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RISK RATINGS: OLD AND NEW APPROACHES

Old approach

Prior to the advent of credit risk rating scales, banks simply combined all pass loans into a single, non-numeric classification called “pass” loans. There are four categories of “non-pass loans” that have definitions established by regulators.

Key characteristics of regulatory definitions of “non-pass” loans		
<p>Other loans especially mentioned (OLEM) or “Special mention”</p> <ul style="list-style-type: none"> • Potential credit weakness or downward trends <ul style="list-style-type: none"> – Already showing up in financial statements • Assumes viable primary source of repayment (PSOR) and secondary source of repayment (SSOR) • Most guarantor-dependent loans 		<p style="text-align: center;">C R I T I C I Z E D</p>
<p>Substandard</p> <ul style="list-style-type: none"> • Well-defined weakness and downward trends • Assumes less-than-satisfactory PSOR, but satisfactory SSOR 	<p style="text-align: center;">C L A S S I F I E D</p>	
<p>Doubtful</p> <ul style="list-style-type: none"> • Non-quantifiable loss • Assumes less-than-satisfactory SSOR on most likely case basis • Assumes satisfactory SSOR on best case basis 		
<p>Loss</p> <ul style="list-style-type: none"> • Quantifiable loss • No realistic PSOR or SSOR • Initiates a policy-prescribed timeline for charging off principal 		

New approach

In order to better identify differences in acceptable levels of risk, banks began assigning as many as three to five labels to “pass” loans. Combined with the four existing “adverse” regulatory risk ratings shown above, this led to numerical scales from one to seven or one to nine, with the lower numbers assigned to the loans with higher credit quality or lower risk. Many banks have also utilized the lowest “pass” category as a transition grade prior to special mention.

For illustration purposes, we will use a nine-point risk-rating system. To determine the borrower risk rating in this system, the business banker first evaluates the business on seven factors, including industry risk and various financial measures. Ratings for each of the seven categories are assigned a percentage out of 100 percent, and the resulting weighted average risk grade is determined. As a final step, the risk grade can be adjusted for issues such as acceptable loan structure, collateral, and guarantor support.

We begin by reviewing the risk rating grid introduced in Course 2 of this level for the three categories of industry, market, and management risk, shown on the following page.

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Risk Rating	1	2	3	4
Label ⇒ ↓ area	Minimal risk, (Superior)	Modest risk (Exceptional)	Average risk	Acceptable risk
Industry/ Industry segment	<ul style="list-style-type: none"> Minimal cyclical Not capital intensive Favorable legal, regulatory, labor outlook 	<ul style="list-style-type: none"> Modest cyclical Modest capital needs Neutral legal, regulatory, labor outlook 	<ul style="list-style-type: none"> Average cyclical Serious industry downturn not likely Neutral legal, regulatory, labor outlook 	<ul style="list-style-type: none"> Intensely cyclical industry Uncertain industry outlook Low barriers to entry Demanding legal, regulatory, labor outlook
Market risk (Position within industry and level of competition)	<ul style="list-style-type: none"> Leader with large share in stable industry Pricing leader and low-cost producer Performance ratios rank high 	<ul style="list-style-type: none"> Reasonable market share nationally or strong regional presence May dominate local market Competitive pricing with good margins Above average performance ratios 	<ul style="list-style-type: none"> Price follower with average market share Stable demand Established and loyal customers Smaller firm with strong local position Performance ratios generally better than peers 	<ul style="list-style-type: none"> Position within industry is weak or deteriorating Maintenance of market share is difficult and expensive Customer/supplier relations price-driven Smaller firm with average local presence
Management and controls	<ul style="list-style-type: none"> Highly experienced management with continuity and depth Excellent internal controls and reporting 	<ul style="list-style-type: none"> Broad industry experience with good continuity Depth in key positions High level of internal controls with quality reporting 	<ul style="list-style-type: none"> Reasonable industry experience with modest depth at key positions Good internal controls Proven character and ability to deal with adversity Principals' ability and willingness to inject capital Good labor relations Low litigation potential 	<ul style="list-style-type: none"> Limited industry experience with little depth Actual or potential friction between owners or potential successors Internal controls marginal with some manual processes Acceptable character Higher litigation risk High owner compensation relative to revenues and earnings

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In Course 2 you learned the key components and issues in analyzing these qualitative factors. The four categories focusing on quantitative factors have now been added to the risk rating grid below.

Risk Rating	1	2	3	4
Label ⇒ ↓ area	Minimal risk (Superior)	Modest risk (Exceptional)	Average risk	Acceptable risk
Earnings & operating cash flow trends	<ul style="list-style-type: none"> • Very strong earnings trend • Continuing excess cash flow and interest coverage 	<ul style="list-style-type: none"> • Consistent earnings with acceptable growth • Stable excess cash flow and interest coverage 	<ul style="list-style-type: none"> • Adequate earnings, cash flow, debt service coverage (DSC) and growth • Revenue and cash flow not dependent on one product or customer 	<ul style="list-style-type: none"> • Earnings, cash flow and DSC inconsistent • Outlook uncertain • Dependent on one customer or product
Asset & liability values	<ul style="list-style-type: none"> • Highest quality assets, few intangible assets • Appropriate liabilities • Superior facilities 	<ul style="list-style-type: none"> • High quality assets, no reliance on intangibles • Liabilities fit assets • Excellent facilities with good efficiency 	<ul style="list-style-type: none"> • Average asset quality and stability • Fixed assets in good working order and remaining useful life • Little reliance on intangibles • Few related party receivables or loans • Liabilities generally match assets • Adequate facilities 	<ul style="list-style-type: none"> • Acceptable asset quality and stability • Fixed assets near end of useful life • Significant intangibles • Asset/liability mismatches in maturity and structure • Outdated or older facilities with average operating efficiency
Financial flexibility & debt capacity	<ul style="list-style-type: none"> • Substantial excess debt capacity and access to national and global capital markets at all times • Very low leverage • Investment grade long-term debt 	<ul style="list-style-type: none"> • Access to capital markets • Low leverage • Ample debt service capacity • Good debt ratings 	<ul style="list-style-type: none"> • Readily able to refinance debt with other financial institutions at similar rates/terms • Stable relationships with good banks • Modest annual WC needs and ability to clean up or payout • Leverage acceptable based on industry and peer group • Access to and average reliance on trade creditors • Low to moderate capital asset needs 	<ul style="list-style-type: none"> • Limited access to alternative banks and may have to refinance at different rate/terms • Satisfactory banking relationships • Leverage above average • Small firm with consistent WC needs • Substantial reliance on trade credit, some slow pays and/or concentration of suppliers • High capital asset replacement needs

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<p>Financial reporting</p>	<ul style="list-style-type: none"> • Clean audit with no qualifications, from major accounting firm 	<ul style="list-style-type: none"> • Clean audit with no qualifications from major accounting firm or substantial local/regional firm 	<ul style="list-style-type: none"> • Audit with nominal qualifications • Review from reputable firm • Principals' personal financial statements are timely, accurate and comprehensive • Prompt availability or interim financials, budgets, etc. 	<ul style="list-style-type: none"> • Audit contains serious qualifications • Internally prepared or compiled financial statements • Other financial data not always reliable in terms of quality or timeliness
<ul style="list-style-type: none"> • Above factors are individually evaluated and weighted (out of 100%) to arrive at borrower's risk rating • The final grade assigned to each individual credit is further adjusted, if needed, ± one grade for the following: <ul style="list-style-type: none"> ✓ Superior or inferior collateral positions and documentation ✓ Lack of an adequate personal guarantee or other third party support ✓ Unsatisfactory loan structure (terms, conditions, and pricing) 				

➤ **Return to the course and click on the EZ Reference button to download and print a copy of the full chart, *Sample Risk Rating Grid*.**

The following are key factors you should consider within each of these four quantitative categories:

Earnings & operating cash flow trends

- **Growth, consistency, stability, or decline**—Using the income statement, a business banker will analyze the trend in net income relative to sales. Using the statement of cash flow or the UCA cash flow model, a business banker will consider the trends in operating cash flow, which expands into the effect from changes in working capital items such as accounts receivable, inventory and accounts payable
- **Adequacy of debt service coverage (DSC) and interest coverage**—This factor incorporates the amount of debt service in comparison to the conclusions on net income and cash flow measures
- **Concentration of revenue and/or earnings**—Businesses with less dependence on one or a few customers for revenue and profits will generally be less risky. Similarly, a more limited product line also presents more risk

Asset & liability values

- **Asset quality**—High asset quality generally involves appropriate levels of liquid assets, such as cash, accounts receivables and inventory, as compared to fixed assets, with few related party receivables and intangible assets on the balance sheet. Riskier businesses generally hold higher levels of accounts receivable and inventory as compared to the industry, or perhaps more intangible assets
- **Liability structure**—This factor deals with the degree of matching of levels of and composition of current and long-term liabilities, as compared to the mix of assets
- **Physical facilities**—The degree to which fixed assets are either new or very well maintained and in excellent locations

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Financial flexibility & debt capacity

- **Debt capacity**—Using various debt coverage ratios and cash flow (such as cash after debt amortization from the UCA model), a business banker can measure ability to service existing debt and the ability to handle additional debt needs
- **Access to financing**—Some firms have ready access to capital markets (common stock and/or bond issues), while others can easily access local or regional banks at similar terms and conditions as compared to what they already have in place. Still others have limited access to other sources of financing and present more risk
- **Financing needs**—This factor measures the degree to which operating cash flow, as we studied earlier in this curriculum with the statement of cash flows and the UCA model, is sufficient to cover debt service and also cover capital expenditures

Financial reporting

- **Business financial statement quality and reliability**— Take into consideration whether the financial statements are audited or reviewed (highest level of reliability), or compiled, direct from the business, or tax returns. This factor includes timeliness and reputation of accounting firm or business financial staff, and availability of interim statements, if applicable
- **Personal financial statement quality**— Take into consideration whether the financial statements of the owners/guarantors (if applicable) are timely, accurate and comprehensive
- **Other financial data**—Consider whether items such as aged listings of accounts receivable, cash budgets and pro-forma statements (projections) are timely and comprehensive

Summarizing the various risk ratings

This section brings together the key factors from all seven sections into a brief summary of each risk rating grade.

- **Risk-rated 1**—These are substantially risk-free loans to borrowers at the highest levels of credit quality, usually including national governments and central banks of major industrialized countries, a few major world-class banks, a few multinational corporations, and the government guaranteed portions of loans and cash secured loans. Financial statements of the borrowing businesses typically are audited with an unqualified opinion. Governmental units and corporations usually have very high credit ratings as assigned by Moody's and Standard & Poor's. Management depth is excellent, with substantial industry experience

This category also can include portions of loans to weaker borrowers, where the portion is backed by Small Business Administration guarantee or similar government support. Another type of loan that can be placed into this category is a loan to a weaker borrower where the loan principal and interest are fully supported by cash collateral (certificates of deposit or cash accounts held at the lending bank). In some cases, where only principal is supported by the cash collateral, the risk rating may be at a "2."

- **Risk-rated 2**—These loans are to borrowers of high credit quality, presently and prospectively. Cash flows over at least three to five years demonstrate exceptionally large and/or stable net profit margins of protection. Balance sheets are very conservative and strong with liquid assets. Projected cash flows, including anticipated credit extensions, exhibit strong trends in net profit margins, liquidity, and debt service coverage. There is excellent asset quality and management, and the borrowers are typically state or municipal governments, or large national, regional, or local companies in stable industries. Generally audited or reviewed financial statements with strong reliability, plus investment-grade credit ratings and access to capital markets

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- **Risk-rated 3**—For these loans, borrowers are middle range of credit quality, and have good prospects for future financial performance. The borrowers have very good asset quality and liquidity with consistently adequate debt capacity and coverage. They represent very good management with reasonable industry experience and depth. The credit extension is considered definitely sound; however, elements are present that suggest the borrower typically does experience temporary impairments. Reasonable access to bank financing at similar terms and conditions is present, though not likely to be able to access capital markets
- **Risk-rated 4**—These loans are at the lower end of acceptable credit quality. The borrowers are definitely sound, but with some minor to moderate risk characteristics. The margin of protection is adequate, with adequate liquidity, stability of profit margins and cash flows, diversity of assets, and good operating systems
- **Risk-rated 5**—Many banks use this grade, sometimes called “management attention” or “high attention—pass,” as a transition from pass to special mention, and most banks using this grade limit the time a loan can stay in this risk rating category to no more than six months. These are pass loans that are currently performing as agreed, but with above-average risk due to potential weaknesses not evidenced yet in the financial statements, such as severe or adverse industry, market or management conditions, operating problems, pending litigation of a significant nature, or declining collateral quality and adequacy. Once these weaknesses appear in the financial statements (declining earnings or even a loss, strained cash flow or increasing leverage) the loan should be moved to a 6 risk rating, or special mention. If the adverse conditions are resolved, or do not ultimately adversely affect financial measures in a material way, and then the loan can return to a 4 risk rating. These loans, usually listed on the bank’s internal watch list, are monitored more frequently than originally planned, and encourage early intervention and monitoring of credits while the business may still be able to obtain similar financing with comparable terms or somewhat worse, from other banks, before that ability may diminish in difficult times
- **Risk-rated 6 loans**—These borrowers exhibit potential credit weaknesses or downward financial trends deserving bank management’s close attention. If not checked or corrected, these trends will weaken the bank’s asset position. Although weak, these borrowers are currently marginally acceptable, but no loss of principal or interest is envisioned. As a result, these loans do not expose a bank to sufficient risk to warrant adverse classification, although they still are considered “criticized.” The borrowers generally have limited additional debt capacity, weak cash flow coverage, and average or below average asset quality, margins, and market share. Some industry, market and management weaknesses likely exist

Most banks include in the 6 risk rating borrowers that are turnaround situations, as well as those loans previously rated 4 or 5 that have shown deterioration, for whatever reason, thereby indicating a downgrading from the better categories. The borrower in this circumstance needs to “turn around” whatever caused the weakness. Typically, these companies are in start-up or deteriorating industries or with a poor and declining market share in an average or declining industry. The following are examples of what might need to be turned around:

- Poor operating margins
- Excessive or unnecessary fixed costs
- Deteriorating collateral value
- Management and owners with limited skills and depth

These are borrowers who regulatory authorities would categorize normally as “special mention.”

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- **Risk-rated 7 loans**—These loans display a definite weakness that jeopardizes the orderly liquidation of debt, although loss is unlikely. This usually matches the regulatory category of “substandard” for a loan not adequately protected by the current net worth and paying capacity of the obligor or by the collateral pledged, if any. Normal repayment from the borrower is in jeopardy, although, again, no loss of principal is envisioned. If the deficiencies are not corrected, there is a distinct possibility that a partial loss of interest and/or principal will occur. Potential loss, although it may exist in the aggregate amount of substandard assets, does not necessarily exist in individual assets classified “substandard.” Management skills, which demonstrate readily identifiable voids, are questionable
- **Risk-rated 8 loans**—These loans indicate probable partial loss. Borrowers are classified as “doubtful” and have the weaknesses found in other substandard borrowers with the added provision that the weaknesses make the complete collection highly questionable and improbable. Serious problems exist to the point where partial loss of principal is likely. The possibility of loss is extremely high, but because of certain important, reasonably-specific pending factors that may work to strengthen the assets; this classification’s “estimated losses” are deferred until a more exact status may be determined. Pending uncertain factors include proposed merger, acquisition, or liquidation procedures; capital injection; perfecting liens on additional collateral; and refinancing plans. Loan loss reserves for each individual substandard loan generally are established to provide for these uncertainties. Management has demonstrated a history of failing to live up to agreements, unethical or dishonest business practices, bankruptcy, and/or conviction on criminal charges
- **Risk-rated 9 loans**—These assets are definite losses. Borrowers are deemed incapable of repayment of what essentially is unsecured debt. Loans to such borrowers are considered uncollectible and of such little value that continuance as active assets of the bank is not warranted. This classification does not mean that the loans have absolutely no recovery or salvage value. Rather, it is not practical or desirable to defer writing off these assets even though partial recovery may be possible

Most banks establish procedures to identify how frequently to review commercial loans for the accuracy of the risk grade. As mentioned earlier, commercial loans should be evaluated on roughly an annual basis, at a minimum, either through renewals and loan originations involving a particular loan or borrower, or a related loan that is adequately analyzed as part of the credit decision. Loans that do not have such opportunities for adequate analysis over the prior twelve months (and no such opportunity immediately available in the next 30-60 days) should have an annual review performed by the business banker. Using the risk rating scale shown above, loans rated 1-4 should meet this annual benchmark.

Loans rated 5 or 6 should shift to more frequent monitoring on at least a quarterly basis, with 7 or 8 ratings monitored even more frequently, such as monthly.

Beyond a schedule of frequency of review based on risk grade, business bankers should re-assess risk grades as market or industry conditions change, or as the borrower’s condition materially improves or deteriorates. Keeping risk grades updated is perhaps the single most important job of lenders and their support staff.