Commercial Credit Overview

Making the Commercial
Credit Decision

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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 INTERMEDIATON*** *(Where To Say No)*

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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!"***

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Cash Outcomes

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

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

Credit Risk Overview

- ***Credit Risk= P x C***
  - ***Probability***➔ Events that will impact repayment
    - *Credit Action* ➔
    - *Activity*➔
  - ***Consequences***➔ Events Not Occurring as Expected
    - *Credit Action*➔
    - *Activity*➔

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Credit Risk Overview

- Appropriately Identify and Mitigate Risks

- *Risk Generators*
  - ***Marketplace Factors Impacting the Business***

  - ***Borrower's Response to Marketplace Factors***

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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***

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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]

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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*

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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➔ enthus**IASM** for:*
  - *Your Products and Services*
  - *Your Customers*
  - *Your Credit Decision Process*

- *Process Application*
  - *Effort versus Exposure*
  - *Tools and Resources*

IASM Credit Decision Process

- ***I**nformation Gathering First!*
- ***A**nalyze The Information*
- ***S**tructure The Relationship*
- ***M**onitor & 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