Credit Risk Readiness in the Banking Sector

One Decade after the Great Recession

What have we learned? What have we fixed? Are we ready for what is next?

lindakeithcpa

Helping Lenders say "Yes" to good loans!™

A Word from Linda Keith

In the course of completing this study, I conducted extensive interviews with the chiefs: chief executive officers, chief credit officers and chief lending officers. I also spoke to special asset managers, lending group team leaders, credit analysts, banking consultants and examiners.

Across the board, they all predict rough seas ahead. In banking, that is always the case. What is different this time is the tough lessons we learned from the Great Recession of 2008-2012. Or did we?

I commissioned this study because I was sensing worry among our community bank and credit union clients. They were not worried that the recession or other credit disruption will come. (It always does.) But rather that we are backsliding from the lessons learned.

As you read this report, I invite you to consider your own ratings of the survey statements. Consider how your thinking stacks up with your colleagues across the country. Provide this report to the rest of your team and start a conversation.

Are we ready for the next major credit disruption? Is your financial institution ready? Are you?

COMMISSIONED BY
Linda Keith CPA Inc.

SPONSORS
CEIS Loan Review
Institute for Extraordinary Banking
Lenders Online Training
Sageworks

CONDUCTED BY
Social Research Lab
University of Northern Colorado
Josh Packard, Ph.D., Executive Director
Megan Bissell, Lead Research Director
Ethan Adams, Research Associate

RESEARCH
This report is based on a survey conducted by the Social Research Lab (SRL) at UNCO at the request of Linda Keith CPA Inc. All identifying information was removed and identified data is stored securely only at the SRL. The SRL is dedicated to assisting individuals and organizations in all stages of data collection and analysis. Any questions about this survey and/or inquiries about specific data should be directed to Josh Packard at josh.packard@unco.edu or 970-351-3385.

COMMENTS
All comments from interview subjects are anonymous per our agreement. Sources for comments from sponsors and consultants are included.

CONTACT
Linda Keith CPA Inc
PO Box 1366, Olympia, WA 98507
(360) 455-1569
Info@LindaKeithCPA.com

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A Decade after the Great Recession

What have we learned? What have we fixed? Are we ready for what is next?

Credit professionals across the country are focused on maintaining or improving readiness for the next major credit disruption.

Linda Keith CPA Inc, a banking credit consulting and training company, commissioned the 2018 Credit Risk Readiness Study and Survey, in which we asked community-based financial institution credit and lending professionals about their greatest challenges from a credit risk perspective.

The 2018 Credit Risk Readiness Study combined interviews with a survey that included respondents from across the United States. Here are just a few of their comments. Do you agree with their perspectives? Disagree?

> When I read loan committee minutes I ask myself: What's coming my way? What standards have we dropped? What guarantees have we limited, thus limiting our recourse for what I call 'sticks I can swing?' Have we eliminated or loosened up on debt service coverage, collateral, and loan to value?
>
> When you get a big well-known developer from the closest good-size city throwing a deal to a small-town community bank, you've got to wonder why we are getting an opportunity to quote on this deal?

Special Assets Assistant Manager, 1.5 Billion Community Bank

This report provides a summary of the findings from the Credit Risk Readiness Survey conducted by the Social Research Lab of the University of Northern Colorado. This study involved in-depth interviews, survey tool creation and implementation, and data analysis used to help understand and inform the lending industry.

Sponsors Sageworks, Lenders Online Training, CEIS Loan Review and the Institute for Extraordinary Banking joined Linda Keith CPA Inc to bring you these results.

In this report, you will discover how well credit professionals believe we are positioned for the next credit disruption and where they believe we still need improvement or are even reverting to past, less prudent practices.

> You can't compete against stupid. But you also need to grow, win deals and bank good customers. I believe you must be disciplined and pick where you're going to stretch but do it for the right reasons.

Chief Credit Officer, $1.3 Billion Community Bank

Even financial institutions that did well during the recession face significant disruptions that create challenges in credit risk readiness.

Consider the impact of natural disasters, tariffs, trade wars and global competition.

Portfolio and Loan Management

Concentration Risk

When did our sweet spot turn into our biggest problem?

In our interviews and the survey, concentration risk was a frequent cause for concern and many took steps to diversify as a result of the recession.

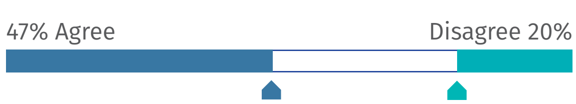
Prior to the recession, my financial institution's loan portfolio was concentrated in too few areas.

Commercial Real Estate (CRE) was cited as the type of lending to watch. This loan type is often the sweet spot of a community financial institution, but many senior credit professionals are paying more attention to either avoid, or adequately mitigate, a return to high concentration in CRE.

> Obviously every recession is different, but I think diversification in the loan portfolio is important. I think it gets awful easy to stretch and to follow a good customer one deal too far.
>
> If you're stretching and cash flows are tight, those are the first ones that go into default. So, we probably stretched on some of the developers because the first project went well, the second project went fairly well, but then the third project maybe not quite so good. We hoped the fourth one was going to bring them back and it snowballed.
>
> We've gone from seven developers down to two. And we're not looking for new ones. If we get a project in our backyard that we like, we may do it. But we understand it has to be on our terms and conditions and we're not going to bend and stretch on those.

Chief Credit Officer, $1.3 Billion Community Bank, Business and Ag Lending

My financial institution has diversified our portfolio to offset concentration risk as a result of the 2008 recession.



Interesting! More banks and credit unions have diversified than thought they were concentrated in too few areas. What do you make of that?

Survey respondents were asked to signal their level of agreement with statements related to credit risk. Their chose between strongly agree, agree, neutral, disagree or strongly disagree.

Blue indicates agree or strongly agree. **Aqua** indicates disagree or strongly disagree.

> Our bank acquired another bank just before the recession hit. That bank was heavily into CRE and both banks got caught up in 'deal heat' As soon as we closed, delinquencies spiked. We doubled down at the wrong time.

Special Assets Manager
$4 Billion Regional Bank

> In the run-up to the Great Recession, lending restrictions were way too loose on commercial real estate, especially. It just concerns me that we're getting to that point again real fast.

Manager of Commercial Credit
$500 Million Community Bank

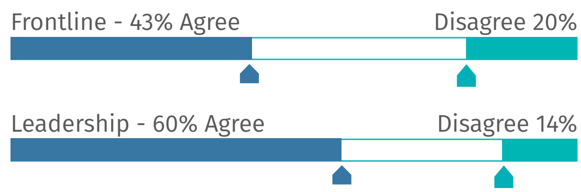
Concentration Risk vs Niche Banking

Differences of opinion: frontline vs leadership

We have sufficiently mitigated the risk of CRE concentration.

Frontline: *Credit Analyst, Underwriter, Relationship Manager*

Leadership: *Chief Executive Officer, Chief Lending Officer, Chief Operating Officer, Senior Loan Officer*



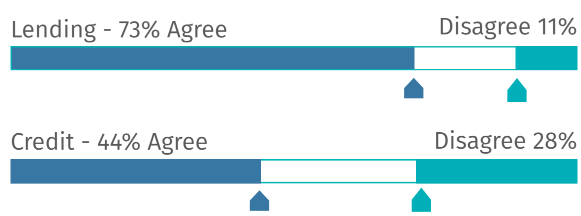
See the left column for job titles included in each category. Generally, throughout the survey, the frontline agreed with the leadership, but not on the subject of CRE concentration. Does the frontline have more of a pulse on this issue? Or does leadership have more experience with mitigation at the institutional level?

Differences of opinion: lending vs credit

My financial institution's loans are currently not too concentrated in one sector.

Lending: *Chief Lending Officer, Business Development Officer, Relationship Manager, Senior Lending Officer*

Credit: *Chief Credit Officer, Credit Analyst, Underwriter*



See the left column for job titles included in each category. The lending professionals are less concerned with concentration in one sector than the credit professionals. Perhaps the lending professionals know that their sweet spot is the easiest type of loan to land, while the credit professionals are more likely to see the slippery slope returning.

> I have always advocated for niche banking, where you get really good at something. You know what the risks are and can mitigate those. The industry has to be big enough to support you and to provide you with loans and deposits. You also get known so that you start getting referrals from CPAs, attorneys and commercial real estate brokers. When they have a deal come through they might say, "Well you need to go and talk to John because he's done four of these in the last year with me, and they worked out really well." So, you knock it down from having ten banks competing for the deal to maybe three banks. I like my odds at three.

Chief Credit Officer, $1.3 Billion Community Bank

Monitoring Loans and the Portfolio

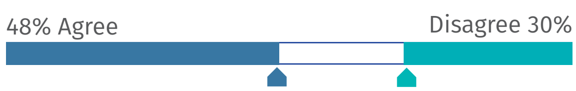
Incentives and monitoring seem to be out of alignment.

SAYING "YES" TO PERFORMING LOANS, CONSISTENT WITH YOUR GUIDELINES AND RISK APPETITE, IS THE POINTED END OF THE SPEAR. BUT GOOD LOANS CAN GO BAD.

Adequately monitoring at the loan and the portfolio level is just as important. As you read these survey results, consider what has changed for the better and what has not changed enough.

Prior to the recession, my financial institution assessed and managed credit risk well.

Prior to the recession, my financial institution had a well-functioning process for problem loans, from early recognition through to resolution.



After the recession, my financial institution has an adequate plan in place to recognize a deteriorating loan.

It concerns me that almost 25% could not agree or strongly agree with the statement above. Does that concern you?

While 55% agreed that their financial institution assessed and managed credit risk well, is it more telling that 45% were either neutral or did not agree? Is 55% agreement good enough?

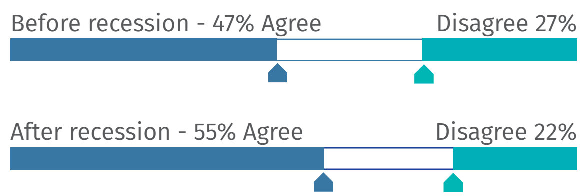
As you review the survey results, consider at what level the dissenters' percentage is sufficient to raise concerns.

Time and Incentives

Time and incentive to monitor loans

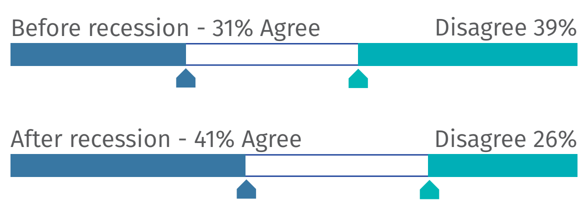
As a credit training provider, I am delighted that loan *origination* gets attention for time and incentive. But I hear over and over that there is not enough time or the incentive to monitor the loans *already on the books*.

The lending and credit professionals have adequate time to monitor loans already made.



Improvement...but is it enough? Does the top-down requirement to monitor loans need to be clearer? And what about incentives?

The lending and credit professionals have incentive to monitor loans already made.



On the plus side, this shows significant improvement from prior to after the recession. On the down side, we are still below 50% and also below the number of respondents who said they have adequate time (55%). How can you improve alignment of time and incentives with the outcome you desire?

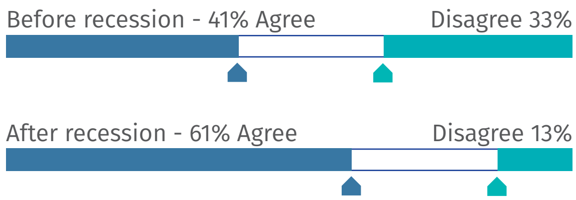
> Board and senior management must show that they want to see information on the monitoring part of the process and see that it's being done effectively; that they care about it and are not just interested in the origination and the growth side. I think it does come very much from the top. Then also, that they're willing to invest. They're not just hiring more and more originators, but they're willing to add more staff to an administration unit or a problem loan management unit and that they value that part of the process.

Elizabeth Williams, Managing Director, CEIS Loan Review
Credit Risk Readiness Study Sponsor

Documentation Receipt and Review

A barometer for monitoring: documentation

The documentation required to monitor a loan is routinely received from the borrower and adequately analyzed by credit staff.



This is significant improvement, but once again, almost 40% do not agree with the statement. Room for more improvement? Is this a systems problem, an incentive problem, or something else? How can you solve for it?

If your system does not easily track success in receiving documentation, it may not seem to your lending or credit team that this is an important step.

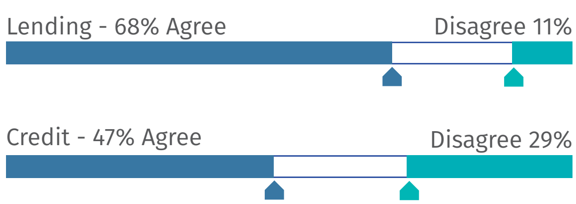
I regularly ask the participants in my credit training on tax return analysis whether they carefully review the documentation they receive and log in. Some do, but many do not.

How do we move from 'check-the-box' receipt of updated financials to actual review and analysis? It starts with management emphasis, time and incentives.

Differences of opinion: lending vs credit

It may not be a surprise to learn that there is a difference in the perception of lending staff and of credit staff in the response to this statement:

Relationship managers regularly monitor their portfolio risk.



This suggests there is a disconnect between the two sectors of the industry. Perhaps, credit professionals are not aware of how much monitoring is done by the lending side. Or the credit professionals define adequate monitoring differently than the lending professionals.

Lending: *Chief Lending Officer, Business Development Officer, Relationship Manager, Senior Lending Officer*

Credit: *Chief Credit Officer, Credit Analyst, Underwriter*

Staffing

Staff Availability and Training

Competition is heating up for experienced people, but training is not keeping up for those you already have.

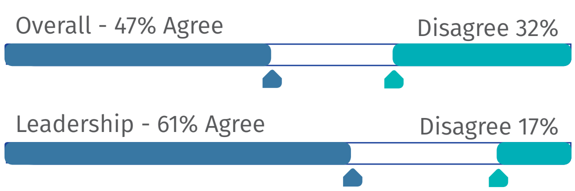
IN THIS SECTION YOU WILL FIND THE MOST SIGNIFICANT CHALLENGE IDENTIFIED BY THE MAJORITY OF RESPONDENTS, AND REPEATEDLY DISCUSSED IN THE INTERVIEWS.

During the recession, financial institutions were under tremendous pressure to maintain or regain adequate capital levels. In the face of dropping revenues from lower loan volume or deterioration of the portfolio, many turned to reducing expenses.

Both the training and staffing budgets took a hit. As staff was laid off, the remaining staff took on more work. And even when loan volume was down, there was a point where you could not staff at lower levels and still get the job done.

Not every financial institution took a beating during the recession. In some parts of the country and in some sectors, it was almost a non-event. But the uncertainty caused by the recession resulted in training cut-backs, even in banks and credit unions not ravaged by the economic events of 2008/2009.

Prior to the recession, relevant employees were well trained in assessing credit risk.



Note the significant difference in the opinion of leadership compared to the overall responses. Did this difference of opinion exist prior to the recession? Or has the opinion of everyone except leadership been shaken by the challenges of the recession? And again, almost 40% of leadership could not agree or strongly agree with this statement.

The farm system of credit staff recruitment

A major change in banking mentioned by many of the very experienced credit staff is how those newer to banking receive their training. One issue came up repeatedly. The national and larger regional banks no longer do as extensive credit training as they did years ago. Community banking used to benefit from a system like the major leagues in baseball. They recruited from the larger banks, after the initial training was completed.

A lot of banks have hired what they call business development officers, where they really don't have authority to make a decision at all. In our size town, those people can't sell because most small business people that I know want to talk to a decision maker. Our commercial credit people are decision makers.

CEO of $72 Million Community Business Bank

If I had a time machine, coming out of the recession, I would go back and go on a hiring spree. We were the only bank that could make loans at that time, so, we should have hired some of the best lenders out there because they were just sitting around doing nothing.

VP of Credit Administration $1.4 Billion Bank

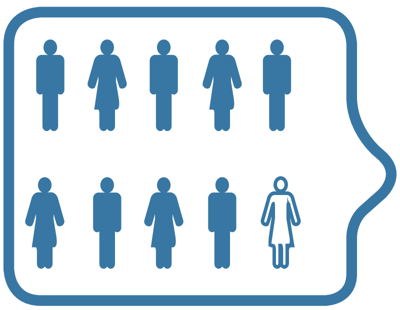
Transferring Skills and Lessons Learned

The hunter-skinner model is a game changer

One of the reasons many of the larger banks do not do the training they used to is the shift to the hunter-skinner approach to lending. At most big banks, and many community banks, the business development officers, relationship managers, branch managers and other lenders bring in the deals. They are sales people with some credit knowledge. But in many cases, they do not underwrite their deals. They are the hunters.

The skinners are the credit analysts and underwriters. They take the information provided by the hunters and try to make the deal work. Perhaps that is where the phrase "this dog just won't hunt" comes from. I have heard it from senior bankers more than a few times.

We are losing experienced leaders, managers and originators



Transferring skills and lessons learned to the next generation of employees is a challenge.

Looking ahead, **nine out of ten respondents** agreed about this challenge in preparing for the next recession: **transferring skills and lessons learned to the next generation of employees**.

Some of the newer credit professionals were in high school during the great recession. If you and I did not learn the lessons from the last major credit disruption, and find a way to pass them on, then we have seriously missed the boat.

How many ways are you shortening the learning curve? Who needs to know more and sooner? What do they need to know to be ready?

> We convey lessons learned to the younger generation during conversations at loan committee, during credit staff meetings, and really, through word of mouth. It's a case-by-case analysis when a loan comes through loan committee.
>
> Another eye opener for some of our younger officers is the impact of rate increases. We went for about seven years with no rate changes. Back in January of 2017, we had to raise our rates. We've done it twice this year. You take somebody who owes a million dollars and you change the rate by half a percent; it makes a difference.
>
> Probably the biggest thing the newer lenders need to learn is not to get lulled into a sense of complacency. What goes up can come down. What looks good one year may not be good the next. You need to build in a cushion. You need to build in a margin.

Chief Credit Officer, $500 Million Ag Lending Institution

One Approach to Staffing

The case against the hunter-skinner model:

We have a strong credit culture here at the bank, and it's a little different than most banks, especially banks of our size. The originating officer of a credit does everything for that loan. You are the salesperson, and the relationship manager, meeting with the customer and drumming up the business. You're the one who underwrites the credit. You're the one who presents it to our loan committee, depending on size. You are the one who administers the credit over the life of the loan, and, if there is an issue with the loan you will be the one collecting on it.

There's certainly an ownership of the loan and the credit that is different here from other places. For larger or more interesting credits that go bad, which luckily is not a common event here, you are required to stand up in front of the charge-off committee; which is senior management and board members. You talk about the errors that you made and the lessons that you learned.

This is one of the things that I always ask my junior officers when I am training them: "Will you feel comfortable standing up in front of charge-off committee, and justifying why you feel this loan is an appropriate loan to make?" I think that's one of the things that differentiates us and helped us throughout the recession.

The challenge of inexperienced staff:

The problem is that things are good until they're not, and when they're not, it can be a pretty sudden downturn. We have a lot of lenders who started within the past five years or so, and they don't know what things were like the last time around.

How we transfer skills and knowledge to the next generation:

Our weekly loan committee is an open meeting, where all of the lenders in the company can either come to the meeting, or they can video conference in from the branches. Any loan that's over $1 million gets presented and has to be approved by the loan committee, which is comprised of directors, senior management, and anybody else who wants to attend.

Members of that group can chime in, and say "Hey, we need to maintain some discipline here in terms of having them have some skin in the game," or "Remember what happened on this loan 10 years ago? This looks similar to that. Here's the issues that I see with it." They use their experience and help communicate that to the whole group of people. There are 150 people in attendance every week to hear the current credit culture and risk appetite, learn some lessons, and gain wisdom and experience from the group.

President of Loan Review and Valuation Services
$17 Billion Holding Company

Contradiction in Staff Readiness

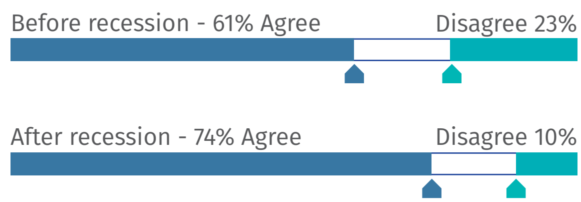
Every time we look for an analyst they give me a raise just to keep me. Talking with recruiters when we have to seek out new analysts, the price just baffles me compared to what I was starting at back in '07. I believe there's going to be a high demand for credit analysts for quite a while and if something does happen to the market here, that will be a stress point again.

Manager of Commercial Credit
$500 Million Community Bank

Are staff well-equipped and ready?

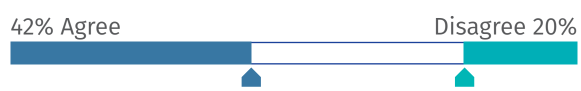
As is often the case in a survey of this type, the answers to some questions, when put a slightly different way in a different section of the survey, seemed to contradict each other. See what you think of these contradictory answers.

Lending and credit professionals at my financial institution were/are well-equipped to assess credit risk.



Respondents indicated significant improvement but this improvement did not seem to translate into a sense of readiness. How would you respond to the next statement? What needs to be done to improve this response?

Looking ahead, the staff at my financial institution is ready for the next recession.



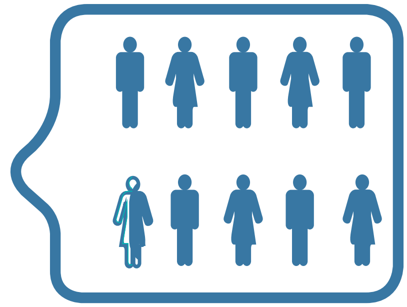
More training, but for whom?

Increased training will help prepare for the next recession.

The overwhelming agreement to the need for training is music to my ears, since loan origination training is the focus of my firm.

But what about the type of training needed? Partly because of the hunter-skinner model and centralized credit decision-making, the decision about what type of training to provide to the lenders comes up frequently. And it seems to be a moving target.

What Type of Training?



Relationship managers should be trained on credit risk.

No one actually disagreed with this statement. This was the **highest level of agreement on any question**, and was the same whether it was lending or credit, banks or credit unions, farm or business lending, leadership or frontline answering the question.

As a credit trainer, the question of who to train comes up when planning in-house training for our clients. This issue was also a frequent topic in the in-depth interviews for this study.

The fear is that the relationship managers, at financial institutions where they have a strong and separate credit function, won't think it is worth their time. But when the relationship managers, business development officers and other "hunters" do not have sufficient credit training:

- They waste their time on deals that will never work
- They waste the time of the credit team on deals that will never work
- They may burn a prospect for another type of loan that could have been done, if they knew more about the credit requirements

One thing a salesperson hates more than being told no by a prospect, is wasting their time on a hopeless deal. When put that way, many relationships managers would appreciate the opportunity to learn enough credit analysis to be better able to spot a good loan and to help smooth the prospect-to-approval process. They would rather get what is needed at the outset or be able to explain to a prospect why additional information is needed.

Relationship managers should be trained in portfolio management.

This response surprised me. I am not sure about the level of portfolio management relationship managers should understand. But perhaps this fits with a preference among some of the respondents that relationship managers and credit analysts be the same person. What do you think?

> There is a trend towards making bankers more responsible for their loans, making them manage their portfolio rather than just sell the deal, close it, and move on.

Rob Ashbaugh
Risk Management Consultant
Sageworks - Credit Risk Readiness Study Sponsor

Sales Culture and Training

Lending is selling. For that matter, business is selling. Many bankers believe the lending professionals need to see themselves as salespeople and management needs to provide the support for that view, along with the requisite tools and training.

Even in the training I offer on global tax return analysis, we go beyond calculating cash flow and debt repayment capacity. Participants learn to be on the lookout for other loan opportunities to meet the borrower's needs. And they learn how to ask questions that are relationship building in nature, and not just transactional.

If the front-line loan originators cannot bring added value through their knowledge and understanding, they will be at a disadvantage in competing with the lender down the street.

> If it feels like selling, your people are doing something wrong. The true skills of selling are based on the premise of caring about and finding out what the customer needs to be successful, and then finding ways to help the customer accomplish that success.
>
> It's also about having your lenders become very clear about the financial and emotional impact of the ways they differentiate you from your competition. To capture and retain the profitable relationships for your financial institution, your front-line lending professionals need to break preoccupation with rate.

Roxanne Emmerich, Founder, The Institute for Extraordinary Banking
Credit Risk Readiness Study Sponsor

On page 15 of this report, the president of loan review and valuation services of a $17 billion bank expressed the opinion that "ownership" of the loan, including sales and credit analysis, is an advantage. That view is not universally held, and the trend towards sales people with sufficient credit training continues. Which do you prefer?

> If banks are serious about growing, the model in which bankers are "cradle to grave" lenders who carry loans from origination through special assets and workout, if needed, is too hands on. They need their experienced, well-networked people on the street developing new relationships.

Nick Miller, President, Clarity Advantage, Banking Sales/Strategy

Credit Training Priorities

What should training accomplish?

Our firm trains lending and credit professionals throughout the United States on global tax return analysis for business, farming operations and complex borrowers. We asked respondents to sort six goals for their credit analysis training by priority. Do you agree with them?

1. Competency in calculating cash flow
2. Consistency
3. Better understanding the borrower
4. Confidence in analysis and presentation
5. Improved documentation
6. Efficient use of time

Before we start the training, I ask the participants to rate themselves on a 1-10 scale. I used to ask them to consider their competence, confidence and consistency in analyzing tax returns.

I had to modify the question when a participant gave herself a pretty high rating and, through the course of the training, it became clear she was very inexperienced.

Later I asked her privately how she had decided on her rating. She said she is definitely not competent or confident but had to give herself a 10 for consistency. 'I consistently do not know what I am doing', she said.

> As we grow and hire more staff, they don't know our culture and they don't know the system. So, training is important. One thing I have done as Chief Credit Officer is bump up our training budget.

Chief Credit Officer
$1.3 Billion Bank

How do examiners see it?

In a recent presentation to banking examiners, we discussed what to look for when considering credit analysis. Here is my short list, and consistency is a key component:

- Do you have a **system, software** or **worksheets** that, when applied, would lead your team to good decision-making?
- If so, does it appear the system is **consistently** applied?
- Do the credit and lending staff appear to have **adequate training** to utilize the system and apply judgment to decision-making?
- Are any deviations from the guidelines explained in a way that the examiner can **understand what you did and why you did it**?

I am a former examiner for the State of Washington. When we see adequate systems and guidelines, consistent application and clear and compelling explanations of variations, we are ready to move on. That is your goal: bore the examiners because there is nothing juicy to dig into.

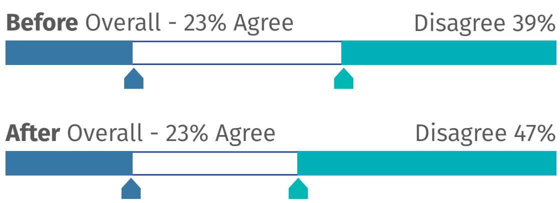
Regulatory Environment and Relationships

Regulatory Environment

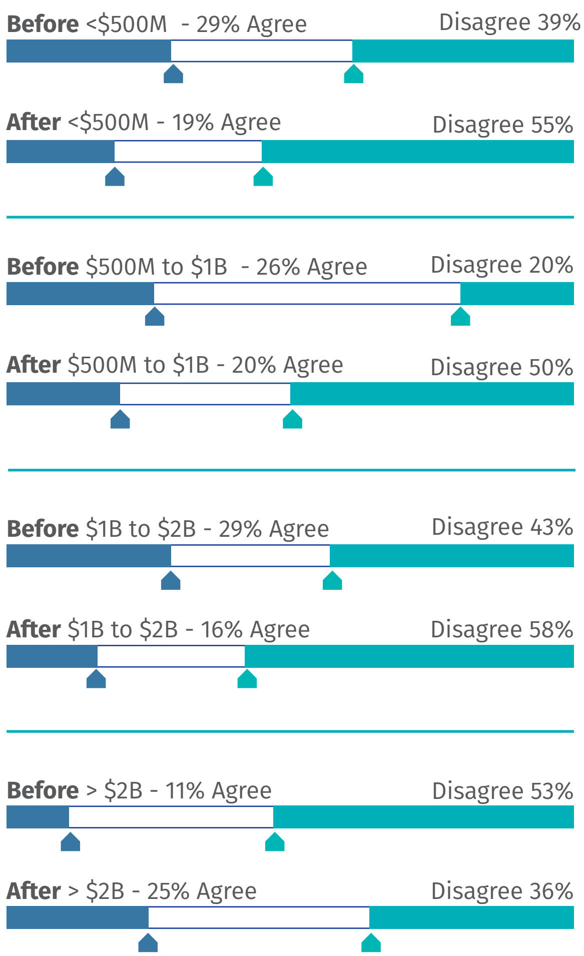
Do we know what they want? How are we getting along?

SENIOR LENDING AND CREDIT PROFESSIONALS GET ALONG WITH THE REGULATORS, BUT THAT DOES NOT MEAN THEY AGREE WITH THE REGULATORY ENVIRONMENT.

The regulatory environment is reasonable, clear and well executed.



The results varied significantly by size, with the largest banks the only ones indicating improvement. (M=Million and B=Billion)



We had a pretty rough regulatory exam in December of 2008, which turned out to be a really good thing for us.

We addressed all the things that they had concern about and while that was a lot of hard work and probably hastened our chief credit officer's retirement, when we had our next regulatory exam, they told us we were the only bank being upgraded at that point in the cycle.

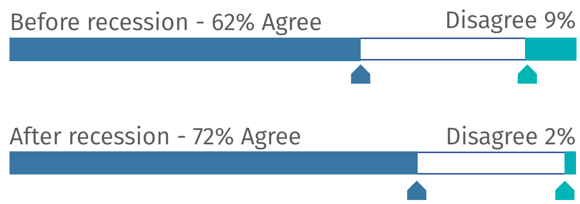
We were one of the community banks in California that remained profitable every year through the downturn.

Chief Credit Officer
$1.4 Billion Bank

Relationships with Regulators

While the regulatory environment is widely criticized, it appears that the individual regulators and their counterparts at the financial institutions are able to work together, and that working relationship is improving.

My institution has a strong relationship with regulators.

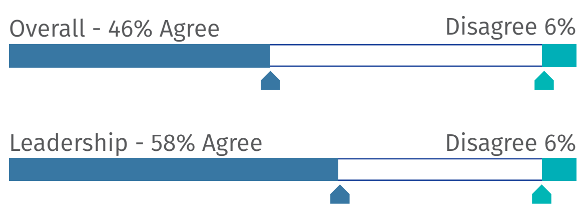


Room for improvement?

With 72% agreement that their financial institution has a strong relationship with regulators, that means that 28% could not agree or strongly agree with that statement.

Leadership is more optimistic

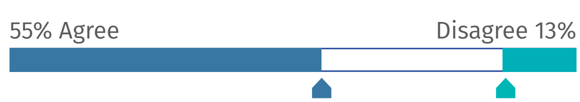
Since the recession, my institution's relationship with regulators has improved.



And yet...

When asked if examiners understand their portfolio, a bare majority of respondents across the board agreed or strongly agreed with that statement.

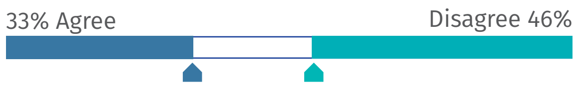
Examiners understand our portfolio.



The Upside of Regulations

It is easy to complain about the regulatory environment , and while 46% disagreed that the extra regulations were necessary, 33% saw the need for additional oversight.

Considering the 2008 recession, extra state or federal regulations on financial institutions were necessary.



How increased scrutiny has helped

> Basel, the bank asset classification system, isn't solely about capital and reserves. It's making sure that you identify risk that's in your portfolio. When you identify that risk through your data; you're capitalizing it, you're reserving for it, and you understand it. It's a significant risk management exercise for banks to make sure that they can identify and quantify their risk. That's the big takeaway from Basel.
>
> Banks are getting better at making their data cleaner. Basel's really going to require that. Many community banks do not mine their data the way the bigger banks do, and that's one of the initiatives that we're going to help restart.

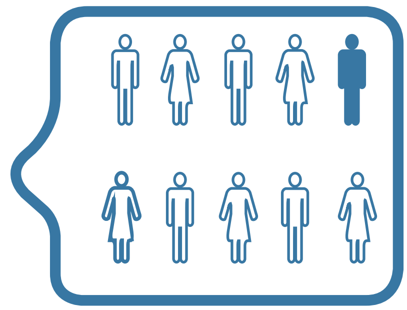
Rob Ashbaugh, Executive Risk Management Consultant
Sageworks - Credit Risk Readiness Study Sponsor

Ready for the Next Recession

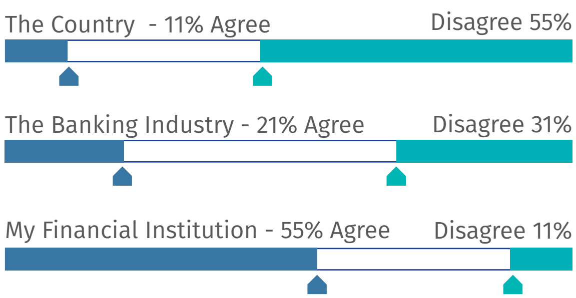
Ready for the Recession

How ready are we? Are we headed in the right direction?

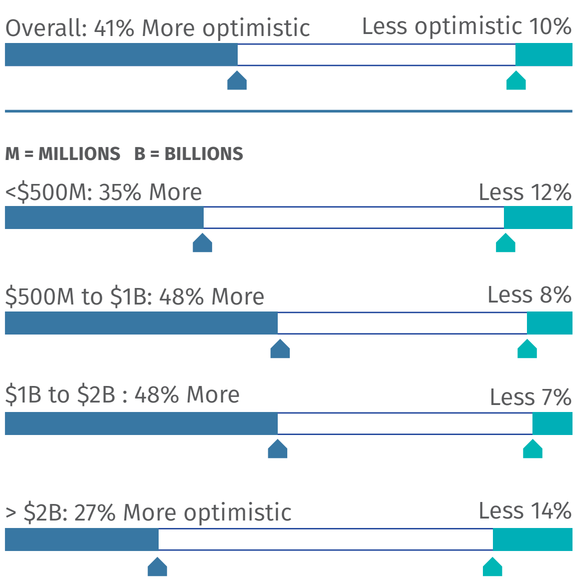
THERE IS SIGNIFICANT AGREEMENT THAT THE COUNTRY IS NOT READY FOR ANOTHER RECESSION. MOST PARTICIPANTS ARE MORE OPTIMISTIC ABOUT THE READINESS OF THE BANKING INDUSTRY, AND MORE SO OF THEIR BANK.



We are ready for the next recession.



Compared to last year, my impression of the financial industry's preparation for the next recession is:



I think all of us are trying to figure out what is that canary in the coal mine for the next downturn? We know it's going to come. We don't know when, and we don't know what it's going to look like. What'll be the signal? I don't know what that is.

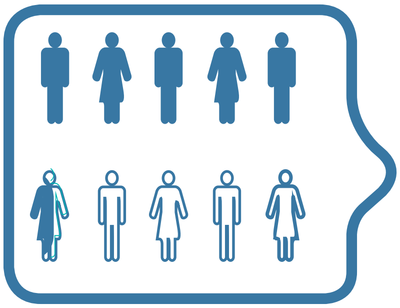
Chief Credit Officer
$1.4 Billion Bank

My financial institution is better at managing and mitigating risk than it was ten years ago.

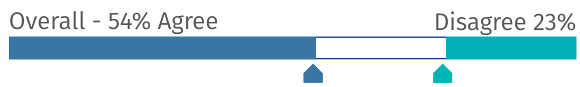
That's a positive step! Even banks who believe they did well in the recession have improved.

Retreat from Prudent Lending Practices

What bad habits are we returning to?



Increased competition is causing backsliding in prudent credit risk practices in the banking industry generally.



Note, these respondents did not say **their** company was backsliding. We did not ask that question. But the sentiment was expressed throughout the interviews as well. Does this concern you? What is the solution?

I know that we ***did*** learn lessons from the past recession, but we quickly chose to forget and we've loosened up the lending.

We were way too loose on commercial real estate, especially. It just concerns me that we're getting to that point again.

Manager of Commercial Credit
$500 Million Community Bank

Honestly, there are banks out there who are acting like they did before the recession. But not as many of them. I think most banks have learned underwriting lessons from the past and understand that you can have too much of a good thing.

CEO of $72 Million Community Business Bank

Regulators are voicing concern about some loosening of structure in commercial real estate lending; more interest-only structures, longer amortization, more nonrecourse lending. This is in response to competition, but down the road if these borrowers start to deteriorate banks will have a harder time working those out and protecting themselves.

What keeps banks from going down that slippery slope? There must be a balance. Lenders at the bank really must know where they draw the line and where they won't go further, and work to limit those areas where they are giving a bit on structure. Sure, maybe you've got a small segment of loans where you were willing to go nonrecourse but limit that. Monitor those loans more closely. Also, make sure you're getting compensated for that risk, if you can. In the last recession, we started to see pricing give first and then structure followed.

Elizabeth Williams, Managing Director
CEIS Loan Review, Credit Risk Readiness Study Sponsor

Ready or Not...

Where have we improved and what is on the radar?

I think there are probably just as many banks with CRE concentrations with investor property, but I also am confident when I say that most of them are doing a much better job of understanding those portfolios.

Chief Credit Officer, $1.4 Billion Bank

Readiness depends heavily on the relationships between credit policy, credit underwriting, and the relationship management or sales teams. Are there good partnerships there? Do the people running those operations like and respect each other? Do they express credit standards and appetites clearly? Do they meet with each other frequently and act quickly on people or client relationship problems?

I worry when banks hire sales people and don't credit train them. I worry, when the line and credit teams operate in silos, that friction between them reduces their willingness or ability to disclose problems and act quickly.

Nick Miller, President, Clarity Advantage, Banking Sales/Strategy

Lenders must not spend time with prospects who are not motivated, and instead spend all of their time with those who are. They need to be able to quickly spot the attributes of qualified prospects.

There is a sales process that allows bankers to escape competition on rates, but it is a process that must be learned, honed, celebrated and rewarded.

Roxanne Emmerich, Founder, Institute for Extraordinary Banking
Credit Risk Readiness Study Sponsor

In banking, it shouldn't matter when the next recession is going to hit. We should be ready for it.

Tom Danielson, CPA
CliftonLarsonAllen

Know what you are going to do when the loan goes bad. Because when the recession hits, it is going to be fast and furious. If you are not ready you will be overwhelmed.

You don't have to have all the details done, but how are you going to handle it? Is the lender going to continue to handle it, or are you going to have some special assets officers? Are you going to convert lenders into that team?

Chief Credit Officer
$1.3 Billion Bank

Back to Fundamentals

THE RECESSION WAS ***NOT*** CAUSED BY BANKS AND CREDIT UNIONS WHO FOCUSED ON THE FUNDAMENTALS OF LENDING AND CREDIT.

It turns out that avoiding some of the mistakes that led to the damage of the last recession in community-level banking is nothing new. While we have to contend with fintech encroaching on traditional lending and a much higher regulatory burden than in days gone by, most of the bankers interviewed agreed that sticking with (or returning to) the fundamentals is the way forward.

Revisiting the causes of the last recession, distilling lessons learned, and finding the way to pass that critical knowledge to the lenders and leaders of tomorrow is one of the greatest challenges identified by the Credit Risk Readiness study.

> Prior to the recession, we continued to keep it simple, but internally there were undoubtedly conversations about why we were so sleepy and stubborn. Everybody else was doing so much better than we were. You had to deal with that internal struggle.
>
> It took leadership at the top level to say, "Sorry, that's the way it is. This is who we are, if you don't like it, go work someplace else."

VP Credit Administration
$1.4 Billion Bank

Mitigate concentration risk

On page 7 of this report, you saw that 39% agreed their financial institution's loan portfolio was concentrated in too few areas. Yet 47% agreed they have diversified since the recession to offset concentration risks.

And when they cannot, either because they are small enough that their geographic concentration is inescapable, or because they have developed a very strong niche in one area of lending, many interviewed discussed the ways they are mitigating those risks.

Find and develop a niche

In a world where lending and credit professionals face pressure to negotiate on rates and terms, they must find another way to add value and be worth the premium pricing.

> If you're really good at something, you should get paid for it. You add value. If you're a jack of all trades, then you're just money and an interest rate. Figure out a way to add some value to the transaction other than simply having the lowest rate or the longest term.

Chief Credit Officer, $1.3 Billion Farm and Business Community Bank

> Seasoned credit people are becoming harder and harder to find.

Credit Officer, $1.4 Billion Bank

Acquire and develop talent

You cannot have a conversation with a loan or credit manager without uncovering a concern about staffing. In many cases, it centers around acquisition and training. In others, in the smaller financial institutions, it is about keeping them around long enough for them to advance if the bank is not growing fast enough.

The Way Forward

Develop relationships vs transactions

Relationship lending gets a lot of press, but do your incentives support that process? And what is relationship lending anyway? Is it capturing as much of the banking relationship as possible through cross-selling services? Is it about creating such a sticky connection that better rates and terms will not be appealing to your customer?

We have always been a lender who looks at our client ***and*** looks at the transaction. What is the client's need? Is the credit facility really the right facility based on, not only their spoken needs, but also their financial condition, and their wherewithal? Does it make sense?

In the 20 years that I've been with the bank, we've never looked solely at what's the debt-to-income ratio? What's the loan-to-value? What's the credit score? Those are components that are used in our decisioning, but in many cases they're not the ultimate drivers of the decision.

The ultimate objective of the bank is to build a very long-lasting relationship with the client. I believe that was the primary reason we were able to weather the recession.

VP of Credit, $73.3 Billion Bank

Some of my best clients, on the day they make the loan, know how they are going to collect it and, to be very blunt about it, if it goes bad they know what they're going to do.

They've got that exit strategy on day one.

Tom Danielson, CPA
CliftonLarsonAllen

Manage growth

According to the material loss review by the regulators, putting growth ahead of fundamentals appears to be one of the factors in the failure of the bank in which I owned shares. Growth is not inherently dangerous but it requires discipline from the top down.

To be ready for the next recession, we will probably do the stuff we're doing and resist the temptation to stretch. We're growing, too, so you know that always concerns the Chief Credit Officer. You hope you're not growing the wrong way. When in growth mode, our liquidity isn't what it was, our loan and deposit ratio is high. All that puts a little more stress on the bank.

Chief Credit Officer, $1.3 Billion Farm and Business Community Bank

Pass it on

It is time to return to one of the major challenges identified in this study:

Transferring skills and lessons learned to the next generation of bankers.

Ask your most seasoned lending and credit professionals to distill and share the lessons learned from the last recession. Create opportunities for knowledge and experience transfer. There are many great ideas in this report from banks who are meeting this challenge.

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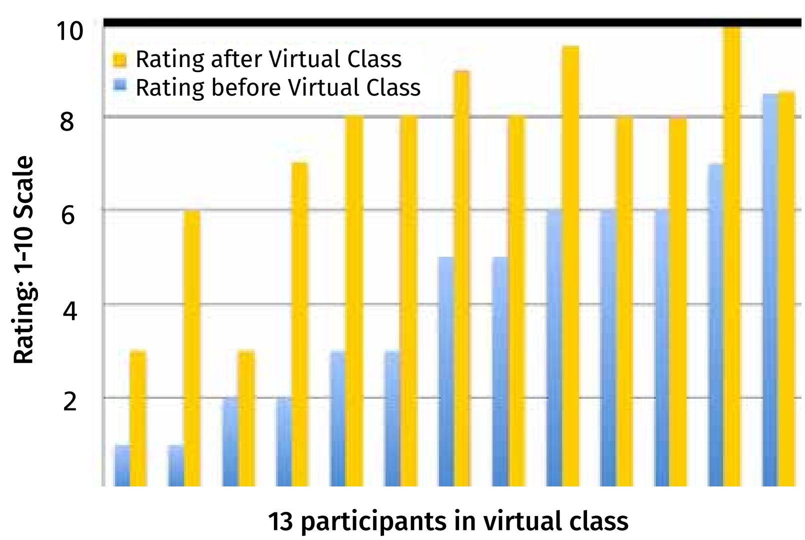
Participant rating:

The graph displays the self-rating of a virtual class of 13 participants on their competence and confidence in tax return analysis. The average improvement was 31%.

Participant feedback:

- The pace is good.
- It forms a good basis for analysis.
- I have a much better understanding.
- I find myself spotting red flags and asking important questions.
- Interactive modules, quizzes and case studies helped me gain in depth knowledge.
- You opened my eyes to additional cashflow.
- Training in small chunks doesn't get boring.

Average Percentage Increase **31%**



Credit Risk Readiness for Leaders, Directors and Managers

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