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From feast to famine:

Conquering non-performing loans in the new era of rising debt burdens

March 2020 witnessed the dramatic end of the longest bull market run in stock market history. From many investors being sanguine about the prospects for 2020 – especially in the UAE where Dubai was due to host the Expo in October (now postponed to 2021) – most companies' revenue streams have been reduced to all but a trickle, with lockdown restrictions only just starting to be eased.

One of the defining characteristics of the last decade, mainly thanks to central banks' ultra-loose monetary policy, has been the cheap access to credit enjoyed by individuals and businesses. Both have taken full advantage. The former to indulge in profligate consumer spending and the latter to fund expensive ventures or share buyback programs (Boeing's USD 11.7bn debt funded share buybacks being one of the most infamous examples).

As such cycles inevitably draw to a close, the implications for banks are obvious. Companies teetering on the brink before COVID-19 now risk being tipped over the edge. Consequently, banks face the risk of holding a substantial book of non-performing loans, especially those exposed to highly cyclical industries or industries directly impacted by the global lockdown measures, such as aviation, tourism, logistics and real estate.

The situation is even more acute in the Gulf where a global pandemic has coincided with an oil price war and regional political stagnation. Banks in the Gulf are heavily reliant on state company oil sales to provide liquidity, but oil is now trading at less than half its value compared to the start of the year. This makes accessing reasonably priced finance for companies even tougher at a time when holding cash has never been more important.

In this environment, banks' top priority is minimising loan impairments. But, when companies are struggling for cash, there is an increased temptation for debtors to engage in fraudulent ventures such as creatively manipulating financial statements and forecasts to avoid breaching covenants or to secure new financing. A failure to monitor borrowers closely can result in fraudulent conduct going undetected until it becomes too late to recover significant value from a loan.

It is therefore imperative that lenders maintain a close eye on borrowers and act quickly to invoke any audit rights at the first sign of trouble. Being able to perform a detailed review of a company's accounts provides an unparalleled insight into the financial position of a company that regular monthly financial submissions to banks cannot. It allows lenders to assess whether significant problems exist beneath the surface, such as overly aggressive revenue recognition practices or long outstanding receivables.

Ultimately, conducting an audit allows an informed business decision to be made that best preserves value for the lender. For instance, where a business has no hope of trading profitably, a liquidation can be initiated whilst the company holds saleable assets. Alternatively, a solvent restructuring may be preferable.

Unfortunately, even these days, lending agreements do not always include audit rights – a valuable lesson to learn - and liquidated businesses often hold little recoverable value. So what is the last resort? Loan agreements often involve personal guarantees where the real value lies with the guarantor rather than the direct borrower. In such instances, banks may resort to the effective tool of tracing the guarantor's assets to recover value. These assets may be hidden in overseas jurisdictions, adding a further layer of complexity. In these circumstances, swift and rapid action is the key to avoid any potential asset dissipation.

Inevitably, all financial institutions will suffer from loan impairments during the current crisis. However, banks have an armoury of weapons that could minimise their impairments:

1. Ensuring audit rights are included in loan agreements and invoking these rights promptly with businesses holding potential non-performing loans;
2. Tracing and recovering assets from guarantors while rapidly acting at the first signs of impairment; and
3. Maintaining communication with legal and restructuring advisors.

There have already been a number of high-profile insolvencies this year, both in the Gulf and globally. In these times of economic fragility, more companies will surely follow. The difference between success and failure for banks may well come down to who is best equipped to deal with the next oncoming wave of non-performing loans.

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