

## TOP MARKET BANK

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### COMPANY BACKGROUND

Total Assets:	\$600 million	Chairman: Monty Blanc
Avg. Deposits:	\$450 million	President and CEO: Paula Pinnacle
Capital:	\$65 million	Chief Credit Officer: Al Pine

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.

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.

In TMB's most recent annual report, Ms. Pinnacle outlined her objectives for the coming year. "Top Market Bank has had the good fortune to be located in a growing and affluent market which has afforded us the opportunity to grow and profit over the years. During the coming year, the bank is committed to improving on prior years' performance with the goal of becoming the leading financial institution in our market for consumers and small business. Loan growth is the engine that drives our success. We have a staff of highly qualified lenders who will seek attractive lending opportunities that meet our lending standards. We have successfully grown our bank faster than the competition without sacrificing credit quality and expect to continue this performance in the future."

The competitive environment has been in a state of flux as large regional banks have acquired several local competitors within the last few years. There are other community banks whose growth infringes on TMB's market territory and who appear poised to move more aggressively into the northern suburbs. Just 16 months ago a new community bank was started by senior

managers from one of the local banks acquired by a super-regional bank. Already the pressure on margins and loan terms has increased noticeably.

Al 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.

The board of directors is visible and well regarded. The board includes a certified financial planner, the largest auto dealer (Casper Chrysler-Plymouth) in the metro area, the president of the local fine arts council, the founder of the Bank's biggest commercial real estate client (Devco Properties), the senior partner of the Bank's accounting firm, and the County School Superintendent. They get along well and generally follow Pinnacle's lead. They try to understand how the bank works but are too busy to spend much time at it. They believe that Pinnacle is doing a fine job of managing TMB.

## MANAGEMENT PROFILES

**Monty Blanc, Chairman.** Despite having just experienced a difficult recession for banks, Monty saw an opportunity to chart his own course and proceeded with tenacity to form his new bank. He had previously worked his way up to senior vice president of correspondent banking and loan participations in a large regional bank and, though successful, wanted to create and run his own organization.

He quickly developed a loyal following of customers and employees who enjoyed being part of Monty's "family." He enjoyed being in the limelight and was known and admired whether he was acting as president of the local country club or heading the United Way drive. While he was well liked in the community, he also stayed very focused on the bottom line and was dedicated to doing those things necessary to create success for the bank. He believed in giving people as much responsibility and authority as he thought they could handle, and he was a big proponent of "two-hatting folks" to save money, cross-train them, and create some internal competition because Monty overlapped spheres of influence occasionally. He still personally approved all annual bonuses recommended by Paula.

Although Monty continues only as titular head of the bank with the primary duty of chairing board meetings, he is still considered the "head of the bank" by folks in the area. He elevated Paula R. Pinnacle to CEO. Pinnacle rose quickly in the bank and earned Monty's trust as a loyal employee.

**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.** 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.”

## **CREDIT EVALUATION**

Pinnacle’s direction to Al Pine when he joined TMB was that she wanted to keep the portfolio growing steadily while maintaining the bank’s credit quality standards. She also wanted him to help her accelerate the credit approval process and be proactive in coaching the lenders in how to “get the deal done right the first time.” She wanted decision-making as close to the customer as possible, so she also expected Al to meet with the bank’s largest clients and be ready to call on major prospects as needed. Monty had made it clear from the beginning that he did not want the “backseat driving and second-guessing from a backroom bureaucracy” that Monty had experienced as a regional bank lender. Monty’s word was his bond, and he expected that when Paula or he committed the bank, the bank would live up to the promise.

Paula recited Monty’s maxim that the bank’s overall goal is to enhance shareholder value by producing high-quality loans. She described the bank’s credit culture as relationship oriented with credit extended to accommodate the unique needs of each borrower, and that requires “flexible policies and reasonable standards so that we don’t lose deals over a point or two of pricing or overly rigid covenant ratio enforcement.”

Al’s first step was to review bank credit guidance as the basis for policy setting. He also wanted to get a better grasp on the bank’s risk tolerance. He found the existing policy manual to be outdated and inadequate as a guide for lending practices, appraisal requirements, environmental risk assessment, client confidentiality, consumer compliance requirements, Reg O, Reg B, and Reg W. In principle, any lender could lend the legal lending limit of the bank, but every lender was expected to work out any problem loans and consult with the CCO on any real estate lending. Lenders were expected to order their own appraisals and review them with the CCO before extending an offer. Al was expected to chair a weekly loan committee where lenders could bring in requests for ratification; attendance was optional.

Almost all loans were closed by either the borrower's or the bank's outside attorneys in order to minimize documentation errors and legal expenses. Lenders wrote memos to explain loan requests, and they sometimes attached spreads of the financials, but Monty Blanc had prohibited memos more than 3 pages including financial information because he preferred "briefs, not books." There was limited information on policy exceptions and advance rates, but collateral margin policy requirements were fairly standard for the industry. The lenders knew that Monty and Paula paid close attention to LTV ratios, DSC ratios, and guarantees, but they also knew that management was not going to let the Bank lose a deal, either.

Each lender was expected to maintain his own credit files and collateral files in several fireproof file cabinets located near the loan operations area adjacent to where the lenders were housed in the bank's main office. The bank employed an individual who wore "three hats" as the internal auditor, compliance officer, and credit review officer; he had expressed to Al his difficulty in performing all three of these functions if the bank continues to grow as rapidly as he had heard Paula and Monty planned to do.

Al reviewed bank performance measure trends for the past four years:

Measures (%)	2022	2023	2024	2025
Loan Growth	18	19	19	17
ROE	17	17	16	15
NPA's	1.62	1.06	0.72	0.90
Losses	1.57	1.08	0.77	0.96
Peer bank averages for 2025 were 14% for loan growth and 0.68% for losses.				

Al turned next to the risk rating system for insight into the levels of risk that have been acceptable. He found that the bank used a system with three "pass" categories. After much effort, he was able to obtain the following risk distribution for the portfolio:

1. High Pass	8%	4. OAEM	4%
2. Pass	36%	5. Substandard	2%
3. Low Pass	49%	6. Doubtful	1%
		7. Loss	0%

Because there were only three "pass" risk ratings, Al decided to examine the Low Pass category more closely to identify those credits whose financial weaknesses warranted a "Marginal Pass" designation. Rather than change the numerical rating system, he designated these credits as 3-. He found that Low Pass contained 20% (of the total portfolio) that should be categorized as 3-.

Al observed that Criticized and Classified loans (risk ratings 4-7) had been increasing over the last two years from 3.5% to the current level of 7%. This was due primarily to some commercial loans that were experiencing performance problems. Using the information he had gathered, Al plans to evaluate the risk tolerance of the bank and the risk rating distribution.

Al next turned his attention to the portfolio mix, with special emphasis on risky concentrations. He asked for a breakdown by line of business. He wanted to determine if the bank was engaging in risky types of lending. The following information was provided by lines of business:

**LINES OF BUSINESS**

<i>Consumer Lending:</i>	<i>\$ Million</i>	<i>%</i>
Direct	\$48	13.3
Indirect	16	4.4
Home Equity	20	5.6
Total	\$84	23.3%
<i>Real Estate Lending:</i>		
Comm'l Construction	\$ 10	2.8
Comm'l Permanent	20	5.6
Res. Construction	40	11.1
Res. Permanent	54	15.0
Land Loans	10	2.8
Total	\$134	37.3%
<i>Commercial Lending:</i>		
Motels	\$20	5.6
Auto Dealers	34	9.4
Restaurants	16	4.4
Retail Stores	12	3.3
All Other	60	16.7
Total	\$142	39.4%
<b>Total Loans</b>	<b>\$360</b>	<b>100.0%</b>

TMB had a legal limit of approximately \$6 million and a House Limit of \$5.0 million. The following information about the portfolio was also provided:

- Consumer Indirect outstandings represent automobile paper financed for auto dealer customers. TMB is not a primary buyer but regards this as a competitive necessity.
- Of the \$34 million for auto dealers, \$28 million is for floor plan lines.
- Virtually all of the Commercial Permanent lending represents loans for build-to-suit buildings to be used by good customers in their business.
- \$8 million of Commercial Construction is related to owner-occupied developments and \$2 million for a small strip shopping center.
- \$20 million of Residential Construction is speculative—not pre-sold.
- Land loans are extended for residential builders as inventory for future development.
- Motels are national flagship franchises with local owner/operators.
- Restaurant financing is primarily fast-food franchises representing nationally known chains with local owner/operators.
- Retail stores include the local men's clothing store, an oil/lube station, a car wash, and other assorted small retail establishments.

### LARGEST BORROWERS

Next, Al obtained a list of the 10 largest borrowers by total credit exposure (TCE), their risk ratings (RR), and their ROAs. He wanted to determine the type of borrowers that made up the portfolio and how well the bank had balanced its risk (ratings) with its reward (ROA):

10 Largest Credit Exposures (CE)		TCE (\$MM)	RR	ROA (bp)
1	Affordable Ford-Lincoln	5.0	2	217
2	Motel Six 66 dba Dew Drop Inn	4.7	3-	249
3	Devco Home Contractors	4.4	4	227
4	Mouse House Restaurant	4.2	2	220
5	Fantastic Elastic Plastics Mfg.	4.0	1	210
6	Fuss Budget Hotel	3.7	3	212
7	Mondo Condo Builders	3.6	3	250
8	Universal Kia-Hyundai-Fiat	3.5	3-	238
9	Gudenuf Autoparts Distributors	3.3	2	214
10	Northside Medical Mall Plaza	3.2	2	240
TOTAL		39.6		
* ROA is expressed in basis points and is not risk adjusted, i.e., cost of risk has not been deducted.				

### SALES FORCE ASSESSMENT

With the realization that credit strategy would have to be altered, Ms. Pinnacle asked that the sales staff be evaluated to ensure that TMB could grow the bank sufficiently, given the revised lending standards. The results of the review were summarized as follows:

- TMB has five commercial lenders, three consumer lenders, and two loan originators. Carla Caisson joined the bank last year to help manage consumer lending, but she's been so busy doing deals that she hasn't had time to organize anything yet. She came from a large bank where she had experience in executive banking and "bank at work" products.
- Business lenders are well connected in the community. Some are active in the Chamber of Commerce, and one is on the local school board.

Pinnacle's assessment of the commercial staff is that one lender can outsell anyone but is swamped with servicing his current customers. Two others are stable, competent lenders who are unfocused and reactive. Two others are hungry rookies who have real promise but seem discouraged. Twice the bank has tried to establish a formal calling program. Each time, the program died from lack of attention and the high lender workload.

### FIVE GROUP DISCUSSION QUESTIONS

1. 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		
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

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

<b>3A-TRANSACTIONAL RISK WORKSHEET—evaluate the risk rating distribution across the A, B, C, or D columns to determine the degree of transactional risk</b>						
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: <ul style="list-style-type: none"> <li>• Low Risk Profile: 75-80% in average &amp; better risk profile (column A) or ≤5% in marginally acceptable &amp; worse (column C)</li> <li>• Moderate Risk Profile: 50%-75% in average &amp; better (column A)</li> <li>• High Risk Profile: 50%+ in acceptable and worse (column B) or 20-25% in marginally acceptable &amp; worse (column C)</li> </ul> *Individual column totals on total line add up to more than 100% because the individual column totals are cumulative in nature.						
<b>3A-Your conclusion—low, moderate, or high transactional risk?</b>						
<b>3B. INTRINSIC RISK WORKSHEET—Evaluate the distribution of risk ratings for each of the LOB's to determine the degree of intrinsic risk:</b>						
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		
TOTAL	100%	23	13	47	10	7
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?**

**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?**

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:

<b>5-Your T-I-C Strategies</b>	
<b>Risks</b>	<b>Specific Strategies</b>
a. Transactional	
b. Intrinsic	
c. Concentration	