

# The Credit Process

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# The Credit Process

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## Overview

This module is devoted to a description of the main components of the credit process. Each of the components will be discussed in detail, so the examiner will understand the importance of every major component and have a basis for evaluating each component on-site.

## Learning Objectives

Upon the completion of this module, you will be able to:

- ◆ Describe the basic elements of a quality credit process.
- ◆ Explain the importance of each component of the credit process.
- ◆ Explain the critical importance of the identification, measurement and evaluation of risk in the credit process.
- ◆ Evaluate the quality of the credit process.

## The Credit Process

The credit process begins with a thorough analysis of the borrower's creditworthiness, or capacity and willingness to repay the loan. The examiner should find an assessment by the credit officer of:

- ◆ The borrower's current and expected financial condition.
- ◆ The borrower's ability to withstand adverse conditions or "stress."
- ◆ The borrower's credit history and a positive correlation between historical and projected repayment capacity.
- ◆ The optimal loan structure, including loan amortization, covenants, reporting requirements – the underwriting elements.
- ◆ Collateral pledged by the borrower – amount, quality and liquidity; bank ability to realize the collateral under the worst case scenario. And,
- ◆ Qualitative factors, such as management, the industry and the state of the economy.

This process begins with the collection, analysis and evaluation of information required to determine the creditworthiness of the borrower seeking credit from the bank. After the credit analysis is completed and borrower has been determined to be an acceptable risk, the credit officer proposes a loan structure for approval that preserves the strengths and protects against identified weaknesses of the borrower. The process ends with determination of a risk rating for the credit and loan approval (or rejection). The bank's credit policy, lending standards and procedures create the parameters for this process, thereby establishing the bank's appetite for risk, conservative or aggressive.

The credit policy and standards should define acceptable loan purposes, types of loans and loan structures, and industries to which the bank is willing to lend, as well as the types of information the lender is required to obtain and analyze. The policy and standards help to create the framework, requirements and tolerance limits for lending in which all bank credit personnel will engage. The lender must understand the bank's credit risk management system and his/her role in it, as s/he engages in lending activities – analysis, underwriting and monitoring.

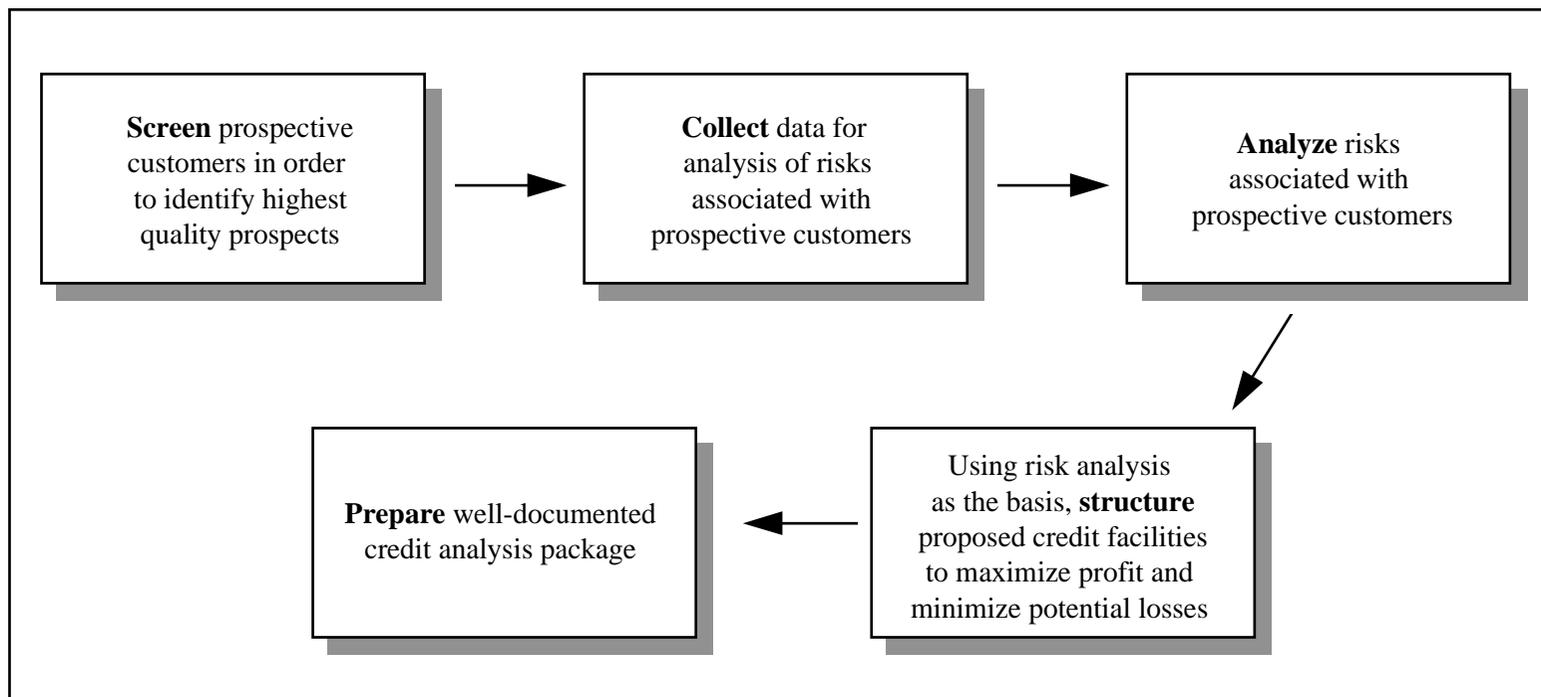
*Food for thought – When was the last time the bank changed its policy with regard to the type of information it requires from potential borrowers in the credit approval process?*

## **The Credit Initiation and Analysis Process**

The objective of the credit initiation and analysis process is to ensure that loans extended by the bank meet credit policy guidelines and that credit standards and procedures established in the credit policy are observed in all geographic areas where the bank is active. The credit policy, updated periodically as necessary, should clarify what types of loans are acceptable to the bank, what loan purposes, tenor, collateral, structure, and guarantees the bank will accept in its lending activities. In other words, the credit policy establishes threshold requirements that any prospective borrower must meet.

The credit initiation and analysis process should follow a typical diagnostic process flow, beginning with screening of potential customers and data collection, followed by identification, analysis and measurement of risks, and then moving to a series of specific risk evaluation and risk mitigation actions in preparing for a credit decision, as shown on the following page.

## CREDIT INITIATION & ANALYSIS PROCESS



Analysis of risks associated with any borrower should focus on the four foundations of creditworthiness, shown below:

**Industry** involves the *industry dynamics* and *the company's position within the industry*. Weakness in the industry itself can significantly impact loan repayment ability and the company's position within the industry is an important issue.

**Financial Condition** focuses on the borrower's ability to generate sufficient cash, the first source of loan repayment, or to draw on existing resources, e.g., capital or assets, to repay bank borrowings. The credit analyst examines the income statement, the balance sheet and the cash flow statement to evaluate this foundation of creditworthiness, focusing on *profitability, efficiency, liquidity, and leverage*, in particular.

**Management Quality** entails the *competence, integrity* and *alliances* of the key individuals running the company. Management weakness or dishonesty can have an impact on both repayment capacity and security realization. Depth of management is always a concern, especially in smaller, family run organizations.

**Security Realization** determines the level of the bank's *control* over collateral and the likely *liquidation value*, factoring in time, i.e., net present value. Weakness in security realization threatens the second source of loan repayment.

## Case Study

As a potential lender, what are your thoughts regarding the potential strengths and weaknesses in lending to the following industries?

- ◆ Oil
- ◆ Grocery Stores
- ◆ Computer/Chip manufacturing
- ◆ Airlines
- ◆ Cellular telephone

The credit officer must have some knowledge of the **industry** in which the borrower operates, in order to assess the key industry factors that impact the borrower today and may influence the borrower tomorrow. Key factors may include the level of competition, domestic and foreign, barriers to entry, government regulation, labor relations in the industry, cyclicity of the industry, and others.

Analysis of the **financial condition** of the borrower may require an extensive effort, depending on the size and complexity of the borrower's business. The more complex the borrower, the more difficult it will be to analyze the financial statements and understand the interrelationship among the balance sheet, income statement and cash flow statement. If the borrower is part of a larger corporate structure, it will require an experienced lender, perhaps even a team of lenders, to fully understand the borrower's financial condition.

Evaluation of the competence, capability and honesty of **management** requires serious due diligence on the part of the lender. This evaluation requires an experienced lender who is capable of probing into the borrower's relationships with customers, suppliers and other creditors in order to understand the borrower's business relationships. Does the borrower enjoy a good reputation in its industry? Does it have longstanding customer relationships?

At the same time, the lender must evaluate the skill and competence of management. Has management experienced several business cycles? Is management respected in its industry? Does the borrower have longstanding supplier and customer relationships? What is the history of the borrower's banking relationships? Does the owner hire competent managers and other personnel around him/her? Has the owner planned for succession? Is personnel turnover high?

In the end, the management factor is the most important of the four credit foundations. In the absence of competent, skilled, honest management (or an owner), in whom the bank has confidence, the loan should not be approved, even if all other factors are rated excellent. Management/the owner is in control and decides if and when to repay loans.

The credit analyst or officer must investigate the **security** or collateral that the borrower proposes to provide as support for the extension of credit and assure himself/herself of the value of the collateral in a liquidation scenario. In the worst case, what can the lender realistically expect to realize from sale of the collateral? The time value of money should also be factored in, especially if the collateral is real estate or a fixed asset whose sale is time consuming.

There should be evidence in the credit file of each borrower that the credit analyst and/or officer has thoroughly analyzed the four credit foundations and identified the strengths and weaknesses of each foundation in relation to the borrower. How this analysis should be performed is the topic of Section 2 of this seminar.

Once the analysis is complete, the internal credit risk rating should be assigned as the culmination of the analysis. The bank's credit policy should provide detailed guidance on assigning borrower risk ratings, including both quantitative and qualitative factors.

## **Credit Underwriting**

Credit underwriting is the process that banks undertake to structure a credit facility to minimize risks and generate the best return, given the risks that the banks assume. The credit structure includes the term of the loan, collateral required, amortization requirement, timing of interest payments, and reporting requirements.

Best underwriting practices include protections for the bank to mitigate the risks and increase the likelihood of loan repayment. Such protections include verification of cash flow to meet loan servicing requirements, proper loan covenants to preserve borrower strengths and limit weaknesses, and the requirement for sufficient, verified collateral and/or guarantees to provide a secondary or even tertiary repayment source.

Underwriting also includes the reporting required of the borrower during the life of the loan. The higher the risk identified in the credit, the more information will be required and the greater the frequency of the information. This reporting forms the basis of post-disbursement loan monitoring.

The structure of the loan is based on the analysis of the four credit foundations and should be approved in accordance with the credit authorities and approval procedures established in the credit policy.

The credit approval should also include confirmation of the borrower's credit risk rating and requirements for monitoring proposed by the credit officer. The higher the risk, the more stringent the monitoring requirements should be. For example, monthly rather than quarterly financial statements might be required.

Loan disbursement should occur once all required documents have been signed and delivered to the bank. The loan documents comprise the bank's primary protection once the loan has been disbursed. If they are not in perfect order, there is potential for problems until the loan is repaid.

The loan agreement, a legal document binding both parties, is the key document for the lender. It should be designed to "control" the borrower and contain protections for the bank. These protections include such items as conditions under which the bank will make funds available and covenants to ensure that borrower strengths are preserved and weaknesses are contained. The strengths and weaknesses should have been clearly identified earlier in the credit process, quantified and then reflected in the loan agreement to mitigate the lender's risk and exercise control.

The loan agreement becomes the primary monitoring tool for the lender, as it contains all of the requirements that the borrower must fulfill until the loan has been repaid in full. Generally, each bank will have its own loan template that is modified to fit the particular borrower circumstances. In the case of large, complex credits, the lender may work with the bank's internal legal department or even outside counsel, in order to ensure that the loan agreement contains all possible protections for the bank.

*Food for thought – Loan covenants.*

*A breach of a loan covenant usually triggers a default of the loan. However, most banks prefer to negotiate a fee-based waiver of the default so long as the ultimate repayment of the loan is relatively assured. How many of you have seen loan covenants in a loan agreement? Have you seen any of these common covenants?*

- ◆ *Cash flow (earnings before interest, taxes, depreciation and amortization, and capital expenditures – so called EBITDA) must cover debt service by 1.2x or more.*
- ◆ *Leverage as measured by debt/equity cannot exceed a pre-set number, such as 100%. In addition, some banks require their pre-approval before the borrower can incur additional debt of any kind.*
- ◆ *Maintenance of minimum current or quick asset ratios at no less than 1.00 and 0.70 respectively.*
- ◆ *Minimum sales or net income.*
- ◆ *Maintenance of an external credit rating above a set level, typically investment grade.*

## Loan Monitoring

Once loans are disbursed, the monitoring process begins. The purpose of loan monitoring is to identify as soon as possible any changes in the borrower's financial condition or performance that impact, or may impact, the borrower's capacity to repay the outstanding loan(s) to the bank as agreed. As noted above, the primary monitoring tool is the loan agreement.

The monitoring process is based on the weaknesses identified during the credit initiation and analysis phase. These may be weaknesses in the borrower's industry, financial condition or performance, changes in which could impact the borrower's capacity to repay the loan in accordance with the credit agreement. The lender should actively monitor the borrower's strengths and, particularly, the weaknesses identified during the underwriting process on a regular basis. The greater the weaknesses identified, the more frequent the monitoring. And, if new or worsening weaknesses are identified, the monitoring should be more frequent.

Typically, the credit agreement requires the borrower to submit financial and other information on a regular basis. Generally, the higher the credit risk, the more often information is required by the bank. In addition to this regular flow of information, the lender contacts the borrower by phone, in person or today by email to track how the borrower is performing. The credit file should contain evidence of monitoring by the credit officer: site visits, phone calls, interim financial reporting, and annual financial statements.

Of course, the best indicator of performance are loan and interest payments in accordance with the credit agreement, although on-time payments are NOT a guarantee that there are no credit problems.

The key to effective monitoring is regular, close customer contact and receipt of financial statements to ensure that the bank has current knowledge of borrower activities. Based on direct customer information, the analytical framework developed during the credit initiation and analysis phase should be used to track borrower performance. The credit officer should monitor any previously identified weaknesses closely and track identified strengths for deterioration. The bank/lender should pay particularly close attention to preserving the two sources of loan repayment – cash flow and security realization.

The primary monitoring tool, the loan agreement, should stipulate the requirements for information that the borrower must provide: types of information and frequency of submission. The loan agreement should also contain covenants that the borrower must observe during the life of the loan. Such covenants may include requirements to observe certain ratios, such as leverage and liquidity, at all times. They may also include certain prohibitions, such as loans to company owners or officers, owner salaries or purchase of equipment without the written consent of the lender.

Once deterioration or negative changes are identified, the bank/lender must determine whether or not the changes are material enough to affect repayment capacity and, therefore, effect a change in the risk rating. A truly material change may even represent a loan default, a violation of the credit agreement (the so-called MAC or Material Adverse Change clause), which would give the bank an opportunity to restructure the credit.

A change in the risk rating sets in motion a series of other actions, including an increase in the loan loss reserve, as stipulated by the credit policy and central bank regulations. Other actions may include the demand for additional collateral, an increase in the interest rate, even demand for immediate loan repayment, “calling the loan.”

Depending on the severity of the changes identified and the subsequent change in the risk rating, an action plan for the restoration of the credit risk rating should be developed, approved and executed.

*Food for thought – Alternative information sources*

*When a company publishes financial information infrequently, or when the reliability of the information is in doubt, banks turn to alternative sources of information. For example...*

- ◆ *VAT tax remittances as a measure of turn-over*
- ◆ *Monthly listing of accounts receivable to measure turn-over and cash generated from sales*
- ◆ *Rent rolls and copies of leases to monitor the performance of commercial real estate*
- ◆ *Court records to identify delinquent payments of taxes or payables to trade creditors*

*What alternative sources of information have you seen your banks use?*

## Credit Workout (Problem Loans)

Credit workout, or working with problem loans, should be covered in detail in the bank's credit policy. The process for dealing with borrowers whose capacity to repay is in doubt or has become impaired is the subject.

Banks have different methods for managing problem loans. Sometimes the responsibility lies with the originating loan unit, sometimes it lies with a special workout unit. The more complex the problem credit and the more bank departments that service the borrower, the greater the likelihood that a special workout unit will be charged with the responsibility of handling the loan. The bank's credit policy will dictate the methodology for working with problem loans.

There must be a mechanism for formal identification of a problem loan, such as a "watch list" and a "watch list" committee of problem credits. This mechanism is part of the process of informing senior management of the problem, so that a decision can be made about bank action as soon as possible. Generally, when a credit is placed on the "watch list," it receives a risk rating downgrade and a higher reserve because the capacity to repay has been, or is on the verge of becoming, impaired. A "watch list" committee meets on a regular basis to monitor progress in managing the "watch list" loans.

When a loan is placed on the watch list, an action plan should be agreed internally and with the borrower as soon as possible. The action plan should include specific actions or goals to be achieved by the borrower and a specific time frame for their achievement. Depending on the severity of the credit impairment, this plan will include either a rehabilitation strategy or an exit strategy, based on the bank's determination of several factors:

- ◆ The probability of success of the strategy chosen,
- ◆ The level of cooperation expected from the borrower,
- ◆ Expenses likely to be incurred in implementing the strategy, and
- ◆ The present value of the recovery expected (if the recovery will require a significant amount of time).

Once the plan is agreed, plan implementation begins. However, unexpected events may cause modification of the plan over time. The key elements are an agreed plan and effective implementation, with constant monitoring of the situation. If it appears the borrower cannot meet the terms of a reasonable and realistic workout plan, foreclosure proceedings should be commenced.

The bank should have a methodology for making either the rehabilitation or exit strategy decision. This methodology should be communicated to all lending units throughout the bank so that a uniform approach to managing problem loans can be adopted. Of course, each problem loan is unique in its own way, but a uniform initial approach is essential.

Problem loans develop when credit weaknesses appear that impair, or will soon impair, the capacity of the borrower to repay. Successful loan workouts depend on **early identification** of credit weaknesses and adverse credit trends. This requires consistent loan monitoring to identify any deterioration in the borrower's creditworthiness that may cause a downgrade of the risk rating. Then, senior management must be informed promptly of the deterioration. Examiners should be alert to delays in reporting of problem credits to senior management because prompt action is crucial to successful management and recovery. Typically, the more time that elapses before action is taken, the greater the loss.

Examples of credit deterioration include a new import regulation that will impact an entire industry, fraud, loss of key management, loss of a critical contract or supplier, or a warehouse fire in which inventory was destroyed.

*Food for thought – Indicators of emerging credit quality concerns*

*There are a number of indicators of emerging or potential credit quality problems, such as:*

- ◆ *Entry of low-cost competitors*
- ◆ *An increase in the cost of production inputs and a limited ability to raise prices*
- ◆ *Labor disputes*
- ◆ *Changes in the tax or tariff structure*
- ◆ *Implementation of international agreements that change the fundamentals of the business, such as WTO*
- ◆ *Launch of substitute technology*
- ◆ *A fraud at the company, which may indicate weak internal controls and an increased risk that the financial results have been mis-represented*
- ◆ *A loss of key management, which may indicate internal political problems*

*Can you think of any other indicators of emerging credit quality problems in addition to past due status?*

## Evaluation of the Credit Process

In order to evaluate the bank's credit process, the examiner will first need to ascertain what kinds of lending activities the bank participates in. What the bank chooses to do sets the requirements for the specific types of risk management systems used. After determining the credit areas that will be the focus of the examination, the examiner will begin by reviewing the bank's credit policy, standards and procedures. The policy, standards and procedures establish the bank's credit risk management system, from the general to the specific. The examiner must determine whether or not the policy and credit risk management system it sets forth is adequate for the types of loans the bank extends to its customers, the bank's credit risk profile. Further, the examiner must assess whether or not the credit process is adequate.

Adequacy means that all of the necessary components of the credit process have been fully implemented, are routinely executed and verified independently. If the process includes a sound credit risk evaluation process that leads to justifiable internal credit risk ratings, then the examiner should do limited testing or validation of that process. If gaps or weak points in the process are evident, then the examiner should focus on those areas in the examination, discuss them with bank management and detail them in the examination report. The credit risk management section of the supervisory plan should then focus on these areas and the examiner should monitor them, or perhaps even follow up with a targeted exam, until the bank has made the necessary improvements.

This is the essence of risk-based supervision, focusing on weak points or gaps in the risk management system and monitoring them continuously until the examiner is satisfied that they have been corrected and the system as a whole is adequate and operating as it should. The goal is for the risk management system to be operating as intended by management, so that examiners need only validate during the examination that the process remains adequate to the risk profile of the bank and no serious weaknesses are evident. One of the primary validation actions is to test a sample of new loans to ensure that the current process remains adequate, that the loans are in compliance with the bank's credit policy and procedures, and that the internal credit risk ratings are appropriate.

## **Case Study: Bank of Makati Credit Process**

### **Instructions:**

1. Read the case.
2. Divide into groups and identify the main issues for this bank's credit process that must be investigated further on-site.
3. Present your group's conclusions to the entire group.

## **Summary**

This module contained a description of the main components of the credit risk evaluation process. We discussed the importance of each component at length, so the examiner now has a basic understanding for the evaluation of each component on-site.

In this module, you learned how to:

- ◆ Describe the basic elements of a quality credit risk evaluation process.
- ◆ Explain the importance of each component of the credit risk evaluation process.
- ◆ Explain the critical importance of the identification, measurement and evaluation of risk in the credit risk evaluation process.
- ◆ Evaluate the quality of the credit risk evaluation process.