Effective Credit Risk Management
Credit Risk Rating Classification System / Transcription

<u>Objective</u>

- *Tight Risk Rating System* – Refresher for assigning timely and accurate credit risk ratings as part of a tight credit risk rating system; this includes Watch designated credits
- *Promote Bank Safety and Soundness* – Facilitate informed decision making through measuring credit risk ratings; serves seven (7) important functions: credit approval, underwriting, guide price setting, relationship management, credit administration, allowance for credit losses (ACL), and portfolio Management Information System (MIS)

<u>Expectations</u>

- *Accuracy and Timeliness* – A must! Risk rating is dynamic and changes when risk changes; understand clear criteria for assigning risk ratings
- *Well-Supported and Documented* – Risk rating conclusions must reflect any credit risk weaknesses; dig deep into the root causes

Accuracy and Timeliness

<u>Why "Accurate and Timely?"</u>

- Promotes safety and soundness, and serves seven (7) important functions listed above
- The entire risk rating system can become ineffective if there are systemic "misses," especially double-downgrades
- Classified loans can "pile up" in a hurry, and the bank can become subjected to enhanced regulatory scrutiny
- Protects the bank against *unwarranted loss* (had it been done it right in the first place); helps ensure the least/best loss scenario

<u>Hesitancy Rationale Resulting in Slower Downgrades</u>

- Incentives are frequently geared toward producing loans than rating them accurately
- Past bank history includes very few payment defaults and even fewer losses
- "But they are paying as agreed, have great LTV's, lots of cash reserves, it's not the borrower's fault, the bank won't lose any money"
- Do not see the risk of any "loss"
- Overlook the repayment capacity via operating cash flows
- Sensitive to relationship needs; competitive forces; may offend borrower/guarantor/sponsor; issues will likely be resolved soon; concerned about having classified loans in portfolio
- Other: compensation programs, relationship management structures, inexperience, incompetence, unfounded optimism

<u>New Approach - Tips</u>

- Enhance the dialogue between the Primary Relationship Officer (PRO) the Credit Administrator (CA) on making risk rating decisions; the PRO maintains primary risk rating responsibility, followed by the CA
- Request and get current financial reporting regardless of requirements to submit; conduct inspections, open enhanced but respectful dialogue with the borrower
- Measure risk, be curious, develop third-party type *deep* questions, ask these better deeper questions *early on*
- Focus on the emerging trends of operating cash flow results, top line performance, margin compression, deteriorating metrics
- Approach CAs when thinking about assigning a potential Watch List designation, before the Watch List designation is prepared
- Get comfortable with and be willing to share news (that may not actually be good news) with the CAs; engage in rating definition discussions earlier
- Internal divergent views are welcome and encouraged! Remember: be respectful, diplomatic, professional; document the facts

<u>Upgrades</u>

- When credits are classified because of well-defined weaknesses (Substandard) of the borrower's financial condition or credit structure, ensure correction of the weaknesses and a period of sustained performance under reasonable repayment terms, should be demonstrated before upgrading the credit rating to Pass
- The mere existence of a plan for improvement, by itself, does not warrant an upgrade

Well-Supported and Documented Conclusions

<u>Well-Supported</u>

- Obtain appropriate *current* financial information from the borrower(s) and guarantor(s), regardless of the standard required financial reporting schedule
- Conduct adequate due diligence by asking important "3rd party type" questions, inspections etc.
- If risk rating conclusions are not well-supported, further inquiry and analysis are often required to determine the appropriate classification

<u>Documented Conclusions</u>

- If in doubt, write it up; start by writing up what you have now so it can be discussed; add to it later
- Documented support for the conclusion instills confidence; "close the loop" with documented analysis, evidence, rationale; vigorous, but respectful, diplomatic, and professional, documented defense of conclusions
- Key assumptions should be reasonable, sufficiently disclosed, well supported, carefully analyzed, and understood by a 3rd party reader: income, cash flow, receivables, valuations, etc.

Watch List Monitoring

- *Watch List Monitoring (for Uncertainties)/Early Warning System* – The Watch List process is really an early warning *system*, (Pass risk ratings), to alert senior management of any heightened, but still

acceptable, borrower risk profiles that should warrant closer monitoring due to uncertainties: financial, operational, managerial, ownership, industry, technology, labor, legal, and environmental
- *Document the Uncertainty* – Be very specific as to the uncertainty that is to be monitored, with dates, amounts, etc., with the intended resolution date
- *Watch List Designation/Timing* – Once the uncertainty is resolved, the Watch List designation should promptly be removed

Regulatory Credit Risk Rating Classifications

Special Mention
- Credit exposures that, while currently protected by the sound worth and paying capacity of the borrower, exhibit distinct weakening trends and or elevated levels of exposure, to external conditions
- If not checked or corrected, these identified potential weaknesses may result in deteriorated prospects of repayment
- These exposures require close management attention to avoid there becoming undue and unwarranted credit exposures

Example: Potential weaknesses in CRE loans may include construction delays, changes in concept or project plan, slower than projected leasing, rental concessions, deteriorating market conditions, impending expiration of a major lease, or other adverse events that do not currently jeopardize repayment. Such loans should receive an elevated level of monitoring.

Substandard
- Credit exposure that is inadequately protected by the current sound worth and paying capacity of the borrower or of the collateral pledged, if any
- Exposures so classified must have a well-defined weakness or weaknesses that jeopardize the orderly repayment of the debt
- They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected

Example: Well-defined weaknesses in a CRE loan may include: slower than projected leasing or sales activity that may result in protracted repayment or default; lower than projected lease rates or sales prices that jeopardize repayment; changes in concept or plan due to unfavorable market conditions; delinquent property taxes; construction or tax liens; inability to obtain necessary zoning or permits to develop the project as planned; diversion of needed cash from an otherwise viable property to satisfy the liquidity needs of a troubled borrower or guarantor; material imbalances in the construction budget; significant construction delays; the expiration of a major lease or default by a major tenant, without a replacement lease or remedy to default in the near term; poorly structured or overly liberal repayment terms; material collateral damage or other significant casualty losses; bankruptcy or replacement of the general contractor, major subcontractor, or suppliers; fraud or the misapplication of loan proceeds.

Doubtful
- Credit exposures classified as Doubtful have all the weaknesses inherent in one classified as Substandard with the added characteristic that the weaknesses may make collection or orderly

repayment in full, based on currently existing facts, conditions, and values, highly questionable and improbable
- The possibility of loss is extremely high, but because of certain important and reasonably specific factors that may work to the advantage and strengthening of the exposure, its classification as an estimated loss is deferred until its more exact status may be determine

Example: Use a doubtful classification for a limited time to permit the pending events to be resolved; circumstances that might warrant a Doubtful classification for CRE loans could include collateral values that are uncertain due to a lack of comparables in an inactive market, pending changes such as zoning classification, environmental issues, or the pending resolution of legal issues that could affect the realization of value in a sale.

<u>Loss</u>

- Credit exposures classified as Loss are considered uncollectible and of such little value that their continuance as bankable assets are not warranted
- This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be affected in the future
- Losses should be taken in the period in which they surface as uncollectible

Example: As a general classification principle, for a troubled CRE loan that is dependent on the operation or a sale of the collateral for repayment, any portion of the loan balance that exceeds the amount that is adequately secured by the market value of the real estate collateral less cost to sale, should be classified as a loss, if that portion of the loan balance amount is deemed uncollectible; this principle applies when repayment of the debt is provided solely by the underlying real estate collateral and when there are no other reliable sources of repayment available.