FINBRIDGE

based on competence and commitment

Integration of Covenants in Credit Processes

Challenges and Solutions

Introduction

In recent years, **covenants** have gained in importance as a tool for credit risk management and have become established as a widespread creditor protection instrument in credit agreements.
Covenants are obligations agreed in the credit agreement with the debtor, which the customer has to fulfill within contractually fixed terms during the repayment term.
These stipulations can have different characteristics and must be complied with by the debtor in addition to the payment obligation. Covenants can be divided into **financial** and **non-financial covenants**.

Design Options and Contractual Consequences

Financial covenants are obligations of the debtor in the loan agreement to fulfill agreed financial ratios. These relate to the capital structure or the earnings and liquidity position of the borrower.
The measures may be cash flow-based, such as the DSCR (debt service coverage ratio), the ICR (interest coverage ratio) or the LLCR (loan life coverage ratio), or based on balance sheet key figures (e.g. leverage ratio, equity ratio or debt-to-equity ratio).
Other key figures are also possible, such as the weighted average unexpired lease term (WAULT) as the sum of the remaining rental payments for the portfolio or building fixed for the contract period, divided by the total rental income at a specific point in time.

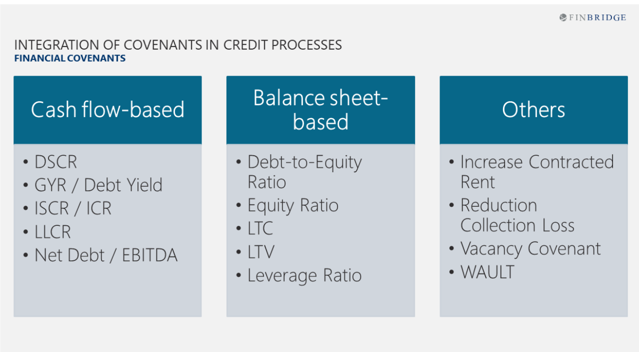

Figure 1: *Financial Covenants*

In contrast to financial covenants, non-financial covenants are defined as additional agreements within a credit relationship that do not relate to compliance with financial ratios.
This may be the obligation of the borrower to provide contractually agreed information or to submit documents within a certain period (informational covenants).
Documents to be submitted include, for example, bank statements, income tax notices, annual account or asset statements. Other contractual agreements, such as commitments to provide collateral or the cash flow use of the borrower (e.g. distribution restriction or prohibition), belong to the non-financial covenants, too.
Failure to comply with covenants by the debtor usually has contractual consequences.
Often, two threshold values of a covenant are defined, the violation of which leads to separate contractual consequences:
The breach of **soft covenants** does not give the lender a right to terminate, but triggers further obligations of the debtor as defined in the loan agreement. Potential consequences of soft covenants include special repayments, blocking of the account, request for further documents and information, or more frequent submission of documents. In practice, it is also possible to agree on a limitation on profit distribution to investors or the increase in regular repayments.
The violation of **hard covenants** can lead to the cancellation of credit lines or the termination of loans. In principle, both soft and hard covenants may incur penalty interest or penalty margins.
Also possible are contract constellations that provide for a so-called **cure period**. During this phase, the re-compliance of the covenant may be effected, e.g. by special repayment or provision of additional collateral. Formally, entering the cure period is not a covenant breach.
In some cases it is agreed that covenants don't have to be fulfilled for a certain period of time (for example, as long as the investment phase is ongoing or in the process of restructuring).
The effective date of contractual consequences after a covenant breach is also specified in the covenant agreement. For example, in case of interest rate adjustments, it is customary to wait until the next interest rate fixing date to increase the margin or interest rate.
In particular, the use of different **waiver** types is common when determining covenant breaches:

- Temporary Waiver (temporarily suspend covenants or restore the covenant through follow-up testing)
- Conditioned Waiver (restoration of the

covenant on fulfillment of substituted conditions)

- Partial Waiver (change of covenant calculation or inactivation of partial covenants)
- Contract modification (change or deletion of covenants)

Challenges

Efficient management and monitoring of contractual obligations requires the **system-side mapping** of a wide range of covenant types and covenant processes. The life cycle of a covenant includes, among other things, the capturing and monitoring of the covenant as well as possible contractual consequences resulting from a breach of the covenant.
In addition to the covenant type (financial covenant, non-financial covenant), limits should be set for financial covenants whose exceeding leads to the covenant breach, as well as valuation date, deadlines, cure periods, cure options, and contract consequences.
The **monitoring** of covenants has to ensure the controlling of financial key figures, reporting obligations and other covenant obligations agreed in loan agreements. The following processes may be included:

- Monitoring of submission deadlines for non-financial covenants
- Effective date reviews of financial covenants
- Automated financial covenant check
- Triggers to the responsible credit admin (if a check is only possible manually)
- Documentation of covenants and reporting
- Management of incoming documents
- Historization of covenants to detect trends
- Control of contractual terms (e.g. interest rates, margins) via covenants

The integration of covenant control mechanisms into the credit process is also challenging.
By **integrating a covenant module** into the credit module, the results from the covenant check can be used directly to derive the current contract terms, such as the automated adjustment of interest and repayment terms depending on financial ratios.
Contract consequences, such as penalty rates or cancellations of lines of credit or cure periods can be initiated in this way.
For credit systems without an integrated covenant

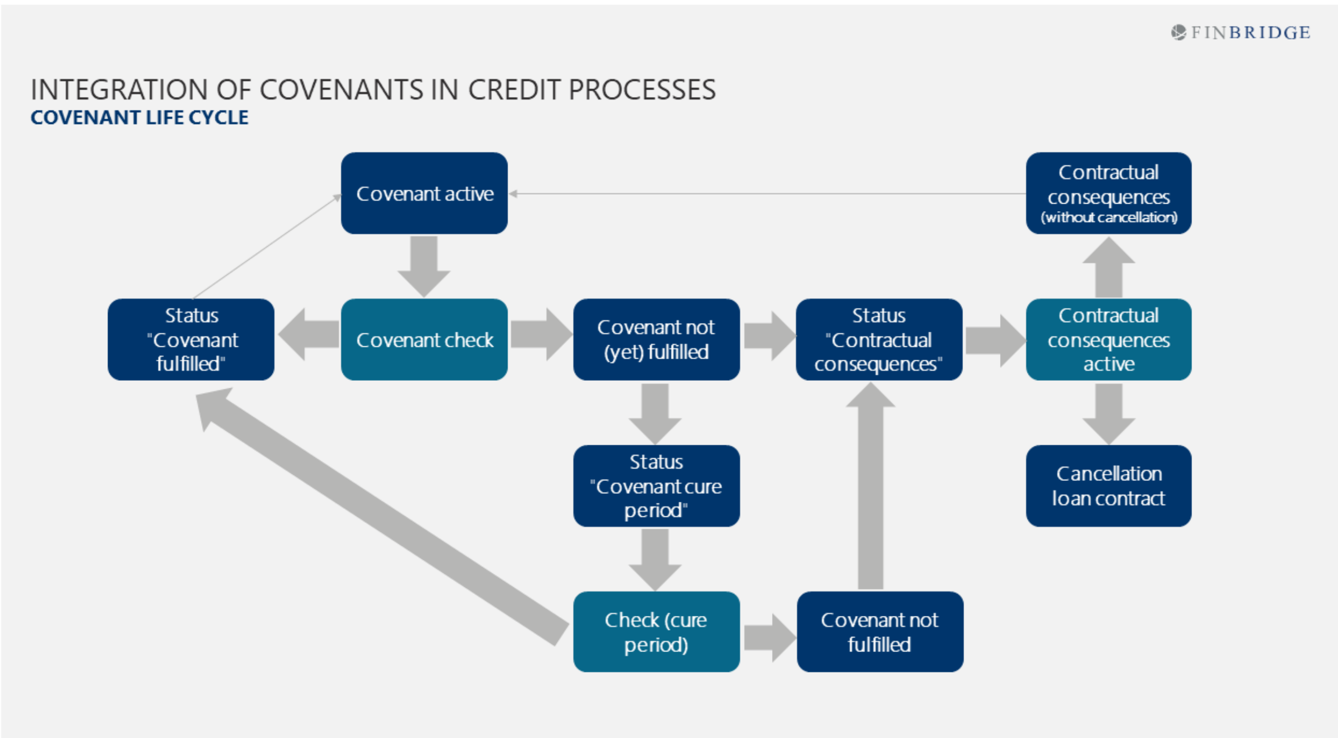

Figure 2: *Covenant Life Cycle*

module, the challenge is that the covenant result must be transmitted to the credit system in time for the contract consequences to become effective and must be assigned to the corresponding credit agreement.
Through a comprehensive **status concept for monitoring and testing processes**, the life cycle of a covenant can be mapped from input through regular inspections to possible contract consequences or cure periods. The goal is to avoid error-prone manual processes.
Since covenant agreements can be very individually designed, special features such as the delayed effect of contract consequences (e.g. interest rate adjustments on the next interest rate fixing date) or the use of waivers or the temporary suspension of covenants must be taken into account.
Also, the **consolidation of stand-alone solutions**, which may have arisen in different areas, leads to a more efficient integration of covenants in the bank's credit processes.

Consulting Approach

The implementation and consolidation of the presented covenant management processes offer a wide range of potential for optimization and automation. We support you in optimally integrating covenants into your credit processes:

- Mapping of various types of covenants (financial and non-financial covenants)
- Automation of contract consequences and deadline monitoring
- Development and implementation of workflows for monitoring and checking covenants
- Comprehensive process analysis and identification of automation potential
- Embedding the credit system in the target IT-architecture and consolidating existing stand-alone solutions
- Conception of incoming and outgoing interfaces

Based on many years of project experience in the field of structured finance, our comprehensive knowledge of various credit solutions and our specialized know-how we develop a tailor-made solution to the needs of your institute and accompany you from conception to implementation.
Feel free to contact us at any time!

About Finbridge

Finbridge is an independent specialised consultancy to financial services. With over 90 highly qualified consultants, Finbridge offers tailor-made implementation approaches throughout the entire process chain. Finbridge supports banks and financial services successfully in designing and implementing change processes resulting from new regulatory requirements, innovative financial products or adjustments to business models in risk controlling, regulatory reporting, trading and settlement.

Contact Information

FINBRIDGE
based on competence and commitment

Alexander Pauli
Senior Manager

Finbridge GmbH Co. KG
Louisenstraße 100
61348 Bad Homburg
www.finbridge.de

Telefon: +49 6172 499770
Telefax: +49 6172 49977-11
Mobil: +49 151 58 25 90 04
alexander.pauli@finbridge.de

FINBRIDGE
based on competence and commitment

Ann-Christin Gerstner
Consultant

Finbridge GmbH Co. KG
Louisenstraße 100
61348 Bad Homburg
www.finbridge.de

Telefon: +49 6172 499770
Telefax: +49 6172 49977-11
Mobil: +49 151 58 06 21 95
ann-christin.gerstner@finbridge.de