Covenant Monitoring

Loan covenants are an essential part of commercial lending. They provide a framework of understanding for the borrower to meet the requirements of the lender. The covenants can include financial reporting requirements, performance-based covenants and operating covenants. The first two are considered affirmative covenants while the last is generally considered a negative covenant. The loan covenants are included within the loan agreement as a part of the overall loan documentation. The specific requirements for the delivery of financial reporting or the testing of loan covenants should be explicitly included in the loan agreement and consistent with the approval of the credit facility.

The identification of the various covenants is one of the key steps in the loan review process. Our loan review process will generally start with the credit approval document to identify the requirements of the borrower as a part of the credit approval. We will then review the loan documentation to ensure the covenants are incorporated into the loan agreement or other document per the credit approval. The next step is to locate the actual financial statements, identify covenant testing has been completed and identify if any operating covenants have been violated. If financial statements are not available or performance covenants are not tested as required under the credit approval, we will note this as an exception and review the institution's tickler list to ensure the financial institution is tracking the missing items.

While this seems to be a straightforward process, we have had many discussions with our customers regarding performance covenants. These discussions are generally focused on the timeframe either permitted or expected by the financial institution to complete the testing of the performance covenants, whether it be monthly, quarterly, annually or other. The question becomes, should the performance covenants be tested upon receipt of financial statements or tested during the annual review process or other credit event. Unlike a financial reporting requirement, most credit agreements do not include a timeframe for which a covenant should be tested. Additionally, most loan policies do not identify an expected or required timeframe for the testing of performance covenants.

From here, there are two additional issues for a loan review professional: 1.) what is a reasonable time frame to allow for performance covenant testing and 2.) if the necessary financial statement has not been provided per the credit approval and therefore the covenant is not able to be tested, is the lack of performance covenant testing an exception?

Loan covenants are in place to manage the perceived risk with the credit relationship. They serve the purpose to monitor the performance of the borrower. Therefore, we believe performance covenant testing should occur as the required financial statements are received. A memo or other document should then be added to the credit file to indicate the date of testing, the specific covenants tested and if the borrower passed the required covenants. Most performance covenants in community banking are tested on an annual basis. This means year-end financial statements are used to test the covenants. Many community-based financial institutions rely on the annual review process to update financials and test covenants. Often, the annual reviews are not closely aligned with the annual financial reporting requirements and therefore weeks or months may pass before the covenant testing occurs. This potential delay can create incremental risk in the credit relationship should there be a deterioration in the financial performance of the borrower. Additionally, the significance of the covenant may be eroded if the borrower is notified of a covenant default months after the financial statements have been delivered.

Our loan review position, therefore, is to expect covenant testing to occur and be documented within 30 days of receipt of financial statements. If not, we generally identify the lack of testing as an exception. In addition, if a required financial statement has not been received, and as a result a performance covenant is not tested, we would also identify this as an exception. Two exceptions would then be noted, one for the missing financial statement and one for the performance covenant test. While it may seem overly critical to identify both as exceptions, the missing financial statement and untested covenant may reflect risk in the relationship and the borrower's willingness or ability to adhere to the loan covenants. We do find most financial institutions will include performance covenants on their tickler list, however, we do not often see un-tested covenants on exception lists. In this prolonged banking cycle, accurate exception lists can identify trends regarding the level and types of exceptions and can be a meaningful tool in the overall loan portfolio management.

There may be a solution to address the timeliness of the testing of the performance covenants. Most institutions require financial reporting from the borrow and leave the covenant testing to the financial institution's staff. This method can lead to significant delays in the testing of the covenants. An alternative to this dilemma; *a covenant compliance certificate requirement*. A covenant compliance certificate could be included as a part of the credit approval and incorporated into the loan agreement. This is a form submitted by the borrow attesting to the compliance/non-compliance with their covenants. A standard form or template can be provided to the borrower specific to their covenant requirements to facilitate future reporting.

A compliance certificate will not only expedite the covenant testing process but also further engage the borrower in a clear understanding of their performance expectations by the financial institution and how they are performing against these requirements. Little additional time may be required by the borrower to complete these certificates on a regular basis as most covenants are formula driven included within a template provided by the financial institution.

We would anticipate compliance certificates to be verified by the financial institution. This process will not only confirm the result of the covenant test but ensure the borrower is accurately calculating the performance covenant.

Covenant compliance certificates have been a long-standing practice for corporate banking and large financial institutions. A greater adoption by community based financial institutions may provide for a more timely and effective covenant management process thereby enhancing the overall risk management process for the institution.

Kevin Graff is the President of Integrity Loan Review. He has significant experience with loan review and credit administration. He is happy to discuss with you how covenant monitoring can become more effective for your institution. Kevin can be reached at 920-857-6225 or kevin@integrityloanreview.com