PROBLEM LOAN SURPRISES
Everything All at Once

Finding the Problem Before It Finds You

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45-Minute Roadmap

01	**The Setup**	How good loans become problem loans
02	**Early Warning**	The signals we miss or normalize
03	**The Domino Effect**	When everything happens at once
04	**Credit Discipline**	Risk ratings, watchlists, MIS & portfolio
05	**Action**	Five things to do Monday morning



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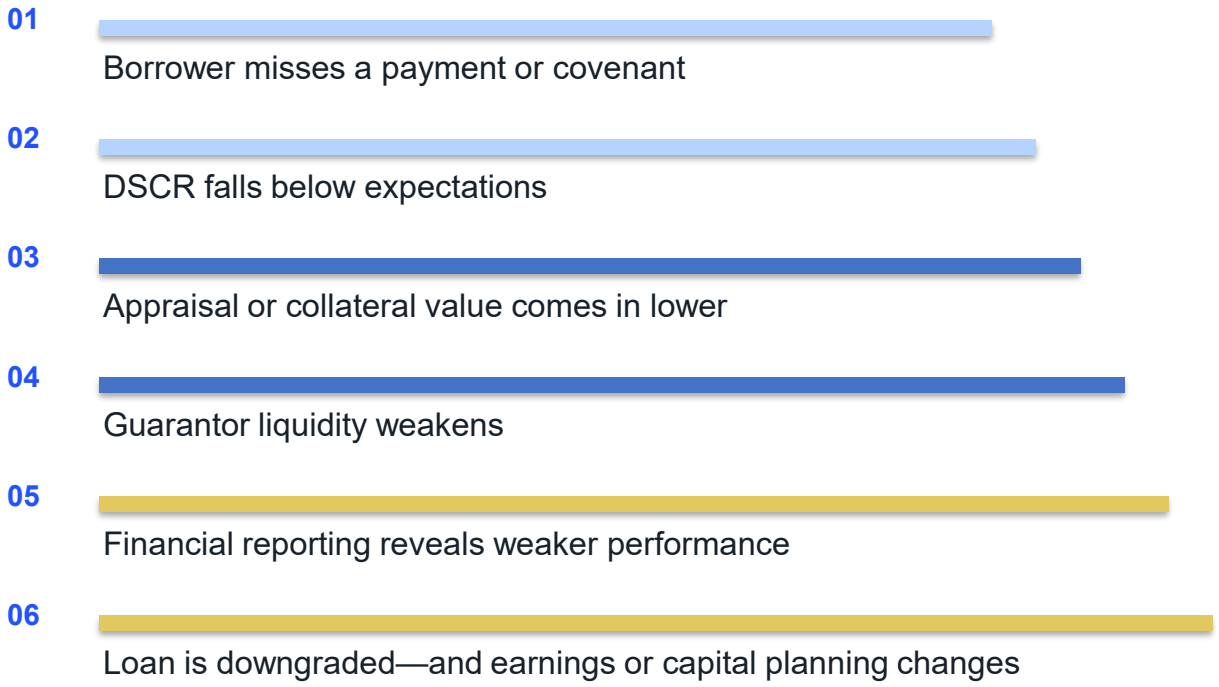
The Setup

Why apparently healthy credits become problems—and why recognition often lags deterioration.

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The “Everything All at Once” Moment

THE SIGNALS ACCUMULATE



6 months

“Why didn’t we see this sooner?”

The real issue

Recognition often lags deterioration.

The evidence was visible before the event was obvious.

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Are We Monitoring Performance—or Merely Documenting History?

Documentation

Annual reviews
Financial statements
Tax returns
Appraisals
Covenant testing
Risk-rating forms

Monitoring

Trend analysis
Variance analysis
Borrower behavior
Risk migration
Stress testing
Forward-looking judgment

The question

Do we have the information?

OR

Are we interpreting it early enough to change the outcome?

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The Problem Loan Lifecycle



The most valuable intervention period is between "something has changed" and "this is officially a problem loan."

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Five Places Problems Hide

01

Borrower performance

Revenue, margins, cash flow, leverage

02

Sponsor / guarantor

Liquidity, contingent liabilities, support capacity

03

Collateral

Value, liquidity, coverage, assumptions

04

Loan structure

Amortization, covenants, maturity, pricing

05

Relationship / behavior

Reporting, exceptions, communication, borrowing behavior

Problems rarely hide in one place. They emerge where the lenses overlap.

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Early Warning

The subtle signals that accumulate before the problem loan becomes obvious.

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How Good Loans Become Problem Loans

INDIVIDUAL SIGNALS

- ↓ Revenue
- ↓ Margins
- ↓ Liquidity
- ↑ Leverage
- ↓ DSCR
- ↓ Collateral coverage
- ↓ Sponsor liquidity
- ↑ Reporting delays
- ↑ Exceptions

1 event **is not the credit story.**

The mistake is looking for the event.

The better approach is recognizing the accumulation of evidence—and whether multiple signals are pointing in the same direction.

Pattern beats point-in-time.

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Tax Returns vs. Operating Performance

Tax reporting

Answers a tax question

- Depreciation
- One-time gains/losses
- Related-party items
- Tax-driven deductions
- Ownership structure

Credit analysis

Answers a repayment question

- Sustainable cash flow
- True debt service capacity
- Normalized earnings
- Liquidity
- Leverage
- Recurring performance

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Adjusted EBITDA: Where Credit Judgment Matters

Owner compensation and personal expenses

One-time or “temporary” expenses

Related-party expenses

Non-recurring revenue

Aggressive add-backs

The test

If the same “one-time” expense appears year after year, is it really one-time?

Credit discipline

Make the judgment explicit. Document what is recurring, what is truly non-recurring, and why.

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Early Warning Signals

Signal	By Itself	Combined With
Revenue decline	Moderate	Margin compression
Margin decline	Moderate	Rising leverage
Late reporting	Moderate	Covenant breach
Lower liquidity	Moderate	Increased borrowing
Lower collateral value	Moderate	Weak cash flow
Sponsor distributions	Moderate	Declining liquidity

Key point

Individual signals are weak. Combinations are powerful.

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The Borrower Story Test

Ask the question

“If I were underwriting this loan today, knowing what I know now, would I structure it the same way?”

Same loan amount?

Same structure and amortization?

Same covenants?

Same guarantor requirements?

Same collateral assumptions?

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The “Boiling Frog” Problem

WHAT CHANGES	WHAT WE TELL OURSELVES
Revenue slips	*“Temporary.”*
Margins compress	*“Industry-wide.”*
Liquidity falls	*“They’ve always recovered.”*
Leverage rises	*“The sponsor is strong.”*
Exceptions increase	*“They’re still current.”*

WHAT HAPPENS

Each issue gets normalized until the cumulative deterioration is too large to ignore.

→ **Recognition arrives late.**

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The Relationship Manager Effect

Relationship knowledge

- Deep borrower knowledge
- Strong communication
- Historical context
- Better access to information

Potential blind spots

- Anchoring
- Advocacy bias
- Normalization of deterioration
- Reluctance to downgrade
- Reluctance to confront the borrower

Credit discipline

Relationship knowledge is valuable. Independent challenge is essential.

The Domino Effect

How cash flow, collateral, guarantor strength and maturity risk interact.

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Risk Rating: The First Domino

A RISK RATING SHOULD

1. Signal changing credit risk
2. Reflect current conditions
3. Support pricing, monitoring and reserves
4. Prompt management action
5. Forecast the direction of risk

THE LATE-RATING TRAP

The rating changes only after…

- ✕ Missed payments
- ✕ Nonaccrual
- ✕ Obvious impairment
- ✕ Major collateral issue

At that point, the "early warning" has already failed.

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Common Risk-Rating Failures

Rating follows payment performance

Collateral masks weak repayment capacity

Guarantor strength masks borrower weakness

Covenant compliance creates false comfort

Relationship history influences the rating

Rating changes lag actual deterioration

Remember

A borrower can be current today and materially riskier than it was a year ago.

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Collateral: The Second Domino

Questions to ask

What is the current value?
How reliable is the valuation?
How liquid is the collateral?
What is the liquidation value?
What assumptions drive value?
What happens under stress?
Are we relying on appreciation?

The distinction

APPRAISED VALUE

is not necessarily the same as

RECOVERABLE VALUE

Collateral is important—but it should not become an excuse for weak primary repayment capacity.

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Guarantor Support: Underwrite the Guarantor

Liquidity and contingent liabilities

Other bank debt and guarantees

Real estate and investment exposure

Tax obligations

Concentration and correlated assets

Other commitments and support obligations

The common assumption

“The borrower is weak, but the guarantor is extremely strong.”

The credit question

What else is the guarantor guaranteeing—and how liquid is the net worth?

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When Everything Happens at Once

Property value		NOI		Interest rate		Sponsor liquidity		Loan maturity
↓	+	↓	+	↑	+	↓	+	**NEAR**

= CAPITAL + EARNINGS RISK

A collateral problem + cash-flow problem + sponsor problem + refinancing problem can become a capital and earnings problem.

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The Maturity Wall

TODAY

Borrower is current
Existing loan structure works
Collateral appears adequate
Sponsor has supported the relationship

MATURITY

Would another lender make this loan today?

If not, what is the realistic refinance or exit strategy?

REUNDERWRITE



Do not wait until 60 days before maturity to discover the borrower no longer fits today's underwriting.

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Portfolio Concentration: The Problem May Not Be One Loan

Industry

Geography

Property type

Sponsor / ownership group

Loan structure

Maturity profile

Risk-grade migration

DSCR / LTV distribution

CCO-level question

The lender may have one troubled hotel.

The chief credit officer needs to ask:

“How many hotels do we have?”

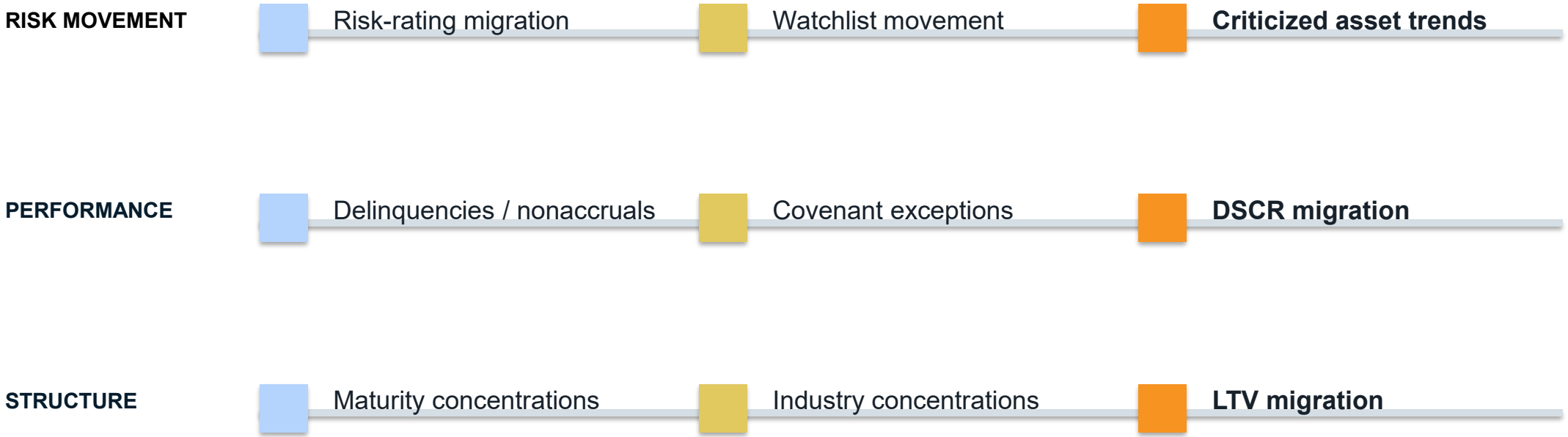
And how many share the same early-warning characteristics?

Credit Discipline

Risk ratings, watchlists, MIS and portfolio oversight as early-warning mechanisms.

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MIS: What Management Doesn't Know, It Can't Manage



Good MIS shows where risk is moving—not merely where it is today.

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The Watchlist: Management Tool, Not Parking Lot

Why is this loan here?

What changed?

What is the current risk?

What are we doing about it?

What is the next milestone?

Who owns the action?

When will we reassess?

A real watchlist has an action plan

What is changing?

What are we asking the borrower to do?

What does success look like?

What is the exit strategy?

When do we reassess?

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Board Reporting: Explain the Direction

Weak

“Criticized assets increased $18 million.”

Better

“Criticized assets increased $18 million, primarily from CRE loans in three property types. Six additional loans show similar early-warning characteristics.”

The board needs

What changed? Why? What could happen next? What is management doing about it?

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The Examiner's Question: “When Did You Know?”

The key distinction

Not when the borrower missed a payment.
Not when the appraisal arrived.
Not when the loan became nonaccrual.

When did the bank have enough information to reasonably recognize increased credit risk?

Credit discipline problem

“We knew six months ago, but we didn't change the rating.”

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Credit Administration Discipline: Four Questions

01

What changed?

→

02

Why did it change?

→

03

What does it mean?

→

04

What are we doing about it?

Apply this everywhere

Every lender, credit officer and portfolio manager should be trained to ask these four questions.

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Action

Practical steps management and credit leaders can take immediately.

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The Early Warning Dashboard

Cash flow

- Revenue trend
- EBITDA trend
- DSCR trend

Balance sheet

- Liquidity
- Leverage
- Working capital

Collateral

- LTV
- Value trend
- NOI trend

Behavior

- Reporting timeliness
- Covenant exceptions
- Borrowing requests

Portfolio

- Risk migration
- Concentration
- Maturities

Movement over time →

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What Experienced Lenders Sometimes Miss

Experience creates advantages

Pattern recognition
Relationship knowledge
Historical context
Judgment
Borrower access

Experience can also create blind spots

Anchoring
Overconfidence
Normalization
Confirmation bias
“We've seen this before.”

Best practice
Create an environment where experienced lenders are expected to challenge their own assumptions.

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The “What If I'm Wrong?” Test

Ask the question

“What would have to be true for my current credit conclusion to be wrong?”

What if collateral is worth 20% less?

What if sponsor liquidity is tied up elsewhere?

What if revenue falls another 10%?

What if the refinance market is unavailable at maturity?

Purpose

Identify fragility—not predict disaster.

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Five Things to Do Monday Morning

01	**Look at risk migration**	Who moved from 2 → 3 → 4?
02	**Review upcoming maturities**	Which loans require refinancing?
03	**Challenge the watchlist**	Does every loan have an action plan?
04	**Stress the “good” credits**	Which credits become problems under modest stress?
05	**Look for patterns**	Where are multiple warning signs pointing in the same direction?

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Discussion

Questions, examples and experiences from the room

Discussion prompts

- What is the earliest warning sign you've seen that was initially dismissed?
- How does your institution identify risk-rating migration before criticized assets rise?
- Where do problem loans most often surprise management in your portfolio?
- How many of you have had a loan that was technically current but, in hindsight, was obviously deteriorating?
- If I gave you your entire commercial portfolio and said you could only review 20 loans tomorrow, how would you pick them?

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Final Message

PROBLEM LOANS DON'T USUALLY SURPRISE US.

Our recognition of them does.

Watch the direction.
Challenge the story.
Connect the dots.
Act early.

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