Rediscovering C&I Lending in 2017

Banks are rediscovering their roots in the C&I lending business by adopting new technology, processes and business applications. The strategic issue is that banks are not getting enough of businesses' spend on financial services and products, and they are not getting paid for their risks. C&I lending is one of the highest return businesses (adjusted for risk) for a bank, and it is far larger than most banks realize.

Technology enables community banks to focus more on what makes them unique in banking and for which there are no substitutes: relationship banking that provides important financial services to key sectors of the economy, with decisions based on personal knowledge of customers' creditworthiness and a keen understanding of business conditions in the communities served.

C&I lending is hard because of its diversity and the loan sizes involved. Corporate credit underwriting today requires 28 separate tasks to arrive at a loan decision. These 28 tasks require collecting information for the credit application, reviewing the financial information, doing data entry and calculations, conducting industry analysis, evaluating borrower capability, and estimating the value of collateral.

A time series analysis of these 28 tasks reveals a two- to three-week process at best and, in some cases, more than four to eight weeks to arrive at one credit decision. Different players in the bank play a role in this process: the loan officer, credit analyst, and credit committee. In addition, it costs $4,000 to $6,000 to underwrite each credit application. With these costs, banks are unable to lend profitably unless the loan exceeds $500,000, which various sources cite as the rising average loan size among banks. Table 1 shows these costs in detail.

Table 1: Corporate Credit Underwriting Cost per Application

People	Task	Time (Hrs)	Total Cost ($)
Loan Officer	Credit Application	6	$415
Credit Analyst	Reviews	19	$1,200
Credit Analyst	Data Entry & Calculations	46	$2,800
Credit Analyst	Industry Risk Analysis	16	$1,300
Credit Analyst	Borrower Capability	2	$115
Credit Analyst	Valuation & Liquidity of Collateral	10	$725
	Total	99	$6,555

The corporate credit underwriting process is not a detriment to middle market and corporate lending activity, but when applied to smaller C&I credits, it is clearly a disincentive to the bank and the loan officer.

Loan review is another process that makes C&I banking unattractive at the moment because it adds significant work for the credit administration function. An effective loan review program provides senior management and the board of directors with a timely and objective assessment of the overall credit quality of the portfolio. Appropriate grading of adversely classified loans enables the bank to take timely steps to minimize credit losses. Identifying trends that affect the ability to collect on loans in the portfolio and recognizing segments of the portfolio that are or have the potential to become problem areas is needed.

The key to an effective loan review system is accurate loan classification or credit grading. Here again, the corporate credit process makes accurate risk ratings a major challenge for banks because of the sheer number of C&I credits in a robust C&I business. Analysis shows that one loan review involves 15 separate steps, ranging from collecting and spreading financial statements to conducting cash flow analysis and adjusting risk ratings. Many departments are involved in this process including the lending, credit, and audit groups. One loan review can take a bank up to two days of work to complete at a cost of over $1,000 per loan as shown in Table 2.

Table 2: Loan Review Cost per Customer

People	Task	Time (Hrs)	Total Cost ($)
Loan Officer	Credit Application	8	$625
Credit Analyst	Reviews	4	$250
Administration	Data Entry & Calculations	4	$150
Sales	Industry Risk Analysis	2	$60
	Total	17	$1,085

To conduct loan reviews annually, a bank with 1,000 commercial customers will incur more than $1.0 million in costs. In some cases, regulators are requiring more frequent loan reviews. That can double this cost, just when banks are trying to cut costs to boost profitability.

Smart community banks are using financial technology to streamline loan underwriting and loan administration. An express underwriting process can reduce the time to underwrite a loan from the typical two to eight weeks down to just a few days. Banks are also finding financial technology useful for lowering the cost of loan review by 39% (and even up to 53%) while at the same time increasing the frequency of the loan review cycle from annually to four times a year for the highest risk accounts. Finally, some community banks are using financial technology to conduct more intensive analysis of concentrations in order to identify hot spots in their local market and ensure exposures remain within policy limits.

Financial technology can benefit loan underwriting by speeding the collection and analysis of borrower characteristics. The 28-task corporate credit process can be used as the basis for creating an express credit process with the following steps:

1. The credit application is submitted and entered into an electronic application (branch or direct source).

2. Information sources are accessed via pre-set application programming interfaces (API).
3. Credit data, including financial statements, payment history, public records, business demographics, and industry trends are combined into a credit package.
4. The credit analysis is conducted.
5. Decision and review rules are checked.
6. Risk ratings are assigned

With technology, the 28-task corporate credit process, which typically takes 30 to 60 days to complete, can be done in four to eight days using a method that reduces the costs of collecting information and frees up the credit department to conduct analysis. The cost per credit application can be reduced by over 40% which lowers the threshold of profitability for smaller loan amounts of $150,000 to $200,000. Credit analysts must be trained on ways to mix traditional and nontraditional financial information in their analyses. External validations must be conducted annually to ensure these systems are operating as planned, but this step can be done by the bank's vendor. Analysis of loan quality shows that this method delivers safe credits that are acceptable risks for the bank.

Loan review is another area where technology can improve capabilities by allowing more frequent reviews and a substantial cost reduction. Financial technology applied to loan review employs a tiered approach to weed out the high-risk accounts for full review each quarter. This new process uses an algorithmic-derived probability of default on each borrower each quarter. The steps are relatively simple but effective:

1. Borrowers are sorted by probability of default to find the highest risk accounts.
2. A risk threshold is established (for example to cull out the accounts with a probability of default in excess of 5%).
3. The accounts with the highest probability of default are sent for full loan review.
4. Low-risk accounts are sent to the credit committee for sign-off in a "lite review" process.

Table 3 outlines this process for a risk threshold of 5%.

Table 3: Loan Review Tiered Approach

Probability of Default (PD%)	Probability of Default Trend	Business Rules	Loan Review	PD %	General Portfolio Mix
High PD	Big Downgrade	• Exposure >$500k • Pennsylvania, North Dakota • Energy, AG	Full Review	>10%	1%
Medium PD	Downgrade	• Exposure $250k - $500k • Texas • Food & Accommodation	Medium Review	>5%	1%
Low PD	No Change	• Exposure < $250K	Light Review	0 – 5%	98%

A risk threshold of 5% results in a 39% lower cost of loan review and more frequent quarterly reviews of the highest risk accounts, as shown in Table 4.

Table 4: Loan Review Cost Analysis

Existing	Portfolio Cost Analysis						
		Portfolio Mix	Borrower Count	Loan Review			
				Type	Freq Per Yr	Cost Per Account	Aggregate Portfolio Cost
	All	100%	1,000	Full	1	$1,000	$1,000,000
	Totals		1,000				$1,000,000

Proposed	Portfolio Cost Analysis						
		Portfolio Mix	Borrower Count	Loan Review			
				Type	Freq Per Yr	Cost Per Account	Aggregate Portfolio Cost
	High Risk	5%	50	Full	4	$1,000	$200,000
	Medium Risk	5%	50	Medium	1	$1,000	$50,000
	Low Risk	90%	900	Light	1	$400	$360,000
	Totals	100%	1,000				$610,000
					Aggregate Portfolio Savings		$390,000
							39%

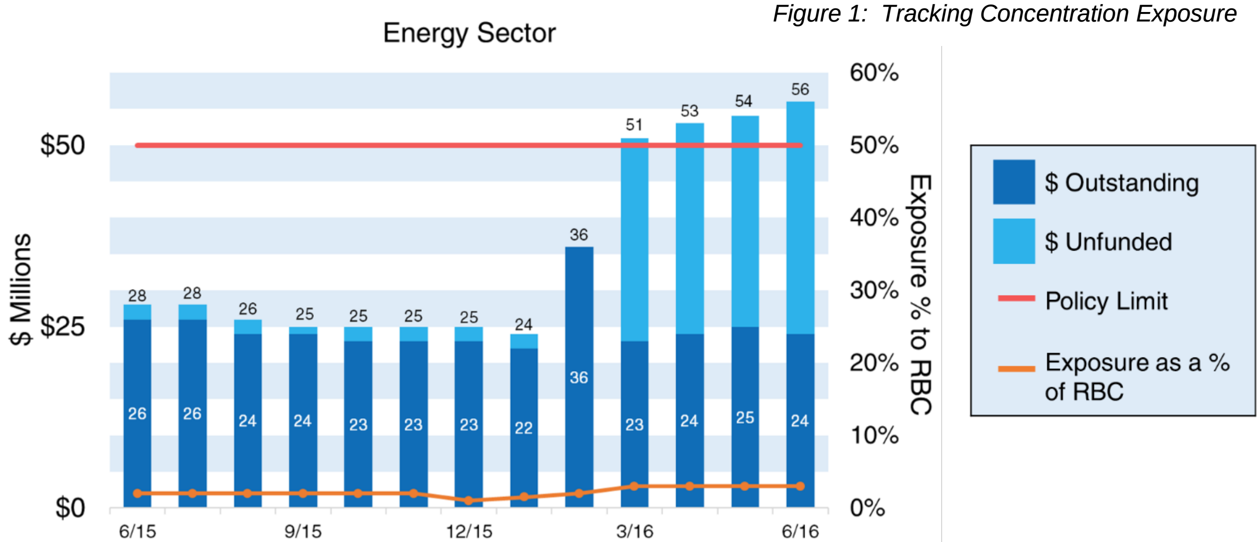
Moreover, concentration risk can be managed using financial technology. Tier 1 and risk-based capital can be arrayed against exposures by industry, geography, and borrower size to measure compliance with credit policy limits. This information is particularly powerful for industries and geographies that are under financial stress, such as energy in the Bakken region or agriculture in the South and Corn Belt. Table 5 provides a representative view.

Table 5: Concentration Risk Analysis, by NAICS

Summary (NAICs)		No. of Borrowers	$ Outstanding	$ Commitment	$ Outstanding/ Risk Based Capital	$ Policy Limits	Probability of Default	Probability of Default $
		1,000	$2,682,562	$3,219,075	76.9%	$3,862,889	1.87%	$50,187
Agriculture & Animal Husbandry	(110)	50	$328,485	$394,182	9.4%	$473,019	1.96%	$6,443
Transportation Services	(480)	45	$162,023	$194,428	4.6%	$233,314	1.78%	$2,880
Construction	(230)	44	$116,654	$139,985	3.3%	$167,982	2.37%	$2,760
Healthcare & Social Services	(620)	43	$127,315	$152,778	3.7%	$183,333	1.73%	$2,198
Realty, Rental & Leasing	(530)	42	$150,873	$181,048	4.3%	$217,258	1.33%	$2,009
Professional & Technical Services	(540)	41	$71,638	$85,965	2.1%	$103,158	2.37%	$1,696

As part of this solution, exposure and commitments can be tracked over time and measured against risk-based capital to determine if the bank is operating within policy limits or has become overexposed, as illustrated in Figure 1.

Figure 1: Tracking Concentration Exposure



Data and analytics give banks a leg up. C&I lending can use technology, data, and algorithms to lower the cost of underwriting and loan review.

About PayNet

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