Effective Credit Risk Management
In Conclusion, Key Take-Aways / Transcription

In Conclusion…

During these times of economic downturn, CreditRMA.com aims to being a new level of awareness to the credit risk management process. It's time to use these sharpened tools to help optimize debt repayment solutions with commercial borrowers. At this point of the economic cycle, we are dealing with 'getting repaid.' It takes a real concerted effort on the part of the stakeholders inside the bank, to work together, listen, learn, and contribute. Each needs to be speak up and be heard with his/her own documented assessment, conclusions, and recommendations.

When it comes to negotiating directly with the Borrower, there needs to be a united voice within the bank that current financial reporting is required and it will be enforced. Deep-dive questions will be developed through careful analysis, and answers will be obtained to identify the root cause of any repayment issues. Understanding the problem will enable the parties to craft the right repayment solution strategy. Borrowers may also be expected to propose their own debt repayment solutions. Mutual respect for all parties will help the communication channels remain open, even when there are differing and divergent points of view.

Again, these stressful times require pro-active credit risk management processes that get to the root of each debt repayment problem, and apply the best debt repayment solution(s). CreditRMA.com encourages a new and fresh approach, beginning in 2024, to the credit risk management function. The next economic cycle will likely be unlike any other for a host of reasons. CreditRMA.com was built specifically for these times. As always, fresh ideas and collaborative thinking are always welcome, as it is imperative that we understand the credit risk on the books to maximize the bank's recovery in the shortest amount of time.

Key Take-Aways

SECTION 1) Credit Risk Rating Classification System –

- The system is critical, for a variety of reasons. Credit risk is dynamic. Asset quality monitoring needs to be thorough and frequent enough to ensure the assets are always rated appropriately. There are also many poor reasons (subject to regulatory criticism) to not downgrade loans on a timely basis, or to the correct risk rating. The risk rating system should be enhanced to include dialogue between the PRO, CA, SAD, and senior management. Each should be enabled and empowered to make documented risk rating decisions, even if the ratings end up being developed with divergent views

- The best way to have a 'healthy debate' over matters in the rating classification system is to have well-documented conclusions that each can analyze and discuss. Banks that use a Watch List designations have an early-warning system for loans that have temporary uncertainties. Lenders need to better utilize the Special Mention risk rating classification earlier on when credits first begin to deteriorate. The heightened monitoring will help ensure the bank minimizes any unwarranted losses in the long run. Once weaknesses become well-defined, they should be risk rated Substandard

SECTION 2) Credit Risk Evaluation Process –

- Risk ratings may be assigned to the "Borrower" and to the "Transaction," or just a single risk rating for the Borrower. Both systems should support the size and complexity of the bank. Assigning risk ratings should be well-supported by deep-dive quantitative analysis into the borrower's cash flow, ratio analysis and benchmarks, careful review of the pro forma projections, and avoiding 'evergreen' loans whose sole source of repayment is that of a 'refinance'

- Bank policy should dictate underwriting guidance. Assessing borrower management and the company's industry should be documented. An enhanced loan structure should include appropriate collateral and loan guarantees to protect the bank's interests. Structural weaknesses are underwriting deficiencies and will compromise the bank's ability to control the credit relationship. Measures to shore up the deficiencies should not be delayed

SECTION 3) Roles and Responsibilities for Credit Risk Ratings –

- In today's credit risk management process, roles and responsibilities need to be refreshed so there is no uncertainty as to what expectations are. Established 'lines of defense' are there for a reason. Revisit those reasons, face to face, to make sure everyone understands their role. The PRO is the first line of defense, and the PRO must state its own opinions as to the risk ratings, being well-documented

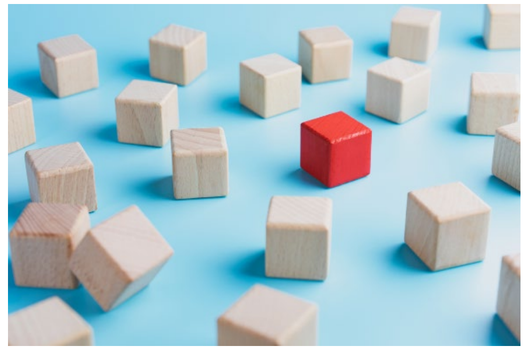
- The second line of defense is CA who should be actively involved in helping with loan structure and the consistent application of policy and credit standards. It is also time for the CA to step up in asset quality monitoring and confirm the root cause analysis with the PRO. SAD should have an active voice in any criticized risk-rated assets, including signing off on reporting at the asset quality monitoring process

SECTION 4) Watch List and Criticized Asset Quality Monitoring –

- The Watch List Reporting (WLR) function serves as a reliable early warning system (Pass risk rated credits) if the process is effective. To be effective, and reduce any unwarranted credit risk, heightened monitoring of documented current uncertainties is necessary. Concise, yet thorough, WLR also includes documenting if the uncertainties are improving or deteriorating, opining on the outlook, triggers for Watch List removal or further downgrade, and regularly presenting a WLR report. Criticized Loan Reporting (CLR) requires deep-dive analysis and questioning

- In effective asset quality monitoring, the relationship is fully disclosed, including borrower exposure, collateral protection, guarantor support, deposits, primary and secondary sources of repayment, root cause analysis, risk rating disposition, accrual status, up/down grade triggers and specific action plans to get the loan back to a Pass risk rating or a $0 balance. The frequency of reporting and individual presentation is either monthly (red), bi-monthly (yellow), or quarterly (green), where independent strategic decisions are recommended by the lines of defense and finalized in the reporting sessions, with minutes taken as an accountability measure

SECTION 5) Culture Enhancement for Divergent Views –



- It is time to rethink how, and with whom, credit risk in general, and asset quality monitoring specifically, is managed in an economic downturn. A healthy credit culture includes spaces and expectations for each stakeholder, a seat at the table, and especially for those who have differing or divergent points of view. There is a myriad of touch points in the credit risk management process, and senior management needs to understand how others see the risk ball as it is rolled around the table for others to opine how they see things. Documented independent opinions, conclusions, and mutual respect are essential. During times of economic stress, pressure builds for the bank in many areas

- But credit risk, is still risk, and the facts are the facts. Such should be documented for the file, and senior management will have ultimate responsibility for decisions that affect the bank's financial statement performance. Meanwhile, the lines of defense still have the responsibility to call the 'balls and strikes' as they seem them, even if others may disagree. Documenting the supportable 'facts' to arrive at conclusions and servicing recommendations is critical to the bank mitigating increasing credit risk developments. Truly, not virtually, valuing and appreciating bank employees has multiple benefits as opposed to an over-bearing and rigid credit culture from the top down (which tends to happen when the bank is under stress)

SECTION 6) Respect and Dealing in Good Faith with Borrowers Having Financial Difficulties –

- Borrowers who are experiencing financial problems, are not problem people. They are regular people who have a borrowing repayment problem. Bankers need to be reminded that they owe the Borrower as much respect as when the loan was granted in the first place. Dealing in good faith is also necessary to get the most recovery and least loss in dealing with borrowers needing to negotiate repayment strategies. Respect builds trust. Trust creates cooperation

- Adversarial relationships cost much more money and time in getting to resolution. Put yourself in the borrower's shoes. While the bank 'holds the cards' per the Loan Agreement and Promissory Note, the borrower still has responsibility to repay, so its voice cannot be ignored. Nor can the borrower be treated heavy-handedly or by being over-bearing. Could the bank and borrower have dinner together when all is said and done?

SECTION 7) Getting the Right Answers for Debt Repayment Solutions –

- To get the best repayment solutions for the bank and borrower, the key ingredients needed include complete financial statement reporting, deep-dive internal analysis, asking the right questions, identifying yellow/red flags, and getting to the root cause causes. After re-reading the financial reporting covenant requirements, the bank needs to respectfully require and enforce the remittance of sufficient financial information to ascertain the current credit risk in the loan. But, by being demanding to the 'letter of the law,' is that the right approach? Talk through it, work through it

- The borrower may be willing or it may not be willing. Understand 'why' before an exit strategy is imposed. Consult with CA, or even SAD to determine what deep-dive questions need to be asked and answered. Do this by identifying and documenting yellow and red flags, or other indicators of potential problem loans. Keep the line of questioning going, internally and with the borrower, until the root cause is documented, and everyone agrees. The PRO should work with CA and SAD to determine if the relationship should be transferred to SAD, or develop a mutually acceptable action plan to bring the risk rating back to a Pass or $0 balance.

SECTION 8) CRE, Problem Loan Risks –

- CRE, a secondary source of repayment, often becomes the new primary source of repayment in a serious economic downturn. The time to prepare for such an event should be as much as a year in advance of such a scenario, or more. The appraisal is a risk document as much as a snap-shot valuation. CRE collateral properties can be very complicated to understand and work with. Any number of CRE risks can have a major effect on the ultimate net realizable value (recovery) upon sale or liquidation

- It is imperative the bank understand the current market conditions, extraordinary assumptions and hypothetical conditions used in the valuation, together with lease/rental rates, vacancy, operating expenses, CAP and discount rates, current interest rates, absorption rates, lease fee estate and leasehold interests, tenant improvements, and whether a new appraisal, evaluation or validation is warranted. From a lending perspective, when negotiating with the borrower, the higher interest rate environments, how will this affect refinance risk? Understanding these risks early on will allow the bank to negotiate resizing opportunities, pricing for risk, conducting physical inspections, reviewing the adequacy of insurance coverage, and assess any potential environmental risk