CEB
WHAT THE BEST COMPANIES DO

Strategies to Address Risk Management in Commercial Lending

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Executive Summary

Commercial lending has long been viewed as one of the most complicated business processes across retail and commercial banking. In the past several years the lending landscape has become increasingly complex due to seemingly constant regulatory changes, the increasing globalization of businesses, the interconnected nature of participants in the lending life cycle, and the often fragmented operating environment through which financial institutions are trying to deliver products and services to business customers.

Regulatory changes have put pressure on banks from both a compliance and cost standpoint as institutions must allocate limited investment dollars to mandated compliance programs and related system updates. New capital requirements have fundamentally changed the way banks write, price, and manage loans — all at a time when financial institutions are under unprecedented pressure to reduce costs and deliver improved operating margins.

As businesses continue to become more global, greater attention to risk management is required to ensure market, operating, and credit risk are all well understood and effectively managed. As syndications, participations, and securitized loans are issued, not only does the processing complexity increase, but also risk that must be managed across all participants.

Banks' complicated operating structures are often the result of the implementation of individual product strategies and the results of mergers with other institutions, leading to complex and siloed technology infrastructures. These are not designed to effectively share information across systems, or nimbly respond to new requirements, thus increasing the challenges financial institutions are facing trying to adapt readily to regulatory changes and customer demands.

To effectively manage the loan life cycle, and specifically address the complexities of risk management throughout the loan life cycle, financial institutions must rely on the use of technologies that inherently improve business results through more efficient workflows, better risk management, and an enhanced customer experience.

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The Commercial Lending Landscape

As the economic recovery slowly progresses, commercial lenders are reporting an increase in loan demand. However the spread of loans over cost of funds has remained low post crisis, and loan and deposit spread margins have drastically tightened (see Exhibit 1).

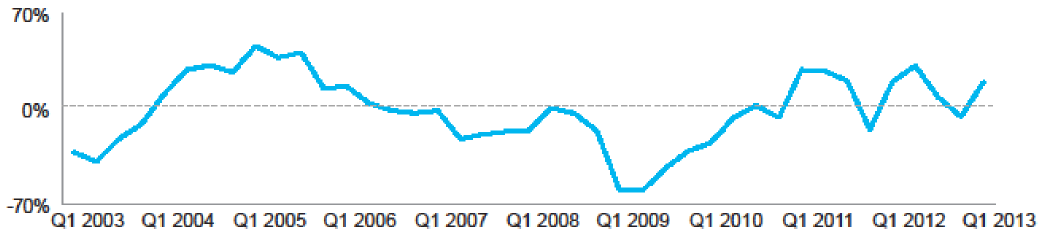
As a result banks are investing in technologies that will enable them to more efficiently manage the lending process and mitigate associated risks.

> *"Forty-one percent of commercial banking executives surveyed globally plan to increase investment in commercial loan origination technology in the next two years."*
>
> *—Joanne Pollitt, Senior Research Director, CEB TowerGroup*

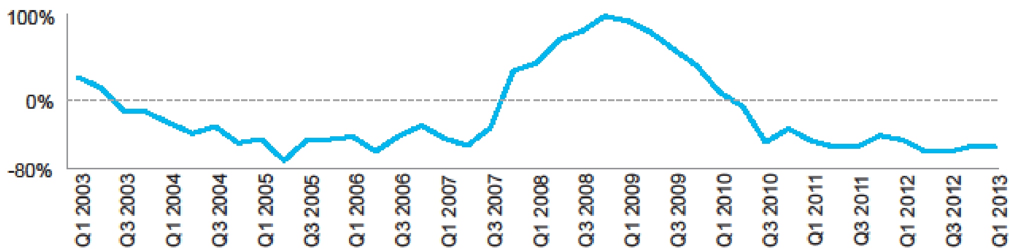
Exhibit 1

MARGIN AND REVENUE PRESSURE ARE A CONSTANT CHALLENGE

Loan Demand Remains Sporadic
Net Percentage of Banks Reporting Increases in C&I Loan Demand



Loan Spreads Over Cost to Fund, Medium and Large Firms
Net Percentage of Banks Increasing Spread of Loan Rates Over Banks' Cost to Fund



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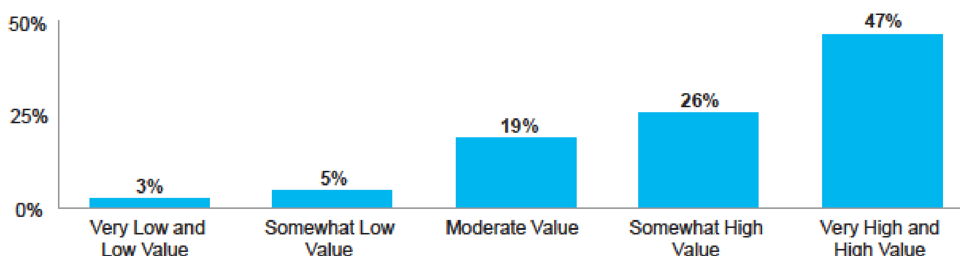
Investment in Commercial Lending Technology Is Increasing

During the economic downturn technology investments were severely constrained, with the majority of funding being directed towards initiatives to address regulatory compliance. As banks emerge from the recession they are renewing investments in technologies that will drive revenue, mitigate risk, and improve efficiencies. Forty-one percent of commercial banking executives surveyed globally plan to increase investment in commercial loan origination technology in the next two years. Citing process improvement as the primary driver for investment, 35% of these firms plan to adopt or replace their commercial loan origination systems by 2017 with the majority of implementations targeted to occur in 2014. As Exhibit two below illustrates, 47% of commercial banks report that commercial loan origination technology provides high or very high value to their company.

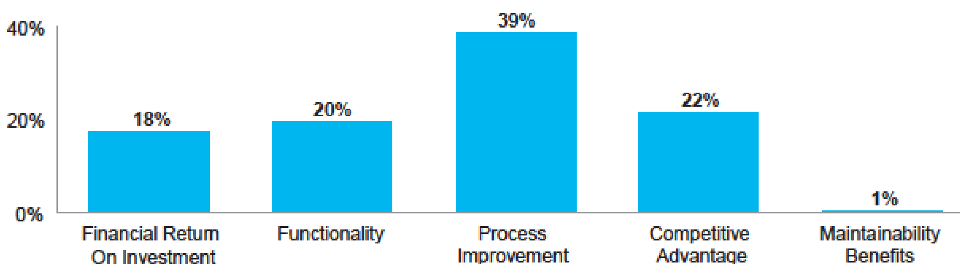
Exhibit 2

COMMERCIAL LOAN ORIGINATION VALUE & DRIVERS

Technology Value for Company



Value Drivers



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Source: CEB TowerGroup FSI Technology Survey, 2012- 2013

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Similarly investment in commercial loan monitoring technology is expected to increase over the next 24 months, with 39% of executives reporting increased investments and 35% replacing or adopting new loan monitoring solutions in the next several years.

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Risk Management as a Discipline Within Commercial Lending

The commercial lending industry has migrated slowly but steadily away from its traditional position as a credit-based set of services to a risk-based business. Credit, operational, liquidity, market, and legal risk each represent different challenges and exposures for a lending institution, and each must be considered as part of a comprehensive risk management strategy. In addition to a complete understanding of the impacts of each type of risk on any specific loan, an overall methodology must be in place for any entity issuing commercial loans to track and manage these risks at the portfolio level on an ongoing basis. For the purposes of this paper we will focus our discussion on credit and operational risk management and the strategies that successful firms are employing to better manage and mitigate exposure.

Credit and Operational Risk: The Opportunity

Simply defined, credit risk represents the potential that a borrower or counterparty will fail to meet its obligations in accordance with agreed upon terms. There are several steps a lender can take to mitigate credit risk including using risk-based pricing, requiring loan covenants, and diversifying the portfolio, among others. In order to effectively implement these strategies, it is critical that a lender has a comprehensive view of customer and market data across the life of the loan.

Operational risk is defined within Basel III regulations as the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. Often technology is leveraged to reduce operational risk, allowing lenders to execute strategies that minimize operational risk within every stage of the loan life cycle. Rather than viewing these risks as prohibitive to growing their business, leading lenders are addressing credit risk management and operational risk management together and implementing systems and processes that result in improved loan performance.

Historically commercial loans have been considered more complex than traditional consumer loans (such as an auto loan or mortgage) and recent trends have increased the complexity of commercial loans and the associated credit and operational risks associated with these loans. Each of these is worth exploring in order to recognize the new potential challenges and address them as needed.

Regulatory Changes

As we are all well aware, the volume of legislation being proposed and enacted in recent years has had a profound impact on the financial services industry. Although many of these regulations were introduced to address consumer protections, some have been extended to apply to commercial loans, subjecting commercial lenders to increased scrutiny and rigorous compliance requirements, more stringent than ever before. In addition to the regulations commercial lenders have been actively preparing for such as Basel II, Basel III, Solvency II, Dodd Frank, and others, commercial lenders must now also ensure they are adhering to requirements of the Home Mortgage Disclosure Act/Regulation C (HMDA), Truth in Lending Act/Regulation Z, and the Community Reinvestment Act (CRA), among others. For example, while HMDA is commonly viewed as relevant for consumer loans only, commercial loans secured by dwellings including multiple-family dwellings, may be reportable. Similarly, because commercial customers may request loans for personal rather than business purposes, loan officers must carefully determine the loan purpose as commercial customers applying for personal-purpose loans are protected by Truth in Lending Act and Regulation Z. Because small business loans are now a component of CRA evaluations, commercial lenders must ensure they collect and provide data consistent with reporting requirements for CRA.

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As a result lenders must gather, process, and manage data in new ways to ensure compliance. Commercial lenders must conduct periodic reviews of compliance requirements as the ongoing changes may well affect the lending policies and activities of the organization.

Globalization and Market Participants

As our economy becomes more global, it is natural that businesses expand operations into new geographies, establish new trading partners, and by extension engage in business dealings with new business entities and individuals around the globe. As firms want to maximize these investments and seek opportunities in emerging markets, the relationships among participants across the supply chain becomes more closely entrenched than ever before. This expansion of networks and geographical footprint brings added complexity specifically related to managing market, operational, and credit risk that must be addressed.

Adherence to local regulations, understanding the participants in all business transactions, and attending to considerations for cultural norms and expectations regarding business behavior has the potential to exponentially increase credit and operational risk when expanding operations and partners in regions around the globe. For example the challenge of adhering to sanction screening requirements increases as financial institutions are required to establish whether they can legally do business with a given entity and local regulations and screening lists vary by country and must be adhered to.

As lenders continue to provide creative lending solutions to borrowers, the relationships among loan participants can become complex, requiring lenders to understand at new levels of granularity the entities they are conducting business with and the inter-relationships among parties.

Leveraging Technology to Better Manage Commercial Loan Risk

Fortunately technology firms recognize the complexities inherent in commercial lending, and have introduced solutions that will enable financial institutions to better manage both operational and credit risk as well provide for an improved client experience.

The long held ambition of straight-through processing (STP) throughout a financial institution is especially relevant in the commercial lending space. Workflow automation and improved data visibility and accessibility through a single application platform are the cornerstones to enabling improved risk management, process standardization, and the efficiency gains desired by most financial institutions.

As Exhibit 3 illustrates, a single application platform provides the opportunity to leverage technology to address each stage of the origination process. Within the front office, the system is able to integrate with core banking systems and external databases to automatically gather borrower and guarantor financial data, thus minimizing manual entry, reducing the opportunity for errors, and achieving efficiencies. In the middle office, the system provides the ability to standardize and optimize spread and risk calculations through the use of built in models, leading to improved credit decisioning and risk based pricing. Finally in the back office the system can automatically create the necessary loan documents, manage required correspondence, and facilitate the booking of the loan in the bank's core accounting system, thus reducing redundant data entry, manual entry errors, and expediting the booking of the loan.

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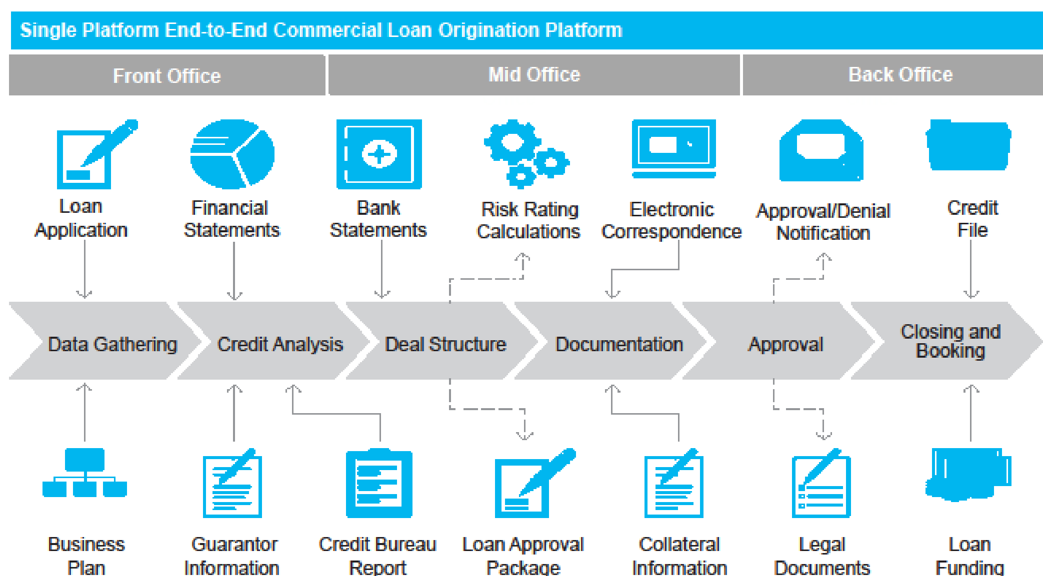
Exhibit 3

STRAIGHT-THROUGH PROCESSING IN COMMERCIAL LENDING

Loan Origination Workflow Model



Note: Dotted arrow depicts inputs to origination process, and solid arrow depicts outputs from origination process.

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Source: CEB TowerGroup Commercial Banking.

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Analytics: The Key to Unlocking Business Performance Potential

The holistic application of analytics including corporate performance management, business intelligence, and portfolio analysis can enable a financial institution to gain competitive advantage and achieve sound risk management. Business intelligence provides banks with a toolkit to convert unstructured data sets into actionable information.

Analytics can be leveraged in several ways to determine and enhance loan-level profitability. Portfolio analytics combines a 360° view of the clients' existing exposures and contributions to profitability, enabling lenders to optimize lending and pricing decisions in the context of the client's overall relationship using risk-adjusted return on capital (RAROC) measurements.

Advanced analytics in an origination system provide banks with the ability to make individual loan decisions in the context of the broader portfolio, making it possible to, for example, proactively avoid limits breaches and optimize pricing relative to capital charges. And finally, analytics can be leveraged to provide competitive advantage. Banks with the ability to gather and analyze data needed to drive their overall portfolio decisions prior to loan approval are well positioned to increase market share.

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Business Process as Fundamental

While technology can and should play a major role in providing transparency, enabling effective decision making, and driving efficiencies, business processes must first be designed to address the needs of the organization across the life cycle.

Technology can then enable the efficient execution of standardized processes across each dimension of the lending cycle. Through the application of business rules modern loan origination solutions provide the ability to define the parameters around which decisions can be made and actions executed. Streamlined automated workflows further ensure the consistent execution of activities that align to established business processes. Because of the number of people, systems, and dependencies inherent in the origination process the ability to systematically apply logic and enforce workflow is a significant benefit provided by best-in-class loan origination systems. For example, risk policies and operating guidelines can be defined centrally by the appropriate parties then deployed through business rules and workflow to ensure adherence to policies for all of the parties involved in the loan decision, whether it be the front line, middle or back office. Through the use of wizards and interactive business logic, manual errors and omissions can be largely reduced, and the length of time to originate a loan accelerated. Thus despite the inherent complexities in commercial lending, technology can be leveraged to satisfy both internal requirements to effectively manage risk and customer demand for greater transparency and faster decisions from lenders.

Conclusions

As the commercial lending business continues to increase in complexity, institutions that leverage solutions that enable improved risk management will be positioned for success as demand for loans increases, regulatory requirements continue to evolve, relationships among loan participants becomes more complex, and firms continues to expand relationships globally. Lenders that implement solutions that provide risk-based pricing frameworks, integrate with risk rating models, and provide integrated business intelligence tools will be well positioned to perform deal level analysis, manage risk, and achieve improved business performance.

Moody's Analytics commissioned CEB TowerGroup to conduct independent research and analysis of commercial lending practices and trends in financial services. The content of this report is the product of TowerGroup and is based on independent, unbiased research not tied to any vendor product or solution. Although every effort has been taken to verify the accuracy of this information, neither TowerGroup nor the sponsor of this report can accept any responsibility or liability for reliance by any person on this research or any of the information, opinions, or conclusions set out in the report.

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