Commercial Credit Overview

Commercial Credit Risk Management
Issues/Activities

Risk Assessment/Management

- Anticipate Your Institution's Future
- Develop Risk Management Framework to Achieve Desired Future
- Implement Necessary Process to Execute for Desired Future
- Generate Action to Achieve Desired Future
- Role of Information

Financial Services Industry

- ***Business Behaviors in Marketplace are Driven by the "Dumbest Competitor"***
- Competitors are everywhere
  - Brick & Mortar
  - Internet
  - FinTech
- Battleground is Too Big to Fail versus Community Banks; *Credit is Weapon of Potential Mass Destruction*

Financial Service Basics

- Exist To ***FULFILL DREAMS***

- Provides→ ***MONEY/INFORMATION***
  - *Convenience* (Facilitate Payments)
  - *Wealth Management*
    - Build (Investments)
    - Protect (Insurance)
  - *Credit* (Replace Borrower's Cash Shortfall)

- Role in Economy as ***RISK INTERMEDIARY***

Credit Risk Management Tools

- ***Avoid the Risk*** *("Just Say No")*
- ***Take the Risk*** *("Just Do It")*

- ***Mitigate the Risk*** *(Collateral/Derivatives)*
- ***Transfer the Risk*** *(Participations)*
- ***Insure Against the Risk*** *(Government Programs)*
- ***Limit the Risk*** *(Legal ➔ House ➔ Concentration ➔ Lending Authority)*

Actions to Manage Credit Risk

- ***Make Credit a Strategic Event, not a Tactical Event***
- *Return to Basics of Sound Credit Risk*
- *Understand Marketplace and Develop Institution's Response* ***(Future Financial Performance)***
- *Inspect What You Expect*

Credit Basics

- Credit➔ Financing the borrowers ***CASH SHORTFALL*** (“Dreams”)

- Focus of credit activity is to assess ability to get the ***CASH BACK*** (“Repayment”)

- Credit Risk Involves Understanding
  - Where/Why Ran Out of CASH (6 Causes)
  - Determine Ability/Willingness to Repay
  - Monitor Behaviors to Repayment

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Credit Risk Management

- *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 Credit Concepts

- *"No one ever makes a loan decision; all decisions are **portfolio decisions**!"*

- ***"You aren't paid to make loan decisions; you're paid to manage credit risk!"***

- *Yesterday's Loan Repaid With Today's CASH;* ***Today's Loan Repaid With Tomorrow's CASH!***

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Key Credit Concept

*"No one ever makes a loan decision; all decisions are **portfolio decisions**!"*

Portfolio Issues

- Represents "pooling" of homogeneous risk
  - Ag
  - C&I
  - CRE
  - Private Banking

- Levels
  - Front Line Officer
  - Branch
  - Bank
  - Holding Company

Credit Risk Outcome

Marketplace Factors Impacting Institution

PLUS

Institution's Response to Marketplace

EQUALS

Institution's Financial Performance

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Credit Risk Activities

- *Understand Marketplace*
  - ***Know Key Driver***
  - Manage to Key Influencers
- *Develop/Implement Response*
  - Establish Institution's ***Credit Priority***
  - Communicate Expectations
- *Inspect What You Expect (MIS)*

Assessing Risk—Marketplace

- ***Risk=Probability X Consequences***
  - ***Probability***= Likelihood that an event will occur ***(Identify)*** ➔
  - ***Consequences***= Impact if that event doesn't occur as intended ***(Mitigate)*** ➔

- ***Challenges to Success***
  - External Factors (Opportunity/Threat)
  - Internal Factors (Strengths/Weaknesses)

Understand Marketplace

- ***Institution's Outcomes are Result of Intersection of Marketplace Factors Impacting Institution and Institution's Response to those Factors***

- *Know Key Driver(s)*
  - Employer
  - Industry
- *Assess Key Influences* (Internal/External)
- Determine ***Level of Credit "Desirability"***
- Manage ***COVARIANCE***

Risk Assessment/Response

- *Marketplace ➔ External*
  - Factors
    - ***Opportunities*** (Competitive Advantage➔ Leverage)
    - ***Threats*** (Competitive Disadvantage➔ Avoid)
  - *Uncontrollable, But Manageable*

- *Institution Response ➔ Internal*
  - Factors
    - ***Strengths*** (Maximize)
    - ***Weaknesses*** (Minimize)
  - *Foster Appropriate Personnel Behaviors*

- *Perform on Ongoing Basis ("Rolling")*

Risk—Response

- Utilize Assessment Analysis
  - Opportunity➔ External➔ Leverage
  - Threats➔ External➔ Avoid
  - Strengths➔ Internal➔ Maximize
  - Weakness➔ Internal➔ Minimize
- Develop/Implement Strategic Credit Risk Plan

Key is assessing potential outcome of External and Internal Factors (Future Financial Performance)

Credit Risk Basics

- ***Manage as Strategic Activity***
  - *"Lending"➔ Tactical Focus*
  - *"Credit"➔ Strategic Focus*
- *Credit "Components"*
  - *Product* (Lines of Business)
    - Replaces Borrower's Cash Shortfall *(Commercial Credit)*
    - Understand True Borrowing Cause *(Cash Shortfall)*
    - Understand Repayment Source *(Self-Liquidating Asset)*
  - *Process* (Solutions to Cause of Shortfall)
    - How to Manage Risks of Delivery *(Strategic Framework)*
    - How to Deliver Solution *(Credit Process)*

Credit Risk Focus—Portfolio

- *Establish Clear Credit Priority*
- *Establish/Communicate Expectations for Front-line Behaviors*
- *Inspect What You Expect*

No one ever makes a "loan decision"; every decision is a "portfolio decision"

Manage Credit Risk—Portfolio

- *Determine How to Manage Credit Paradox* ***(Credit Priority)***
- *Determine Credit Activities to Achieve Priority* ***(Credit Risk Management Strategy)***
- *Manage for Long-term/Consistent Earnings* ***(Credit Policy)***
- Establish/Manage Credit Priority Control ***(Credit Process)***

Risk Management Framework

- ***Determine Credit Priority***
- ***Implement Appropriate Credit Culture***
- ***Determine Risk Strategy***
- ***Implement Necessary Risk Controls***

Corporate Objectives

- Philosophy=***Credit Priority*** *(Determine Level of Risk to be Managed)*
  - Growth
  - Profitability
  - Quality
- Action=***Credit Policy*** *(Establish Risk Management Control)*
  - Role=*Communication Of Priority*
  - Focus=*Board Expectations*
  - Outcome=*Personnel Behaviors*

Goal is Long Term Consistency of Earnings

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Role of Credit Policy

- ***Credit Policy***, NOT Loan Policy
  - *Strategic* versus *Transaction* Outcomes
  - Credit Risk
    - *Primary Exposure—Direct Risk*
    - *Secondary Exposure—Indirect Risk*
- Establishes ***Credit Priority***
  - Soundness/Quality
  - Profitability
  - Growth

Ensure to make Credit Policy YOURS!!!!

Role of Credit Policy

- Generates *Desired Behaviors* for Front Line Personnel ***(Credit Culture)***
- Determines Criteria for Credit Review ***(Inspect What You Expect)***
  - *Policy Compliance*—Doing the Correct Things
  - *Procedure Adherence*—Doing Things Correctly
  - *Risk Rating Reliability*—Monitoring/Level of Credit Administration

Manage PROACTIVELY

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Credit Culture

- Culture is Determined by ***ALIGNMENT***
  - Management ***OBJECTIVES***
  - Personnel ***BEHAVIORS***
- Outcome
  - *Loose*
  - *Tight*
- Approach *(Develop/Foster)*

Risk Strategy Actions

- ***Utilize appropriate activities/tools to achieve desired priority to generate long-term, consistent earnings regardless of marketplace situation***

- ***Proactively Manage COVARIANCE***

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Risk Controls

- Focus➔ *Achieve Credit Priority*
- Action Needed➔ *Achieve Alignment*
  - Management Objectives
  - Personnel Behaviors
- Results Needed➔ *Manage Covariance*
- Outcome➔ *Measure Against Priority* (Adjust as Appropriate)

Risk Controls

- ***Can't Manage What You Can't Measure***
- *Tools*
  - *Underwriting Process* (Standards versus Guidelines)
  - *Structure* (Alignment—Cause/Repayment Source)
  - *Risk Rating System* (Potential Volatility to Repayment)
    - Banker➔
    - Bank➔
  - *Approval System* (Affirmation of Decision)
  - *MIS/Reporting* (Inspect What You Expect)

Strategic to Tactical Risk Response

- *Be Aware of Marketplace*
  - Challenges to Success
  - Rolling Assessment
- *Develop/Implement Strategic Credit Plan*
  - Credit Policy
  - Credit Priority
  - Short and Long Term Outcomes
- *Execute Strategic Credit Plan—Credit Process*
  - Credit Risk Activities
  - Actions to Achieve Strategic Credit Plan

Credit Risk—Activities

- ***Process****—What Needs to be Done to Manage Credit Risk?*
- ***Systems****—How Will Credit Risk Be Done?*
- ***People****—Who Will Do Credit Risk?*

Process="What"

- Provides Credit Risk Framework—***Credit Priority***

- Key element is *Credit Policy* **(Strategy)**

- Provide linkage between Management Objectives and Personnel Behaviors ***(Credit Culture)***

Systems="How"

- Provide for Credit Delivery Activities
- Key element is *Procedures* ***(Tactics)***
- Execution must be customer/employee friendly
- Enable banker to provide value added for customer and bank
  - Credit Risk Management
  - Customer Relationship Management

People="Who"

- Must *understand what is expected* to accomplish job responsibilities ***(Process)***
- Must *have/use correct tools* to achieve desired outcomes for customer and bank ***(Systems)***
- Must *receive correct training* to achieve desired outcome for customer and bank ***(People)***
- Must be *given the opportunity* to apply skills successfully for customer and bank ***(Incentive)***

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Credit Risk Concept

"You Aren't Paid to Make a Loan Decision; You Are Paid to ***Manage Credit Risk!****"*

Credit Process Components

- ***Portfolio Management****—What Are We Trying to Achieve with Credit?*
- ***Portfolio Acquisition****—How Are We Going to Do Credit?*
- ***Portfolio Maintenance****—What Do We Do With the Credit Now That We Have It?*

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Credit Process Components

- ***Portfolio Management***

- Portfolio Acquisition

- Portfolio Maintenance

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Process—Portfolio Management

- *Philosophy/Objectives*
- *Portfolio Management*
- *Credit Planning*
- *Relationship Planning*

Credit Process

- Portfolio Management
- ***Portfolio Acquisition***
- Portfolio Maintenance

Portfolio Acquisition

- *Borrower Analysis*
- *Risk Assessment*
- *Structure*
- *Pricing*
- *Approval*
- *Documentation*
- *Relationship Administration*

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Credit Risk Defined

Probability

Times

Consequences

Risk Management—Transaction

- Credit Risk *Issues*
  - Probability➔ ***Identifying*** Risks
  - Consequences➔ ***Mitigating*** the Risks Taken
- Credit Risk *Activities*
  - Probability➔ ***Analysis***
  - Consequences➔ ***Structure***

Credit Risk Management—Transaction

- Credit Risk *Actions*
  - Identify Changes ***(Questions)***
  - Anticipate the Future ***(Cash Results)***

- Credit Risk *Outcome*
  - ***ALIGN*** the *Probabilities and Consequences* to Achieve Institution's Desired Financial Results
  - ***GET THE CASH BACK***
    - Borrower➔ Ability to ***REPAY***
    - Guarantor➔ Ability to ***PAY***

Risk Assessment

- ***Financial Analysis➔ Identify Change***
- ***Credit Analysis➔ Reason/Impact of Change***
- ***Anticipate the Future***
- ***Credit Decision➔ Make Recommendation***

Yesterday's Loan Repaid With Today's CASH, Today's Loan Repaid With Tomorrow's CASH!

Credit Process

- Portfolio Management

- Portfolio Acquisition

- ***Portfolio Maintenance***

Portfolio Maintenance

- *Credit Review*
  - Policy Compliance
  - Procedures Accuracy
  - Risk Rating Reliability
- *Problem Loan Administration*
  - Philosophy
  - Policy
  - Procedures

Credit Risk Concepts

- ***Focus on the Future***
  "Yesterday's loan repaid with today's cash; today's loan repaid with tomorrow's cash!"
- ***Be Strategic***
  "No one ever makes a loan decision; all decisions are portfolio decisions!"

  "Credit Policy is your Strategic Plan for your credit business."

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Credit Risk Concepts

- ***Operate Within Your Competency***
  "Bank performance is intersection of its marketplace and its response to that marketplace."
- ***Balance the Credit Paradox***
  "Bane of credit risk is finding the sweet spot between appropriate amount of growth with appropriate amount of quality."

Credit Risk Concepts

- ***Understand Institution's Credit Culture***
  "Maintain alignment between *Management Objectives* and *Front Line Personnel Behaviors*."
- ***Reinforce Through Ongoing Communication***
  "Its about the Message!"
- ***Manage to Desired Outcome***
  "Inspect What You Expect""

Credit Quality Management

- *Must Reinforce Business Strategy*
- *Must Be Broadly Communicated*
- *Must Be Proactively Managed*
- *Will Have Significant Impact On Organizational Performance*

Role of Information

- Institution Sources
  - Annual Report
  - Call Report
  - Uniform Bank Performance Report

- Focus of Credit Risk Assessment
  - ALLL/Reserves
  - Provision
  - Non-Performing
  - Charge-offs

Action Plan

- ***Be PROACTIVE***
  - Know Marketplace
  - Know Institution
  - Know Customers
  - Know People
- ***Anticipate the FUTURE***
  - Consider Probabilities/Consequences
  - Manage to Strategy