

Improving the Efficiency and Effectiveness of the Credit Process

By Claude A. Hanley, Jr. and John R. Barrickman

To woo qualified borrowers, banks must enable lenders to focus on business development and relationship management.

In today's economic environment, commercial lenders must continue to find ways to improve operating efficiency while simultaneously improving their ability to compete for loan opportunities in a postrecession environment. Both of these goals can be accomplished by undertaking simple steps to improve the credit process.

Outlook for 2010

Since 2007, credit quality issues commanded the attention of executive management, credit personnel and loan officers at many midsized regional and community banks. During those dark days, the primary concern was the preservation of capital and liquidity. Understandably, most institutions curtailed loan originations, bolstered credit reserves and sought to reduce expenses. Often, the focus of loan officers was shifted away from loan originations to deposit generation and loan monitoring.

While commercial real estate (CRE) remains a concern and the macroeconomic outlook for 2010 is far from rosy, there are signs that the worst of the contraction might be behind us and there may be loan opportunities as we emerge from the recession. The federal government has taken significant steps to stimulate the economy. Enactment of the American Recovery and Reinvestment Act of 2009 should benefit the construction sector. Recent data

from the Federal Reserve suggest that industrial production has hit a bottom and is positioned for a rebound in 2010. The business and professional services sector should exhibit slow but steady growth. And certain economic sectors have performed well emerging from a recession, such as international trade.

The strength and sustainability of the recovery is still largely uncertain. What is certain is some lenders have curtailed lending or ceased operations

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completely and banks are under political pressure to increase lending. We believe there will be commercial loan opportunities, and banks that have the financial wherewithal to lend will have an opportunity to acquire

new relationships. However, to increase share and woo qualified borrowers, banks must offer a competitive product set, provide a clear value proposition and—most important—enable lenders to focus on business development and relationship management. The credit process underpins each of these elements, and banks would be well advised to take steps to ensure that their credit process is properly designed.

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Common Problems in the Credit Process

The credit process, defined here to include business development, application, underwriting, approval, booking and monitoring, should align with the bank's strategy and credit risk profile. Suboptimal credit processes cause significant inefficiencies that often translate into a poor customer experience in the form of unnecessary documentation and approval delays; missed revenue opportunities in the form of application fallout and time spent by lenders on issues unrelated to business development; and unnecessary expense in the form of personnel spending time on manual, redundant or superfluous tasks. Inefficiencies commonly found in the credit process include the following:

- Analysis required to support a loan application is too extensive and/or is identical for all applications, regardless of the size of relationship exposure, whether it's a new loan or a renewal, risk in the credit, *etc.*
- The flow of loans through the credit approval process is a logjam. This can occur for a number of reasons, including incomplete loan packages, ad hoc prioritization requests, inexperienced credit personnel, *etc.* Often, a subcomponent of this is poor communication between the credit department and loan officers about the status of loans in process, which causes frustration among the loan officers and borrowers.
- Loan officers are unduly burdened with administrative and monitoring responsibilities as a consequence of the current poor credit environment or efforts by the bank to reduce administrative expenses.
- Information systems are not integrated, require manual work-arounds and rekeying of data or have inadequate capabilities that necessitate creating reports in spreadsheets.

It's important to acknowledge that these impediments are often interrelated. While it is easy to identify the bottlenecks, loosening them can be complicated because solutions often require interdepartmental cooperation and doing things differently. When embarking on a reevaluation of the credit process, it is helpful to set forth clear project objectives and to involve individuals at

each stage of the process. At the most basic level, a successful redesign of the credit process will achieve the following:

- Increase the amount of time loan officers have to devote to business development and relationship management.
- Improve the customer experience and lender productivity by eliminating unnecessary documentation and reducing the time needed to make a decision about a loan.
- Improve the overall efficiency of the commercial lending function and raise origination volumes per full-time employee.
- Increase portfolio outstandings.
- Improve portfolio profitability.

These objectives can serve as useful touchstones when wading through process minutia and making difficult choices. Objectives should be stated in such a way that quantitative measures can be established and tracked to measure progress.

Analyze the Composition and Profitability of the Current Portfolios

The most fundamental improvement to the underwriting and approval process is to develop and institute differentiated processes according to credit relationship exposure. Common sense tells us that loans that represent small credit exposure (and smaller contributions to profitability) should be easier to apply for and should be decided more quickly than loans that represent a more material credit exposure. But what are the appropriate relationship thresholds and what constitutes materiality? The first step to address these issues is to establish the appropriate relationship exposure tiers. Start the process by performing a simple stratification of the existing commercial and industrial (C&I) and CRE portfolios by relationship tiers. Exhibit 1 shows a sample C&I portfolio stratification with relationship tiers for a hypothetical community bank.

Exhibit 1 highlights that the majority of relationships within the hypothetical bank's C&I portfolio are less than \$250,000 credit exposure, but they constitute only 11 percent of total dollar credit exposure. Conversely, relationships of \$1 million or more

constitute merely 12 percent of relationships but more than 70 percent of dollar exposure. This distribution is consistent with the portfolio of many community banks. The analysis suggests that the hypothetical bank should develop differentiated application, underwriting and approval processes among the relationship tiers. The same

stratification should be performed on the CRE portfolio. If relationship data is not available, the stratification should still be performed using outstanding balances on individual notes. This factual representation of the composition of the existing portfolio will help to frame opportunities to institute differentiated treatment by loan exposure.

Ideally, this stratification analysis should be augmented with profitability analysis. For each relationship tier, it is helpful to calculate the estimated average net revenue per loan. Net revenue is defined as interest income and fees less interest expense and credit loss. As defined here, net revenue is what is left to cover expenses for marketing and business development, underwriting, approval and servicing activities. Typically, the analysis will show that per loan net revenue available to cover credit processing costs is modest for small loans; therefore, it reinforces the need for expedited, cost-effective processes. Armed with the stratification and profitability information, it is easier for executives to formulate informed improvements to the current process.

Define the Institution's Willingness to Sustain Loss

Analyzing the existing portfolios is the first step, but decisions to establish differentiated underwriting and approval processes must be made within the context of the institution's tolerance for risk. Practically speaking, this means getting executive management

Exhibit 1. Hypothetical Community Bank's C&I Portfolio

Relationship Tier (\$000s)	# of Relationships	% of Total	Credit Exposure (\$Millions)	% of Total
< \$100	3,000	60.0	75.0	4.2
\$100–\$250	800	16.0	120.0	6.7
\$250–\$1,000	600	12.0	285.0	15.8
\$1,000–2,500	400	8.0	560.0	31.1
> \$2,500	200	4.0	760.0	42.2
Total	5,000	100.0	1,800.0	100.0

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to agree upon what constitutes a material loss. In our experience, achieving consensus on what constitutes a material loss is one of the more challenging issues in credit process redesign. To tackle this thorny issue,

try to define a quantitative benchmark for risk tolerance at the institution. This is more colorfully referred to as the "threshold for pain." It is the largest loss the institution could sustain without the loss becoming an agenda item

for the credit committee or engendering two or more hours of board discussion. For most banks with less than \$3 billion in total assets, the threshold of materiality is usually between \$250,000 and \$500,000 and often coincides with the point at which credits are underwritten using judgment or require a more extensive loan package. For the typical bank, this definition of materiality will constitute 60 percent to 70 percent of the dollar value of balances outstanding of the portfolio (and approximately 30 percent of relationships). Among bigger banks, the percentage coverage will be less. Once an agreement has been reached on what constitutes a material loss, the relationship exposure tiers can be established and differentiated processes can be designed and instituted.

Examine Approval Rates, Usage Rates and Fallout Rates

One more piece of analysis is needed to complete the picture of the existing credit process and highlight opportunities for improvement. Specifically, the bank should dissect volume reports on application approval, loan and line usage rates and application fallout rates.

Low approval rates may indicate the need for prequalification of borrowers (discussed in more detail below). Approval rates should be subdivided into those approved based on a counteroffer. Customizing loan approval amounts often adds time and cost to the underwriting process and is likely unjustifiable on a cost/benefit basis for small-balance loans. The bank should institute a mechanism to calculate the qualified loan amount early in the application process to prequalify the requested credit amount in advance of sending the application to the underwriting group. Low usage rates may indicate that loan officers are opening accounts that customers do not intend to use. The bank might wish to institute an application fee and an annual facility fee for lines below a certain usage threshold to discourage uninterested applicants, recoup the cost to process the application and to mitigate fraud.

A high level of application fallout clogs the credit process and suggests inefficiencies in the process itself. It is necessary to pinpoint the cause of the fallout before a solution can be formulated. To do this, the fallout volumes should be parsed into subcategories of declines, counteroffers not accepted and applications withdrawn. The composition of the application fallout volume will suggest opportunities to improve the process. For instance, a high level of declines might suggest that unqualified borrowers are applying for loans. To reduce the number of declines, the bank may wish to institute a prequalification form for loan officers and branch personnel to screen applicants at the beginning of the business development process. The prequalification form might consist of a short list of criteria that prospective borrowers must meet to be considered for a loan, such as minimum years in business, company sales size, declaration of personal bankruptcy by business principal, *etc.* This will discourage unqualified borrowers from applying. An exception can be made for existing customers. If counteroffers not accepted comprise a large portion of the fallout volume, the bank may wish to institute a qualified loan amount step early in the application process. A high volume of applications withdrawn may be driven by too lengthy time-to-approval or time-to-funding or overly extensive documentation requirements.

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Establish Expedited Underwriting

Once the relationship tiers have been established, the next step is to institute an expedited underwriting process for loans that fall below the bank's definition of materiality. Loans that fall within the small-balance exposure tier (in our example, those relationships of less than \$250,000) should have a short-form application and go to a central area dedicated to handling the underwriting and approval of small credits. Depending on the risk tolerance of the bank and the level of experience of the underwriter, the underwriting process for these

small loans can be a combination of credit score and judgment. It may make sense to limit reviews based on judgment to only a subsegment of applications, such as those that represent a larger credit request. In

our example, Hypothetical Bank might institute an auto-decision approach for credits of less than \$100,000 and an underwriting process involving judgment for credit exposures between \$100,000 and \$250,000. To preserve the expedited nature of the review, the judgmental review can be standardized by using a one-page decision checklist of factors that the institution deems important to augment the credit score.

In designing the credit process for various loan exposures, a useful discipline is to set turnaround times for credit approval. These turnaround times will vary by credit exposure tier. The standards should account for both the competitive environment and the bank's own value proposition (discussed in more detail below). Turnaround standards do not have to be the quickest, but they must be at competitive parity. In general, for small credit exposures in major metro markets, a turnaround time from application to funding should be no longer than 72 hours for small loans and renewals. The turnaround time will be longer as the size of the credit request increases, but even the largest loans that require loan committee approval should be subject to a turnaround standard of 10 business days.

Loan renewals and lines of credit are often additional opportunities where expedited underwriting can be instituted. Financial spreads and write-ups might be dispensed with for renewals where customer profiles fall within acceptable standards, measured by account usage, loan payment history and credit scores. Renewals can be underwritten using a short-form decision checklist. Similarly, lines of credit could be underwritten as if they will term out in either two or three years. Among other benefits, this will reduce the need to review them each year. It's important that amortization associated with the term-out should be included in the calculation of debt service coverage when underwriting the original application assuming a three- to four-year amortization period.

Reexamine the Required Documentation

Incomplete loan applications are among the major causes of inefficiencies in the credit process. Efforts to complete application data significantly lengthen time to approval and time to funding. Information collection to support underwriting and documentation is often an expensive activity involving loan officers, credit analysts and administrative personnel. To simplify the application process for the borrower and to reduce the time spent on gathering the information, banks should review their required documentation and eliminate documents that are not needed for underwriting or not required by competitors. A standard checklist of required documentation should be established, and the bank should also establish minimum standards that must be met for an application to be processed. Loan applications should be checked for completeness before being forwarded to underwriting. Write-ups should be designed to support risk analysis or risk management capabilities.

The bank should consider appointing a gatekeeper to determine the completeness of loan packages as well as to track the status of loan applications as they progress through the internal process. The gatekeeper should create and maintain a mechanism to track an application through the internal review and approval process. The tracking mechanism does not have to be sophisticated. It can take the form of a spreadsheet posted on the bank's intranet. At a

minimum, the tracking mechanism should contain the borrower's name, the loan officer assigned, the major work-in-process steps and an indication of the exact status of the application. The tracking system should be accessible to all loan officers. This will help to minimize distracting telephone calls and emails from lenders to processing personnel to check on the status of an application and will facilitate the establishment and monitoring of turnaround standards.

Align the Delivery Channels with the Process

The bank's delivery channels should be aligned to complement the differentiated credit process. The branches should be used to help originate loans to small businesses. With proper training and central support, branch managers could take the lead in prospecting for small business borrowers. The bank may assign commercial lenders to support the branches in this effort. This would enable other loan officers to focus their calling frequency on existing customers, to work their referral network and centers of influence such as attorneys and CPAs and to prospect in industry growth segments. Sales productivity metrics should be instituted and tracked for each channel. For branches, a metric might be monthly applications per branch. For loan officers, it would be origination volume calibrated by sales size of the borrower or another segmentation measure that reflects average loan size and relationship complexity.

Free Loan Officers from Activities Without Customer Value

Another vital element of improving the credit process is to determine how loan officers spend their time. This can be done by surveying a representative sample of loan officers. Obviously, loan officers should be spending a majority of their time on business development. In suboptimal credit processes, however, one of the primary inefficiencies is that loan officers are preoccupied by tasks such as spreading statements, operational issues, documentation, portfolio maintenance and monitoring, collateral monitoring and problem loan management. Often, these responsibili-

ties have simply accrued to them over time, but they also have been assumed as a result of a deliberate decision by executive management to economize on support personnel. This is myopic as it hinders the ability of loan officers to generate revenue.

In addition, the administrative responsibilities of loan officers may be a by-product of the size of the portfolios assigned them. Loan officers with portfolios that are too large must spend more time on portfolio maintenance and monitoring. Ideally, portfolios of loan officers should reflect the level of administrative support, relationship size and complexity and loan officer experience. Exhibit 2 shows some recommended portfolio sizes for C&I and CRE loan officers by relationship complexity.

Ultimately, to optimize the credit process, banks should remove and centralize any aspect of the loan officer's job that adds no value to the customer. These responsibilities should be placed in specialized units or with a portfolio maintenance and monitoring assistant at a ratio of one assistant for every two lenders. An important assumption underlying the workloads shown in Exhibit 2 is administrative support, which is a vital component in an efficient credit process.

Reevaluate the Technology Platform

Often, inefficiencies in the credit process stem from too many manual process steps or system work-arounds. These inefficiencies can arise for three distinct reasons: inadequate functionality of the existing technology, lack of knowledge among bank employees of the functionality of the existing technology and extraneous process steps and reporting requirements imposed on the credit process (typically for compliance or risk management purposes). It is important to separate process-related inefficiencies from limitations of the technology.

For instance, covenant tracking systems are often handicapped by insufficient resources and are not fully used. The basic functionality of technology systems offered by major third-party vendors should provide the following:

- Data entry solutions/loan application status
- Integrated score and business retrieval information/integrated credit analysis tools
- Automated support for credit write-ups
- Automated document preparation/remote document printing
- Loan covenant tracking/portfolio reporting/monitoring

Vendor solutions to support elements of the credit process are proliferating and several provide automated solutions with this functionality.

Use the Credit Process to Support the Bank's Value Proposition

A value proposition is the combination of product, service, pricing and delivery system offered to the customer: a set of tangible results a customer gets from using the bank's products or services. To be effective, a value proposition should be based on recognized customer needs, and it should be specific about the values it provides. There are three ways to achieve competitive advantage:

- **Cost advantage.** Be the low-cost producer in the industry.
- **Differentiation.** Become unique along dimensions that are widely valued by buyers.

Exhibit 2. Proposed Commercial Loan Officer Workloads

Type of Lending/ Relationship Tier	Number of Relationships	Portfolio Outstandings (\$Millions)	Annual Production (in \$Millions)
C&I			
Small business < \$250K*	200–225	30.0–35.0	10.0
Small business > \$250K < \$2.5M**	100–125	75.0–100.0	15.0
Middle market > \$2.5M**	50	150.0	30.0
CRE	75–100	100.0	25.0

* Assumes most of the business development and relationship management is done by the branch manager and underwriting/documentation are central. One lender would serve three to five branches.

** Assumes one administrative assistant/portfolio manager for two lenders.

- **Focus.** Select a segment and tailor the strategy to serve it.

The bank's credit process can be leveraged to facilitate the bank's chosen value proposition to attain competitive advantage. For instance, a value proposition positioning loan officers as trusted advisors and experts in particular industries can use the intelligence gathered in the credit process to enable loan officers to provide insights into the operations of customers. Loan officers can develop recommendations for strategies, products and partners (such as trust and wealth management) that enable customers to improve business performance and manage life cycle events. Tools can be developed to help loan officers provide advice, analyses, checklists and contacts to help customers fund growth, lower financing costs, plan for succession and identify personal wealth management needs utilizing data captured in the credit process. Examples of tools include the following:

- **Peer benchmarking.** Compares customer business performance measures to those of similarly sized businesses within the same industry.
- **Financing needs projection.** Calculates the level of increase in sales that can be achieved without additional financial leverage; recommends the amount and type of financing required to sustain a desired level of expansion under different scenario assumptions; projects working capital requirements and business core cash flow.
- **Impact analyses.** Projects benefits to be gained from more aggressive approaches to receivables/payables/inventory financing and vendor sourcing.
- **Treasury management assessment.** Describes and gives examples of products, including explanations of how specific services would enable customers to achieve improvement opportunities identified through the impact analyses.
- **Succession planning checklist.** Explains key issues to consider and recommended strategies to support the customer's transition objectives.

These value-added analyses will reinforce the bank's expertise and commitment to the market and should complement the bank's lending appetite and credit philosophy. Importantly, the bank

must get paid for these value-added services. To deliver this payoff effectively, loan officers must fully understand and accept the bank's policy and underwriting parameters. Also, the advice must not extend to telling the borrower how to manage the business, which could lead to potential lender liability and other legal claims.

Conclusion

For commercial lenders, the near-term economic environment will be characterized by opportunity. To retain existing customers and grow share, commercial lenders must ensure that their credit process is designed to achieve both efficiency and competitive differentiation. To accomplish this, banks should take the following steps to optimize their credit processes:

- Analyze existing portfolios to identify opportunities to establish differentiated underwriting and approval processes and the institution's definition of what constitutes a material loss.
- Dissect volume reports on application approval, loan and line usage rates and application fallout rates and take remedial steps to address issues.
- Institute expedited underwriting treatment where appropriate.
- To simplify the application process for the borrower and reduce time spent gathering information, review required documentation and eliminate documents that are not needed for underwriting or that are not required by competitors.
- Appoint a gatekeeper to evaluate the completeness of loan packages as well as to track the status of applications.
- Align the bank's delivery channels to complement the differentiated credit process.
- Remove and centralize any aspect of the loan officer's job that adds no value to the customer.
- Reevaluate the adequacy of the technology platform.
- Leverage the credit process to facilitate the bank's chosen value proposition to attain competitive advantage.

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