

Commercial Credit Overview

Making the Commercial
Credit Decision

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”*

Institution Objectives

- Balance *VALUE* maximization and *LOSS* minimization → ***Credit Paradox*** (“Sweet Spot”) ***[Portfolio]***
 - *Credit Quality*
 - *Credit Growth*
- Determine/Communicate ***Credit Priority***
- Appropriately ***Manage Credit Risk [Transaction]***

Credit Risk Management

- ***Portfolio Management*** [*Pools of Homogeneous Transactions*]
 - *Strategy (What?)*
 - *Tactics (How?)*
- ***Role of Credit Policy*** → “Having the Ability to Say NO!” (*Establishes Strategy*)
- ***Role of Credit Process*** → Method of Delivering Strategy (*Establishes Tactics*)

Credit Risk Management

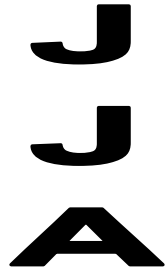
- *Process*—What Needs to be Done to Manage Credit Risk?
- *Systems*—How Will Credit Risk Be Done?
- *People*—Who Will Do Credit Risk?

How We Do It

- Product is...*MONEY/INFORMATION*
- Products belong to...*CUSTOMERS*
- Products are...*COMMODITIES*
- Core Business is...*RISK
INTERMEDIATION (Where To Say No)*

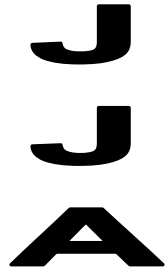
How We Do It

- ***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



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!”*

Cash Outcomes

- *Uses (Cash Outflows)*
 - *Increase Assets →*
 - *Decrease Liabilities →*
 - *Decrease Equity →*
- *Sources (Cash Inflows)*
 - *Debt →*
 - *Equity →*

Credit Risk Overview

- ***Credit Risk*** = $P \times C$
 - ***Probability*** → Events that will impact repayment
 - *Credit Action* →
 - *Activity* →
 - ***Consequences*** → Events Not Occurring as Expected
 - *Credit Action* →
 - *Activity* →

Credit Risk Overview

- Appropriately Identify and Mitigate Risks
- *Risk Generators*
 - *Marketplace Factors Impacting the Business*
 - *Borrower's Response to Marketplace Factors*

Credit Risk Overview

Marketplace Factors Impacting Business

PLUS

Borrower's Response to Marketplace

EQUALS

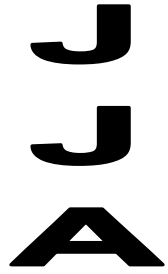
Financial Statements

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” → Issues Creating “Numbers”*
 - *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***

Credit Risk Assessment

- *Analysis Activities*
 - *Financial Analysis* → “Numbers” (Questions)
 - *Credit Analysis* → “Events” (Reason/Impact)
- *Credit Decision* → *Assess Risk Generators*
 - *Marketplace Factors Impacting Business*
 - *Borrower’s Response to Marketplace Factors*
- ***DECISION IS A RESULT OF ANTICIPATING THE FUTURE!***



Credit Risk Assessment Outcome

FUTURE Marketplace Factors Impacting Business

PLUS

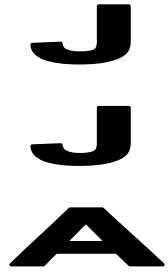
FUTURE Borrower's Response to Marketplace

EQUALS

FUTURE Financial Statements

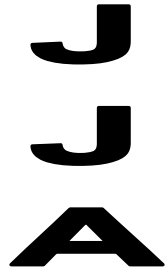
Credit Risk Assessment

- *Desired Actions → Proper Assessment*
 - *Commercial Credit → Replaces Borrower's **Cash Shortfall (Cause)***
 - *Commercial Loan → Financing of an Asset that will be **Self-liquidating (Repayment Source)***
- *Desired Outcome → Proper Risk Management (P x C)*
 - *P → **Identify Risk** → Analysis (Manage Assessment)*
 - *C → **Mitigate Risk** → Structure (Manage to Repayment)*



Key Credit Risk Concepts

- Focus on *Events*, Not *Numbers*
- Many *Numbers*, Few *Issues*
- Core Business-*Know Business of Business*
- Understand *Marketplace Factors* Impacting Business
- Understand *Management Response* to Marketplace Factors
- ***Anticipate the Future***
- *Manage to Repayment* (“**GET THE CASH BACK!**”)



Credit Decision Framework

- *Preliminary Analysis* [Prioritize Risk]
- *Request* [Gather Input Regarding Risk]
- *Marketplace Factors* [Impact Borrower]
- *Analysis* [“P” → Identify Risk]
- *Recommendation* [Credit Memo]
- *Structure* [Manage to Repayment]
- *Monitoring* [Increase Likelihood of Repay]

Credit Risk Assessment

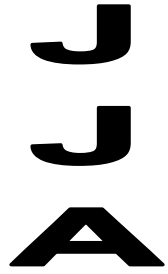
- *Desired Approaches*
 - Quantitative → “Numbers” → Questions → *Financial Analysis*
 - Qualitative → “Events” → Explain Numbers → *Credit Analysis*
- *Desired Result → Anticipate the Future! (Get the Cash Back!)*
 - 7 Cash Drivers (Assess Borrower Behaviors)
 - Cash-to-Cash Cycle (Understand How Cash Moves Through the Business)

Commercial Credit—Focus

- Successful commercial analysis involves the *effective* and *efficient* gathering, utilization, and management of **INFORMATION**
- Risk Generators → Information Needed
 - *Marketplace Factors Impacting Business*
 - *Borrower Response to Marketplace Factors*
- ***Anticipate the Future—Use of Information***
 - *Future Marketplace Factors Impacting Business*
 - *Future Borrower Response to Marketplace Factors*

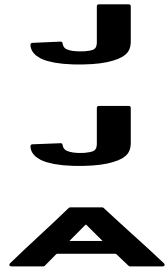
Customer Relationships

- *Competitive Advantage Against Large Bank Holding Companies*
 - They leverage transaction efficiency
 - You can't beat them at that game!
- *Customers Want Relationships*
- *Loyalty Is Cheaper Than Acquisition*



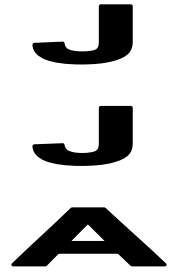
Communication & Information

- *Leverage Communication*
 - *Open/Honest*
 - *Value Added*
 - *Internal/External*
- *Enhance Use of Information*
 - *Qualify Borrower*
 - *Decision Making*
 - *Value Added*
- *Increase Effectiveness*
 - *Ask Better Questions*
 - *Improve Interview Skills*



IASM Credit Decision Process

- *Success Activity* → *enthusIASM* for:
 - *Your Products and Services*
 - *Your Customers*
 - *Your Credit Decision Process*
- *Process Application*
 - *Effort versus Exposure*
 - *Tools and Resources*



IASM Credit Decision Process

- *Information Gathering First!*
- *Analyze The Information*
- *Structure The Relationship*
- *Monitor & Extend The Relationship*

Role of Information

- Quality of Credit Decision is Directly Proportional to the Quality of Information Used in Making the Decision!
- Must Have Appropriate Information
 - Gather
 - Assess
 - Manage

Role of Information

- Enhances Results
 - Better Analysis (“P”)
 - Better Credit Memos
 - Better Structure (“C”)
 - Better Risk Management
 - Better Relationship Enhancement
- Key is Communication
 - Borrower to Banker
 - Banker to Analyst
 - Analyst to Banker
 - Banker/Analyst to Approvers