Special Edition / April 2012 Newsletter

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2012 is here and well underway. We all know from experience that the banking business is only going to get tougher, because the months of recession will be replaced by hypercompetition that would make us feel as if we have jumped from one “stew” into another. Well, let’s look on the positive side, the majority of banks have survived one of the worst recessions on record and New England has faired quite well overall.

As this newsletter is being written, Greece was able to secure a substantial debt write-down acceptance from its lenders - the news highly anticipated, yet questions are abound. What kind of message does it send to other countries with exorbitant debt loads and houses of finance build like houses of cards, ready to topple. Will this solve the Greek financial problems? Chances are, it will not. It is a step in the right direction but the system that led to this situation is there. How will they turn the situation around? Is this another one of those “too big to fail” (the term that will haunt for many years the U.S. financial system)? Which country is next and what will ultimately happen to the Euro zone? One of the most frequent question is how will this impact the recovery in the U.S.?

Enough of the world problems and global challenges, although it is no longer possible to shelter ourselves in the confines of North America - we live in a global economy!

There are, however, some exciting news from the RMA New England Chapter - the Loan Officer Resident Seminar that the RMA New England has been delivering, improving, re-designing, and teaching year over year for over the last 30 years is **SOLD OUT** by mid-February!! While it is not uncommon for the program to fill up fast, we are wondering if this is a sign of banks hiring and training again. Perhaps this means that the industry is also gearing up for the next growth wave and want to strengthen its credit and risk management cadres.

Whatever the reasons are, THANK YOU for your continued support!! As many of you know, LORS is a natural extension for a program called CCL (Credit for Commercial Lenders) that comes out every fall. CCL is a part-time, 9-week training program. LORS is a one-week full time emersion into credit program. Both are the two building blocks of essential credit skills, and it is encouraging to see that the region’s financial institutions are beginning to invest in its human capital again.

Another exciting news and the key reason why this Special Edition of our newsletter is being published is a very recent event on March 9 titled “Booking Prudent Loans in Uncertain Times; Applying Lessons Learned to Avoid Past Mistakes”. The lending (yes, the majority of attendees were lenders!) and credit / risk management audience observed and participated in an ideas-filled exchange of 3 banking executives with a lively moderation by Davis Aloise (many of you know him already). The discussion was filled with experience-sharing and practical advice - far from dry and boring “you-should-do-this-or-that”. And if you do not believe us (and we hope you do not), take a look at the next few pages that follow. You will be pleasantly surprised.

Lastly, for those of you who are interested in getting involved in the RMA New England Chapter (and even this newsletter), let us know! The list of the Board Members is on the last page.

We welcome our newest institutional members:

YOUR NAME CAN BE HERE
(the smallest of many “benefits” we provide!)

They join over 200 member institutions of the RMA New England Chapter that range from large super-regional to small banking institutions and financial service firms

IN THIS ISSUE:

Booking Prudent Loans in Uncertain Times
Applying Lessons Learned to Avoid Past Mistakes

Presenter / Moderator:
David A. Aloise, *Founder and Principal, Aloise & Associates, LLC*

Panelists:
Daniel J. Sullivan, *Executive Vice President, Chief Credit Officer, Eastern Bank*
Daniel R. Gillette, *Senior Vice President, Market Manager, Corporate Banking, RBS Citizens*
Gerard F. Nadeau, *Executive Vice President, Commercial Banking, Rockland Trust*

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For those who have seen David Aloise "in action" as a presenter, you know that his style is filled with energy and humor. Furthermore, he knows his trade, has been around the block so to speak, and, when it comes to tenured banking audience, many bankers have worked with him and hold him in high regard.

Mr. Aloise opened with a poll of the audience on whether the economy was turning the corner and we were out of the recession. Not surprisingly, the audience was not quick to raise hands, reflecting the uncertainties of recovery. Nonetheless, the conclusion was that we seem to be slowly climbing out of the current economic disaster. While it is impossible to predict how long this recovery will take and how slow it will be (and the indications seem to support that it will be slow and painful), let's hope that it will not be like the lost decade in Japan.

A question to the audience has revealed that most attendees lived through at least one, the most recent economic cycle. A number of individuals in the audience also lived through the early 2000s recession. However, only a handful individuals in the audience experienced 3 cycles (including early 1990s; not a pretty time in New England) and even fewer 4 or more, indicating that there were many junior to mid-career bankers in the audience.

The credit cycles will always be there! This is the nature of the economy, and the best we can do is to a) learn from its lessons and b) take advantage of them (not something every institution does). The challenge for us as bankers is the aggressive competition - we chase our respective clients, term sheets, and even employees. Additional risk lies in non-bank finance companies that are pushing the envelope on both pricing and structure, and we are taking the challenge by becoming equally aggressive to fend off these "outsiders".

As the moderator continued with the 1st portion of the event (his presentation), he mentioned an experience at a national conference of bankers. He asked the audience how many out of ~500 banking executives had sales incentive plans that adjusted for risks. Out of the entire audience, only 4 (!) raised their hands to answer "yes".

Mr. Aloise commented that over the past years, lenders have been looking less and less at what's behind the financials of borrowers, especially what's behind the revenue and analyzing revenue composition. Bankers have to do more with less, and it is one of the contributing factors to not asking questions and having a false sense of understanding their borrowers. The other problem is of course the lack of training, and not just formal but experiential exchange from more to less experienced generations.

While we focus on some data about borrowers, we do not truly understand and take advantage of this information. Few institutions have developed early warning systems by focusing on key operating data points and trends of borrowers and their industries. Furthermore, the feedback loop is absent, thus causing bankers to have meaningless data in front of them. The presenter continued to question the audience and uncovered that very few institutions do true downside analysis, beyond some basic rate sensitivity analysis. What's missing is "what ifs", such as scenarios that will play out in downturns, workouts, bankruptcies, and other troubled situations. We do our analyses with the good times in mind and forget that the bad times are quite possible. Mr. Aloise mentioned as an opposite example that his mutual fund clients are "vicious" when it comes to following and adhering to limits on portfolio concentrations - one of many data points that they follow and enforce constantly.

The moderator highlighted the fact that there are many banks that still analyze cash flow using EBITDA, which is far from understanding cash flow of C&I borrowers. Few banks do any kind of cash flow forecasting and wait until loans are in workout to do proper underwriting due diligence. He reviewed specific elements connecting downturns and credit cycles. He then moved onto the review of the last three cycles with over a dozen of factors that contributed to the downturns, as outlined below:

- Overvaluation / overcapacity of real estate
- Leverage comfort - assets and collateral, not cash flow or absolute debt level
- Debt capacity / repayment focused on forecast / tomorrow's value
- Overaggressive LBO lending
- Severe undercapitalization of banks and financial institutions
- Periods of severe lack of liquidity

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- Abundance of capital and demand for higher returns
- Overexuberance factor - only way is up thinking
- Cyclical and industry change
- Tech and telecom bubble, then housing bubble again
- Accounting and management malfeasance
- Extreme / unprecedented asset value decline - consumer real estate
- Driven by seriously eroded underwriting, particularly consumer R/E (subprime)
- Risk management practices were outpaced
- All rating and regulatory bodies failed to understand scope of systemic risk
- Regulatory and supervisory framework - inadequate
- Incentive plans totally disconnected from risk taking

Then, Mr. Aloise moved onto "common and overlapping lessons". Some of them are presented below.

- Values are never static - often lend as if they are
- Cash flow and debt service capacity are far more important than collateral / asset values
- Early warning systems - too focused on after the fact financial info vs. industry / operating change.
- Fallback and downside analysis - superficial, not based on "real world" scenarios and not continuous
- Must be mindful of the power of market and herd instinct
- Officer experience, skill and workloads must be commensurate with risk taking
- Overreliance on "relationship" and "projections" often leads to inordinate risk taking
- Human nature, ignorance, greed and arrogance are constants and cause flawed decisions

The 2nd portion of the presentation was the panel discussion proper. What made the discussion particularly memorable was its honesty and sincerity, with the speakers willing to share their real life experiences and advice.

Q 1. On specific and clear underwriting guidelines and management of exceptions.

One bank took its lessons from the early 1990s when it almost failed - the experience that stays with people for the rest of their careers and guides their actions. This bank has a very clear and detailed credit policy to drive its employees in the right direction. It evolved over the years and has been updated to adjust for lessons learned and market conditions. The bank has four policy exception categories based on their severity. All are tracked year over year and the analysis is provided to management, including some data being reported to the board.

Another panelist described his bank's policy as thorough, detailed and web-based, which makes reference and navigation a lot easier that the old-school hard copies, with easy updating of content and distribution to employees. Different sign-offs are required on exceptions, based on the levels of severity. While individual business lines have their own signing authority, credit staff typically signs off on policy exceptions. Both credit and lending sides participate in the development of the policy, and it is being updated monthly, if needed, with scheduled quarterly revisions.

The third panelist outlined similar credit policy management practices and indicated that his bank has a credit policy committee to "manage" the policy and procedures around it.

Q 2. On due diligence prior to underwriting deals and whether banks do post mortem analyses.

Each bank has a culture and some procedures to ensure that before deals go to underwriting and approval, they are adequately vetted by key credit and lending staff. One respondent stated that rejection of a deal at the approval level is practically unheard of and will result in serious feedback to the lending team involved.

Terms sheets should not be going to prospects before there is a buy-in from both credit and lending. There is nothing worse than structure tweaking during underwriting or approval. When this happens, in the opinion of the panel members and Mr. Aloise, it is a sign of the lender and other team members not doing their job.

An annual cap on policy exceptions is a highly recommended business practice to ensure that your policy / policy exceptions are treated with proper regard; that certain triggers are in place to require portfolio level action; and that your policy reflects your institution's risk tolerance and is in touch with reality.

Q 3. On credit cultures today and on making improvements to lending or underwriting effectiveness.

Consider implementing a process to screen deals and, as a result, ensure effective and successful underwriting and approval.

Mr. Aloise identified that banks tend to do little of real down side analysis beyond a simple interest rate sensitization. For instance, which institutions do downside scenarios based on the likely events that can occur in a given industry? Who does a scenario to estimate loss of a major customer? Is debt service coverage of 1.25x good enough to cover effective interest rate of ~3% when you are locking the rate for three or five years? Even worse,

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what if the rate is floating and even now the client is barely meeting your minimum debt service coverage covenant? Is your institution really stress-testing pro forma assumptions or just buying into what you are provided with and doing some superficial and meaningless "testing"? What happens when the rates rise and the client is not able to refinance its debt in a financially troublesome situation?

The panel talked a bit about the committee structure, as the banks present have diverse systems ranging from signature authority on smaller deals and committee approval on larger to more of lending and credit balanced dual sign-off with both credit and lending taking responsibility for credit actions. One conclusion emerged in connection with credit decisioning by credit committees -- individual committee members can hide behind the committee vote and avoid taking responsibility individually. When disagreements emerge, those who oppose may be going along for a ride because they do not want to vote against the majority, particularly if the deal will still be approved.

Another panelist stated that his bank builds its approval process around healthy and constructive tension between lending and credit (making the audience smile by such a response). This bank's committee includes lending, credit and workout professionals, among others.

The panel concluded is that if you are not comfortable with educating, listening, defending your prospects and portfolio clients intelligently, and engaging in an open and patient discussion, you should not be in the lending business.

Q 4. On having proactive early warning and portfolio management systems and how its success and effectiveness are measured.

Both lending and credit people have to have their "hands in the fire" when it comes to making and managing loans. As discussion progressed, the speakers noted that last year was overall a good year for them, and they had clean portfolios with losses being in the 20+ bps.

In answering Mr. Aloise's question on whether the panelists' banks has Watched credit category (aka W category), all three banks did. However, there were no clear definitions for the timeframe that it takes to migrate credit to a better risk rating (improvement) or into a lower (deterioration) and ultimately workout. Mr. Aloise commented that many of his customers have a strict rule of no more than 12 months to ensure that the problems are dealt with proactively.

Q 5. On top three responsibilities required of every RM on a day to day basis.

One panelist responded that his institution has a saying: "Every day is a risk rating opportunity day", drawing laughter from the audience. Annual reviews are a must for all credits. Exposures of over 7-figures get touched more than annually because they all have covenants that require more frequent testing. This institution conducts quarterly reviews of every team member's portfolio, including a review of mistakes. In essence, they have a formal score card system. Their credit review has a penetration of 60%. The next panelist commented that his bank's lenders get regular and frequent exception reports; so do managers and portfolio managers.

Q 6. On 2012 goals and how lending officers are incented.

One panelist indicated that their incentive plan consists of 3 components: base salary, non-credit cross-sell incentive, and annual bonus potential. The bonus money has a claw-back provision to account for portfolio losses. Additionally, a portion of the bonus is deferred for a short period of time to account for immediate credit issues.

The next panelist commented that a percentage of annual performance is based on portfolio quality as measured by delinquencies, risk rating changes, and charge-offs. This bank also has a claw-back provision on the bonus. There was an example mentioned of an entire bonus taken away for making a "unwise loan" that could have been avoided.

The last panelist indicated that his bank manages the incentive plan on an annual basis, tweaking it based on the institution's direction and economic environment. The incentive plan can be impacted by late downgrades, double downgrades "dumb loans", missing financial statements, and is measured comparing gross margin to loan profitability. Each institution seemed to have a well-defined compensation and incentive structure.

In conclusion, the panelists talked about their focus areas for the next one to two years. The key issues on their minds are 1) interest margins (unwise to be underwriting loans in the vicinity of 3%, given an impending recovery) and 2) compliance and regulatory changes and costs that come with them.

The presentation was followed by a Q&A session, highlights of which are outlined next:

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- Financial trends and projections need to be sensitized even more than the interest rate sensitivity that many banks are already doing.
- Management teams of borrowers need a real close look rather than making assumptions that numbers will do all the work (do not forget about the references!).
- Due diligence has ranged and will continue to range widely, with more riskier loans needing more attention. What we should be actively thinking about is real analysis rather than robotic following of some accustomed to steps. Each deal is different!
- Mezzanine loans? Yes, they are still around but, as one panelist noted, their leverage maximums of 3.0x for senior and 6.0x for total debt are still much higher than the actual levels of borrowers.

The moderator closed with two final thoughts:

Those who forget and fail to learn from the past are condemned to repeat it

It's a person's ignorance that gets them into trouble and their arrogance that keeps them there

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Although this summary has lots of valuable information, much more was covered during the presentation that is not possible to include herein. Therefore, we hope to see you at our future events. Do not forget about the networking component of these events.

See the following page for some of the upcoming events!

A great way to stay in touch and see what's happening is by signing up for our LinkedIn groups:
- RMA New England Chapter
- RMA New England Chapter Young Professionals

New England area events by the New England Chapter

Recent Event
Young Professionals Committee Downtown Networking Night
Thursday, March 29, 2012; Boston, the Living Room

Loan Officer Resident Seminar (LORS)
SOLD OUT!!
April 22 – April 27, 2012; the Exeter Inn, Exeter, NH

RMA National training courses offered in New England

April 23-24, 2012
Financial Statement Analysis - Boston, MA

April 26, 2012
Real Estate Fundamentals in Commercial Lending - Boston, MA

May 22, 2012
Analyzing the Commercial Borrower's Industry, Market, and Competitive Risk - Boston, MA

June 14, 2012
Lending to Wealthy Individuals - Rockland, MA

Visit www.rmanewengland.org
For more details and to register

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We want to hear from you!

We are a group of high energy banking professionals who put together educational, networking, panels and various other events and products. We work within our business community to bring value to our peers through a wide range of services.

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