RISK RATING: THE COMMON LANGUAGE OF CREDIT

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INTRODUCTION

Since the fall out and recovery from the financial crisis and the recession that followed, institutions have had to grapple with three main issues: restoring the strength of their balance sheet in the wake of the crisis, grappling with increased competition and compressed spreads in a perennially low-rate environment, and dealing with heightened scrutiny from regulators and auditors. With balance sheets returning to strength after years of recession and restricted lending, financial institutions have largely dealt with the first challenge—it is the other two—low-interest rates and increased regulation—that show no sign of letting up.

INTRODUCTION (CONT.)

RESOURCE:

Complimentary whitepaper:
The Definitive Guide to Global Cash Flow

Download whitepaper

These two challenges pull institutions in opposite directions. Historically low-interest rates have led to a razor-thin spread, pushing institutions to take on more risk in search of growth and margin; meanwhile the heightened regulatory environment often has precisely the opposite effect—reigning in risk to ensure balance sheets are capable of withstanding stress tests and economic shocks. Institutions looking to actively and aggressively expand—either through M&A or increased lending—are further faced by the challenges of competing in a crowded market. Navigating this dilemma—growing the portfolio while quantifying and managing risk—is thus emerging as one of the key challenges that institutions face in the post-crisis era.

It is in response to this challenge that having a comprehensive and precise risk rating system becomes absolutely crucial. Though many institutions have long had a process for generating risk ratings in place, in many cases it is plagued by several well-known issues. The most fundamental problem is not having a standard risk rating model in place. In practice, this may mean that risk ratings are set by the whims of credit analysts or lenders. But even those institutions that have a formal risk rating model in place will encounter challenges if the process is not consistently followed. As we will see in more detail later, this in turn impacts a number of different crucial functions—from accurately pricing the loan, to loan administration and finally to calculating the ALLL. Having a comprehensive risk rating that is consistently applied affects virtually every area of credit and risk management throughout the institution.

WHY YOU SHOULD CARE ABOUT **RISK RATING**

The short answer is because regulators and auditors do. Indeed, in a handbook on credit risk published by the OCC, regulators begin by stating:

> *Credit risk is the primary financial risk in the banking system and exists in virtually all income-producing activities. How a bank selects and manages its credit risk is critically important to its performance over time; indeed, capital depletion through loan losses has been the proximate cause of most institution failures. Identifying and rating credit risk is the essential first step in managing it effectively.*[1]

By creating a uniform process for rating credits, institutions are guarding against what regulators take to be the biggest risk facing their institution: credit risk.

There are also non-regulatory reasons to care about having an effective risk rating process. Notice that the OCC speaks of both selecting and managing credit risk. This helps illustrate the fact that risk rating is a tool primarily for quantifying and managing, not restricting risk. Each institution has a particular risk appetite—the amount of risk that it's willing to take on given a host of considerations: the desire to grow, the current make-up of the portfolio, their capital cushion and the interest rate and general economic environment. Risk rating is thus not necessarily a means of restricting, but rather calibrating and optimizing, risk.

WHY YOU SHOULD CARE ABOUT **RISK RATING** (CONT.)

There is a final reason that institutions should take risk rating seriously: assigning a single number to a credit is an easy and efficient way of distilling hours of analysis and research into a figure that can be readily compared. By giving every credit a numerical risk rating, institutions can easily compare the riskiness of one deal to the rest of its portfolio without having to re-analyze spreads and key metrics. Distilling the credit risk of a loan into a single metric has other benefits: it can be tracked over time, to see both the evolution of a single credit as well as the portfolio as a whole; it is a consistent and easy way to talk about credit risk throughout the life of the loan, from underwriting to calculating ALLL (more on this later).

In short, institutions should take their risk rating process seriously not only because their regulators and auditors do, but also because it serves as an efficient management tool to calibrate, track and manage risk.

PASS					SPECIAL MENTION	SUB-STANDARD	DOUBTFUL	LOSS
1	2	3	4	5	6	7	8	9
Largely risk free	Minimal risk	Modest risk	Bankable	Additional review	Criticized	Classified	Classified	Classified
>2.5x	>1.75x	>1.4x	>1.2x	>1.0x	<1.0x	<1.0x	<1.0x	<1.0x

Example Risk Ratings Scale

WHAT CRITERIA SHOULD YOU LOOK **FOR IN RISK RATING?**

Institutions that decide to create, evaluate or revamp their risk rating framework and processes should do so with several criteria in mind. While certainly not the only measures that should be considered when crafting a risk rating system, the below rules can be particularly helpful in ensuring that risk ratings are a robust risk management tool.

Key Takeaway:
"If credit risk is the main threat to the institution's solvency and growth prospects and if risk ratings are a key tool in understanding credit risk, then it follows that the board of directors must have a deep understanding of the role that risk ratings play."

Board of directors should understand and approve the risk rating system. According to the OCC, the board should also "receive sufficient information to oversee management's implementation of the process."[1] It is essential for the board of directors to have a clear understanding of the institution's risk rating process so that they can align their lending practices with their strategic focus, ensure that management is consistently applying the agreed upon framework to all credits, and to proactively manage the levels of risk in the portfolio. If credit risk is the main threat to the institution's solvency and growth prospects and if risk ratings are a key tool in understanding credit risk, then it follows that the board of directors must have a deep understanding of the role that risk ratings play.

There should be an adequate number of ratings that allow for a clear differentiation in the levels of risk. A recent Sageworks article on the topic notes, "It's important to have varying degrees of pass ratings in order to appropriately differentiate between risk levels of non-adversely rated loans. This is critical in determining the amount of credit to be extended, the structure of the loan offered (collateral required, covenants, etc.), loan pricing, frequency of review, frequency of contact with the borrower, appropriate ALLL reserves and strategic decisions related to concentrations of credit."

WHAT CRITERIA SHOULD YOU LOOK **FOR IN RISK RATING?** (CONT.)

Risk ratings should be dynamic and timely. The rating should be capable of adjusting to different levels of risk. For example, if during the annual review process the DSCR increases or decreases by a material amount, this should likewise impact the risk rating for that loan. The risk rating should thus be responsive to a range of different factors: change in the quality of collateral, improvement or decline in the health of an industry, payment history and so forth.

Example risk criteria for capacity of borrower:

CAPACITY	RISK SCORE		WEIGHT	RAW SCORE
Current DSCR	_______	X	20%	=_________
Historical DSCR	_______	X	20%	=_________
Income Sensitivity	_______	X	10%	=_________
Rate Sensitivity	_______	X	10%	=_________
Bus. Credit Score	_______	X	10%	=_________
Customer Base/Lease	_______	X	30%	=_________
			CAPACITY =	_________

Risk ratings should also be back-tested in order to ensure that they have predictive power—that is, lower risk ratings should have a lower probability of default. Institutions should back-test their portfolio to measure whether or not their risk rating system is an adequate measure of risk. For example, credits that had a risk rating three should, taken as a whole, lead to fewer and less costly defaults than those rated a five. If the risk rating process does not have predictive power, the institution should redesign their risk rating templates.

WHAT CRITERIA SHOULD YOU LOOK **FOR IN RISK RATING?** (CONT.)

Finally, the risk rating process should be well documented. In practice, this means two things. First, it requires that the data used to risk rate a particular credit is readily available. This information should be easy to find so that auditors and regulators can quickly validate that the institution's declared risk rating process is used consistently across the portfolio. Secondly, this requires that there is a clear and easy to use template to risk rate loans. Depending on the composition of the portfolio, it is often a good idea to have multiple different templates. For example, the template used to risk rate a CRE loan will be considerably different than one used to rate a construction loan. This template should take into account a variety of factors. See, for example, a recent Sageworks presentation on the Five Cs of Credit.

Capacity	Capital	Conditions	Collateral	Character
Measures a borrower's ability to repay a loan by comparing income against recurring debts	Refers to the net worth or equity of a business	Characterizes the economic, industry and market environment, which can and will change	Estimates the collateral available to secure the debt	Assesses the personal integrity of business owners and guarantors
Key question: *Can the borrower generate adequate cash to repay the loan?*	**Key question:** *Is the borrower adequately capitalized within industry standards to withstand unexpected loss?*	**Key question:** *Is the borrower flexible enough to adapt to changing conditions?*	**Key question:** *Is there an alternative source of repayment is the primary source fails?*	**Key question:** *Is management willing to repay the loan and will it attempt to do so under adverse conditions?*

HOW DOES RISK RATING AFFECT **OTHER INTERNAL PROCESSES?**

As we have seen, one of the reasons having a comprehensive risk rating system is so important is because it impacts so many other processes at the institution. In this sense, risk ratings are the "common language" that can be spoken throughout the life of the loan. Most other metrics and processes are only useful at a particular time. Underwriting and stress testing, for example, require very different skill sets and processes. Risk rating, however, helps to underpin and unite the entire process, as it is used in virtually every step in the life of the loan. Though the below list is not comprehensive, it helps to give a sense of just how deeply risk rating permeates portfolio management.

RESOURCE:

Complimentary whitepaper: Predicting Credit Risk

Download Whitepaper

Credit Analysis—risk ratings help to distill hours of credit research into a single number that can be tracked over time. By assigning a credit a single number, institutions can then aggregate these metrics and track the overall trends of the portfolio.

Loan Pricing—there are two mistakes that can be made when pricing a loan. The first, pricing the loan too high, can lead to lost business as borrowers are able to find a more competitive rate from rival lenders. The second, pricing the loan too low, means that the institution is taking on uncompensated risk, thus decreasing profitability and harming key performance metrics. An accurate and reliable risk rating process can help lenders avoid both of these mistakes—allowing the institution to remain competitive on rates, while still being adequately compensated for the risk that they take on. When combined with a loan pricing model, risk ratings help lenders know what price to set and potentially when to walk away from a loan or renewal.

HOW DOES RISK RATING AFFECT **OTHER INTERNAL PROCESSES?**

Loan Administration—high risk loans require more institutional oversight, as lenders will want to ensure that the borrower remains capable of making payments. This often entails collecting and analyzing financials every year, and in some cases on an interim basis as well. Lower risk loans, however, require less oversight. Similar to the loan pricing trap, failure to accurately judge risk will lead institutions to either waste labor on supervising low-risk loans or take on unnecessary risk by failing to monitor high-risk loans. The solution, of course, is to tailor the loan administration process to the riskiness of the credit, and in order to do this effectively, an accurate risk rating is required.

RESOURCE:

Complimentary whitepaper: 2015 Review: FASB's CECL Model

Download Whitepaper

ALLL and Stress Testing—finally, the risk rating is also a crucial component when it comes time to set the reserve and stress test the portfolio. ALLL and stress testing quantify and manage risk at the portfolio level, but risk ratings are nonetheless a crucial component in those analyses. The portfolio is, after all, made up of individual credits. Assigning an accurate risk rating to each loan, and updating that risk rating on a regular basis allows managers and the board to have an up to date measure of risk in the portfolio, which is necessary in order to achieve key strategic objectives, set the reserve and protect the financial health of the institution.

For example some key reports to review could include:

- Migration of risk ratings by segment
- Exposure in watch, special mention or substandard loans
- Changes in risk ratings under stress scenarios
- Risk rating by loan officer

CONCLUSION

Risk rating is an integral function for financial institutions in order to accurately quantify, manage and mitigate their risk. It is important to remember that this process is not necessarily restrictive—rather, it helps the institution fulfill it's strategic mission and align the portfolio with its given risk appetite. In today's competitive, low rate environment where borrowers often have more than one option, accurately gauging risk can make the difference between winning and losing new business. It likewise helps institutions guard against taking uncompensated risks, accurately calculate their reserves and conduct a comprehensive stress test. This is why risk rating is the "common language" of credit risk management.

Endnotes

1 "Rating Credit Risk." OCC.gov. Comptroller of the Currency Administer of National Banks. Web. Accessed 4/1/16.

http://www.occ.treas.gov/publications/publications-by-type/comptrollers-handbook/rcr.pdf

ADDITIONAL **RESOURCES**

"Quantifying the 5 Cs: Credit Analysis Ratios that Matter," *Sageworks*.

http://web.sageworks.com/quantifying-5-cs-credit-analysis/

"Predicting Credit Risk: Smarter Loan Decisions and Risk Management," *Sageworks*.

http://web.sageworks.com/predicting-credit-risk/

"The Definitive Guide to Global Cash Flow," *Sageworks*.

http://web.sageworks.com/global-cash-flow-software/

ABOUT **SAGEWORKS**

About Sageworks

Sageworks is a financial information company working with financial institutions, accountants and private-company executives across North America to collect and interpret financial information. Thousands of bankers rely on Sageworks' solutions to streamline credit analysis and agricultural lending, loan pricing, risk rating, portfolio stress testing, loan administration, workflow and ALLL calculation. Sageworks is also an industry thought leader, regularly publishing whitepapers and hosting webinars on topics important to bankers.

About the Author

Keith Pulling is a credit risk consultant at Sageworks, where his primary responsibilities include assisting financial institutions in credit analysis and loan administration. Keith focuses particularly on helping institutions across the country develop consistent and transparent underwriting processes. Prior to joining Sageworks in 2015, Keith served as a consultant working with national health systems. He received his B.A. from the University of North Carolina at Chapel Hill in 2014.

Sageworks Credit Analysis

Sageworks Credit Analysis is a credit analysis solution with tax return input screens for straight-forward data entry or the Electronic Tax Return Reader. The output is dynamic and includes financial spreads, global cash flow analysis, the impact of proposed loans on financial metrics, forecasting models, customizable credit memos, private-company benchmarks using Sageworks' real-time database and narrative analysis reports.

Sageworks Risk Rating

Sageworks Risk Rating enables banks and credit unions to systematically rate portfolio loans through templates that match the institution's existing ratings. Sageworks increases objectivity with ratings by using both quantitative and qualitative factors and provides detailed, standardized documentation. Users can also create their own risk rating criteria to incorporate into templates.