Inconsistency with Financial Institution Data & Analysis

Creating a ruckus in credit risk management
When an orchestra plays a symphony, a stellar performance requires, at a minimum, that each musician plays from the same page in the music. Ideally, the conductor has also ensured a standard technical competency among the musicians and has provided a framework for musicians’ interpretation of the notes.

Similarly, for a financial institution to have the kind of credit quality that it expects and that regulators increasingly want to see documented, it’s critical that loan officers, credit analysts and other staff members start “on the same page” in their risk management processes. That’s particularly true when it comes to how they collect data from potential borrowers, calculate ratios and interpret results, industry experts say.

Of course, when it comes to the risk management process, financial institutions have a wide variety of approaches, said Tim McPeak, director of financial markets advisory services at Sageworks Inc.

“It is as much an art as it is a science,” he said. “Everyone’s going to have their own ways, and from bank to bank they will have different underwriting guidelines and standards. At a high level, that’s fine. That’s what creates good banks and bad banks; some banks are better at those things than others.”

At the same time, inconsistent procedures and methodologies within a financial institution create some of the biggest challenges for credit risk management, McPeak said.

Indeed, recent regulatory enforcement orders requiring improved loan portfolio management have called out the need for procedures that ensure conformance with loan-approval requirements and ensure satisfactory collateral documentation.
Examiners of the credit risk process, McPeak said, “want to make sure you’re comparing apples to apples, and they want to see your work.”

Kevin Atwood, executive vice president of Bank of Cadiz & Trust, a western Kentucky community bank with $100 million assets, said the data-gathering process is one area where it’s important to safeguard against inconsistency.

“Putting something in the wrong field can have a detrimental or positive impact on a ratio that would not be merited,” he said.

In addition, is everyone asking the borrower for the same set of information? Do borrowers know exactly which forms and schedules are included in the tax return you need? The problem is that any of these factors can take a not-quite-good-enough credit and turn it into a “just barely good enough.”

Other common areas where inconsistency can creep in include:

1. **“Spreading.”** Three analysts at the same institution may spread three tax returns into financial statements three different ways, McPeak said. For example, if a business sells an asset and makes a gain, do you count that gain as income or exclude it because it’s not recurring? Doing it one way may makes sense to one credit analyst, while doing it another way makes sense to the other two analysts. “But now you’re comparing those loan packages to make decisions, and you’ve got an information problem,” he said. “It comes down to the apples and oranges thing.”

2. **Applying regulatory guidance.** Are standards being applied consistently across the portfolio? For example, are the same metrics being evaluated for each borrower’s risk rating score? Financial institutions need a systematic and consistently applied process for determining the provision for loan and lease losses (ALLL). An incorrect allowance can misrepresent a bank’s financial condition or its earnings, so having a consistent way to measure the extent of every loan’s impairment is critical.

3. **Data tracking and documentation.** Is there adequate documentation for regulators and auditors of how risk ratings are derived? “It’s like a math teacher,”
McPeak said. “You might have an ‘answer,’ but if you can’t show how you got there, what’s the point? It basically says you’re guessing.”

Financial institutions must also recognize that a lender’s motivations may be different than a credit analyst’s. And of course, differences in calculating ratios and interpreting what it all means can also cause problems, McPeak said. Therefore, institutions may need to put procedures in place to account for differing motivations to ensure a consistent analysis.

**The key to combating inconsistency in the risk management process is an institution’s credit culture.**

A financial institution’s credit culture will usually include the establishment of procedures for gathering data and a common understanding of certain relevant terms and definitions, so variations within the institution are minimized. Those, McPeak said, can turn a deal that a bank might do, and turn it into one the bank turns down.

“Probably even more worrisome is the deal they probably shouldn’t do, and they end up doing it,” he said. “What is the cost to your bank of one bad loan?”

Technology is another key to creating a consistent methodology for entering data and documenting loans. Depending on the solution, technology can also generate reports for loan grading, global cash flow analysis, and calculating reserves. It can make it easier to have a systematic and consistently applied process for determining the ALLL, and it can go back and test the accuracy of previous ALLL calculations.

Atwood of Bank of Cadiz & Trust said that even with trustworthy technology, he needs that solution to allow him to look easily behind the reports generated and review the work behind them. “If I see something that just doesn’t make any sense, or if [bank employees] say, ‘These ratios are not what I expected them to be,’ I go in and look at the input itself,” he said.

Reviewing inputs up front also helps when bank examiners are involved, he said. “If you’re not consistent on that, you’re going to eventually get crucified by the regulators, because they’re going to say where in the world did you come up with this?”
About the Author

Sageworks is a financial information company that works with financial institutions, accountants, and private company executives across North America to collect and interpret financial information. The mission of the company is to help people make more-informed financial decisions in a business by giving them information they can understand and use. Sageworks’ data, the largest database of real time private company financial information in the U.S., grows as more than one thousand reports are run each day, and the new data is screened and anonymously incorporated into our industry statistics. We incorporate this data into our products for financial institutions including credit analysis and ALLL estimation solutions.