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ANALYTICS

Whose Job Is Credit Risk?

WHITE PAPER //////////// **ENSURING INSTITUTIONAL FINANCIAL SAFETY**

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////////// INTRODUCTION

A teller's actions may have provided early warning to bank management about a business customer's credit risk. It started when the business owner, an individual well-known to the teller, began withdrawing large amounts and transferring funds to accounts at other institutions. Understanding that the business needed cash to repay its loans and recognizing that these were unusual transactions for this customer, the teller brought it to the attention of branch management, which in turn notified the appropriate loan officer and credit administrators. While this customer was neither in default nor engaging in illicit activities, **the warning prompted timely conversation with the borrower and allowed the bank to revise its credit terms**, constraining the diversion of funds to other ventures.

While this story highlights the actions of an exceptional employee, it also raises some instructive questions:

What institutional norms empowered this employee to take this initiative?

How did the employee gain the necessary skills and knowledge to make the appropriate judgment?

To what extent does this employee's behavior reflect the values of the institution?

How likely are other employees to behave in the same fashion?

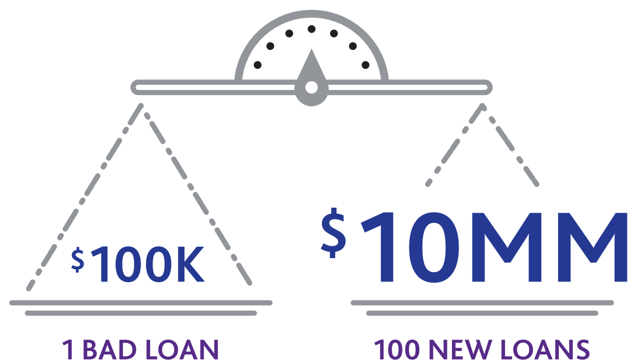
INVESTING IN SAFETY

Building a foundation of credit skill and knowledge among all employees creates a strong risk management culture that protects the financial safety of the institution. Yet most people would say that credit risk is the loan officer's job. So why should a financial institution invest in developing credit skill and knowledge in someone when it's "not their job"? Because there are consequences for not doing so.

The Occupational Safety and Health Administration (OSHA) establishes guidelines that are designed to keep employees safe in the workplace. Unsafe working conditions and practices have consequences, so for most businesses, compliance with OSHA requirements is a given. But what about the financial safety of your institution?

First, let's examine the consequences of "unsafe credit conditions." Loans are a financial institution's biggest asset—and biggest risk (even though they may not be the biggest new income generator in today's environment). Loans are only profitable when principal is repaid with interest. So what are the costs of charging off a single loan of $100,000? It's more than the current-period loss of principal and interest.

If the bank's return on assets is 1 percent, in order to earn back the loss, the bank would need to make $10,000,000 in new loans that all performed for one year. That's interest on 100 new loans of $100,000 each to replace the principal and interest lost on a single $100,000 bad loan.



Here's another perspective: If the net interest margin on the bank's loans is 3 percent, then charging off a single loan of $500,000 would more than wipe out the total profit contribution from the remaining loans in a $10,000,000 portfolio.

Clearly, even relatively small proportions of credit losses can adversely impact the financial health of a lending institution. Here is a simple syllogism: Everyone's job is dependent on the health of the institution. Credit risk affects the financial health of the institution. Therefore, everyone should care about credit risk.

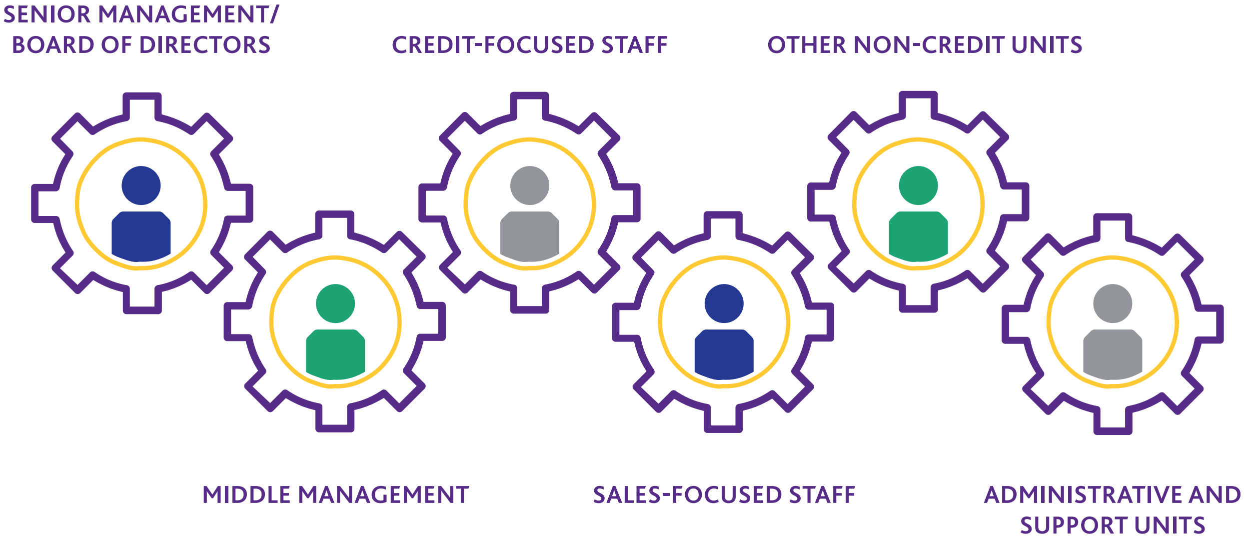
KNOWING YOUR CUSTOMER

One of the basic tenets of building and managing relationships is knowing the customer. This is especially true for credit-based customer relationships; knowing your customer not only helps strengthen the relationship but also detect and avert credit risks. The problem is that banking relationships, particularly credit relationships, are rarely one-dimensional. It takes teamwork to serve and maintain the overall relationship. Each team member, from loan officers to operations specialists to letter of credit processors, has a point of contact with information about the customer, whether through direct or indirect interaction.

- **What are your team members learning about customers' credit risk from their normal, day-to-day interactions with customers?**
- **Are they asking questions to learn more?**
- **Are they asking the right questions?**
- **Do they know how to interpret the customer's answers?**
- **Are they noting what they learn?**
- **Are they empowered to act on or disseminate this information?**

Knowing your customer involves knowing who at your institution has a connection to any part of the customer relationship. Whether they realize it or not, these individuals can influence credit safety by simply understanding the nature of risk in the customer information they see and hear. The most highly effective credit-driven organizations do not leave such opportunities to chance.

Ensuring that each group has the applicable credit skills and knowledge can contribute to ensuring financial safety for the institution. These groups include:



////////// SENIOR MANAGEMENT / BOARD OF DIRECTORS

Through meetings and memoranda, the senior management of one regional bank conveys the importance of being a "credit-driven organization" where everyone proactively contributes to managing credit risk. However, lacking specificity and deliberate top-down drivers to sustain this mission, behavior down the organization becomes inconsistent, increasing risk and diminishing the impact of senior management's message.

Senior management has a responsibility to ensure the financial safety of the institution. There is little room for error at the top, because this is where accountability for institutional credit risk must begin and end.

Senior management is responsible for:

- Establishing and communicating goals, objectives, and strategies related to credit risk
- Balancing credit risk and short-term growth/profits
- Creating and enforcing credit policies and practices
- Clarifying the organizational structure to support efficient risk management

In high-performing credit cultures, senior management conveys its commitment to the financial safety of the organization by initiating and fostering an institution-wide respect for managing credit risk. Leaders should visibly support the cultivation and use of credit skills at all levels of the organization to draw attention to the issue and develop trust among those who are expected to execute credit policies and strategies. Senior management must also watch for and address the inevitable imbalances between the competing priorities of managing credit risk and short-term revenue or asset growth. These imbalances will invariably result in poor financial performance, or worse.

After receiving an infusion of equity capital from its new owner, the senior management of a regional bank was determined to generate quick results by aggressively lending in the commercial real estate market throughout the state. While the bank was able to book new loans of an amount multiple times its new capital, it was also able to generate substantial fee income, primarily because many of the borrowers were of higher credit risk. Management assumed that the underlying value of real estate collateral would mitigate this risk…until it didn't.

Misguided executive leadership is demonstrated in more than just such blatant examples. Most anecdotes of effective and ineffective credit risk practices at all levels can be traced back to senior management. This is not to suggest that senior management must micromanage or oversee all activities that may contribute to credit risk. The point is that when it comes to credit risk, senior management must lead the way, early and often. They must communicate regularly about this priority and ensure that all systems and incentives are aligned to support it, instead of simply setting a goal, monitoring, and hoping everyone else follows through.

////////// MIDDLE MANAGEMENT

A financial institution followed a practice of absorbing loan charge-offs centrally while basing bonuses on profit at the group level. After some deliberation, this practice was changed so that each group was required to absorb its own loan losses on its respective P&L . Driving accountability down the chain sharpened focus on credit risk, resulted in a higher-quality portfolio, and improved profitability.

While the vignette above might appear to be an example of senior management leadership, it also illustrates the impact of driving responsibility and accountability for credit safety to the appropriate levels. In many instances, credit risk practices are most tangibly felt at divisional or departmental levels and below.

Middle management plays a crucial role in ensuring the credit safety of the institution. Middle managers are the bridge between senior managers and employees, and like senior managers, they must exhibit and reinforce credit risk management practices.

Middle managers are responsible for:

- Implementing and executing credit strategies
- Overseeing their units' credit-related activities
- Providing credit coaching and mentoring

Middle managers must interpret and enforce risk management practices within their units, as well as adjudicate conflicts with other units. For example, conflicts can occur when one department has primary responsibility for underwriting credit risk while another department originates the deals. Middle management must balance the tension between these two areas. Layers also exist in functions not directly involved in credit underwriting or origination. Here, successful middle managers embrace the institution's risk philosophy and translate its applicability to the actions of these units. One of the most important tasks of middle managers in all functions is coaching and mentoring their staff. This is particularly critical to achieve results from the institution's investment in training.

A large bank invests heavily in credit training for lending staff, relying on the trainers alone to ensure that new skills and techniques are used properly and sustained after training. Management cites other priorities and cost as reasons that middle managers are not involved either before, during, or after training. Within months of completing the training initiative, it becomes apparent that the quality of analyses by recent trainees is inconsistent; they seem tentative when making and presenting decisions. In the short-term, this situation requires more supervision by middle managers and a greater investment in time than would have been needed if coaching had been conducted during or immediately after training. Over the long-term, the problems discredit senior management's talk about the importance of credit culture and training.

Moody's Analytics' decades of work with clients to improve risk management skills has empirically shown that coaching is the key to transferring skills from the training environment to the job, and for ensuring that skills are sustained. How well prepared are your middle managers to provide this vital function?

CREDIT-FOCUSED STAFF

Consider the example of a large bank lacking an institutionally uniform understanding of cash flow, while actively engaged in lending to different markets. Some units relied heavily on EBITDA measures; others favored a UCA cash flow approach; and still others used net profit plus depreciation. Management was unaware of the inconsistencies in calculating, representing, and interpreting cash flow—until bank examiners became critical of credit risks being assumed because of the various metrics used to calculate debt service coverage.

Credit-focused staff includes all employees with direct and daily activities involving credit risk: loan officers, credit administrators, credit analysts, underwriters, loan documentation specialists, relationship managers, credit review, collections, and special assets. This category also applies to all types of credits and markets (corporate, commercial, consumer, real estate, domestic, and international).

Credit-focused staff is responsible for:

- Evaluating lending opportunities
- Recommending, structuring, and documenting loans
- Monitoring loans and managing credit relationships
- Ensuring institutional compliance with regulatory requirements
- Overseeing aggregate credit risk at a portfolio level

Credit-focused employees are the institution's main line of defense. Their collective actions have by far the greatest influence on institutional credit risk, and thus typically receive the most attention and largest allocation of credit-related resources. Yet, as the example illustrates, ensuring that consistent and effective practices are being followed is an ongoing challenge.

The skills required by this group include questioning and data gathering; credit analysis techniques and loan structuring; evaluating sources of repayment; and forms of support, pricing, documentation, presentation, monitoring, and negotiating. Most employees don't start out with these skills, and those who do have prior experience often find that their approach is not exactly aligned with the institution's way of doing business. A critical success factor for credit-focused employees is matching their training with the specific skills that must be applied consistently throughout the organization.

A high-performing regional bank has earned a well-deserved reputation for the quality of its credit training program. Over decades, this program has generated scores of highly qualified loan officers who have become the core strength of the institution. Alumni of the program are actively recruited by rival banks, but most have chosen to remain, citing pride in being affiliated with an institution known as the best at managing credit risk.

Pride and passion for the job are qualities that can elevate a risk management culture to the next level. When credit-focused staff are appropriately recognized and rewarded for their approach to risk management, the result is often excellent institution performance.

////////// SALES-FOCUSED STAFF

A bank that is focused on small and mid-market businesses has a dedicated business development staff whose role is to build new relationships. Typically, the business development officers have been effective salespeople with little or no credit experience. Customer relationships involving credit often led to tension between the sales team and the credit analysts and underwriters. The bank addressed this by requiring all business development officers to participate in a modified version of the credit training given to the lenders.

Sales-focused staff includes all employees with direct and daily activities involving the development of new customer relationships and the expansion of existing relationships: business development officers, relationship managers, account managers, sales support, and customer service staff. Employees in these roles may have little or no credit expertise, yet they have a direct influence on credit risk.

Effective sales and business development activities can actually improve credit risk by driving more qualified opportunities into the pipeline and generating a larger pool of credit prospects from which the institution can then select the best deals. Successful institutions build superior sales-driven organizations by viewing both selling and credit risk as everyone's job.

Related to managing credit risk, sales-focused staff is responsible for:

- Pursuing qualified prospective borrowers
- Identifying and presenting new lending opportunities
- Establishing and building credit customer relationships

Building relationships with qualified borrowers involves asking questions and interpreting information to determine, at least preliminarily, whether the credit risk is likely to be acceptable to the institution. Many organizations have attempted to address this through training in prospecting, selling, and relationship management skills.

Banks that achieve the best results have also required training in basic business acumen, fundamentals of credit analysis, and risk management. These organizations have found that even basic knowledge of credit among sales teams yields higher quality prospects, which in turn results in a higher quality loan portfolio with sustainable profitability. These banks also claim that sales teams are more efficient and productive when they have a better understanding of credit risk.

A bank's internal employee survey revealed that the loan underwriters felt intimidated by the pressure put on them by the business development staff. They were afraid to say "no" to many of the loans, even when the level of risk made them uncomfortable.

Growth is a challenging driver in competitive markets, and there have been instances of executive priorities falling out of balance. Sales-focused staff can have a profound effect on credit risk, especially when their influence appears to be endorsed by senior management.

One of the most effective ways to balance sales efforts with a strong risk management culture is to train sales staff in credit skills.

////////// OTHER NON-CREDIT UNITS

The management of an influential financial institution has applied some outside-the-box thinking to its treasury management group by providing training in business acumen and credit fundamentals. Treasury management teams apply these skills in collaboration with credit-focused staff to craft relationship solutions that use cash management services to improve business borrowers' cash flow and optimize credit utilization. Management believes that this approach strengthens customer relationships, while enhancing fee income and limiting credit risk.

Other non-credit units include money market and investment services, retail services, treasury management, and trust services. Employees in non-credit functions provide important support for credit relationships and are often a critical source of customer knowledge that may affect credit risk.

Non-credit units are responsible for:

- Providing non-credit services to customers with credit relationships
- Identifying credit-related risks and opportunities

By developing their business acumen, business lending, and credit skills, employees in non-credit units build their understanding of business operating cycles and business and consumer cash flow drivers. This helps the units provide better non-credit solutions, and it improves their ability to detect credit risks and opportunities.

A retail services unit of a bank recently noticed several large deposits made by an individual. Knowing that the customer and his spouse had loans with the institution, the service employee refrained from attempting to cross-sell deposit or investment opportunities. Instead, the employee brought the information to the attention of the loan officer, believing that it might be relevant to the customers' cash flow and credit risk. The loan officer investigated and discovered that the customer had received an inheritance, and as a result was able to proactively reduce and restructure the loans in a way that was more favorable to the customer and the institution.

The ability to recognize customer behavior that may increase or decrease credit risk is an extremely valuable skill for employees who are not normally involved with lending activities. While training teaches them what to look for and why, the institution's credit culture will determine how (or whether) they act on the information.

////////// ADMINISTRATIVE AND SUPPORT UNITS

When it needed to upgrade its loan platform, one progressive bank took an unusual approach. After deciding to use in-house IT resources, the bank invested in basic credit training for its technology specialists. It did not take long to realize returns on the investment, beginning with the efficient and collaborative design of specifications, and culminating in development of a system that exactly matches the needs of all credit-focused staff that is precisely tailored to the risk management practices of the organization.

Administrative and support staff play important roles in supporting the activities of credit-focused units. While they may not typically have customer contact, their contributions can make managing credit risk either easier or more challenging. These functions include auditing, accounting, central operations, compliance, human resources, IT, legal, and marketing.

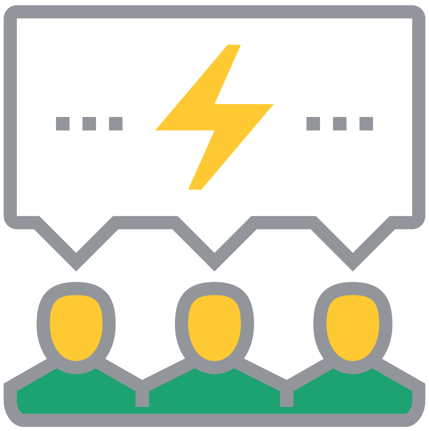
In terms of credit risk, administrative and support staff are responsible for:

- Supporting credit-focused staff
- Identifying credit-related risks and opportunities

When support staff understand the basic elements of credit and risk management, they are better prepared to deliver solutions that meet the needs of credit-focused staff. High-performing institutions understand that the benefits of accurate and efficient support justify the investment in training support staff.

The human resources group at a large financial institution was in charge of hiring and training credit professionals. While they received considerable guidance from credit administrators, HR managers felt they needed more, and took the initiative to participate fully in credit training. This training provided valuable insights about the nature of credit risk management, which led to more effective collaboration with credit administration, better hiring selections, and even an improved training curriculum.

Not all support units are able to take the initiative that these HR managers did. Often, senior management must launch the effort to support risk management. Nonetheless, determining how everyone's job affects credit risk is a good first step to ensuring the financial safety of your institution.



SUMMARY

1. **The strongest credit cultures are built on the contributions of all employees.**

2. **The actions (rather than pronouncements) of senior management are vital to creating a risk-aware environment and balancing this perspective with growth initiatives.**

3. **Skills, knowledge, and initiative drive the contributions from non-credit staff to help manage risk. Training and coaching provide and sustain skills and knowledge, while culture promotes initiative.**

4. **Efficiency and productivity improve with credit and risk training, as non-credit units are able to recognize events that impact credit risk and communicate more effectively with credit-focused staff.**

Ensuring the financial safety of your institution is everyone's job. Many of the top-performing financial institutions in the world have discovered that the benefits of developing credit skills and knowledge across the organization outweighs the cost of training.

The Moody's Analytics Difference

We understand that your business operates in a highly competitive marketplace where the skill level of your associates correlates directly with enterprise success. We leverage the expertise of our own credit, banking, and training experts to ensure that our training solutions provide your organization with targeted content that enables growth in the volume and quality of your loan portfolios.

Get in touch for more information about our learning solutions.