

WHITEPAPER

Author

Kevin Begg
Senior Advisor

Contact Us

Americas	+1.212.553.1653
Europe	+44.20.7772.5454
Asia-Pacific	+852.3551.3077
Japan	+81.3.5408.4100

Five Reasons Why Banks Must Modernize Their Credit Process

The global financial crisis exposed many banks around the world for having underinvested in their risk technology over the preceding decades. IT budgets have swollen in the years since to be consumed by new systems addressing regulatory requirements, enlarged compliance functions, and seemingly black hole risk optimization programmes. However, a study has shown that as much as 85% of technology time and resources are devoted simply to keeping legacy systems on life-support.

To many loan originators or underwriters, the technology world does not appear to have moved on and the credit lifecycle remains the domain of manual processes, over-lapping yet unconnected systems, and enough paper to keep the world's printer and ink manufacturers in business. But does it have to be this way?

Viewed from the perspective of a former banker who spent many years in the weeds of a traditional bank credit process, this paper shortlists five reasons why banks might consider technological solutions to their loan origination gremlins.

1. Process efficiency: reducing the "time to yes"

Loan origination concerns the onboarding of risk. And when banks function as part of what some commentators refer to as "the real world economy," they take on risk by providing credit to individuals, firms, corporations, the public sector, and also amongst themselves. However, whilst the risk onboarding process necessarily involves a technical assessment of customer default probability, loss in the event of default and whether or not a credit fits within the bank's risk appetite, most bankers will tell you this is not where the time is swallowed up. The inefficiency in the underwriting process occurs in the preparation of the credit proposal, outlining in Technicolor detail for the credit committee what all these risks are and calculating their likelihood and impact alongside what can be done to mitigate them.

In practical terms, the credit underwriting process is as much concerned with the flow of information between those who have it (the borrower and the relationship team) and those who need it to form an opinion (credit analysts and underwriters). However, the procurement, interpretation, and presentation of this information can often take several weeks and can be a joyless endeavor to boot, especially if you are the bank customer on the receiving end of countless information requests. If efficiency is a measure of output relative to the sum of input, then tackling this arduous information process ought to be a priority for banks.

Rather than an underwriting process built on an endless to and fro of information request and response between different parts of the bank and the customer, consider one based upon a single shared source of information. Rather than a model where every fact and figure of client intelligence is the realm (often jealously guarded) of the relationship team, consider one where this knowledge is under the common ownership of the front, middle, and back office (subject, naturally, to the laws of compliance). Rather than a process dependent on the manual aggregation of information or data from a number of different systems, imagine one that houses all this information in the same place.

There is no need to dream. Today banks have an abundant choice of credit origination software that to varying degrees makes the above vision a reality. Collaborative platforms exist that integrate a bank's CRM database with limit and exposure reporting, whilst also incorporating several components of the underwriting process – risk appetite, spreading, risk rating, facility structuring, collateral management, and covenant scheduling. Many systems also marry these with a document generator to assemble a range of credit submission templates available to print or push electronically to the risk department for loan approval.

In defence of the relationship manager, getting the required information from a client to enable risk to form a credit opinion is often difficult. This is especially true in the small and mid-size enterprise (SME) segment, where the owner-operator of the business often wears two hats as the over-worked bookkeeper charged with responding to the bank's endless information demands. But here, recent advances in technology also serve up a solution via the ability of bank systems to directly interface with the financial accounting software package used by the prospective borrower. This makes it possible for the bank to remotely access the information it needs to make an initial assessment of the applicant's financial position, and even to calculate a preliminary risk rating.

Given these capabilities, it is easy to imagine how much time could be taken out of the underwriting process for a new loan proposal; reducing the "time to yes" by as much as 30% to 40% is realistically achievable. Moreover, why should banks require relationship officers to prepare and submit annual reviews when all the information necessary for the risk department to fulfill its obligations is contained in the system they both share? Ditto covenant compliance reporting; ditto minor amendment requests and waivers; ditto updates on the borrower's management details. In fact, when the information required to lubricate the credit machine is shared instantaneously, processing and turnaround times can only benefit.

2. Raising the standard: transparency, consistency, and auditability

When asked, banks have little difficulty providing an example of their credit process working at its efficient best. However, too often this gold standard is an isolated case and the truth is that many bank credit processes are characterized by manual procedures, laborious data reconciliation, inconsistent underwriting quality, knowledge concentrated in the heads of a few, and opaqueness when it comes to the final decision. The result is often an outcome based on imperfect information or a process so long and drawn-out that the customer goes elsewhere.

Attempts to replicate best practice across the bank to challenge this status quo often meet familiar obstacles – the rainmakers are too occupied with wooing clients and doing deals to share the secrets of their success. (And oftentimes the organization would rather they maintained that focus.) Meanwhile, headcount pressures have meant priority is given to operational needs, whilst investment in formal credit training programmes has been pared back over recent years due to cost control.

Modern loan origination systems can bring a level of standardization to credit underwriting by ensuring conformity to an optimal way of managing the process. Individual banks vary in certain details, but

overwhelmingly the credit underwriting process follows a consistent pattern in most banks and this process can be improved if everyone involved with it shares a common platform. Having instantly shared access to the information required to undertake the underwriting process brings efficiency but also a heightened degree of transparency, whilst reducing the operational risk of critical information being the preserve of a few key personnel.

For large banks with wholesale corporate clients whose financing needs are complex, coordination of the credit process can quickly spiral out of control. Several steps in this process are undertaken by different individuals, utilizing a variety of different applications, timelines, and working methods. Moreover, most of this activity relies heavily on the deal principal to ensure all the plates are kept spinning in the air and don't come crashing to the floor.

Replacing manual methods for financial spreading, risk grading, and facility structuring (including covenant and collateral management) with a collaborative platform which acts as both the electronic credit file and delivery vehicle for new loan requests and amendments can also yield compliance and audit benefits. The system records each step in the process and generates an audit trail of what was proposed, when, and by whom; and as the transaction progresses it will also record the decision rationale and all the conditions attached. Saving all these steps digitally in a permanent record rather than in an amalgam of email, instant messages, spreadsheets, and document templates is not just a better way of working, but also brings considerable advantages for internal and external audit review as well as compliance.

3. It's all about the data

Banks generate vast amounts of client data and most are very bad at managing it. Never was this more apparent than during the financial crisis, when many global banks were unable to quickly aggregate single-name risk exposures across their portfolios, causing many to incur huge losses. Moreover, in the aftermath of the crisis, as banks sought to establish asset reduction programmes to repair their balance sheets, painstaking data remediation projects had first to be undertaken. This was a resource-intensive diversion from the core tasks of nurturing client relationships and generating revenues, just when these banks needed to focus on those activities the most.

Banks that had grown rapidly through acquisition and those that had expanded aggressively into new business lines and across geographical borders had neglected in many cases to construct an appropriate data infrastructure to keep pace with their business expansion. Others, quite simply, did not attach importance to it and found less mundane uses for their profits. No one ever joined a bank with the ambition of working in data management.

Whatever the reason, the result was the same: multiple and disparate legacy systems holding much the same data and client records – indeed, often multiple contradictory records of the same information. Yet how banks create, store, and make use of data, in particular risk data, is about to become a lot more interesting.

Introduced in January 2016, Regulation 239 of the Basel Committee on Banking Supervision (BCBS) outlines standards the committee expects global systemically important banks or G-SIBs to implement with regard to risk data aggregation and their reporting practices. This is an unapologetic nod to the problems faced by banks during the financial crisis, and adoption of the BCBS principles will demand a mind shift amongst those in the bank who create and use such data. Traditional headaches such as duplicated, stale, erroneous, and dirty data will all need to be addressed systematically. This will inevitably lead to an appraisal of how existing bank systems handle this data. Further, where G-SIBs go (or are forced to go), many aspirational domestic

and regional banks will follow; within a few short years it is reasonable to expect BCBS 239 to be widely adopted across the global banking landscape. Regulators will also play a part in this expansion.

Next, enter the latest upgrade by the International Accounting Standards Board (IASB) to IFRS 9 – the equivalent of FASB's Current Expected Credit Loss or CECL in the US. As the replacement for IAS 39, IFRS 9 will be applied to financial entities in more than 100 countries worldwide from January 2018 (2020 for CECL), although many banks will have already commenced parallel running of both standards throughout 2017 in the run-up to go live (CECL: 2019). IFRS 9 has profound implications for the way banks will manage their risk and finance data, and it is expected to collapse the traditional data silo model that has prevailed in banking for decades.

Another data driver comes in the form of the European Central Bank's AnaCredit Project. This regulation, which also has its roots in the inadequacy of banks' data management uncovered by the financial crisis, will require European banks to report granular detail of their lending activities via their national central bank to the ECB from March 2018 onwards.

Banks will need to decide whether, in raising their standards to meet the demands of BCBS 239, IFRS 9, and in Europe, AnaCredit, their existing data infrastructure is up to the job. Clearly for many banks the answer will be a resounding No. Here, a compelling argument will emerge for a re-engineering of their risk data infrastructure from the ground up, which starts with the point of risk origination and the individuals responsible for creating and owning this risk data – and crucially, what systems they employ to do so.

4. Better Lending Decisions

Perhaps the case for modernizing the bank credit process is even more simple: the old ways have failed in too many respects and on too many occasions. Economic cyclicality has played its part, yet banks that unintentionally built up dangerous risk concentrations in their portfolios or otherwise made poor lending decisions have contributed to successive credit boom and bust cycles that have damaged the economies in which they operate. Surely some of this is attributable to the way credit decisions are made in banks.

Banks' inability to identify aggregated risk concentrations for connected borrowers was responsible for heavy losses at several leading banks during the financial crisis. Even today it is not uncommon for banks to keep track of positions utilizing manually updated spreadsheets or at best, adding up the numbers from multiple systems. Simply quantifying current single-name exposure remains a test for many banks; how they then assess incremental exposure requests or spot when current exposure is approaching or breaching risk appetite limits poses a significant challenge.

Having all the information related to a credit relationship in a shared platform, as opposed to multiple systems and manual records, gives a bank the opportunity to create a golden source of client data under more accountable ownership. A "single source of truth" leads to data quality benefits through de-duplication, which in turn leads to credit decisions made on a more reliable base. Accessing one system containing a 360-degree view of the credit relationship, rather than many views during the course of the underwriting process, can reduce the chances for errors to creep in to the adjudication of a new lending proposal.

But it is not simply in the origination process that decision making can be improved. Robust risk management at an individual counterparty level requires, amongst other things, close supervision of covenant performance and effective collateral management. Sadly, in many banks both these functions fare only marginally better than data management and tend to be relegated to back office processing teams. Poorly managed, this can underestimate the capacity of these functions to incur potentially significant losses. Well managed,

for example by being core components of an integrated risk management platform, covenant monitoring and collateral acquire greater visibility and attention. Automatic calculation of covenant values on entering updated financial information alerts to pinpoint potential breaches, and notifications to advise collateral valuation due dates and actions are all standard functionality in many systems.

At a macro level, the data analytics capability offered as a core component of most modern credit platforms provides an indispensable view of portfolio composition, performance, and trending values. Instant access to this information in the form of dashboards and reporting is far easier and more timely for risk managers utilizing a modern system.

5. Improving Customer Service

You are hard pressed to meet a banker anywhere who is happy with his institution's credit response times, nor in the method and apparatus employed to secure that approval. Such unease is shared equally by both the front office and the risk department. So spare a thought for the customer.

A fragmented and drawn-out credit process serves bank clients poorly, and for those with a choice, the reaction is often to walk away and try elsewhere. The emergence of challenger banks and marketplace lenders owes something to reputedly better customer service models built on technology delivery and faster response times. However, most entrepreneurs and corporate treasurers have yet to take the leap of faith in entrusting this nascent sector with the financing of their businesses and still look to the traditional lenders. According to a recent report by PwC, this reluctance is not about to change significantly any time soon.

That does not mean, however, that banks are off the hook; there are signs that traditional lenders acknowledge the service quality gap and are making efforts to close it. This paper has made a case for improving response times through the efficiency gains that a modern origination system can bring to the credit process. However, important as the speed of decision making is, today's borrowers demand a lot more: they expect to be able to communicate with their lender via a range of channels and at a time that suits them. They are too busy running their own business to prepare voluminous files of information in support of their loan request. They expect a level of service that they themselves provide to their own customers. And they increasingly want to deal with partners whom they regard as having a modern, efficient, and world-class business model and technology stack.

Making the case

Banking technology is rapidly expanding the possibilities open to lenders to reshape their credit processes. However, this pace of innovation is sometimes at odds with the speed at which many traditionally conservative banks adopt new technology, alongside others' outright reluctance to invest in this area. This is understandable up to a point; a case of "if it isn't completely broken, don't fix it."

For all banks, modernizing the credit process demands a comprehensive and compelling business case; banks ought to be clear on the reasons why they are implementing a technology solution. These will vary depending on each bank's particular circumstances and this article has set out five broad factors for banks to ponder and decide where their need is greatest. Of course, all five of these factors provide equally compelling reasons to take steps to modernize and improve your business.

Learn more

Moody's Analytics has produced a series of insightful articles related to IFRS 9, which can be found here: moodysanalytics.com/Insight-Summary/Publications/Risk-Perspectives/2016/ifrs-9-impairment-regulations-summary

© 2016 Moody's Corporation, Moody's Investors Service, Inc., Moody's Analytics, Inc. and/or their licensors and affiliates (collectively, "MOODY'S"). All rights reserved.

CREDIT RATINGS ISSUED BY MOODY'S INVESTORS SERVICE, INC. AND ITS RATINGS AFFILIATES ("MIS") ARE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES, AND CREDIT RATINGS AND RESEARCH PUBLICATIONS PUBLISHED BY MOODY'S ("MOODY'S PUBLICATIONS") MAY INCLUDE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES. MOODY'S DEFINES CREDIT RISK AS THE RISK THAT AN ENTITY MAY NOT MEET ITS CONTRACTUAL, FINANCIAL OBLIGATIONS AS THEY COME DUE AND ANY ESTIMATED FINANCIAL LOSS IN THE EVENT OF DEFAULT. CREDIT RATINGS DO NOT ADDRESS ANY OTHER RISK, INCLUDING BUT NOT LIMITED TO: LIQUIDITY RISK, MARKET VALUE RISK, OR PRICE VOLATILITY. CREDIT RATINGS AND MOODY'S OPINIONS INCLUDED IN MOODY'S PUBLICATIONS ARE NOT STATEMENTS OF CURRENT OR HISTORICAL FACT. MOODY'S PUBLICATIONS MAY ALSO INCLUDE QUANTITATIVE MODEL-BASED ESTIMATES OF CREDIT RISK AND RELATED OPINIONS OR COMMENTARY PUBLISHED BY MOODY'S ANALYTICS, INC. CREDIT RATINGS AND MOODY'S PUBLICATIONS DO NOT CONSTITUTE OR PROVIDE INVESTMENT OR FINANCIAL ADVICE, AND CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT AND DO NOT PROVIDE RECOMMENDATIONS TO PURCHASE, SELL, OR HOLD PARTICULAR SECURITIES. NEITHER CREDIT RATINGS NOR MOODY'S PUBLICATIONS COMMENT ON THE SUITABILITY OF AN INVESTMENT FOR ANY PARTICULAR INVESTOR. MOODY'S ISSUES ITS CREDIT RATINGS AND PUBLISHES MOODY'S PUBLICATIONS WITH THE EXPECTATION AND UNDERSTANDING THAT EACH INVESTOR WILL, WITH DUE CARE, MAKE ITS OWN STUDY AND EVALUATION OF EACH SECURITY THAT IS UNDER CONSIDERATION FOR PURCHASE, HOLDING, OR SALE.

MOODY'S CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT INTENDED FOR USE BY RETAIL INVESTORS AND IT WOULD BE RECKLESS AND INAPPROPRIATE FOR RETAIL INVESTORS TO USE MOODY'S CREDIT RATINGS OR MOODY'S PUBLICATIONS WHEN MAKING AN INVESTMENT DECISION. IF IN DOUBT YOU SHOULD CONTACT YOUR FINANCIAL OR OTHER PROFESSIONAL ADVISER.

ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY LAW, INCLUDING BUT NOT LIMITED TO, COPYRIGHT LAW, AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT.

All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, all information contained herein is provided "AS IS" without warranty of any kind. MOODY'S adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources MOODY'S considers to be reliable including, when appropriate, independent third-party sources. However, MOODY'S is not an auditor and cannot in every instance independently verify or validate information received in the rating process or in preparing the Moody's Publications.

To the extent permitted by law, MOODY'S and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability to any person or entity for any indirect, special, consequential, or incidental losses or damages whatsoever arising from or in connection with the information contained herein or the use of or inability to use any such information, even if MOODY'S or any of its directors, officers, employees, agents, representatives, licensors or suppliers is advised in advance of the possibility of such losses or damages, including but not limited to: (a) any loss of present or prospective profits or (b) any loss or damage arising where the relevant financial instrument is not the subject of a particular credit rating assigned by MOODY'S.

To the extent permitted by law, MOODY'S and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability for any direct or compensatory losses or damages caused to any person or entity, including but not limited to by any negligence (but excluding fraud, willful misconduct or any other type of liability that, for the avoidance of doubt, by law cannot be excluded) on the part of, or any contingency within or beyond the control of, MOODY'S or any of its directors, officers, employees, agents, representatives, licensors or suppliers, arising from or in connection with the information contained herein or the use of or inability to use any such information.

NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER.

Moody's Investors Service, Inc., a wholly-owned credit rating agency subsidiary of Moody's Corporation ("MCO"), hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by Moody's Investors Service, Inc. have, prior to assignment of any rating, agreed to pay to Moody's Investors Service, Inc. for appraisal and rating services rendered by it fees ranging from \$1,500 to approximately \$2,500,000. MCO and MIS also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually at www.moodys.com under the heading "Investor Relations — Corporate Governance — Director and Shareholder Affiliation Policy."