaying the borrower's other debts.

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In terms of potential interference, a business banker should never become a member of a company's board of directors. Further, a bank may face legal action if it zealously exercises the terms of a loan agreement that give the bank a voice in operational decisions. Some loan agreements give banks the right to prohibit some business actions, such as purchasing fixed assets. Although it may have the right to veto unwise business practices, the bank should not become closely involved in making business decisions.

Interfering with a contractual relationship between a borrower and a third party also may be grounds for a lender liability lawsuit. Charges of interference can occur when a business banker persuades a borrower not to fulfill a contract in order to protect the bank's financial interests. Allegations of interference can result when a bank attempts to acquire additional collateral as security or tries to ensure that the value of its existing collateral is not impaired. For example, a bank may ask a manufacturer to delay or to halt delivery of goods to one party in order to sell the goods more profitably to another party or at a more favorable time.

Defamation—Problem loan situations sometimes create ill feelings between business bankers and borrowers. Regardless of a borrower's actions, however, a business banker should avoid letting personal relations affect what should be a professional, business relationship. A past experience with a borrower in a tough workout session or a heated loan negotiation can cloud a lender's judgment. It may lead to an untruthful or half-truthful communication to a third party. As a result, the bank may be exposed to a lawsuit charging defamation of character. This can occur, for example, when a business banker, as a way of getting even with a borrower, responds to a credit inquiry by saying that the owner of the business in question is unfit to run a company. A business banker should never express an opinion about a customer to a third party. All information should be factual and, if necessary, confidential.

Warning

Stick to the facts

Be sure all comments are factual. Never write anything in a credit file that can be embarrassing or taken out of context in a court of law.

Most bankers avoid lender liability lawsuits by simply exercising caution and common sense. Making unsubstantiated threats to a customer, misleading a customer about actions the bank will take if certain conditions are not met, speaking negatively about a customer, becoming too involved in a borrower's business affairs, exerting undue influence on a borrower's business decisions, and changing lending actions for personal reasons are all inappropriate actions that can trigger a lender liability lawsuit. A business banker should maintain an appropriate banker–borrower relationship, keep complete and accurate records, consult with bank legal counsel when necessary, and follow a consistent problem loan resolution and foreclosure procedure. These actions help protect the bank from becoming a defendant in a lender liability lawsuit.

As an added measure of protection, a business banker should request that another bank officer be present during any loan workout meeting with a borrower. In case the borrower later alleges that threats or inappropriate comments were made, a witness to the exchange can substantiate the business banker's version of events.