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The Benefits of Modernizing the Commercial Credit Decisioning Process

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Regulators and auditors expect banks' data submissions to be more detailed than ever before. However, many banks still labor under outdated credit decisioning systems – black holes in which valuable loan data disappears and can no longer be used for critical processes such as stress testing. This article explains the benefits of an online decision system to deliver higher returns on risk while making regulatory compliance easier and cheaper.

Introduction

Commercial bankers understand that granting a loan is an iterative and dynamic process, not a distinct event with a simple "yes" or "no" outcome. It involves many data inputs and outputs, as well as examination of risk and revenue tradeoffs. A facility often evolves substantially before finalization.

Traditionally, a "loan file" was essentially closed once a bank finalized the facility, made the credit decision, and released the funds. Bank credit policies typically required an annual review, at which time the bank would update the borrower rating and close the loan file for another year. Periodically – and often haphazardly – the bank's staff checked the compliance status of the loan covenants (or, being overwhelmed, ignored them). Banks rarely placed enough clean, consistent, and quality data in a searchable system to determine covenant compliance without having to manually reopen a credit file.

Today, the data from the loan decisioning process for complex commercial credit facilities is still rarely aggregated in a searchable, reportable, and auditable system – even at sophisticated banks. Instead, this data is manually loaded into Excel or Word documents from various source systems and left in flat files where it can't be re-used for more critical processes, such as stress testing, covenant monitoring, or model validation.

The data on a typical commercial loan decision document comes from many areas, including customer relationship management (CRM), core systems, deposit and exposure systems, financial statement spreading systems, and scoring systems. This aggregated information is frequently used only to facilitate credit committee decisions and is not conveniently stored in one system. Banks thus lose invaluable opportunities to repurpose a rich dataset for meaningful activities that could ultimately increase revenues and greatly lower compliance and audit costs.

Credit decision data can help answer regulators' questions

The recent financial crisis revealed that some banks did not electronically store data from the credit decisioning process and lacked systems to track covenant compliance. In addition, regulatory expectations for data retention, storage, and reporting have grown considerably – indeed, both regulators and auditors are increasingly requiring that banks capture and store all key data points and collateral information associated with making a commercial loan decision. Antiquated and standalone systems no longer meet these demands, much less optimize revenues.

- Faster loan approvals, which will increase the bank's loan closure rate and throughput
- Automated covenant monitoring and reporting
- Lower regulatory compliance costs
- Ability to re-use origination data for stress testing and model validation
- More consistent underwriting and better return on risk

We will examine each of these benefits in detail, as well as some of the challenges that banks may encounter when switching their systems.

We know of one leading US commercial bank that employs 20 full time workers to aggregate and clean data in preparation for the FR Y-14Q quarterly data submission for stress testing. What if the bank had a clean, aggregated, and reliable source of data? Both regulatory compliance costs and data error rates would decline, and the bank would be able to more meaningfully deploy resources to more profitable tasks.

The questions regulators ask banks might seem easy, but experienced bankers know that they can be difficult to answer, owing to the limitations of their systems. Among some of the simple but challenging regulatory and audit questions are the following:

- How many loans are guaranteed by the same guarantor, for example, by a high net-worth individual or real estate developer?
- How many loans comply with covenants? How many do not?
- What credit decisioning data does the bank have for model validation?
- What is the bank's direct and indirect exposure to a given customer or financial institution?
- Can the bank stress the inputs to its rating models for enterprise stress testing?
- Can the bank recreate its rationale for a commercial loan decision?
- How many loans are related to a specific customer?
- Why does the bank have multiple spreads or credit files for a given customer? Which one is correct?

Enter the era of modern online commercial credit decisioning

Answering these questions is challenging, but improving the credit decisioning process will make it easier and will also provide banks a number of benefits, among them:

Faster loan approvals increase loan closure rates and productivity

Loan approvals often face bottlenecks, whether from multiple approval requirements because deals exceed credit authority or a key credit officer is on vacation. Modern credit decisioning systems can assign approvals to the appropriate credit officer and reroute requests when resources are out of the office.

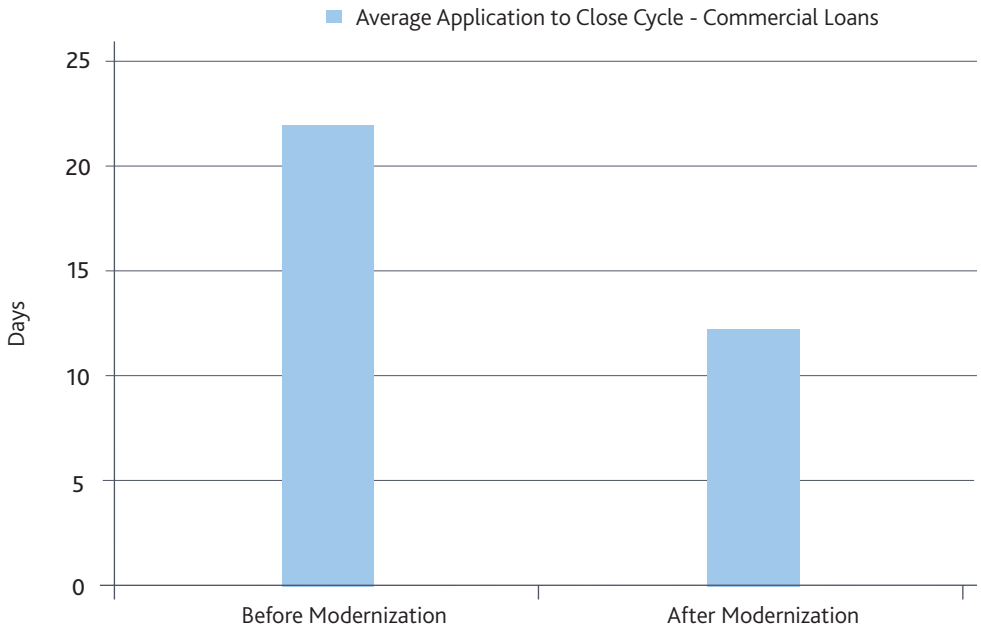
Bankers can use online technology to improve the speed and accuracy of their loan decision making process, earning them more business. Credit teams can add new approvers on the fly (or the system can do this automatically) and establish a "service level," or a schedule that outlines when the tasks required in the credit process have to be completed. For example, if the service level for financial statement spreading and analysis is four hours, the deal team can expect turnaround within that time span. Service levels can be tracked to identify bottlenecks and improve productivity.

These and other process efficiencies can shorten the cycle for credit decisioning. If a complex commercial credit decisioning process can be cut from 22 to 12 days, productivity and profitability will increase dramatically, which could boost loan throughput significantly.

Automated covenants monitoring and reporting

Regulators and auditors have expanded their scrutiny of covenant monitoring and reporting. For example, in the US Federal Reserve regulators are increasingly issuing Matters Requiring Attention

Figure 1 Decision cycle length for large commercial loans: before and after modernization



Source: Moody's Analytics

(MRAs) to commercial banks to improve systematic monitoring and compliance reporting for both financial and non-financial covenants.

An efficient credit decisioning process will automatically capture covenants at the point of credit underwriting and monitor them throughout the life of the loan. Banks can select from a library of standard covenants or customize them for a customer's specific risk attributes. Integration with the spreading process can automatically test financial covenants when a borrower's monthly, quarterly, or annual financial statements are analyzed. Portfolio- or business line-level reports can automatically identify customers who do not meet covenant requirements. Banks can track the entire covenant resolution process – granting customers a grace period, giving them the opportunity to cure the covenant, and monitoring the cure periods – so that they can determine how to improve or expedite the process.

Moreover, having this data and history at hand provides banks another powerful benefit: They can more quickly adjust their credit policies to eliminate covenants that do not result in a meaningful reduction of risk. Imagine a credit policy with fewer but more effective loan covenants!

Decreased regulatory compliance costs

Historically, most banks stored credit decision data and documents in an unstructured or even imaged process. Given that regulators now require more information about the rationale and all of the data involved in a commercial lending decision, however, these systems are inadequate and unable to deliver the information in the format required.

Most underwriting and decisioning systems were designed for a single purpose – credit decisioning – and not for submitting data in bulk to the regulator. This has led to banks' hiring dozens of people to cut, paste, and audit underwriting data for consistency and de-duplication as they prepare information for submission to regulators.

We know of one leading US commercial bank that employs 20 full time workers to aggregate and clean data in preparation for the FR Y-14Q quarterly data submission for stress testing. What if the bank had a clean, aggregated, and reliable source of data? Both regulatory compliance costs and data error rates would decline, and the bank would be able to more meaningfully deploy resources to more profitable tasks.

Re-use of decisioning data for stress testing and model validation

One essential element required for both stress testing and model validation is good, clean, standardized data. A modern credit decisioning system can deliver this data in droves to stress testing and quantitative teams, which can then build and update more powerful and relevant models.

Banks can use data validation rules in the origination process so underwriters don't mistakenly enter incorrect data. The data from credit decisioning can be used to build bottom-up or top-down stress testing models. Historical data on a borrower's financial status, loan performance, and other key data elements can be quickly exported to model development environments to build more relevant models. This lowers the costs of ad hoc data requests from quantitative teams because the system provides the crucial data to the modeling teams on the back end.

Delivering a higher return on risk

A modern credit decisioning system can help a bank identify trends, giving it a competitive edge and boosting its commercial portfolio profits. Readily accessible portfolio-level reporting can help banks spot performance trends in borrowers' financials and also regional or industry trends.

With reliable underwriting and loan performance data and an online decisioning system, a bank can segment its portfolio by region or industry and quickly analyze data and identify bright spots in the market. For example, during the financial crisis, many banks abandoned commercial real estate owing to the housing market crash; medical office loans, however, performed well – throughout the crisis. Banks can adjust their industry and regional portfolio composition to beat the competition in promising market segments.

Conclusion

A modern, more powerful online credit decisioning process can help improve a bank's commercial portfolio performance, no matter the economic condition, through a combination of increased revenue, process efficiency, and lower regulatory compliance costs.

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