

Non-Performing Loans (Exposure)

What Every Small Business / Farm
Needs to Know

Spring 2020

Credit Review

INTRODUCTION

As with all Credit Review information notes, reading this short article will help you to understand how you can ensure your business or farm has access to credit when it needs it.

This note specifically explains what a 'Non-Performing' loan is; why banks are selling them; and how this can affect your business/farm's ability to get bank finance.

More than ten years on from the financial crisis, our Banks are required to deal with their legacy issues and comprehensively reduce their 'Non-Performing' loans. The Banks are obliged, by the Banking Regulators (in Ireland and the EU), to reduce their Non-Performing loans to no more than 5% of their Loan Books by the end of 2020. Achieving this target and maintaining it will influence the lending risks which all Banks will take going forward.

As a result, some Irish-based banks have been selling large bundles of these loans to Investment Funds, in order to meet their regulatory requirements. This note specifically explains:

- A. What is a 'Non-Performing Loan' (NPL) or 'Non-Performing Exposure' (NPE).
- B. How you can go from Performing to Non-Performing Status.
- C. How a Non-Performing status affects a customer's overall banking relationship, including applying for new loans.
- D. Checking if your loan/credit facilities are classed as Non-Performing.
- E. What to do if your loan/credit facilities are classed as Non-Performing.



WHAT IS A NON-PERFORMING LOAN/ EXPOSURE?

The European Banking Authority (the EU agency responsible for setting a common set of rules for all banking undertaken within the European Union) defines a bank loan to be a Non-Performing loan where either, or both, of the following situations arise:

- 1) A loan repayment is more than 90 days past the due date.**
- 2) The Borrower is assessed, by the lending bank, as being unlikely to meet the full credit obligation without realisation of collateral.**

Put another way, this is where the borrower is considered unlikely to pay back the loan without needing to sell off some tangible assets, particularly those securing the loan.

If ANY of your loans are non-performing, the bank may deem ALL of your loans to be a 'Non-Performing' Exposure.

B

HOW YOU CAN GO FROM PERFORMING TO NON-PERFORMING STATUS

Let's look at how your 'Performing' loan can become classified as 'Non-Performing' in a bit more detail:

1) A loan repayment is more than 90 days past the due date.

Where a business/farm misses a scheduled repayment on a loan, the bank classifies the payment as 'past due'. At that point the clock starts running. You have 90-days to make up on the missed (past due) payment to avoid the loan being classified as Non-Performing.

If the missed repayment is not made up in the 90-day period, then the loan becomes classified as Non-Performing status – even if subsequent loan repayments are made in accordance with the terms of the loan.

Even within the 90 day period, where a recent loan repayment has been missed, the Bank's risk management system alarms are triggered, and the Bank may decide to take a closer look at the Borrower's overall position. If, after doing so, the Bank takes a view that there is a likelihood of non-full repayment of the loan, then it is obliged, by regulation, to immediately classify that loan as Non-Performing.

2) The Borrower is assessed as unlikely to meet the full credit obligation without realisation of collateral (the security pledged against the loan).

Many people are shocked to discover that their business, farm or home loans have been classified as Non-Performing and sold on to Investment Funds, even when loan repayments are up to date and in accordance with the Loan agreement.

“How did this happen?”

It is important to understand that the Bank assesses the full credit obligations of the borrower; that is the full extent of all your loan commitments and your ability to pay them. Even if most of your commitments are healthy, it is the weakest link in a customer’s banking loan portfolio which can pull businesses, farms and people down.

While the primary business/farm loan or mortgage may be in order, any connected borrowing, such as a struggling buy-to-let mortgage, must also be taken into account by the Bank. If any part of the full credit exposure is considered by the Bank to be unsatisfactory, it can lead to ALL of your loans being classified as Non-Performing.

It may even be that the financial health of any guarantor for your loans is taken into account – so a guarantor who is classed as Non-Performing can also result in an otherwise financially healthy business/ farm debt being classed as Non-Performing.

Other factors such as the day-to-day conduct of a business/farm’s current account will also be taken into consideration, even if the loan is otherwise performing to the loan agreement. If cheques/ standing orders are being returned because the agreed overdraft limit is exceeded, or even if the current account is not in credit for at least a few days a year (usually a minimum of 30 days in any one year), then the overall exposure may be deemed to be at risk of ‘being unlikely to meet the full credit obligation without realisation of collateral’.

The Performing loan may then be classified as part of an overall Non-Performing credit exposure.

Make every effort to know what the weaker links in your banking arrangements are so you can manage or even strengthen them. This ensures your loans stay out of trouble by maintaining their ‘Performing’ loan status.

2) The Borrower is assessed as unlikely to meet the full credit obligation without realisation of collateral security pledged against the loan. (CONT'D)

When a Loan is obtained from your Bank, a loan agreement document is signed. This specifies the amount and term of the loan, the collateral security given against the debt, the repayment conditions, and the rules for what happens if the agreement is not kept to.

This is an important document, as during the term of the loan, if any of the conditions in the loan agreement are not met (breached), with or without the consent of the Bank, then the Bank can classify it as Non-Performing and can demand its immediate repayment in full.

Repayment in full includes a Bank's right to sell a Non-Performing loan to Investment Funds in order to help it meet the Bank Regulator's 5% target level of Non-Performing Loans referred to above.

We suggest if you believe financial difficulties (like a missed loan repayment) are likely to arise, it is very important to engage with your Bank as early as possible, rather than just allowing a loan to fall into arrears.

Contacting your Bank in such circumstances is not easy, but it helps for both parties to recognise in advance that there is an issue, and a need to agree on solutions together. Ignoring a problem will not make it go away and may lead to other unnecessary complications for your current and future banking needs.



HOW A NON-PERFORMING LOAN AFFECTS A CUSTOMER'S OVERALL BANKING RELATIONSHIP, INCLUDING APPLYING FOR NEW LOANS

If your loan is classified as Non-Performing, then ALL of your banking credit facilities can be sold to an Investment Fund – not just the ones that have missed repayments; it is your entire loan portfolio exposure which may be sold. Since you will have breached terms of an original credit/loan agreement, the Investment Fund may be able to demand full repayment of all debts – and with only a short period of notice.

You should also be aware that another consequence of being in default on your bank facilities, and having a Non-Performing Loan, is that your name and loan details will also appear on the new Central Credit Register for a period of time (and with other credit reference agencies such as the Irish Credit Bureau).

The Central Credit Register is available to all finance providers operating in the Irish market. Your credit record and credit score will be weakened. This would make accessing new loans more difficult, possibly more expensive, and would also serve to highlight your financial issues to other Banks that you deal with.

Banks are required to reduce and then keep their ongoing Non-Performing Loan ratio under 5%, and this has reduced their appetite to lend money to higher risk borrowers. Borrowers who have previously been classed as Non-Performing will not be attractive customers to either their own, or other Banks. This will make it difficult to get finance to grow your business/farm, or to get refinanced if you have been offered a settlement deal by an Investment Fund that has bought your loan as part of a loan portfolio.

Prospective borrowers need to make well-argued loan applications showing their repayment capacity, and that the business/farm's operation of its current account, and loan repayments, are not problematic. (Banks will still seek security to cover their lending)

D

CHECKING IF YOUR LOAN/CREDIT FACILITIES ARE CLASSED AS NON-PERFORMING

Firstly, you know your business/ farm best. After reading this note, ask yourself if there was any period when your business/ farm went through a rough patch and you missed payments, or sought help from your Bank on existing Loans. Perhaps there were a lot of breaches of your overdraft conditions, and dishonoured payments or cheques?

If so, you need to talk with your Bank to find out if your lending has been classified as Non-Performing, as it is in your interest to get that classification back to Performing status as soon as possible. Please be aware that how each Bank categorises such lending is more technically complex than can be covered in this information sheet.

If you are concerned, ask your Bank to confirm the status of your loans in writing, remembering that the Bank views your business/farm loans in the context of the total risk you represent to them. All of your related business/farm and any connected personal accounts may be grouped into the Bank's classification of Non-Performance.



WHAT TO DO IF YOUR LOAN/CREDIT FACILITIES ARE CLASSIFIED AS NON-PERFORMING

Arrange a formal meeting with your Bank to agree what is required to return the lending to Performing Status. This will be in the best interest of both You and the Bank.

Each of our Banks should have internal policies to re-classify loans as performing. The European Banking Authority guidance on rehabilitating Non-Performing Lending states:

Exposures (loans) may be considered to have ceased being non-performing when all of the following conditions are met:

- a) the exposure meets the exit criteria applied by the reporting institution [the Bank] for the discontinuation of the impairment and default classification; (i.e. when the loan repayments are up to date and the loan and accounts are being operated to the standards and for the period required by the Bank)
- b) the situation of the debtor [the Borrower] has improved to the extent that full repayment, according to the original, or modified*, loan conditions, is likely to be made;
- c) the debtor does not have any amount past-due (missed payment) of more than 90 days.

***Note:** If you have reached agreement on a modified, or restructured deal, for your loan with your Bank, they have to set the revised terms of that agreement out in writing to you and you should receive a hard copy of this, within the Bank's specified timeframes.

Contact Credit Review in good time before meeting the Bank to ensure that you are fully informed on the credit management issues relevant to your situation.

☎ **1850 211 789**

✉ info@creditreview.ie

For some readers of this article, it may be that your loans have been classified as Non-Performing, and have already been 'sold on' by your bank to an investment Fund. Credit Review has a separate information sheets for Small Business and Farms to assist. These can be found in the Resources section of Credit Review website www.creditreview.ie/resources/

Credit Review