

CDFI Small Business Growth Collaborative Webinar: Small Business Risk Rating Systems

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Agenda

■ Overview of a Risk Rating System

- Uses of a Risk Rating System
- Elements of an Effective Risk Rating System
- Assessing a Risk Rating System
- Problems with Risk Rating Systems

■ Case Study 1 – Enterprise Cascadia

■ Case Study 2 – Pathway Lending



Uses of a Risk Rating System

- **Loan Loss Provisioning**
 - Percentage of provisioning is tied to individual risk grades
 - Migration of specific risk grades
- **Portfolio Management**
 - Monitoring of shifts in average grades
 - Reviewing average risk grades of individual loan officers, branches, product types or industries
- **Monitoring Standards**
 - Individual risk grades will be tied to specific monitoring requirements



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Elements of an Effective Risk Rating System

- Clear definitions of ratings and elements of ratings
 - Weighting system
- System to directly tie a rating to a provisioning amount
- Clear procedures for upgrading, downgrading, and reviewing



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FASB Required Accounting Changes

■ Accounting Changes

- Loan loss provisioning methodology should be clearly stated. Risk rating is one methodology. Other methodologies include historical losses. Need to 'prove' your provisioning is correct.
- Risk grades need to clearly provide criteria for rating (DSC, Collateral Coverage, etc.)
- Accountant should verify methodology

■ FASB 5 & 114



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Assessing Your Risk Rating System

- Historical write offs compared to recommended provisioning per risk grades
- Migration of specific risk grades
- Review of risk grades
 - Recommendation to change the grades of more than 10% of total outstanding reviewed indicate a problem
- Review what happened in economic downturn
 - Was the downturn reflected in your average risk rating?



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Problems and Red Flags

- Loans move from two or more ratings at a time
- Too granular or too general
- Loans are not re-rated in a timely manner
- Ratings are not taken seriously by the loan officers
- No clear procedures in place to define when a loan is downgraded or upgraded
- Risk grading system changes frequently



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Case Study 1: Enterprise Cascadia

- Overview of Risk Rating System
 - 4 Risk Grades (will be modified to 5)
 - Based on 7 Categories
 - Operating Margins/Cash Flow
 - Balance Sheet: Tangible Net Worth
 - Balance Sheet: Working Capital
 - Management/Credit History
 - Management
 - Collateral/Secondary Source of Repayment
 - Industry/Market/Competitive Advantages
 - Scoring System: 20% of rating is based on Operating Margins/Cash Flow



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Case Study 1: Enterprise Cascadia

- When was current system developed? Has it been modified over the year?
- Procedures
 - Who completes initial rating?
 - How often is a loan re-rated? Who re-rates?
- Enterprise Cascadia's use of its system
 - LLR
 - Portfolio Management
 - Monitoring



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Questions?



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Case Study 2: Pathway Lending

Past Risk Rating System

- Previous system used 9 ratings (1 – 9)
- Vast majority of credits were either a 3,4,5,6,7
- In this system each rating had a different allowance percentage (changed to FAS 5 & 114)



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Case Study 2: Pathway Lending

Why Pathway Lending Made the Change

- 2010 added a new loan program for Energy Efficiency Lending for commercial and industrials. These were not our traditional clients (much better credits)
- Now we were looking at two sets of ratings for two different types of programs (level of confusion starts growing)
 - Example: a “4” credit in the EE program would equate to a “2” credit in traditional business portfolio
- Reviewing system we determined we had Pass Credits and Non-Pass Credits



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Case Study 2: Pathway Lending

■ Goals of the New Risk Rating System

- To shine a light on problems not *gradients* of problems
- System that identifies problems

■ New Risk Rating System

- Simplified our system to be more efficient at focusing us
 - Above the Line (Pass Credits)
 - Below the Line (Problem Credits)
- Two ratings in each area
 - P1 and P2
 - Substandard (S) and Doubtful Loss (DL)
- This system allowed us to easily see issues whether it was in our traditional portfolio or EE portfolio
- We evaluate and track monthly the credits in the system



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Pathway Lending: Two Pass Ratings

- **Pass One:** During the underwriting process, management will determine if a loan meets Pathway Lending's underwriting criteria. All approved loans will be assigned an initial risk rating of Pass One. If the borrower's repayment history and financial condition remains satisfactory, the risk rating will not change.
- **Pass Two:** Assets in this category have most of the same characteristics as loans rated Pass One. However, the occurrence or potential occurrence of an event has been identified that would moderately increase the level of risk. Such events might include an adverse trend in financial performance or a specific event that has negatively impacted the borrower. Close supervision of these loans are required by the loan officer. Loans assigned to this risk rating must be upgraded or downgraded within 12 months.



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Pathway Lending: Two Classified Ratings

- Substandard:** Loans in this category have well-defined weaknesses that jeopardize the collection of the debt and expose Pathway Lending to increased risk of loss. These loans are marginally protected by the repayment capacity of the borrower, guarantors, and the collateral. These loans require special monitoring and management to mitigate increased losses.
- Doubtful/Loss:** Assets in this category exhibit serious risks that will likely hinder the collection of the full loan balance and result in a loss. These loans are severely unprotected by the repayment capacity of the borrower, guarantors, and the collateral. Strict management attention is required.



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Pathway Lending: Monthly Reporting to Board

Rating	P1	P2	S	D/L
January	89.72%	4.13%	6.15%	0%
February	87.18%	6.93%	5.89%	0%
March	88.11%	6.52%	5.37%	0%
April	89.64%	4.01%	5.56%	.79%
May	90.48%	4.40%	4.93%	.19%
June	86.13%	8.88%	4.99%	0%
July	87.94%	7.80%	4.26%	0%
August	88.86%	6.33%	3.89%	.92%
September	90.01%	4.13%	5.86%	0%



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Pathway Lending

■ Procedures

- Who completes initial rating?
- How often is a loan re-rated? Who re-rates?

■ Pathway's use of its system

- LLR
- Portfolio Management
- Monitoring

■ How will we know this risk rating system is working?



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Questions and Discussion



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