Fundamentals of Assessing and Controlling Bank Lending Risk

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1. Introduction

Banks' lending activities are typically the main source of bank profitability and risk. Accordingly, the focal point of bank risk management examinations is usually assessing the quality of a bank's loan portfolio and bank management's capabilities in controlling loan portfolio risk.

The purpose of this article is to provide central bankers who are not involved in bank supervision matters with an overview of the foundations of sound bank lending, as well as how lenders control risks in underwriting individual loans through properly documented terms and conditions. First, the "Five C's of Credit" are discussed, followed by an overview of basic loan documentation used to protect a bank's interests should a borrower's financial condition materially weaken or they default on their loan repayment obligations. Bank examiners need to be proficient in these technical matters in order to properly assess loan portfolio risk.

❖ Part 1: The "Five C's of Credit"

Among all the lessons learned and relearned from past recessions, some bankers seem to suffer a memory lapse when it comes to the basics of credit, and nothing is probably more basic than the 5 C's of Credit – assessing a Borrower's **C**haracter, **C**apacity, **C**ollateral, **C**apital and external **C**onditions that may impact loan repayment.

These basic tenets of loan underwriting seem to have been discarded in favor of less labor-intensive approaches by many banks as has the evaluation of "character," or determining the "willingness" of the borrower to repay. There is a difference between the "willingness" and the "ability" of a borrower to repay a loan, so in the hope of breaking this repetitive cycle of recession and expansion, remission and recovery, let's examine the 5 C's, distinguish between willingness and ability to repay, and offer some old-fashioned guidance on how to evaluate it all.

The Five C's of Credit: Long Time Coming

The Five C's of Credit have been around for a long time, and their longevity suggests how useful they are in helping bankers remember what to evaluate in determining the creditworthiness of their borrowers. Four of the C's assess borrowers' ability to repay, and one of them their willingness to repay. The four C's that help us evaluate repayment ability include Collateral, Capacity, Capital and Conditions, but the C that assesses whether the borrower will actually perform is Character. Let us refresh our memories on what these five credit icons really mean, especially Character.

Character. Character can be defined as the complex of mental and ethical traits marking and often individualizing a person, group, or nation. Its synonyms include decency, dignity, nobility, quality, reputation, worth, honesty, and integrity. Typically ranked first among the five C's in determining creditworthiness, Character is a banker's way of summing up a borrower's determination to pay, and it is tested by cash shortages, hard times, and poor business conditions. The other C's have their places, but unless the borrower is willing to live up to his promise to repay the debt, the lender is taking a risk at the outset of the credit extension so great that the other C's are unlikely to offset a character failing. The borrower's willingness to honor obligations reflects the value the borrower puts on reputation, honesty, and integrity.

We can track character negatively, that is, by the lack of it, in a review of the borrower's payment history. Information reflecting negatively on the integrity of the borrower is critical because time and costs limit the extent and depth of investigation. Credit bureau reports and credit agency reports provide the necessary statistics, but of course, their inherent weakness is their reliance on past performance. No one's willingness to pay is tested in good times; it takes a recession to find out whether a borrower will honor his promises and meet his commitments.

So the analytical key to character is willingness to pay, probably the most difficult of the five C's to ascertain. The other Four C's of Credit can be quantified into measures of ability to pay, but there remains a wide gap between a borrower's available repayment funds and his willingness to part with them.

Capacity. Capacity usually follows Character as the second "C." Capacity is the ability of the borrower to operate the business successfully and generate the cash needed to repay obligations as they come due. Its synonyms include ampleness, sufficiency, room, extent, potential, ability, capability, adequacy, sufficiency, endowment, strength, endurance, and perseverance.

Capacity is sufficient power, enough strength, and adequate resources to start, maintain, and expand operations as the firm passes through its life cycle. It reflects the experience of the principals and the demonstrated ability of the business to operate successfully and profitably. Inherent in this "C" is the sum of experience, training, and skills that make someone successful. However, winning sport team coaches do not have to be the best players in their sports to be successful leaders of their teams. On the other hand, Enron's[1] management was viewed as an all-star ensemble, and in its October 1999 issue, CFO magazine named its chief financial officer Andrew Fastow as "CFO of the year" just two years before its failure. One by one, management's integrity was found to be wanting as Ken Lay, Jeff Skillings, and Andrew Fastow, among others, demonstrated that credentials are no substitute for character. Now let us look at the other C's to show in more detail how they differ from Character in their emphasis on ability to repay rather than willingness to repay.

Capital. Does the capable character have sufficient funds to "prime the pumps"? It takes money to make money, so the principals of a business must invest some funds in the beginning to cover start-up costs, acquire earning assets and provide working capital. Capital refers to the adequacy of funds needed by the business to allow it to operate efficiently in generating cash flow and effectively within its competitive business environment. Capital is what is needed to carry the firm past the breakeven point, profitable operations and satisfactory returns on equity. Its synonyms include principal, assets, stock, investment, funds, money, finances, savings, means, resources, wealth, riches, fortune, and treasure.

Conditions. Conditions connote the economic and environmental influences on the firm's financial condition and performance. Conditions represent the factors typically beyond the borrower's immediate and direct control, events sometimes referred to as force majeure in contracts. Regardless of who or what controls them, Conditions must be considered in any credit decision. Synonyms of Conditions include such phrases as the economy, the business climate, the business environment, the national outlook and the legal and regulatory situation.

Collateral. When all else fails, Collateral, the property pledged by a borrower to protect the interests of the lender, is the final source of repayment and stands guard as the last line of defense against loan loss. Synonyms of collateral include security, insurance, assurance, surety, guarantee, pledge, warrant, and endorsement.

Assets likely to retain their values in deteriorating business conditions make the most desirable kind of collateral and borrowers pledge these assets to offset weaknesses in the firm's capital and capacity. Further, sometimes the collateral cannot be liquidated easily, especially if the market for the Collateral evaporates. History is full of asset bubble blow-ups — from the 1637 collapse of the tulip bulb market in Holland to the eBay Beanie Babies frenzy a decade ago.

Oscar Wilde's advice to would-be gamblers is that "one should always play fairly when one has the winning cards." Some borrowers might argue that bankers have embraced Wilde's advice by stacking the repayment deck with cash flow, collateral, and guarantee cards. Lenders do expect their credit bets to be covered, but even uncollateralized loans to cash-poor borrowers ultimately get repaid if there is a big enough Character chip on the table.

How to Put Character Back into Credit: Some Good Questions

A good first step toward getting Character back into the credit game is for banks to decide whether their lending strategy is going to be based on transactions or relationships. Transaction lending's appeal is how quickly loans can be produced with the right pieces in place — centralized underwriting, standardized documentation, continuous monitoring. If priced satisfactorily, the transaction pays for itself, and the extra effort and cost associated with building relationships is avoided. A credit score on the principals and a trade payment report on the company are cheaper than the time and effort in calling on the client, reviewing financials, and custom fitting a lending solution to the unique needs and wants of the borrower.

It has been well documented in the banking literature that relationships turn out to be more profitable than transaction financing in the long run, and part of the long-term return is because in the relationship building, the lender identified a requisite degree of willingness to repay on time, as agreed, and in full. As the relationship grows, so does the mutual trust and commitment between the lender and the borrower. A high character "C" is likely to reduce both the probability of default and loss given default because even if the borrower is momentarily unable to repay on time or as agreed, he remains morally committed to repaying his obligations in full.

How does a banker identify Character? Bankers develop an appreciation of the diversity in the personalities, motives, and capabilities of the principals in the businesses their banks finance. Firms' aspirations and circumstances can and do change abruptly, so the face-to-face meeting allows the lender to read borrower body language as he asks these kinds of questions:

1. Has any of the principals ever walked away from a loan or refused to pay a creditor?
2. Is the firm or its principals delinquent in payment of its taxes, fees, licenses, etc.?
3. Have any of the principals or the firm ever been involved in deceptive, misleading, or fraudulent practices?
4. Do the firm and its principals fail to pay their creditors according to terms?
5. Do any of the firm's principals lack the skills, training, and experience necessary to perform their functional responsibilities?
6. Have any of the firm's principals misrepresented their background, experience, skills, training, or education?
7. Are the principals or the firm unwilling or unable to provide financial information?
8. Are the principals unwilling to offer personal guarantees, provide collateral, or accept any conditions or covenants?

9. Does the firm fail to meet its projections and/or meet its budget?

10. Do the firm's facilities appear poorly maintained, look unsafe, or feel uncomfortable?

11. Do the firm's management and major stockholders or its partners disagree about the firm's goals and objectives?

12. Are the principals unwilling or unable to provide references from colleagues, competitors, suppliers, lenders, customers, lawyers, accountants, etc.?

An affirmative answer to one or more of these questions raises a red flag warning of questionable character. Some of the answers to the questions can be found in credit bureau reports and credit agency reports. Internet searches of public records and local media archives are another way to find answers to these questions. Other answers come from personal inquiries of people and entities that have had dealings with the borrower. Some questions may have to be posed directly and tactfully to the borrower, and reticent responses may in themselves reveal some potential character flaws.

Nothing on this list is new or unique. Guess what? It was not so long ago that the 12 questions above and others like them were part of the credit investigation, evaluation, and analysis of prospective borrowers. Yes, it takes some time and effort, but that is part of knowing your customer and in the end, you have also documented the borrower's character.

Conclusion: the C's Have It

The Five C's of Credit are no panacea for the solution to today's credit challenges, but they do provide a concise checklist for evaluating a borrower's "ability" and "willingness" to pay. Today's bitter irony is that while the banking industry has improved its quantitative skills in assessing ability to repay, of the Five C's, Character is becoming harder to assess in our increasingly impersonal, faceless society. Our "Twittery, Facebooked, Instagrammed" culture makes it easier to avoid invasive, in-your-face, watch the-body-language interrogation in favor of less time-consuming, external, out-of-sight intelligence. These impersonal measures of character suffer the same weakness that relegate spy satellites a poor second option behind on-the-ground intelligence.

A satisfactory credit score may reflect more a positive combination of Capacity, Capital, Conditions, and Collateral, making ability to repay possible, but as conditions deteriorate and Capacity, Capital, and Collateral shrink, the credit score only serves as a historic record of the borrower's repayment activities. What if the borrower enters into an economic environment much tougher than those in recent years, such as the current period compared to the recession-lite years of 1999–2001, for example? Perhaps it is time to readjust the weight we put on each of the five C's, to look at character harder, and to know our customer more. Let us narrow the gap between ability to repay and willingness to pay by assessing character better. Our banker's battery of covenants and conditions, guarantees and collateral, notes and agreements add up to an expensive barrier against dishonest borrowers. That is a high price to pay compared to meeting with the customer, making inquiries of the borrower's other creditors and business associates, reviewing payment practices, and building a relationship with the client.

We expect our borrowers to be able and willing to repay their debts, and we avoid those who practice Napoleon's philosophy on success, "If you wish to be a success in the world, promise everything, deliver nothing." Napoleon might have been more successful by following the advice of the Roman playwright Terence, "You can take a chance with any man who pays his bills on time." Terence knew character when he saw it. So should lenders.

❖ Part 2: Basic Loan Documentation

Anyone who has ever worked in loan documentation preparation has probably had to work around the clock to meet a closing deadline, and the involvement of bankers unfamiliar with basic loan documentation can sometimes run out the clock. So what do bankers need to know about loan documentation to keep the doc clock running on time?

The Basics

It is essential that bankers have a thorough understanding of the types, purpose and content or loan documentation which is used to protect the bank's interests in a loan contract. Loans documentation plays two basic roles:

1. Loan documents represent a contract between the borrower and the bank that defines:

    - The responsibilities of the borrower in repaying the loan in full, on time, and as agreed
    - The rights of the bank for repayment of the loan

2. Full repayment of the loan's principal and interest is the primary responsibility of the borrower, and the bank usually expects the cash flow from the borrower's business to repay the loan. If the borrower's business cash flow falls short, the bank may also require additional repayment from alternative sources including liquidation of collateral and exercise of personal guaranties. The bank's loan documents will spell out all the rights and actions the bank may take to collect the loan.

Of course, the bank's loan documents are bank-friendly. After all, the bank is risking its funds when it lends to the borrower. Typically, the borrower uses the loan proceeds in its business to earn a profit, and in providing the opportunity for the borrower to earn that profit, the bank has the right to have the loan principal repaid and to collect interest income and fees. Making that right legally enforceable requires some key loan documents, so now let's identify and explain these key loan documents — promissory note, commercial loan agreement, collateral documents.

Promissory Note. The promissory note is the fundamental loan document. The note "evidences the indebtedness of the borrower." Simply put, by executing, i.e., signing the note, the borrower is acknowledging the act of borrowing money from the bank and, more importantly, promising to repay the borrowed amount plus interest.

The note defines the most basic terms of the loan:

- Loan amount
- Interest rate
- Repayment terms

Default. The note also addresses "default". An "event of default" occurs when the borrower does not comply with one or more terms or conditions of the loan. The most basic act of default is payment default. For example, if a borrower does not make a loan payment within 30 days of the due date – the borrower has defaulted in payment ("payment default"). If an event of default occurs, the bank typically has the right to "call the loan" meaning that full repayment of the loan's principal and interest is immediately due. The bank communicates "calling the loan" in writing to the customer.

Besides payment default, there is also technical (or compliance) default. Technical default occurs when the borrower does not comply with any term or condition of the loan other than payment default. Technical default can range from not providing the required periodic financial statements to the occurrence of a "material adverse change" ("MAC") in the condition of the borrowing entity. A MAC event is so severe that it threatens the ability of a borrower to repay the loan.

Grace or "Cure" Period. Banks typically provide the borrower with a grace period, also known as the "cure period," of say 10 or 15 days, to remedy technical defaults. If the borrower does not cure the default within the grace period, the bank has the legal right to call the loan. However, most banks are unlikely to call a loan because of a technical default unless the default impairs the borrower's ability to repay the loan. Nevertheless, repeated technical defaults may cause the bank to renegotiate the loan and supporting documents.

A MAC is hard for a borrower to swallow. As explained earlier, a MAC is the occurrence of an internal or external event that materially weakens the ability of the borrower to repay the bank's loan. MAC's include such events as a substantial judgement levied against the borrower's business or assets or the loss of a major customer. But a MAC implicitly relies on fuzzy words like "material," "major," "substantial," "significant," so unless these adjectives are defined quantitatively, e.g., major customer defined as generating 25% or more of annual revenues, invoking a MAC can be a very subjective call best made with sound legal guidance and concurrence of senior bank management.

The note generally includes two other vital default sections:

- **Default Rate of Interest** – After an event of default occurs, the Bank may want to increase the loan's rate of interest by some percentage, e.g., 2% or 3%. Why boost the rate on borrower having trouble paying the current interest rate? The rate is supposed to reward the bank for credit risk, and a defaulted loan is a higher risk. Ideally, the bank should earn a higher return on a defaulted loan, and if the threat of a higher interest rate induces the borrower to counter with more collateral, another guarantor, or even a co-borrower, the lender can also think of this provision as an additional negotiating tool.

- **Right of Setoff** - Under the right of setoff, if an event of default occurs, the bank can draw from the borrower's depository accounts the funds needed to cover the unpaid principal, interest, and fees.

Commercial Loan Agreement. The loan agreement serves two purposes:

1. **Bill of Health** – The loan agreement contains several representations and warranties regarding the "health" of the borrower. These representations and warranties usually include:

   - Accuracy of Financial Information – The financial information provided by the borrower to the bank is complete and accurate.
   - Good Standing - The borrower is a properly formed legal organization in good standing with all applicable licenses in the jurisdiction(s) where it operates.
   - Taxes – The borrower is current on all tax payments, e.g., income, sales and real estate taxes.
   - Liens and Judgments – the borrower has no material liens or judgments against it.
   - Environmental – The borrower complies with all environmental laws and regulations.

The borrower's "representations and warranties" assure the bank lender that the borrower is a law-abiding citizen. For large loan transactions and an additional layer of protection, the bank may require the borrower's attorney to make representations and warranties regarding the health of the borrower in the form of a borrower's attorney's opinion of counsel letter addressed to the bank.

2. **Covenants** – While conditions require the borrower to be in healthy shape at the inception of the loan, the bank may want to govern the borrower's behavior going forward over the course of the loan by imposing affirmative "must do" covenants and negative "must not do" covenants.

   - Affirmative Covenants – Affirmative covenants require the borrower to do something, such as:

     - Maintain qualified management for the business
     - Provide annual financial statements and tax returns to the bank
     - Maintain insurance on the borrower's business assets
     - Promptly notify the bank of any material adverse changes, e.g., death of a principal, damage to the borrower's facilities, loss of copyright protection for its software products, etc.
     - Comply with all terms and conditions of all the applicable loan documents
     - Comply with financial covenants requiring some minimum level, e.g., current ratio of 2.0x (i.e., current assets are two times current liabilities), working capital of at least USD 1,000,000, etc.

   - Negative Covenants - Negative covenants are prohibit the borrower from taking some action unless given prior bank approval, such as:

     - Not selling the borrower's business assets
     - Not changing the ownership of business
     - Not starting or acquiring a new line of business
     - Not incurring any liens or indebtedness outside of the normal course of business such as accounts payable or accrued expenses. Specifically, this covenant prohibits the borrower from borrowing money from another lender.
     - Not making any loans or guaranteeing the debts of another entity of individual.
     - Not exceeding financial covenant limits, e.g., debt/worth ratio of no more than 1.5x, capital expenditures of no more than USD 50,000 annually, etc.

Violation of any affirmative or negative covenant constitutes an event of default. Covenants are not intended to ensure that the borrower operates the business in a manner that protects the bank's right to repayment.

Collateral Documents. A bank usually takes as collateral the borrower's assets that the bank is financing, e.g., inventory, accounts receivable, equipment, real estate, etc. What differentiates real estate from non-real estate property is its fixity. Real property isn't going anywhere; it is fixed in place, and the current owner's rights to the property are granted by the governmental entity having jurisdiction over it. Therefore, perfecting a security interest in a borrower's assets necessitates separating real estate from non-real estate property. Real property is real estate, and real estate is governed by federal or local law. On the other hand, personal property includes all the other non-real estate assets, e.g., inventory, accounts receivable, equipment, stocks, bonds, certificates of deposits, customer lists, patents and copyrights. Personal property is generally governed by separate federal or local laws.

Personal Property. Collateralizing a loan with personal property is usually a two-step process involving, first, the creation of a security interest, and, second, perfecting the security interest:

1. Creating a Security Interest – the security interest is created using a "security agreement" that identifies

    - The borrowing relationship between the bank and the borrower
    - The assets comprising the bank's collateral
    - The bank's rights - If the borrower defaults and the bank calls the loan, the bank has the right to take possession of the collateral and liquidate it. Upon liquidation – the bank can use the proceeds to pay down the loan principal and related amounts of unpaid interest, fees, and collection costs. Any leftover proceeds are returned to the borrower.

2. Perfecting the Security Interest – Once the security interest is created via the "security agreement," the bank must "perfect the lien" by recording the lien in a specified "public record." The most common way to "perfect the security interest" on personal property is to file a standard governmental document with the appropriate governmental official in the national or local jurisdiction where the borrower is incorporated. Some types of personal property, mainly, transportation equipment such as vehicles, boats, planes, require additional steps to perfect the lien, sometimes including actual possession of the vehicle titles by the lender.

Real Property. For real property, a "mortgage" document is used instead of a security agreement to identify the collateral and record the bank's rights to the collateral. The mortgage is then filed with the appropriate jurisdictional official to perfect the lien.

Mortgages include several unique provisions that can vary from jurisdiction to jurisdiction:

- "Grantor" – Mortgages tend to call the borrower "the grantor." The "grantor" is the person or entity that owns the real estate being pledged as collateral. In most cases, the grantor is the borrower.
- Loan Specific – A mortgage must include the date and amount of the loan note collateralized by the real estate. If the real estate collateralizes more than one loan, each of those loans' promissory note date and amount must be included in the mortgage. If a loan amount is subsequently increased, the mortgage must be amended to reflect the revised loan amount, or a new mortgage executed.
- Insurance and Taxes – the grantor is required to maintain casualty insurance on the property and pay real estate taxes on the property. If the grantor cannot pay for insurance, the bank usually has the right to obtain insurance coverage on the property to protect the collateral. If the grantor does not pay real estate taxes, the taxing authority can file a tax lien on the collateral property. A government tax lien takes priority over the bank's first mortgage. To protect the bank's position, the mortgage typically allows the bank to pay the taxes and preclude a tax lien from being filed. The bank can then seek to recover from the borrower the real estate collateral's insurance and tax amounts paid by the bank.
- Notarization – The signing of the mortgage usually must be witnessed and notarized by a notary public or other licensed official that can validate the signatory's identity.

Guaranty Agreement. The final basic loan document is the Guaranty Agreement. Most business loans are personally guaranteed by the business owner(s). Once the bank declares the borrower to be in default, besides the bank's right to liquidate the borrower's collateral, the guaranty agreement gives the lender the right to demand payment of the remaining balance from the guarantor(s). Upon the borrower's default, the guarantor then becomes responsible for repaying the loan.

The standard bank guaranty is usually unlimited in amount, i.e., the guaranty applies to all amounts unpaid--principal, interest, fees and collection costs. The guaranty typically applies to all loans from the bank to the borrowing entity at the time the guaranty is signed plus any future loans made to that borrower. However, if new loans are subsequently made to the borrower, it is prudent to have a new guaranty agreement executed.

The standard guaranty includes several key provisions:

- Order of action – If a loan goes into default and the bank calls the loan, the bank has the right to immediately pursue payment from the guarantor. The bank does not have to exhaust its rights against the borrower and collateral before pursuing payment by the guarantor.

- Right of Setoff - Under the right of setoff, if default occurs, the bank can charge the guarantor's deposit and/or savings accounts maintained with the bank for the unpaid loan amounts.
- Subordination – All loans from the guarantor to the borrower are subordinated to the bank's loans to the borrower. No payments on these loans are allowed unless approved by the bank.
- Witness to the Guaranty - This requirement serves to eliminate any future question as to whether the guarantor signed the guaranty agreement.

Post-Closing Compliance. A standard note and loan agreement typically includes a "post-closing compliance" clause. Under this clause, if there are any errors in the closing documentation, the borrower is obligated to cooperate with the bank in correcting the mistakes.

Additional Documentation. Depending on the loan and local jurisdictional requirements, there may be other loan documents needed to properly document a loan and support its legal enforceability.

2. Summary

Lenders and bank examiners need to be technically competent and pay close attention to detail in ensuring that proper loan documentation exists so that the loan contract is legally enforceable and the bank can pursue its remedies and protect its interests if a borrower defaults. Credit officers as well as bank examiners need to know how each piece of loan documentation contributes to the construction of a legally enforceable contract. Knowing why each document is needed enables the banker to competently and confidently explain the documents to the borrower. This knowledge also girds the lender for inevitable demands from the borrower to revise or delete portions of the loan documentation. Making the loan is a good beginning, but an even better ending is collecting the loan in full, on time, and as agreed.

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Endnotes

1. Enron Corporation was a large, renowned U.S. American energy, commodities, and services company based in Houston, Texas, which failed in 2001 in due to widespread accounting fraud. Enron was the sixth largest corporate bankruptcy in U.S. history.