



Building Success. Together.

# Credit Risk Management: Principles & Practices, Tools & Techniques

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# Course Objectives

- Recognize credit risk's prominence among all the enterprise risks
- Acknowledge that successful risk management starts with managing credit risk
- Explain the key role of credit culture in managing credit risk
- Offer some methods for measuring and managing credit risk
- Learn how to
  - Identify your bank's credit culture, appetite, and tolerance and
  - Employ policy to align it with your bank's credit risk strategies



# Agenda

- Credit risk and enterprise risk
- Credit risk management and credit culture
- Types of credit culture and credit risk management framework
- Risk appetite vs. risk tolerance and transaction-intrinsic-concentration risk
- Risk ratings
- Credit policy
- Loan structure, conditions, and covenants
- Credit administration
- Summary & closing



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## Credit Risk's Prominence among All Risks across the Enterprise

Credit risk	Default, counterparty, concentration, sovereign—ability and willingness to repay
Operating risk	Operational (internal control, compliance, technology, settlement, fraud), business
Market	Interest rate (funding, prepayment, spread), trading (volatility)
Liquidity	Funding mismatch, access to capital
Reputation	Regulatory, public relations, shareholder relations
Strategic	Competitive, execution

# Credit Risk Defined

- Risk that a customer, counterparty, or issuer may not perform in accordance with contractual terms resulting in potential loss of value in assets; unable or unwilling to
  - Pay in full from
    - Cash flow
    - Collateral
    - Guarantees
  - Pay on time
    - At maturity
  - Pay as agreed
    - Comply with all conditions and covenants



## Successful Risk Management Requires Identification of Risks in all the Bank's products and services

Risk	Content of Risk	Product or Service
Credit risk	Default, counterparty, concentration, sovereign	
Operating risk	Operational (internal control, compliance, technology, Settlement, fraud), business	
Market	Interest rate (funding, prepayment, spread), trading (volatility)	
Liquidity	Funding mismatch, access to capital	
Reputation	Regulatory, public relations, shareholder relations	
Strategic	Competitive, execution	

- ▶ So how do you identify and mitigate all these risks on new credit products and services?
  - ▶ Easy—set up PRAC . . .

## Product Risk Assessment Committee (PRAC) assignments for evaluating risk in new products and services

Risk	Description	PRAC Assignment
Credit risk	Default, counterparty, concentration, sovereign	Chief credit officer or designee
Operating risk	Operational (internal control, compliance, technology, Settlement, fraud), business	Ops risk manager or designee
market	Interest rate (funding, prepayment, spread), trading (volatility)	Investments manager or designee
liquidity	Funding mismatch, access to capital	Finance manager or designee
reputation	Regulatory, public relations, shareholder relations	Legal, audit, and/or risk review
strategic	Competitive, execution	President or designee

Try the PRAC approach at your bank, you might like it!

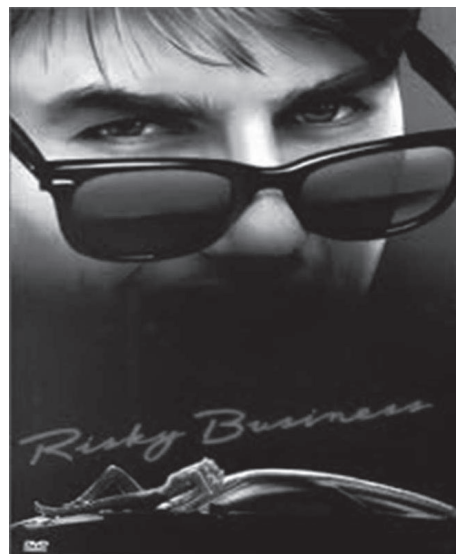
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# Role of Credit Risk Management

•To ensure stability and orderly growth of shareholder value by managing credit risk through:

- formulation and enforcement of prudent credit policy
- accurate identification of risk and sound credit approval decisions
- timely monitoring and reporting of credit risk management performance



## Key Elements of Credit Risk Management

### – Key Elements

- Risk tolerance
  - Risk measurement
  - Risk strategy
  - Portfolio management
  - **Credit culture**
- Now let's assemble these key elements into a cultural framework for achieving our desired credit risk management



## Credit Culture Defined

- Values, beliefs and practices that drive behavior
- “How we do things around here”
- The thread that binds the organization



## Why Is Culture Important?

- Focuses the organization—everyone on the same page
- Reduces organizational conflict and confusion—priorities
- Minimizes need for rigid controls
- Supports commitment to the organizational vision and mission

# High Performance & High Quality Built on Strong Credit Culture

- Top-performing banks all show high asset quality, typically measured and monitored by these 6 ratios:
  - % 30- day delinquent/loans outstanding
  - % 90+ days delinquent/loans outstanding
  - % criticized assets/loans outstanding
  - % classified assets/loans outstanding
  - % non-accruals/loans outstanding
  - % net charge-offs/loans outstanding
- Good asset quality results from good credit risk management
- The best credit risk managements promote and maintain strong credit cultures

## Optimal Credit Culture

- Top management sets asset quality as a corporate priority and says so regularly
- Line mgt consistently supports asset quality objectives
- Policies written in collaboration with line, approved, monitored, and enforced by independent CRM across various LOB portfolios
- Policy exceptions infrequent and mitigated
- Credit standards, credit policy, business plans, and incentive plans are in sync
- Credit discipline tools are in place . . .



# Credit Discipline Tool Checklist

- What the tools mean . . .

Tool	Explanation
1. Written credit policies	Written policies applicable to all the bank
2. risk-driven credit analysis	Scope and depth increase with risk and total borrower exposure
3. Uniform credit packages	One credit package format used across the bank
4. Experienced underwriting	Underwriters are skilled, trained, experienced, especially in CRE, ABL, etc
5. Informed decision-making	Credit approver has enough information in time to make sound decision
6. Proper loan approval	Credit approver with sufficient authority approves the loan
7. Valid, granular risk rating system	No bunching--enough grades to evaluate both default and loss probabilities
8. Legally enforceable loan documents	All the docs needed to ensure legally, enforceable loan gets closed
9. Reliable closing and booking	Loan is closed and booked as approved
10. Loan performance monitoring and reporting	Periodic, frequent monitoring and reporting of asset quality
11. Independent loan review & audit	Loan review and audit are independent of lending units they monitor
12. Adequate ALLL	ALLL is sufficient to absorb losses
13. Skilled problem asset management	Problem assets are transferred from line lender to problem asset officer
14. Credit and lending training	Training is conducted regularly for all levels of credit risk and lending



## 2. Credit Discipline Tool Checklist Self-Check

- How many of these tools does your bank have?

Credit Discipline Tool	Yes/ No?	If no, who will develop & implement?	Completion Deadline	Status/Update
1. Written credit policies				
2. risk-driven credit analysis				
3. Uniform credit packages				
4. Experienced underwriting				
5. Informed decision-making				
6. Proper loan approval				
7. Valid, granular risk rating system				
8. Legally enforceable loan documents				
9. Reliable closing and booking				
10. Loan performance monitoring & reporting				
11. Independent loan review & audit				
12. Adequate ALLL				
13. Skilled problem asset management				
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## Credit Risk Management Framework

1. Set Corporate Priority	2. Pick culture	3. Select credit risk strategy	4. Determine degree of risk management	5. Implement policy, process, & procedure to support risk mgt
Asset Quality	Values driven	Conservative	Influencing	Guidance
Mix of AQ and G/MS	Immediate performance driven	Managed	Directing	Governance
Growth/Market Share (G/MS)	Production driven	Aggressive	Controlling	Directives
No clear priorities	unfocused	Various	Commanding	Commands

# Credit Risk Management Framework— 1-Set Corporate Priority

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# 1. Credit Risk Management Framework— Set Corporate Priority



1. Set Corporate Priority	2. Pick culture	3. Select credit risk strategy	4. Determine degree of risk management	5. Implement policy, process, & procedure to support risk mgt
Asset Quality (AQ)	Values driven	Conservative	Influencing	Guidance
Mix of AQ and G/MS	Immediate performance driven	Managed	Directing	Governance
Growth/Market Share (G/MS)	Production driven	Aggressive	Controlling	Directives
No clear priorities	unfocused	Various	Commanding	Commands

## Credit Risk Management Framework for Implementing Desired Credit Culture — 2-Pick Culture

1. Set Corporate Priority	2. Pick culture	3. Select credit risk strategy	4. Determine degree of risk management	5. Implement policy, process, & procedure to support risk mgt
Asset Quality	<b>Values driven</b>	Conservative	Influencing	Guidance
Mix of AQ and G/MS	<b>Immediate performance driven</b>	Managed	Directing	Governance
Growth/Market Share (G/MS)	<b>Production driven</b>	Aggressive	Controlling	Directives
No clear priorities	<b>unfocused</b>	Various	Commanding	Commands



## 2. Analysis of 4 Types of Credit Cultures

CULTURE TYPE → ANALYSIS	Values (GOOD) 	Immediate performance	production	Unfocused (BAD) 
Top priority	L-T consistent performance	Current earnings, stock price	Market share, loan growth, & loan volume	Changes frequently
Driving force	Corporate values & market consistency	Annual profit plan	Commitment to be the largest	Management reacts by changing priorities
Credit environment	Strong credit organization, few policy exceptions	Credit quality emphasized in strong economy but loosens in weak economy	Strong systems, controls, & good credit leadership, but credit told to find a way to do the deal	Line produces, credit tries to respond to frequent changes in direction
Hidden policy	Not a factor—consistent with written policy	Conflict with written policy during soft loan demand	Lenders' job is to produce regardless of written policy	Lenders confused by inconsistency and shifting priorities
Success factor	Balance between credit quality & revenue generation	Credit has to be strong enough to resist line pressure to do riskier deals in down cycles	Credit must control loan approval process, keep individual authorities low, & resist production pressure	Credit quality depends on strong policies, systems, and leadership
Culture Vocabulary	Quality, balance, soundness, prudence, ownership, conservative	Quality loan volume, balance, aggressive, growth-oriented	Market share, growth-oriented, aggressive, loan volume	Creative, think out of the box, fluid, dynamic responsive



## Credit Risk Management Framework— 3-Select Credit Risk Strategy

1. Set Corporate Priority	2. Pick culture	3. Select credit risk strategy	4. Determine degree of risk management	5. Implement policy, process, & procedure to support risk mgt
Asset Quality	Values driven	<b>Conservative</b>	Influencing	Guidance
Mix of AQ and G/MS	Immediate performance driven	<b>Managed</b>	Directing	Governance
Growth/Market Share (G/MS)	Production driven	<b>Aggressive</b>	Controlling	Directives
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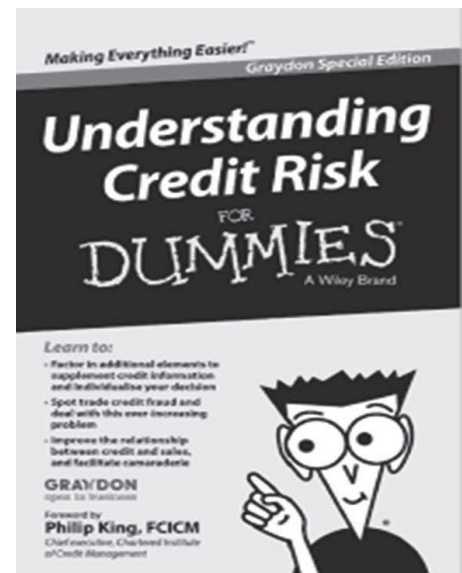
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# Risk Appetite = Risk Tolerance?

- Risk Appetite
  - Amount and type of risk a bank is **willing** to accept in pursuit of its business objectives
  - Bank will expand its SBA loan exposure by 20% annually over next 3 years
- Risk Tolerance
  - Specific maximum risk bank is **able** to take
  - Bank's SBA loan portfolio must meet 15% minimum RAROC
- Risk Appetite vs Risk Tolerance
  - Wants (appetite) vs. needs (tolerance)
  - You might want a pitcher of beer, but one 12-oz glass is all you can tolerate and still comply with state's blood alcohol limit

## Risk Measurement Predictors

- Short-term, right now . . .
  - Past-dues, NPA's, criticized, classified, NCO's
- Medium-term, a little more lead time
  - Watch lists
  - Past-due and Loss trends
- Long-term, one to two years out . . .
  - Risk rating distribution (transaction risk)
  - Exposure to high-risk types of lending (intrinsic risk)
  - Concentrations (concentration risk)
  - Administrative (credit-related operational risk)
    - Credit policy and loan documentation exceptions
    - Stale financial statements
    - Stale renewals and annual reviews
    - Excessive loan extensions



# Risk Tolerance and Measurement

- Risk Appetite (RA) vs.. Risk Tolerance (RT)—how much do you want vs.. need?
  - Where in RA range can bank operate profitably and prudently?
- CAMELS rating as a proxy for risk tolerance
  - Graded 1 to 5 on 6 areas--**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, **S**ensitivity to Market Risk—and then assessed a final composite grade
  - Composite grades: 1-2 good, 3-4 not so good, 5 goodbye
- Risk Tolerance-Risk Measurement example:

- Too little risk
- Too much risk

Measure	RT Limits	Year 1	Year 2	Year 3	Year 4
30 days pd	.50-.75	.50	.60	.75	1.25
90 days pd	.05-.10	.01	.10	.12	.25
Criticized	1.25-1.50	1.25	1.30	1.50	2.60
classified	.25-.75	.50	.60	.80	1.50
Non-performing	.05-.10	.02	.04	.10	.35
NCO's	.25-.50	.02	.05	.35	.75



## Maintaining Risk-Reward Balance

- Achieving adequate reward for risk
  - Pricing must reflect risk
    - Rate, fees, services, deposits, other?
    - Cost of funds—average, current cost, other?
    - Income from other sources?
    - ROE, RAROC, other?
  - Pricing must be disciplined
    - Based on risk rating
    - Exceptions require one-up approval



## Pricing Discipline

Minimum Rate Based on collateral and guarantees	Risk Rating		
	1-3	4-5	6-9
Secured by liquid collateral	P	P + 1	P + 1.5
Secured by properly margined real estate	P + 1	P + 1.5	P + 2.0
Secured by properly margined receivables or inventory	P + 1.5	P + 2.0	P + 2.5
Secured by any other assets	P + 2.0	P + 2.5	P + 3.0
Unsecured	P + 2.5	P + 3.0	P + 3.5
If guaranteed, reduce minimum rate by factor based on guarantor's risk rating	1-3 rated guarantor = reduce minimum rate by 1.0 4-5 rated guarantor = reduce minimum rate by 0.5 6-9 rated guarantor = reduce minimum rate by 0.25 If multiple guarantors, use average rating weighted by guaranteed exposure		

## How Banks Get into Trouble

- Poor risk assessment
  - Too many risky borrowers
- Excessive exposure to risky types of lending
  - Too many second mortgage loans
  - Too many spec construction loans
- Concentrations of aggregate risk
  - Lend too much to one borrower
  - Lend too much to one place
  - Lend too much to one industry
  - Lend too much in one bank line of business (LOB)





## Types of Risks

Type of Risk	Definition	Measurement
Transaction (T)	Risk in individual transactions	Measured by risk rating system
Intrinsic (I)	Risk associated with LOB's	Measured in LOB sub-segments by risk scoring process
Concentration (C)	Risk from aggregated exposures by borrower, LOB, industry, geography, etc.	Measured as % of capital

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## Transaction Risk (T): Risk rating distributions

Grade	Left Bank	Right Bank
1 best	5	5
2 good	20	15
3 average	35	20
4 acceptable	25	30
5 marginal	10	25
6 OAEM(SM)	2	3
7 substandard	3	2
8 doubtful	0	0
9 loss	0	0
TOTAL (%)	100	100



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7 substandard	3	2
8 doubtful	0	0
9 loss	0	0
% Average or Better—(1 +2+3)	60	40
% Acceptable and Worse— (4+5+6+7+8+9)	40	60
% Marginally Acceptable and Worse— (5+6+=7+8+9)	15	30
% Criticized and classified—(6+7+8+9)	5	5
TOTAL (%)	100	100



## Cumulative risk rating distributions to determine risk profile

Cumulative Risk Ratings (%)	Left Bank	Right Bank
A-Average or better	60	40
B-Acceptable and worse	40	60
C-Marginally acceptable and worse	15	30
D-Criticized and classified	5	5
<b>RISK PROFILE</b>	<b>Low/mod/high?</b>	<b>Low/mod/high?</b>
<b>Low risk profile:</b> $\geq 75$ -80% in average or better risk profile (A above) or $\leq 5\%$ in marginally acceptable and worse (C) <b>Moderate risk profile:</b> 50+% in average or better (A) <b>High-risk profile:</b> 50+% in acceptable and worse (B) or 20-25% in marginally acceptable and worse (C)		



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## Three Types of Risks

Type of Risk	Definition	Measurement
Transaction (T)	Risk in individual transactions	Measured by risk rating system
Intrinsic (I)	<b>Risk associated with LOB's</b>	<b>Measured in LOB sub-segments by risk scoring process</b>
Concentration (C)	Risk from aggregated exposures by borrower, LOB, industry, geography, etc.	Measured as % of capital

## Intrinsic Risk (I): LOB Risk Ratings

high-risk	Spec CRE construction Asset based lending Credit cards
High to moderate	Ag operating and equipment Consumer indirect Spec residential construction
Moderate	Presold residential construction Commercial permanent Commercial and industrial CRE construction (owner-occupied) Ag real estate
Low to moderate	Consumer direct Municipalities
Low	Home equity Residential mortgage Government guaranteed student loans

## Risk rating distributions

LOB Distribution	Left Bank	Right Bank
Spec CRE construction	0	12
Consumer Indirect	5	8
Spec Residential Construction	0	18
Presold Residential Construction	13	25
Commercial & industrial	22	22
Consumer direct	23	10
Home equity	10	0
Residential Mortgages	27	5
TOTAL (%)	100	100



## Intrinsic risk—Left vs. Right?

### • Who's Intrinsically Riskier?

LOB Distribution	Left Bank	Right Bank
Spec CRE construction	0	12
Consumer Indirect	5	8
Spec Residential Construction	0	18
<b>% High and High Moderate</b>	<b>5</b>	<b>38</b>
Presold Residential Construction	13	25
Commercial & industrial	22	22
<b>% Moderate</b>	<b>35</b>	<b>47</b>
Consumer direct	23	10
Home equity	10	0
Residential Mortgages	27	5
<b>% Low and Low Moderate</b>	<b>60</b>	<b>15</b>
TOTAL %	100	100
<b>INTRINSIC RISK—HIGH/MODERATE/LOW?</b>	<b>?</b>	<b>?</b>

### ► Intrinsic Risk Guidelines

- Low intrinsic risk
  - <15% of portfolio in high-risk types or
  - <20% in high and high moderate or
  - >40% in low and low moderate
- Moderate intrinsic risk
  - 15-25% of portfolio in high-risk types or
  - 20-30% in high and high moderate
- High intrinsic risk
  - >25% of portfolio in high-risk types
  - >30% in high and high moderate



## Intrinsic risk—Left vs. Right?

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<b>TOTAL %</b>	<b>100</b>	<b>100</b>
<b>INTRINSIC RISK— HIGH/MODERATE/LOW?</b>	<b>LOW</b>	<b>HIGH</b>

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## Three Types of Risks

Type of Risk	Definition	Measurement
Transaction (T)	Risk in individual transactions	Measured by risk rating system
Intrinsic (I)	Risk associated with LOB's	Measured in LOB sub-segments by risk scoring process
Concentration (C)	Risk from aggregated exposures by borrower, LOB, industry, geography, etc.	Measured as % of capital



## Concentration Risk (C) Guidelines

Concentration	Low	Moderate	High
Geographic	<40% of outstandings	40-60	60+
Borrower	<50% capital	51-100	101+
Industry	<50% of capital	51-100	101+
LOB	<100% capital	101-150	151-250



## Concentration Risk—Left vs. Right?

Concentration	Left Bank		Right Bank	
geographic	High	H	High	H
borrower	Moderate	M	High	H
industry	Low	L	Moderate	M
LOB	High	H	High	H
Concentration Risk (L/M/H?)	1L, 1M, 2H=> MOD High		0L, 1M, 3H=> HIGH	
Notes				
1. Both serve markets concentrated in and around small cities				
2. Outstanding debt of Left Bank's 10 largest borrowers = 70% of capital vs. Right Bank's 100+%				
3. Left has one industry with 60% of capital vs. Right's 110%				
4. Both have LOB's >150% of capital; Left's is residential mortgages and Right's is residential construction				

Risk	Guidance to Assessment of Degrees of Aggregate Concentration Risk							
	Low	L-M	L-M+	Mod	M-H	H-M-H	High	H+
Low (L)	4	3/2	1	0	1/0	0	0	0
Mod (M)	0	1/2	3	4	1/3	2	1/0	0
High (H)	0	0/0	0	0	2/1	2	3/4	4



## TIC Summary of Left and Right Banks

Type of Risk	Left Bank	Right Bank
Transaction (T)	Moderate	High
Intrinsic (I)	Low	High
Concentration (C)	High-Moderate	High
Conclusion	A little too much C	T, I, C

## Credit Risk Management Guidelines

- ▶ **Never allow**
  - High levels of transaction risk
  - High levels of intrinsic and concentration risk in combination
  - Any risk (T,I, or C) to exceed the first (lowest) third of the high-risk category
- ▶ **Aggregations from most to least dangerous**
  - T,I,C = lending too much in risky ways to high-risk borrowers
  - T, I = combo of high-risk borrowers and high-risk types of lending
  - T, C = lending too much to high-risk borrowers
  - T = lending to high-risk borrowers
  - I, C = high exposures to risky types of lending
  - I = risky types of lending
  - C = exposure needs to be spread around more
- ▶ **Never get TIC'd off!**



## T-I-C Risk Strategy Alternatives

Some Risk Strategy Alternatives	T	I	C
Reduce exposure to marginally acceptable borrowers	X		
Manage risk distributions by LOB	X		
Set exposure limits by risk rating	X		
Limit exceptions to collateral LTV's and guarantees	X		
Reduce exposures in riskier LOB's		X	
Exit ABL lending		X	
Grow lower risk LOB's		X	
Buy and sell participations to reduce concentrations			X
Set concentration limits on high-risk LOB's			X
Raise limits for lower risk LOB's			X

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# Risk Rating Principles

- Have enough risk ratings to separate out good, bad, ugly
  - No more than 30% of loans in any one rating
  - Pass ratings and classified ratings (SM, Substd, Dbtfl, N-A, Loss)
  - So most banks need 8 to 10 risk ratings
- Final risk rating estimates potential loss (EL) based on:
  - Probability that borrower will default (PD)
  - Probable loss given default (LGD)
  - Credit Exposure at time of default
  - Example:
    - $PD (10\%) \times LGD (50\%) \times \$1MM \text{ outstanding} = EL \text{ of } \$50M$
- Observations on PD and LGD
  - PD rises as borrower size decreases and loan term increases
  - LGD rises as collateral type becomes more illiquid and LTV increases
  - 2-dimensional risk ratings—obligor and facility
- Tip: Monitor stale ratings, risk rating migration, top 10 riskiest borrowers by line of business and for entire bank; watch out for single borrower concentrations



# Obligor Risk Rating

- Obligor rating is based on probability of default (PD) determined by borrower's ability to repay

Rating	PD %	GDSC	Liquid assets	Relationship track record, credit score, etc.
1	1			
2	10			
3	15			
4	20			
5	30			
6	40			
SM	50			
SS	80			
Doubtful	90			
Loss	100			

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# Example of Obligor Risk Rating

- Obligor rating is based on probability of default (PD) determined by borrower's ability to repay

Rating*	PD	GDSC	Liquid assets	Relationship track record, credit score, etc.
1	1	>1.50x	LA/TBE > 100%	FICO > 800
2	10			
3	15			
4	20			
5	30			
6	40	<1.00	LA/TBE < 0%	FICO < 600
SM	50			
SS	80			
Doubtful	90			
Loss	100			
*If transaction is placed on non-accrual, then PD is 100% regardless of rating.				

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## Facility Risk Rating

- Facility rating is based on LTV & liquidation value of collateral type

Rating	A-well secured	B-sufficiently secured	C-insufficiently secured	D-definitely unsecured
CRE Example LTV ≤ 80%	LTV = 50%	LTV = 80%	LTV = 90%	unsecured
1				
2				
3				
4				
5				
6				
7=SM				
8=SS				
9=Doubtful				
10=Loss				

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## Definitions of facility collateral classes

- Classes
  - Well Secured
    - A cash, marketable securities
  - Sufficiently Secured
    - B+ real estate
    - B ABL managed receivables & inventory
    - B- perfected security interest in receivables & inventory
  - Insufficiently Secured
    - C+ intangible assets—copyrights, patents, trademarks
    - C blanket lien on assets
    - C- springing lien, negative pledge, comfort letter
  - Unsecured
    - D unsecured

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## Example of Facility Alpha Rating Determined by Collateral Type & LTV

Collateral Type	LGD (%) by collateral type and LTV(A)									
	A-Well Secured			B-Sufficiently Secured			C-Partially Secured			D-Unsecured
LGD Alpha Rating	A+	A	A-	B+	B	B-	C+	C	C-	D
Loss Given Default (%) (D)	1-5	6-10	11-19	20-25	26-30	31-35	36-40	41-45	46-50	51-100
Cash or mkt sec	1-75	76-90	91-100							
Real estate & fixed assets				1-50	51-80	81-100				
ABL managed AR & Inv (B)					1-50	51-80	81-100			
Perfected sec int AR & inv						1-50	51-80	81-100		
Intangible assets (C)							1-50	51-80	81-100	
blanket lien on assets								1-50	51-80	
Contingent collateral (E)									1-100	
Unsecured (F)										No LTV

(A) If LTV for any asset collateral exceeds 100%, the portion of the exposure left unsecured is to be assigned at least a 51% LGD and weight –averaged with secured portion to arrive at final LGD, e.g., \$1MM loan secured by \$800 CD, final credit approver assigns 5% to \$800M and 51% to unsecured \$200M to arrive at \$40M + \$102M = \$142M/\$1MM = 14.2% for final LGD A- rating.

(B) ABL regimen imposed—borrowing base, audits, cash dominion

(C) Intangible assets include copyrights, patents, trademarks

(D) Final credit approver has authority to select specific LGD to be used within range for alpha rating

(E) Contingent collateral—springing lien, negative pledge, comfort letter

(F) Unsecured transaction must be assigned LGD of at least 51%

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## Installing a Risk Rating Matrix in Your Bank

Example of a 2-dimensional risk rating grid with EL in bps, e.g., 1%=100bps

Obligor Rating		Facility Rating			
Obligor Rating	Obligor's P(D)	A-well secured	B-sufficiently secured	C-insufficiently unsecured	D-definitely unsecured
		LGD=5%	LGD=20%	LGD=40%	LGD=50%
1 Very Strong	1%	EL=5 bps	EL=20bps	EL=40bps	EL=50bps
2 Strong	10%	50	200	400	500
3 Sound	15%	75	300	600	750
4 Acceptable	20%	100	400	800	1000
5 Marginal	30%	150	600	1200	1500
6 Weak	40%	200	800	1600	2000
7=SM	50%	250	1000	2000	2500
8=SS	80%	400	1600	3200	4000
9=Doubtful	90%	450	1800	3600	4500
10=Loss	100%	500	2000	4000	5000

## Strategies Based on Risk Rating (RR), Total Borrower Exposure (TBE), and Portfolio Management (PM) to Reduce T-I-C Risk

Strategies	RR	TBE	PM
1-Increase # of risk ratings if any category holds 30% or more of transactions	X		
2-Adopt risk rating system with at least 2 pass grades below average	X		
3-Set exposure limits for these two lower grades	X		
4-Prune weak performers in these two lower grades	X		
5-Set maximum TBE by risk rating		X	
6-Limit 2 lowest pass grades' TBE < best grade's TBE		X	
7-Limit high-risk portfolio distribution (T)			X
8-Reduce or eliminate high-risk aggregations (T+I)			X
9-Set maximum exposures to high-risk lending types (I)			X
10-Reduce exposure to large borrowers (C)			X

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## Credit Risk Management Framework— 4-Determine Degree of Risk Mgt

1. Set Corporate Priority	2. Pick culture	3. Select credit risk strategy	4. Determine degree of risk management	5. Implement policy, process, & procedure to support risk mgt
Asset Quality	Values driven	Conservative	Influencing	Guidance
Mix of AQ and G//MS	Immediate performance driven	Managed	Directing	Governance
Growth/Market Share	Production driven	Aggressive	Controlling	Directives
No clear priorities	unfocused	Various	Commanding	Commands

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## Determining Degree of Risk Management

Degree	Description
Influencing-- Values	<ul style="list-style-type: none"> <li>◦Strong credit organization, few policy exceptions</li> <li>◦Balance between credit quality &amp; revenue generation</li> </ul>
Directing-- Immediate Performance	<ul style="list-style-type: none"> <li>◦Credit quality emphasized in strong economy but loosens in weak economy</li> <li>◦Credit has to be strong enough to resist line pressure to do riskier deals in down cycles</li> </ul>
Controlling-- Production	<ul style="list-style-type: none"> <li>◦Strong systems, controls, &amp; good credit leadership, but credit told to find a way to do the deal</li> <li>◦Credit must control loan approval process, keep individual authorities low, &amp; resist production pressure</li> </ul>
Commanding— Unfocused	<ul style="list-style-type: none"> <li>◦Line produces, credit tries to respond to frequent changes in direction</li> <li>◦Credit quality depends on strong policies, systems, and leadership</li> </ul>

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## Agenda

- Credit risk and enterprise risk
- Credit risk management and credit culture
- Types of credit culture and credit risk management framework
- Risk appetite vs. risk tolerance and transaction-intrinsic-concentration risk
- Risk ratings
- **Credit policy**
- Loan structure, conditions, and covenants
- Credit administration
- Summary & closing

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## Credit Risk Management Framework— 5-Implement Policy, Process & Procedure

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## Credit Discipline Tool Checklist

- What the tools mean to you . . .

Tool	Explanation
1. Written credit policies	Written policies applicable to all the bank
2. risk-driven credit analysis	Scope and depth increase with risk and total borrower exposure
3. Uniform credit packages	One credit package format used across the bank
4. Experienced underwriting	Underwriters are skilled, trained, experienced, especially in CRE, ABL, etc
5. Informed decision-making	Credit approver has enough information in time to make sound decision
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11. Independent loan review & audit	Loan review and audit are independent of lending units they monitor
12. Adequate ALLL	ALLL is sufficient to absorb losses
13. Skilled problem asset management	Problem assets are transferred from line lender to problem asset officer
14. Credit and lending training	Training is conducted regularly for all levels of credit risk and lending

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## 1-Written Credit Policies

- Approve, maintain & sustain Bank's credit culture and risk appetite and risk tolerance
  - Support Bank's credit strategy with practical guidance for managing credit risk
    - Analysis & underwriting
    - Approval & lending
    - Monitoring and reporting

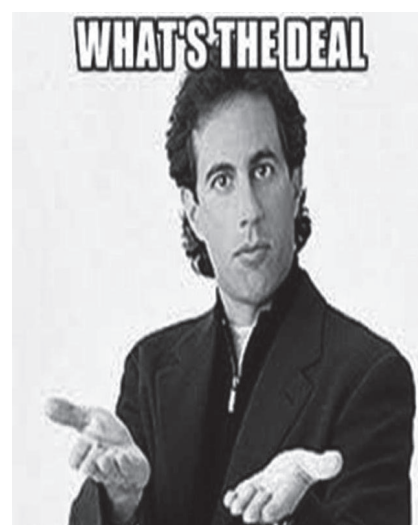


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## OCC Policy Expectations

OCC has its own hitlist of subjects it expects to see in a good loan policy:

- 1) loan authorities;
- 2) limits on aggregate loans and commitments;
- 3) portfolio distribution by loan category and product;
- 4) geographic limits;
- 5) desirable types of loans;
- 6) underwriting criteria;
- 7) financial information and analysis requirements;
- 8) collateral and structure requirements;
- 9) margin requirements;
- 10) pricing guidelines;
- 11) documentation standards;
- 12) collections and charge-offs;
- 13) reporting requirements;
- 14) guidelines for loan participations; and
- 15) off-balance sheet exposure.
- 16) effective risk management tool across all loan portfolios.



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# OCC Policy Expectations

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- 14) guidelines for loan **participations**; and
- 15) **off-balance sheet** exposure.
- 16) effective **risk management tools** across all loan portfolios.

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# FDIC Expectations on Credit Policy Content

- What the FDIC examiner expects to see in the examinee's credit policy:
  - General fields of lending in which the bank will engage and the kinds or types of loans within each general field
  - Appropriate and adequate collection procedures including, but not limited to, actions to be taken against borrowers who fail to make timely payments
  - Lending authority of each loan officer
  - Limitations on the extension of credit through overdrafts
  - Lending authority of a loan or executive committee, if any
  - Limitations on the maximum volume of loans in relation to total assets
  - Responsibility of the board of directors in reviewing, ratifying, or approving loans
  - Description of the bank's normal trade area and circumstances under which the bank may extend credit outside of such area
  - Guidelines under which unsecured loans will be granted
  - Guidelines, which at a minimum, address the goals for portfolio mix and risk diversification and cover the bank's plans for monitoring and taking appropriate corrective action, if deemed necessary, on any concentrations that may exist
  - Guidelines for rates of interest and the terms of repayment for secured and unsecured loans
  - Guidelines addressing the bank's loan review and grading system ("Watch list")
  - Limitations on the amount advanced in relation to the value of the collateral and the documentation required by the bank for each type of secured loan
  - Guidelines addressing the bank's review of the Allowance for Loan and Lease Losses (ALLL)
  - Maintenance and review of complete and current credit files on each borrower
  - Guidelines for obtaining and reviewing real estate appraisals as well as for ordering reappraisals, when needed
  - Guidelines for adequate safeguards to minimize potential environmental liability
- The bank's executive team and Board of Directors also should determine what additional policies and procedures need to be implemented to
  - incorporate the bank's general loan philosophy, risk appetite, and strategic plans for the bank's future.
  - Does the bank intend to lend more heavily in commercial real estate? If so, perhaps the bank needs to devise policies that deal specifically with real estate volatility risk. Is the bank more focused on consumer lending and growing low-cost deposits throughout its community? Then there ought to be policies that support its consumer banking and depository strategies. The FDIC also suggests establishing a well-rounded loan review system, credit grading system, preferred qualifications of loan review personnel, maintaining adequate ALLL, and enumerating the responsibilities of the Board and executive management.



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## Where Good Policy Comes from--Consensus

- Recommendations developed on collaborative basis among line, credit, audit, credit review, regulators, legal counsel, senior management ...
- Line-credit-others task force evaluates issues and recommends policy changes to their policies
- Credit Policy reviews and recommends policy proposals to appropriate approval body
- Approved policy is published

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## Policy Template “Look and Feel”

Sections	Description	•Example: Guarantees
Scope	Explains who must comply	Applies to all LOB's
Roles & Responsibilities	Describes the parties impacted by the policy and their responsibilities with the policy	<ul style="list-style-type: none"> <li>•RM</li> <li>•Underwriter</li> <li>•Credit approver</li> <li>•Loan Doc &amp; Closing</li> </ul>
Policy Elements	Core components of the policy	<ul style="list-style-type: none"> <li>•When guarantee is required</li> <li>•When it's not</li> <li>•Exception approval</li> </ul>
References	Other related policies or reference information	<ul style="list-style-type: none"> <li>•Loan documentation &amp; closing policy</li> <li>•Risk rating policy</li> </ul>
Point(s) of Contact	Key contact information for the policy	<ul style="list-style-type: none"> <li>•Legal department</li> <li>•Loan doc prep and closing</li> <li>•Credit policy</li> </ul>
Glossary	Definition of key terms covered in the policy	<ul style="list-style-type: none"> <li>•Types of guarantees</li> <li>•Consideration</li> </ul>
Appendix	Documents relevant to the policy	<ul style="list-style-type: none"> <li>• standard guarantee form</li> </ul>
Change Log	Logs significant changes to the policy since the last version	<ul style="list-style-type: none"> <li>•Dec 2013: limited guarantees OK if they add up to at least % of credit exposure</li> </ul>

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## Policy or Procedure?

- Regulatory expectation—policy and subordinate procedures should be current and in sync
- One person's perfect policy is another's petty procedure . . . But here's some guidance on sorting policy from procedure:

Policy vs.. procedure?	Policy	Procedure
Application	Widespread	narrow
Change	Changes less frequently	Prone to more frequent change
Scope	Usually expressed in broad terms and addresses major issues	Often stated in detail and describes process
Content	Addresses questions of: <ul style="list-style-type: none"> <li>■What</li> <li>■why</li> </ul>	Addresses questions of: <ul style="list-style-type: none"> <li>■How</li> <li>■When</li> <li>■who</li> </ul>
Responsibility	Credit Risk Management	Line of Business Management if LOB has infrastructure in place to keep procedure current. If not, policy will have to contain procedure, too

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## Policy Writing Rules of Thumb

- Policies vs. procedures
- Principles vs. practices
- Requirements vs. guidelines
- Responsibility and authority
  - Who is responsible for doing the work or the task
  - Who must approve the work
  - If rejected or declined, resolution or appeal process to bring closure
- Maximums and minimums
  - > vs. ≥ and < vs. ≤
  - At least, up to and including, or more
- English, not legalish
  - Wherefore, therefore, and heretofore = why, so, and before
- Strunk & White's *Elements of Style*—be succinct
  - As of now = now
  - In the event = if
  - Accordingly = then
- Tone
  - Should, would, could—no good
  - Should => is to, is, must
  - Neutral tone—typically, usually, generally
  - Use active tense, avoid passive tense
  - Positive requirements work better than negative constraints
- Pareto's law is the norm
  - Deal with 80-90% of the items, not the 10-20%
  - Treat the 10-20% group as exceptions with appropriate one-up approval and violations appropriately punished
    - Never legalism works—ineligible instead of prohibited
- Keep it timeless
  - Current events belong in Newsweek or on CNN, not in policy
  - Titles, no names

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## How to tell if your policy is due for a tune-up

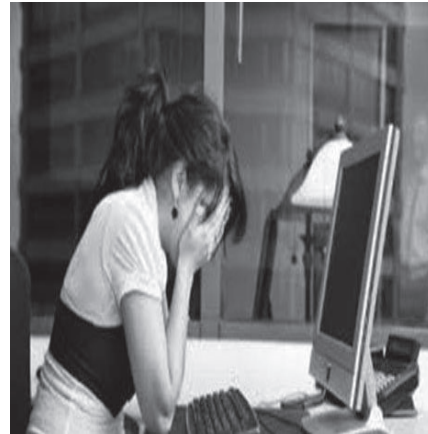
- Your policy is probably due for a tune-up if:
  - 1) Policy has not been revised or re-approved in more than a year
  - 2) Multiple versions of policy are circulating
  - 3) Policy contains addendums still not incorporated into it
  - 4) Policy contains misspellings, typos, and/or grammatical errors
  - 5) Anachronistic functional titles still in policy and/or new titles not yet in policy
  - 6) Designated trade territory includes areas no longer served and/or new areas not yet included
  - 7) Discontinued products and services still in policy and/or new ones not yet included
  - 8) Superseded regulations still in policy and/or new ones not yet included

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## Behind Out-of-date Policies Lie These Bigger Issues

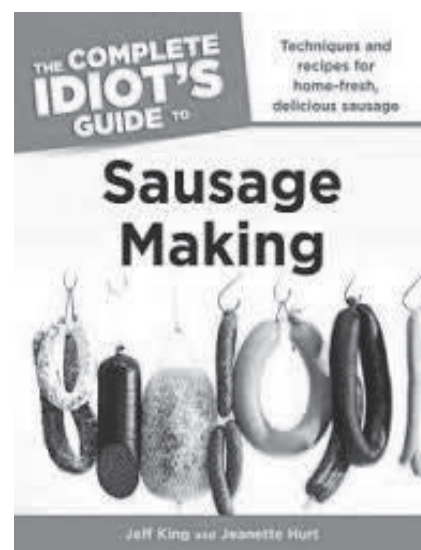
- Actual lending practices vary from policy
- Increasing numbers of policy exceptions are occurring in deal flow
- Policy limits are being breached and no one is being held accountable for breaches or their resolution



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## Credit Process

- **Credit information**
  - Internal—depository, credit experience
  - External—credit agency reports, credit scores, trade, other lends
- **Credit analysis**
  - Degree of analysis depends on risk and exposure
  - **Repayment**
    - Cash flow
    - Collateral
      - LTV's
      - Appraisals
      - Environmental assessments
    - Guarantees
    - Other credit enhancements or cushions of protection?
- **Underwriting**
  - Terms
  - Conditions
  - Covenants
  - Exceptions to policy
  - Risk rating—line recommends, credit concurs, loan review checks
- **Credit approval**
  - Signatures or Committee
  - Concurrence with, not waiver of, policy and documentation exceptions



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## Credit Policy Contents

- 1. Regulatory and legal compliance
- 2. Lending limits
  - Concentration limits
- 3. Lending authorities
- 4. Credit process
  - Evaluation
    - Credit information
    - Credit analysis
      - Cash flow
      - Collateral—LTV's, appraisals, environmental risk assessment
      - Guarantees
  - Underwriting
    - Terms
    - Covenants and conditions
    - Exceptions to policy
    - Risk rating
  - Credit Approval Document
- 5. Documentation of Decision
- 6. Administration

### THE ROAD TO NOWHERE



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## So how does your bank's contents compare?

Credit Policy Contents	Your Bank's Contents?	Gap Resolution Plan?
1. Regulatory and legal compliance		
2. Lending limits and concentration limits		
3. Lending authorities		
4. Credit process		
•Evaluation		
-Credit information		
-Credit analysis		
•Cash Flow		
•Collateral		
•Guarantees		
•Underwriting		
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•Exceptions to policy		
•Risk rating		
•Credit Approval		
5. Documentation of Decision		
6. Administration		

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# Credit Policy Exceptions

- Selection
  - Evaluate problem loans
    - lenders, credit approvers, loan review officers, work-out specialists look for common analytical and underwriting defects, e.g., insufficient or inadequate repayment sources—cash flow, collateral, guarantees—resulting in loss to bank
  - Analyze the defects to determine most significant PE's
    - Decide which PE's to “track”
      - Validate connection between TPE's and problem assets
  - Define PE
    - clear and measurable
      - Quantitative—minimum or maximum
      - Heuristic—yes or no
      - Specificity—not ambiguous, e.g., “should,
    - Avoid ambiguity and excessive conditionality
      - “should,” “prefer,” “encourage,” “discourage”
      - PE is cited if A or B but not if B also includes C or D is greater than A . . .

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## Common Trackable Obligor – Obligation TPE's

- Most TPE's are obligation-specific, e.g.,
  - One obligation may be guaranteed, another may not be
  - One obligation may meet LTV requirements, another may not
- But a few TPE's are obligor-specific, e.g., financial info, DSC, etc.
  - For example, count financial statements once against obligor, not against each obligation
  - Likewise, cite DSC against obligor, not against each obligation
- Obligation and obligor TPE's

Obligation	Obligor
10 guarantor	11 borrower
13 loan term	12 DSC
14 amortization	15 financial statement quality
18 undesirable collateral	16 TBE
19 max LTV	17 higher risk/undesirable industry
20 exceeds FIDICIA LTV	30 time in business
21 appraisal	55 LFT
22 environmental risk	
23 speculative purpose	
36 unsecured LOC	
50 LOC clean-up	
40 pre-leasing/pre-sales	
41 leasing/occupancy rate	
43 release prices	
44 max LTC	
45min equity	





# TPE's—Citation Issues & Remediation

## Citation Issues

- Recognition
  - at inception, renewal, or other credit action
  - By lender, approver, or loan reviewer?
- Approval options
  - Recognition vs decision to make loan
  - Recognition vs waiver of TPE
  - “One-up” approval required of loans with TPE
- Post-recognition
  - Point-in-time vs over life of loan
  - Potential for TPE to be cured over time

## Remediation

- Training options
  - All lenders
  - Lenders with high rate of TPE's
  - Other participants?
- Consequences
  - Lending authority—reduction, suspension?
  - Compensation—“credit administration” factor in performance review
  - Job—transfer to problem asset unit or loan review unit, probation or termination



# Credit Discipline Tool Checklist

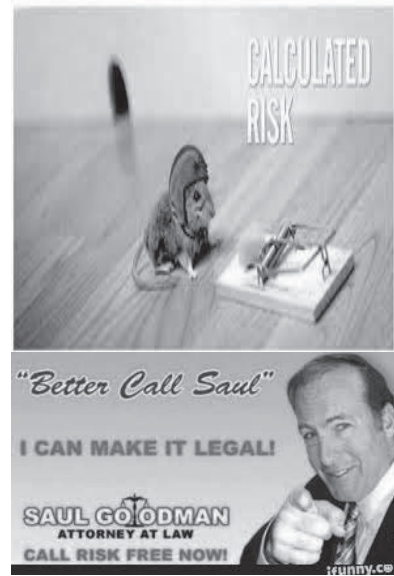
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## 2-Risk Driven Credit Analysis

- The larger the exposure and the worse the risk rating, the riskier the request
- The riskier the request, the more thorough the analysis must be
- Credit analysis must answer question about borrower's ability to repay
- Require management to conduct mandatory annual training to keep lenders and credit approvers updated on current policy for analysis and underwriting with emphasis on:
  - Ranges for key numerical targets, e.g., LTV ratios, loan portfolio segment limits
  - Responsibility for enforcing and monitoring loan policy requirements
  - Documentation requirements for various types of loans
  - Remedial measures or penalties for loan and documentation policy exceptions
  - Preparation and content of loan approval requests
  - Individual and committee lending authorities limits
- Tip: monitor loan review's critique of credit analysis quality, watch out for rising trend in past-due annual reviews & renewals



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## 3-Uniform Credit Package

- ▶ If goal is better, faster, cheaper—then standardize the deal package
  1. Purpose
  2. Amount
  3. Repayment terms
  4. Pricing
  5. Collateral and guarantees
  6. Conditions and covenants
  7. Repayment ability from cash flow, collateral, and guarantees
  8. Policy exceptions
  9. Risk rating
  10. Approval
- ▶ Put more effort into new deals, complex credits, expedited review of creditworthy clients
- ▶ Tip: monitor turn-around time on credit packages—if slow, is it lack of info or lack of resources, or imbalance between effort and risk?



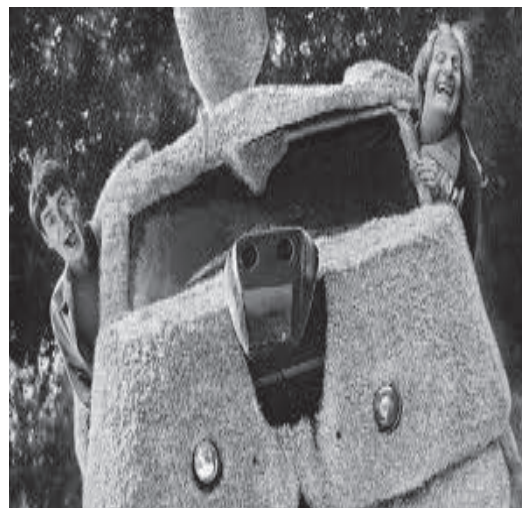
## Credit Discipline Tool Checklist

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Tool	Explanation
1. Written credit policies	Written policies applicable to all the bank
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14. Credit and lending training	Training is conducted regularly for all levels of credit risk and lending

## 4. Experienced Underwriting

- ▶ General C&I lending
- ▶ Typical specialized lending
- ▶ Evidence of lenders' & approvers' experience, training and skills
  - ▶ Commercial Real Estate
  - ▶ Ag lending
  - ▶ ABL
  - ▶ Floor plan lending
  - ▶ SBA
  - ▶ Energy
- ▶ Tip: periodic review of specialized lending production, lenders, approvers & asset quality trends; beware of concentration risk



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## 5. Informed Decision-Making

- Early involvement of credit approver
- Rising policy exceptions(PE's) as red flags
- Tip: monitor
  - % of approved deals/total deals
  - % of approved deals w/PE's
  - % of approvals requiring loan committee (LC) & executive loan committee (ELC) approval



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## 5. Lending Limits

- Total borrower exposure
- Legal limit
- House limit
- Portfolio concentration limits
  - Any single borrower or borrowing entity
  - Industry
  - Geography
  - Line of business
  - Other: Product, Term, Rate, etc.

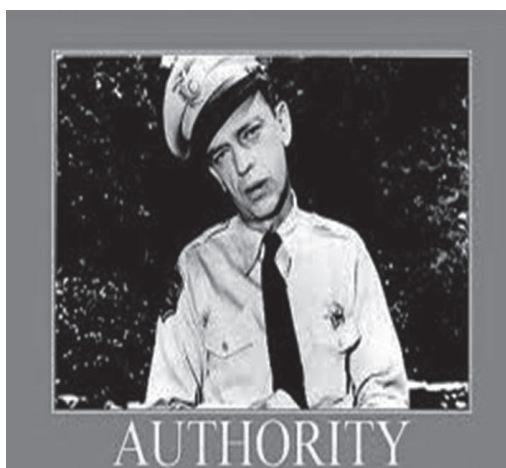


“A man’s just gotta know his limits . . .”

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## 5. Lending Authorities

- Individual authorities vary by
  - Position
  - Risk
    - Obligor
    - facility
  - Exposure
    - Transaction
    - TBE



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## 5. Lending authorities grid

Position	1-3 Rating	4-5 Rating	6-7 Rating Criticized & Classified	8-9 Rating Non-Accrual & Charge-off
Lending Officer	250	125	0	0
Lending Manager	500	250	0	0
Senior Lender	1,000	500	0	0
Credit Officer	2,000	1,000	500	250
Loan Committee	5,000	2,500	1,000	500
Special Assets Officer	0	0	2,000	1,000
Chief Credit Officer or Bank President	Legal lending limit	Legal lending limit	Legal lending limit	Legal lending limit
Notes: • Authority level should be based on TBE, not transaction size • Cash-secured credit is often twice the stated TBE limit, but attention must be paid to documentation. • Authority level should permit 60 to 80% of loans with no policy exceptions to be approved by concurrence of line lenders and credit officer • Real estate lending authority to REDI and Co-REDI borrowers should be restricted to officers with CRE skills and experience • Loans with policy exceptions are typically approved by one-up approval • Problem loan management should be restricted to special assets officer, CCO, and/or bank president, including approval of non-accrual, write-downs, and charge-offs.				

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## Agenda

- Credit risk and enterprise risk
- Credit risk management and credit culture
- Types of credit culture and credit risk management framework
- Risk appetite vs. risk tolerance and transaction-intrinsic-concentration risk
- Risk ratings
- Credit policy
- **Loan structure, conditions, and covenants**
- Credit administration
- Summary & closing

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## Structure—making sure we get repaid

- Structure deals to ensure borrower repays
  - In full
  - On time
  - As agreed
- As agreed means setting some conditions and covenants
  - Conditions-what we expect from borrower at inception
  - Covenants-what we expect borrower to do or not do over life of loan



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## Examples of Covenants

Covenant Examples	Affirmative	Negative
Quantitative (Financial)	Current Ratio $\geq 2.0x$  NWC $\geq \$500,000$	Debt/Worth $\leq 3.0x$  Annual CAPEX $\leq \$100,000$
Qualitative	Quarterly financial statements within 15 days of quarter-end  Annual unqualified audited financial statements prepared by CPA satisfactory to Bank submitted within 120 days of FYE	No borrowing from other lenders without Bank's prior approval  No acquisition or disposition of subsidiary entities without Bank's prior approval

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## Policy & Administrative Considerations

- Borrower compliance with covenants
  - Setting ticklers for covenant compliance
    - How much time to give borrower?
    - Reviewing borrower's compliance with covenants
      - Lender or Credit Officer?
      - Others?
    - Frequency
      - Should not exceed borrower's financial statement frequency
- Non-compliance
  - Establish deadline for decision, action, notification
    - Internal actions
      - » Waiver, restructure, or demand for payment?
      - » Approval of action
    - External actions
      - » Notification of borrower and guarantors
      - » Execution of action—waiver, demand for payment

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## Manage the ends, not the means

- Manage the results, let the borrower manage how to achieve them:
  - Set a net worth & NWC minimum, if the borrower decides to pay dividends or pay bonuses, borrower still has to meet NW and NWC minimum
  - Let borrower figure out how to balance CAPEX, NWC, cash balances, officers' compensation, dividends, draws, etc.
- Monitor & manage covenant compliance
  - Timely receipt of financials & compliance certificate, e.g., NLT 30 Days of month-end, quarter-end, etc.
  - Prompt written response OK'd by credit approver to out-of-compliance event, e.g., 30 days of receipt of compliance certificate
  - Waiver should come at a cost to borrower, e.g., higher interest rate, reduction in exposure, more frequent monitoring, etc.
  - But only monetary defaults are worth calling the loan . . .

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## 5. Credit Discipline Tool Checklist

- What the tools mean to you . . .

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## 5. Documentation of Decision

- Documentation needed to book legally enforceable loan
  - Note
  - Loan agreement
  - Security perfection
  - Insurance
  - Other
- Closing-Booking Decision
  - Approved = closed = booked = funded?
  - Dry closing until all critical docs received?
  - Closing without all critical docs should be one-up approval
- Documentation exceptions
  - Occur when missing, incomplete, or inaccurate
  - Exist over life of loan until renewal or restructuring when opportunity to cure them; they should not be waived

## 8-Legally Enforceable Loan Docs

- ▶ Standard docs preferable
- ▶ Loan doc exceptions (LDE's)
  - ▶ Missing
  - ▶ Incomplete
  - ▶ Erroneous
- ▶ Common errors
  - Filing the perfection document in the wrong location
  - Using the wrong borrower/debtor name
  - Not obtaining the proper authorization documentation
  - Improper assessment of lien position
  - Failing to amend your UCC-1
  - Failing to continue or terminate your UCC-1
  - Leaving items to post closing or making exceptions
  - Failing to properly monitor your borrower's post closing documentation obligations
  - Inadvertently waiving rights
- ▶ Tip: monitor loan doc exceptions by line of business, lenders with most doc exceptions, loan doc training program—remedial training for lenders with excessive LDE's



## 9-Reliable Closing & Booking

- ▶ Audit check
  - ▶ Approved=closed=booked=funded?
- ▶ Loan doc prep and closing and funding process
- ▶ Tip: monitor these ratios to find out where prospective borrowers might be dropping out:
  - ▶ % of closed loans/approved loans
  - ▶ % of booked loans/closed loans
  - ▶ % of funded loans/booked loans



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# Credit Administration

- Credit files
  - Primary credit file
- Collateral files
  - Original loan documents
- Monitoring and portfolio management
  - Financial statements
  - Credit scores and risk rating changes
  - Periodic review/renewal
  - Policy exceptions
  - Documentation exceptions
  - Independent risk review and audit function
  - Allowance for loan and lease losses (ALLL)
- Remediation
  - Problem asset management for classified loans
  - Separation of problem assets from line of business
  - Strategy—repair or exit?



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## 10. Loan Performance Monitoring and Reporting

- ▶ Short-term, right now . . .
  - ▶ Past-dues, NPA's, criticized, classified, NCO's
- ▶ Medium-term, a little more lead time . . .
  - ▶ Watch lists
  - ▶ Past-due and Loss trends
- ▶ Long-term, one to two years out . . .
  - ▶ Risk rating distribution (transaction risk)
  - ▶ Exposure to high-risk types of lending (intrinsic risk)
  - ▶ Concentrations (concentration risk)
  - ▶ Administrative (credit-related operational risk)
    - ▶ Credit policy and loan documentation exceptions
    - ▶ Stale financial statements
    - ▶ Stale renewals and annual reviews
    - ▶ Excessive loan extensions
- ▶ Tip: monthly reporting of asset quality and credit administration measures



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## 11-Independent Risk Review and Audit Functions

- Independence
  - Ideally, risk review and audit functions report to board of directors, not to line or credit
    - Risk review to risk committee
    - Audit to audit committee
- Function
  - Risk review usually concentrates on assets, loan transactions
  - Audit typically examines processes, operations
- External liaisons
  - Risk review often liaises with bank examiners
  - Audit generally works with bank's accounting firm
- Tip: ensure these units report to board or its risk committee, not to bank management



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## Successful Loan Review (LR) Function's Characteristics

Characteristics	Explanation
1. Tone from top	Board and CEO are responsible for clear decisions, investments, & management actions that emphasize and respect need for LR to provide effective challenges. Nothing happens without a firm commitment, codified in policy and supported by resources and compensation
2. Independence	Organizational structure must demonstrate LR's independence from credit function with solid line to full board or board committee
3. Skill parity	To counter loan officer's deep knowledge about borrower relationship and portfolio, LR skill set must be maintained by ongoing training, assignment rotation, industry certification, & internal peer review
4. Governance	LR managers attend critical governance committee meetings as ex officio members and be assigned to own discrete portfolios within bank monitoring their performance business-unit-generated reports and LR metrics
5. Off-season coverage	Stay in contact between exams to monitor performance, keep apprised of personnel changes, portfolio acquisitions, changes in risk appetites, & new product introductions. These kind of events or audit results from other areas may change risk profile and precipitate changing exam start or scope
6. Evidence of influence	After exams, file work, downgrades, etc., can LR point to tangible improvements in lending culture? If not, LR's disconnect is preventing this critical line of defense from doing its part to maintain credit culture
7. Career path	If LR is able to attract top performers and also place them in senior-level credit and line positions, that shows solid career path and provide pipeline of interested employees
8. External focus	Bank lending's innate cyclical and local market dynamics require LR to monitor these changes in economic and industry trends and report them as part of its regular board updates
9. Forward focus	LR also reports developing risks to board
10. Risk appetite link	LR monitors and reports risks outside of bank's stated risk appetite
SOURCE	Marcucci, "Count on Loan Review for the Ugly Truth," <i>The RMA Journal</i> , June 2013,

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## Credit Discipline Tool Checklist

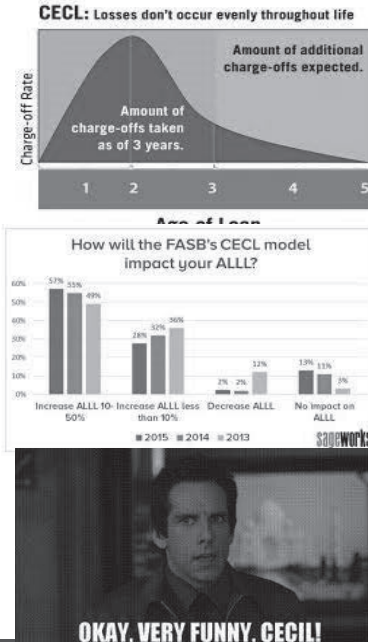
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# CECL Considerations

- Past events
- Current conditions
- Forecasts about the future that are reasonable and supportable
- They can be quantitative or qualitative
- Related to a specific customer or the broader macroeconomic environment



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# CECL Data Management

## Must Have

- Account number
- Product type (structure)
- Origination date
- Origination amount
- Original commitment (for vintage)
- Outstanding amount by segment/pool (beginning and ending)
- Maturity date
- Portfolio segment identifier
- Periodic & cumulative charge-off and recovery amounts by date
- Paydown data by loan(scheduled and prepayments)

## Additional Relevant Data

- Collateral/asset type
- Performance status (past due, nonperforming)
- Other credit risk metrics (LTV, credit score, Geo location)
- Renewal or modification date
- Credit quality risk tracking
- Any data needed to justify reasonable and supportable adjustments for current conditions and forecasts

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## 12. Adequate ALLL

- Risk ratings' EL feeds ALLL
- FASB CECL-loss estimated over life of loan phasing in over 2020-2023, maybe
- Unallocated reserve expected to be small
- Tip: compare bank with peer bank ALLL % and asset quality of bank's lines of business, especially N-A's and NCO's



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## 13. Skilled Problem Asset Management (PAM)

- Professional PAM vs. amateurs
- Transfer of problem loans to PAM
  - Credit extended to criticized loans require concurrence of PAM
  - Classified loans must be transferred to PAM
- Tip: monitor compliance with PAM policy, size and trends in PAM portfolio, milestone PAM progress (transfer, restructure, default, judgment, liquidation, charge-off, OREO, sale)



**loan officer**  
(noun) ◀ [lohn aw-fuh-ser]  
1. a person who solves a problem you didn't know you had in a way you can't understand.  
2. a person who does precision guesswork based on unreliable data provided by those of questionable knowledge.  
see also: wizard, magician, superhero, ninja

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## 14. Credit & Lending Training

- ▶ Credit-lending training before loan authority granted
- ▶ Basic training
- ▶ Advanced training
- ▶ Sources
  - ▶ ABA
  - ▶ RMA
  - ▶ Other organizations
- ▶ Tip: quarterly review of internal and external training of lenders, approvers, support staff conducted by bank



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# Summary of Credit Risk Management

- Credit risk is the most prominent of the various enterprise risks
- Credit risk is the chance that a borrower will be unable or unwilling to repay in full, on time, or as agreed
- Good credit risk management ensures that the chance of credit loss occurs at a level where the return on the risk meets overall bank objectives
- Credit risk management's key elements include credit culture, risk tolerance, risk measurement, risk strategy, and portfolio management
- Credit risk management framework is built on
  - Prioritizing corporate strategies
  - Picking the appropriate credit culture
  - Selecting credit risk strategy
  - Determining the degree of risk management
  - Developing, implementing, and maintaining policies, processes, and procedures
- Good credit risk management builds on a strong credit culture articulated in a written credit policy to monitor, measure, and guide its risk strategy
- The optimal credit culture is values driven with strong credit discipline tools to manage the credit process
- Moving to a strong credit culture requires your bank to
  - Assess its tolerance for risk by measuring transaction, intrinsic, and concentration risk
  - Undertaking appropriate strategies to reduce T, I, and/or C risk
  - Translating your bank's risk appetite into measurable risk tolerance limits and documenting those limits in your written credit policy
- **"In theory, there is no difference between theory & practice. In practice, there is." Yogi Berra**
- **A little intro to the case study . . . Top Market Bank**

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## Top Market Bank

- **Top Market Bank**
- Total Assets: \$600 million Chairman: Monty Blanc
- Avg. Deposits: \$450 million Pres. and CEO: Paula Pinnacle
- Capital: \$65 million Chief Credit Officer: Al Pine
- **Top Market Bank (TMB)**
  - TMB is located in the northern suburbs of a city with an approximate 500,000 in population. The bank has benefited from the city's overall prosperity and especially from the rapid growth of the city's north side. Predictably, new restaurants, motels, auto dealers, and retailers have followed the residential growth northward.
  - The banks' consumer and commercial lending portfolios also have benefitted from the strong economy in their northerly market area. As a result, loan growth and bank profitability has exceeded peer averages.
- **Monty Blanc, Chairman**
  - Blanc founded Top Market Bank (TMB) in 1998. He managed it as chairman, president and CEO until 2013, when he named Ms. Pinnacle his successor as president and CEO and retained the chairmanship of TMB. The bank grew rapidly through acquisitions and by establishing itself as a consumer and small business lender and through the financing of residential construction in the area.
- **Paula Pinnacle, CEO**
  - Pinnacle came to TMB soon after graduating from college. She started in TMB's management training program and after quickly demonstrating an interest and an aptitude for banking became one of Monty's protégés. Monty treated her as a daughter, and Paula dutifully responded by working very hard and contributing significantly to the growth and success of the bank.
  - Contrary to Monty's management style, Paula was much more inclined to encourage other team members to be creative and innovative. She was never reluctant to recognize a colleague's good idea and run with it. She challenged employees to be more entrepreneurial, to "think out of the box," and take responsibility for results, rather than waiting for "orders from the top."
  - She was fond of saying, "Sure, ask for forgiveness, just be sure you were right." She had inherited a very personalized bonus philosophy from Monty, but she was trying to design an incentive compensation program that was more objective. Paula was known for treating people well and could be counted on to keep her word. Her verbal concurrence on a credit request meant that the lender was expected to get it closed and booked quickly.
- **Al Pine, CCO**
  - All Pine was hired recently by Pinnacle to become the chief credit officer (CCO). Because of the bank's size and the pressure to produce, Ms. Pinnacle realized the need for adding a chief credit officer to set policies and monitor portfolio performance. Until now, the bank was small enough that it was possible for a few people to know most of the borrowers and the loan portfolio without need for sophisticated risk management procedures.
  - Al is a seasoned credit professional who thrives on the analytical side of the credit function. He was an accounting major in college and had planned a career in accounting, but he was recruited into banking as an internal auditor where he found his skills were needed and appreciated. Drafted later into the bank's credit training program, he discovered he had an aptitude and an interest in credit administration and decided to follow that path to success as the credit risk expert on the bank's permanent acquisition team.
  - Pine's strengths have been the establishment of sound credit policies and the oversight of compliance issues. He also brings good skills in risk rating systems, credit analysis and underwriting, credit decision processes, loan documentation procedures, and credit controls. He works long hours, tends to be highly structured in his work habits, and is viewed as somewhat formal in his relationships with co-workers. He stressed to Monty Blanc in his final interview, "Prudent profitability protects the bank's bottom line."

## Answer these 5 questions about TMB . . .

- 1-Your comparison of Al Pine and Paula Pinnacle's Views
- 2. Using the information provided in the case, select TMB's current credit culture—values driven, immediate performance, production, unfocused? Be prepared to support your choice in group discussion
- 3A. Analyze TMB's risks--(3A) transactional, (3B) intrinsic, and (3C) concentration—to determine its overall risk profile. Is it low, medium, or high for each of the 3 risks?
- 4-Based on your observations of TMB, complete the following credit discipline tool checklist
- 5- After the Board of Directors reviewed the Risk Profile, which you (Al) prepared, The Board has requested that senior management provide clear risk tolerance-appetite guidance and develop a strategy and plans to ensure that the bank's risk profile matches that tolerance

•Compare and contrast what you think are the respective views of Al Pine and Paula Pinnacle on these topics:

### 1-Your comparison of Al Pine and Paula Pinnacle's Views

1-Your Comparison of Al Pine and Paula Pinnacle's Views		
Topics to Compare & Contrast	Al Pine	Paula Pinnacle
A-Balancing loan production and credit quality?		
B-Managing the credit decision process to minimize policy and loan documentation exceptions?		
C-Pricing loans to ensure satisfactory RAROC?		

2. Using the information provided in the case, select TMB's current credit culture—values driven, immediate performance, production, unfocused? Be prepared to support your choice in group discussion.

CULTURE TYPE→	Values Driven	Immediate performance	production	Unfocused
Top priority	L-T consistent performance	Current earnings, stock price	Market share, loan growth, & loan volume	Changes frequently
Driving force	Corporate values & market consistency	Annual profit plan	Commitment to be the largest	Management reacts by changing priorities
Credit environment	Strong credit organization, few policy exceptions	Credit quality emphasized in strong economy but loosens in weak economy	Strong systems, controls, & good credit leadership, but credit told to find a way to do the deal	Line produces, credit tries to respond to frequent changes in direction
Hidden policy	Not a factor—consistent with written policy	Conflict with written policy during soft loan demand	Lenders' job is to produce regardless of written policy	Lenders confused by inconsistency and shifting priorities
Success factor	Balance between credit quality & revenue generation	Credit has to be strong enough to resist line pressure to do riskier deals in down cycles	Credit must control loan approval process, keep individual authorities low, & resist production pressure	Credit quality depends on strong policies, systems, and leadership
Culture Vocabulary	Quality, balance, soundness, prudence, ownership, conservative	Quality loan volume, balance, aggressive, growth-oriented	Market share, growth-oriented, aggressive, loan volume	Creative, think out of the box, fluid, dynamic responsive

3A. Analyze TMB's risks--(3A) transactional, (3B) intrinsic, and (3C) concentration—to determine its overall risk profile. Is it low, medium, or high for each of the 3 risks?

**3A-TRANSACTIONAL RISK WORKSHEET**—evaluate the risk rating distribution across the A, B, C, or D columns to determine the degree of transactional risk

Risk Rating Distribution:	%	A-Avg & better	B-Accept & worse	C-Mrgn accept & worse	D-Crit & Class
1-High Pass	8	8			
2-Pass	36	36			
3-Low Pass	49		29		
4-OAEM	4		20	20	
5-Substandard	2		4	4	4
6Doubtful	1		2	2	2
7-Loss	0		1	1	1
Total*	100	44	56	27	7

**Transactional Risk Guidelines:**

- Low Risk Profile: 75-80% in average & better risk profile (column A) or ≤5% in marginally acceptable & worse (column C)
- Moderate Risk Profile: 50%-75% in average & better (column A)
- High Risk Profile: 50%+ in acceptable and worse (column B) or 20-25% in marginally acceptable & worse (column C)

\*Individual column totals on total line add up to more than 100% because the individual column totals are cumulative in nature.

**3A-Your conclusion—low, moderate, or high transactional risk?**

3B. Analyze TMB's risks—(3A) transactional, (3B) intrinsic, and (3C) concentration—to determine its overall risk profile. Is it low, medium, or high for each of the 3 risks?

3B. INTRINSIC RISK WORKSHEET—Evaluate the distribution of risk ratings for each of the LOB's to determine the degree of intrinsic risk:						
LOB Distribution:	%	Low	Low-Mod	Moderate	High-Mod	High
Consumer-direct	13		13			
Consumer-indirect	4				4	
Consumer-home equity	6	6				
RE-comm construction	2			2		
RE-comm permanent	6			6		
RE-residential construction	12			6*	6*	
RE -permanent	14	14				
RE-land loans	3	3				
Comm-motels	6			6		
Comm-auto dealers	9			2**		7**
Comm-restaurants	4			4		
Comm-retail stores	3			3		
Comm-all other	18			18		
<b>TOTAL</b>	<b>100%</b>	<b>23</b>	<b>13</b>	<b>47</b>	<b>10</b>	<b>7</b>
Intrinsic Risk Guidelines: Low Risk Profile: <15% in high, <20% in H-M, or >40% in low and L-M Moderate Risk Profile: 15-25% in high or 20-30% in H-M High Risk Profile: >25% in high or >30% in high and H-M *100/200=50% x 12%, 6% pre-sold, 6% spec **140/170=87% x 9%, so 7% is ABL high-risk floor plan						
3B-Your conclusion—low, moderate, or high intrinsic risk?						

2025

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3C. Analyze TMB's risks--(3A) transactional, (3B) intrinsic, and (3C) concentration—to determine its overall risk profile. Is it low, medium, or high for each of the 3 risks?

3C-CONCENTRATION RISK WORKSHEET—evaluate the risks associated with each measure of concentration risk to determine the overall degree of concentration risk:				
Factors:	Analytical Factor (Guidance)	Low	Moderate	High
Geographic	Market (Low <40%, Mod 40-60%, High >60% of outstandings)			X
Borrower	10 largest borrowers (Low <50%, Mod 51-100%, High >100% of capital)		X	
Industry	Industry (Low<50%, Mod 51-100%, High > 100% of capital)			X
Line of business	LOB outstandings (Low <100%, Mod 100-150%, High >150% of capital)			X
Concentration Risk Guidelines: Moderate risk: only 1 high Low-moderate risk: 1 high and 3 lows High-moderate risk: 1 high and 3 moderates High-moderate-high risk: 2 highs and 2 lows High risk: 2 highs and 2 moderates OR 3 highs Really high risk: 4 highs				
3C-Your conclusion—low, moderate, or high intrinsic risk?				

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## 4-Based on your observations of TMB, complete the following credit discipline tool checklist:

4-Credit Discipline Tool Checklist	Yes/No?	If no, explain why	If no, offer your solution
1. Up-to-date written credit policies			
2. risk-driven credit analysis			
3. Uniform credit packages			
4. Experienced underwriting			
5. Informed decision-making			
6. Proper loan approval			
7. Valid, granular risk rating system			
8. Legally enforceable loan documents			
9. Reliable closing and booking			
10. Loan performance monitoring & reporting			
11. Independent loan review & audit			
12. Adequate ALLL			
13. Skilled problem asset management			
14. Credit and lending training			

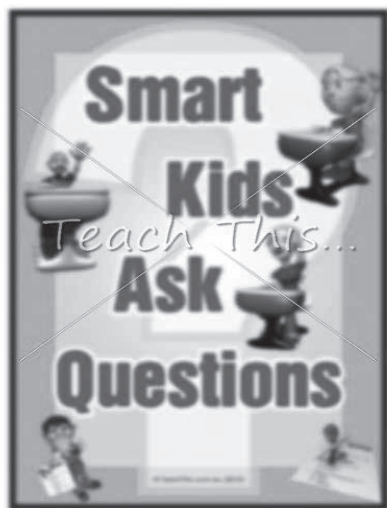
5. After the Board of Directors reviewed the Risk Profile, which you (AI) prepared, The Board has requested that senior management provide clear risk tolerance-appetite guidance and develop a strategy and plans to ensure that the bank’s risk profile matches that tolerance

- After much deliberation, it was agreed that the following asset quality parameters would guide lending strategy toward a more favorable CAMELS rating:
- Non-performing assets: 0.75-1.25%; Loan losses: 0.25-0.75%; Marginally Acceptable or worse: 15% maximum
- The ranges for non-performing assets and loan losses represent the guidelines that the bank wishes to stay within at the top and bottom of the credit cycle.
- Your final task is now to develop 2 or 3 strategies to mitigate the T, I, and C risks you believe necessary to reposition the risk profile within management’s new risk tolerance-appetite:

5-Your T-I-C Strategies	
Risks	Specific Strategies
a. Transactional	
a. Intrinsic	
a. Concentration	



# Questions?



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## Appendix: Glossary

A&D	Acquisition & Development	LOB	Line of Business, e.g., commercial lending, CRE lending, private banking, consumer lending, mortgage banking, etc.
ALLL	Allowance for Loan & Lease Losses		
ABL	Asset Based Lending		
AR	Accounts Receivable	L-T	Long-Term
CA/CL	current assets to current liabilities ratio, aka current ratio	LTC	Loan to Cost ratio
		LTV	Loan to Value ratio
CAMELS	Bank rating system assessing Capital, Asset quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk	Max	Maximum, ≤
		Min	Minimum, ≥
CAPEX	Capital expenditures	NOI	Net Operating Income
CCO	Chief Credit Officer	NW	Net Worth
CoREDI	non REDI borrower who decides to engage in REDI activity, e.g., doctors who borrow to buy office building	NWC	Net Working Capital
		OAEM	Other Assets Especially Mentioned, aka Special Mention (SM)
CRE	Commercial Real Estate	%	percentage, e.g., LTV = 80%
CRO	Chief Risk Officer	PD	Probability of Default
CRM	Credit Risk Management	PRAC	Product Risk Assessment Committee
Doc	Documents, documentation	RAROC	Risk-Adjusted Return on Capital
DSC	Debt Service Coverage ratio	RE	Real Estate
D/W	Debt to Worth ratio	REDI	Real Estate Developer-Investor , full-time professionals in CRE
EL	Estimate of Loss	ROA	Return on Assets
Inv	Inventory	SM	Special Mention, aka OAEM
FDICIA	FDIC Investment Act	S-T	Short-Term
LGD	Loss Given Default	TBE	Total Borrower Exposure
		X	ratio, e.g., DSC = 1.2X

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