Credit Portfolio Management

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What is the goal of Credit Portfolio Management?

SIMPLY PUT

To limit credit risk and limit credit losses

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Course Overview

- Banking/Credit Industry Update
- Historical Bank Failures
- Strategic Portfolio Management
- Tactical Portfolio Management
- Review
- Home Study Overview

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Banking/Credit Industry in 2026

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WHY DO BANKS FAIL?

Almost always due to an economic or geopolitical catalyst that leads to …

- Credit/investment losses that erode the bank's capital position
- Runs on deposits that erode the bank's liquidity position

In short, the bank cannot meet its obligations

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HISORICAL BANK FAILURES

- Economy contracts
- Real estate values drop
- Consumer spending drops
- Unemployment rises
- Credit losses mount

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WHAT ABOUT THE GREAT FINANCIAL CRISIS?

LEADING UP TO IT.....

- Long period of economic growth
- Stable interest rate environment post 9/11
- Housing boom
- Relaxed underwriting (sub-prime and adjustable rates)

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WHAT ABOUT THE GREAT FINANCIAL CRISIS?

THEN BOOM! IT HAPPENED

- Interest rates rise to combat inflation
- Mortgage payments rise and homeowners beginning selling
- Housing market collapses
- Banks are heavily invested in housing on both the credit side and the investment side (mortgage backed securities)
- 527 Bank failures

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What leads up to credit losses so catastrophic?

TWO PRIMARY DRIVERS.....

- Credit Process
- Concentrations

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What does the Credit Process include?

Six Essential Components

- Credit risk policy
- Credit underwriting process
- Credit approval process
- Credit documentation process
- Credit measurement and monitoring process
- Credit oversight and controls

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What are some potential weaknesses in Credit Risk Policy?

- Appetite for speculative loans
- Extended repayment terms (long i/o periods, extended amortizations)
- High LTVs / Limited equity
- Low debt service thresholds

Key Risk

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What are some potential weaknesses in the Credit Underwriting Process?

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What are some potential weaknesses in the Credit Approval Process?

- High lending authorities for those directly responsible for production
- High lending authorities for inexperienced credit approvers
- Single pen lending authorities

Key Risk

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What are some potential weaknesses in the Credit Documentation Process?

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What are some potential weaknesses in the Credit Measurement & Monitoring Process?

- Over reliance on automation
- Review levels that start at too high of a dollar amount
- Review as a tick mark rather than credit assessment

Key Risk

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What are some potential weaknesses in Credit Oversight & Controls?

- In effective credit review process
- Lack of diversity in credit review (loan size, loan type, geography)

Key Risk

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What constitutes a Concentration?

- Credit exposure where potential losses are large relative to the bank's capital position and/or the overall loan portfolio
- One size does not fit all
  - Concentration limits may vary from bank to bank based on risk tolerance
  - Concentration limits may vary by the asset class based on historical performance

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What are some types of Concentrations?

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Commercial Real Estate Concentrations

- General CRE Regulatory Concentration Limits
  - 100 Bucket
    Includes construction, land development and land loans not to exceed 100% of the bank's capital
  - 300 Bucket
    Includes 100 bucket plus multi-family and other non-owner occupied commercial real estate not to exceed 300% of the bank's capital

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Commercial Real Estate Concentrations

- Property Type Concentrations

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Industry Concentrations

- Measured at sector and specific industry levels
- Sectors may include
  - Manufacturing
  - Medical
  - Retail
  - Wholesale
- Specific industries may include

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Product Type Concentrations

- Consumer Products
- Business Products

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Other Concentrations

- Geography
  - Different for every bank based on bank's footprint
  - Market and submarket
- Borrower
  - Legal lending limit
  - House limit

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How can Credit Portfolio Management Reduce the Impact of Credit Process and Concentration Risks?

- Strategic Credit Portfolio Management
  (Process/Portfolio Level)
- Tactical Credit Portfolio Management
  (Borrower/Loan Level)

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Strategic Credit Portfolio Management should have the following well defined

- Responsibility for reviewing, approving and implementing credit risk strategies and policies
- Credit approval criteria to include analysis and understanding of borrower, market conditions, loan purpose and repayment of funds
- Credit approval process to include approval authority levels for types and sizes of loans along with policy exceptions

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Strategic Credit Portfolio Management should have the following well defined

- Credit limits for borrowing relationships (house verse legal lending limits) and how to manage exceptions
- Credit limits for industries and how to manage exceptions
- Credit limits for property types and how to manage exceptions
- System for assigning internal risk ratings
- Process for on-going monitoring of credits based on size and/or complexity

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But wait, there's more!

- Information systems and analytics for monitoring the composition, quality and credit limits within the portfolio
- On-going Credit Review function operating independently of the Credit Approval function
- System of managing problem credits and workout situations
- Framework for loan documentation and collateral due diligence

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Let's move on to Tactical Credit Portfolio Management

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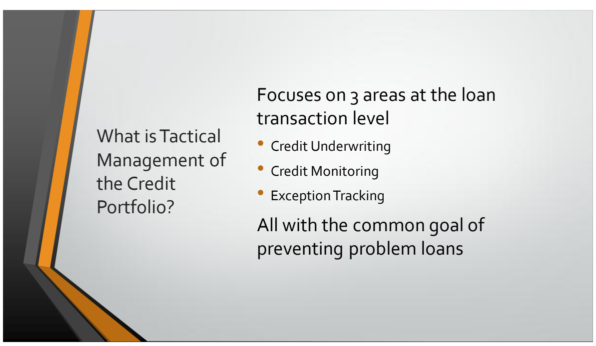
What is Tactical Management of the Credit Portfolio?
Focuses on 3 areas at the loan transaction level
Credit Underwriting
Credit Monitoring
Exception Tracking
All with the common goal of preventing problem loans

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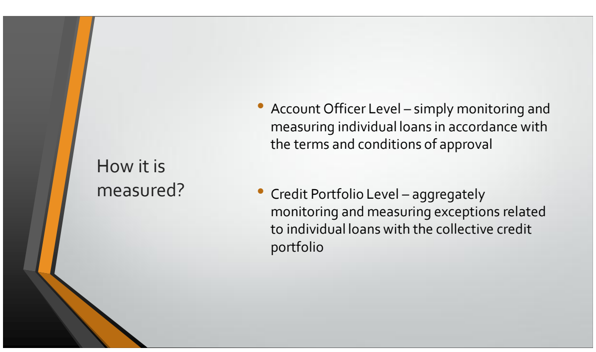
How it is measured?
Account Officer Level – simply monitoring and measuring individual loans in accordance with the terms and conditions of approval
Credit Portfolio Level – aggregately monitoring and measuring exceptions related to individual loans with the collective credit portfolio

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It all begins with underwriting

"An ounce of prevention is worth a pound of cure"

Ben Franklin, 1735

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Underwriting Considerations

Know your borrower and guarantors

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Underwriting Considerations

Consider Economic Conditions and Industry

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Underwriting Considerations

Loan Structuring

- Do the repayment terms match the collateral?
- Do the repayment terms match the purpose?
- Do the loan covenants pertain to the key credit risks?
- Does the structure fall within policy?

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Underwriting Considerations

Obtain current and sufficient financial information

- How much historical data is needed? 1, 3, 5 years?
- When should projections be prepared?
- How much guarantor information is needed?
- How much information is required for the related interests of the borrower and guarantors?

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Underwriting Considerations

Interpret financial information

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Underwriting Considerations

Know your collateral

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Loan Closing Considerations

Loan Documentation

- When should outside counsel required?
- Is a loan agreement required?
- Who is responsible for collateral perfection?

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Monitoring Considerations

Financial Reporting

- What types of reporting?
- How frequently?
- What quality?
- Is financial reporting within policy?

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Monitoring Considerations

Credit Review

- What dollar level?
- How frequently?
- How extensive?
- Covenant compliance?
- Discuss financial results with the borrower?

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Monitoring Considerations

Refinance Risk

- What is it?

  The impact on upcoming loan maturities (up to 24 months out) based on the interest rate at renewal verses the current interest rate.
- Why is it important?

  Impacts the ability of the borrower to repay the loan, thereby creating a credit quality weakness. Commercial Real Estate is experiencing the most impact
- What are the options?

  Right-size the loan through paydown

  Add additional collateral

  Extend the amortization

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Common Credit Thoughts

My borrower has overdrafts and runs past due on their payments but the financial numbers look good!

Bad Behaviors outweigh Good Numbers

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Common Credit Thoughts

My borrower has never missed a payment but their financials don't look very good!

Bad Numbers outweigh Good Behaviors

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What do I do when I discover an issue with a credit?

Tell someone!!!!

A Raised Hand is better than a Buried Head

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Exception Tracking
What exceptions should be tracked?

Categorize into 3 areas

- Loan Policy Exceptions
- Financial Exceptions
- Loan Documentation Exceptions

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Loan Policy Exceptions

What are Policy Exceptions?

Deviations (approved or not approved) from loan policy

Which exceptions should be tracked?

- Regulatory Loan-to-value limits for real estate
- Loan-to-value, Loan-to-costs, Equity
- Amortization, Maturity
- Debt Service Coverage
- Guarantor

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Financial Exceptions

What are Financial Exceptions?

Borrower/guarantor specific information related directly to financial performance

Which exceptions should be tracked?

"The Big 3"

- Financial statements (borrower, guarantor, related)
- Credit reviews
- Covenant compliance

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Loan Documentation Exceptions

What are Loan Documentation Exceptions?

Deviations from standard loan closing requirements that could potentially impact the enforceability of the loan documents

Categories of Documentation Exceptions

- Account/Note Level – Note, Loan Agreement, etc
- Collateral Level – Mortgage, UCC, Title, etc
- Guarantor Level – Full, Limited, Burn off, etc

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Exception Tracking

Should all exceptions carry equal weight?

Of course not! Generally, those which have the greatest impact carry the most weight

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Exception Tracking

- How long should exceptions be reported?
  - 12 months?
  - 18 months?
  - Life of the loan?
  - May be different for each type of exception
- What is an acceptable level of exceptions?

  Will be different for each type of exception

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What to do with the exception tracking data?

- Measure banker performance
- Measure loan assistant performance
- Determine appropriate exception levels
- Identify specific areas of weakness/risk
- Prove to the banking regulators that you are managing the business!

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Let's Review

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Home Study Problem

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