CHANGE IN LENDING

by Steve Brown

People really don't like to change very much. Whether that is because we get complacent, we like the comfort of certain patterns of life, are afraid of failure or afraid of the unknown, few people will seek out and embrace change. Given the time of year, we are going to take a shot here and ask readers to consider changing ever so slightly in one area - lending. As you begin to think about the year that was and to consider the future of the industry, consider the future of managing a loan portfolio. As the crisis has shown, having a strong Chief Credit Officer is critical if you are going to get out of trouble, but having a way to better analyze risk in the loan portfolio is important to avoid trouble in the first place. Additionally, following the credit crisis, regulatory expectations have shifted to require much more management and board reporting in a much deeper level, so we challenge you to consider changing things up some in 2012. To effectively manage your existing loan portfolio on an ongoing basis, seriously consider assigning a team to input codes using the North American Industry Classification System (NAICS) for every single loan on the books. NAICS provides a standard that is used by government statistical agencies when they classify business establishments for the purpose of collecting, analyzing and publishing statistical data related to the economy. That can help when you are seeking information on how to adjust your loan loss reserve qualitative factors at a minimum, but it also gives you insight into the portfolio that can be then compared to the economic data swirling around you. We suggest inputting the 6 digit codes to get a good start on things without overwhelming your resources. For instance, if you have a loan to a doctor, a simple search on the NAICS database shows that falls under the highest level two digit code #62 "Health Care and Social Assistance." Then, assuming this loan is to an optometrist, the 6 digit code becomes 621320 "Offices of Optometrists." Once you have that, you have the tiger by the tail so to speak and can then pull in reams of statistics on lending to this type of doctor from various sources. All it takes is a bit of reading (to get the code), a spreadsheet (the codes can be downloaded for easy access), some elbow grease (to input the codes) and consistency (to change the loan boarding process to capture the codes up front) and you are off to the races. This small change can deliver amazing value to your bank. Next, consider changing from a single risk rating loan grading system to a dual risk rating approach. Many banks currently use a 10 notch loan grading system that runs from 1-4 Pass, 5-6 Watch, 7 Special Mention, 8 Substandard, 9 Doubtful and 10 Loss. That matches up pretty well with older regulatory guidance, but a closer look shows human beings just aren't very good at grading like this. The vast majority of loans tend to get bunched up in one or two Pass categories, despite significantly different underlying debt coverage, LTVs, types of business and other key factors at the individual loan level. Key problems with this approach include requiring substantial judgment, introducing unintended bias, limiting granularity, introducing subjective inconsistencies, reducing the incentive for timely and accurate assignment of asset quality ratings and creating the potential for conflicts during the grading process. Since loan grading is one of the most important components of managing loan portfolio risk, it is critical to get the process right and to consider refining it. To start down this path, go loan by loan and assign a probability of default (PD) and loss given default (LGD). Then, take the loan balance and multiply it by the PD and the LGD. Then form groupings based on the expected potential loss. Here, we note PD is the likelihood that a loan will not be repaid, while LGD is the loss expected if that were to occur. To get more systematic, just drop your loans into a spreadsheet, capture the PD from a loan pricing model or historical database of your actual defaults (or rating agency data or market inputs on loans of similar type). Then get LGD from these sources and do the math. As you think about the changes in the loan portfolio and the regulatory landscape over the past 4Ys and ponder the next 4Ys, consider making subtle changes to improve performance and better manage risk. As author Robert C. Gallagher once said, "Change is inevitable - except from a vending machine."

BANK NEWS

Spooky

Central banks from around the world took coordinated action to boost global stimulus and rein in turmoil in Europe. The Fed and Central Banks from Canada, England, Japan, Europe and Switzerland all lowered pricing on US dollar liquidity swap arrangements. Meanwhile, European ministers looked to the IMF for more help, after Italy's borrowing costs hit a record 8% and worries jumped around France's AAA rating.

Banks Blasted

S&P downgraded 37 banks, after overhauling its rating system to better reflect the link between the health of the economies in which the banks operate and less confidence governments will bail them out. Nearly every major US bank was downgraded, including BofA, Citigroup, JP Morgan, Wells Fargo, Morgan Stanley and Goldman. Short term and long term ratings, on average, went down 1 notch or less. In other news, Moody's said it may cut the rating of the largest lenders in France, Italy and Spain.

Credit Ratings

Before you get to hung up on the above, consider that the OCC has announced its proposal to do away with all references to credit ratings under Dodd Frank. The goal is to mitigate risk that bankers overly rely on ratings for credit decisions. This will impact investment portfolios, as banks now have to conduct a separate credit analysis before purchasing securities to determine suitable credit quality. In particular, banks with "investment grade" hurdles in their policies will have to remove the statement and add other tests. Comments are due at the end of Dec.