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rma Model Validation

Contact:
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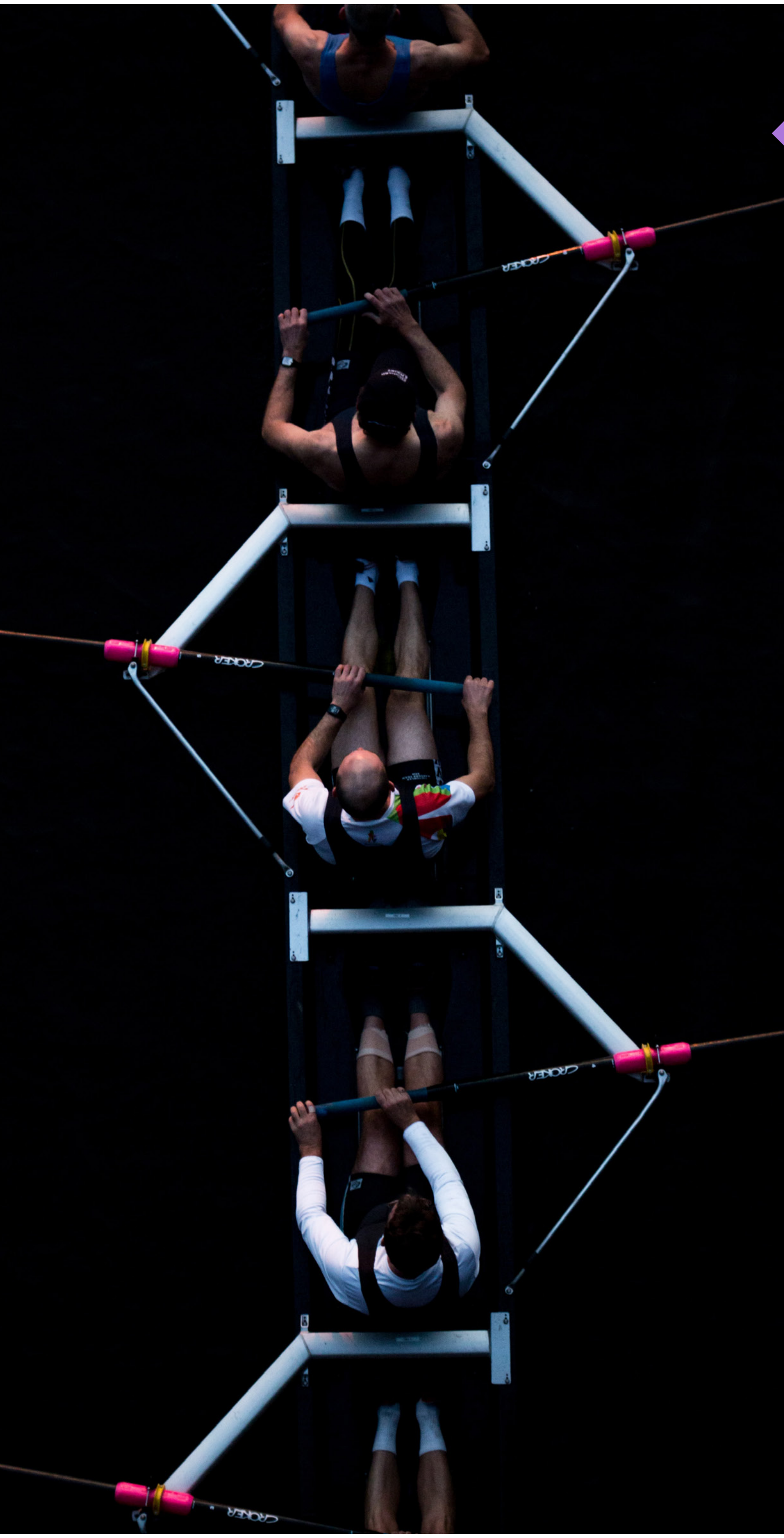

Departments

In Every Issue

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"We've gotten through many challenges over the years, and are stronger because of it."

Appreciate How Banking Has Changed, but Also How It Hasn't

There have been many takes and reports on who and what contributed to the recent bank failures. One thing that's clear is the renewed appreciation and need for robust risk management.

The continuing stress reminds us that banks must pay close attention to the fundamentals related to asset-and-liability, concentration, and interest-rate risk management. That is as true now as it was when RMA was founded nearly 110 years ago.

But there are also newer and emerging risks related to liquidity risk that must be managed. We experienced what was called "the first Twitter-fueled bank run." We saw a vivid example of how electronic platforms can speed up withdrawals—$42 billion in one day at one institution. And we were reminded of the need to keep up with changing technology and behavior when we assess fundamental risks like liquidity and interest rates.

And increasingly today, you have to be vigilant in surveying the landscape for future risks you may have yet to imagine. In addition to a liquidity crisis, this year has brought daily reports on the wonders and threats of artificial intelligence. The world is changing fast. We have to be better equipped and more prepared to respond than ever before.

That's much easier said than done, I know. But I am optimistic about the ability of our industry to adapt and thrive, and positive that RMA will continue to have a large role in shaping and serving it. Why? Because RMA continues to draw on the energy and expertise of its members. You share your experiences, expertise, and insights so RMA can create relevant and timely resources that benefit not only RMA members but the industry as a whole. That's how RMA has helped bankers prepare for and react to myriad crises since it was founded in 1914—through two world wars, a depression, 9/11, the financial crisis (and its aftermath), and a devastating global pandemic.

As the issues and challenges have changed, RMA has adapted. Amid the uncertainty of these past few months, RMA has offered themed editions of our Insider newsletter, curated a resource page on our website, and hosted webinars covering legal and regulatory requirements for bank liquidity and the potential implications of the bank collapses.

Through this and every kind of economic environment, I encourage you to take advantage of everything RMA has to offer you and your institution: Our consortiums, statement studies, conferences, roundtables, courses, risk management frameworks, and so much more.

Thank you for being part of RMA. By doing so, you are supporting a tradition that has strengthened banks, communities, businesses, and the industry for nearly 110 years.

We've gotten through many challenges over the years, and are stronger because of it. Together, we will continue to weather the storms and make the most of opportunities that the future holds.

Best Regards,

Nancy Foster

Nancy J. Foster | RMA President and CEO
nfoster@rmahq.org

Calendar of **Events**

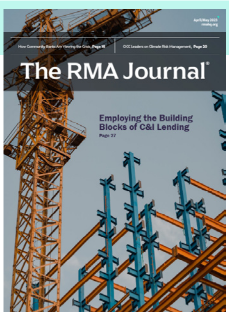
July/August 2023

Analyzing Business Tax Returns ·· **July 5-7, 2023** 11:30 A.M. – 2:00 P.M. EASTERN	**Cash Flow Analysis I: UCA Fundamentals** ·· **July 5-12, 2023** 2:00 P.M. – 4:30 P.M. EASTERN	**RMA Commercial Lending School** ·· **July 6, 2023 - October 4, 2023**	**RMA Commercial Lending School (Virtual) & Self-Directed Online Learning Bundle** ·· **July 6, 2023 - October 4, 2023**	**RMA Commercial Lending School Virtual & Commercial Real Estate Lending I: Introduction (Virtual)** ·· **July 6, 2023 - October 12, 2023**
RMA Commercial Lending School (Virtual) & Commercial Real Estate Lending I: Introduction (Virtual) & Self-Directed Online Learning Bundle ·· **July 6, 2023 - October 12, 2023**	**Commercial Loan Documentation (Virtual)** ·· **July 10-21, 2023** 12:00 P.M. – 2:30 P.M. EASTERN	**Critical Thinking (Virtual)** ·· **July 12-13, 2023** 1:00 P.M. – 4:00 P.M. EASTERN	**Model Risk Management Summit (Virtual)** ·· **July 13, 2023** 11:00 A.M. – 5:00 P.M. EASTERN	**Lending to Medical and Dental Practices (Virtual)** ·· **July 17-19, 2023** 1:00 P.M. – 3:30 P.M. EASTERN
RMA Risk Readiness Webcast: Credit Risk in Energy Lending (Virtual) ·· **July 18, 2023** 1:00 P.M. – 2:00 P.M. EASTERN	**Loan Operations Management Forum (Virtual)** ·· **July 18-19, 2023** 11:30 A.M. – 2:30 P.M. EASTERN	**2023 RMA Internal Audit Seminar Series - 8. Cyber Risk and Security Developments (Including Third Party Risks – Cloud-Based Services)** ·· **July 26, 2023** 12:00 P.M. – 1:00 P.M. EASTERN	**Operational Risk Management Forum (San Francisco, CA)** ·· **August 3, 2023** 8:30 A.M. – 4:30 P.M. PACIFIC	**Fair Lending Analytics Forum (San Francisco, CA)** ·· **August 4, 2023** 8:00 A.M. – 4:30 P.M. PACIFIC

For a complete listing of educational opportunities, visit the RMA website, rmahq.org.

Letters to the Editor

Interact with us: The RMA Journal welcomes letters from our readers. Letters can be emailed to Frank Devlin, Senior Editor, fdevlin@rmahq.org. We look forward to hearing from you!



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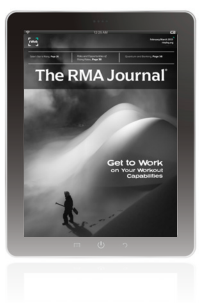

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Bank of China | New York, NY

Bank of Dudley | Dudley, GA

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The RMA Journal®

The Journal of Enterprise Risk Management

Risk Management Association

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The RMA Journal

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In Brief

How Unpriced Climate Risk May Affect the US Housing Market

A RECENT [study in the journal Nature] suggests that residential properties exposed to flood risk are **overvalued by $121 billion to $237 billion**—much more than previously established—posing challenges for property owners, insurers, mortgage lenders, and the federal government.

While the future dynamics of how unpriced flood risk is captured by the housing market will be critical, the study cautioned it remains uncertain if and when overvaluation will become realized and price deflation will occur.

Some **highlights** from the study:

- Increasing frequency and severity of flooding under climate change is predicted to **increase the number of properties exposed to flooding by 11%** and average annual losses (AALs) by at least 26% by 2050.
- Highly overvalued properties **are concentrated in counties along the coast** with no flood risk disclosure laws and where there is less concern about climate change.
- Mortgage lenders could serve an important role in determining future capitalization of flood risk. Evidence suggests **lenders are increasingly transferring the credit risk associated with flooding** to "government-sponsored enterprises" (i.e., Fannie Mae and Freddie Mac) and to capital markets through increased securitization of mortgages in flood-prone areas. Other mitigation options include **credit rationing** through lower loan-to-value ratios, broadening and enforcing mandates to carry **flood insurance**, increasing **interest rates**, and/or **denying loans.**

Office Real Estate 'the Next Big Shoe To Drop'

As the Wall Street Journal reported recently, the return to the office has stalled. But, if you have ventured into the office recently, you probably didn't need a newspaper to tell you that. All you had to do was look around.

Hybrid here to stay? Office occupancy, which hit the 50% mark for the first time since the pandemic earlier this year, has now stalled. And, according to Scoop Technologies, which tracks workplace strategies, the number of companies requiring employees to work from the office full-time actually decreased over the past three months, from 49% to 42%. Hybrid employees typically spend around 2.5 days in the office each week.

NPR's Planet Money newsletter notes that around 20% of U.S. office space sits empty, a number that "exceeds the vacancy rate following the 2008 financial crisis." In some cities, like Los Angeles and San Francisco, the percentage is creeping closer to 30%.

Perhaps unsurprisingly, share prices for some of the largest commercial landlords have plummeted recently, nearing historic lows. And many short-sellers are now targeting office stocks, betting the prices will drop further.

Banks in the crosshairs. Businesses that rely on foot traffic from office workers continue to struggle, but regional banks could be next to feel the hit—much of the estimated $1.2 trillion in office space debt is owed to them. In its Financial Stability Report this month, the Federal Reserve warned that the decreased demand in office space could lead to a correction in the values of office buildings and higher interest rates will make many borrowers unable to refinance their loans.

"It's the next big shoe to drop," Kenneth Rosen, of the real estate research firm Rosen Consulting Group, told NPR.

Adding to the concern, The Wall Street Journal reports that some heavy hitters in office real estate are choosing to cut their losses and default on some loans. These big landlords with deep pockets fear foreclosure less than smaller borrowers, because they know their creditworthiness won't take too much of a hit.

"The thinking was that the institutions would be the last to give the keys back, but it may be the other way around in some cases," says Rachel Vinson, president of U.S. debt and structured finance at CBRE.

Welcome to the Era of the Bank 'Sprint'

Many agree that the collapse of Silicon Valley Bank was not caused by the speed of the bank run that preceded it. But it has become clear that the mix of technology and social media that enabled the lightning-fast run—or bank "sprint," if you will—is something the industry needs to ponder.

Not-so-fun fact: Per NPR, in the run that helped topple Washington Mutual in 2008, depositors withdrew $16.7 billion over 10 days. The SVB run? One day, $42 billion.

"You have transactions that can be done much faster ... and get cleared much faster," Reena Aggarwal, the director of the Psaros Center for Financial Markets and Policy at Georgetown University, told NPR.

And there was this from CNN: "In the day leading up to the bank's collapse, multiple prominent venture capitalists took to Twitter in particular, and used their large platforms to raise alarms about the situation, sometimes typing in all caps."

Now that we have experienced what House Financial Services Chair Patrick McHenry called "the first Twitter-fueled bank run," **how can banks prevent or respond** to a possible next one?

It's still early days. But former bank risk management executive Tyler Stambaugh tweeted that possible approaches include a **stronger social media presence** for banks and **meet-**

ing customers "where they are"—on their preferred medium—to make sure they have accurate and complete information about a bank's position.

Bank Failures Shine Spotlight on Concentration Risk

The takes and takeaways from the recent bank failures have been plentiful. But one lesson that rings true across the industry is the need to **pay heed to concentration risk.**

The concentration of lending and deposits in one area of the economy "always introduces more risk," Risk Management Association President and CEO Nancy Foster said shortly after regulators announced emergency measures to stem spreading bank runs in March. "Recent events make clear that banking fundamentals, including balance sheet management and addressing concentration risk, remain critical," Foster said.

It is **not uncommon for banks to have certain concentrations**, and there can be different types: by geography, by industry, etc. In many cases, a specialty in a particular industry is a source of strength. It builds expertise, boosts the brand, and helps to better attract and serve customers.

But **a customer base that is too concentrated** could react in the same way to market stress, said Grigoris Karakoulas, president of InfoAgora, a risk analytics firm in Toronto and New York City. And concentration in any sector—agriculture, leisure and accommodation, etc.—**can eventually spell trouble.** "An idiosyncratic event in such industries might trigger higher deposit outflows in times of stress," Karakoulas said.

Another element to bear in mind is **the potential power of key influencers** in client concentrations. Some industries are tight-knit, and their influencers could persuade others to exit relations with a bank—something that can happen quickly in the era of social media and high-speed transactions.

Of course, concentrations are a potential danger on the lending side as well. (The FDIC has made available this piece on managing commercial real estate concentration risk.)

Among other risk management measures, Karakoulas suggested that banks "review their asset and liability management (ALM) policy regarding concentration limits on their balance mix and use ALM key performance indicators as early warning signals."

7 Steps to Cut Your Institution's ChatGPT Risk

Chances are pretty good your employees are already using a **large language model** (LLM) to carry out tasks from idea generation, to fact-checking, writing, and editing, to writing proprietary code. **ChatGPT** is the most notable LLM, but there are dozens of others—with more on the horizon.

In a recent blog post, law firm Debevoise & Plimpton outlined the main LLM risks and how to reduce the risks associated with using these services at work.

Risks include:

- **Quality control risks** (ChatGPT and the like can generate wildly inaccurate answers to some queries).
- **Contractual and privacy risks** (sharing confidential information in a query is sharing it with a third party).
- **Consumer protection risks** (e.g., when consumers interact with ChatGPT-driven chatbots).
- **Intellectual property risks** (some ChatGPT outputs may not be copyrightable).

The firm suggests several steps to reduce risk:

- **Creating a risk** rating for each category of use.
- **Documenting all uses** and reporting this inventory to a team charged with tracking and assigning a risk rating to each use.
- **Internal labeling** for some uses, and flagging content as created by an LLM to internal reviewers for extra scrutiny.
- Clearly **identifying content as created by an LLM** when sharing these outputs outside the firm.
- **Maintaining records** of prompts used and the time that content was generated (especially for high-risk uses).
- **Periodic training** for employees on acceptable and unacceptable uses.
- **Using tools to monitor** whether information was generated by an LLM and, if so, its compliance with company policy.

The Cyber Threat Has Changed. Have Banks?

An article in Tech Monitor warns that the cyberattack "threat environment has changed rapidly in recent years" and many banks may not be appropriately prepared. Rogue nations and "cybercrime cartels" are increasingly sophisticated and "on the lookout for juicy targets," the piece says. And banks fit the bill.

Buck Rogers, the former chief information security officer at the Bank of England, suggests **governments should consider financial infrastructure "critical"** and "approach it as we would gas and electric," because if something goes seriously wrong it could sap confidence in the entire financial system.

But a recent IMF survey of 51 financial jurisdictions found more than half have no national cyber strategy for the financial sector. And 64% lack mandatory cybersecurity testing (or guidance on what banks should do if they are hacked).

Banks do their own stress testing for cyberattacks and are well aware of the risks. A Bank of England survey of banking executives showed that **three quarters consider cyberattacks their top threat.** But, Rogers says, some "executives don't fully understand the advice they're being given on how best to prevent them."

Some takeaways from the story:

Stress test the right things. Many war games focus on the wrong kind of cyber threats, specifically denial-of-service attacks. That's not enough anymore. The article warned of so-called watering hole attacks, where cyber crooks target specific groups of users by infecting websites they commonly visit.

Know your partners. Banks may need to pay more attention to potential threats posed by the systems they outsource to third parties. An attack on a managed service provider could "paralyze operations at multiple financial institutions overnight." Third-party testing needs to reach "further down into the supply chain than ever before."

Defend from within. Banks may no longer be able to assume they will be able to successfully defend themselves from all cyberattacks and keep all hackers out of their systems. "Intrusion suppression" should be a focus.

Talent is paramount. Security decisions should be made by security staffers. If the global IT security skills shortage makes it hard for banks to find the right internal personnel, "hire a managed detection and response firm specializing in financial cybersecurity."

Scammers Bust Out the Old-School Hits

While the return to the office may have stalled for many workers, there are clear signs of **a return to stores for fraudsters.**

After scammers relied on digital tactics during the pandemic, "a lot of old tricks are starting to pop up again," according to Dustin White, head of U.S. risk at Visa. "Many schemes we knocked down in 2017 to 2019 are coming back."

Card-present transaction fraud is back, with scammers swiping counterfeit cards loaded with stolen info at the point of purchase. Visa said it was fighting back by "increasing the data available to analyze in-store and digital transactions to recognize unusual patterns."

"Friendly fraud"—where customers successfully dispute legitimate card purchases to have them taken off their bill—is also seeing a resurgence, according to American Banker.

And some scammers are going even deeper into the old-school playbook. The Wall Street Journal recently reported on **a rise in check fraud.** Checks are stolen from mailboxes and then either endorsed with fake signatures or they are "washed"—the recipient and the amount of money gets altered.

The Treasury Department's Financial Crimes Enforcement Network (FinCEN) has noticed a sharp uptick in check-fraud reports from banks: the 680,000 reports in 2022 are almost double the number from 2021 (350,000). The U.S. Postal Inspection Service, the law-enforcement arm of USPS, saw a similar rate of increase in mail theft.

Aware of consumer complaints of long waits for resolutions, banks say they are working to find ways to speed up the reimbursement process. The WSJ also noted the industry was looking into improved technology and better communication between big and small banks.

'Frankenstein' Fraud and What It Means for Banks

Every day, it seems, we learn of a paradigm-shifting way AI is altering how we live and work. And with each new advancement comes another possible security threat. Artificial intelligence? Try artificial identities.

According to a survey by forensics firm Regula, over the past year 46% of organizations globally have experienced what's known as synthetic identity fraud, which involves scammers stitching together authentic and fake ID information to create new personas. These "Frankenstein" identities are then used to make fraudulent purchases or set up bank accounts. AI is enhancing these efforts.

A 2022 story by Stateline chronicled crooks who "combined real Social Security numbers with mismatched or phony names to create new identities." They were eventually charged "with 108 counts of illegal financial activity, mostly borrowing huge amounts of money they never intended to pay back."

Banks are a big target. The Regula survey found that banks are the most popular targets of synthetic identity fraud. More than 90% of banking industry respondents said they perceive it as a real threat and 49% said they have already experienced it.

Meanwhile, AI-generated "deepfakes"—both voice and video—are a growing concern. Several recent articles have documented how AI voice clones can successfully bypass biometric login platforms commonly used by banks. There are even how-to videos on YouTube.

Deepfake defenses. Regula's chief technology officer, Ihar Kliashchou, says neural networks can help detect deepfakes, but "they should be used in conjunction with other antifraud measures that focus on physical and dynamic parameters, such as face liveness checks, document liveness checks via optically variable security elements, etc."

We are almost certainly just seeing the tip of the AI iceberg. Geoffrey Hinton, a generative AI pioneer who recently left his post at Google, now looks back on his half century in the field with a touch of regret. "It is hard to see how you can prevent the bad actors from using it for bad things," Hinton says.

Regulatory Roundup:

A Handy Wrap-Up of Recent Regulatory Developments and Action

A Call To Bring Banking Out of the Shadows

FEDERAL RESERVE BOARD Governor Michelle Bowman is making the case for more banks, saying the process for startup banks to receive charters should be easier and more transparent.

"We need a viable pipeline for the creation of new banks in the United States," Bowman said at the Wharton Financial Regulation Conference in Philadelphia. "There are troubling indications that we are falling short on this front."

Bowman emphasized the need for more competition in an environment where the number of U.S. banks dropped from roughly 9,300 to 4,700 between 2002 and 2022, and pointed to the U.K.'s New Bank Start-up Unit as a potential model to emulate.

She also noted the risks of "the ongoing shift of traditional bank activities into shadow banks."

According to the Financial Stability Board, **nearly half of financial assets globally are held outside banks,** in entities including pension funds and hedge funds. This non-bank sector has expanded rapidly since 2008's global financial crisis, at an average clip of 7% a year, according to CNN.

In her speech, Bowman noted the dangers of shadow banks engaging in credit intermediation without the level of transparency and regulatory oversight found at a bank. When a shadow bank goes south, it can have knock-on effects to traditional banks due to links—perceived and real—between the two industries. An infamous example would be the failure of Archegos Capital Management in 2021, which saw banks lose some $10 billion.

Shadow banks account for 14% of global financial assets, CNN says, and often attract riskier assets and deals that traditional banks may not want to touch.

Despite indications that "tighter funding conditions and weaker macroeconomic conditions will likely slow down global shadow banking activity," S&P Global says in a recent report that the potential for "contagion risk—via perceived proximity or reputational risk—should not be underestimated."

FDIC Expands Appraisal Examinations To Identify, Eliminate Bias

The FDIC is enhancing its examination focus on property appraisals in an effort to eliminate racial bias in the appraisals used in mortgage lending and refinancings.

"Homeownership remains one of the biggest drivers of the racial and ethnic wealth gap," the FDIC says on a new web page, saying bias is associated with **"wide racial and ethnic disparities in homeownership rates** and [in] the financial return associated with sustainable homeownership."

Per American Banker, the FDIC's move "comes as discriminatory actions in home valuations have taken center stage for regulators in recent years." Two years ago, for example, the Property Appraisal and Valuation Equity (PAVE) task force was launched, followed by findings and an action plan last year.

The agency signaled its intentions in its recent Consumer Compliance Supervisory Highlights, which also include sections on crypto-related activities, flood insurance compliance, and Home Mortgage Disclosure Act reporting.

On the Agenda: The FDIC says it will enhance its risk-scoping process to evaluate a bank's compliance management system for appraisals. It is also developing enhanced examiner training to heighten awareness of potential bias in the appraisal process, as well as developing educational materials to inform consumers about appraisal bias and the PAVE Action Plan.

The Clock Is Running To Comply With Quicker Securities Settlement Rule

Two years after the stock-trade settlement process was tied to controversy in the meme stock market, the Securities and Exchange Commission has announced its new rules to shorten the standard settlement cycle.

What's changing: For most broker-dealer transactions, the rules reduce the settlement window from two business days after the trade date (T+2) to one (T+1). This and related changes the SEC announced will, in the words of SEC Chair Gary Gensler, "upgrade our market plumbing from bronze to copper" starting in May 2024.

While Gensler said the rules "address the meme stock events of 2021," they are more widely designed to reduce the credit, market, liquidity, and counterparty risks in securities transactions for all involved. In a statement responding to the SEC's announcement, the Securities Industry and Financial Markets Association (SIFMA) noted that the industry has been moving toward T+1 since 2020.

Time crunch? The SEC's settlement rules have been widely praised, but some think they might be coming a bit too quickly—including SIFMA, which said "we strongly disagree with the implementation date." SEC Commissioner Mark T. Uyeda withheld support for implementation of the rules, saying "a smooth transition will take significant investment and system changes."

Uyeda said it would make sense for T+1 to take effect in September 2024, about the same time Canada will adopt the shorter settlement cycle.

In an April 2022 comment letter to the SEC after the rules were proposed, RMA asked to delay implementation until the end of 2024. Without such a delay, RMA said, lenders might add restrictions or limits to their securities lending programs to avoid trade settlement fails—which would reduce liquidity and lead to further trade settlement failures.

New York Attorney General Stakes Claim on Crypto Regulation

New York Attorney General Letitia James has released what she called "the strongest and most comprehensive set of regulations on cryptocurrency in the nation."

According to James' office, the draft legislation, which will be considered by state lawmakers in the coming weeks, would:

- Require **audits of cryptocurrency exchanges** and prevent individuals from owning related companies, such as brokerages and token generators, to stop conflicts of interest.
- Require crypto platforms to **reimburse customers** who are the victims of fraud.
- Define the New York State Department of Financial Services' (DFS) **regulatory authority of digital assets**.

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American Banker reports further: "James' bill would also require digital asset firms to implement the kinds of 'know your customer' procedures already applied to banks, and ban the use of the term 'stablecoin' to market virtual currencies, except when the asset values maintain a one-to-one ratio to the dollar."

According to Fortune, there are some who wonder whether James' move will **create friction between her and Adrienne Harris**, superintendent of New York's DFS, which already regulates crypto firms via its BitLicense virtual currency program.

In a statement the DFS said it was the "only prudential regulator with virtual asset-specific authority in the United States."

Earlier this year, James made headlines for suing crypto platforms CoinEx and KuCoin for failing to register with the state.

Also ...

- **In May, the FDIC released a proposal for replenishing its Deposit Insurance Fund**, which took a big hit after the agency backstopped billions in uninsured deposits after the failures of Silicon Valley Bank and Signature Bank of New York. The FDIC estimates that 113 banks will pay special assessments that will foot the $16 billion expense, with 95% coming from banks with more than $50 billion in assets. Banks with assets less than $5 billion would be exempt. What hasn't changed is the progress toward restoring the minimum reserve ratio. In the FDIC's semiannual update on the restoration plan for the DIF, FDIC Chairman Martin J. Gruenberg said that, because of the special assessments, the bank failures "are not expected to have a material effect on the projected timeline for reaching the statutory minimum reserve ratio of 1.35%." He added, "The reserve ratio is expected to reach the minimum ahead of the statutory deadline of September 30, 2028."
- **The Federal Reserve announced that the FedNow Service will start operating in July.** Through financial institutions participating in FedNow, businesses and individuals will be able to send and receive instant payments at any time of day, and recipients will have full access to funds immediately. "With the FedNow service, the Federal Reserve is creating a leading-edge payments system that is resilient, adaptive, and accessible," said Tom Barkin, president of the Federal Reserve Bank of Richmond and FedNow program executive sponsor. "The launch reflects an important milestone in the journey to help financial institutions serve customer needs for instant payments to better support nearly every aspect of our economy."
- **The Office of the Comptroller of the Currency (OCC) announced the establishment of its Office of Financial Technology**. Prashant Bhardwaj was selected to lead the office as Deputy Comptroller and Chief Financial Technology Officer. The new office is designed to bolster the OCC's expertise and ability to adapt to the rapid pace of technological changes in the banking industry and ensure the agency's agility in providing high-quality supervision of bank-fintech partnerships. Bhardwaj joins the agency after nearly 30 years of experience serving in a variety of roles across the financial sector.
- **The Consumer Financial Protection Bureau (CFPB) finalized the 1071 rule required by Congress to increase transparency in small business lending, promote economic development, and combat unlawful discrimination.** Lenders will collect and report information about the small business credit applications they receive, including geographic and demographic data, lending decisions, and the price of credit. The 1071 rule will work in concert with the Community Reinvestment Act, which requires certain financial institutions to meet the needs of the communities they serve. "Many local businesses were shuttered during the COVID-19 pandemic after they struggled to obtain credit under the Paycheck Protection Program," said CFPB Director Rohit Chopra. "This small business loan census will give the public key data on this market to ensure that banks and nonbanks are serving small businesses fairly."

Bank Awarded Proceeds From Consigned Goods Sale

By Michael L. Weissman

In Brief

A 2022 Texas appellate court case explores who had a claim to the proceeds of the sale of goods: the consignor of the goods? Or the lender to the consignee? Learn why the court ruled in favor of the lender-bank.

The Facts

The consignor was a manufacturer of computer tablets. Some of the tablets were sold on the Home Shopping Network under a drop shipment agreement which required the consignor to hire a third party to fulfill the HSN orders and ship the tablets to consumers. Accordingly, the consignor signed a fulfillment services agreement with a shipper. At no point was title to passed onto the shipper.

Despite terms in the two agreements to the contrary, HSN sent payments it received from the sale of the tablets to the shipper, not the consignor. The consignor did not perfect a UCC security interest in accounts by HSN or the shipper.

Later, the shipper borrowed from a bank, executing a perfected agreement that created a security interest in all its assets. A few years later, the shipper defaulted on the loan and surrendered all the cash it received to the lender-bank. The bank deposited the cash into a cash collateral account. Funds deposited in the cash collateral account were applied in payment of the shipper's indebtedness to the bank.

At issue was $357,750 from the sale of 3,000 tablets. The shipper had processed the orders and HSN paid the shipper, but the shipper did not pay the consignor.

When sued, the consignee framed the issue this way: Was its consignment with the consignor a "true" consignment? Or was it subject to Article 9 of the Uniform Commercial Code?

The court said that under the UCC, the security interest of a consignor in consigned goods is a purchase money security interest that requires the filing of a UCC-1 financing statement in order to be perfected.

The court cited Section 9-319 of the UCC, which states, "for purposes of determining the rights of creditors of … a consignee, while the goods are in the possession of the consignee, the consignee is deemed to have rights and title to the goods identical to those the consignor had or had power to transfer." It goes on to say that "for purposes of determining the rights of a creditor of a consignee, law other than this chapter [9] determines the rights and title of a consignee while the goods are in the consignee's possession if … a perfected security interest held by the consignor would have priority over the rights of a creditor."

Having laid down the ground rules, the next question was whether a true consignment had been created. That proved to be critical. Section 9-102(a)(20) of the UCC defines a consignment as a "transaction, regardless of its form, in which a person delivers goods to a merchant for the purpose of sale and: (A) the merchant … (iii) is not generally known by its creditors to be substantially engaged in selling the goods of others …"

The consignor had contended that the bank was generally aware of the consignee's business, thereby taking the consignee's business out of the coverage of Article 9 and the need for the consignor to file a UCC-1 financing statement.

The Ruling

Having considered the evidence of record, the court concluded there was sufficient evidence to support the trial court's conclusions that the consignee was not generally known by its creditors to be substantially engaged in selling the goods of others —so Article 9 applied to the bank's rights as a creditor of the consignee and to the consignor's rights as consignor. Since the consignor did not file a UCC-1 financing statement to perfect its security interest, the bank's perfected security interest was deemed paramount.

The Takeaway

Once again, prudence dictates a UCC filing whenever a debate may arise over whether a party's status warrants one.

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Image Credit: Unsplash.com

BUMPS on the Important ESG Path

By Elisabeth A. Wilson

It's safe to say that climate risk is probably not yet in the everyday banker's wheelhouse. Bankers are mathematical and precise, focused on generating revenue, growing the balance sheet, and helping customers achieve their financial goals. For many of us, climate risk can still be an obscure—and perhaps overwhelming—concept.

Still, it's hard to ignore. The effects of seemingly stronger and more devastating natural disasters have thrust climate risk to the forefront of the national consciousness. (In 2022 alone, the United States sustained $165 billion worth of climate-related disaster damage.) And the steady procession of proposed climate risk guidance from regulators has certainly put climate into the consciousness of bankers.

From November 2021 to March 2022, Basel, the OCC, the FDIC, the Federal Reserve, and the newly formed International Sustainability Standards Board all proposed climate-related disclosure guidance.

For its part, the SEC issued proposed guidance that clearly sets out what all publicly traded companies will be expected to do: report on the three scopes of carbon emissions and on material climate change-related risk exposures.

Banks have incorporated complex and costly regulatory guidance into their repertories before. The SEC's climate-related disclosure rules will be a challenge, but they will also provide banks with new avenues to lead and evolve methodologies to better position their companies—and their customers—to meet the challenging years ahead. The evolving climate regulatory landscape will be taken in stride, and financial institutions will help to shape the answers.

The gathering regulatory focus on climate is part of an overall environmental, social, and governance (ESG) movement in the financial industry. These concepts, of course, have always been important. But you could say governance—the "G"—has been a particularly hot topic since the Great Recession. And social—the "S"—became a critical corporate concern in 2020, in the wake of social unrest. Then came the stepped-up focus on environmental—"E"—from regulators that came with a new presidential administration.

This has all added to the attention—from investors, consumers, and government-related entities—on the ESG practices of financial institutions.

Now that banks have heard this call—with many banks passionate about their own ESG priorities as well—they can happily go about integrating ESG into their activities, right? We know it's not that simple.

As banks seek to impress customers by touting ESG strategies, they must be careful to avoid any "greenwashing" that would come with overstating their ESG efforts or failing to reach promised goals.

And just like the communities they serve throughout the U.S., the financial industry is divided on ESG. For example, some feel climate-related regulatory guidance is a temporary annoyance that will go away as soon as a new president is sworn in. Others identify climate change as a very real threat to the sustained safety and soundness of their organizations.

Further complicating matters, some states are enacting legislation that prohibits them from doing business with institutions that engage in ESG practices or refuse to invest in oil, gas, and coal—possibly creating a new "green" term: "greensquelching." (In response, some banks have resorted to "greenhushing"—underreporting their ESG practices.)

This red-blue antagonism is bleeding into the financial sector, causing more consternation and confusion about the path forward. It's a challenge. But we can't let it freeze us into ESG inaction.

Regardless of how climate regulations ultimately take shape, banks will be managing climate risk for years to come. Issues regarding coastal property values, the weather's effect on agriculture, and the transition from fossil fuels—to name just a few—will ultimately permeate every bank's balance sheet. And, as noted, there is mounting pressure from shareholders, investors, and consumers for companies to transparently address climate.

ESG is a concept already inherent in a financial institution's prime directive: Preserve and support the communities we serve to ensure they thrive; promote equality to give everyone a fair shot at the American Dream; and safeguard our institutions by doing good business in a safe and sound manner.

The course of ESG and climate change-related exposures is being set by shareholders, investors, and consumers. And employees, too. More and more prospective hires want to be aligned with the companies they work for from a values perspective. In light of the "great resignation," ESG became another ace up the sleeve of hiring institutions trying to gain an edge. How an institution approaches ESG is suddenly a demarcating factor in what may draw a much-desired reputational bump.

This is why financial institutions currently under no formal obligation—yet—to report on anything are working hard to provide a public explanation about their ESG practices. Financial institutions know how to market to customers, and how to develop products that give them the edge. They know how to foster meaningful relationships with consumers who need guidance around their financial futures. ESG is a new market space, and one banks should continue to corner. Ⓡ

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How Recent Bank Failures Are Affecting Community Banks

As an academic whose research includes community bank funding strategies, Jon Scott has been tracking the recent runs and failures in the banking industry with a keen eye.

And ear.

One compelling comment he has heard recently: It may be time to add three more C's to the traditional Four C's of Credit Risk.

Long understood to be capacity, capital, collateral, and character, the new C's would be concentration, contagion, and communication—all of which played a part in the recent bank runs.

Those events can be seen as a "wake-up call," said Scott, a professor of Finance at Temple University's Fox School of Business and chair of the Office of Finance at the Federal Home Loan Bank System. In a recent interview, Scott spoke about the state of the financial industry, in particular for community banks, as what many have described as a "liquidity crisis" for some institutions continues to unfold.

For the most part, Scott said, he is not seeing evidence that community banks are being affected much.

Scott said he had spoken with several community bankers and officials from the regional Federal Home Loan Banks. And they reported, well, not much. "They saw a bit of deposit outflows," he said. "But it was idiosyncratic. It wasn't based on anything related" to the forces that led to bank runs elsewhere in the financial system.

Not that community bankers weren't concerned. After the failure of Silicon Valley Bank, he said, some community banks "made plans over that weekend to contact all of their customers that had uninsured deposits to reassure them. And they made those calls. Others didn't do anything, but a few of their big customers called them. The banks explained there was no problem."

Whether recent events touched a particular bank or not, he said, all of them received a "wake-up call" about the risks of a highly connected and digitized environment where momentum for a bank run can build on social media—and where it can be carried out at lightning-quick speed with mobile banking.

"I do think mobile banking, especially its availability with commercial accounts, really amplified what happened," Scott said. "The velocity of the deposit withdrawals was just astounding. In some cases, bank management couldn't even give the regulators good estimates of how much money they needed. It was changing so fast."

The readily apparent risks of electronic banking will not slow its continuing spread and advancement though, he said. Banks need to keep investing in and developing technology to be sure they can meet customer needs, not only now but a decade from now. That continuing pressure and risk may prompt some small banks to look for buyers.

"Some family-owned banks may say, 'That's enough. This is too complicated,'" Scott said. Even if the liquidity crisis did not affect their institution, the implications may have them saying "this is the last crisis I want to deal with."

As for continuing pressure on and competition for deposits, Scott said community banks are certainly raising interest rates on CDs and other products, and would continue to do so. "Rates on their 12-month CDs have gone up," he said. "They are adjusting new and maturing CD rates to market levels." But they know it is hard to match the rates of other types of institutions, so they will, as they always have, stress relationship banking to attract and retain deposits. "The advantage that a community bank has is it can offer customers a single point of contact. Somebody will walk you through the alternatives knowing your situation," he said.

"They're not trying to attract deposit rate shoppers," he added. In some instances they may need to go to market for brokered deposits, but that would be a specific case of paying a premium, he said, and it would not affect the entire base of deposits.

Community banks can also attract and retain deposits by expanding the security customers seek from FDIC insurance. To wit: Through reciprocal arrangements with peer banks, they can divvy up customer cash into multiple insured deposits that do not exceed the $250,000 maximum. "Most banks I talk to have some reciprocal relationship," he said. "It is a way to break the deposits apart."

"Banks have always done that," he said, but in light of the current environment, "some have spent a little more time focusing on who the depositors are who might have concerns" about uninsured deposits.

In addition to maximizing deposits, banks are also "thinking a lot about managing contingent liquidity," he said. A number of banks have made the necessary arrangements—filling out forms and pledging the necessary collateral—to draw from the Federal Reserve's new Bank Term Funding Program if needed, he said.

"A concern a number of bankers have is, if they borrow under this program, will there be some surprises at maturity? But, nonetheless, their boards feel it's prudent to set up the line," Scott said.

Community banks are also watching for new and/or renewed regulations in response to the bank failures. Even though any regulations would likely apply only to banks larger than the community bank category, directives can filter their way to smaller institutions by affecting the way they are examined.

In an exam report, an examiner may characterize a certain practice as a recommendation, Scott said. But recommendations are likely to become a matter requiring attention "if you don't do something about it," he said.

As for the concentration risk that is seen as playing a large part in the recent stresses, Scott said community banks "are better diversified in their loan portfolios than a lot of people think.

On average, their commercial and industrial portfolio is only 12% of their loans, though some may go up to 20%, while commercial real estate is higher—25% at the end of 2022, he said. But there are nuances to consider, including the type of CRE. For example, while office space is stressed, warehouses are in demand. Ownership distinctions are important too. Owner-occupied and small business-use CRE may be less prone to default than other CRE because those borrowers have skin in the game, he said.

"I don't know how many articles I've read over the last 30 years about how commercial real estate is going to kill community banking," he said.

"I don't see a potential crisis there," he said, "but it doesn't mean we shouldn't monitor performance closely."

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The OCC's View on Climate Risk Management:

An Update From Acting Comptroller Michael Hsu and OCC Chief Climate Risk Officer Yue Chen

It's been nearly a year since The RMA Journal interviewed Acting U.S. Comptroller of the Currency Michael J. Hsu on the state of climate risk management in the financial industry and the OCC's related efforts. The interview followed the release of the OCC's Principles for Climate-Related Financial Risk Management for Large Banks proposal—and preceded similar proposals by other agencies. Recently, The RMA Journal met with Hsu again, as well as OCC Chief Climate Risk Officer Dr. Yue (Nina) Chen, to discuss the intervening climate risk management progress that has been made, and the work yet to come. The following interview has been edited for length and clarity.

Image Credit: Bilanol | Shutterstock.com

THE RMA JOURNAL: Since our last interview, what have been the major developments in climate risk management and regulation?

HSU: First of all, thanks so much for having me back, this time joined by Dr. Chen. There have been a number of changes and developments in climate risk management. On the regulatory front, there's been greater convergence and coordination, especially domestically. The Federal Deposit Insurance Corporation (FDIC) and Federal Reserve followed the OCC's lead on issuing climate risk principles and published similar guidance. There has always been good collaboration between the agencies but it has increased in quantity and quality the past year. Also, the Financial Stability Oversight Council stood up the Climate-Related Financial Risk Advisory Committee to serve as an interagency approach to climate financial risk. The committee is like an umbrella, with various work streams from the agencies working together. At the last Federal Financial Institutions Examination Council meeting, we shared climate risk management approaches and practices across agencies. There is a lot of collaboration, coordination, and convergence on this issue. With this topic, we all need to engage with each other a lot to avoid surprises, and to move in the right direction.

While the OCC is currently focused on climate-related financial risks for large banks with more than $100 billion in total consolidated assets, I've also made it a point to meet with a lot of community banks. During our interactions, climate risk management comes up pretty much in every meeting. The only difference is whether it's the first or second question they ask. We welcome that engagement even though it is not our focus. It's been very helpful. We wanted to make sure that we are not just talking to community banks, but that we are going to where they and their communities are—where fears around climate change, its impacts, and policies in Washington are heightened. These visits are very important to us. We are going to continue engagement with financial institutions of all sizes.

Meanwhile, at the OCC we further professionalized our climate risk management efforts. We officially established an Office of Climate Risk and hired Dr. Chen, who was previously the executive deputy superintendent of the Climate Division at the New York State Department of Financial Services, to head it. Through these efforts we are institutionalizing and increasing the profile of climate risk management and providing more resources—which helps improve our internal capacity and our processes.

THE RMA JOURNAL: Can you describe what the chief climate risk officer role entails?

HSU: I will let Dr. Chen field that question but first I will provide some context around her position. The topic of climate-related financial risk management is novel, complex, and politically tricky. That means we have to be especially credible if we're going to be trusted to do the right thing in this space—credible with the banks, credible with scientists, and credible with the public. This is a very fraught topic. We want to do it right. We need a leader in the organization who knows the science, who knows finance, who knows supervision, and Dr. Chen is that person. She is the right leader in the organization to build that credibility.

CHEN: I feel very honored to have the opportunity to lead and direct the OCC's activities related to climate-related financial risk. We are working in a very collaborative manner. There is a lot to learn and to continuously adapt to, for example: developing consistent strategies, policies, and guidance for our risk-based exams. The draft principles the OCC issued are the starting point of that. We also want to have consistent messaging on what this risk is, and what the OCC's work is about. We need to have a very educated workforce to execute this work. From a regulatory perspective, we want to be able to understand, identify, and assess these risks just like we expect our regulated entities to do. Lastly, we want to be supportive of our regulated entities as they start considering climate-related financial risk management. This is a learning process for them and us. We have information we can share with them. We want to be on this learning journey together.

"The **large banks** are faced with **limitations** in terms of **climate-related data**—not just in the U.S. but **internationally**."

THE RMA JOURNAL: The OCC's operating plan for 2023 says at the largest banks examiners will monitor the development of climate-related financial risk frameworks and will engage with bank management to understand the challenges that banks face in this effort. How has that effort been going and what kind of feedback are you getting from the banks? What are you learning?

CHEN: We've been observing that the large banks of $100 billion and larger are still in the early stage of implementing climate risk programs. During the past few months, we have been doing very in-depth discovery reviews of these programs. Early last year, we did range-of-practice reviews and got a lot of good information from the industry. We have noted that, since then, large banks have been making progress incorporating climate-related financial risk in their risk management frameworks and governance. But the level of progress among the largest banks still varies.

Some large banks are developing project plans and organizing structures across the three lines of defense to be able to better identify and manage risk. Some are training both their board and senior management as well as staff, and building subject matter expertise internally. It is a new area and a lot of expertise is needed. There are also some large banks making progress toward including climate-related financial risk in their risk appetite statements. So far, most are observing qualitative risks. But there have been efforts toward quantitative metrics as well. Overall, many large banks are still in the early phase of understanding this potential risk. But we are seeing progress and tools being built and so on. As we learn more, we hope to share more information on leading practices with the banks.

THE RMA JOURNAL: What are their biggest challenges in assessing climate-related financial risks?

CHEN: The large banks are faced with limitations in terms of climate-related data—not just in the U.S. but internationally. Many are using external data and some supplement it with internal data. For example, with physical risk, it's very challenging for banks to obtain very precise, location-specific data. They might know where the headquarters of their obligors are, but they don't necessarily know where the relevant facilities are. That's still a developing area, and we are seeing more data providers specializing in this space.

Large banks with more mature programs have started to develop forward-looking scenarios to better understand how climate risk might impact them. But that creates another question in terms of the right timeframe. Is it short term? Medium term? There are many modeling choices, and many assumptions banks can make. In our discovery review, we're trying to understand all of this. Large banks with less-mature programs are still developing their internal capacity and hiring, and trying to close the knowledge gap.

THE RMA JOURNAL: What, if anything, has been surprising about the climate risk management journey for banks and regulators?

HSU: Luckily, not much has surprised me—for two reasons primarily. First, this is a shared journey. Banks and regulators are doing this together in terms of learning what the risks are, how to think about the risks, and how to identify and measure them. That has resulted in a lot of engagement. It's hard to have surprises when you're constantly talking to each other. Meanwhile, on an interagency basis—domestically and internationally—there's a lot of engagement. That's healthy. It does take a commitment. But we've made that commitment and it helps to keep the surprises to a minimum.

Where there has been what one may call a surprise is at the community bank level—in cases where there hasn't been engagement. That's part of the reason why we're getting out there and talking to community banks. Because once you start engaging, the issue is a lot less scary. The community banks I've been talking to often say something like, "Okay, we have a better feel now for where this is going and what you're trying to do. Your objectives are safety and soundness and risk management. We get that." Without such engagement, there could be a lot more unanswered questions on this topic. We are trying to keep all banks informed and stay focused.

THE RMA JOURNAL: The OCC has indicated that community banks will not be regulated regarding climate risk for some time. That being the case, what steps should community banks be taking at this time?

HSU: What I tell every community banker is "use the time wisely." They are going to have some time before we do examinations on these particular risk management issues since our focus is on large banks with more than $100 billion in total consolidated assets. I liken climate risk issues to learning a new language. Some of those risks everyone understands. But depending on where you are and your business model, each bank is different. Many community bankers say, "We've been dealing with weather-related risks for some time." Which is true. But the severity, the frequency, the duration, the scope of the risks—those are new elements. The transition risk element—how shifts in policies, markets, and consumer preferences will affect bank credits—is also new. It's not easy to go into that world without knowing the vocabulary of how to talk and think about those things.

This period of time can be used to learn that vocabulary. Climate risk profiles can be particularly divergent for community banks. A community bank in the Midwest is going to have a very different climate risk profile than one on the Gulf Coast versus one on the West Coast. I get told all the time, "Don't treat all community banks as one size fits all. Please recognize that we're different and don't do trickle-down regulation." I want to address climate risk the right way for community banks. We can do that best if they use this time to learn the climate risk language so that we can have an informed discussion in the future to say, "Okay, what are you doing? How are you thinking about things?" And they can say, "Here's how." That's a much better conversation than if we show up in the future and the bank says, "What do you want me to do?" That's a hard conversation to have unless there's been some learning done and banks ask questions. This is a journey we're on together. This is not us versus them.

THE RMA JOURNAL: How did it come about that the OCC was the first U.S. prudential regulator to release climate risk management principles?

HSU: I made climate risk one of my top four priorities for the agency when I came here in May 2021. That was a result of thinking through the major threats to safeguarding trust in the banking system—the things that we have to marshal our resources for and focus time and attention on to get right.

Acting on climate-related financial risks was one of those priorities. That drove several actions, including having the OCC join the Network for Greening the Financial System and appointing a chief climate risk officer.

It's significant that the other agency climate principle proposals are very similar. That's because from day one, at the principal level down to the staff level, there has been a lot of coordination and collaboration. One thing we've heard from a lot of banks is "please stick together as regulators on this." That request is well taken. It will help everybody, both banks and regulators, if there is a lot of coordination. We've endeavored to do that, and that helps explain how, content-wise, we are looking very similar.

THE RMA JOURNAL: Comptroller Hsu, at the time the OCC principles were released, you suggested questions that boards should be asking their management teams regarding climate risk. Do you still stand by these questions? Would you add any? And if so, what would they be?

HSU: I absolutely stand by the questions. But there's a slight tweak to one, which I will explain, considering the climate-related elements in the Inflation Reduction Act. But to take them in order, the first question to ask was, "What's our overall exposure to climate?" Obviously, that's the main question that drives a lot of the work. The second question was, "Which counterparties or sectors and locales warrant heightened attention?" That's kind of a subset of the first question, so that obviously warrants a lot of focus and attention. That's also a keeper. The third question was about transition risk and requires a tweak. I posed, "What's the exposure to something like a carbon tax?" What's interesting is that Congress then passed the Inflation Reduction Act, whose effect will be the opposite of a carbon tax because of its incentives. It's more carrots than sticks. The original question is still correct in terms of discussing transition risk. But now it's more properly stated as "What's our exposure to the changes that will result from the IRA being implemented?" That links well with another question, which was, "How can you seize opportunities from the climate transition?" There are obviously risks. That's how The Risk Management Association and risk managers see the world. But with risk comes opportunity. Those who manage risks well will be able to navigate those opportunities better. It's interesting that Congress has taken an approach which is more carrots than sticks. That might tie in, depending on the bank and its business models, with certain opportunities that banks can perceive.

The last question was about vulnerability of data centers and critical operations. We've seen a lot of events this past year where that's kind of a live question. I think the questions as a whole are pretty solid. Ask us again next year. We're hoping that as we go through our range-of-practice exercise, asking these questions really starts to bear fruit.

THE RMA JOURNAL: You also said at that time that within a year, management teams hopefully should be able to answer these questions with greater accuracy and confidence. Are you seeing any evidence of that happening or not happening?

HSU: We are seeing progress at the large banks in terms of developing the governance process and structure to better identify and understand climate-related financial risk. We're also seeing increased confidence at large banks with more mature programs to develop processes to manage the risks—to go beyond just identifying them. But there's still a lot of work to do. And integrating that work into business decisions is still a work in progress.

THE RMA JOURNAL: What are the OCC's goals regarding regulation and messaging about climate risk management at banks? What milestones might you have in coming months or years to indicate whether you are meeting your goals?

HSU: The real goal boils down to safety and soundness. Can banks effectively risk-manage their exposure to climate? That may sound basic but it begs a lot of questions. For example, what exactly are the climate risks? We've had many conversations about physical risks and transition risks. Those are tricky to identify and to quantify—to get your arms around. The goal is to make this similar to what we do for every other risk in banking: interest rate risk, liquidity risk, market risk. So that it becomes an area where the practices and approaches, and what's prudent, are well understood. And banks know what the expectations are and we know how to examine for that. That's the ultimate goal, but it is going to take a while to get there. Luckily, there are a lot of very dedicated professionals at the OCC and in the industry focusing on that.

The milestones are harder. We want to make sure there is progress. But it's fair to say progress is not going to be monotonic and linear. That's the nature of dealing with things that are novel and challenging. Sometimes you are going to see what seems like a lack of progress and then suddenly a lot of progress. That's not unusual. What's critical is that commitment is there, that engagement is there, that we are doing the work. We will be doing that and we expect the banks to be doing that.

We are interested in the long-term success of what we're trying to do. We do expect folks to hold us accountable; this is not a paper exercise. This is something that we seriously need to do.

Culture Matters

Strong Performance Depends on Getting Risk and Work Cultures Right

By Joseph Ferry

Larry Senn, who founded the culture-shaping organization Senn Delaney in 1978 and is considered by some to be the "father of corporate culture," was once quoted as saying, "All organizations have a culture. The only question is do you shape it or does it shape you?" A robust risk culture at a financial institution is critical to ensuring the organization operates in a safe, sound, and ethical manner. At the same time, it helps an organization stay aligned with its objectives, values, and principles—and deliver value to stakeholders including customers, employees, investors, and regulators.

The bottom line? The right culture will drive the right behavior, which is going to drive the right performance for the organization.

According to organizational psychologist Thomas Diamante, speaking at a recent RMA New York webinar on the topic, risk culture "reflects the extent to which your business strategy focuses on preventing bad or unwanted events from occurring, and the extent to which it embraces or encourages desirable actions or healthy risk."

Diamante added that risk culture reflects a host of other, sometimes unexpected or intangible factors: social norms; unconscious, unproductive bias; unwise risky group decision-making; and incongruities between what management rewards (incentives) and what management conveys (expectations). Not surprisingly, risk culture and work culture are intertwined—after all, an unhealthy work culture can pose an undeniable risk to the organization.

"Informally, risk culture is what gets you by," Diamante said. "How do I create a career in this organization? Who do I need to work with to get noticed? What risk is good risk and what is bad? What topics can be discussed? What topics must I avoid at all costs? What metrics truly matter?"

On one hand, he said, an organization is trying to avoid undesirable outcomes. But on the other hand, organizations need to be "adaptive and curious. Employees must ask 'why and why not' if they want to remain relevant. 'Don't ask' cultures are a fast track to obsolescence."

"You want a flexible, learning, creative, open, and healthy organization. That requires people to share, to express opinions, to discuss," Diamante said. "There has to be expression internally so there's learning going on all the time."

The consequences of a nonexistent or ineffective risk culture are real and can erode a company's capital, reputation, and trust, panelists agreed.

Truly successful risk culture comes from the top down, said Richard Vestuto, managing director of Data Insight and Forensics for Kroll. Vestuto said the board of directors, senior executives, and risk managers all play critical roles in shaping the risk culture of an organization. It's necessary that they articulate the company's risk appetite, establish clear risk policies and procedures, promote open communication and feedback, and hold individuals accountable for their risk-related decisions and actions. "CEOs can't see everything, but they better be driving that down through the organization," Vestuto said.

That can be especially important regarding newer hires, who, depending on the size and complexity of the organization, can "change the game in terms of what type of personality and behavior they bring into the equation," said Shahryar Shaghaghi, a technology, risk management, and cybersecurity executive at CyTech Partners, and a faculty member of the Enterprise Risk Management program at Columbia University. The onboarding process is key, he said, because it's a new employee's "first impression" of the company.

By encouraging a strong risk culture, leaders can create a sense of purpose, integrity, and excellence to inspire and motivate employees to do the right thing, even in challenging situations. Employees need to feel as though there's a level of trust that "if they raise a concern and they self-identify something they won't automatically be tasked with getting it fixed," said Deborah Hvratin, CRO for CLS Group. You also don't want them to feel as though "they'll come under scrutiny for making that judgment," she said. "At CLS we promote good self-identification as one of our key metrics that we track against risk culture."

Encouraging the concept of "doing the right thing because you believe in it is another key," Shaghaghi said.

Hrvatin said she has found that good strategy is what drives good decision making. She described a scenario involving a company considering migrating its platforms to the cloud. It's imperative to do the proper risk assessment on such strategic decisions, she said.

"You need to understand what your risk appetite is for moving to the cloud and assess it appropriately," she said. "And that all gets embedded in culture. Risk culture sits across all of the dimensions of how we look at operational risk or compliance or technology, in design and delivery of data. The expectation is that people operate within those behaviors and norms as we deliver strategies."

Developing and sustaining an effective risk culture is difficult enough when your workforce is engaged in the organization's future. But the advent of "quiet quitting"—the recent trend of employees doing only the bare minimum to survive—has added another layer of complexity to the effort. How do you instill that necessary sense of accountability and purpose in a worker whose top priority is just making it to the end of the day?

During a recent RMA Risk Readiness webcast, Priya Dixit Vyas, a partner at Heidrick & Struggles with a focus on culture shaping, said research has shown that culture is an important predictor of a company's trajectory. "Almost 51% of people will tell you that their organization's culture needs to change, needs to evolve where they feel included, where they feel engaged," she said.

For starters, culture must be aligned with strategy. "Every employee wants to know what they're contributing," Dixit Vyas said. "What's the big purpose? What is it that you're trying to deliver as an organization? What's the impact you make, the greater good? There is a clarity around strategy—people understand it in the simplest way possible."

Diversity and inclusion are among the keys to developing the right culture because they foster collaboration, which in turn drives better decision making. "The foundation of all of it is, is there psychological safety? Do people feel safe? If they can speak up, they can collaborate, they can innovate. And if you have some of these ingredients in your culture, you're onto a winning formula," Dixit Vyas said.

Purposeful leadership is another important factor in developing culture. "Leaders have to have a very clear vision of what their culture is, how that culture will contribute to delivering a strategic ambition, and then, how will they role model it?," she said. To do that takes more than putting up a nice looking poster that lists out the company values. "How are leaders going to authentically lead, be at their best and help the teams and organization be at their best? That requires a personal change," she said.

While there is not a single "right" culture, according to Dixit Vyas, there are specific drivers that are foundational to every successful culture: trust, emphasis on ethics and integrity, quality, customer focus, and spirit and vitality .

"But you have to find what's the culture which works for you," said Dixit Vyas. "Make the connection with purpose and strategy. Think about, of course, the role from the top, but equally, how do you engage everybody in the organization in this journey?"

Mike Roemer, chief risk officer at Discover, said for more than a year his company has been focusing on changing the dynamics of how it runs performance and talent management. Discover hired more than 3,000 people during the pandemic who never set foot in its Chicago headquarters. Last year, Discover held two large events directed at employees who had been hired over the past two years. Presentations covered company history and, of course, company culture.

"But we also wanted them to watch the behavior of people who have been with us a long time," Roemer told the webinar audience. "Because I'm a big believer that observable behavior is the biggest driver of culture."

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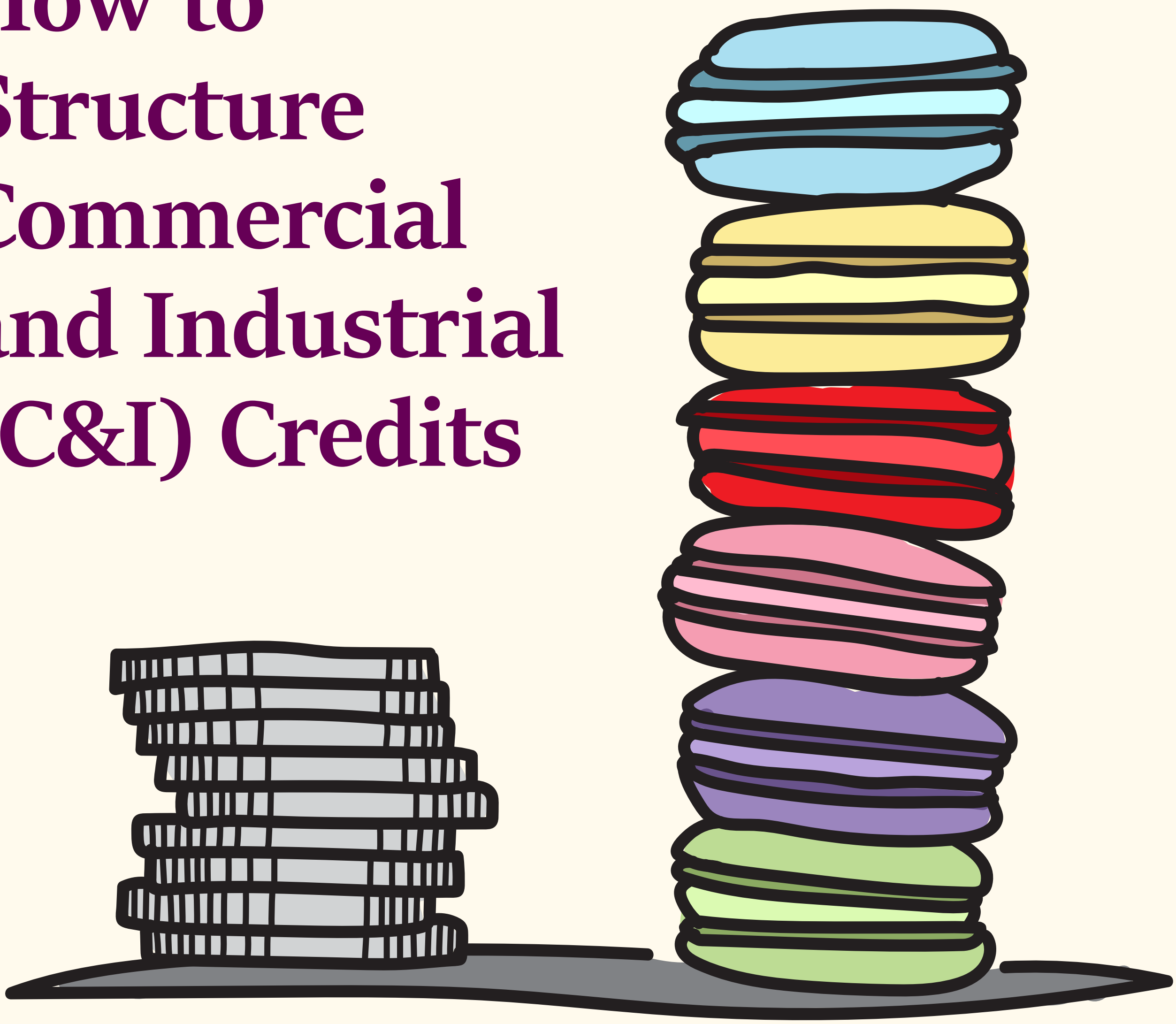
How to Structure Commercial and Industrial (C&I) Credits



By Hooi Lim

Commercial and industrial (C&I) loans typically account for 20% or more of bank lending, so learning the tried-and-true practices for underwriting these important credits is key. Getting started includes studying the building blocks of all C&I lending: the common loan structures, their purposes, and how each is typically repaid.

This article provides information on those building blocks, and includes some exercises to test what you've learned.

The Big Picture

Structuring C&I credits requires knowledge of four particular loan types, what they are used for, and how they are repaid. The banker needs to identify a borrower's primary, secondary, and tertiary repayment sources, and be sure that the loan purpose and borrowing cause are within the bank's risk tolerance level. (In other words, they fit the types and amounts of risk the bank has strategically decided to take on.) The banker also needs to understand the borrowing business's operating cycle. After all, the business's cash is what will repay the debt.

When structuring credits, the banker should focus on these questions:

- What does the business do, and how long has it been in business?
- What is the loan purpose and borrowing cause?
- Are there primary, secondary, and tertiary repayment sources?
- What issues were identified, and what are the mitigants?

Four Loan Types

Terminology and categorization can differ. But for the purposes of this article, let's use the four types of loans noted in the 2001 RMA book "Beyond Traditional Credit Analysis." In it, author Edgar M. Morsman Jr. describes seasonal, permanent capital, term, and bridge loans. Let's look at each.

Seasonal loans include lines of credit (LOC) and loans lasting up to a year that support short-term cash shortfalls. Borrowers repay these seasonal loans as their accounts receivable and inventory are converted to cash. Consider a ski and snowboard maker. Sales, receivables, and inventory peak in fall and winter. Then it pays down its line of credit in the spring as it converts receivables into cash.

Permanent capital loans include borrowing base lines-of-credit and term loans up to five years. As with seasonal loans, permanent capital loans are also repaid through the shrinkage of accounts receivable and inventory to cash—but over a longer period. Say that the ski and snowboard maker gets a contract to supply Walmart. That's great news: The deal will double the borrower's revenues over three years. But in the meantime, the borrower is facing immediate increases in raw materials, work-in-process inventory, and other costs to support that growth. Getting to those increased revenues requires an increase in the company's borrowing base LOC.

Term loans fund fixed assets, a change in ownership, or a business acquisition. Borrowers repay over several years from cash from operations. Our ski maker might use a term loan to buy additional equipment to support the Walmart deal.

Bridge loans are for gap financing. Repayment is from refinancing, sales of assets financed, or equity injection. The ski manufacturer's 18-month construction loan, if it is refinanced by a longer-term construction loan, is an example of a bridge loan.

Table 1 shows the four loan types, the purposes they are used for, and how they are repaid.

Table 1. Four Loan Types

Loan Types	Purpose	Repayment
Seasonal	Fund temporary increase in accounts receivable and inventory	Conversion of trade assets (accounts receivables and inventory)
Permanent capital	Finance permanent increase in accounts receivable and inventory	Cash from operations over several years; or the shrinkage of accounts receivable and inventory
Term	Fund fixed assets, change in ownership, business acquisition, and/or run longer than one year	Cash from operations over several years
Bridge	Gap financing, such as construction loans or SBA 504 bridge notes	Refinance, sale of an asset financed, or equity injection

Primary, Secondary, and Tertiary Repayment

All loans must have three sources of repayment: primary, secondary, and tertiary. The primary repayment for seasonal loans is the conversion of trade assets—receivables and inventory—to cash. For permanent capital loans it is the conversion of trade assets and cash from operations. For term loans, it is the cash from operations. The primary repayment for bridge loans is the refinancing or selling of the asset funded or an equity injection.

Let's move on to secondary sources. For seasonal and permanent capital loans, the secondary repayment method is typically a blanket Uniform Commercial Code (UCC) filing on a borrower's accounts receivable, inventory, equipment, and other assets. A UCC filing places liens on the debtor's business assets. A bank's secondary repayment source for term loans is holding the asset financed, such as equipment and real estate, as collateral. Cash and marketable securities that secure loans are secondary repayment sources for term loans as well.

Tertiary repayment for the loans discussed comes from the business owner's or guarantors' net worth outside the business ownership. For tertiary support, review a current personal financial statement (PFS). Focus on cash, marketable securities, and lendable equity in real estate, and verify cash and marketable securities with a recent bank or brokerage statement. Lendable equity real estate is the estimated market value of the real estate multiplied by 75% less the mortgage outstanding. For example, a residence with an estimated market value of $1 million and a mortgage of $500,000 will have lendable equity of $250,000 ($1,000,000 x 75% - $500,000 = $250,000).

Purpose and Borrowing Cause

The loan purpose and borrowing cause must be within the bank's risk appetite—defined in this RMA Journal article as "broadly speaking … an organization's articulation of how much risk it is willing to assume." The loan purpose means how the loan proceeds will be used. The borrowing cause is the reason for the funds. For example, if loan purpose is buying an owner-occupied warehouse building, the borrowing cause could be the need for a

Table 2. Loan Types, Purposes, and Borrowing Causes

Loan Type	Loan Purpose	Borrowing Causes
Seasonal Lines of Credit	LOC to finance short-term cash needs	• Support seasonal increases in accounts receivable and inventory • Fund temporary slowdown in inventory and accounts receivable collections • Pay trade payables and take trade discounts • Pay operating expenses until accounts receivables are collected
Permanent Capital Loans	To finance long-term cash needs or term out the balance on LOC that has not revolved	• Support accounts receivables and inventory due to long-term sales projections beyond sustainable growth • Fund slowdown in accounts receivable collections and inventory due to structural changes in business operations
Equipment Loans	Purchase new or used equipment	• Routine replacement of equipment • Equipment needed to support new contracts or revenue growth • Reduce cost and increase efficiency and overall productivity
Owner-occupied real estate	Purchase, refinance, expand, or construct a building	• Need for a larger building due to sales growth • Fund a second location with a move into a new market • Own versus lease • Investment income for space not occupied • Refinance for a lower rate • Refinance to improve cash flow
Investment real estate	Purchase, refinance, expand, or construct a building	• Investment income • Capital appreciation • Asset diversification • Positive cash flow

larger facility due to sales growth. Table 2 shows examples of loan types, purposes, and possible borrowing causes.

Operating Cycle

The operating cycle describes how cash moves through the business from cash to inventory, sales, accounts receivable, and back to cash. Trade credit from accounts payable reduces the cash required for inventory purchases. Companies borrow when the operating cycle does not generate sufficient cash for daily operations. The cycle can be short term for seasonal increases in revenues or long term for permanent revenue increases. It differs for manufacturers, wholesalers, retailers, and service firms.

Seasonal LOCs are used for short-term cash needs: 12 months or less. Permanent capital LOCs and term loans are used for long-term purposes (longer than 12 months).

Credit Facilities

Standardized processes, credit products, documentation, and booking allow business development officers, relationship managers, underwriters, and support teams to serve their borrowers more effectively and efficiently. Standardization allows for faster delivery from loan application to funding. The general parameters of the credit facilities that are about to be described in this article are typical throughout the banking industry. However, the specifics vary from bank to bank.

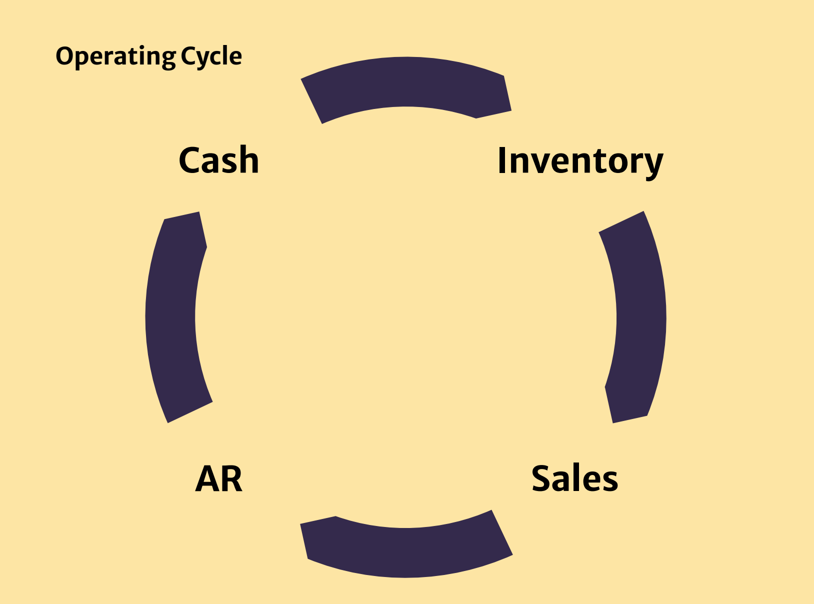
Table 3 presents the three standard credit lines. A small business LOC is evergreen, meaning there is no maturity. The line can be unsecured or secured with a perfected UCC security interest on receivables, inventory, equipment, and other assets. Requiring a 1% principal payment on the monthly balance plus interest is not uncommon. For example, the borrower has a $100,000 small business LOC and owes $25,000 at month's end. The borrower would be required to pay interest on the balance outstanding plus pay down the balance by $250 (1%). Banks use credit scoring models to originate and monitor these credits.

A seasonal LOC is a standard LOC with typically annual maturity, and sometimes maturity extended to 24 months. Terms for an LOC secured with real estate are up to 60 months. Lenders often require borrowers with these revolving loans to maintain a zero balance for a period of time each year. Covenants typically require a period of 30 or 60 days.

Borrowing base LOCs are for higher dollar (see Table 3) commitments with minimal tertiary support from the individual guarantor. A borrowing base credit line is considered secured financing by the Office of Comptroller of the Currency. Loans are monitored monthly via a borrowing base formula that excludes ineligible receivables and inventories to determine the borrowings available not to exceed the LOC commitment.

Table 4 reviews two Small Business Administration LOCs commonly underwritten by commercial and industrial (C&I) underwriters instead of SBA lenders.

SBA Express lines are for borrowers who do not qualify for a conventional LOC or request a higher dollar commitment than the bank is comfort-



able approving. For example, the borrower requests a $250,000 LOC but qualifies for $175,000 based on limited business balance sheet support. With the SBA's 50% guarantee, the bank's exposure on a $250,000 SBA Express LOC is $125,000, which is well within the bank's initial intended commitment and its risk tolerance. The maximum term is 10 years, with the first five years as a revolving LOC and the balance amortized over the remaining five years. SBA CAPLines are for commitments above $500,000. These are typically borrowing base LOCs enrolled in the SBA CAPLine because the borrower does not qualify for conventional borrowing base LOCs. Monitoring is similar to a traditional borrowing base LOC.

Table 5 summarizes term loans, equipment lines and loans, and real estate loans. The collateral determines the maturity and amortization of term loans. Terming out the balance on a seasonal LOC used to finance trade assets should not exceed 48 months.

Equipment lines are non-revolving lines to fund equipment purchases within the next six months. The advance rate and term/amortization are determined at funding and based on the type of equipment financed. For example, an equipment line is approved for $500,000, with the first draw in Month 1 for $300,000 to purchase new packaging equipment amortized over seven years. The second draw is in Month 3 for $200,000 to finance new testing machinery amortized over five years.

Stand-alone equipment loans fund specific or specialized equipment purchases.

Real estate loans are generally for purchasing or refinancing and have a term or maturity shorter than the amortization, resulting in a balloon payment.

Banks categorize equipment financed from most to least desirable. Equipment loans are fully amortizing loans, meaning the term and amortization are the same. Typical equipment category, amortization, and advance rates are shown in Table 6.

Most desirable comprises manufacturing and production equipment such as machine tooling, food processing, and packing machinery.

Moderately desirable includes construction equipment, testing and measurement machinery, forging equipment, mining equipment, semiconductor manufacturing, warehouse equipment, office furniture, automotive repair, and commercial laundry. Healthcare equipment such as computed tomography (CT) scanners,

Table 3. Lines of Credit Parameters

Description	Small Business LOC	Seasonal LOC	Borrowing Base LOC
Amount	Up to $250,000	Over $250,000	Over $2.5 million
Term	Evergreen	12 to 24 months	12 to 24 months
Repayment	Percentage of the balance plus interest	Interest monthly and balance at maturity	Interest monthly and balance at maturity
Collateral	Unsecured or a perfected security interest in receivables, inventory, and equipment	Secured by a perfected security interest in receivables, inventory, and equipment or real estate equity	Secured by a perfected security interest in receivables, inventory, and equipment
Rate	Prime rate + spread	Prime rate + spread	Prime rate + spread

Table 4. Small Business Administration LOC Parameters

Description	SBA Express	SBA CAPLines
Amount	Up to $500,000	$500,000 to $5 million
Maximum Term	Revolving LOC or term loans with terms of up to 10 years	Revolving LOC with terms up to 10 years
Repayment	Interest due monthly and balance at maturity for LOC and fully amortizing for term loans	Interest due monthly and balance at maturity
Collateral	Secured by a perfected security interest in receivables, inventory, equipment, and other assets	Secured by a perfected security interest in receivables, inventory, equipment, and other assets
Rate	Prime rate + spread	Prime rate + spread
SBA Guarantee	50%	85% guarantee up to $150,000 75% guarantee over $150,000

ultrasound, and mammogram equipment fall into this category.

Least desirable consists of restaurant equipment, office equipment, telephone equipment, computer and related equipment, and retail equipment.

Table 7 shows the property types, loan-to-value (LTV), term, amortization, and coverage ratios.

The most common term is a 10-year maturity with a 25- to 30-year amortization. Real estate loans over 10 years are typically fully amortized—usually not to exceed 15 years but in certain situations up to 20 years.

Determining the Appropriate LOC Amount

Determining the appropriate seasonal LOC commitment requires a 12-month cash flow budget detailing cash and loan receipts and cash outflow for operations, capital expenditure, and loan repayment. Short of a cash flow budget, a good rule of thumb is 10% of revenues not to exceed 70% of accounts receivable (A/R) and 40% of inventory. The discounted accounts receivable and inventory provide collateral support for the LOC. The bank's debt service coverage ratio (DSCR) and leverage calculation further reduce the line commitment. DSCR is designed to ensure sufficient cash flow to service existing debt payments and interest on the LOC. Limiting leverage reduces total liabilities on the borrower's balance sheet and risk to the bank.

DSCR is determined by the bank's policy. DSCRs are usually between 1.25 to 1.35 times higher than the debt payments—the higher the better. Some banks calculate debt services using only the interest payment, as if the LOC is fully disbursed, and others amortize the fully disbursed LOC over five to seven years.

Leverage is a borrower's total liabilities divided by tangible net worth (TNW). Total liabilities include the proposed debt. TNW is net worth minus intangible assets, including goodwill and related party notes receivable. Most banks deem businesses to be highly leveraged when total liabilities are four or more times larger than TNW.

An illustration: ABC Inc. shows revenues of $10 million, cost of goods sold (COGS) of $6.4 million, accounts receivable (A/R) of $466,000, inventory of $333,000, and accounts payable (A/P) of $316,000. At 10% of revenues, the maximum LOC is $1 million. However, 70% of A/R and 40% of inventory provides only $459,000 in collateral support [($466,000 x 70% = $326,000) + ($333,000 x 40% = $133,000) = $459,000]. The appropriate LOC commitment approximates $450,000, assuming DSCR and leverage are within the bank's guidelines or policy. (LOCs are typically written in $25,000 increments—for example, $425,000, then $450,000, then $475,000.)

The LOC commitment further presumes the commitment of $450,000 plus $316,000 in A/P is sufficient to support the borrower's seasonal cash flow needs, which can only be determined from a detailed cash budget—which in most cases you will not receive. Most junior lenders will want everything, but seasoned lenders will not need it. The LOC can also be used to pay down accounts payable should it be advantageous, such as discounts for early payment. The banker should consider a borrowing base LOC if there is a need for a larger LOC due to projected sales growth.

A borrowing base LOC commitment is typically greater than $2.5 million. It is common for the LOC to exceed 20% of revenues. The maxi-

Table 5. Term Loans, Equipment, and Real Estate Parameters

Description	Term Loans	Equipment Lines or Loans	Real Estate Loans
Amount	Over $25,000	Over $75,000	Over $150,000
Term	3 to 60 months	36 to 84 months based on equipment type	5 to 10 years maturity with amortization between 20 to 30 years
Repayment	Principal and interest fully amortizing	Principal and interest fully amortizing	Principal and interest with a balloon payment
Collateral	Secured by a perfected security interest in receivables, inventory, equipment, and other assets	Secured by a perfected security interest in equipment financed	Commercial real estate
Rate	Fixed or adjustable rate	Fixed or adjustable rate	Fixed or adjustable rate

mum borrowings for each month are limited to a calculation not to exceed the commitment amount. There has to be sufficient collateral to support borrowings. The borrowing base calculation only considers eligible A/R and inventory multiplied by an advance rate not to exceed 80% for A/R and 50% for inventory.

Cash businesses such as restaurants, hotels, tourism-related services, and retailers have shorter operating cycles, defined as A/R days plus inventory days under 30 days, and require a smaller LOC than a manufacturer or wholesaler. LOCs for a business selling products or services for cash should be limited to 10% of revenues not exceeding $250,000, and usually support inventory purchases or unexpected cash shortfalls.

Credit Scenarios

The following scenarios incorporate the learnings from this article to structure the borrower's credit request. The information provided is intentionally limited but sufficient to structure the request. As stated, when structuring credits, the banker should focus on four questions:

- What does the business do, and how long has it been in business?
- What is the loan purpose and borrowing cause?
- Are there primary, secondary, and tertiary repayment sources?
- What issues were identified, and what are the mitigants?

For each scenario, determine the appropriate credit structure, explain the rationale, and see if it matches the recommendation.

Scenario 1:

- The business is a specialty retail women's clothing store, in business for more than 12 years.
- Revenues are $3 million, and leverage is under 3:1.
- The business does not currently have an LOC.
- The request is for an operating LOC for miscellaneous needs.
- There is good DSCR, profitability, and tertiary support from the owner.

Recommendation: A small business LOC for $150,000, which is well within the 10% of revenues, to a borrower that currently does not have an LOC or an immediate borrowing need. The facility is suited for cash businesses, and the owner has good tertiary support.

Table 6. Equipment Category and Terms

Desirability	Most	Moderately	Least
Amortization:			
New	7 years	5 years	3 years
Used	5 years	5 years	2 years
Advance Rate:			
New	100%	100%	75%
Used	75%	75%	50%

Table 7. Real Estate Loan Terms, Amortization, and Coverage Ratios

Property Type	Loan to Value %	Term (Years)	Amort. (Years)	DSCR or Debt Yield (DY)*
Owner-Occupied	75	10 15 20	30 15 20	1.25x DSCR
Investor	75	10 10 15	25 20 15	1.25x DSCR or 10% to 11% DY
Multi-Family	75	10 15	25 15	1.25x DSCR or 8% to 10% DY
Special Purpose	50 to 65	10	20	1.35x DSCR

*DSCR is the debt service coverage ratio. Debt yield is net operating income ÷ loan amount.

Scenario 2:

- The business manufactures doors and has been in business for more than 11 years.
- Revenues are $5 million, receivables $500,000, inventory $400,000, and leverage is under 3:1.
- The business has a $300,000 LOC (balance of $200,000) with a competitor bank.
- The request is for a $500,000 LOC to support operating cash needs.
- There is good DSCR and tertiary support from the owners.

Recommendation: A seasonal LOC for $500,000 with performance covenants for a 30-consecutive day clean-up requirement to ensure the LOC revolves. Suggest a 24-month maturity with reporting covenants for annual financial statements. There is good DSCR, secondary support, and tertiary support from the owners. The leverage is moderate.

Scenario 3:

- The business is a wholesaler of janitorial supplies and has been in business for more than 15 years.
- Revenues are $17 million, receivables $2 million, inventory $1 million, and leverage is under 3:1.
- Revenues grew an average of 30% annually the past three years.
- The owner-occupied (OO) building's estimated value is $3 million and in the owner's name; there are no liens.
- The business has a $1.5 million LOC (balance of $1 million) with a competitor bank.
- The request is for a $2 million LOC to support sales growth.
- There is good DSCR but marginal tertiary support from the owner other than the owner-occupied building.

Recommendation: A seasonal LOC between $2 million to $2.25 million (75% of $3 million OO CRE) to the business secured by the owner-occupied building for a maturity of five years. Consider a borrowing base LOC should the borrower not want to provide real estate as collateral. There is good DSCR, secondary support, and moderate leverage. Real estate security mitigates the accelerated revenue growth and marginal tertiary support from the owner beyond the owner-occupied building. Although secured by real estate, the bank should file a UCC security interest in receivables, inventory, equipment, and other assets since the turn of trade assets is what repays the LOC. It also prevents other lenders from financing the trade assets.

Scenario 4:

- The business is a wholesaler of plumbing supplies and has been in business for more than seven years.
- Revenues are $14 million, receivables $1.4 million, inventory $700,000, and leverage is under 5:1.
- Revenues grew an average of 30% annually the past three years.
- The business has a $1.5 million LOC (balance of $1.2 million) with a competitor bank.
- The request is for a $2 million LOC to support sales growth.
- There is marginal DSCR and marginal tertiary support from the owner.

Recommendation: An SBA CAPLine—a borrowing base LOC enrolled in the SBA CAPLine for a 75% SBA guarantee—for $2 million. At origination, the maturity is two years and is renewed every two years for up to 10 years. The rationale for the SBA CAPLine is marginal DSCR, high leverage, and marginal tertiary support from the owner.

Scenario 5:

- The business is a bakery that sells to retailers and has been in business for more than 20 years.
- Revenues are $22 million, receivables $2.5 million, inventory $1.2 million, and leverage is under 4:1.
- The business has a $1.5 million LOC with a balance of $1.2 million.
- The request is for a $500,000 LOC increase for two months for a one-time Costco contract.
- There is good DSCR and tertiary support from the owner.

Recommendation: A term loan for two to three months at interest only, with the balance due at maturity. The need is one-time and short-term. A loan with a balloon payment meets the borrower's needs. Review the LOC for an increase at renewal. The borrower shows good DSCR, secondary support, and tertiary support. The borrower should he encouraged to retain earnings to reduce the high leverage at renewal.

Scenario 6:

- The business is a manufacturer of industrial pumps and has been in business for more than 20 years.
- Revenues are $25 million, receivables $3 million, inventory $2 million, and leverage is under 3:1.
- The business has a $2 million LOC (balance of $1.2 million) with a competitor bank.
- The LOC outstanding has peaked at $1.7 million with a low of $500,000.
- Capital expenditure averages $300,000 annually, funded from cash flow.
- The request is for a $2.5 million LOC to support revenue growth averaging 5% annually.
- There is good DSCR and tertiary support from the owner.

Recommendation: A seasonal LOC for $2 million since the line usage has not exceeded $1.7 million, and a permanent capital loan of $500,000 and amortized over 48 months to term out the balance on the LOC that has not revolved. An equipment line for $400,000 for capital expenditures that have historically been self-funded should improve cash flow. The borrower shows good DSCR, secondary support, and tertiary support. The leverage is moderate.

Scenario 7:

- The business is a CPA firm that has been in business for more than eight years.
- Revenues are $2 million, receivables are $150,000, and leverage is under 3:1.
- The business has a $150,000 small business LOC (balance zero).
- The request is for a conventional loan to purchase an owner-user building for $1 million.
- The borrower requests maximum LTV, terms, and amortization.
- There is moderate DSCR and tertiary support from the owner.

Recommendation: A real estate loan for $750,000, or 75% of the purchase price, for a 10-year term and 30-year amortization. These are typically the maximum LTV, term, and amortization for conventional lending. DSCR, leverage, and tertiary support from the owner are moderate. For owner-occupied real estate, some banks lend up to 85% of value to higher-rated borrowers.

Scenario 8:

- The business provides janitorial services and has been in business over six years.
- Revenues are $8 million, receivables are $900,000, and leverage is under 5:1.
- The business has an $800,000 LOC showing a balance of $750,000 for the past 8+ months.
- The request is for the annual renewal of the LOC for an additional 12 months.
- The customer has been a borrower and depositor for over six years.
- DSCR is 0.9x, and there is marginal tertiary support from the owner.

Recommendation: Downgrade the credit to a watchlist due to weak DSCR, high leverage, and the LOC not revolving. One option would be to term the balance on the LOC over 48 months, focusing the borrower on managing gross margins, reducing expenses, and improving cash flow to repay the bank. Another option that would be more palatable to the borrower would be to term out $200,000 over 12 months and renew the LOC for $600,000 for 12 months. Both options reduce the LOC by a substantial amount. However, the second option provides the borrower with a reduced LOC for operations. Monitor the credit for further deterioration or improvement of the borrower's financial condition.

Summary

Understanding the four loan types, purposes and borrowing causes, and operating cycles equips bankers to structure the borrower's loan request. The four loan structures provide the building block for all loan facilities. The concepts of loan purpose and borrowing cause allow the banker to understand what is requested and why. And knowing the operating cycle gives the banker awareness of how the business generates cash for repayment. With these tools and learnings, lenders can best meet the needs of customers while protecting the interests of the bank.

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WHAT COULD GO WRONG?

Walking the Land

Leads To a Spooky Surprise

The late October sun was sinking when Roberta Simona pulled up to 1 Industrial Way. Earlier, as she rushed out of her downtown office at Earnings Bank to walk this property, she had thought about going back to her desk for her sneakers. She decided against it.

"Leaving the sneakers behind wasn't very good risk management," she muttered, crunching across muddy gravel.

But the reason Roberta was plodding through the mud was absolutely good risk management. She could still hear the words of her former boss, Wilson Charles— "Workout Willy"—ringing in her ears: "You've got to *walk the land!*" Wilson would say to his workout team. "It's not called a property *scan*. It's called a property *inspection.*" Another of Workout Willy's practices? Reading appraisal reports. "Every. Single. Page."

Pulling her sweater around her, Roberta comforted herself with the thought that the deal she had worked with former auto dealership owner "Honest" Bob Locke was a pretty good one for Earnings Bank.

As workout deals go, this one could have gone much worse. For one thing, the bank should have acted earlier in escalating the loan to workout. A few years back, the Hyundais weren't exactly zooming out the door and Bob's revenue fell by over 50%. That triggered a debt service coverage default. With payments continuing to arrive on time, the first line hadn't taken any action.

The $8 million loan did not go to workout until the bank learned—not from Honest Bob—that Bob had sold his Hyundai franchise rights. That triggered a change-in-business default. Bob might be honest, but he was not always forthcoming.

But here was Roberta, about to make Earnings Bank whole. She hoped. If that line she noticed in the appraisal—the one that prompted her to rush over to the property with the wrong footwear—turned out to be a false alarm.

In exchange for the bank wiping out his debt, Bob had agreed to simply turn over the property. Which, it turned out, appraised at $8.8 million—more than the amount of the original loan. The bank could sell the property, and there would be no need to spend money and time on legal proceedings against Bob. Done and done.

Word was that Bob had done quite well with the sale of the franchise, which the new owner put in a different location across town. Perhaps to the tune of around $2 million. That would explain why Bob was fine with walking away from his equity in the now-vacant property. Roberta was curious to know if that figure was true. But the important part, she reminded herself as she stepped onto a path leading from the dealership's service building to an impressive wall of foliage, was that the bank could cut its losses to zero. It might even make a little on the deal!

But Roberta couldn't shake her worry over that odd line in the appraisal. It said $150,000 in value had been subtracted due to something labeled "PETCEM" on an attached lot. She and her colleagues had puzzled a bit over that one back at the office. Was it … petroleum and cement? Was the property sitting on a Superfund site? She hoped it was just a mistake.

As Roberta peeked around the wall of foliage, her heart sank. This didn't look like any industrial-park green space she'd ever seen. The meaning of "PETCEM" was coming into focus.

She spotted a gate wedged into the tight wall of evergreen, and stepped into a picturesque ruin: overgrown grass, gnarled ornamental plants, and weathered marble everywhere. The last beams of light from the setting sun played across worn headstones: Champ. Heidi. Max. "Charlie, 1932-1941. Faithful Companion." All single names. All cute. And all the lives seemed heartbreakingly short.

Roberta was standing in a pet cemetery.

"Uh oh," Roberta thought. Time to call Earnings Bank's counsel, Sam Mendoza.

"Sam," she said. "I never thought I would ask this question, but what kind of issues are we up against if we end up with a property that includes a pet cemetery?"

"Why do you ask?" Sam said.

"Because I'm standing in one right now," Roberta said. "It's attached to a parcel we have a deal to take back from the borrower. A really good deal, too."

"OK, well, if you start to hear sounds from under the ground? Like a pet has been reanimated? And is now evil, and is trying to scratch its way to the surface? Well, as the firm's legal counsel I strongly advise you to get out of there."

"What the heck are you talking about, Sam? Just tell me what kind of situation Earnings Bank would be in if we got stuck with this land." (Roberta was not a fan of the horror genre.)

"Well, legally I don't think it would be a problem," Sam said. "The bank would be able to clear the pet remains and sell it to a new owner. There is no *legal* risk."

"No *legal* risk. Yeah, I think I see where you are going," Roberta said, walking toward a weathered gazebo that had just caught her eye. "But it sounds like we would be opening ourselves up to a heap of reputation risk. From the headstones here, it looks like the animals all died decades ago. But I have no idea if people still visit here and if they would be upset if something happened to this place." She had a vision of the WKRT news truck pulling up next to the cemetery as workmen hauled off the remains of once beloved pets, picketers in the background.

Shaking the vision off, Roberta noticed a bronze plaque affixed to the railing of the gazebo, which, it turned out, was a memorial. "Here lies Fred Blurt, Friend to All Animals: 1870-1943."

"Uh, Sam? What would happen if a ... a ... *person* were buried in this pet cemetery?"

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Back at the office the next day, Roberta dropped into a chair in Sam's office with a sigh.

"So, you survived the pet cemetery, I see," Sam said.

"No thanks to you! OK—tell it to me straight. What are we looking at?"

"I hate to say it, but this situation is a real problem for Earnings Bank," Sam said. "It would not look great if we dug up those pet remains and moved them somewhere else so the bank could sell the property more easily. But the dead guy … what's his name again?"

"Fred Blurt," Roberta said.

"What is he doing in a pet cemetery?"

"That whole industrial park used to be the grounds of the Blurt estate. Fred was an animal lover. Seems he wanted to create a space where people could remember their pets. He loved it so much that he decided he wanted to be buried there himself."

"That probably explains why that green space still exists," Sam said. "Dead Fred really complicates things. To move remains to another burial site, you need approvals, you need to notify next of kin, you need a coroner. As long as Fred is there, the owner of that land has to maintain the property, ensure that next of kin has access to it—there are a ton of requirements. How did a car dealership end up with a pet cemetery on its property, anyway?"

"The appraisals don't say much, but apparently it had something to do with them expanding years back. To build, they needed more drainage, and the only way they could get it was to buy this adjacent grassy area. Which I guess just happened to include this pet cemetery. Well, pet and human cemetery, actually. Now I have to figure out a way I can preserve this deal," she said, before heading back to her desk to think.

Was it possible, she wondered, that a buyer would want the property along busy Route 11 so badly that they wouldn't worry about taking ownership of the pet (and human) cemetery? Maybe it's as simple as that, she thought. But the market was pretty soft—companies were in a position to pick and choose. And why would a buyer willingly take on the same risks the bank was trying to avoid?

Then again, if she couldn't strike a deal with Honest Bob, and the bank ended up with the property after a lengthy foreclosure battle, it would be out the money the deal was going to save on legal work. And the bank would end up owning the cemetery anyway.

Maybe Earnings Bank could simply leave the pet cemetery out of the deal. Take the usable land from Bob and say, "You know what? You keep the cemetery parcel. Good luck with it!" But then she remembered the drainage requirement.

And then it hit her.

"Hmm," she thought. "Yes, that might work. Bob might not go for it. But suppose he does?"

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The next day, Roberta arranged to meet Bob and his attorney at the former car dealership site for a final negotiation. She had given a lot of thought to the location. Walking through the cemetery would allow her to illustrate the bank's plan. At the same time, the hulking empty buildings and vast empty parking lots of the dealership would remind Bob of how badly he wanted to finally be free of his loan—a point he had made several times to Roberta. She could tell he was being honest about that.

It was a glorious fall day. Bright sunlight, not a cloud in the sky. Roberta had a good feeling as she set out the conditions and reasons for the deal.

"Bob, I know you want to settle this as much as Earnings Bank."

"I do," Bob admitted. "And it sounded like we were getting very close to a deal. So, what's the problem?"

"You're standing in it, Bob," Roberta said.

"Oh." Bob's gaze flicked among the headstones. "The pet cemetery. I almost forgot it was here. So, what can I do?"

"Earnings Bank wants you to keep ownership of it," Roberta said, "and we'd like you to grant an easement that will allow us and the eventual new owner of the property to use the land to meet the county's drainage requirement."

"I don't know about this."

Just then, Bob's attorney chimed in. "Can you please give us a moment?" he said.

"I'll leave you guys to it," Roberta said. "Enjoy the beautiful day!"

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Roberta didn't know what Bob's attorney discussed with him as they sat on a marble bench amid the graves. On a crisp fall day, it was a rather lovely space. Maybe Bob shared her soft spot for animal companions. And maybe he was eager to reach a deal. In any case, Bob called later that day and agreed to the bank's terms. Six months later, Earnings Bank sold the land for the appraised $8 million to a Ford dealer that was looking to move from a smaller site.

Roberta received high praise from her Earnings Bank colleagues and bosses, who lauded her workout acumen. It felt great. But so did the realization that she had done a thorough job. She had read and understood the details of the appraisal, and, in a move that would have delighted old Workout Willy, wasted no time in walking the grounds when she suspected a problem.

Not long after the sale closed, Roberta dropped by the cemetery again with Larry, her beloved golden retriever. She was a little surprised, and also pleased, to see that the property wasn't just groomed—it had been manicured. Maybe Bob had recognized the charms of the place. She and Larry sat together for a few minutes in Fred Blurt's gazebo, among the spring blossoms, remembering all those resting there—the pets, and the man who loved them—before moving on.