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Commercial Credit Overview

Role of Financial Institutions and Commercial Credit

Financial Institutions and Credit

- Financial Institutions
  - Core Business
  - Role in the Economy
- Institution Risk Management
  - Marketplace Factors Impacting Institution
  - Institution’s Response to Marketplace Factors
- Commercial Credit and the Institution
  - Role and Activities
  - Role of Information

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What We Do

- *Products:*
  - ➔ Money
  - ➔ Information

- *Delivery*➔ Commodity Activity

- *Core Business*➔ [*Prudent **RISK***]

What We Do

- *Exist To **Fulfill Dreams***
- *Bank Product/Service➔ **Money/Information***
  - ***Convenience** (Facilitate Payments)*
  - ***Wealth Management***
    - *Build Wealth* (Investments)
    - *Protect Wealth* (Insurance)
  - ***Credit** (Replace Borrower's Cash Shortfall)*

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Risk Generators

- Marketplace Factors Impacting the Institution
- Institution’s Response to Marketplace Factors

Marketplace Factors

- External➔ No Control, But Can Manage if Aware of Issues (Opportunity/Threat)
  - Marketplace Driven by the “Dumbest Competitor”
  - Increasing Competition
  - Economy

Response to Marketplace

- Internal➔ Resources Available/Needed to Respond to Marketplace Factors (Strength/Weakness)
  - Process➔ What Needs to be Done to Manage Risk?
  - Systems➔ How Will Risks Be Managed?
  - People➔ Who Will Manage the Risks?

Role of Commercial Credit

- Two-edged Sword
  - Primary Source of Revenue Generation
  - Primary Source of Risk to Institution

- Role of Credit
  - Consumer=Individual (Compliance)
  - Commercial=Entity (Legal)

Credit Risk Overview

- ***Credit Risk= P x C***
  - ***Probability***➔ Events that will impact repayment
    - *Credit Action* ➔ ***Analysis***
    - *Activity*➔ ***Identify Risks***
  - ***Consequences***➔ Events Not Occurring as Expected
    - *Credit Action*➔ ***Structure***
    - *Activity*➔ ***Mitigate Risks Being Taken***

Commercial Credit Assessment

- *Commercial Credit*➔ Financing the Borrower's ***"Cash Shortfall" (CAUSE)***

- *Commercial Loan*➔ Finance a ***Self-liquidating Asset (REPAYMENT SOURCE)***

- ***Properly Managed Credit ALIGNS the Cause with the Repayment Source***

- ***Key focus is on "Getting the Cash Back!"***

How We Do It

- ***Credit➔ Financing the Borrower's Cash Shortfall***
  - Where/Why/What for ***Cause*** of Cash Shortfall
  - Events Necessary to Generate ***Cash for Repayment***

- General Approaches to Credit Decisions
  - *Character*➔ "How Long Have You Lived in the County?
  - *Collateral*➔ "What's It All Worth?"
  - *Credit Scoring*➔ "How Have You Been Behaving?"
  - ***Cash Flow➔ Borrower Behaviors!***

Behaviors→ Cash Drivers

- (IS) Sales
- (BS) Inventory DOH
- (BS) Accounts Receivable DOH
- (BS) Accounts Payable DOH
- (IS) Gross Margin
- (IS) Operating Expense as % of Sales
- (BS) Capital Expenditures

Cash Outcomes

- ***Uses*** *(Cash Outflows)*
  - *Increase Assets* ➔
  - *Decrease Liabilities* ➔
  - *Decrease Equity* ➔

- ***Sources*** *(Cash Inflows)*
  - *Debt* ➔
  - *Equity* ➔

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Credit Risk Assessment

- ***Financial Analysis*** ➔ ***Quantitative Analysis***
  - *Involves "Numbers"*
  - *Obtain Multi-year Data* ➔ *Perform Trending* ➔ *Identify Change*
  - *Generates "Questions"* ➔ ***Start Point*** for Credit Analysis
  - ***Key Tool to Perform Credit Analysis***

- ***Credit Analysis*** ➔ ***Qualitative Analysis***
  - *Involves "Events"*
  - *Generates "Explanation" of Reason/Impact of Change* ("Risks")
  - *Used to Understand Issues Impacting Repayment (*Borrower's Response to Marketplace Factors Impacting Business)
  - ***Key Tool to ANTICIPATING THE FUTURE***

[GET THE CASH BACK!!!!]

Key Credit Concepts

- *No One Ever Makes a Loan Decision; Every Decision Is **a Portfolio Decision**.*

- ***You aren't paid to make a loan; you are paid to manage credit risk!***

- *Focus of Analysis on **"Anticipating the Future"***

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Risk Assessment

No One Ever Makes a Loan Decision; Every Decision Is a Portfolio Decision.

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Portfolio Risk

- Results from Institution’s Response to Marketplace in the Future *[SWOT]*
- Driven by Credit Policy
  – Communicates Institution’s Business Plan for Credit Products
  – Sets Expectations for Personnel Behaviors
- Occurs at Several Levels

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Risk Assessment

You aren't paid to make a loan; you are paid to manage credit risk!

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Credit Risk Management

- Credit Risk=P X C
  - Probability➔ *Identify Risks*➔ ***Analysis***
    - Financial➔ Identity Change➔ Generates Questions
    - Credit➔ Explain Events➔ Anticipate the Future
  - Consequences➔ *Mitigate Risks*➔ ***Structure***
    - Covenants
    - Collateral
    - Documentation
    - Pricing

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Credit Risk Management

- Portfolio Management➔ What Risks Are We Willing to Take?
- Portfolio Acquisition➔ How Will We Manage the Risks Taken?
- Portfolio Maintenance➔ What Do We Do With It Now That We Got It?

Risk Assessment

Focus of Analysis is on "Anticipating the Future"

Credit Risk Management

- Yesterday's Loan Repaid With Today's Cash; Today's Loan Repaid With Tomorrow's Cash
- Must GET THE CASH BACK!
- Must Have/Understand Activities to Increase Likelihood of Repayment
  - Strategy➔ Credit Policy
  - Tactics➔ Credit Process
  - Action➔ Credit Practice

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Role of Information

Organized ***DATA*** ➔

Becomes ***INFORMATION***➔

Creates ***KNOWLEDGE***➔

Generates ***OPPORTUNITY!***

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Action Needed

- Assess Your Current Situation
  - Current Marketplace Factors
  - Current Response to Factors

- Understand Desired Results for Institution
  - Future Marketplace Factors
  - Future Response to Factors