Credit Risk Ready Podcast

Host Linda Keith CPA with Ancin Cooley

Risk Appetite: The Battle Between Lending & Credit (and How Both Can Win)

Hi, this is Linda Keith CPA with Credit Risk Ready, a podcast where we interview senior credit and lending professionals from community financial institutions across the United States, their regulators, and banking advisors to better understand and mitigate credit risk.

I love the subject of this episode: the battle between lending and credit and how can both win? I've had the opportunity to do the very same tax return analysis training for relationship managers and then the next day for the underwriters from the same company. Now, interestingly, the underwriter smoked a lot more, so I don't know what that says about their stress levels. But they have a very different outlook, lending versus credit. Sometimes it seems like a battle, and yet both groups need a volume of performing loans to carry the day.

Today we're going to look at how risk appetite, usually a purview of the board of directors and management, impacts the loan originators as well, and how they can work together to help each other get to the finish line. Our guest today is Ancin Cooley, a CIA-certified internal auditor and CISA-certified information systems auditor, and founder of Synergy Consulting, providing a suite of risk management services to financial institutions, which include loan reviews, information technology audits, internal audits, directors' exams, and regulatory compliance reviews. Risk appetite is a common focus of his work with boards of directors and management. Ancin is also a former OCC examiner with experience working with banks from $100 million to $8 billion in asset size. He worked for a regional accounting firm with a focus on internal audits, loan, and pre-regulatory examiner reviews.

Hey, welcome back, Ancin.

Ancin Cooley:
Thank you for having me, Linda. It's always a pleasure to be with you. I'm excited about this topic today.

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Linda Keith:
Well, I am excited about you. Because you know what? I know a lot about some things. There's a bunch of things that I know a little about and I need people like you, my experts, to come in and round out that information for this whole credit risk area. Because credit risk is a big topic.

Ancin Cooley:
Absolutely.

Linda Keith:
So, thinking about our topic today. In my experience, lenders have roles like relationship managers, business development officers, branch managers, and sometimes just called loan officers. As a group, they seem comfortable with more risk. They're often sales oriented. They see that the relationship they are creating or sustaining through this loan request is often the tip of the iceberg. They are focused on asset quantity. How many deals can they do? But you know what? Those darn credit people. Sometimes they just get in the way.

Now, the credit analyst or the underwriter may be comfortable with risk, but perhaps more defined risk. They can't possibly know the story of the borrower unless that lender has done a good job of telling that story. They are focused on asset quality, and how to protect the bank or credit union and their job. But those lenders. Oh, my gosh. They are so unreasonable. They bring in stuff all the time those dogs won't hunt.

Ancin, does that sound familiar at all?

Ancin Cooley:
It sounds very familiar. I can think of several instances where a lender has spent months courting a potential new borrower that's currently doing business with another financial institution. You know, golfing, a couple of lunches. When they finally get that loan opportunity, and analysts spend a bunch of time — three, four days — requesting information, doing an analysis, only for that particular deal, only to get, maybe, I don't know, a conversation that lasts maybe five to seven minutes in loan committee before it gets shut down. All because that particular opportunity did not fall within that financial institution's appetite for risk. In a lot of ways, I find that tension between your first line of defense and second line of defense can be very frustrating for both parties involved.

Linda Keith:
Because both lending and credit need a quantity of performing loans. Right? They actually both need the same thing. But sometimes it does feel like they're butting heads.

You mentioned risk appetite. How does risk appetite, as determined by the board, communicated by management, factor in? Or am I just assuming that banks and credit unions actually do a good job at the board level defining risk appetite, at the management level taking that information, and pushing it down to our originator so that they do know what they're looking for?

Ancin Cooley:
Absolutely. Let's just give you some context. We do business with both banks and credit unions. One of the additional services that we do is we help these financial institutions develop enterprise risk management processes. A component of your enterprise risk management process is monitoring one of the largest risks, and financial institutions' is credit risk. Okay? There's always going to be a, in some ways a needed, tension between your gas function and your brake function. In that tension is how we find the goal. How we push forward while ensuring that we don't steer off the road.

But as you mentioned, you said, "Well, do people even care? Is this something that's fully implemented?" In my experience, I find that some institutions do a great job of creating a fully mature enterprise risk management program that encompasses risk appetite and risk tolerance in the context of economic capital. But in a lot of ways, some institutions give lip service to it. But they have half-baked enterprise risk management programs, which lead to wasted time, money, and effort, like I gave in an example in the beginning.

I really think that one of the things that we can really improve, bringing more money into institutions while also reducing risk, is leaning more into these processes by ensuring that our boards have an opportunity to communicate their risk appetite during the strategic planning process. I mean, a lot of times they do say, "We're going to grow loans by 10%." But where? In what concentrations? What types of loans? At what point are we going to take a look at the loans that we're originating month over month and so, you know what? We've done a good little bit of C and D paper because there's some margins there. But we're getting a little bit too full to the point where it's going outside of our what? Our appetite for risk and our established tolerances.

Linda Keith:
If that's changing… Right? Maybe we've had a tolerance for some C and D paper based on some other criteria. If and when that's changing, being someone who doesn't know about this part of credit, I'm just going to ask you, Ancin, has that been a role of management? First of all, to go to the board and bring to their attention that, "We're kind of moving out of some of our tolerances and our appetite." Then, secondly, whatever that change is, then communicating that through in a way that our loan originators actually understand maybe even buy into, but don't get blindsided by?

Ancin Cooley:
Right. I think one of the things that's important to realize is that a lot of institutions do not have a formalized risk appetite and risk tolerance risk processes statement. Because of that, we have these cultures, or these defacto risk appetites, that are either held in individual positions or by a group of people within your institution.

But I think this might be a good opportunity for us to kind of revisit, conceptually, what risk appetite and risk tolerance is, and let's… Play this game along with me. When you're driving along, when do you stop to get gas? Do you stop to get gas at a half of a tank, a quarter of a tank, or do you wait until the light comes on?

Linda Keith:
Well, I… Usually it's a quarter or better, but I also think about when I next need to go about 150 miles. I'm actually planning ahead being sure I don't have to get gas on the way to my 97-year-old mother-in-law's, for example.

Ancin Cooley:
All right. What you just described in your last statement is two very, some people might say complex, topics, but you just describe them in a very simple way. In that you may have an appetite for more risk, meaning you might wait to a quarter tank and, like me, you might wait to a half of a tank, but your tolerance for that risk is determined by how far the next gas station is.

In the same way, some institutions may have an appetite for higher risk, but their capital levels cannot what? Tolerate it. Every risk that we have in our institution has to be looked at in the context of our capital, liquidity risk, credit risk, transaction risk. Okay? In that, that capital, our tier-one, tier-two capital, provides us the cushion to absorb what? Credit losses. If I have abundant capital, let's just say 13-14%, I can have a higher appetite for risk than a financial institution that has a tier-one capital ratio of 8%. Your capital influences the amount of risk that you can take. You always want to look at it within that context.

With that being said, at the beginning of each year, you should set your strategic goals based on your appetite for risk and have that push through all of your lines of businesses so everyone can be on the same page. Because, as you mentioned, you have a couple of loan officers that always bring in some of their hairy borrowers. But what if, within your loan production department, you tell Jim, “Hey, Jim. Look, I know you want to bring this person in and this person in from the last institution. But for this quarter, we only have the capacity or the risk capacity for two to three of your C and D loans, and then everything else you bring in the loan committee needs to be A and B paper.” That way, up front, that individual knows, “Okay, I know how we're playing this game.” And they, after we've reached our upper limit, if they bring something in there when we present our opportunity memo before we allocate resources in time to analyze a loan that we no longer have the capacity to, we look at the opportunity memo. So, “You know, I'm not even going to pass this to an analyst and waste their time, Jim, because we do not have the appetite or the capacity for it at the moment.”

I think it creates an open environment between, again, your gas and your brake function. Then let your rock star loan officers know where they should be spending their time and resources.

Linda Keith:
What I love about that is if I was that rock star that has personally kind of a more of a risk tolerance than my financial institution is on board with, you've just let me know that of my C and Ds that I'm pursuing I need to pick my best three and go for those instead of spreading my time across a wider range. Maybe I can get maybe three through, so I've got to pick my best three to actually pursue. Then the rest of them I have to do something different with.

Ancin Cooley:
Absolutely.

Linda Keith:
This reminds me, on a personal level, a couple of things. One is, as we record this, we're still in the pandemic recession. This whole idea of risk tolerance and risk appetite is really playing out as people go back out into public settings. For example, my son is getting married in September. I just got a phone call from my sister in California who has made a very tough decision not to come to the wedding. She happens to be in a health situation. She's going to have to take some stuff that will be immune compromised. She completely had it planned. She had her hotel, the whole bit, and then her circumstances changed and that's impacting, you know, our family wedding.

People have to do this all the time, personally. I have a risk appetite, personally, that is like off the charts. My son, when he found out that I went and scaled Panorama Face on snowshoes and then glissaded down without an ice axe, or even any training on self-arrest, said to me, "Mom, I had no idea you were going to do that. So now that we know what you would do, we need to schedule time." He is a mountaineer. He's scaled Mount Rainier twice. He says, "You need to buy an ice axe. We need to schedule time to go out." So, sometimes you find out after the fact that somebody has gotten a little riskier than you're comfortable with. But I'm assuming that in loan review/loan management, that's what's important about being really tightly in touch with your hunters, your relationship managers, and so forth. So you know what they're working on and can see what might be like scaling Pan Face without an ice axe.

Ancin Cooley:
Absolutely. I think one of the things that I wanted to mention to you that you may be presuming sometimes, and that I found that isn't always the case, is that there's friction between the first and second lines of defense. Meaning in some institutions, the way their loan departments and their credit departments are set up, the credit department can become an adjacent function of the loan production. Meaning loan officers and credit analysts go out together to look at deals. I have to just say this upfront: I have biases, or I don't like that. What can happen is is because, in my opinion, when your credit analyst goes out to meet the borrower, they can become invested in the deal in the same way that the loan officer can be invested in the deal. It can affect their independence to the point where they don't protect the risk appetite in the same way that they should. So again, every institution doesn't necessarily have that friction between the first and second line of defense. Which that makes the responsibility fall

on the third line of defense, loan review and internal audit, to monitor to ensure that those functions are staying within the accepted tolerance levels.

Linda Keith:
Ancin, I have one really major client who works primarily with high-income, high-net-worth borrowers. They're nationwide. Really great business model. But in their case, lending and credit is actually at the loan origination space, not separate at all. The same person does it both, and then has to present it to loan committee. But if the thing goes down, that same person has to explain why it didn't work out. Right? What they need to do about it is very different. Clearly those relationship managers who I'm training all the time, they have to have a really good understanding of credit. Right? But they also are out looking for the deals. Now, this is also a fairly conservative financial institution, so they're not actually doing super risky things. They have a strong requirement of very solid borrowers. They've put together a model that actually the hunter and the skinner are not different.

That probably would really drive you a little bit nuts, Ancin, because you're right. Where are the brakes? Well, the brakes, here's one of the places of the breaks, is how people are held accountable. Should the deal go down? Right? They actually have a lot more responsibility at the lending side—

Ancin Cooley:
Right.

Linda Keith:
—to find these things that will, in fact, work. Because they still have to present it to loan committee. Right? They have presented and say why they think this will work. So all the way from very separate entities and even, you know, centralized credit, and the lenders are all out in the field to going together, or to having both credit and lending in the major regional areas, to possibly the same person doing both things and then having to sort of wear both of those hats.

Perhaps one step for management or directors listening today is to consider those lenders and credit analysts on the front line and help determine, given whatever model you've chosen, is the friction between the two healthy because it could be or has it gotten combative? We need to somehow help both sides understand the other. Now, I will tell you from loan origination. When I do this training on tax return analysis, which is about half of it is number crunching, but the other half is recognizing red flags, understanding the story, making good long decisions, documenting it well. When I'm focused on the relationship managers, I help them understand that the credit analysts don't have the story you have. You can't sit there and say in your head, “This is a great deal.” Part of the reason it is is because you know the history of the borrower, you know how long they've been with the institution, you've visited their business, and you have all this information, but you're only giving numbers and documents to the credit analysts. The analysts need some of this backstory sometimes to put it in perspective.

On the other side, credit analysis often will come back with questions that the lender is supposed to ask the borrower or the prospective borrower, but they don't give them enough information. They'll say, "I need to know" x, and then that person will call the borrower. They'll get the answer. They'll provide that back to the credit analysis who says, "Oh. Well, since they said, "No," we need to know this." So now your lender's back and comes back and, "Oh, okay. Good. They did say, "Yes." We're going to need a copy of" some document. And about the fourth time the lender is having to call the very same borrower or prospect with questions that they should have been able to ask all at once if they'd gotten enough information from credit, then they're put in a bad light, and, frankly, so as the financial institution.

Ancin Cooley:
Right.

Linda Keith:
From my perspective, it is partly that the lenders need to understand what the credit analysts need to be able to do the deal and the credit analysts need to give the lenders enough information. So you don't get this ping-pong thing going back and forth and then have the thing fall apart after both the lending officer and their borrower has put a lot of time into this.

Ancin Cooley:
Right.

Linda Keith:
Any other ideas for how the origination team can either understand risk appetite better or work better together?

Ancin Cooley:
Absolutely. I think what you just described is a broken process. What can happen sometimes when processes are broken and individuals become frustrated, they throw the baby out with the bathwater, if you will. They just do things like combine the two to make the process more efficient. It's almost like, you know, you go ahead and you put a V12 engine in your car with Yugo brakes. It's not going to work.

In my opinion, I will say that I do have a skew toward loan review, and I skew toward an examination perspective. But just because a loan officer and a credit analyst miss each other, we need to figure out how to make that communication happening more succinctly. Do not throw out the entire function, or combine the function, for the benefit of production and the chagrin of credit risk for the entire institution.

One of the ways I like to do it is I ensure that each constituency are at the same level to advocate with each other. Meaning if you've got a chief lending officer, you need to have a chief credit officer. All right? If you have a chief credit officer, then you need to have a chief loan officer. Meaning everybody needs to be able to punch within the same weight class. Okay?

A lot of times, though, when you look at an org chart, it tells you a lot about the culture based on who has an S on their chest and who doesn't. Meaning who's an SVP versus just an assistant VP and a VP. That tells you a lot about that institution, how they value credit risk, how they value loan review, and how they value loan production. All right?

Then also, just to answer your question specifically, I would come in sometimes and help out broken processes. One of the ways in which I've fixed things is that I opened up communication so that we can make everything transparent. For example, if loan officers like to pick up the phone, and just, "Hey, can I get you real quick, credit analysts?" Well, I stopped that. "Hey, if you have a question, you're going to send an email, and you're going to Cc the credit officer so that we have a timestamp when the question was asked, how it was asked, and when that credit analyst responded. So that when we get in the loan committee meeting, we don't have all this finger pointing. We have documentation as to how the process functions and where it's breaking down. Okay? We do that for a little while and then we can go back to something a little bit more informal once we have a full picture of what's happening. That's one thing I do.

Also, go ask some of your clients, "How many steps does it take us to go from when we have the original ask to an origination when the money is actually funded?" Ask five different people that same question and see how many different answers that you get.

Linda Keith:
How many you think we're going to get?

Ancin Cooley:
I would say a lot. Some people say three. Some people say seven. Some people say 10. Well, what institutions need to do is they need to get that Swimlane diagram out and say, "This is our origination process." Then once you have it laid out and everyone is on the same page, then you can see where the traffic jam is happening.

A lot of things that you're describing around risk appetite and things of that nature have a lot to do with poor communication and different constituencies within the institution not being leveled off and being able to advocate for their particular perspective.

Linda Keith:
I can imagine the little confirmation bias kicks in here, too. Because if you're a credit analyst, and this particular lender is always bringing you something that just doesn't fit muster, then the next time they bring something to you you're already rolling your eyes before you even start with it. That's part of the picture, I imagine, as well is for everybody to give it a fresh look.

I also know in another episode, we did focus on the regulators. You talked about letting the regulators know how the sausage is made.

Ancin Cooley:

Yes.

Linda Keith:

You specifically talked about in the documentation being able to see the credit analyst's perspective, the lender's perspective, and they actually don't have to tee up. The whole picture needs to end up supporting the final decision. But they don't actually have to agree and be in lockstep for it to either be declined or approved with confidence.

Ancin Cooley:

Absolutely. I think one of the things that we should begin, just as a quick takeaway, that I would like you to consider. So you made a new loan, but it was a kind of a hairy one, but it's a passed loan. Okay? It's a passed loan, but it shows that your risk appetite's increasing. Let's just say you have a risk rating where your passed is a 3, but you rate from a risk appetites perspectives A, B, C, D, E. Well, on your origination form, you could have a 3C. Now, we know it's a pass, but we're tracking the income in our appetite for risk. Quarter over quarter, we can see how many 3Cs, 3Ds, and 3Es that we have. Although today it cash flows, and also today we have sufficient cash flow and guarantor support, we can also track the overall increase in credit risk in the portfolio by doing that.

Linda Keith:

This lets loan management start pulling back away from the cliff edge by interacting with originators about, "Here's what we're looking for now."

Ancin Cooley:

Absolutely.

Linda Keith:

"We want the A and B. We, you know, here's what we need to do." Or even, I imagine this is not necessarily about individual loans. But again, it could be industry. "We've got too many gas stations. We have too many, you know, whatever it is. Too many small restaurants. Too many…" Even with COVID, you could look at your portfolio and say, "All right. These are the industries that are most damaged by the pandemic. So with regards to re-upping on lines of credit, and so forth, we need to give those more scrutiny." They could actually… I'm making this up, Ancin, because I don't know. That's why you're here. But I'm thinking there's could be a way internally that we actually identify from a management standpoint, "These are the areas that by their nature are riskier right now and we need to give them more attention." Does that make sense?

Ancin Cooley:

It makes a lot of sense. But actually, let me give you another bend on it. I think a lot of times risk professionals don't do a good job of selling how putting these monitoring parameters in place benefits production. Let me give you an example. For another financial institution in a different geographic area, a speculative lot loan may be a 3C or 3D. Or, in other words, a scary rattlesnake, if you will. If you touch it, you might get bit. Right? But for us, it may be as innocuous as a garden snake. Why? Because of perhaps where we are located. We may have a competitive advantage in our credit analysts. Our loan officers may have better relationships. We may end up rating those loans 3D initially. But after three years, we can do a migration analysis and look at. “Wait a minute. 3D spec loans are actually doing better than this other pool.” So now we have the actual empirical data to support the fact that for someone else it's a rattlesnake, but for us it's just a little garden snake. Using the data to actually empirically support how well you underwrite, the differences between your geographic area and someone else around the country, it gives you the ability to communicate that effectively to your primary regulator and the loan reviewers who may have biases towards certain loan types.

Linda Keith:
It almost gives your rock stars the… Releases some of the chains from them if they are, in fact, even though they sound like a riskier category, they're doing a great job finding the right people. Putting it together. Staying connected. The credit analysts are doing what they need to do. All of a sudden, we can actually see in the loan portfolio that this category that this person is the best at bringing in is actually pretty good for us.

My company initiated a credit risk ready study in 2018. I remember having a conversation with one chief credit officer who said, “You know what, Linda? Gas stations are something that scare our competitors in town. But actually, when once we did the first one, we got more comfortable about what we needed to understand about the environmental impact. We did a second one, got even better. Actually, I would do gas stations all day long because I have the confidence that we are able to do it and my competitors don't want to do it.” So, it started as a rattlesnake perhaps and now this is a really good, strong area for them. Becomes a concentration risk a little bit because of how many they're doing, but it's working for them.

Ancin Cooley:
Absolutely. I think it can become a competitive advantage, especially in an environment where many of our institutions are flush with liquidity in areas where they can find niches that they can lean into, develop some core competencies about, and have the analysis to support. “Hey, I know there's a concentration there. But let me show you years of data that communicate we know how to manage that concentration effectively.” But if you're afraid of being transparent from the beginning, you won't even get the data you need from each loan memorandum, put it in your core system, so that you can extract it and then use it at top-down level to make your case. Hiding doesn't help you. Being upfront and saying, “You know what? It may be risky for somebody else. But let me show you how we do it here and how we do it differently.” That's what I like my clients to do. Lean into your risk. But do it in a safe and sound manner.

Linda Keith:

What I'm struck by as I have been a commercial borrower or real estate borrower, as well. What you're describing is kind of what I do when I come to the lender in the first place. "I know this year didn't look quite right. But let me tell you what we were doing." And I'm giving them the rest of the story. Well, I'm the business owner so I know that story. But what I hear you saying is our systems have to gather that information at the bank level, because any given person may not have that story in their head, but they can once they can see it in the data.

Ancin Cooley:

Absolutely.

Linda Keith:

Well, risk appetite. This has been an interesting conversation. I know how it works for me on Mount Rainier. I know how it works at loan origination. it's really helpful to see how it works all the way up to the board of directors. How it can inform what we put together so that we can make good loan decisions. That lending and credit can work together, but still have that healthy tension of the brakes and the gas so that we end up with financial institutions working the way it's designed.

Thank you so much, Ancin. There are going to be links in the show notes. Ancin has a lot of information for you on risk appetite. It's one of his areas of expertise. So, Ancin, thank you for being here.

Thanks for joining us on the Credit Risk Ready podcast. Subscribe, comment, or share on social media to stay connected and spread the word. Join me next time as we bring our bank, our customers, and our communities through the recession safe and sound.

Take care.

Resources

- Synergy Credit Union Consulting:
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  https://synbc.com
- YouTube:
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- Linkedin:
  www.linkedin.com/in/ancincooley
- Interagency Credit Risk Review Guidance:
  https://www.federalregister.gov/documents/2020/06/01/2020-10292/interagency-guidance-on-credit-risk-review-systems

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About Ancin Cooley

Ancin Cooley is certified and certifiable. He is a CIA (Certified Internal Auditor), CISA (Certified Information Systems Auditor), and is the founder and principal of Synergy Credit Union Consulting, Inc., and Synergy Bank Consulting, Inc. Synergy provides a suite of risk management services to financial institutions, which include loan reviews, information technology audits, internal audits, directors' exams, and regulatory compliance reviews.

He comes by that knowledge from a wealth of experience. Prior to founding the firm, he worked as an OCC examiner working with banks from $100 million to $8 billion dollars in total assets. He also worked for a regional accounting firm with a focus on internal audits and loan and pre-regulatory examiner reviews.

About Linda Keith

Linda Keith, CPA, draws on her 30-plus years of experience consulting with and training lending institutions; background in public accounting; 15-plus years as CFO of the family residential construction company; and experience as an examiner with the Washington State Auditor's Office and as adjunct faculty in Accounting Principles and Managerial Accounting to help lending and credit professionals say “yes” to good loans.

Of course, you know those are not consecutive years or she'd be over 100 by now!

Linda is known by her clients to be both practical and funny. In fact, there is a movement afoot to change the 'P' in CPA to stand for 'Playful'. The fact is people absorb ideas and learn better when they are having a little bit of fun. So, Linda brings the fun along with her practical knowledge and depth of understanding to provide credit analysis training and presentations that make a difference.

She is the founder of Lenders Online Training, a virtual classroom approach to improving tax return and financial statement analysis capabilities; the host of the Credit Risk Ready Podcast; and a consultant/trainer on credit risk to banks and credit unions across the country.

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