

Where Do We Go from Here?

By James M. Neckopulos

Bankers need good business intelligence to recognize risk early.

The past 18 months have been among the most difficult in banking and lending since the Great Depression. As we look ahead, many questions remain:

- Would it have been possible to predict some of the problems with commercial and industrial (C&I) and commercial real estate (CRE) loans?
- Have we learned meaningful lessons from this round of credit problems that will truly result in real change—particularly a change in behavior?
- What changes should bankers and commercial lenders make going forward?

This article addresses these questions, while providing both some historical perspective and a point of view looking forward.

20/20 Hindsight?

The more things change, the more they stay the same. With respect to business lending, many of the problems of the past two years were supposed to have been previously identified, addressed and corrected. Just 10 years ago, the results of the Office of the Comptroller of the Currency's (OCC) credit underwriting survey reflected some positive developments related to underwriting standards for commercial loans. At that time, the examiners reported that 25 percent of the surveyed banks tightened standards, compared to just four percent in 1998. Overall, firming up was also evident in syndicated/national and international lending. While underwriting standards were strengthened in many areas, easing of standards persisted for

some commercial products: CRE and middle-market lending. In the late 1990s, increased pricing was the most prevalent method used to tighten standards (56 percent), followed by adjusting maximum credit availability (33 percent), increasing collateral requirements (31 percent) and strengthening loan covenants (28 percent). For banks that strengthened standards at the end of the last decade, examiners reported economic outlook and a change in risk appetite as the primary reasons.

Perhaps the most worrisome finding in that prior survey was the continued increase in credit risk reported for all commercial and retail products. At that time, the primary response was modest changes in risk tolerance and an emphasis on risk-based returns for commercial credit. Since 1999, and certainly over the years from 2004 to 2007, competitive pressures of the marketplace exerted more pressure to originate

more loans—many with more risk.

The recent economic environment has brought these risks to light and put bank examiners' focus on deteriorating credit standards. The crisis has highlighted the need for bankers to implement

risk evaluation and management systems commensurate with increasing credit risks. In particular, regulators have been looking for loans with specific types of structural weaknesses and are factoring those weaknesses into their judgments about the quality of individual credits, portfolios and portfolio risk management.

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The change in economic environment and the increased scrutiny of the examiners revealed five key structural weaknesses:

- Nonexistent, weak or waived covenants
- Indefinite or overly liberal payment terms
- Inadequate financial analysis and elevated leverage ratios
- Insufficient collateral support
- Repayment dependent on highly optimistic or undemonstrated cash flows

What is disturbing is that many of these same areas were cited as needing improvement back in 1999.

Meaningful Lessons Learned?

Have we learned meaningful lessons from this round of credit problems—lessons that will result in a change in behavior?

Enhance exception tracking to improve performance. Risk taking is inherent in the business of

banking, and exceptions are an expected component of the underwriting process. Lenders underwrite a certain number of loans with exceptions, based on a premise that good controls over and intelligence on changes in underwriting standards will be applied. This requires information that routinely identifies the aggregate level of loans that do not meet approved underwriting criteria, segmented by portfolio and type of exception. Over the years, many bankers have resisted the need to identify and track exceptions to their risk selection and underwriting policies. Recent results from regulatory examinations indicate that lenders that routinely track exceptions and analyze their implications for portfolio risk are among the better-performing banks.

Improve the accuracy and timeliness of problem loan identification. The integrity of banks' own internal risk ratings is critical to sound portfolio risk management. Many banks have made substantial progress, setting higher internal standards for accuracy and using credit models to back-test and

cross-check the integrity of their internal ratings. But most have room to improve the accuracy and timeliness of problem loan identification. Even the most sophisticated banks can improve the precision and reliability of distinctions among the various levels of pass-rated credits. This is imperative today, because specific consideration is being given to using those internal risk ratings to set components of bank capital requirements.

Tighten compliance with policies and procedures. The higher risk inherent in bank portfolios today has, in some cases, called into question the adequacy and robustness of loan loss reserves and necessitated a reexamination of allowance for loan and lease losses (ALLL) methodology. Often, risk has been exacerbated by lax or poorly defined policies and procedures that have allowed loan officers to delay risk-rating changes to save "good customers" or to avoid blemishes on their records. In these cases, significant losses occur without any migration through

proper credit management processes that might have reduced—or possibly avoided—losses.

Question secondary sources of payment. Leveraged finance, with its reliance on so-called enterprise values to justify collateral shortfalls, has caused increased losses in this cycle. The premise behind reliance on "enterprise values" as a secondary source for re-

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payment is that the borrower's business can be sold or refinanced based on a projected earnings capacity. The problem with this approach is that it can be based on optimistic earnings and cash flow projections that never materialize. If the borrower gets in trouble—say demand for its product declines—the enterprise value used to underwrite the loan can quickly appear inflated. In this situation, the potential for substantial loss to the bank group is high.

Changes Going Forward?

What changes should bankers and commercial lenders make going forward? To be successful in

good times and bad, bankers must recognize risk early and move decisively to control it and reduce it where warranted. This can only be done with good business intelligence: reliable and timely risk ratings; effective and objective internal loan review; and, most important, credit risk management that is adept at assessing the data, the trends and relevant market intelligence. Bank executives should ask themselves: "Am I comfortable with my bank's culture and credit controls, including my credit risk rating system?" Bank CEOs, in particular, should ask: "Are my independent risk identification and control functions telling me what I want to hear or what I need to hear?"

On a tactical level, the changes that should be made to ensure that the issues that have caused significant risk and loss to date are addressed going forward include the following:

- **More diligence related to covenant compliance and tracking.** Relationship managers are the first and most important component for this key risk management action. Relationship managers should aim to better understand what is happening with their business borrowers, including changes in their customers, industry trends, changes in suppliers and trends in pricing of supplies and materials. Communicating with clients about the need for timely covenant compliance should be one of the key metrics used to evaluate lending personnel.
- **Risk-based pricing that considers not only the risk of the loan but also the risks at the enter-**

prise level. Risk-based pricing requires a good understanding and underwriting of secondary sources of repayment and related collateral valuations and of the business overall. Loan pricing should be based on input from treasury, risk managers and relationship managers. It is important to understand how all key business assets have been assessed; risk managers must be comfortable not only with assessed values but also with the process. While information such as industry concentration is important, lenders also must understand the unique factors of a specific business in even seemingly attractive industries.

- **Better and timelier risk information and enhanced accountability.** Improvements to risk management need to be pursued with the same enthusiasm as new business opportunities or cost-cutting initiatives. While downsizing to improve efficiency ratios is a reality in today's difficult economy, these efforts should not re-

duce the effectiveness of credit risk control. Given the higher risk inherent in bank portfolios today, bankers need to be more skilled at quantifying and mitigating credit risk compared to a decade ago. Going forward, the implementation of more robust business intelligence to include *forward-looking*

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risk metrics will give management and boards insight into potential problems. These risk metrics need to be captured on the front line and to incorporate not only internal but also external information. And risk managers need the independence and empowerment to be candid about risk in the portfolio.

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