



Building Success. Together.

## Managing Your Commercial Loan Portfolio

Presented by: Christie Drexler, Drexler Consulting, LLC

## Agenda

- Portfolio Management Defined
- Performance Management Bank Benchmarks
- Monitoring Performing Loans
- Problem Loan Monitoring
- Relationship Building

## Bank Loan Portfolio Management

Loan portfolio management is oversight of a collection of loans with the goal of balancing profitability and risk exposure.

- Oversight of the bank's loan portfolio by bank leadership
- Evaluate and monitor credit risk and compliance risk
- Ensure loan diversity
- Minimize loan losses and maximize portfolio profitability

## Bank Loan Performance Ratios

- Quickly measure certain aspects of a bank's loan portfolio performance
- Provide easy performance comparisons to competitors and industry averages
- Useful tool for bank leadership in loan portfolio management and oversight
- Used by regulators to set and measure minimum operating standards for banks

## Key Performance Measurements

- Capital Adequacy
- Profitability
- Liquidity
- Lending & Credit Quality

## Capital Adequacy

- Tier 1 Risk Based Capital Ratio - Measures a bank's core capital as a percentage of assets weighted by risk.
  - Included common equity, retained earnings, and certain preferred stock
  - 6 percent minimum; 8 percent well capitalized
- Tier 1 Leverage Ratio - Measures a bank's core capital as a percentage of total assets.
  - Includes all on and off-balance sheet assets
  - 3 percent minimum; 5 percent well capitalized

## Profitability

- ROA – Measures net income as a percentage of total assets
- ROE – Measures net income as a percentage of shareholder equity
- Net Interest Margin – Measures net interest income as a percentage of average earning assets
- Non-interest income/average assets
- Non-interest expense/average assets
- Efficiency ratio - Non-interest expenses/revenue

## Liquidity

- Loan/deposit ratio
- Core deposits/total assets
- Liquid assets/total assets

## Lending and Credit Quality

- Texas Ratio:  $\text{Non-performing assets} / \text{Tangible common equity} + \text{Loan Loss Reserves}$
- Non-performing assets/total assets
- Loans 30-89 days past due/total loans
- Loan loss reserve/total loans
- Loan loss reserve /non-performing assets
- $(\text{Gross charge-offs} - \text{recoveries}) / \text{total loans}$
- Concentration risk
- Policy exceptions
- Part 365 exceptions as a percent of capital
- Major document exceptions

## Loan Risk Rating Process

A Risk Rating Process should be in place to ensure that risk rating evaluations on credits of a certain size are conducted on a minimum of an annual basis to assess the bank's risk of loan loss.

- Criticized loans and loans to borrowers in a weak industry require additional attention and should be reviewed more frequently.
- **Accuracy is key!!!** Risk ratings should be verified by an independent loan review department or a senior manager not involved in credit decisions.
- Regulators will review risk ratings and will downgrade, if necessary.

## Risk Rating Responsibility

Who is responsible for the accuracy of loan grades/risk ratings?

- The bank's Loan Policy should indicate; however, account officers are the likely choice as they are most familiar with the credit relationship and can obtain timely financial information.
- Risk ratings should be reassessed with the collection of updated financials, or as risk changes.
- Lenders should document all factors that may impact repayment and assign risk rating accordingly and consistently.

## Credit Risk Ratings

- Based on information received and analyzed, recommend appropriate Risk Grade/Loan Grade.
- Fully assess the credit's strengths, weaknesses, and mitigating factors.
- Risk Grade Worksheets - designed so that a consistent measurement can be applied to similar loan types.
- Ideally, should include a balance of objective and subjective factors that assess the borrower's ability to repay its debt.

## Assessing Risk and Mitigants

Strengths	Weaknesses	Mitigants/Compensating Factors
<ul style="list-style-type: none"><li>➤ No competing projects within 10-mile radius</li><li>➤ 20% equity contribution</li><li>➤ Borrower has successfully completed similar projects</li><li>➤ Projected cash flow from leases at market rate cover DS 1.3x.</li></ul>	<ul style="list-style-type: none"><li>➤ Capital is weak, profits are not being retained in company</li><li>➤ Shareholder note of \$x is in repayment</li><li>➤ Only 20% of the project is preleased</li></ul>	<ul style="list-style-type: none"><li>➤ Subordination of S/H debt will be condition of approval</li><li>➤ S/H distribution will be restricted until the project is stabilized.</li><li>➤ Guarantors are strong with substantial liquidity</li></ul>

## Risk Rating Matrix



## Loan Covenants

- Loan Covenants – clauses in a loan agreement that are promises between a borrower and a bank
- Affirmative Covenants – actions required by the borrower in the future
- Negative Covenants – actions or conditions that the borrower must prevent from occurring in the future
- Financial Covenants – Conditions are defined in absolute amounts or ratios and are derived from borrower/guarantor financial statements



## Loan Agreements and Covenants

- Some covenants are standard language in loan agreements. Examples include:
  - Maintenance of property & casualty insurance on collateral
  - Maintain books and records in accordance with GAAP
  - Maintain property in good repair
  - Limits on changes in ownership
- Standard loan agreement documents vary by loan type
  - i.e. Construction Loan Agreement
- Other covenants are specific to the loan request, and the language must be added to the loan agreement. These covenants should be documented in the credit memo.

## Customized Covenants

When recommending loan covenants:

- They should be relevant to mitigating existing or potential weaknesses in the credit
- Useful in setting risk guardrails for a credit and in risk monitoring
- Don't set covenants that the bank will not monitor and enforce
- Follow the **KISS** principal:
  - Well defined for borrower and lender
  - Easily measured
  - Tracked and documented

## Financial Statement Covenants

- Go beyond the “check the box” financial statement exception requirement.
- Do not wait for annual reviews, loan reviews, or regulatory exams to gather and review statements.
- Set a collection time in the loan agreement that aligns with loan/collateral risk and covenant monitoring requirements. Some loans necessitate more than the minimum annual financial statement collection requirement.
- Effective portfolio monitoring requires that financial statements should be collected **and** immediately reviewed/analyzed.

## Loan Covenant Examples

### Affirmative Covenants

- Minimum liquidity to loan
- Minimum cash in bank
- Minimum net worth
- Minimum net working capital
- Minimum current or quick ratio
- Minimum debt to worth
- Minimum DSC Ratio
- Borrowing Base Limitations

### Negative Covenants

- No new borrowing or leases greater than \$\_\_\_\_\_
- No changes in management
- No loans by borrower to outside parties
- No mergers or acquisitions of other businesses
- Limit annual dividends/withdrawals in excess of \$\_\_\_\_\_
- Limit on officer salaries

## Loan Exception Monitoring

- Policy Exceptions
- Document Exceptions
- Financial Statement Exceptions
- Insurance Exceptions

## Collateral Monitoring

- Land
- Office Building
- Equipment
- Crops
- Inventory
- Accounts Receivable
- Stocks/Bonds/Mutual Funds
- Life Insurance

## Formal Loan Monitoring

- Financial Statements
- Collateral Reports
- Other Information as Required Per Loan Agreement
- Annual Reviews
- Loan Reviews
- Loan Maturities
- Regulatory Exams

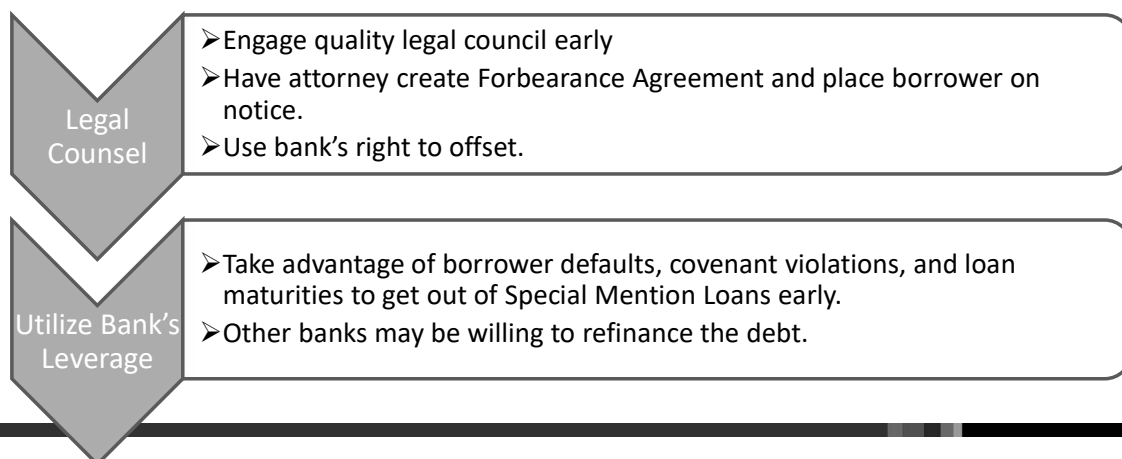
## Problem Loan Monitoring

- Recognizing risk elevation or credit deterioration early is essential for the bank to exit a credit or minimize losses. Actively monitor loans so you are aware of weaknesses before the loan is past due.
- Early past dues should be actively managed by the loan officer. Risk ratings should be reassessed at this time. When collection problems escalate, these problem loans are often transferred to a work-out area.
- Utilize a more frequent formal review process for downgraded credits (i.e. move from annual reviews to quarterly reviews).
- While effectively managing problem credits is time-consuming, it is critical for to bank loan portfolio performance.

## Problem Loan Monitoring

- All workouts should start with a full file review (including collateral).
- Stay on top of government guarantees (SBA, USDA).
- Order title work, UCC search, updated collateral valuations.
- Check for taxes owed and insurance lapses.
- Make more frequent customer calls and require more frequent financials. Always spread financials and analyze changes.

## Problem Loan Mitigation Strategies



## Problem Loan Mitigation Strategies

### Change Terms

- Increase rates for Special Mention credits to encourage refinancing.
- Require additional collateral or additional guarantees with renewals.
- Give up something in the short-term to gain in the long-term.

## Problem Loan Resolution

- The goal is for the bank to sustain the least amount of loss/expense (protecting shareholders and depositors while preserving its commitment to service and ethics and its positive reputation in the community).
- The more proactive the bank is in recognizing early problems and begins taking steps to resolve, the less damage it will bare financially and reputationally.

## Relationship Building

Effective loan portfolio management requires relationship building.

To effectively manage your loan and to grow the bank, how often should customers hear from their lender?

## Contact Management Plan

- Use your calendar to plan contacts in advance for ALL loan customers in your portfolio:
  - A** – Monthly (i.e. Top 10 and Problem Loan Customers)
  - B** – Quarterly (i.e. Top 25)
  - C** – Semiannually (i.e. Top 50)
  - D** – Annually (All)
- Prepare in advance for calls. Review financials, assess collateral, measure covenant compliance, get industry updates, meet with bank leadership, etc.

*Inspect what you expect to gain respect!*

## Trusted Advisor

- **Trust** – Assured reliance on the character, ability, strength, or truth of someone or something. Requires character, competence, and caring.
- **Advisor** – A person who gives advice in a particular field.

Lenders have an enormous ethical responsibility to balance the interests of internal and external stakeholders:

- We don't take their trust for granted.
- We never take advantage of their trust.

## Becoming a Trusted Advisor

- **Order taker.** You are a product vendor or someone who fulfills one-off tasks.
- **Problem solver.** Stakeholders view you as a reliable resource and a problem solver for more in-depth issues.
- **Advisor.** You offer advice, identify bank and client needs, and provide solutions.
- **Trusted Advisor.** You are trusted with great levels of responsibility in the bank. Customers come to you with big opportunities, for help with major decisions, to celebrate great accomplishments, to share defeats, overcome crises, and to build a loyal, personal relationship.



*"It is not the critic who counts; not the man who points out how the strong man stumbles, or where the doer of deeds could have done them better. The credit belongs to the man who is actually in the arena, whose face is marred by dust and sweat and blood; who strives valiantly; who errs, who comes short again and again . . . who at the best knows in the end the triumph of high achievement, and who at the worst, if he fails, at least fails while daring greatly."*

**Theodore Roosevelt**

## Connect With Us

➤ **Linked In:**

- Christie Drexler, Drexler Consulting LLC
- Joshua Collins, Drexler Consulting, LLC

➤ **Website**

- [drexlerconsultingllc.com](http://drexlerconsultingllc.com)

➤ **Email**

- [information@drexlerconsultingllc.com](mailto:information@drexlerconsultingllc.com)

