MBA

MARYLAND BANKERS ASSOCIATION

Credit Decisions & Management

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Abrigo

MARYLAND BANKERS ASSOCIATION
MARYLAND BANKING SCHOOL
Credit Decisions and Management (Year II)
Syllabus – 2023
Kent Kirby (Kirby)

Course Description: *Explore (in some detail) the basic strategic framework for making credit decisions and managing the business once the decisions are made.*

Course Objectives: *To better understand the strategic framework for credit decision making and management so that you can advocate for a sustainable environment that works for your institution and stakeholders (and satisfies the agencies).*

Format: *Lecture, Q&A and Discussion*

I. Prologue: Why are we here?
    a. Why do banks fail?
    b. Stewardship
    c. Balancing meeting the needs of the community while maintaining the safety and soundness of the institution

II. Part 1: Basic Considerations (Session 1)
    a. Risk Appetite
    b. Policy, Guidance and Procedure
    c. Risk Rating Framework
    d. Financial vs Business Risk

III. Part 2: Credit Decisions (Session 2)
    a. Consumer, Small Business and Commercial
    b. Does the borrower know why they want the money?
    c. Pro-forma and Projections
    d. Exceptions
    e. Covenants
    f. The Role of Effective Challenge

IV. Part 3: Credit Management (Session 3)
    a. Concentration Management
    b. Ongoing Monitoring Requirements
    c. Annual Review Process
    d. Problem Loan Identification and Management

V. Post-Script: Other Considerations

a. Staffing
b. Regulation => Public Policy
c. "Behavior" (i.e., "Alternative") Scoring
d. Non-bank alternatives
e. ESG (Environmental, Social, Governance)
f. Artificial Intelligence

Session 1

BASIC CONSIDERATIONS

Credit Decisions and Management

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Agenda

1 Why are we here?

2 Risk Appetites

3 Policy Guidance and Procedure

4 Risk Ratings

5 Financial vs. Business Risk

Prologue – Why are we here?

- Why ARE YOU here?
- Why do banks fail (root cause analysis)?
- Concept of Stewardship
  - Motivation of (your) Creditors
  - Motivation of (your) Debtors
- Balancing the needs of the community while maintaining the safety and soundness of the institution
  - Fair Lending – doing right by all major segments of your community
- Housekeeping
- Questions?

ADD A FOOTER TITLE

Does everyone understand our risk appetites?

For that matter, do you have any? Does (do) it (they) make sense?

- Financial Stability Board – Principles of an Effective Risk Appetite Framework (2013)
  - Risk appetite statement
  - Risk limits
  - Roles and responsibilities
- Articulation of our philosophy toward realistic risk taking
- Best practice – plural, not singular
  - General statement
  - Specific to major lines of business and/or product types
- If you don't have an effective appetite regime, the default becomes "Let's throw it against the wall and see if it'll stick."
- Example of general risk appetite: As far as is manageable, our book should reflect the economic make-up of the communities we serve.
- Questions?

Are our policies and guidances clear, consistent, and accessible?

AND are they being consistently applied?

- Difference between Policy, Guidance and Procedure
  - Policy - articulates the fundamental principles of how the FI will operate in the arena
    - Changes infrequently
    - Requires agreement at all levels of the enterprise
  - Guidance – articulates the risk appetite of the bank and how the risk appetite is to be executed at a strategic level
    - Consistent with policy
    - Changes are possible; Credit Policy Committee (ERM) approval
  - Procedure – articulates the day-to-day activity required to execute the guidance
    - Changes frequently; manager approval
- Simple and Succinct
  - Length and complexity breed confusion => disinterest
  - Don't cross the streams
- Applies to everybody, including you….
- Questions?

Intermission

Is our risk rating framework robust enough to ascertain the quantity <u>and</u> velocity of risk?

AND are we risk rating accurately?

- Quantity - granularity is critical (no more than 15-20% in a bucket)
  - Balancing act – has to be understandable conceptually (6-10 pass ratings)
- Velocity - pick up deterioration before it picks up speed
  - Risk is not linear!!!!
- Objective (non- black box) framework
  - Financial (45-50%), industry (15%), qualitative factors (35-40%)
    - Financial - Typically looking in the rearview mirror
      - Consider doing risk rating post-financing
    - Industry - Consider third party subscription
    - Qualitative – focus on "governance" (management, succession, controls, etc.)
- Focus on pass ratings – "regulatory" is its own world and hard to quantify
- "Conservative" risk rating practices are NOT your friend.
- Takeaway: Personally risk rate the borrowers of the top 25 relationships in your bank by your gut. Match your experience against your framework.
- Questions?

Risk in a Credit Transaction

- What do you think are the major risks in a transaction?
- Financial Risk
  - Banks have 70-100% of financial risk
  - Borrowers have 0-30% of financial risk
- Business Risk
  - Banks have 0% of business risk
  - Borrowers have 100% of business risk
- **Trick is to manage business risk (without appearing to be managing the company) to ensure financial risk is minimized**
- Questions

Session 1 - Recap

Takeaways to remember

- Financial Institutions don't own jack – they are stewards of other peoples' money
- Risk Appetite(s) articulate where you are willing to place your bets and how much you are willing to place (strategically and tactically)
- The more prescriptive you make Policy, the more headache you cause for little gain – be gentle on yourself; give yourself wiggle room
- Risk rating frameworks don't have to be complicated. They do have to be robust enough to provide insight into the granularity of risk in your portfolio. AND they have to be objective enough that a "reasonable" person can understand them
- Financial Institutions walk into EVERY transaction at a disadvantage. The trick is to lower that discrepancy to a manageable level.

Session 2

CREDIT DECISIONS

Credit Decisions and Management

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EXAMINING INDUSTRIES – WHAT MATTERS? 2

Agenda

Consumer, Small Business, Commercial

General Considerations

- Consumer
  - Typically to finance consumption
  - Public Policy considerations
  - Automation an established process
- Small Business
  - Operate in an environment unique from consumer and commercial
  - Public Policy considerations
  - Cost vs benefit in underwriting
- Commercial
  - Debt vs leverage
  - Size matters (need to watch those eggs)
  - Wide variety of complexity
- Participations
  - Syndication vs Participation
  - You're taking someone else's trash
  - Loss of control
  - Counterparty analysis is as critical as credit analysis

Are the right questions being asked on each credit?

The Five Questions you want folks to be asking

1. **Is the business plan of the borrower adequately explained**? Does it make sense? Is it being followed? If they are deviating from historical practice, do we know why and are we comfortable with that? Are governance and control issues adequately explained and/or mitigated?
2. **Is the analysis consistent with the complexity of the transaction**? What are the industry considerations? What are the threats and opportunities? Is the financial analysis consistent with the numbers presented? Are concentrations/aberrations/outliers properly explained?
3. **Does the deal make sense**? Is the structure of the deal consistent with the economic use of proceeds and risk that the bank is taking on? Do covenants make sense to the deal? Are aberrations properly mitigated?
4. **Are there exceptions that affect the risk rating of the deal**? What are they and why do they affect the rating? Do we still want to do the deal? If yes, what can be done to change that assessment?
5. **On problem loans, is there a workout plan and is it workable**? If Special Mention, what are the transition elements and is the timeline clearly outlined? If Substandard, what are the performance metrics that lead to an upgrade or defer non-accrual? If non-accrual, what are the metrics that defer charge-off?

Pro-forma and Projections

It’s not an academic exercise to satisfy the CCO

- What is your institution’s policy on pro-forma and projections?
- When are they appropriate?
  - Time matters; risk matters
  - Anticipated impact of the financing transaction (I know it when I see it)
- Pro-forma
  - What the borrower looks like 1 second after the deal is funded
  - Risk rating factors should be based off the pro-forma, not the historical
- Projections
  - **BORROWER’S** quantitative articulation of the business plan
    - Are they consistent?
  - How you will be repaid over a reasonable time period

Where are we allowing exceptions?

And why?

- What's your definition of an exception? What's your least favorite exception (and why)?
- Rule #1 – Exceptions have to hurt
  - The issue is not that an exception exists, but WHY it exists?
    - Avoid pet peeves
    - Risk based exceptions
  - Mitigants matter, as long as they are legit
- Three characteristics of an exception
  - Specific
  - Well defined risk justification for the exception
    - Exceptions to exceptions can create confusion – balancing act
  - How long an exception will exist and the path to clear/mitigate it is clearly articulated
- Hold the right people accountable for the exception and make sure they know it
- Concept – a policy (guidance?) ON exceptions
  - What's the exception? What does it take to clear it? How long does it live?

Intermission

What's a covenant?

- What a covenant is NOT
  - Representations and Warranties
  - Default provisions (a covenant breach IS an event of default)
- What a covenant IS
- It's all about CONTROL
  - Motivate behavior
  - Compensate for the increased risk in the transaction
    - Time
    - Risk Rating deterioration due to the financing transaction
    - Inherent riskiness of the transaction (e.g. ABL)
  - Exercise your rights in the event of default

Types of covenants

- Capital (Incurrence) covenants
  - Deals with the capital structure of the borrower
- Performance ("Financial") covenants
  - Tripwires on operating efficiency
- Administrative covenants
  - Information needed to understand and monitor the situation
  - No-brainers: need 'em regardless
  - Full-term mortgages are not an excuse to avoid exercising prudence
- Sidebar: Positive and negative covenants

When are covenants appropriate?

- **When you need a path to return to an Original State (or better)**
  - **Appropriateness of pro-forma / projections – see it as a basis for covenant building**
  - **Risk rating on pro-forma / projections (and root cause analysis)**
- MYTH: All term loans require (non-administrative) covenants
  - No, they don't
  - Some short-term facilities may require covenants (e.g. ABL)
- DON'T SET THE BORROWER UP TO FAIL!!!!!
  - 'One size fits all' is a prescription for failure
  - Stair step approach
    - Pricing tied to stair steps is not uncommon
  - Sidebar: Standardized covenants – benefits and pitfalls
- Myth: Competitive pressures require us to mitigate or forgo covenants
  - There is no written or unwritten law that requires you to accept a facility strictly on a borrower's terms
- Make sure you get what you **need** to monitor the situation (depends on what the situation is)
  - May be more than financial statements

Ok, they blew a covenant. Now what?

- Technical Event of Default
  - The last thing you want to do is accelerate payment
  - Root cause analysis
  - What's a REASONABLE action plan?
  - Helps to begin with the end in mind when building covenants
- Waiving a blown covenant is ok…up to a point
  - Beware of "course of dealing"
  - Make it clear that things are not normal here
  - It's not only ok to get paid – probably a sin if you don't
- Sidebar: Forbearance
  - Pandemic vs. work-out

Example #1 – Generational Transfer

- Borrower is buying Parent's dental practice. Terms are 50% cash and 50% on a five year note. Borrower projects to increase business 20% p.a. over five years (basically doubling the business).
- Considerations for Covenants
  - Capital
    - Subordination of parent debt – possibly require no/reduced payments for first year (or two?)
      - Flesh out if one or two families living out of this practice
        - Building lease (check that out!!)
      - If Pari-passu, parents guarantee debt (potential Reg B issues)
    - Limitation on salary (possible stair step)
      - Focus on building the business – meet that 20% growth goal
    - Limitation on equipment financing w/o bank approval
    - Consideration of gov't program (i.e. SBA)
  - Financial
    - Leverage ratio to decline over the five year period (based off projections)
    - DSC ratio based on projected income from practice (should tie with leverage ratio)
    - Possible Dental KPIs (production per new patient, case acceptance) – I prefer to monitor as opposed to control.
  - Administrative
    - Financials
    - Periodic Internal reports (dashboard metrics)
    - Operating accounts at bank (auto-debit requirement)
    - Business Insurance
    - Key man Life Insurance

Am I providing effective challenge?

Who is challenging ME?

- Three lines of defense
  - First line – owns and manages the risk
  - Second line - strategic framework and oversight
    - Identify and address emerging risks
  - Third line – objective and independent assurance (Audit)
- NOT just being tough in loan committee/approval
  - Holistic credit risk framework
    - Test – "blame game"
  - Am I playing by the same rules?
- Internal or external loan review is part of the process
  - Providing effective challenge for you
- Self-reflection: Where are YOUR biases? What is YOUR dark matter?
- Takeaway: NETWORK!!!!!
  - Smart credit is not a strategic advantage; it's a survival skill
  - ThinkBig Conference
  - Any interest in an Abrigo facilitated practitioner's forum?

Session 2 - Recap

Takeaways to remember

- The credit decision process is the process to understand (and to some extent control) business risk so that the protection of your financial risk in enhanced
- "Projections" is the quantitative articulation of the borrower's business plan to manage business risk. Pro-forma is what the business looks like 1 second after the deal is funded
- Exceptions need to hurt to be effective
- Covenants (if done correctly) are the most effective way to manage business risk
- You need to understand where you are coming from in the decision process BUT
  - If the deal doesn't make sense to you, it probably doesn't make sense

Session 3

CREDIT MANAGEMENT

Credit Decisions and Management

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Agenda

1 Concentration Management

2 Ongoing Monitoring

3 Annual Reviews

4 Problem Loan Management

5 Other Considerations

Do I have the right data to know what the hell is going on?

Banks are data organizations. Most are dysfunctional. Many are just plain broken

- Data is an organism that requires care and feeding
- Data governance is a thing
  - Internal standards for how data is gathered, stored, processed and disposed
  - A simple question
  - Collaboration and agility
- Data should not reside on Gilligan's Island
  - Ideal state – centralized repository ("data lake")
- Reconsider your "source(s) of truth"
  - Governance around those sources
- Baby step – Identify five (or so) critical data elements and focus on cleaning them up and developing a governance framework to keep them clean
  - Commercial: risk rating, collateral code, call code, NAICS code, class code (catch-all)
  - Are they consistent (e.g., Call, collateral and ledger codes)

Are concentration (risk) limits identified and clearly communicated?

AND, are we following them?

- What is a concentration?
  - Regulatory definition – 25% of Tier 1 Capital + ACL
  - Kirby definition – it can hurt you, or at least get your attention (risk limits)
    - Adversity, or the threat of adversity, causes you to change your strategic outlook and the way you do business
- Tied to risk appetite (and portfolio risk assessment)
- A tiered approach to limits is a best practice
  - Tiers need a basis that is understood and accepted by the board and executive management
  - Not all risk are equal => limits are not uniform
  - Capital (Y axis) and WARR (x axis) are good benchmarks as that's your skin in the game
- Thresholds at the segment aggregate and sub-aggregate is a best practice
  - Sum of Sub-aggregates can exceed the aggregate (the aggregate is a governor)
- What happens when we approach a threshold? Breach it?
- Are thresholds part of the business development process?
- Takeaway: work with the board to establish a stoplight threshold framework for the top five credit risk areas in the bank (and have a reason why the thresholds exist)

Do we really understand the risks in areas of expansion? Have risks in our core competencies shifted?

Do we understand the Dark Matter?

- What in the heck is "Dark Matter?"
- What can affect credit risk?
  - Economic, environmental, political, regulation, obsolescence, etc etc etc
  - How far back do you peel the onion?
- Most "Black Swans" are really "Gray Rhinos"
- Buying (and selling) risk requires heightened scrutiny
  - Loss of control
  - Counterparty analysis and concentration limits should be considered
- There are resources out there to help – taking the time to understand what they are trying to tell you is righteous time

Intermission

Ongoing Monitoring Requirements

- What is your bank's monitoring requirements?
- General Considerations
  - Depends on the complexity of, and risk in, business risk
- Short-term horizon (<24 months)
  - Trade cycle
  - Specialized lending requirements
  - Refinancing risk
- Long-term horizon (>24 months)
  - Covenant testing
    - Make the borrower do it
  - Industry (product) considerations

ADD A FOOTER TITLE

Annual Reviews

It's NOT Loan Review

- Under what circumstances do you all require an annual review?
- What an Annual Review is (and isn't)
  - Not a renewal
  - Not a problem loan
  - Can't do anything that is not contractually allowed
  - It is chance for credit approvers to monitor progress when no financial transaction is present
  - Opportunity for additional business
- Requirements for the annual review process
  - Risk based
  - Should not exceed (or equal) requirements for initial underwriting

Abandoning the Titanic

Trick is to let the other unfortunate wretch remain on ship

- What is your bank's primary early warning system for problem loan identification?
- Special Assets people - #1 thing people could do to avoid a problem situation?
- Early warning system
  - Risk ratings
    - Transitory nature of Special Mention
  - Relationship Manager
- Exit strategies
  - Relationship Strategy - Expand/Stable/Decrease/Exit
  - When is the right time to sell, and to who (Centerre effect)?
    - How much of a loss are you willing to incur?
- Relationship Management considerations

Post-script: Other Considerations

Are the right people in the right place doing the right thing?

AND being incented in the right way?

- Considering the complexity of the credit:
  - Is credit being underwritten by people who have the right skill sets?
  - Is credit being approved by people who have the right skill sets?
    - Are Lending Authorities appropriate for the skill set?
  - Is credit being managed by people who have the right skill sets?
- Are people using their time wisely?
  - Business development people shouldn't be writing credit memos
- Can technology help? Can centralization help?
  - We make our money in pennies. We lose it in dollars
- Your loan review team (internal or external) can (should) help in the assessment
- Incentive plans
  - What behavior do I want to incent?
  - Do I have the right people in the pool?

Miscellaneous and Sundry Discussion Items

(If we have time)

- Role of regulation
- Behavior ("alternative") scoring
- Non-bank competitors
- ESG (environmental, social, governance)
- Artificial Intelligence

Session 3 - Recap

Takeaways to remember

- Data matters
- Clear articulation of, and adherence to, concentration limits matter
- #1 concern of Credit Management – what is obvious that I'm missing?
- Monitoring requirements vary – what is consistent is the need to monitor
- The trick to problem loan management is to let someone else worry about it
- People will behave in a manner that is profitable to them

Thank you