Effective Credit Risk Management
Credit Risk Evaluation Process / Transcription

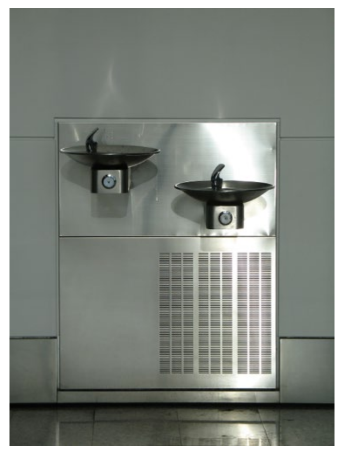
Objective

- *Credit Risk Ratings Evaluation Process* – Refresher for understanding the credit risk evaluation process in the timely and accurate assessment of rating credit risk

Expectations

- *Team Approach* – Broaden the scope and understanding of evaluating credit risk; Primary Relationship Officers (PROs) and Credit Administrators (CAs) working closer together as credit risk changes

Two (or Single) Tier Risk Rating System



Two Tier Risk Rating System
The risk rating process is accomplished in stages, Borrower Risk Rating (BRR), and Transaction Risk Rating (TRR). The TRR is used for regulatory reporting.

Borrower Risk Rating (BRR)
The BRR starts with a thorough analysis of the borrower's ability to repay in establishing the BRR. The BRR is based on the general financial strength of the borrower/issuer, and is independent of any transaction issues such as structure, collateral, or guarantors. It is an overall assessment of a borrower's financial and operating strength, including competitive issues, quality of management, financial reporting issues, industry, or economic factors, including:

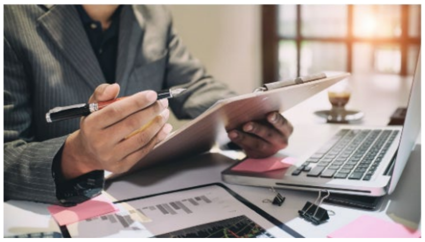
- The borrower's current and expected financial condition: cash flow, liquidity, leverage, free assets
- The borrower's ability to withstand adverse, or stressed conditions
- The borrower's history of servicing debt, whether projected and historical repayment capacity are corrected, and the borrower's willingness to repay
- Underwriting elements in the Loan Agreement, such as loan covenants, amortization, and reporting requirements
- Qualitative factors such as the caliber of the borrower management, the strength of its industry, and the condition of the economy

Transaction Risk Rating (TRR)
After the determination of the BRR, the TRR is established, taking into consideration the structural elements enhancing the loan transaction including the existence of:

- Collateral quality and control
- Guarantees and 3rd party support
- Transfer (currency conversion) risk

Single Tier Risk Rating System
Use of the BRR approach; cash secured loans would be risk rated as Pass

Quantitative Financial Statement Analysis



Quantitative analysis of revenues, profit margins, income and cash flow, leverage, liquidity, and capitalization, should be sufficiently detailed to identify trends and anomalies that may affect borrower performance.

- *Cash flow* – Business cash flow is the operating revenue derived from ordinary business activities, less operating costs paid (not simply incurred), plus non-cash expenses such as depreciation and amortization. Changes in working capital accounts, capital expenditures, and other uses of cash should be reviewed to understand the cash flow implications

- *Ratio Analysis and Benchmarks* – Analyze vital information about balance sheet and income statement proportions. Compare borrower's financial ratios with prior periods, and industry or peer group norms, to identify potential weaknesses; noted ratio deviations should have identified root causes

- *Analysis of Projections* – Expected performance should be measured against historical performance and how likely they will be achieved. Consider multiple scenarios: stressed/downside, break even, borrower management case, and bank base case

- *Refinancing* – Loans for which refinancing is a source of repayment should only be made if the borrower has the capacity to repay the loan, either through business cash flow or the liquidation of assets. A loan whose repayment continually relies on refinancing, often referred to as "evergreen loans," or whose borrower fails to achieve successful recapitalizations, requires added scrutiny; such loans are speculative at best and may warrant an adverse rating

Qualitative Financial Considerations

Qualitative analysis of sound underwriting, management, and borrower's industry, conformance to bank policy, with any exceptions adequately mitigated and documented.

- *Underwriting* – Underwriting is the process by which banks structure a credit facility to minimize risks, and generate optimal returns for the risks assumed. Sound underwriting provides protections, such as coordinating repayment with cash flow, covenants, and collateral, thereby increasing the likelihood of collection

- *Management* – Addresses the character, capability, and stability of the management team. It considers their qualifications, experience, and effectiveness in developing and implementing appropriate business and financial strategies. Competency and integrity, cannot be overstated. The ability of managers to guide, exploit opportunities, develop, and execute plans, and react to market changes, is extremely important. Unexpected loss of one or two key employees can be detrimental.

Even the most experienced management teams can be challenged by high growth (common reasons for business failure)

- *Industry* – Understand the conditions in which a business operates and the cyclical, competitive, and technological changes it is likely to experience. Most industries exhibit some degree of cyclical volatility, and some industries are exposed to seasonal variances, too. Such volatility affects the operating performance and financial condition. Technological change and new competitors, or substitute products, also affect performance

Transaction Risk Ratings

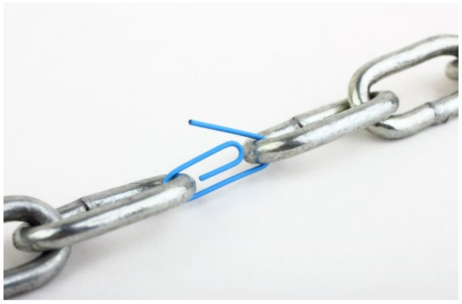
Credit risk can be moderated by enhancing the loan structure. Parties to a loan can arrange for mitigants such as collateral, guarantees, letters of credit, credit derivatives, and insurance during or after the loan is underwritten. Credit mitigants primarily affect loss when a loan defaults and, except for certain guarantees, generally do not lessen the risk of default.

- *Collateral* – Collateral is any asset that is pledged, hypothecated, or assigned to the lender and that the lender has the right to take possession of if the borrower defaults. The lender's rights must be perfected through legal documents that provide a security interest, mortgage, deed of trust, or other form of lien against the asset. Once the lender has taken possession of the collateral, loan losses can be reduced or eliminated through the sale of the assets. The level of loss protection is a function of the asset's value, liquidity, and marketability. Realistic collateral valuation is important at loan inception and throughout the loan's life, but it becomes increasingly important as the borrower's financial condition and performance deteriorates

- *Loan Guarantees* – Loans may be guaranteed by related or unrelated businesses and individuals' guarantee agreements should be as precise as possible, stating the specific credit facilities being guaranteed, under what circumstances the guarantor will be expected to perform, and what benefits the guarantor received for providing the guarantee. Guarantees can be unconditional or conditional. If a guarantee is to enhance a credit's risk rating, the guarantor must display the capacity and willingness to support the debt. A presumption of willingness is usually appropriate until financial support becomes necessary. At that point willingness must be demonstrated. When adequate evidence of guarantor performance is lacking, the guarantee should not have a beneficial effect on the risk rating

- *Letters of Credit (LC)* – An L/C is a form of guarantee issued by a financial institution. An L/C rarely protects against default risk, unless it specifically can be drawn on for loan payments. An L/C issuer is typically more creditworthy than a guarantor. When an L/C that protects against default is obtained from a high-quality institution, it may effectively prevent default and losses. The issuers low credit risk substantially mitigates the borrower's higher credit risk. Before a loss scenario could develop, both the borrower and the L/C issuer would have to default. An L/C can be irrevocable, which means all parties must agree to its cancellation, or revocable, which means the L/C can be cancelled or amended at the discretion of the issuer. Revocable letters do not mitigate credit risk. A standby L/C pays only when the obligor fails to perform

Structural Weaknesses



Structural weaknesses are underwriting deficiencies that can compromise a bank's ability to control a credit relationship if economic or other events adversely affect the borrower. Evaluate the relative importance of such factors in the context of the borrower's overall financial strength, the condition of the borrower's industry or market, and the borrower's total relationship with the bank. Third-party reviewers will take note of the following:

- *Indefinite or Speculative Purpose* – The loan purpose should clearly reflect the actual use of the proceeds. Loans for ambiguous or speculative purposes deserve extra scrutiny

- *Indefinite or Overly Liberal Repayment Program* – Loans that lack a clear and reasonable repayment program, source and timing, present extra risk, regardless of their nominal maturity. This includes loans that revolve continually or "evergreen loans," where the bank is essentially providing debt capital. Typical indicators of unrealistic repayment terms include: bullet maturities unrelated to the actual source of repayment funds, rewrites, or renewals for the purpose of simply deferring a maturity, loans used to finance asset purchases with a repayment plan significantly more than the useful life of the asset, and advances to fund interest payments

- *Nonexistent, Weak, or Waived Covenants* – Whereas effective covenants provide the bank with the opportunity to trigger protective action upon covenant default, be alert for covenants that have been waived or renegotiated by the bank to accommodate a borrower's failure to maintain the original standards. Make use of meaningful covenants

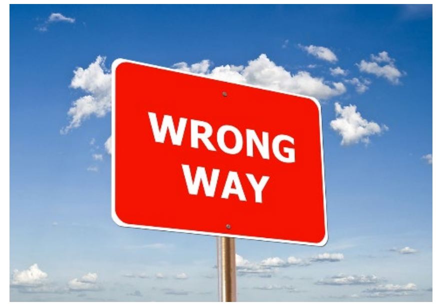
- *Inadequate DSC* – The initial underwriting of loans that are intended to be repaid from operating cash flow, should provide for an acceptable margin to repay both principal and interest in a reasonable time based upon historical performance. If repayment is predicated on new revenues that are expected to be enabled by the loan, then anticipated future cash flows should be reasonable and well documented

- *Elevated Leverage Ratio* – Acceptable leverage ratios vary based on industry, loan purpose, covenant definition, capital expenditure restrictions, and dividend payouts. Review the reasonableness of the leverage ratio and how it is defined. Leverage ratios may be calculated as debt to worth or debt to cash flow. Industry standards prescribe which methodology is most appropriate

- *Inadequate Tangible Net Worth* – Companies need tangible net worth to sustain them during unforeseen, adverse situations. Consider both the absolute amount of tangible net worth and its amount relative to debt

- *Insufficient Collateral Support* – This occurs when the borrower is not deserving of unsecured credit, but is either unwilling or unable to provide a satisfactory margin of collateral value. Consider senior liens, the costs associated with liquidation of the collateral, and the potential reputation risk that might influence the bank's willingness to liquidate, including lender liability issues

- *Inadequate Collateral Documentation and Valuation* – Collateral should be documented by evidence of perfected liens and current appraisals of value. Federal regulations govern the appraisal requirements relating to many forms of real estate lending. Other unregulated types of collateral should also be supported by appraisals or valuations reflecting an economic value commensurate with the loan terms. Loans for which the bank is not materially relying on the operation or sale of the collateral as repayment (i.e., the bank has truly obtained collateral as an abundance of caution), should not be included in this category



- *Overly Aggressive Loan-to-Value (LTV) or Advance Rates* – LTV and advance rates should reflect the useful life of the collateral pledged, depreciation rates, vulnerability to obsolescence, and market volatility. Loans-to-cost (LTC) relationships should also be considered, particularly for CRE projects

- *Inadequate Guarantor Support* – Guarantors may serve a variety of purposes in the credit process, including as an abundance of caution. Analyze guarantor support in the context of the bank's actual expectations of the guarantor, as well as the guarantor's willingness to support the credit, if called upon to do so. Inadequate guarantor support may result when the bank relies on a guarantors presumed financial strength, but has not fully analyzed the guarantor's financial information, including contingent liabilities and liquidity. Inadequate guarantor support may also occur when a guarantor, whose support was critical to the original credit decision, is subsequently released from the obligation without other offsetting support

- *Repayment is Highly Dependent on Projected Cash Flows* – Where repayment relies heavily on optimistic increases in sales volumes, or savings from increased productivity or business consolidation; may also include loans whose projections do not adequately support debt service over the duration of the loan or whose projections rely on an unfunded revolver or other external sources of capital or liquidity. CRE loans with limited or no pre-leasing or sales should be considered for this category

- *Repayment is Highly Dependent on Projected Asset Values* – Where loans that are projected to be repaid from the conversion of assets at a value that exceeds current value when the projected appreciation is not well-supported; may also include loans for which the LTV is too thin to weather a decline in value resulting from normal economic cycles

- *Repayment is Highly Dependent on Projected Equity Values* – Where loans that are predicated on the projected increasing value of the business as a going concern fits this category. These enterprise value loans typically have all the business assets, including goodwill and stock of the borrowing entity, pledged as collateral. Enterprise values can fluctuate widely especially during economic downturns

- *Repayment is Highly Dependent on Projected Refinancing or Recapitalization* – Where loans are made based on the expectation that proceeds from the issuance of new debt or equity will repay a loan. These are not bridge loans pending a closing, rather, the future debt or equity event is uncommitted or has other elements of uncertainty. May rely on optimistic assumptions about the future direction or performance of debt markets, equity markets, or interest rates