

New Urgency for Credit Checkups

By Jim Neckopulos

Five factors that can affect the profitability of the commercial loan portfolio.

The current economic and credit environment is the most challenging we've seen in decades. While much of the attention is still focused on the subprime loan crisis and the residential real estate market, small business and commercial areas of lending may present the next set of widespread financial problems. The subprime crisis showed the importance of looking for ways to identify early warning signals and of acting decisively when risks are identified. Therefore, banks should proactively evaluate five areas to understand their potential effect on earnings:

- Credit scoring model rules and assumptions
- Secondary sources of repayment
- Allowance for loan-loss reserves
- Entity documentation
- Insurance coverage

Credit Scoring Model Rules and Assumptions

Many banks use credit scoring models established in years past to approve small business loans. It is uncertain how these loans will actually perform in the current, rapidly changing environment. When many lenders first developed their own scoring models or implemented a commercial model, small business credit-scored loans were a relatively new concept. The financial and economic environment was considerably different. Many lenders adopted credit scoring in order to increase volume and to reduce the time and cost of originating loans. Credit scoring models need

to be reviewed and updated to be compatible with the current business climate.

Banks should make sure that the business rules supporting their credit scoring models, whether internally developed or licensed from a vendor, reflect current credit policy. First, the chief credit officer should review the business rules in the model and determine whether or not the model is consistent with credit policy. Second, internal audit should assess the controls related to the model: who can use it, who can change it, what is the process for making changes and what authorizations are required. Best practices suggest that scoring models should be independently reviewed at least semiannually—more often during volatile credit markets.

In addition to updated scoring models, banks need good business intelligence to support credit decision making. Performance measures should include banking industry signals, such as default trends; industry information, such as new orders and inventory levels; and financial market data, such as bond spreads. To benefit from business intelligence, banks need well-developed data governance and access capabilities.

Secondary Sources of Repayment

In a deteriorating economic environment, it is important to understand and evaluate secondary sources

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of repayment, which are an important risk-reduction mechanism. While required for nonscored and larger commercial loans, secondary sources of payment may not be diligently scrutinized when loans are underwritten. For example, when bank and borrower have a long-standing relationship, the lender may have a false sense of security. Close review, however, may reveal that the secondary source of repayment is real estate. The dependence on real estate for some portion of repayment makes these loans more risky. As result, many small business loans should probably be assessed as real estate loans.

When the economy is weak, there is a need to do more frequent and in-depth analysis of borrowers' operations. This should include understanding the impact of changes in the economy on the customer's business and on any critical dependencies (such as demand for the customer's product and services, cost and availability of raw materials, transportation expenses). To gain early insights into potential problems, financial institutions should define rules for customer calls and visits: frequency, topics to be discussed, documentation required, in-person versus phone, *etc.* In the recent past, relationship officers frequently treated these visits as social events rather than as an opportunity to assess the health of the customer's business.

For banks that are involved in agent and syndication loans, due diligence is even more important. Agents and lead lenders have the responsibility to keep the other lenders informed of any material changes in the customer's financial condition. Nevertheless, syndicate members must establish their own procedures for communicating with the agent and obtaining the information needed to assess risk.

Allowance for Loan Losses (ALLL)

Lenders should reexamine the adequacy of loan-loss reserves. Through 2006, while accountants and regulators debated the proper level of reserves, most banks decreased reserves—in some cases significantly. Because lenders may have more real estate loans than they realize, small business and commercial loan portfolios should be reassessed to determine their impact on the calculation of loan-loss reserves.

The current environment requires more frequent assessment of the loan portfolio. A number of vendors offer portfolio evaluation tools for small business scored loans. But there is no substitute for an in-depth review of segments of the portfolio by experienced credit review personnel. For nonscored and large commercial loans, more frequent portfolio reviews are important. In less stressed economic times, it is fairly typical to complete a credit review of the entire portfolio during the year. Banks should segment the portfolio to ensure more frequent review of loans in riskier grades.

Loan grading is another area where laxness has crept into the credit review process. Loan officers often lobby to maintain or improve grades either because of the potential negative effect on their own performance evaluations or to "protect good customers." In banks where the organizational structure does not provide for the appropriate level of independence—whether explicitly or implicitly—the result has been "grade inflation" for many loans. When loans have not been properly graded, unexpected—and sometimes large—losses can result.

Risk identification and good management of the ALLL require accurate and timely data, so banks need to have the tools in place to properly identify, measure and manage the risk in their portfolios. This is especially critical for banks that have recently gone through a merger or other corporate upheaval, where multiple loan systems, systems conversions or entirely new systems may disrupt the flow of critical information to decision makers. Knowing where the risks are in your portfolio, quantifying and tracking their course and keeping the board of directors well informed are important components of good risk management.

Entity Documentation

Regardless of the economic environment, financial institutions can protect themselves by ensuring they have the appropriate documentation for the type of entity to which they are making a loan. Bankers should work with their attorneys to determine what documents are required, depending on whether the business is a sole proprietorship,

partnership, limited liability company (LLC), corporation, S corporation, *etc.* Armed with this understanding of the business structure, a banker can determine what evidence is required from the customer to establish that he or she has appropriate authority to enter into the transaction and what loan covenants are appropriate.

Over the past several years, unfortunately, lenders have been lax to get and update key documents. Relationship managers, because of inexperience, laziness or a desire to “not bother” the customer, fail to get updated business entity documents and authorizations. As a result, lenders are unable to pursue legal protections that would be available if they had followed prudent policy and procedures.

Related to this point is the increased practice of not obtaining timely and updated financial statements. Not only is this required by most loan covenants but also it is good business practice. Updated financial statements provide insights into the client’s overall business health. Good business process also includes documenting any changes, such as emerging trends (for example, a pattern of reduced revenues), changes in management personnel or new competitive factors. While this point seems obvious, it is an area that has received short shrift in recent years in the rush to increase loan production.

Insurance Coverage

Insurance can protect both the customer and the lender from financial loss. While many banks have good loan administration systems, there has been a tendency over the last few years not to follow up on renewal notification or even to let insurance coverage lapse. In today’s environment, good loan administration can mean the difference between full or partial recoveries and nothing.

Today’s more difficult economic environment may tempt some business owners to cut corners, especially when it comes to insurance. This may mean trying to self-insure without the financial wherewithal to do so or not buying or renewing key man life insurance.

Time for a Credit Checkup

A good banker should conduct periodic checkups of customers. In today’s higher-risk environment for small business and commercial lending, it is imperative that bankers do an immediate credit checkup to ensure that they have risk factors comfortably under control. This will not only enhance the relationship and understanding of the client’s business but also show areas that may require adjustment or closer attention.

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