JERRY STAKER

EFFECTIVE CREDIT RISK MANAGEMENT

MANAGING ASSET QUALITY AND BORROWERS DURING A SERIOUS ECONOMIC DOWNTURN

CREDIT RISK MANAGEMENT ADVISORY, LLC
CreditRMA.com

Credit Risk Management Advisory, LLC

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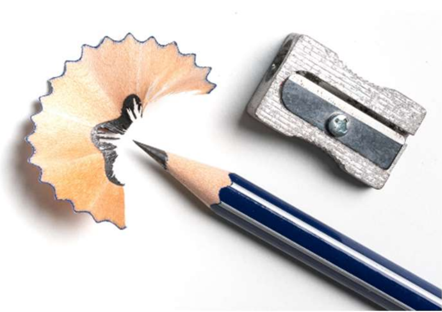
Introduction

Sharpening Credit Risk Management Tools



During these times of economic downturn, CreditRMA.com introduces new and effective credit risk management tools to optimize debt repayment solutions with commercial borrowers. Let's begin with the effectiveness of the regulatory credit risk rating system, credit risk evaluation, and understanding critical roles and responsibilities for these processes.

Equally important is the adequacy of the asset quality monitoring function for Watch List and criticized credits. Reflection is given to the credit culture in welcoming divergent views, demonstrating proper respect for all commercial loan borrowers and dealing in good faith. Finally, understanding how to get the borrower to cooperate in providing appropriate answers to getting to the root cause of credit risk, along with special risks like commercial real estate.

These stressful times require pro-active credit risk management processes that get to the root of each debt repayment problem, and apply the best debt repayment solution(s). CreditRMA.com brings a new and fresh approach to the credit risk management function. With over four decades of seeing the effects of numerous economic cycles, these tools are uniquely prepared to help community banks through challenging times like these. CreditRMA.com was built specifically for these times. Fresh ideas and collaborative thinking are always welcome. It is imperative that we understand the credit risk on the books to maximize the bank's recovery in the shortest amount of time.

SECTION 1

Credit Risk Rating Classification System

Objective

- *Tight Risk Rating System* – Refresher for assigning timely and accurate credit risk ratings as part of a tight credit risk rating system; this includes Watch designated credits
- *Promote Bank Safety and Soundness* – Facilitate informed decision making through measuring credit risk ratings; serves seven (7) important functions: credit approval, underwriting, guide price setting, relationship management, credit administration, allowance for credit losses (ACL), and portfolio Management Information System (MIS)

Expectations

- *Accuracy and Timeliness* – A must! Risk rating is dynamic and changes when risk changes; understand clear criteria for assigning risk ratings
- *Well-Supported and Documented* – Risk rating conclusions must reflect any credit risk weaknesses; dig deep into the root causes

Accuracy and Timeliness

Why "Accurate and Timely?"

- Promotes safety and soundness, and serves seven (7) important functions listed above
- The entire risk rating system can become ineffective if there are systemic "misses," especially double-downgrades
- Classified loans can "pile up" in a hurry, and the bank can become subjected to enhanced regulatory scrutiny
- Protects the bank against *unwarranted loss* (had it been done it right in the first place); helps ensure the least/best loss scenario

Hesitancy Rationale Resulting in Slower Downgrades

- Incentives are frequently geared toward producing loans than rating them accurately
- Past bank history includes very few payment defaults and even fewer losses
- "But they are paying as agreed, have great LTV's, lots of cash reserves, it's not the borrower's fault, the bank won't lose any money"
- Do not see the risk of any "loss"
- Overlook the repayment capacity via operating cash flows
- Sensitive to relationship needs; competitive forces; may offend borrower/guarantor/sponsor; issues will likely be resolved soon; concerned about having classified loans in portfolio
- Other: compensation programs, relationship management structures, inexperience, incompetence, unfounded optimism

New Approach - Tips

- Enhance the dialogue between the Primary Relationship Officer (PRO) the Credit Administrator (CA) on making risk rating decisions; the PRO maintains primary risk rating responsibility, followed by the CA
- Request and get current financial reporting regardless of requirements to submit; conduct inspections, open enhanced but respectful dialogue with the borrower
- Measure risk, be curious, develop third-party type *deep* questions, ask these better deeper questions *early on*
- Focus on the emerging trends of operating cash flow results, top line performance, margin compression, deteriorating metrics
- Approach CAs when thinking about assigning a potential Watch List designation, before the Watch List designation is prepared
- Get comfortable with and be willing to share news (that may not actually be good news) with the CAs; engage in rating definition discussions earlier
- Internal divergent views are welcome and encouraged! Remember: be respectful, diplomatic, professional; document the facts

Upgrades

- When credits are classified because of well-defined weaknesses (Substandard) of the borrower's financial condition or credit structure, ensure correction of the weaknesses and a period of sustained performance under reasonable repayment terms, should be demonstrated before upgrading the credit rating to Pass
- The mere existence of a plan for improvement, by itself, does not warrant an upgrade

Well-Supported and Documented Conclusions

Well-Supported

- Obtain appropriate *current* financial information from the borrower(s) and guarantor(s), regardless of the standard required financial reporting schedule
- Conduct adequate due diligence by asking important "3rd party type" questions, inspections etc.
- If risk rating conclusions are not well-supported, further inquiry and analysis are often required to determine the appropriate classification

Documented Conclusions

- If in doubt, write it up; start by writing up what you have now so it can be discussed; add to it later
- Documented support for the conclusion instills confidence; "close the loop" with documented analysis, evidence, rationale; vigorous, but respectful, diplomatic, and professional, documented defense of conclusions
- Key assumptions should be reasonable, sufficiently disclosed, well supported, carefully analyzed, and understood by a 3rd party reader: income, cash flow, receivables, valuations, etc.

Watch List Monitoring

- *Watch List Monitoring (for Uncertainties)/Early Warning System* – The Watch List process is really an early warning *system*, (Pass risk ratings), to alert senior management of any heightened, but still

acceptable, borrower risk profiles that should warrant closer monitoring due to uncertainties: financial, operational, managerial, ownership, industry, technology, labor, legal, and environmental

- *Document the Uncertainty* – Be very specific as to the uncertainty that is to be monitored, with dates, amounts, etc., with the intended resolution date
- *Watch List Designation/Timing* – Once the uncertainty is resolved, the Watch List designation should promptly be removed

Regulatory Credit Risk Rating Classifications

Special Mention

- Credit exposures that, while currently protected by the sound worth and paying capacity of the borrower, exhibit distinct weakening trends and or elevated levels of exposure, to external conditions
- If not checked or corrected, these identified potential weaknesses may result in deteriorated prospects of repayment
- These exposures require close management attention to avoid there becoming undue and unwarranted credit exposures

Example: Potential weaknesses in CRE loans may include construction delays, changes in concept or project plan, slower than projected leasing, rental concessions, deteriorating market conditions, impending expiration of a major lease, or other adverse events that do not currently jeopardize repayment. Such loans should receive an elevated level of monitoring.

Substandard

- Credit exposure that is inadequately protected by the current sound worth and paying capacity of the borrower or of the collateral pledged, if any
- Exposures so classified must have a well-defined weakness or weaknesses that jeopardize the orderly repayment of the debt
- They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected

Example: Well-defined weaknesses in a CRE loan may include: slower than projected leasing or sales activity that may result in protracted repayment or default; lower than projected lease rates or sales prices that jeopardize repayment; changes in concept or plan due to unfavorable market conditions; delinquent property taxes; construction or tax liens; inability to obtain necessary zoning or permits to develop the project as planned; diversion of needed cash from an otherwise viable property to satisfy the liquidity needs of a troubled borrower or guarantor; material imbalances in the construction budget; significant construction delays; the expiration of a major lease or default by a major tenant, without a replacement lease or remedy to default in the near term; poorly structured or overly liberal repayment terms; material collateral damage or other significant casualty losses; bankruptcy or replacement of the general contractor, major subcontractor, or suppliers; fraud or the misapplication of loan proceeds.

Doubtful

- Credit exposures classified as Doubtful have all the weaknesses inherent in one classified as Substandard with the added characteristic that the weaknesses may make collection or orderly

repayment in full, based on currently existing facts, conditions, and values, highly questionable and improbable
- The possibility of loss is extremely high, but because of certain important and reasonably specific factors that may work to the advantage and strengthening of the exposure, its classification as an estimated loss is deferred until its more exact status may be determine

Example: Use a doubtful classification for a limited time to permit the pending events to be resolved; circumstances that might warrant a Doubtful classification for CRE loans could include collateral values that are uncertain due to a lack of comparables in an inactive market, pending changes such as zoning classification, environmental issues, or the pending resolution of legal issues that could affect the realization of value in a sale.

Loss

- Credit exposures classified as Loss are considered uncollectible and of such little value that their continuance as bankable assets are not warranted
- This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be affected in the future
- Losses should be taken in the period in which they surface as uncollectible

Example: As a general classification principle, for a troubled CRE loan that is dependent on the operation or a sale of the collateral for repayment, any portion of the loan balance that exceeds the amount that is adequately secured by the market value of the real estate collateral less cost to sale, should be classified as a loss, if that portion of the loan balance amount is deemed uncollectible; this principle applies when repayment of the debt is provided solely by the underlying real estate collateral and when there are no other reliable sources of repayment available.

SECTION 2

Credit Risk Evaluation Process

Objective

- *Credit Risk Ratings Evaluation Process* – Refresher for understanding the credit risk evaluation process in the timely and accurate assessment of rating credit risk

Expectations

- *Team Approach* – Broaden the scope and understanding of evaluating credit risk; Primary Relationship Officers (PROs) and Credit Administrators (CAs) working closer together as credit risk changes

Two (or Single) Tier Risk Rating System

Two Tier Risk Rating System

The risk rating process is accomplished in stages, Borrower Risk Rating (BRR), and Transaction Risk Rating (TRR). The TRR is used for regulatory reporting.

Borrower Risk Rating (BRR)

The BRR starts with a thorough analysis of the borrower's ability to repay in establishing the BRR. The BRR is based on the general financial strength of the borrower/issuer, and is independent of any transaction issues such as structure, collateral, or guarantors. It is an overall assessment of a borrower's financial and operating strength, including competitive issues, quality of management, financial reporting issues, industry, or economic factors, including:

- The borrower's current and expected financial condition: cash flow, liquidity, leverage, free assets
- The borrower's ability to withstand adverse, or stressed conditions
- The borrower's history of servicing debt, whether projected and historical repayment capacity are corrected, and the borrower's willingness to repay
- Underwriting elements in the Loan Agreement, such as loan covenants, amortization, and reporting requirements
- Qualitative factors such as the caliber of the borrower management, the strength of its industry, and the condition of the economy

Transaction Risk Rating (TRR)

After the determination of the BRR, the TRR is established, taking into consideration the structural elements enhancing the loan transaction including the existence of:

- Collateral quality and control

- Guarantees and 3rd party support
- Transfer (currency conversion) risk

Single Tier Risk Rating System
Use of the BRR approach; cash secured loans would be risk rated as Pass

Quantitative Financial Statement Analysis

Quantitative analysis of revenues, profit margins, income and cash flow, leverage, liquidity, and capitalization, should be sufficiently detailed to identify trends and anomalies that may affect borrower performance.

- *Cash flow* – Business cash flow is the operating revenue derived from ordinary business activities, less operating costs paid (not simply incurred), plus non-cash expenses such as depreciation and amortization. Changes in working capital accounts, capital expenditures, and other uses of cash should be reviewed to understand the cash flow implications

- *Ratio Analysis and Benchmarks* – Analyze vital information about balance sheet and income statement proportions. Compare borrower's financial ratios with prior periods, and industry or peer group norms, to identify potential weaknesses; noted ratio deviations should have identified root causes

- *Analysis of Projections* – Expected performance should be measured against historical performance and how likely they will be achieved. Consider multiple scenarios: stressed/downside, break even, borrower management case, and bank base case

- *Refinancing* – Loans for which refinancing is a source of repayment should only be made if the borrower has the capacity to repay the loan, either through business cash flow or the liquidation of assets. A loan whose repayment continually relies on refinancing, often referred to as "evergreen loans," or whose borrower fails to achieve successful recapitalizations, requires added scrutiny; such loans are speculative at best and may warrant an adverse rating

Qualitative Financial Considerations

Qualitative analysis of sound underwriting, management, and borrower's industry, conformance to bank policy, with any exceptions adequately mitigated and documented.

- *Underwriting* – Underwriting is the process by which banks structure a credit facility to minimize risks, and generate optimal returns for the risks assumed. Sound underwriting provides protections, such as coordinating repayment with cash flow, covenants, and collateral, thereby increasing the likelihood of collection

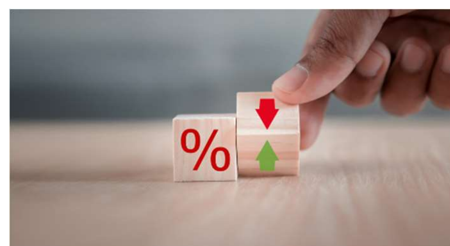
- *Management* – Addresses the character, capability, and stability of the management team. It considers their qualifications, experience, and effectiveness in developing and implementing appropriate business and financial strategies. Competency and integrity, cannot be overstated. The

ability of managers to guide, exploit opportunities, develop, and execute plans, and react to market changes, is extremely important. Unexpected loss of one or two key employees can be detrimental. Even the most experienced management teams can be challenged by high growth (common reasons for business failure)

- *Industry* – Understand the conditions in which a business operates and the cyclical, competitive, and technological changes it is likely to experience. Most industries exhibit some degree of cyclical volatility, and some industries are exposed to seasonal variances, too. Such volatility affects the operating performance and financial condition. Technological change and new competitors, or substitute products, also affect performance

Transaction Risk Ratings

Credit risk can be moderated by enhancing the loan structure. Parties to a loan can arrange for mitigants such as collateral, guarantees, letters of credit, credit derivatives, and insurance during or after the loan is underwritten. Credit mitigants primarily affect loss when a loan defaults and, except for certain guarantees, generally do not lessen the risk of default.



- *Collateral* – Collateral is any asset that is pledged, hypothecated, or assigned to the lender and that the lender has the right to take possession of if the borrower defaults. The lender's rights must be perfected through legal documents that provide a security interest, mortgage, deed of trust, or other form of lien against the asset. Once the lender has taken possession of the collateral, loan losses can be reduced or eliminated through the sale of the assets. The level of loss protection is a function of the asset's value, liquidity, and marketability. Realistic collateral valuation is important at loan inception and throughout the loan's life, but it becomes increasingly important as the borrower's financial condition and performance deteriorates

- *Loan Guarantees* – Loans may be guaranteed by related or unrelated businesses and individuals' guarantee agreements should be as precise as possible, stating the specific credit facilities being guaranteed, under what circumstances the guarantor will be expected to perform, and what benefits the guarantor received for providing the guarantee. Guarantees can be unconditional or conditional. If a guarantee is to enhance a credit's risk rating, the guarantor must display the capacity and willingness to support the debt. A presumption of willingness is usually appropriate until financial support becomes necessary. At that point willingness must be demonstrated. When adequate evidence of guarantor performance is lacking, the guarantee should not have a beneficial effect on the risk rating

- *Letters of Credit (LC)* – An L/C is a form of guarantee issued by a financial institution. An L/C rarely protects against default risk, unless it specifically can be drawn on for loan payments. An L/C issuer is typically more creditworthy than a guarantor. When an L/C that protects against default is obtained from a high-quality institution, it may effectively prevent default and losses. The issuers low credit risk substantially mitigates the borrower's higher credit risk. Before a loss scenario could develop, both the borrower and the L/C issuer would have to default. An L/C can be irrevocable, which means all parties must agree to its cancellation, or revocable, which means the L/C can be

cancelled or amended at the discretion of the issuer. Revocable letters do not mitigate credit risk. A standby L/C pays only when the obligor fails to perform

Structural Weaknesses

Structural weaknesses are underwriting deficiencies that can compromise a bank's ability to control a credit relationship if economic or other events adversely affect the borrower. Evaluate the relative importance of such factors in the context of the borrower's overall financial strength, the condition of the borrower's industry or market, and the borrower's total relationship with the bank. Third-party reviewers will take note of the following:

- *Indefinite or Speculative Purpose* – The loan purpose should clearly reflect the actual use of the proceeds. Loans for ambiguous or speculative purposes deserve extra scrutiny

- *Indefinite or Overly Liberal Repayment Program* – Loans that lack a clear and reasonable repayment program, source and timing, present extra risk, regardless of their nominal maturity. This includes loans that revolve continually or "evergreen loans," where the bank is essentially providing debt capital. Typical indicators of unrealistic repayment terms include: bullet maturities unrelated to the actual source of repayment funds, rewrites, or renewals for the purpose of simply deferring a maturity, loans used to finance asset purchases with a repayment plan significantly more than the useful life of the asset, and advances to fund interest payments

- *Nonexistent, Weak, or Waived Covenants* – Whereas effective covenants provide the bank with the opportunity to trigger protective action upon covenant default, be alert for covenants that have been waived or renegotiated by the bank to accommodate a borrower's failure to maintain the original standards. Make use of meaningful covenants

- *Inadequate DSC* – The initial underwriting of loans that are intended to be repaid from operating cash flow, should provide for an acceptable margin to repay both principal and interest in a reasonable time based upon historical performance. If repayment is predicated on new revenues that are expected to be enabled by the loan, then anticipated future cash flows should be reasonable and well documented

- *Elevated Leverage Ratio* – Acceptable leverage ratios vary based on industry, loan purpose, covenant definition, capital expenditure restrictions, and dividend payouts. Review the reasonableness of the leverage ratio and how it is defined. Leverage ratios may be calculated as debt to worth or debt to cash flow. Industry standards prescribe which methodology is most appropriate

- *Inadequate Tangible Net Worth* – Companies need tangible net worth to sustain them during unforeseen, adverse situations. Consider both the absolute amount of tangible net worth and its amount relative to debt

- *Insufficient Collateral Support* – This occurs when the borrower is not deserving of unsecured credit, but is either unwilling or unable to provide a satisfactory margin of collateral value. Consider senior liens, the costs associated with liquidation of the collateral, and the potential reputation risk that might influence the bank's willingness to liquidate, including lender liability issues

- *Inadequate Collateral Documentation and Valuation* – Collateral should be documented by evidence of perfected liens and current appraisals of value. Federal regulations govern the appraisal requirements relating to many forms of real estate lending. Other unregulated types of collateral should also be supported by appraisals or valuations reflecting an economic value commensurate with the loan terms. Loans for which the bank is not materially relying on the operation or sale of the collateral as repayment (i.e., the bank has truly obtained collateral as an abundance of caution), should not be included in this category

- *Overly Aggressive Loan-to-Value (LTV) or Advance Rates* – LTV and advance rates should reflect the useful life of the collateral pledged, depreciation rates, vulnerability to obsolescence, and market volatility. Loans-to-cost (LTC) relationships should also be considered, particularly for CRE projects

- *Inadequate Guarantor Support* – Guarantors may serve a variety of purposes in the credit process, including as an abundance of caution. Analyze guarantor support in the context of the bank's actual expectations of the guarantor, as well as the guarantor's willingness to support the credit, if called upon to do so. Inadequate guarantor support may result when the bank relies on a guarantors presumed financial strength, but has not fully analyzed the guarantor's financial information, including contingent liabilities and liquidity. Inadequate guarantor support may also occur when a guarantor, whose support was critical to the original credit decision, is subsequently released from the obligation without other offsetting support

- *Repayment is Highly Dependent on Projected Cash Flows* – Where repayment relies heavily on optimistic increases in sales volumes, or savings from increased productivity or business consolidation; may also include loans whose projections do not adequately support debt service over the duration of the loan or whose projections rely on an unfunded revolver or other external sources of capital or liquidity. CRE loans with limited or no pre-leasing or sales should be considered for this category

- *Repayment is Highly Dependent on Projected Asset Values* – Where loans that are projected to be repaid from the conversion of assets at a value that exceeds current value when the projected appreciation is not well-supported; may also include loans for which the LTV is too thin to weather a decline in value resulting from normal economic cycles

- *Repayment is Highly Dependent on Projected Equity Values* – Where loans that are predicated on the projected increasing value of the business as a going concern fits this category. These enterprise value loans typically have all the business assets, including goodwill and stock of the borrowing entity, pledged as collateral. Enterprise values can fluctuate widely especially during economic downturns

- *Repayment is Highly Dependent on Projected Refinancing or Recapitalization* – Where loans are made based on the expectation that proceeds from the issuance of new debt or equity will repay a loan. These are not bridge loans pending a closing, rather, the future debt or equity event is uncommitted or has other elements of uncertainty. May rely on optimistic assumptions about the future direction or performance of debt markets, equity markets, or interest rates

SECTION 3

Roles and Responsibilities for Credit Risk Ratings

<u>Objective</u>

- *Unique Responsibilities* – Refresher for understanding the roles and responsibilities for assigning timely and accurate credit risk ratings

<u>Expectations</u>

- *Learn Your Duty* – Effectively exercise key roles and joint monitoring responsibilities by Primary Relationship Officers (PROs), Credit Administrators (CAs), with Special Assets Department (SAD) oversight

Primary Relationship Officer (PROs)

<u>PROs/First Line of Defense</u>

PROs are responsible to continuously ensure the accuracy of the credit risk rating throughout the bank organization within a given credit relationship. This responsibility cannot be abdicated under any circumstance. Consider the following responsibilities:

- The PRO has authority to approve credit risk rating changes without any additional approvals
- Any perceived change in risk characteristics must be evaluated and where the need for a risk rating change is evident, the officer must immediately process a risk rating change
- Timely detection of credit improvement or deterioration must be exercised by the PRO to ensure accurate capital allocation to measure profitability and to develop appropriate loss protection measures
- The need for revision of a risk rating may be manifested by financial improvement or deterioration, events that are internal or external to the company such as the death of a principal manager, or related to performance on credit facilities, including covenant defaults

Second Line of Defense (Rating Validation) – Each person concurring on or approving a credit validates the accuracy of the risk ratings assigned by the PRO. Each signatory to a credit request may modify credit risk ratings established by previous signatories

Third Line of Defense (Credit/Loan Review) – Credit review has final determination on all credit risk ratings

Credit Administrator; Credit Administration (CA)

<u>Credit Administrator, or CA Staff</u>
CA supports the line lending staff in the review, structuring, and approval of credit requests. CA ensures appropriate and consistent application of bank credit standards and credit policies. CA also provides leadership in the transmission of the bank's credit culture.

- *Active Credit Administration* – CA will meet with lenders on a regular basis to review portfolio quality and engage in various early warning activities designed to provide early identification of emerging problem credits. It also conducts pipeline management reviews, and performs timely advisory reviews of Watch List credits, Special Mention, and Substandard rated credits. Once a credit has been downgraded due to performance issues, or other deteriorating financial conditions, CA will be actively involved with the PRO to assess the current condition, and work collaboratively to establish an action plan to remediate the concerns and return the credit to a Pass risk rated status

- *Root Cause Analysis* – CA will work together with the PRO to analyze and determine the underlying causes of credit deterioration based on gathered information from diverse sources, including periodic financial statements, checking account activity, trade reports, market information, personal observations, and discussions with borrower management

- *Asset Quality Monitoring* – CA will also provide oversight of the heightened monitoring to improve borrower performance, including those credits designated on the Watch List (Watch List Reporting – WLR), or criticized loans (Criticized Loan Reporting – CLR) action plans. In those cases where further downgrade or risk of nonaccrual, or loss is possible, a transfer of responsibility for the customer relationship to SAD may be appropriate

Special Assets Department (SAD)

<u>SAD</u>
SAD has oversight responsibility for loans risk rated Special Mention, Substandard, or Doubtful (criticized). As the PROs and CA work together to make appropriate risk rating changes on a timely basis, once a loan has criticized status, CA will consult with SAD to determine the appropriate roles and responsibilities of the PRO, CA, and SAD personnel as they relate to the administration of the credit going forward. If it is determined that SAD should have an oversight role in the management of the relationship, the role may be in either of the following two forms:

- *SAD Advisory (Indirect)* – Advisory is where the relationship is jointly managed by the PRO and SAD with strong oversight from CA. Customarily, the PRO retains customer contact and day-to-day account management, with credit approvals and administrative actions flowing through SAD and CA. Sad assists the PRO with criticized loan reporting and action plans, and other routine credit administration actions. CA may also serve in an indirect advisory role

- *SAD Primary (Direct)* – Primary means the relationship is managed solely by SAD, where all aspects of contact and management of the customer are the responsibility of the SAD officer. Such duties would include the approval of credit actions within delegated authority limits, making proper credit risk rating changes, preparing asset quality monitoring reports, monitoring collateral values and

market conditions, performing annual property inspections, and overseeing the valuation process. SAD will utilize all available legal remedies to recover bank assets, including legal action against the borrower, guarantors, and collateral. This will include the liquidation of underlying collateral, in conjunction with legal counsel, for secured credits. SAD may also confer with the legal department in conducting a review of the current loan documentation on a discretionary basis

SECTION 4

Watch List, Criticized Loans – Asset Quality Monitoring

Objective

- *Early Warning System* – The Watch List process is really an early warning *system*, (Pass risk ratings), to alert senior management of any heightened, but still acceptable, borrower risk profiles that should warrant closer monitoring due to uncertainties
- *Reduce Credit Risk* – To reduce credit risk exposure on potential and problematic (Criticized) credits

Expectations

- *AQ Monitoring Process* – Effectively manage the WLR and CLR monitoring processes to check (unwarranted) credit risk; become accountable by adequately documenting and regularly reporting Watch designated credits
- *Comprehensive Credit Risk Analysis* – Thoroughly analyze uncertainties, repayment risks, and action plans. Get criticized loan exposures upgraded to Pass or to a zero balance

WLR / CLR Preparation and Presentation

WLR and CLR Preparation & Presentation

- *Responsibility/Accountability* – PROs are responsible for the initial preparation of both the Watch List Loan Report (WLR), or the Criticized Loan Report (CLR), together with subsequent revisions/updates. Analysts or underwriters may prepare initial and subsequent drafts for the PRO; the PRO's signature confirms that the information is complete and accurate to the best of his or her knowledge

- *Reporting Frequency and Management Attendees* – Senior management should determine the reporting frequency of WLRs and CLRs, together who will be in attendance. Consideration is also given to loan size and the use of reporting/monitoring thresholds. For example, WLRs may be presented at the CA level, with WLRs with exposure over a certain amount will be reported to senior management (i.e., threshold reporting levels). Similarly, CLRs may be presented at the SAD level (with CA), with others being presented to senior management over a certain threshold

- *Due Dates* – Subject to senior management concurrence, the PRO will also recommend the 'reporting' frequency and be prepared to 'present' the WLR to management as per the frequency schedule. The WLR and CLR will be submitted by the 5th day after each reporting period (monthly, bi-monthly, quarterly), and presented by the 10th day to management

- *Review and Concurrence* – Prior to the completed draft or presentation of the WLR, the same will be reviewed and concurred by (with any comments/questions being addressed) the CA, if applicable. Similarly, the CLR will also be signed off by the SAD officer, if applicable

WLR Detail and Report Format

WLR Report Format (Use/adapt/expand the 'all-inclusive global' WLR template, as applicable)

- *Borrower Exposure* – For clarity's sake, list, and document each credit facility so that a 3rd party could easily understand the credit-related uncertainties in the relationship, etc.

- *Current Uncertainties* – Unlike a loan risk-rated Special Mention (with potential weaknesses that may become well-defined weakness if not corrected), a Watch List loan is where there is some kind of uncertainty that needs close attention. These may include things like: financial, operational, managerial, ownership, industry, technology, labor, legal, environmental, etc. Again, sufficiently describe the uncertainties so that an independent 3rd party could clearly understand

- *Current Trend* – Cite the trend of the uncertainty; is it improving or deteriorating? Make a defensive and clear case either way – own the conclusion so that it is unquestionable in the reader's mind

- *Resolution Strategy* – Opine on what you believe will be the likely outcome on the uncertainty and a summary of what it will take and how long to get there

- *Accomplishments Since Prior WLR* – Document what has transpired since the prior WLR

- *Triggers for Watch List Removal or Further Downgrade* – Per the resolution strategy, the path of the credit will either be to remove it from the Watch List, or the prospect of a potential downgrade will be addressed. Break-down either scenario into smaller steps along with their estimated competition dates. If in doubt, use your best estimate and adjust on the next WLR (it is okay to do your best work even if it turns out to be mistaken – that is how we learn – so give it your best)

- *Upon Presenting (Make Sure Good Notes Are Taken)* – Management will assist in the WLR process by using the data and facts presented to guide and direct the credit relationship. As a PRO, you have done your part with the preparation and presentation of the Watch Credit. In the loan discussion, record the final conclusions and any recommendations from the meeting, and move on

WATCH LIST LOAN REPORT (WLR)

Borrower:		As of Date:
Primary Officer/Dept:	Underwriter/Analyst:	Credit Administrator:
Watch List Date:	WLR Reporting Frequency: (30-Monthly, 60- Bimonthly, 90-Quarterly)	Est. WLR Removal Date:

CURRENT STATUS (000's)

BORROWER EXPOSURE							
Facility	Type/Loan # (C&I, CRE, Const. etc.)	Committed	Outstanding	Note Date	Maturity Date	Risk Rating BR	Risk Rating TR
#1							
#2							
#3							
	Total:	$ -	$ -				

Comments:

CURRENT UNCERTAINTIES
• Financial – • Operational – • Managerial – • Ownership – • Industry – • Technology – • Labor – • Legal – • Environmental – • Other –
Comments:

TRENDS - CREDIT IMPROVEMENT / DETERIORATION
• Improvement – • Deterioration –
Comments:

1

RESOLUTION / FORWARD OUTLOOK STRATEGY
• Resolution / Forward Outlook Strategy –
Comments:

ACCOMPLISHMENTS SINCE PRIOR WLR
Comments:

TRIGGERS

WATCHLIST REMOVAL	ESTIMATED DATE
1)	
2)	
3)	
4)	
5)	
Comments:	

DOWNGRADE TRIGGERS	ESTIMATED DATE
1)	
2)	
3)	
4)	
5)	
Comments:	

WLR MEETING CONCLUSIONS
• *Conclusions –* • *Recommendations –*

2

CLR Detail and Report Format

CLR Report Format (Use/adapt/expand the 'all-inclusive global' CLR template, as applicable)

- *Borrower Exposure, Collateral Protection, Guarantor Support* – For clarity's sake, list, and document each credit facility for each of the three areas so that a 3rd party could easily understand the linkage for each credit facility in the relationship, etc. (double tap in these sections to expand the rows if needed; use embedded Excel files for these sections)

- *Deposit Relationship, Financial Reporting, Covenants* – In a general sense, summarize the deposit relationships, the overall financial reporting requirements, as well as other key financial performance covenants, and compliance thereto. Note whether covenants have been waived or forborne, and support the 'why'

- *Repayment Risks (Primary Source of Repayment, 'PSOR')* – Assessing the risk of repayment for a criticized loan is essential. There are multiple reasons for there being increasing credit risk. Develop, as applicable, the facts that support: cash flow, net operating income (NOI), profitability, efficiency, leverage, liquidity, performance to plan (P2P), pro forma outlook, management, competition, and other red flag warnings (C&I loans)

- *Lender Protection Risks (Guarantors, Liens, Collateral, Documentation)* – Serving as an additional or secondary source of repayment ('SSOR'), analyze and document these risks more thoroughly if

there is a chance they could become the new PSOR in the near term. Likewise, develop the facts that support guarantor/sponsor strength, UCC/Mortgage/Deed collateral lien perfection, UCC business assets, commercial real estate (CRE), insurance, environmental, documentation, and even a character assessment

- *Analysis (Root Cause, Risk Rating Disposition, Accrual Status, and Up/Downgrade Triggers)* – If the Repayment Risks and Lender Protection Risks were adequately identified and documented, the root cause should be easy to identify. Once you document the root cause, it becomes easier to apply the correct risk rating and accrual status. Upgrade and downgrade triggers almost fall automatically into place, as applicable. Part of the PRO being accountable is documenting the accomplishments since the prior CLR was prepared and presented

- *Action Plans (Steps back to a Pass Rating, or all the way to a $0 Balance)* – The PRO will come prepared (with the help of CA and/or SAD) with the recommended action plan, a disposition of whether to keep or exit the current exposure. Measures may include: Workout/Retain-Renew, Restructure/A-B Note Split, 3rd Party Refinance, Collateral Liquidation, Note Sale, Litigation/Judgment, or Other. Determine all the (likely) key action steps necessary to return the credit back to a Pass risk rating, and best-estimated dates for completion, or, similarly, to exit the relationship

- *Upon Presenting (Make Sure Good Notes Are Taken)* – Management will assist in the CLR process by using the data and facts presented to guide and direct the credit relationship. As a PRO, you have done your part with the preparation and presentation of the criticized loan reporting. In the loan discussion, record the final conclusions and any recommendations from the meeting, and move on

CRITICIZED LOAN REPORT (CLR)

Borrower:		As of Date:
Primary Officer:	Cost Center/Dept:	SAD Officer/Role: (Advisory, Primary, Indirect)
Underwriter/Analyst:	Credit Administrator:	CLR Reporting Frequency: (30-Monthly, 60-Bimonthly, 90-Quarterly)
Recommendation[1]:	Accrual Status: (Accrual, Non-Accrual)	Impairment Status: (Yes, No)

[1] Workout/Retain-Renew, Restructure/A-B Note Split, 3rd Party Refinance, Collateral Liquidation, Note Sale, Litigation/Judgment, Other

CURRENT STATUS (000'S)

BORROWER EXPOSURE

Facility	Type/Loan # (C&I, CRE, Const. etc.)	Committed	Outstanding	Note Date	Maturity Date	Risk Rating BR	Risk Rating TR
#1							
#2							
#3							
	Total:	$ -	$ -				

Comments:

COLLATERAL PROTECTION

Facility	Description	Lien Status	Value	Value Date	C/LTV	NRV (Fair Value)	Prior Lien Amount	Enviro. Risk (L, M, H)
#1								
#2								
#3								

Comments:

GUARANTOR SUPPORT

Facility	Guarantor/Entity Name	Guarantee Amount	F/S Date	Liquid Assets	Total Liabilities	Adjusted N/W	Contingent Liabilities
#1							
#2							
#3							
	Total:	$ -		$ -	$ -	$ -	$ -

Comments:

1

DEPOSITS / OTHER SERVICES

- **Business Deposits**
  - *Bank –*
  - *Other Bank(s) –*
- **Individual Deposits**
  - *Bank –*
  - *Other Bank(s) –*
- **Other Services**
  - *Cash Management –*
  - *Merchant Services –*
  - *Other –*

FINANCIAL REPORTING / COVENANTS

- **Financial Reporting**
  - *Requirements –*
  - *Compliance –*
- **Covenants**
  - *Requirements –*
  - *Compliance –*

REPAYMENT RISKS

PRIMARY SOURCE OF REPAYMENT & RISK ASSESSMENTS

Comments:

- **Cash Flow**
  - *DSCR –*
  - *Global Cash Flow –*
  - *Interest Reserve –*
- **NOI**
  - *Stabilized –*
  - *Vacancy –*
  - *Expenses –*
  - *Debt Yield –*
- **Profitability**
  - *Sales –*
  - *Margins –*
  - *Expenses –*
  - *Profits –*
- **Efficiency**

2

  - *Inventory Days –*
  - *Receivables Days –*
  - *Payable Days –*
- **Leverage**
  - *Funding Sources –*
  - *Capacity –*
  - *Ability to Meet Obligations –*
- **Liquidity**
  - *Sources –*
  - *Cash Burn –*
- **Performance to Plan**
  - *Budget vs. Actual Prior Performance –*
  - *Revisions to Plan –*
  - *History of Meeting Budget/Overly Optimistic –*
- **Pro Forma Outlook**
  - *Outlook Realistic –*
  - *Assumptions –*
  - *Cash Basis –*
- **Management**
  - *Succession Plan –*
  - *Recent or Pending Retirements/Changes –*
  - *Key Personnel Changes –*
- **Competition**
  - *New or Pending Direct Competition –*
  - *Customers Lost to Competition –*
- **Red Flags/Warnings**
  - *Changes in Company –*
  - *Receivables Collection Slowdown –*
  - *Rising Inventory $/% –*
  - *Inventory Turnover Slowdown –*
  - *Heavy Liens on Assets –*
  - *Noncurrent Asset Concentrations –*
  - *High Intangible Assets –*
  - *Increases in L/T Debt –*
  - *Major Gap Between Gross/Net Sales –*
  - *Rising Cost Percentages –*
  - *Rising Assets vs. Sales –*
  - *Major Change in B/S Structure –*

LENDER PROTECTION RISKS

GUARANTORS, LIENS, COLLATERAL, DOCUMENTATION

3

- **Guarantors / Sponsors**
  - *Financial Ability –*
  - *Demonstrated Willingness –*
  - *Incentive to Provide Support –*
  - *Economic Incentives –*
  - *Global Incentives –*
- **UCC/Mortgage/Deed Collateral Lien Perfection**
  - *Verified Lien Priority Position(s) –*
  - *UCC Renewal Date(s) –*
  - *Insurance Coverage & Expiration –*
- **UCC Business Assets**
  - *Receivables –*
  - *Inventory –*
  - *Equipment –*
  - *Payables –*
  - *Detailed A/R, A/P Aging(s) –*
  - *Concentrations –*
  - *Borrowing Base –*
- **CRE**
  - *Relevant Market Conditions / Impact on Borrower –*
  - *Collateral Risks –*
  - *Extraordinary Assumptions –*
  - *Hypothetical Conditions –*
  - *Resizing Opportunities –*
  - *Project Feasibility –*
  - *Refinance Risk –*
  - *Rental Rates –*
  - *Structure –*
  - *Operating Expenses –*
  - *Vacancy –*
  - *Absorption –*
  - *Leases –*
  - *Interest Rate Risk –*
  - *CAP Rates –*
  - *Discount Rates –*
  - *LTV –*
  - *Repricing Risk –*
  - *Physical Inspection –*
  - *Insurance Coverage –*
  - *Appraisal Recommendation*: (*New appraisal*, *validation*, or *evaluation* based on relevant/material changes in market conditions, project performance, geographic conditions, variances from original appraisal assumptions, change in project specs, loss of lease or takeout, high pre-lease fallout, or as borrower's financial condition deteriorates) –
- **Insurance**
  - *Type –*
  - *Amount –*
  - *Timing –*
  - *Valid Claim Acceptance –*

4

- *Valid Claim in Doubt –*
- *Protracted Resolution –*

- **Environmental Risk(s)**
  - *Last Lender Environmental Inspection Results/Date –*
  - *Last Borrower Environmental Questionnaire Results/Date –*
  - *Prior Phase I Results/Date –*
  - *Prior Phase II Results/Date –*
  - *Next Steps Recommendation –*

- **Documentation and/or Legal Review**
  - *Issues –*
  - *Next Steps Recommendation –*

- **Character Assessment**
  - *Summary –*

- **Repayment History**
  - *Summary –*

ANALYSIS

ROOT CAUSE, RISK RATING, ACCRUAL, TRIGGERS

- **Root Cause(s)**:
  - *Deficiency –*
  - *Weaknesses –*

- **Risk Rating Justification**:
  - *Special Mention*: Distinct weakening trends, that if not corrected could deteriorate repayment prospects; required close attention –
  - *Substandard*: Inadequately protected, well-defined weaknesses, may jeopardize repayment, potential for loss if not corrected –
  - *Doubtful*: Highly questionable and improbable repayment based on current facts, values; high loss risk, pending review of specific factors –
  - *Loss*: Considered uncollectable, may have potential for some recovery but still is an un-bankable asset –

- **Accrual Status Justification**:
  - *Accrual*: Reasonable Assurance of Repayment and Performance (prudent terms) –
  - *Nonaccrual*: Substantial Doubt of Full Collectability (or >90 DPD) –
  - *Return to Accrual Status*: Demonstrated sustained repayment performance over a reasonable period (i.e., 6 months) –

- **Triggers**
  - *Upgrade –*
  - *Downgrade –*

- **Accomplishments Since Prior CLR**
  - *Results –*

5

ACTION PLANS

STEPS TO PASS RATING (RETAIN)	ESTIMATED DATE
1)	
2)	
3)	
4)	
5)	
6)	
Comments:	

STEPS TO $0 BALANCE (EXIT)	ESTIMATED DATE
1)	
2)	
3)	
4)	
5)	
6)	
Comments:	

CLR MEETING CONCLUSIONS

- *Conclusions –*
- *Recommendations –*

6

SECTION 5

Cultural Enhancement for Divergent Views

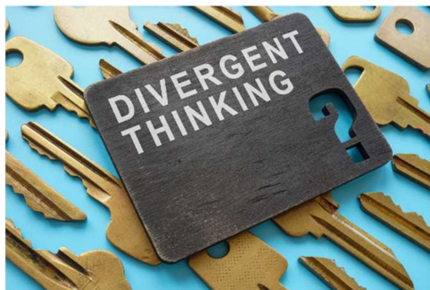
Objective

- *Team Approach* – Managing credit risk 'together' during stressful economic downturns
- *Open Culture* – Building on a credit culture that values and welcomes documented divergent views.
- *Monitoring Frequency and Thresholds* – Achieve timely and accurate credit risk ratings (efficient process), WLR and CLR monitoring frequency and thresholds, and recommendations to retain or exit credit exposures

Expectations

- *Senior Management* – Encourage people to express their divergent views *in writing* (not just vocally, but so that there is a documented analytical discussion on file), in a safe and respectful environment
- *All Other Stakeholders* – More fully exercise your responsibility to document your independent opinions by using supported and well-documented facts to support your own conclusions

Stressful Times



Pressures and Stresses Happen Because They Are Real

- *Be Understanding* – When banks face an economic downturn (or worse), pressures and stresses build quickly. Senior management has a huge job pulling and fitting all the pieces together to make the bank work. It is a massive responsibility and task. They handle matters that others in the bank will not even be aware of. They need to keep the ship sailing in a safe and sound manner. Employees need to be patient, professional, and understanding because a lot is happening. A lot is on the line. Everything is on the line. Normalcy, the way we have always done credit risk management, can suddenly feel like it is shifting. To the PRO, or even CA, things may not make sense. The normal approaches and all, they can become delayed or even ignored, and top-down pressures can be exerted. Not everyone will be or needs to be aware of all that's going on either

- *Signals Present?* – However, as pressures build, indirect signals or messaging can take place. For example, these signals may be directed at the usual processes used for the timing and accuracy of identifying, measuring, monitoring, and controlling credit risk. Decisions and their timing cost the bank money, money that may not readily be there. But, frankly, that's senior management's problem; everyone else must do their job under the ordinary course. Notwithstanding, pressures come. As a result of such downgrade timing delays, for example, unwarranted credit risk can build up quickly. Regulatory scrutiny increases. Senior management and the Board may ultimately be required to take (immediate) corrective action. But that doesn't mean it can become a period of intense headaches as the stakeholders each try to do their jobs. It's a rough time. Economic cycles seem to always come, and these stressful times come along with them. It happens all the time

during each cycle. But note the changes in signals and messaging that come during an economic downturn. You may feel your usual voice and level of participation in credit risk discussions may be stifled, or worse.

- *Be Professional, Diplomatic, and Respectful* – As a PRO, or CA, this can be a tough period in your career. Pressures and stresses can be forwarded on to your shoulders. Through these times, it is imperative that you be professional, diplomatic, and respectful, if you have a differing opinion about credit risk from others in the bank. Hopefully, there is a culture where you can share your thoughts and written credit analysis, freely. However, that is not always the case, especially when the bank is under stress. Depending on where the culture is, you can best serve if you stick with documented and supported facts, conclusions, and recommendations. Your calls, as only you see them, may even become to look more like 'divergent views' from the signals and messages from senior management. For several reasons, these new stresses, pressures, and approaches in handling increased credit risk may change. But that does not mean you can or should change your actual thinking as a PRO or CA, even though the signaling and messaging can be compelling. The bank needs independent thought (no group think) and analytical opinions whether it realizes it or not. Facts are facts. You know the facts because of your documented due diligence work. Management still needs those facts to make appropriate decisions, even though those facts may 'cost the bank.' The PROs and CAs need to continue to do their jobs and let senior management do their job (despite the new signals and messaging that can come when the bank can't afford to address credit risk under the ordinary course). Hence, rigorous loan discussions based on documented analysis, monitoring, and reporting should continue to be the norm during stress periods. This is a good thing

- *Differences of Opinion?* – More specifically, as far as the timing goes for things like downgrades, risk ratings should be timely and accurate. But what if there are actual, or perceived as actual, pressures to delay a downgrade to another quarter, or past year-end, resulting in differences of opinion? It happens, often. Who is going to ask the deep-dive questions that nobody now wants to ask, or answer? Who will be expected to answer them? How will any of this be documented? Should or will it even be documented? Will regulators be critical of the bank for not being timelier and more accurate? Is there a reasonable period where downgrade dispositions can be made without being criticized by the regulators? What if there are differing opinions as to the timing of a downgrade, and the risk rating itself, between the PRO, Credit Administration, Special Assets, senior management, or even Credit Review? Finally, in those cases where it is, perhaps, 'culturally improper' to speak up and share your own opinion (i.e., you're not the boss 'it's disrespectful to speak up', you're supposed to 'recognize the senior person's authority and expertise', etc.), senior management should remind all the stakeholders that it is expected that they can, should, and will share their own documented opinions about credit risk; that this is one of the key reasons they are getting paid.

Why Divergent Views?

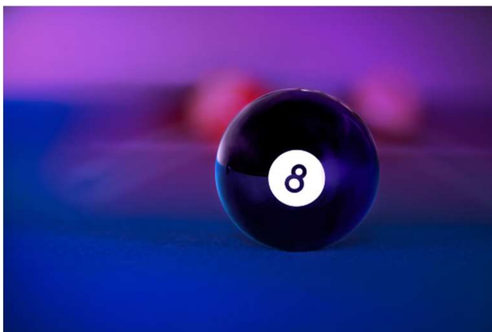
<u>What is the Real Picture?</u>

- *Seeing the Complete Picture* – It is best to follow the credit policies and guidance, right? If you want to get rid of a wart, you cannot just shave off the top of it and expect it to go away. The remedy requires that you get (treat) to the root/bottom of the wart so it will go away once and for all, once properly treated. Similarly, when we have a problem credit, we need to understand the facts (bottom of the wart), and eventually get to the root cause of the problem so we can apply the appropriate remedy/action plan. We need to get to the facts, and differences of opinion are beneficial to this process

- *Seeing a Different Picture* – Say, for example, the PRO writes up a WLR or CLR and obviously states the facts as she/he sees them. Or, at least that is what is supposed to happen. And what if another officer in the bank, be it from CA, or SAD, or even senior management, sees things differently? How do the stakeholders handle such a matter? How to they achieve consensus if one person sees the facts differently than the next person? Is that a bad thing? No, it's a good thing.

- *Seeing What Others Are Seeing* – Imagine a culture where divergent thinking is encouraged, say, in a WLR or CLR meeting, where viewpoints and solutions to important matters are freely shared. Things like carefully listening and asking questions about another's point of view, respectfully challenging the so-called facts, asking 'deep dive' questions, and even brainstorming. This is where and how we learn and understand from each other, in a culture or environment that is safe and respectful. This is where each stakeholder genuinely feels comfortable sharing his/her opinions. Good and rewarding work happens in this environment

The Credit Risk Ball; So, Roll It Around the Table



The Credit Risk Ball (risk rating) – Ask: "How Do You See It?"

- *Document the FACTS* – In short, the facts are the facts. Decisions should be based on facts. Facts should be documented in writing (use WLR and CLR reporting to document the facts). When stress comes to a bank, pressures build, facts can be pushed aside, or, in some cases, even ignored altogether. But responsible parties, like the PRO, CA, SAD, and senior management, should all have a 'seat or voice at the table.' And as the 'credit risk ball' or risk rating disposition is rolled around the table to such stakeholders, there is a distinct possibility not everyone will identify with the presented facts. But each has the responsibility to offer their own *documented* facts as each sees them. And there likely are, likely will be, and should be, differing opinions and points of views (however large or small) when it comes to credit risk. As the credit risk ball rolls around the table, each sees the ball from a different point of view. There better be different points of view.

- *When Differing Opinions Arise* – The PROs (and an Analyst or Underwriter) are responsible for documenting the facts as they understand them. A properly completed WLR or CLR will ensure the facts are documented. At a WLR or CLR meeting, the other stakeholders (especially senior management) may have different opinions, views, perspectives, etc. They may differ from those documented in the WLR, or CLR. The PRO will use the WLR or CLR and defend its position by the facts given. After discussion, if there is consensus, the WLR or CLR can be amended and resubmitted by the PRO.

- *The Final (Documented) Call* – However, if the PRO 'can't get there' and still disagrees with other opinions, the individual (not the PRO) with the divergent view from the original WLR or CLR will prepare an addendum to the WLR or CLR, which will be placed in the file. The bank officer with the highest credit authority may make the divergent view call (divergent view to the WLR or CLR) through the memorandum process, so there's a transparent audit trail for any changes to the WLR or CLR recommendations. Therefore, it is possible the PRO's original WLR or CLR will thereby have been overridden and reflected as such in the credit file. Subsequent WLRs or CLRs will note changes made by the senior officer, but the PRO doesn't change its WLR or CLR otherwise. The original addendum is attached to an original WLR or CLR, as applicable, by the higher-in-authority CA or senior management officer, and the decision is final. Either way, the file will reflect a healthy rigor of discussion and evidence of a divergent view culture. If desired, in such a case, the matter with differing opinions can be escalated to Credit Review for their final call to validate the best conclusion. The WLRs and CLRs, addendums, memo, will serve as a transparent audit trail.

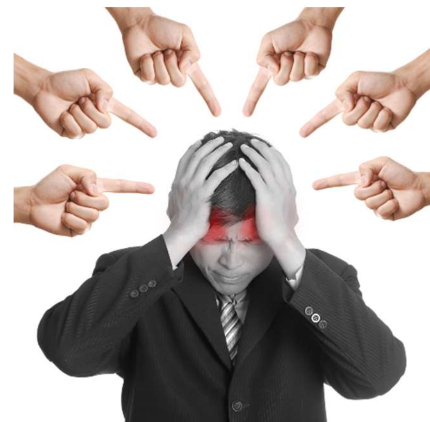
Reminders for Senior Management – Employee Appreciation the Real Way

Valuing and Appreciating That a Human Being Employee is REAL (not pretend, not a machine or servant)

- *How Do Employees Really Feel?* – During periods of economic stress or not, bank management should often anonymously survey their employees to gauge how well things are going, culture-wise. Generally, accountability *should* reside with senior management during good times and stressed times. But what does bank leadership and management look like in the eyes of the employees? How does the average employee feel like management thinks of him/her? Does senior management take credit (and large bonuses) during the good times and blame, burden, cut bonuses, and even layoff other people during the bad times? Senior executives at banks often make more in annual bonuses than what other employees will earn in their entire 40-year careers. Does senior management even have a clue what the average employee is feeling, in terms of being valued and sincerely appreciated? Would it not be interesting to know employees' 'true thoughts and feelings' about senior management? What would they really say if the employees expressed how they really felt, with no fear of getting fired. What it be that they don't like about senior management? Many believe the so-called anonymous surveys are not so anonymous, as they later learn that feedback somehow makes its way back to department managers (it can and does). It is likely that in every place of employment, and regardless of the supposed values the company lists on their web site, there are plenty of supervisors, managers, directors, and senior leadership that many employees would want to avoid altogether. Why? Because the employees are not truly valued, appreciated, or adequately recognized, that's why. Believe it or not, respect goes both ways. Employees are dedicated and come to work each day to work hard. They are real people, each and every one of them. Preference can't be for the favorites that went to a certain school. So, what is your company's real employee valuation and appreciation culture (by senior management), notwithstanding the pulse survey results? Do all employees, even those who offer divergent views, feel truly valued and appreciated by all of management?

- *Real or Virtual Appreciation?* – Is more 'actual, real, human' appreciation needed? Sometimes out of those surveys, management will focus on improving employee-to-employee relationships. Even though pretty much every company 'states' or identifies its employees as its 'greatest assets,' do all employees feel that way? Probably not. Why is that? A few 'bad' managers/supervisors, or an 'overbearing' executive officer or two? Maybe it's a heavy-handed top-down driven culture? Probably. What is behind any so-called employee dissatisfaction? Do all employees, at every level, truly feel valued by others, and especially senior management? Does senior management even care enough to genuinely show human-to-human appreciation? Or, would it rather just punt the whole thing and go the quarterly 'virtual' appreciation list route? Like putting someone's name on a virtual recognition bulletin, say, with a few dozen other 'names'? Does senior management really believe this is supposed to be genuine appreciation, because they're too lazy to do it right? How many view this as being mechanical? Employees might say that virtual recognition is *not* real appreciation, that it's a cheap farce. Others will brag that their name made it onto a list for the 'whole world to see,' that, that somehow makes them important. A cheap sell-out? Maybe. Those who accept this nonsense don't know what being personally valued and appreciated is all about. It may work for a piece of machinery, or a season, but not for a human-being, and for the long-term. How hard is it to stop by and express personal appreciation to an individual who has accomplished something noteworthy? Apparently, it's way too hard. So sad. Some people focus too much on their millions

- *When Mistakes are Made* – When (unintentional) mistakes are made, how does management react? How does the employee feel about it? Is there an 'unforgiving' culture, where an employee might feel his/her name is now on 'Santa's naughty list'? Does the management culture demand so much time and effort from its employees that mistakes are effectively not allowed to happen (even at the expense of an inefficient process)? For whatever reason, however, mistakes do happen. Such mistakes are good opportunities to improve a process or practice, if they're handled properly. Management should use mistakes to not penalize and punish the employee, but to use them as learning opportunities to improve a process in becoming more efficient. Mistakes allow the stakeholders to build increased trust in each other when mistakes are handled as a learning experience. It should be a real team environment that everyone can feel, where mistakes can even be valued as key learning and improvement opportunities. Again, mistakes have to be made in order to improve a process. In the end, staff employees at every level need to be valued and appreciated in a culture that fosters divergent views, and learning opportunities from making mistakes. This (new) culture is necessary while proactively monitoring asset quality during an economic downturn.



Benefits of an Enhanced Divergent Views Culture

<u>Benefits of Sharing Divergent Views During Stressful Economic Times</u>
Consider these 20 divergent view benefits for the bank and its staff:[1]

- *Innovative Solutions* – Divergent views can lead to innovative solutions that may not have been considered otherwise

[1] Source: Conversation with Bing, 11/13/2023

- *Better Decision-Making* – Divergent views can help decision-makers consider multiple perspectives and make better decisions
- *Improved Risk Management* – Divergent views can help identify and manage risks more effectively
- *Increased Creativity* – Divergent views can stimulate creativity and lead to new ideas
- *Improved Communication* – Divergent views can improve communication and collaboration among team members
- *Increased Engagement* – Divergent views can increase employee engagement and motivation
- *Better Problem-Solving* – Divergent views can help identify problems and find solutions more effectively
- *Increased Adaptability* – Divergent views can help organizations become more adaptable to change
- *Better Customer Service* – Divergent views can help organizations better understand and meet the needs of their customers
- *Improved Performance* – Divergent views can lead to improved performance and productivity
- *Increased Job Satisfaction* – Divergent views can increase job satisfaction by giving employees a sense of ownership and involvement in the decision-making process
- *Better Employee Retention* – Divergent views can help retain employees by creating a positive work environment
- *Increased Diversity* – Divergent views can increase diversity and inclusion in the workplace
- *Better Conflict Resolution* – Divergent views can help resolve conflicts more effectively
- *Improved Morale* – Divergent views can improve morale by creating a sense of community and shared purpose
- *Better Leadership* – Divergent views can help develop better leaders by encouraging them to consider multiple perspectives
- *Increased Transparency* – Divergent views can increase transparency by encouraging open and honest communication
- *Better Organizational Learning* – Divergent views can help organizations learn from their mistakes and improve their processes
- *Increased Accountability* – Divergent views can increase accountability by encouraging employees to take ownership of their work
- *Better Organizational Culture* – Divergent views can help create a positive organizational culture that values diversity, creativity, and innovation

SECTION 6

Respect and Dealing in Good Faith with Borrowers Having Financial Difficulties

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Objective

- *Respect / The Big "Why"* – Understanding why borrowers with problem loans deserve respect
- *Do Good Business* – Understand how doing good business benefits the bank, bankers, shareholders

Expectations

- *Always Be Respectful* – Due regard for the feelings, wishes, and rights of others
- *Always Deal in Good Faith* – Mediation, negotiation, peacekeeping, tact, discretion

Why Borrowers Deserve Due Respect

The Big "Why"

- *Dignity as Human Beings* – First of all, business owners are individuals, just like you. You deserve due respect, always. Borrower's deserve due respect too, even when things get tough. They wake up each morning and get dressed just like everyone else. They have personal needs and desires just like everyone else. They take on heavy responsibilities and manage the company's operations so payrolls and debt repayment are possible. What can you do differently to give the borrower the respect and dignity he deserves?

- *Respect Builds Trust* – First of all, the borrowing relationship was built on mutual trust, else the extension of credit would not have funded in the first place. When the banker treats the borrower with respect, it fosters a spirit of cooperation. A cooperative and productive relationship is materially less expensive to the bank, as opposed to an adversarial relationship. Set the tone from the beginning, that you value and appreciate the owner(s) as individuals. Let them know that you intend on maintaining a healthy relationship, and that you and the borrower should work together in a cooperative manner at this difficult time

- *A Borrower with a Problem Loan, is not a Problem Borrower* – While most bankers have conquered the complexities of cash flow, some bankers view and treat borrowers who are having financial difficulties, not like human beings, but like numbers on financial statements (total disregard). Many institutions value *respect* as one of its core values. But does that respect only apply to interactions within the bank itself, or does it also include the bank's customers who are in financial trouble?

- *Put Yourself in the Borrower's Shoes* – A borrower in financial trouble may be experiencing highly stressful and mixed emotions like never before. Great uncertainty is at play. A borrower is unsure whether it might default on its loan, or make payroll, and what comes next. How would you like to be treated if you were in the borrower's shoes? Seriously. Think about it. Some bankers, dealing with borrowers experiencing financial stress, can easily forget to be respectful, especially when the borrower fails to uphold its covenants in the Loan Agreement

Dealing In Good Faith

A Really Great Fundamental Principal to Remember

- *Dealing in Good Faith* – How would you describe what doing business in 'good faith' means when dealing with a borrower experiencing financial difficulties? Would not every party and stakeholder to the Loan Agreement expect such persons to act in good faith? Maybe it has something to do with being sincere, having good intentions, and what about being honest? Certainly, when the loan was originated, all the parties to the loan were honest and adhered to the terms of the Loan Agreement. But why do borrowing relationships become soured and contentious? Can the various parties, even when there is disagreement on proposed repayment terms and conditions, not exhibit respect and good faith during those negotiations? What if the borrower becomes contentious and will not deal in good faith? Does the banker lose his temper and just foreclose on the collateral and force the borrower into bankruptcy?

Re-Read the Loan Agreement

- *Exercising Rights vs. Acting Like a Bully* – A borrower has certain rights and responsibilities under the terms of the Loan Agreement. As you carefully read the Loan Agreement, the borrower will obviously see that the bank 'holds all the cards.' If the borrower fails to keep its end of the agreement, the bank is entitled to pursue any or all its remedies to recover the exposure. That is fine. But no one should be exercising heavy-handed maneuvers, and display an over-bearing attitude that may be construed as being a bully, especially at the PRO level where no one can or is paying attention to such behavior

- *Avoid Being Over-Bearing or Mean-Spirited* – Being over-bearing, mean-spirited, or heavy-handed with any party to a Loan Agreement is just plain unacceptable. It is in the bank's best interest to always be respectful, and deal in good faith with each other

- *Let's Have Dinner* – Another way to view dealing with respect and in good faith would be the following example: "I could try to work out a deal, or take it all the way through foreclosure, or even through bankruptcy, and when it was all over, still have dinner with the borrower." The bank can and will get whatever it wants due to the loan structure; its repayment will be what it will be. But, how well you manage your own behavior with such borrowers does not mean you need to act tough or like a hard-headed bully. One could ask such an offensive or disrespectful banker: "Who do you think you are?" "You just represent the bank, but the bank would never treat people like this!" So, what will be said of you, your attitude, and your actions? Is there animosity between you and

the borrower? Take a close look at the following examples of people dealing with each other in good faith and you will get the picture

Examples of People Dealing With Each Other in Good Faith (Source: Conversation with Bing, 11/14/2023)

- A landlord who returns a tenant's security deposit promptly and without dispute
- A seller who discloses all known defects in a product before selling it to a buyer
- An employer who pays employees on time and in full
- A contractor who completes a project on time and within budget
- A lender who offers a borrower a fair interest rate and repayment terms
- A customer who pays for goods or services received in a timely manner
- A business owner who treats employees with respect and dignity
- A supplier who delivers goods on time and in good condition
- A manufacturer who produces products that meet or exceed industry standards
- A service provider who provides high-quality services to clients
- A lawyer who represents clients with honesty and integrity
- A doctor who provides medical care with compassion and professionalism
- A teacher who treats students with respect and fairness
- A coach who encourages athletes to do their best and play fairly
- A neighbor who respects the privacy and property of others
- A friend who is honest and loyal in their dealings with others
- A family member who supports and cares for their loved ones
- A volunteer who donates their time and resources to help others
- A citizen who obeys the law and respects the rights of others
- A politician who serves their constituents with honesty and integrity

SECTION 7

Getting Best Answers for Debt Repayment Solutions

Objective

- *Getting to Yes* – Understanding the need for complete financial reporting, internal analysis and asking the right questions, identifying red flags and root causes
- *Getting Enough Data* – Key reminders for balance sheet, income statement, and other financial metrics

Expectations

- *Finish the Job* – Get the necessary financial reporting, thoroughly analyze, ask the necessary 'deep-dive' questions, and identify root causes

Getting Financial Statement Information

Financial Reporting Covenants

- *What's In Your Covenants?* – Having the appropriate financial statement reporting structure requirements in the Loan Agreement in the first place is paramount. This includes business and individual financial statements and corresponding tax returns. Most Loan Agreements obviously have adequate reporting requirements. However, some Loan Agreements may need to be adjusted for adequacy as credit risk increases, but generally have a provision for the Lender to reasonably request additional financial statement reporting from the obligated parties. The question is, how will the borrower and guarantors react when the bank requests financial reporting, especially for detailed financial reporting when that has not been the case in the past?

Let Us Get Something Straight

- *Stakeholders Need to Uphold Their End of the Agreement* – Subject to the terms of the signed and agreed upon Loan Agreement, the parties will have their various rights, responsibilities, and remedies when it comes to financial statement and tax return reporting covenants. From the inception, the bank should make it very clear that the required financial statement reporting is fully expected throughout the term of the loan relationship. And to also make it clear that the bank will enforce this provision, and carefully weigh any covenant defaults (forbear, waive) in the future. Additionally, a word to the borrower and guarantor: 'If you signed a Loan Agreement with financial reporting covenants, you must comply, regardless of whether you want to.' And, they should expect the bank to, as applicable, enforce its default remedies if an unwarranted default were to occur (generally an increase in the interest rate to the default rate). And, such remedies, where warranted, should be enforced. All requests for financial information should be specific, and communicated in writing with defined remittance or due dates

The Willing

- *When Things Go Right* – What is better than a cooperative and steadfast banking relationship through thick and thin? Many borrowers and guarantors will readily step up and take care of their responsibilities. Imagine that. And, a strong bank may be better able to assist a borrower with a problem loan by extending prudent workout or modification terms. The borrower and guarantor will gladly submit not only the necessary financial information on time, or as requested, but step up and offer the bank additional lender protection (higher or full guarantee amount, additional collateral, loan resizing, etc.). Borrowers should also prepare their own pro forma repayment solutions based on their own cash flow projections recommendations. This is the way it is supposed to be, right? However, do not be so sure this will be the case when push becomes shove. Pressures and stresses can change anyone

<u>The Unwilling</u>

- *When Things Go Wrong* – But what if the borrower and guarantor turn adversarial and become unwilling to provide the requested financial reporting? Their history of willingness is beginning to shift. Look at it this way. Perhaps the borrower needs to be aware that the bank may have loaned the borrower (and therefore have a greater interest in the company's assets) more than the guarantor/owner. From a leverage (bank's) perspective, it may be 1.5x, 2x, or even 3x more debt than equity. Therefore, the lender may feel disdain for the borrower if the borrower does not step up and comply with all the terms of the Note and Loan Agreement. The borrower may feel similarly about the lender by not fully understanding the borrower's needs either

- *Revisit the Given Expectations* – If a borrower is unwilling to provide the requested financial documentation in a reasonable period, the decision to retain or exit the relationship should be revisited. Using the utmost respect and good will, unless there is a well-documented and supported reason to the contrary to forbear the covenant default, the bank should quickly enforce its remedies and pursue getting the required financial reporting. The bank should never 'lend in the dark,' but bring the 'full necessary day light' to the table

<u>Level of Financial Reporting Detail</u>

- *Get Whatever Level of Detail is Necessary* – The bank will have a set of current financial reporting requirements. However, to get at the root cause of financial deterioration, additional financial information may be warranted. There are numerous financial documents that may be needed: detailed aging reports for accounts receivable and payable, inventory reports, copies of complete leases, detailed list of contingent liabilities, full tax returns, verification of deposits, and so on

<u>Internal Analysis and Questions</u>

- *This Can Be Tricky* – In order to save time and money in the long run, and assuming the proper financial reporting has been received, spread, and analyzed by analysts or underwriters, determine if the right questions have been asked. Stakeholders should review the analysis and be sure to ask challenging questions that may not have already been addressed. Look at the analysis through the eyes of an independent third-party (credit review, internal audit, regulatory supervisor). Another way to think about it is to ask if Credit Administration or Special Assets has any "deep dive" questions that they need answers to, so that the proper risk rating can be identified. Some credits

are known to be 'hands off' to everyone except senior management, which can quickly become problematic. Too often in the asset quality monitoring process, gaps or weaknesses exist without a full understanding as to why. Insufficient curiosity and rigor become apparent, especially when it comes to finding the root cause of declining financial performance. There may also be a lack of experience by the PRO, CA, or other stakeholder (as serious economic downturns are not all that frequent). Such questions and answers should be documented, and the answers sought and obtained by the obligated parties in short order. Don't stop until you get all the answers, even if you have to keep going back and ask for more information

The Hard Part – Questions, Yellow / Red Flags

Zero-In on the Issues

- *Flags or No Flags?* – Are there yellow or red flags, indicators of potential problems? Most C&I exposures, with increasing credit risk, will have red flag warning metrics before too long. The point is, that a conscious effort is given to confirm any red flags, and why deterioration is specifically happening. Zero in on the target by asking as many questions and getting verified answers as needed. You must understand what management intends to do to cure the negative performance

Following are Examples of Such Yellow and Red Flags, and Indicators of Potential Problems:[2]

- *Working-Capital Advances Used for Funding Losses* – A business uses advances from a revolving line of credit to fund business losses, including the funding of wages, business expenses, debt service, or any other cost not specifically associated with the intended purpose of the facility

- *Working-Capital Advances Funding Long-Term Assets* – A business will use working-capital funds to purchase capital assets that are normally associated with term business loans

- *Trade Creditors Not Paid Out at End of Business Cycle* – While the bank may be paid out, some trade creditors may not get full repayment. This can cause a strained relationship as unpaid trade creditors may be less willing to provide financing or offer favorable credit terms in the future. In turn, the business will become more reliant on the bank to support funding needs that were previously financed by trade creditors

- *Overextension of Collateral* – The business does not have the collateral to support the extension of credit, causing an out-of-borrowing-base situation. Review borrowing-base certificates to verify that coverage meets the prescribed limitations established by the bank's credit policy for the specific asset being financed

- *Value of Inventory Declines* – If a business does not pay back the bank after inventory is converted to cash or accounts receivable, the value of the inventory declines. Other causes of inventory devaluation include obsolescence; a general economic downturn; or, in the case of a commodity, market volatility. Declines in inventory value will commonly put a working-capital facility in an out-

[2] Federal Reserve Bank – Commercial Bank Examination Manual, Section 2080.1

of-borrowing-base situation and require the excess debt to be amortized and repaid through future profits of the business

- *Collectability of Accounts Receivable Declines* – The increasingly past-due status of accounts receivable, or deteriorating credit quality of account customers, both result in the non-collection of receivables. This can also cause an out-of-borrowing-base situation for the bank

- *Working-Capital Advances Used to Fund Long-Term Capital* – Funds may be inappropriately used to repurchase company stock, pay off subordinated debt holders, or even pay dividends on capital stock

- *Accounts Receivable* – A slowdown in the receivables collection period. This symptom often reveals that the borrower has become more liberal in establishing credit policies, has softened collection practices, or is encountering an increase in uncollected accounts

- *Inventory* – Noticeably rising inventory levels in both dollar amount and percentage of total assets. Increases in inventory levels are usually supported by trade suppliers, and financing these increases can be extremely risky, particularly if turnover ratios are declining. The increase in inventory levels or lower turnover ratios may also be related to the borrower's natural reluctance to liquidate excessive or obsolete goods at a reduced price. Many businesses are willing to sacrifice liquidity to maintain profit margins

- *Slowdown in Inventory Turnover* – This symptom may indicate overbuying or some other imbalance in the company's purchasing policies, and it may indicate that inventory is slow-moving. If the inventory is undervalued, the actual turnover is even slower than the calculated results

- *Existence of Heavy Liens on Assets* – Evidence of second and third mortgage holders is a sign of greater-than-average risk. The cost of junior money is high. Most borrowers are reluctant to use this source of funds unless conventional sources are unavailable

- *Concentrations of Noncurrent Assets Other Than Fixed Assets – A* company may put funds into affiliates or subsidiaries for which the bank may not have a ready source of information on operations

- *High Levels of Intangible Assets* – Intangible assets, which shrink or vanish much more quickly than hard assets, usually have very uncertain values in the marketplace. In some cases, however, intangible assets such as patents or trademarks have significant value and should be given considerable credit

- *Substantial Increases in Long-Term Debt* – This symptom causes increasing dependence on cash flow and long-term profits to support debt repayment

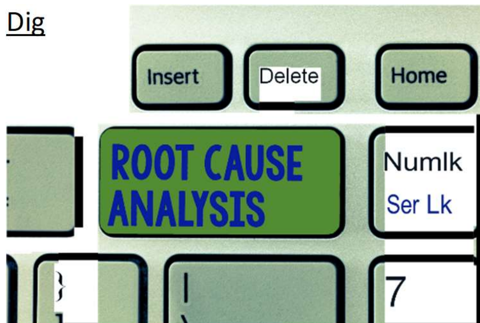
- *A Major Gap Between Gross and Net Sales* – This gap represents a rising level of returns and allowances, which could indicate lower quality or inferior product lines. Customer dissatisfaction can seriously affect future profitability

- *Rising Cost Percentages* – These percentages can indicate the business's inability or unwillingness to pass higher costs to the customer or its inability to control overhead expenses

- *A Rising Level of Total Assets in Relation to Sales* – If a company does more business, it will take more current assets in the form of inventory, receivables, and fixed assets. Be concerned when assets are increasing faster than sales growth

- *Significant Changes in the Balance-Sheet Structure* – These changes may not be the customary changes mentioned previously, but they are represented by marked changes spread across many balance-sheet items and may not be consistent with changes in the marketplace, profits or sales, product lines, or the general nature of the business

Document the Root Cause(s)



Dig Until You Get to the Bottom of the Root

- *Clearly Document the Root Cause* – If you are not 100% certain of the root cause(s) behind the financial deterioration, then keep digging until you find the reason(s). Why? Because to identify and apply the right risk rating, accrual status, covenant structure, workout repayment solution, and action plan, you must know what caused the deterioration or problem in the first place. Otherwise, there could be a missed opportunity to apply the optimal repayment plan, which could end up costing the bank more in time and money

- *Look Who Wins* – As analysts and underwriters help identify root causes as part of the ongoing monitoring processes, overall quality and efficiency will improve. Risks will have been better managed, including an understanding as to whether financial performance covenants should be waived or forborne. It is also less expensive to manage a credit in the long run when appropriate action is taken at the right time, the first time. Management and lending staff will also become more enabled through improved decision-making. Borrowers will also take comfort knowing the bank is aware of the issues, and build trust with the bank by keeping the bank informed on its remediation progress through better communication. As individuals and teams work together to identify root causes, they become more accountable, more engaged, and will contribute more to bank's success through job satisfaction too.

Key Reminders/Tips for Credit Metrics

Cash Flow

- *Debt Service Coverage Ratio (DSCR - ability to repay); Global Cash Flow (individual and business); Interest Reserve (fund interest on construction loan)* – Monitor and know the adequacy of each borrower's ability to repay on a continuous basis. It is critical to evaluate the cash flow trends, particularly declining trends, including a comparison to industry peer performance. Make sure

extensions are not just covering up repayment issues. Consider the level and trend of the DSCR in assigning a credit risk rating. In a downturn, the obligated parties may have increased demand from global cash flow sources which need to be carefully analyzed, not double-counting income, etc. Ensure complete business and personal tax returns are obtained from all obligated parties. Consider the financial strength of the obligated guarantors in the credit risk rating determination. Confirm the time the interest reserve is in place compared to the needed financing, and make sure any cash flows the property generates go to service the debt; continue monitoring the project lease-up. Ask any necessary questions until you fully understand the current and projected cash flows

Net Operating Income (NOI)

- *Stabilized NOI (fully leased with maximum rental income); Vacancy Impact (direct reduction of rental income); Operating Expenses (CRE maintenance); Debt Yield (DY: risk in deal, viability, stability)* – Determine why units are vacant, for how long, and exactly how the borrower intends on getting them leased. Carefully review key increasing expenses from an historical perspective and ask any necessary questions to understand extraordinary expenses. When monitoring a loan's performance, compare the current DY to that of the original loan underwriting and to policy underwriting thresholds for the same new loan today. A low DY will require additional analysis and questions should be generated around increasing a personal guarantee, offering additional collateral, or even resizing opportunities to properly increase the DY (regardless who the customer is, especially the high-profile borrower/depositor). Look at the deal as if the bank had to take back the property with the current DY

Profitability

- *Sales (top line performance), Expenses (controlling costs), Profits (benefit)* – Measures efficiency in sales and profit levels, controlling expenses and a return on investment. Evaluate trends in sales revenues, gross and net profit margins, and other notable cost and expense ratios. Determine the reason behind material changes in key metrics. Identify material expense trend increases as a percentage of sales. What is the outlook? Understand what is driving the profit margins and what needs to happen in the future to improve the same. Ask any necessary questions until satisfied

Efficiency

- *Inventory Days (days to sell average inventory); Receivables Days (A/R on hand); Payable Days (average time to pay trade suppliers)* – Detailed inventory reports can be used to conduct an inventory inspection by sample testing and ensuring accuracy (holding the borrower to account for discrepancies). If there are material differences in the DOH by comparison of values of similar, same industry companies, continue your inspection. Determine if and how much functional or technical obsolescent inventory is in stock. With detailed current A/R and Customer List reports on hand, carefully analyze ineligible A/R (past dues, concentrations, etc.), and determine their collectability. If necessary, ask the borrower "how much, and when" for all material A/Rs to get a clear idea of how much will be collected and by when. Suppliers obviously play a key role in the success of operations. Carefully analyze the DOH over time and determine if the borrower is operating efficiently, or is unable to pay its creditors on time. Similarly, get an AP Aging report and, if necessary, ask the borrower "how much, and when" for material past due payables as to when these will be paid

Leverage

- *Funding Sources and Capacity (financial resources: earnings, debt capital, equity capital, to meet obligations; ability to manage finances)* – Determine the viability of each funding source and if those sources of capital are available or sustainable. How possible is refinancing, and at what cost and on what terms? Is the sponsor or guarantor able or willing to inject additional capital? Is the projected period to de-lever to a sustainable level acceptable? Does the cash flow analysis rely on overly optimistic or unsubstantiated projections? Are the projections stressed-tested for a downside case? Determine the ability to meet obligations, and the extent of plan variances. Document poor structures and limited covenants, if applicable. How vulnerable is the borrower to sharp economic and business cycle swings?

Liquidity

- *Sources (cash on hand, short-term funds, cash flow management, secondary sources, cash burn)* – Review the liquidity needs of the borrower and if primary sources are sufficiently available, or if secondary sources need to be liquidated to meet current obligations. Carefully review current maturities, the size and timing of payments, interest rates, uncollected receivables, obsolete inventory. Determine root cause for liquidity problems. If (net) cash burn exists, confirm how much time is needed before returning to positive cash flow, and the sources to recapitalize. Carefully study the cash burn analysis as often as is needed, and adjust the credit risk rating when necessary. Ask the borrower how it intends to lower the cash burn rate

Performance to Plan

- *Budget vs. Actual Variance Analysis (performance evaluation, expectation review)* – Important to understand not only why the variance(s) occurred, but to determine if the bank has confidence in the borrower's budgets, and whether they need to be stressed for the bank's case. Do you have confidence in future forecasting based on historical variances, and what reasonable adjustments are necessary? Is the budget overly optimistic? If you do not know, ask. Monitor revisions to plan but get the level of understanding where the bank has confidence in borrower projections. Variance analysis can be performed monthly, quarterly, or annually as needed

Pro Forma Outlook

- *Outlook Realistic (forecast future financial performance); Assumptions (projections, educated guesses); Cash Budget (budget plan on debt repayment workouts)* – During times of economic downturn, use pro forma statements to structure workout or loan modification repayment solutions. Ensure the statements are conservative in both revenue and expenses, and include upcoming one-time expenses. Depending on how severe the current economic conditions are, have the borrower prepare its pro forma statements with its own recommended repayment plan. It should include, detailed, well-supported, foot-noted explanations on the assumptions used. Repayment terms can be temporarily used, with the frequency of updated pro forma statements adjusted as necessary. Risk ratings will similarly be adjusted according to regulatory guidance. Under extreme circumstances, a cash-in and cash-out monthly budget can be utilized to show possible debt repayment solutions

Management

- *Succession Plan (transition of leadership)* – Economic challenges must be successfully unmanaged by skilled leaders. Understand borrower's succession management planning for all key positions (not just at the most senior level). Are there recent or pending retirements, and how might those changes (and their tangible contributions) in staffing impact the borrower's competitiveness?

Competition

- *New or Pending Direct Competition (market share); Customers Lost to Competition (negative impact on borrower operations)* – New competition can affect a borrower's operations and ultimately its ability to repay its loans. The potential loss of market share could result to a decline in revenue and profits. Determine if increased price competition is likely as new competitors may enter the market with lower prices, affecting profit margins and impact repayment ability; this may affect or result in increased marketing and advertising expenses. Understand the strategies management uses to be proactive in mitigating competition risk, and how it differentiates themselves from their competitors

SECTION 8

Commercial Real Estate (CRE) Risks

Objective

- *CRE Valuation Risk* – Understanding the general risks of commercial real estate lending, and from a valuation (appraisal, evaluation, or validation) perspective

Expectations

- *CRE as a Source of Repayment Source* – Spend sufficient time and training into CRE lending risks, and view CRE collateral as a potential sole source of repayment during an economic downturn

CRE Collateral Risks – Appraisal Considerations

New Views on CRE Risks

- *Relevant Market Conditions / Impact on Borrower* – Analyze how market conditions during a downturn economic environment impact CRE borrowers: declining CRE valuations, inflation, increasing interest rates, employment rates, borrowing costs, increasing vacancy rates, decreased lease (rental) rates, increased operating expenses, decreased demand for CRE, lack of available financing, and less economic growth. Determine how these measures affect the borrower's ability to repay. Determine and document how these conditions are impacting the borrower

- *Extraordinary Assumptions* – Stakeholders, including the appraisal review function, analysts, underwriters, PROs, and CAs need to read and understand any noted extraordinary assumptions in a CRE appraisal report. These may include, for example, the following assumptions that the property is free of: zoning violations, structural defects, encroachments, easements, liens, title defects, flood risk, fire hazards, mold, termites, environmental contamination, hazardous materials, asbestos, radon, lead-based paint, sinkholes, soil contamination, water damage, foundation issues, roof leaks, etc.

- *Hypothetical Conditions* – Stakeholders, including the appraisal review function, analysts, underwriters, PROs, and CAs need to read and understand any noted hypothetical conditions in a CRE appraisal report. These may include, for example, the following conditions that the property may/may not be subject to: clear title, legal disputes, pending litigation, zoning changes, environmental conditions or regulations, building code violations, easements, liens, encroachments, leasehold interests, mortgage interests, restrictive covenants, adverse physical conditions, adverse economic conditions, adverse legal conditions, adverse market conditions, adverse political conditions, adverse social conditions, or any adverse technological conditions

- *Leases/Rental Rates, Vacancy, Operating Expenses* – Review current rental rates and compare them to market conditions (interest rates, tenant demands, zoning). Analyze vacancy trends over time and its impact on borrower income, and the root cause for higher vacancy: market conditions, tenant demand, economy, zoning; anticipate changes to vacancy rates. Observe material operating expense increases as a percentage of gross income, and determine the reason for the increase: improvement to the property and attract tenants, maintain, and prevent deterioration, reflect changes in the market, tenant demands, zoning regulations, etc. Project material changes with supported and documented analysis

- *CAP Rates (The ratio of a single-year of NOI to the property asset value)* – In an increasing interest rate environment as capitalization (CAP) rates increase, analyze the effect CAP rates are having on CRE valuations. In a down economy the CAP rate will increase as stakeholders become more risk-averse, thus making it more difficult to obtain financing, resulting in lower CRE values. Analyze and document how the bank's exposure on such CRE collateral needs to be handled. Consider additional risks to the bank and the borrower: market conditions, credit, liquidity, collateral valuation, environmental, legal, zoning, construction, tenant, management, hypothetical conditions and extraordinary assumptions in the appraisal report

- *Discount Rates (The investor's required rate of return, discounting future cash flows during the holding period back to the present to determine value)* – In a down economy the CAP and discount rates tend to increase, and both rates share these risks. Other risks include: default risk, foreclosure risk (the bank having to sell foreclosed properties in a down economy)

- *Absorption* – Understand the rate at which commercial space is being leased-up in the subject market. Review the original appraisal absorption assumption and compare that with the current demand for similar space today in a downturn market, as absorption rates will be lower, properties will take longer to sell, leased at lower prices, require more marketing or incentives such as rent concessions, tenant improvements to attract tenants or buyers. Per a physical inspection, identify any significant repairs

- *Leasehold Interest* – Confirm the remaining length of the leasehold interest, rent escalations for reasonableness. Look for resizing requirements, additional collateral or guarantees if necessary; do it now before the leasehold interest buries the subject wasting asset altogether, if applicable

- *Tenant Improvements (TIs)* – Carefully analyze the TIs financed by the bank, whether they are cosmetic changes or major structural renovations. Get a resizing if necessary

- *Appraisal Recommendation (New appraisal, validation, or evaluation)* – Based on relevant/material changes in market conditions, project performance, geographic conditions, variances from original appraisal assumptions, change in project specs, loss of lease or takeout, high pre-lease fallout, or as borrower's financial condition deteriorates

CRE Lending Considerations

Emerging CRE Risks

- *Interest Rate Risk* – Higher interest rates result in likely higher borrowing costs, more difficulty for the borrower to repay or obtain replacement financing, and result in a higher likelihood of default and foreclosure. Possible mitigating strategies for managing interest rate risk is using interest rate swaps (exchanging a variable rate for a fixed rate). Interest rates can be capped to limit increases or maximize costs, or have floors that provide a minimum borrowing cost

- *Refinance Risk (Higher interest rates have a material impact on refinance risk)* – With the increased cost of borrowing, it becomes more difficult for borrowers to refinance, possibly leading to payment default and collateral liquidation. The property's value may become reduced and make it even more difficult to refinance. Banks should pay close to the earlier 'resizing opportunities' before refinance risk increases too far, including: closely monitoring interest rates and market conditions, borrower creditworthiness, upping guarantees, and taking additional collateral. Determine if outside financing is even possible, if the loan will need to be downgraded, extended with disclosable modification terms, or the collateral even be sold. The borrower may take measures to improve its creditworthiness and the property value, reduce debt levels, increase cash flow, obtain an additional interested guarantor, provide more collateral or guaranty percentage, or offer and negotiate a workout or loan modification

- *Resizing Opportunities* – As a commercial banker, you can determine if a CRE loan needs to be paid down or re-sized by considering various factors such as a higher interest rate environment, reduced net operating income due to decreased rents and higher operating expenses, declining economic market conditions, lower debt yield, weak forecast, poor liquidity, uncertain repayment ability, etc. Document the case for a resizing opportunity by using repayment tools like DSCR, LTV, DY, and stressed interest rate sensitivity, and propose and document a resizing paydown recommendation. Put the interests of the bank first, and the borrower second, even with a 'high deposit' borrower

- *Repricing Risk (The possibility a CRE loan may need to be refinanced at a higher interest rate upon maturity)* – Especially in an economic downturn and high interest rate environment, interest rates should cover cost of funds, loan servicing, probable loss, as well as a reasonable profit margin. Keep the following in mind when the borrower's creditworthiness, income, and the collateral property have declined: borrower's loss of a major client, supplier, employee, major contract, customer, or vendor

- *Physical Inspection* – Identify potential risks by conducting a thorough physical inspection of the CRE. Start with reviewing the loan documentation (title, survey, zoning) to learn of potential legal issues. The visual inspection should include the interior and exterior of the building and site, to document any potential physical or environmental issues to avoid potential liability. Review the borrower's balance sheet, income statement, and property lease agreements and note any other issues or questions for follow-up and discussion with the borrower. Conduct regular inspections.

Remember to not ignore identified issues, get borrower authorization to conduct inspections, obtain necessary training, use proper safety precautions, and ensure proper supervision

- *Insurance Coverage (type; amount; timing; claims acceptance, doubt, or protracted resolution)* – Hazard and fire insurance coverage should help protect damage from fires, natural disasters (property, general liability, business interruption, equipment breakdown). Review the adequacy of insurance coverage for loans secured by CRE, and determine how sufficient it will cover the cost of repairs or replacement in comparison to the actual outstanding loan balance. If the land value is excessive, the cost to replace the damage may be less than the loan balance. Ensure the policy is in force and has not lapsed. For claims, the insurance company will investigate the validity of the claim to confirm the destruction was caused by a covered event. Work with legal counsel if the claim is doubted, or if the claim resolution is expected to be protracted

- *Environmental Risk (Lender inspection, borrower questionnaire, base review, Phase 1 and 2 reviews)* – Ensure the bank conducts sufficient environmental risk due diligence, including an environmental lender inspection, borrower-completed questionnaire, and obtain Phase One environmental site assessments (ESA), or Phase Two ESA, if necessary. Review documentation to confirm the borrower's responsibilities with respect to environmental compliance and remediation, considering the use of environmental indemnification agreements to shield the bank of potential environmental claims

SECTION 9

In Conclusion, Key Take-Aways

In Conclusion…

During these times of economic downturn, CreditRMA.com aims to being a new level of awareness to the credit risk management process. It's time to use these sharpened tools to help optimize debt repayment solutions with commercial borrowers. At this point of the economic cycle, we are dealing with 'getting repaid.' It takes a real concerted effort on the part of the stakeholders inside the bank, to work together, listen, learn, and contribute. Each needs to be speak up and be heard with his/her own documented assessment, conclusions, and recommendations.

When it comes to negotiating directly with the Borrower, there needs to be a united voice within the bank that current financial reporting is required and it will be enforced. Deep-dive questions will be developed through careful analysis, and answers will be obtained to identify the root cause of any repayment issues. Understanding the problem will enable the parties to craft the right repayment solution strategy. Borrowers may also be expected to propose their own debt repayment solutions. Mutual respect for all parties will help the communication channels remain open, even when there are differing and divergent points of view.

Again, these stressful times require pro-active credit risk management processes that get to the root of each debt repayment problem, and apply the best debt repayment solution(s). CreditRMA.com encourages a new and fresh approach, beginning in 2024, to the credit risk management function. The next economic cycle will likely be unlike any other for a host of reasons. CreditRMA.com was built specifically for these times. As always, fresh ideas and collaborative thinking are always welcome, as it is imperative that we understand the credit risk on the books to maximize the bank's recovery in the shortest amount of time.

Key Take-Aways

SECTION 1) Credit Risk Rating Classification System –

- The system is critical, for a variety of reasons. Credit risk is dynamic. Asset quality monitoring needs to be thorough and frequent enough to ensure the assets are always rated appropriately. There are also many poor reasons (subject to regulatory criticism) to not downgrade loans on a timely basis, or to the correct risk rating. The risk rating system should be enhanced to include dialogue between the PRO, CA, SAD, and senior management. Each should be enabled and empowered to

make documented risk rating decisions, even if the ratings end up being developed with divergent views

- The best way to have a 'healthy debate' over matters in the rating classification system is to have well-documented conclusions that each can analyze and discuss. Banks that use a Watch List designations have an early-warning system for loans that have temporary uncertainties. Lenders need to better utilize the Special Mention risk rating classification earlier on when credits first begin to deteriorate. The heightened monitoring will help ensure the bank minimizes any unwarranted losses in the long run. Once weaknesses become well-defined, they should be risk rated Substandard

SECTION 2) Credit Risk Evaluation Process –

- Risk ratings may be assigned to the "Borrower" and to the "Transaction," or just a single risk rating for the Borrower. Both systems should support the size and complexity of the bank. Assigning risk ratings should be well-supported by deep-dive quantitative analysis into the borrower's cash flow, ratio analysis and benchmarks, careful review of the pro forma projections, and avoiding 'evergreen' loans whose sole source of repayment is that of a 'refinance'

- Bank policy should dictate underwriting guidance. Assessing borrower management and the company's industry should be documented. An enhanced loan structure should include appropriate collateral and loan guarantees to protect the bank's interests. Structural weaknesses are underwriting deficiencies and will compromise the bank's ability to control the credit relationship. Measures to shore up the deficiencies should not be delayed

SECTION 3) Roles and Responsibilities for Credit Risk Ratings –

- In today's credit risk management process, roles and responsibilities need to be refreshed so there is no uncertainty as to what expectations are. Established 'lines of defense' are there for a reason. Revisit those reasons, face to face, to make sure everyone understands their role. The PRO is the first line of defense, and the PRO must state its own opinions as to the risk ratings, being well-documented

- The second line of defense is CA who should be actively involved in helping with loan structure and the consistent application of policy and credit standards. It is also time for the CA to step up in asset quality monitoring and confirm the root cause analysis with the PRO. SAD should have an active voice in any criticized risk-rated assets, including signing off on reporting at the asset quality monitoring process

SECTION 4) Watch List and Criticized Asset Quality Monitoring –

- The Watch List Reporting (WLR) function serves as a reliable early warning system (Pass risk rated credits) if the process is effective. To be effective, and reduce any unwarranted credit risk, heightened monitoring of documented current uncertainties is necessary. Concise, yet thorough, WLR also includes documenting if the uncertainties are improving or deteriorating, opining on the

outlook, triggers for Watch List removal or further downgrade, and regularly presenting a WLR report. Criticized Loan Reporting (CLR) requires deep-dive analysis and questioning

- In effective asset quality monitoring, the relationship is fully disclosed, including borrower exposure, collateral protection, guarantor support, deposits, primary and secondary sources of repayment, root cause analysis, risk rating disposition, accrual status, up/down grade triggers and specific action plans to get the loan back to a Pass risk rating or a $0 balance. The frequency of reporting and individual presentation is either monthly (red), bi-monthly (yellow), or quarterly (green), where independent strategic decisions are recommended by the lines of defense and finalized in the reporting sessions, with minutes taken as an accountability measure

SECTION 5) Culture Enhancement for Divergent Views –

- It is time to rethink how, and with whom, credit risk in general, and asset quality monitoring specifically, is managed in an economic downturn. A healthy credit culture includes spaces and expectations for each stakeholder, a seat at the table, and especially for those who have differing or divergent points of view. There is a myriad of touch points in the credit risk management process, and senior management needs to understand how others see the risk ball as it is rolled around the table for others to opine how they see things. Documented independent opinions, conclusions, and mutual respect are essential. During times of economic stress, pressure builds for the bank in many areas

- But credit risk, is still risk, and the facts are the facts. Such should be documented for the file, and senior management will have ultimate responsibility for decisions that affect the bank's financial statement performance. Meanwhile, the lines of defense still have the responsibility to call the 'balls and strikes' as they seem them, even if others may disagree. Documenting the supportable 'facts' to arrive at conclusions and servicing recommendations is critical to the bank mitigating increasing credit risk developments. Truly, not virtually, valuing and appreciating bank employees has multiple benefits as opposed to an over-bearing and rigid credit culture from the top down (which tends to happen when the bank is under stress)

SECTION 6) Respect and Dealing in Good Faith with Borrowers Having Financial Difficulties –

- Borrowers who are experiencing financial problems, are not problem people. They are regular people who have a borrowing repayment problem. Bankers need to be reminded that they owe the Borrower as much respect as when the loan was granted in the first place. Dealing in good faith is also necessary to get the most recovery and least loss in dealing with borrowers needing to negotiate repayment strategies. Respect builds trust. Trust creates cooperation

- Adversarial relationships cost much more money and time in getting to resolution. Put yourself in the borrower's shoes. While the bank 'holds the cards' per the Loan Agreement and Promissory Note, the borrower still has responsibility to repay, so its voice cannot be ignored. Nor can the borrower be treated heavy-handedly or by being over-bearing. Could the bank and borrower have dinner together when all is said and done?

SECTION 7) Getting the Right Answers for Debt Repayment Solutions –

- To get the best repayment solutions for the bank and borrower, the key ingredients needed include complete financial statement reporting, deep-dive internal analysis, asking the right questions, identifying yellow/red flags, and getting to the root cause causes. After re-reading the financial reporting covenant requirements, the bank needs to respectfully require and enforce the remittance of sufficient financial information to ascertain the current credit risk in the loan. But, by being demanding to the 'letter of the law,' is that the right approach? Talk through it, work through it

- The borrower may be willing or it may not be willing. Understand 'why' before an exit strategy is imposed. Consult with CA, or even SAD to determine what deep-dive questions need to be asked and answered. Do this by identifying and documenting yellow and red flags, or other indicators of potential problem loans. Keep the line of questioning going, internally and with the borrower, until the root cause is documented, and everyone agrees. The PRO should work with CA and SAD to determine if the relationship should be transferred to SAD, or develop a mutually acceptable action plan to bring the risk rating back to a Pass or $0 balance.

SECTION 8) CRE, Problem Loan Risks –

- CRE, a secondary source of repayment, often becomes the new primary source of repayment in a serious economic downturn. The time to prepare for such an event should be as much as a year in advance of such a scenario, or more. The appraisal is a risk document as much as a snap-shot valuation. CRE collateral properties can be very complicated to understand and work with. Any number of CRE risks can have a major effect on the ultimate net realizable value (recovery) upon sale or liquidation

- It is imperative the bank understand the current market conditions, extraordinary assumptions and hypothetical conditions used in the valuation, together with lease/rental rates, vacancy, operating expenses, CAP and discount rates, current interest rates, absorption rates, lease fee estate and leasehold interests, tenant improvements, and whether a new appraisal, evaluation or validation is warranted. From a lending perspective, when negotiating with the borrower, the higher interest rate environments, how will this affect refinance risk? Understanding these risks early on will allow the bank to negotiate resizing opportunities, pricing for risk, conducting physical inspections, reviewing the adequacy of insurance coverage, and assess any potential environmental risk

Addendum

Dedication

This publication is dedicated to all professional community bankers. In times of economic stress, together let us sharpen our credit risk management tools to the mutual benefit of your shareholders and commercial loan borrowers.

Mission Statement

CreditRMA.com seeks to being a new level of debt repayment awareness and solutions during times of economic downturn.

About the Author

Jerry Staker founded the following companies:

- National Credit Awareness and Resolution Association, Inc. (NCARA.org) for small business, in 2020
- Tunabudget LLC (tunabudget.com) for individuals and families, in 2020
- Credit Risk Management Advisory, LLC (CreditRMA.com) for creditors, in 2023

The following points may be of interest:

- Birth: 1960
- Residency: Utah, Rhode Island, Arizona, and Hawaii
- Family: Married, four children, five grandchildren
- 40+ Year Career: 28 years in commercial banking (community and regional banks: workout loans, credit review, Director/Credit Management Group); 12 years Bank Supervision & Regulation (Commissioned Bank Examiner - FRBSF)
- Shared National Credits (SNC) Examinations: As a voter, risk grades assigned in nine SNC examinations in New York City and San Francisco: ~30 credit relationships for ~$40 billion in 2011, 2014, 2015, 2016, 2017, 2019, 2021; SNC Business Lines: Leveraged lending, asset-based lines, term and revolving credit facilities, oil, and gas lending
- Examinations: Participated in 146 multi-state onsite State Member Bank (SMB) community and regional bank examinations (112), Foreign Bank Organization (FBOs) examinations (24), and BHC inspections (10)
- Travel: Up to 80% travel to 12 U.S. States over a 12-year period

- Interests: Walking, traveling, gardening, writing, music, family, service, journal writing, family history work, fishing
- Ambitions: Sing, play Ukulele, under 200 lbs.
- Other Interests: Earthquakes, volcanos, tornados, solar, water, wind, astronomy, consumer finance, politics, personal life histories, sunny beaches
- Banks Served: 52 Loan Review and other assignments were completed (often at several cycles) at the following banks from 2009 to 2021:
  - Arizona
    - Gold Canyon Bank (closed)
    - Western Alliance Bank ($68 billion)
  - California
    - Bank of India (foreign bank)
    - Bank of the Orient ($875 million)
    - Bank of Taiwan (foreign bank)
    - Commercewest Bank ($1.1 billion)
    - Commonwealth Business Bank ($1.8 billion)
    - Cornerstone Community Bank ($622 million)
    - East West Bank ($68 billion)
    - E. Sun Commercial Bank (foreign bank)
    - Farmers and Merchants Bank of Long Beach ($12 billion)
    - Friendly Hills Bank ($392 million)
    - Hamni Bank ($7 billion)
    - Heritage Bank of Commerce ($5 billion)
    - Land Bank of Taiwan (foreign bank)
    - Liberty Bank ($598 million)
    - Oak Valley Community Bank ($1.8 billion)
    - Pacific Coast Bankers' Bank ($1.2 billion)
    - Pacific Enterprise Bank (merged)
    - Pacific Mercantile Bank (acquired)
    - Pacific Premier Bank ($20 billion)
    - Silicon Valley Bank (closed)
    - Silvergate Bank (closed)
    - Taiwan Business Bank (foreign bank)
    - United Business Bank ($2.5 billion)
    - United Overseas Bank (foreign bank)
    - Wells Fargo Bank ($1.8 trillion)
    - West America Bank ($6 billion)
    - Woori Bank (foreign bank)
  - Hawaii
    - Bank of Hawaii ($24.9 billion)
    - Territorial Savings Bank ($2.2 billion)
  - New York
    - Citibank ($2.4 trillion)
    - Deutsche Bank ($36.9 billion)
    - JPMorgan Chase Bank ($3.8 trillion)
  - Oregon
    - Oregon Pacific Bank ($750 million)
  - Utah

    - Green Dot Bank ($3.7 billion)
    - Marlin Business Bank (acquired)
    - Utah Independent Bank ($133 million)
    - Bank of Utah ($2.6 billion)
  - Washington
    - Coastal Community Bank ($3.5 billion)
    - Commencement Bank ($615 million)