

Process Improvement and Strategic Positioning for Small- and Mid-Size Banks and Thrifts During Times of Stress

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We are at an inflection point in the financial markets—as much a time for attention to the pressing matters of portfolio management and default resolution as it is an opportunity for critical,

end-to-end evaluations of the processes that brought us to this moment. This is also a time to prepare for added regulatory oversight, for those who are already overseen as well as an introduction to oversight for those who have, until now, been exempted. And, as the secondary markets are stalled and re-intermediated primary lenders are struggling with the resultant capital and funding limitations, these efforts can lead to the development of useful alternative-debt and equity strategies.

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THE BENEFIT OF END-TO-END PROCESS EVALUATION

The transaction cycle begins at deal origination, moving through underwriting to documentation and closing. These are all, “front-end” activities. After closing, the transaction becomes a part of the larger portfolio, whose management elements include loan administration, customer service, routine collections, default resolution, litigation and recovery; the so-called, “back-end” activities.

Fundamental to the front-end process is: (i) a thorough and objective understanding of the risks associated with any asset generation activity, supported by thoughtfully designed policies and procedures; (ii) an ingrained culture of comprehensive underwriting with an eye toward recovery so that default resolution is not confined to a single strategy; (iii) proper segregation of responsibilities so that those who stand to personally gain are not also in a position to unreasonably influence; and, (iv) periodic testing, self-assessments and enforced accountability.

At the back-end, portfolio management is like a relay race where the baton, which is in this case the customer relationship or “deal,” is passed from one area in the portfolio management continuum to the next. And, just as it is with a relay race, it is important that each participant clearly understands his/her professional responsibilities and position in line. By way of example, relationships that honor their commitments are serviced as a matter of

course, while those that do not will then move into the world of collections and default resolution. Taking this a step further, the collections group's objectives should include: (i) managing migration; (ii) preventing non-accrual and, (iii) collecting fees for

the lender's carrying costs and added effort. The group should also be responsible for: (iv) identifying material changes in account behavior; and, (v) communicating that information to superior levels and/or the next link in the portfolio administration chain.

While all of this is happening, portfolio managers accumulate and evaluate critical data points in order to help them predict performance. In this regard, the quality of an institution's management information systems is key. In particular, data points are analyzed for evidence of weakening trends by geography, demography, collateral type or even origination source or methodology. Lenders are today focusing acute attention and substantial resources on the tail end of the portfolio management process. But, that's like emptying the bucket without repairing the roof. Credit performance problems should be traced back to their point of origination with routinely collected portfolio data used to uncover systemic deficiencies.

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THE EFFECT OF INCREASED REGULATORY OVERSIGHT

As the credit cycle moves through the various segments of consumer lending and into small business, commercial real estate, middle market and beyond, the extent to which risk management and other matters subject to regulatory oversight have been compromised for the sake of competitive position and/or desired rates of growth has become painfully apparent. Regulators are testing for adherence to stated underwriting policies and process integrity. They are also determining whether the risks that are attendant to certain commercial finance activities are fully understood by the management team whose job it is to devise effective, offsetting strategies. And, they are making certain that otherwise sound underwriting and portfolio management policies and practices are not being compromised for the benefit of overarching relationships. In other words, a given customer's non-interest fee income potential or consideration for an underlying referral source should not trump otherwise prudent credit underwriting.

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Inherent in all of this is the philosophical difference between commercial banking and commercial finance.

Commercial bankers pursue relationships while commercial finance business develop-

ment executives are transactionally oriented. These business-development executives compete with their peers at other commercial finance subsidiaries and divisions of other banks as well as with those at entities which have, until this point in time at least, been subjected to less rigorous external examination. As such, commercial financiers fret that added regulation and amplified oversight constrain creativity, responsiveness and competitiveness. Consequently, they often resist, omit or otherwise devise dubious “work-arounds” because they mistakenly believe doing so will help them maintain their competitive positions.

A better solution involves the development of rational, explicit and consistently articulated policies and procedures, in full view of risk management and their regulatory counterparts, that will protect the enterprise without compromising its place in the market. It is important to keep in mind that when the current crisis is ultimately resolved, a likely outcome will be greater oversight for all. As such, the playing field will become much more level than it is right now.

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THE ARGUMENT FOR ALTERNATIVE STRATEGIES

Banks today are struggling with capital preservation and funding availability. Consequently, lending slows down (i.e., the “credit crunch”). Transactions that represent depository relationships are therefore more highly valued than those that do not, whether they are in-footprint or otherwise. Therefore, the right side of the balance sheet has once again begun to play a more active role in the decision to retain or divest certain left-side development activities.

Banks are accustomed to originating (or purchasing from third parties) real estate-related assets for sale to others. In the past, the secondary market for residential mortgages and home equity lines of credit has been fluid and efficient because standards for their origination and servicing are well understood and consistently applied. So, adverse-risk selection has not been an issue.

However, this is not necessarily true for commercial assets. Segmented portfolios of commercial receivables, such as for term loans and lines of credit supported by varying types of collateral including commercial real estate,

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accounts receivable, inventory, FF&E, etc., are oftentimes less granular than for consumer transactions; especially for small to mid-size banks. Likewise, underwriting, closing and servicing policies and protocols can vary for each of these lines of business. Consequently, few structured finance transactions comprised of these assets have made their way into the secondary markets.

Balanced and consistently applied standards for business development, underwriting, documentation, closing and servicing coupled with sound portfolio management policies and practices, all of which are overseen and periodically tested by credit risk managers in full view of their regulators, is a good and responsible business practice. Additionally, these efforts will ultimately yield reliably predictable pools of receivables that will appeal to the secondary markets, once they return. As a result, the financial institution may then more easily choose which assets to retain and which to fund out as it manages its capital support and leverage positions. That said, this is not to advocate an “originate to distribute” model for commercial receivables origination activities. Rather, the intent here is to suggest a flexible, alternative strategy for the institutional single-investor that toggles between the management of depository and non-depository-related relationships.

SUMMARY

We all know that unstable times demand a situational approach and prompt, corrective action. But, for curative measures to be long lasting, the source of a current trouble needs to be quickly identified, thoroughly understood and thoughtfully resolved, even if to do so results in a substantive redesign of the front-end piece of the business model or a revision to fundamental policy assumptions. At the same time, care should be taken not to overlook those meaningful, if not potentially transformational, opportunities for systemic improvements that are almost always present in the midst of market turmoil.

Mitchell D. Weiss consults with banking industry, private equity and hedge fund executives regarding credit risk management, regulatory relations management and strategic direction as they pertain to commercial and specialty finance interests.

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