8 BEST PRACTICES FOR MANAGING CREDIT RISK
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Effective credit risk management is critical for the viability of your institution. Help safeguard your lending program by learning about the following eight elements of managing credit risk.

1. KNOW YOUR CUSTOMER

Knowing your Customer is essential because it is the foundation for all succeeding steps in the credit process. To be successful, you must operate on pertinent, accurate, and timely information. The information you gather and the relationships you establish are critical to positioning yourself as a valued financial consultant and provider of financial products and services. Establishing a good relationship can bring a long stream of equity to your institution.

A poorly planned and executed initial call could limit your opportunity for future business. One of the best ways to get to know the customer’s needs and establish yourself as a valued financial consultant is through face-to-face meetings to discuss the customer’s history and plans. Prior to meeting with the customer, you should find out as much as you can about the company and its industry. This up-front exploration will allow you to make the most of the time that you have with the customer and help you set up an effective calling plan to guide you through the interview process. You should make sure that you elicit all key information, keeping in mind that the most important skills you can demonstrate are the ability to listen effectively and to respond to a customer’s needs. Listen for verbal cues and watch for non-verbal cues to help establish a customer’s needs.

During the initial interview, establish your credibility as a professional, knowledgeable, and friendly businessperson. Ask questions and gather information about the company’s products and services, customers, suppliers, facilities, management, ownership, and history. This is when you can develop your initial observations about management’s behavior and start to evaluate their qualifications and abilities to carry out the company’s business strategy.

On subsequent calls, investigate competition, market share, and the probable impact of economic conditions on the business. And identify the company’s business strategy and what the company must do to succeed.
2. ANALYZE NONFINANCIAL RISKS

Understand your customer’s business by analyzing nonfinancial risks. Information gathered in this step is critical to positioning yourself as a financial consultant to your customer and a valued member of your financial institution’s lending team.

The concept of risk management can apply to a single loan or customer relationship (micro) or to an entire loan portfolio (macro).

The whole concept of institutional risk management is to ensure that an issue has been identified as a risk. At the micro level, a loan is a risk. At the macro level, a portfolio of loans is a risk. Your credit policy department will identify risk factors and query the entire loan portfolio (macro) to judge whether the particular risk is relevant to other customers of your institution. The key question is, “How does this identified risk affect a company’s ability to repay debt?”

Risk Management is a continuous process (not a static exercise) of identifying risks that are sometimes subject to quick and volatile changes. The identification of risks may result in opportunities for portfolio growth or may aid in avoiding unacceptable exposures for the institution.

There is risk to every line item on the balance sheet and income statement and you must learn how to evaluate those risks, which fall into the broad categories of:

- Industry
- Business
- Management

The integration of the analysis of risks associated with the industry, business, and management of a company is a critical piece in the overall credit underwriting process. From your institution’s perspective, senior credit policy management wants to know:

- Is there enough capital available on the institution’s balance sheet to support the risk being taken?
- Is the institution being adequately compensated for the risk?

The focus of risk analysis is not to eliminate risk, but to understand its effect on your client’s ability to repay. Certain fundamentals of risk management have emerged as classic, time-proven strategies.

The process of understanding risk includes the following:

- Identify the risk.
- Analyze the risk.
- Quantify the risk.
- Mitigate the risk.
- Monitor the risk.
- Anticipate unidentified risks.
• Are there adequate controls in place at the institution to assure the proper tracking of the risk and minimize the element of surprise?

Evaluating industry, business, and management risks enables you to ask questions of customers and prospects in order to fully identify, quantify, and if possible, mitigate key risks. As a result, you develop critical thinking skills that integrate economic, political, and market issues into the overall underwriting process. Assuming the loan meets underwriting and credit approval criteria, properly analyzing these risks gives you the information to help structure the loan in a fashion that will ensure the highest probability of repayment.

Analysis of the industry, business, and management risks precedes or is concurrent with financial analysis of an individual company. If the financial institution has, or wants to gain, a significant exposure to a particular industry, it usually has industry experts on both the lending and credit analyst teams. Industry experts provide an intimate knowledge of an industry and will,

• Identify, understand, evaluate, and mitigate risk.
• Provide expertise in the event of a loan workout situation with a customer.
• Provide efficient marketing strategies in acquiring creditworthy and profitable clients within a particular industry.

An understanding of the economic and industry factors that influence a company’s financial stability and financing requirements is necessary before evaluating the numbers. Because you can’t analyze a company in a vacuum, it must be analyzed within the larger context of its industry and the world economy.

Industry, business, and management risks are inherently an important part of the overall credit underwriting process. A company’s financial statements reflect a company’s management decisions as that company interacts with the outside world. Industry, business, and management risks (nonfinancial risks) describe that outside world.
3. **UNDERSTAND THE NUMBERS**

There are many benefits and risks associated with establishing a banking relationship with any entity or individual. As a lender, you should know:

- How the requested funds are going to be used and how they are anticipated to be repaid.
- How to identify, categorize, and prioritize all of the risks inherent with the customer that are known at the time of the analysis as well as those that are anticipated to be in existence over the period of the relationship.

To understand the numbers, you should focus on the financial capacity of the company as evidenced by the information provided and examine the accuracy of the information as well as the quality and sustainability of financial performance. Before beginning any financial analysis, it is important to understand why companies and individuals borrow money.

**Why Do Companies and Individuals Borrow Money?**

When dealing with new clients, it is doubly important to probe into how and why the loan request originated. When loaning to established relationships, your assessment of the loan will be guided by your knowledge of the changes in your customer’s asset structure as it goes through its business cycle.

The reason for borrowing provides you with insights into the company’s ability to repay. A complete understanding of the historical and projected financial performance of your customer is key to your analysis.

The loan request is generally the most scrutinized part of a credit write-up. Once you are comfortable with the

The key question is, “Why does this company really need to borrow at this point in time?” On a request for a working capital loan you should specifically ask: “Why does this company or individual need cash?” The underlying reason for borrowing can include any one or more of the following factors:

- Support increased level (permanent or temporary) of sales which necessitates increased funding for inventory and accounts receivable.
- Finance inefficiencies in working capital asset management, i.e., slowdown in accounts receivable or inventory turnover.
- Purchase of long-term operating assets or investment assets, including purchases related to merger and acquisition strategies.
- Make personal investments.
- Show more cash balances.
- Repay trade creditors, other bank debt, “friendly” debt, taxes, or any other liability that has come due.
- Repay long-term debt.
- Make payments for dividends and stock repurchase programs within the equity account.
- Pay expenses, but hopefully not unplanned operating losses.
nature of the loan request, the process of understanding the numbers can begin. The process includes:

- **Knowing the Auditor** – Analyze the competency and reputation of the firm or individual preparing your customer’s financial reports.

- **Accounting Fundamentals** – Review the auditor’s Engagement Letter, Financial Statements, and Management Letter, as well as accounting fundamentals and generally accepted auditing principles (GAAP).

- **Balance Sheet Quality Analysis** – Analyze the balance sheet along with relevant liquidity and leverage ratios.

- **Income Statement Quality Analysis** – Analyze revenues and costs along with income statement ratio analysis.

- **Cash Flow Statement Analysis** – Analyze operating cash flow, investing cash flow, financing cash flow, and cash flow ratios.

- **Analyzing Financial Efficiency Cash Flow Drivers** – Use profitability ratios and turnover ratios to analyze a company’s cash flow drivers.

- **Developing Projections** – Determine the reasonableness of assumptions behind business fundamentals and swing factors.

- **Personal Financial Statement Analysis** – Analyze the personal financial statement and tax return in the event that you are lending directly to or seeking additional credit support from an individual.

- **Company Financial Statements** – Analyze the company’s financial statements and provide an overview. Obviously, a small company will have a simpler chart of accounts, while a large domestic or international corporation will be more complex.

### 4. STRUCTURE THE DEAL

The first step is to understand the business. Before completing a financial analysis on the organization, you identify the characteristics that influence a company’s success by studying:

1. The nature of the business.
2. The nature of the industry.
3. The impact of economic conditions.
4. Its business strategy.
5. The competencies or deficiencies of management.
Learn what the company does and how it operates. Then examine how it fits into its industry and how it is affected by economic conditions. That information shows you what the company’s business strategy should be and how easy or difficult it will be to carry out that strategy. Finally, you can evaluate how competent the company’s management is to accomplish the activities you have identified as crucial to the company’s success.

Having completed the analysis of the business, you can then move to analyzing the financial reports, historical and forecasted. Understanding profitability and cash flow, liquidity, and leverage are key to structuring the facility.

You cannot determine what product(s) fit the customer’s profile until these steps have been completed. Once this process has been completed, applying the appropriate structure becomes a simple procedure. By taking the time to understand the personal, financial, and business strategies of the owners, you will have an easier time getting to “yes,” with a risk profile acceptable to your financial institution.

Once you have identified the underlying borrowing cause(s) and understand both primary and secondary repayment sources available, the next step is to structure the loan.

Loan structure is important because your customer needs to clearly understand the boundaries within which it can operate and continue to depend upon your institution for its financial services needs. The structure of the deal appropriately establishes your customer’s expectations for how your institution will perform during the term of the relationship. Your customer needs this assurance in order to run the business efficiently, i.e., if they operate in accordance with the terms and conditions of the loan agreement, your customer can expect funding from your institution.

Loan structure depends on the nature of your customer’s business and how your institution intends to provide financial services to the company. To properly structure a customer relationship, you must be able to:

- Project how the company will perform in the future, including likely primary and secondary repayment sources.
- Anticipate challenges and problems that may arise.
- Match an appropriate type of loan to both the loan purpose and the likely repayment sources.
- Develop a set of covenants that protects your institution for the duration of the relationship.
- Secure the credit facility with collateral.
- Consider requiring additional loan support, such as guarantees.
By having an appropriate structure to the relationship, agreeable to both parties, you have established a mechanism for monitoring individual transactions within a relationship. This monitoring process can be accomplished in two ways:

- Have a loan covenant checklist that routinely tracks your customer’s adherence to covenants.
- Require that an officer of the company regularly (quarterly, for example) certify as to the company’s compliance with all of its outstanding agreements.

Failing to notify your customer of a covenant default may make your institution’s future enforcement of the covenant difficult.

5. **PRICE THE DEAL**

Determining the appropriate pricing is a critical. It ensures that your financial institution will be adequately compensated for the risk of the deal.

In the late 1970s, nearly 90% of all floating rate loans were linked to the prime rate and used as a benchmark for loan pricing. Adjustments to the incremental spread over/under the prime rate generally signaled the softening or hardening of loan conditions. These adjustments were not always closely synchronized with changes in short-term money market rates, such as the Fed Funds rate or other cost of funds indices.

However, over the past 20 years, increasing competition from foreign financial institutions seeking business in the U. S. through offshore branches and agencies and the expansion of the commercial paper market have caused a movement from prime-based loans to pricing based on money market base rates. As U.S. banks’ access to overseas sources of funds has increased, London Interbank Offering Rate (LIBOR) has become an increasingly popular base rate index among customers of regional and even small banks. LIBOR is the rate that the most credit-worthy international banks dealing in Eurodollars (U.S. currency held in banks outside the United States, mainly in Europe) charge each other for loans.

With money market rates of interest fluctuating dramatically over the past 20 years, banks’ loan pricing systems have become largely based on floating rates. This pricing tactic ties the loan rate to a base rate that responds to movements of money market rates. Financial institutions painfully learned their lessons with respect to managing interest rate risk in the early 1980s. Institutions with large portfolios of low fixed-rate loans found they were exposed to considerable interest rate risk when variable funding costs rose sharply. Today, banks have created increasingly complex strategies for
managing interest rate risk through the use of financial futures and options. Interest rate risk management and loan pricing are now highly interrelated through the use of pricing models.

Traditionally, banks have used pricing models that parallel the format of their income statement. As the major source of profitability for many banks, loan interest income has played an important role in the banks’ return to shareholders. As the market for loans has become more competitive, banks have had to change the way that they look at profitability.

Many complex factors determine the final rate a bank charges its commercial clients. In addition to company-specific variables, factors that affect pricing include the following:

- Marketplace in which the bank operates.
- General economic conditions.
- Matching of the pricing and maturity of the bank’s assets and liabilities, i.e., Asset Liability Committee (ALCO) policies.

6. PRESENT THE DEAL

Communicating your findings in a cogent and professional manner is a critical step in getting your proposal approved. Credit decisions should not be made on financial statement analysis alone. A credit review would not be complete without an equally significant emphasis on the qualitative issues such as the ability of management, the competitive business environment, and the economic issues relating to the business.

Whether you write the credit presentation or hold a credit discussion, the following format will be equally applicable.

The five key sections that are integral to any effective credit recommendation report or presentation are:

1. **Summary and Recommendations** – A one-page summary of all the information that has been gathered in the analysis that supports the credit recommendations.
2. **Economic and Competitive Environments** – Analyses of the company’s current and evolving position in the industry and how susceptible it has been, and may be, to changes in the general economy.

3. **Management Assessment** – Evaluations of the company’s operations and management’s capabilities.

4. **Financial Analysis and Projections** – Analysis of the financial position of the company and evaluation of the projected performance of the company.

5. **Sources of Repayment** – Identification of all projected sources of repayment and the appropriate loan structure.

**7. CLOSE THE DEAL**

Closing the Deal takes place after the analysis, structuring, and pricing have been completed. Do the following and it is more likely that your loan closing will be successful:

1. Prepare a closing memorandum or detailed loan documentation checklist.
2. Provide sufficient time for the borrower and any other parties involved in the transaction to gather documents.
3. Provide the borrower and any other parties with instructions on how to complete your standard documents and ensure that they return the forms to you for review prior to the closing.
4. Prepare drafts of loan documents and deliver them to the borrower or other involved parties prior to the closing with sufficient time for the recipients to have the documents reviewed by their own legal counsel.

**8. MONITOR THE RELATIONSHIP**

In today’s competitive environment, you cannot afford to wait for your loans to be repaid and expect your clients to call you for other products and services. To have a competitive advantage in today’s market, you must continue to monitor the risk profile of your client and, at the same time, pursue opportunities to develop and expand the relationship.

A profitable relationship can quickly turn into an unprofitable one. Loan payments may be timely, but deteriorating collateral, idle equipment, or unpaid taxes can create serious risk for you. Periodic reviews, ratings, and audits can ensure that the client is one that will create long-term profitability for your bank.
Asset quality is one of the key success factors of a financial institution. Although every bank is subject to scrutiny from state and federal regulatory agencies, most banks supplement these functions with internal monitoring.

In a recent survey of banks conducted by RMA, the following were determined to be critical to a successful risk management strategy:

- A quantitative risk-rating system with a wide range of grades, which includes subjective factors, such as management quality. A wider range of grades allows the bank to assign credit costs more precisely.
- An effective management information system to track credit exposure.
- Risk pricing based on required rates of return that are then used in customer sourcing.
- A business strategy that reflects a proactive role in guiding relationship managers on credit exposures in the portfolio.

For additional information about the credit process, visit https://www.rmahq.org/ where you can:

- Find many related articles in the Credit and Lending Studies Packs.
- Enroll in The Lending Decision Process for an in-depth look at the lending process and to learn how to accomplish the best practices discussed in this white paper.
- Subscribe to eMentor to make smarter, faster credit decisions.
- Apply for the Credit Risk Certification exam.
ABOUT RMA

The Risk Management Association (RMA) is a not-for-profit, member-driven professional association serving the financial services industry. Its sole purpose is to advance the use of sound risk principles in the financial services industry. RMA promotes an enterprise approach to risk management that focuses on credit risk, market risk, operational risk, securities lending, and regulatory issues.

Founded in 1914, RMA was originally called the Robert Morris Associates, named after American patriot Robert Morris, a signer of the Declaration of Independence. Morris, the principal financier of the Revolutionary War, helped establish our country’s banking system.

Today, RMA has approximately 2,500 institutional members. These include banks of all sizes as well as nonbank financial institutions. RMA is proud of the leadership role its member institutions take in the financial services industry. Relationship managers, credit officers, risk managers, and other financial services professionals in these organizations with responsibilities related to the risk management function represent these institutions within RMA. Known as RMA Associates, these 18,000 individuals are located throughout North America and financial centers in Europe, Australia, and Asia.

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