Bank Lending Practices that Can Lead to Future Loan Portfolio Problems

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1. Introduction and Background

Most bank profitability is derived from assuming credit risk. Banks accept deposits and other funding liabilities which they use to make loans and purchase debt securities to generate revenue that exceeds their funding and overhead costs, producing a net profit. Banks' ability to identify, measure, evaluate, monitor, control and price credit risk is critical to achieving their strategic objectives and maximizing financial performance in a safe and sound manner.

There is an adage among many seasoned bank supervisors that "bad loans are made in good times." This maxim reflects their professional experience that banks tend to relax loan underwriting standards and loan terms and pricing during extended periods of favorable economic conditions. Bank managements often justify looser loan underwriting standards and pricing by asserting they are necessary to match the actions of competitors in order to retain loan customers, expand business, or meet short-term performance goals.

In the years preceding the Great Financial Crisis of 2007-2008 (the "Crisis"), the economy seemed to be stable. This led some lenders to take greater risks that allowed less stringent bank credit risk management practices to proliferate. Bank credit underwriting standards – especially assessing borrower repayment capacity and valuing collateral – became lax. A sizeable price bubble developed in many domestic real estate markets. Some banker compensation schemes became tied to improper incentives, such as loan portfolio growth, inducing imprudent lending strategies such as subprime residential housing loans, home equity lending, and "no-doc and low-doc" mortgage lending. The "good times," fueled in part by these risky credit products, ended abruptly when residential real estate markets began to experience sharp price declines, in some cases 30%-40% from peak values.

Unfortunately, when economic activity eventually declines or recessionary forces emerge, banks that engaged in riskier lending practices frequently experience a sharp rise in loan payment delinquencies, defaults, restructurings, foreclosures and losses. After the fact, the risks of lax or unsound bank lending practices that had an unfavorable outcome may seem obvious. However, many post-mortem analyses from recent banking crises identified lending "red flags" and risks that were evident pre-crisis, but which were either underestimated, dismissed or not recognized.

The objective of this article is to provide an overview of the elements of sound bank credit risk management, especially as they relate to commercial lending, since that lending category usually poses the most risk. The article also discusses some examples of "red flags" or circumstances that should receive scrutiny by bank supervisors as they may indicate situations that can lead to excessive risk or problems.

2. Credit Risk Control Infrastructure

Basel Core Principles for Effective Supervision

The Basel Committee on Banking Supervision ("BCBS") is the international standards-setter for the banking industry. The BCBS has specified the essential preconditions and standards that are necessary to have an effective supervisory regime in its "Core Principles for Effective Supervision" ("BCP"). The latest version of the BCP was published in September 2012 and contains 29 principles. Principals 17, 18 and 19 relate to credit risk management:

> "Principle 17 – Credit risk: The supervisor determines that banks have an adequate credit risk management process that takes into account their risk appetite, risk profile and market and macroeconomic conditions. This includes prudent policies and processes to identify measure, evaluate, monitor, report and control or mitigate credit risk (including counterparty credit risk) on a timely basis. The full credit lifecycle is covered including credit underwriting, credit evaluation, and the ongoing management of the bank's loan and investment portfolios.
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> Principle 18 – Problem assets, provisions and reserves: The supervisor determines that banks have adequate policies and processes for the early identification and management of problem assets, and the maintenance of adequate provisions and reserves.
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> Principle 19 – Concentration risk and large exposure limits: The supervisor determines that banks have adequate policies and processes to identify, measure, evaluate, monitor, report and control or mitigate concentrations of risk on a timely basis. Supervisors set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties."[1]

Elements of Effective Credit Risk Control

Effective Credit Risk Control is a process of checks and balances which includes:

- Specification of the roles and responsibilities of banks' boards of directors and senior executive management;

- Board committee structures and processes for effective risk oversight;
- Setting the bank's risk strategy and establishing a sound credit risk culture;
- Establishing appropriate individual and committee lending authorities;
- Developing comprehensive lending policies and procedures and exception reporting; and,
- Establishing an independent loan review process.

Bank supervisors should require that banks have an effective system in place to identify measure, monitor and control credit risk as part of an overall approach to risk management. They should conduct an independent evaluation of a bank's strategies, policies, procedures and practices related to the granting of credit and the ongoing management of the portfolio.

Bank Lending Policies

Banks should establish written lending policies and related operating procedures to guide bank personnel in administering the credit-granting process properly to ensure that credit exposures are consistent with prudential standards and internal limits. Policies should be reviewed and approved by the board annually and updated as needed to ensure their continued relevance.

Permissions required for policy exceptions, also known as policy overrides, should be tightly controlled, with a mechanism for secondary review and reporting to senior executive management and possibly the board. Frequent overrides are a "red flag" that could indicate that loan policy provisions being overridden are either out-of-date or that there is the possibility that policy waivers may not have proper justification.

Establishing a Sound Credit Risk Culture

During the Crisis, banks operating in the same trade area experienced significantly different results. Some made it through the Crisis relatively unscathed, while others experienced significant losses and in some cases failed. What were the reasons for the differential performance? In my opinion, it largely due to differences in the quality of banks' credit risk management and especially their risk cultures.

What is meant by "risk culture"? Risk culture encompasses the following considerations:

- Is the bank's board of directors actively engaged in overseeing executive management and serving as an effective check and balance against excessive risk-taking?
- Does the board clearly and formally articulate the bank's risk tolerance, reinforced by incentive arrangements?

- Do the actions of senior bank leadership and "tone from the top" reinforce the stated risk appetite?
- Do the bank's risk management systems and controls and governance arrangements allow bank executive management and board of directors to effectively measure, monitor, and control risk close to "real time?"
- Is the bank's board aware of changing external factors that could impact risk appetite and loan portfolio performance?
- Do those involved in credit-granting have a consistent understanding of what lending risks are acceptable in the bank and what credit proposals would likely be problematic?

Independent Loan Review

The ability to accurately monitor loan portfolio quality is essential to generating reliable data that allows a bank's board of directors and senior executive management to know the level and trend of overall credit risk on a continuing basis. The loan review process should be conducted by experts who are independent of a bank's lending function to prevent conflicts of interest and ensure objectivity.

3. Potential Sources of Excessive Credit Risk or Unsound Lending Practices

Over-Emphasis on Collateral Values in Loan Underwriting Decisions

There are several ways most commercial loans get repaid:

- Cash flow generated by a borrower's business and/or pledged collateral;
- Sale of collateral securing the loan; or
- Refinancing the loan with another lender.

The typical source of commercial loan repayment is through cash flow generated by the borrower's business. Without getting too deeply into the technical details, lenders analyze historical business performance and make assumptions about future sustainable cash flow. Cash flow is computed by adding non-cash expenses, such as depreciation and amortization, to net income.

Loan underwriting decisions should be based on the analytically supported determination that the borrower can continue to generate sufficient profitability and cash flow to pay principal and interest on a timely basis. Lending policies may specify minimum cash flow requirements above required principal and interest payments, and may formally require this by imposing those requirements in loan contracts (these requirements are referred to as loan covenants). Failure to adhere to loan covenants usually constitutes an event of loan default.

Lenders should carefully assess the value of any collateral pledged to secure a loan. In the event of loan default which cannot be cured by the borrower, the lender may need to foreclose on the collateral and sell it, using the sales proceeds to offset any outstanding loan principal and interest.

Frequently, commercial loans have real estate collateral such as an office building or business premises or equipment used in a borrower's business. Banking regulations usually require that valuations of loan collateral be supported by independent assessments conducted by credentialed professionals such as certified real estate appraisers. Loan offering memoranda (which contain a bank's internal analysis supporting a loan proposal) need to carefully document analysis of appraisal assumptions and computational methodologies to substantiate that the estimated collateral value is reliable.

Credit problems sometimes arise when lenders move away from a loan underwriting approach which considers both borrower repayment capacity and collateral protection, and places disproportionate weight on collateral values to support lending decisions. This risk is especially prevalent during periods of sustained escalation in commercial property values. Bankers sometimes assume that collateral values will continue to go up, dismissing the risk that markets are cyclical and that collateral may experience large reductions in value under disorderly market conditions.

The use of faulty or overly optimistic assumptions in collateral appraisals can generate unreliable collateral valuations. For many commercial real estate properties, appraisers project future cash flows and compute a net present value using an appropriate discount rate. Any inaccuracies in the computational inputs, such as the chosen discount rate (which the appraiser must justify), can materially undermine the reliability of the appraisal and lead to unsound lending decisions.

Rollover of Delinquent Loans Can Mask Loan Problems

There are some lending practices that may have the intended or unintended effect of masking potential loan problems. For example, a one year unsecured term loan with principal and interest due at maturity becomes due and payable. The borrower cannot pay the principal and interest due. To avoid reporting a loan delinquency, the loan officer renews the loan for another year, paying the interest due on the original loan by adding it to the principal balance of the new loan. Depending on the circumstances, the practice might not be objectionable if there is a financially strong borrower who is seeking a renewal for convenience. However, in the case where the borrower cannot pay, the renewal is problematic. A variation of this situation is the granting of separate loans to pay interest.

Rapid Growth

During boom times, some banks embark on a rapid expansion of their loan portfolios. This can lead to problems if the volume of activity exceeds the capacity of bank staff to maintain adequate quality control, which is frequently the case.

Credit Risk Assessment in Financial Conglomerates' Subsidiary Banks

Large banking conglomerates may centralize certain loan underwriting and risk control functions with the parent company or another affiliate. Bank board members may be expected by the parent to approve purchases of participations in large syndicated credit originated by affiliated banks. Such "outsourcing" arrangements do not relieve the board and senior executive management from exercising independent control over the institution's lending function and for responsibility for sound outcomes.

4. Concluding Remarks

The Asia Pacific region, while affected by the Crisis, has avoided a major cross-border banking crisis since 1997-1998. Continuance of that status depends in large measure on maintaining sound lending practices. Hopefully the foregoing commentary provides some insights on the attributes of sound credit risk management as well as some specific lending practices that can lead to difficulties.

Endnotes

1. Basel Committee on Banking Supervision. 2012. *Core Principles for Effective Banking Supervision*. Basel, Switzerland: Bank for International Settlements, pp. 11-12, available at www.bis.org/publ/bcbs230.htm