Bankable Strategies for More Effective Corporate Credit Management

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EXECUTIVE OVERVIEW

With a heavy portion of their assets invested in the commercial loan and leases market, it is incumbent on banks to manage their corporate credit process more effectively. They must originate and underwrite more—and better quality—loans and leases, employ more sophisticated financial modeling and analysis techniques for portfolio management, and gain access to better reporting capabilities in order to grow their businesses. They are interested in leveraging technology to improve their credit management performance and strengthen their portfolios. This paper will explore the challenges, approaches and benefits to be achieved by leveraging technology to improve credit management performance and portfolio strength.

INTRODUCTION

The banking industry today is in a state of flux. Demands created by consolidation pressures, increased government scrutiny and regulation, a cooling economy with volatile interest rates, and increasing global competition all combine to produce a "pressure-cooker" atmosphere, in which it is becoming increasingly difficult to maintain and increase profitability. In this environment, it's imperative for banks to find ways to gain better access to information to enable them to reduce their risk exposure and improve business performance.

In 2005, net loans and leases made up 57 percent of assets at FDIC-insured commercial banks. What's more, the market for commercial loans and leases is worth a staggering US$6.12 trillion—and growing.

One business area that banks are examining more closely to mitigate risk and improve overall business performance is the corporate credit market. Why corporate credit? In 2005, net loans and leases made up 57 percent of assets at Federal Deposit Insurance Corporation (FDIC)-insured commercial banks. What's more, the market for commercial loans and leases is worth a staggering US$6.12 trillion—and growing.

The Hyperion corporate credit management solution from Oracle enables banks to protect their current heavy investment in this market, and to increase the number and quality of loans and leases they originate and underwrite. This solution will allow banks to capture an even-greater share of this growing market with sophisticated financial modeling and analysis techniques for portfolio management, and better reporting capabilities.

TOUGH CHALLENGES IN CREDIT MANAGEMENT

Even under ideal circumstances, the corporate credit management process presents challenges for most banks. Customers are sometimes unpredictable, and good decisions can go bad.

In their quest to more-effectively manage their corporate credit process, most banks face some tough hurdles. Even under ideal circumstances, the corporate credit management process presents challenges for most banks. Many banks face challenges with information technology (IT) systems that often hinder rather than help them. At many banks, the IT systems used by analysts, underwriters, loan officers, and portfolio and relationship managers are often a mishmash of outdated customized legacy systems that make the loan management process convoluted and more difficult to navigate.

Problems with the Information Architecture

Manual processes and spreadsheets are often not linked in any way—with each other or with financial data providers—so data is inconsistent and perhaps inaccurate.

A common problem at many banks is that the architecture of information systems they use to facilitate the credit management process is a loose assortment of applications and technologies. There is typically a tangle of different processes, spreadsheets, and modeling applications (typically in the form of ad hoc desktop databases) that are used for performing tasks such as spreading customer financials, financial modeling, credit memo production and submission, and portfolio monitoring and forecasting.

These manual processes and spreadsheets are often not linked in any way—with each other or with financial data providers—so data is inconsistent and perhaps inaccurate. These systems certainly provide great flexibility, but they provide almost no standardization of processes.

The result? In the origination and underwriting process, scenario comparisons are often cumbersome, and model auditing is time consuming, if not nearly impossible. In the latter stages of the underwriting and credit approval process, the way in which key metrics, such as earnings before interest, taxes, depreciation, and amortization (EBITDA) coverage and return on invested capital (ROIC), are computed, and the manner in which key macroeconomic assumptions, such as London Interbank Offered Rates (LIBOR) and prime rates, are applied are often wildly inconsistent—from division to division, or even branch to branch.

What's more, credit memos are often submitted via e-mail, or in the form of spreadsheet reports. In the portfolio management process, financial updating—of actuals and forecasts, for example—is cumbersome, and new modeling spreadsheets are often generated as circumstances or economic conditions change. And frequently, these spreadsheets are completely disconnected from the base model upon which the original approval decision was made. In other words, there is no single version of the truth about enterprise loan and lease information.

The Consequences of Inconsistent Information

Let's look at an example of the chaotic consequences of using a loosely linked, predominantly spreadsheet-based architecture for the credit management process. Consider the lifecycle for a large, intricately structured commercial loan, underwritten by a multinational bank with joint participation by its New York and London offices. Information for the loan is kept in separate spreadsheets and standalone databases in New York and London. There is little or no synchronization of these spreadsheets and databases—let alone of the information that populates them. It makes for a disorganized analytical environment that provides almost no ability to see the "big picture" of the loan's lifecycle.

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For example, during the underwriting process, the New York office might include the current portion of interest in the EBITDA coverage to interest ratio when spreading the financials; the London office might not. The New York office might make the assumption that the LIBOR is 2.5 percent, whereas the London office assumes the LIBOR is 2.8 percent. See Figure 1. The New York office might have one set of metrics to measure whether the loan is meeting the overall corporate strategic goals for the underwriting process. London might have a slightly different set of metrics for this purpose.

These variances in the information used to underwrite the loan are seemingly minor, but they can cause serious problems in the ongoing portfolio analysis and management processes. The errors might manifest themselves when the leverage ratios are calculated later on: New York will have one ratio, London another. Or

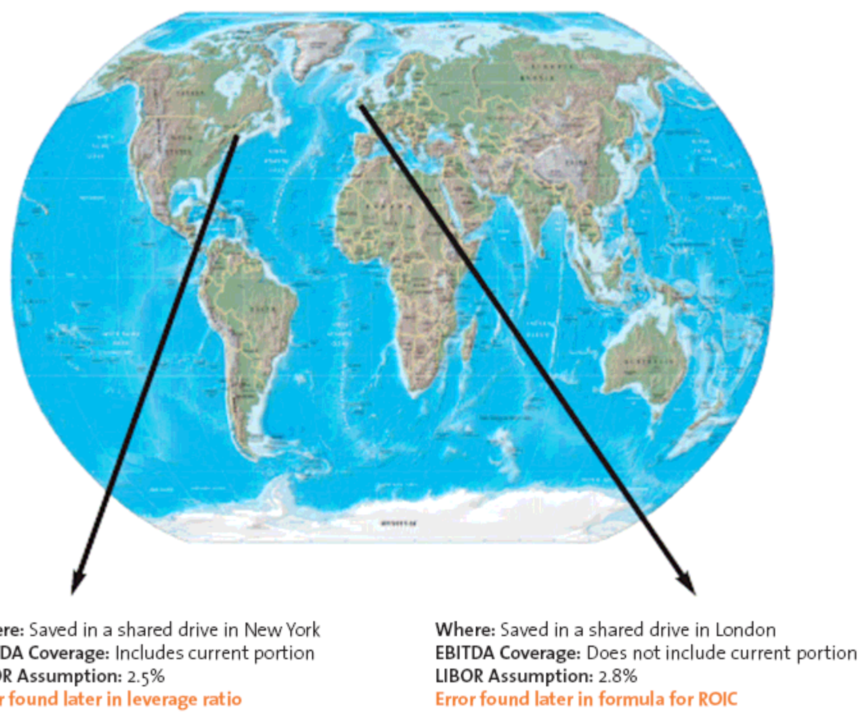

Figure 1: A consequence of poor IT architecture for credit management.

maybe they will become evident when the ROIC is calculated: New York will have one estimate of its return on its invested capital, London another.

Bad decisions are made—leading to bad loans, reduced profitability, and perhaps a loss of stakeholder confidence.

This scenario—although not always international in scope—is all too common for many banks. Their disparate, unintegrated credit management applications fail to provide them with the timely, consistent, accurate information that they need for insight into the business. Underwriting is compromised by the lack of correct information, and analysis is hampered by inconsistencies during the underwriting process. Ultimately it becomes difficult to effectively monitor and analyze the credit portfolio. Bad decisions are made—leading to bad loans, reduced profitability, and perhaps a loss of stakeholder confidence.

SUCCESSFUL IT MANAGEMENT: THE KEY TO CREDIT MANAGEMENT SUCCESS

Although these challenges are significant, they are not insurmountable. Using IT resources effectively is the key to overcoming the obstacles to credit management success. In 2005, McKinsey & Company performed a study of IT spending and use at successful banks. The study revealed that successful banks don't necessarily spend more than their competitors on their information architectures. Indeed, some of the most successful banks spent the least on IT. Instead, the study found that the IT systems used by successful banks to manage their credit business had two characteristics in common: (1) they were high quality and (2) they supported the goals of the business.

This improved access to enhanced information enables successful banks to leverage their IT investments to meet their business goals more effectively and to gain that single version of the truth.

Successful banks design their technical architectures to enable them to meet these two criteria. They select tools and technologies that enable them to build a foundation for successful credit management—one that provides better access to consistent, accurate, and timely information. This improved access to enhanced information enables them to leverage their IT investments to meet their business goals more effectively and to gain that single version of the truth about enterprise information that they so urgently seek.

The Components of Credit Management Success

There are three components that must be in place, and must function smoothly together, to facilitate successful credit management. The Hyperion corporate credit management solution includes all three components. When combined properly, these components provide analysts with the tools and information they need to make better credit decisions and more-effectively manage loans and leases once decisions are made.

User Confidence in the Process

The first component of effective credit management is confidence in the credit management process. Credit managers and credit committees need confidence in the modeling integrity of loan write-ups. Underwriting analysts and portfolio managers will perform better knowing their solution offers a robust financial analysis capability that includes prebuilt (but flexible), fully standardized, integrated financial statements (profit and loss statement, balance sheet, and cash flow statement).

Integrated Information for Improved Financial Modeling and Analysis

Multiscenario creation capabilities also make it possible to explore a variety of operating assumptions with different financing alternatives.

The second component is consistent, accurate, and timely information that is fully integrated across the enterprise. To perform sophisticated scenario analysis and financial modeling, analysts must be able to access quality information from anywhere. They should also be able to make different operating assumptions and create alternative scenarios when doing financial modeling or analyzing and managing the portfolio. Modeling capabilities should include advanced customization. In particular, users should be able to aggregate and analyze property-specific variables, assumptions, and drivers. This ensures that the resulting model(s) are based on sound economic drivers. These multiscenario creation capabilities also make it possible to explore a variety of operating assumptions with different financing alternatives.

Robust, Flexible Reporting

The third component of successful credit management is robust, flexible reporting that enables users to spot trends early with graphical interactive dashboards, allowing them to quickly leverage opportunities or take corrective action. Enhanced reporting capabilities also empower business users by providing an intuitive user interface, which requires minimal training and support to learn—and get the most out of—the system. These reporting capabilities should be integrated with the existing IT systems, and as a result, be able to pull data from multiple heterogeneous datasources.

The Benefits of Effective Credit Management

The benefits of using the components described to build a foundation for effective credit management span the credit management lifecycle.

The benefits of using the components described to build a foundation for effective credit management span the credit management lifecycle—improving processes from origination, underwriting, and credit approval to portfolio analysis and ongoing management. The benefits are

- **Improved origination activities.** Analysts have the ability to integrate data from financial data providers, as well as the ability to automatically spread financials to compile a comprehensive picture of the prospective borrower or lessee. They also have the use of generated or customized forecasts of fully integrated financials to uncover any abnormalities or unhealthy trends in the potential customer's business. Finally, analysts have the capability to thoroughly comprehend the prospect's capital structure so that they make better decisions about which potential customers might be the most profitable in the long term.
- **Enhanced underwriting analysis.** Analysts have the ability to perform unlimited scenario analyses of prospective loans and leases. They are also able

to manipulate model details using near-real-time intelligence. Finally, they have the flexibility in account management and reporting to support customization and changes to models in order to predict multiple outcomes, based on available information and analysis.

There is improved financial transparency in reporting, which is the key to enhancing the integrity of financial models.

- **More-effective credit approval process.** The integrity of the financial models, as well as the overall credit approval process, is enhanced. There is improved financial transparency in reporting, which is the key to enhancing the integrity of financial models. When information is integrated enterprisewide, calculations, metrics, and account definitions are standardized, and analysis is based on consistent financial statements.
- **More-efficient portfolio and risk management.** Portfolio managers have the ability to quickly and easily update actuals and use them for reforecasting. They also have access to flexible, robust ad hoc modeling and reporting that enables them to compare previous underwriting cases against budgets and actuals. There is less duplication and manual reconciliation because information from multiple, disparate sources is integrated. Finally, the components of effective credit management also provide the ability for analysts to comprehensively assess and manage portfolio risk.

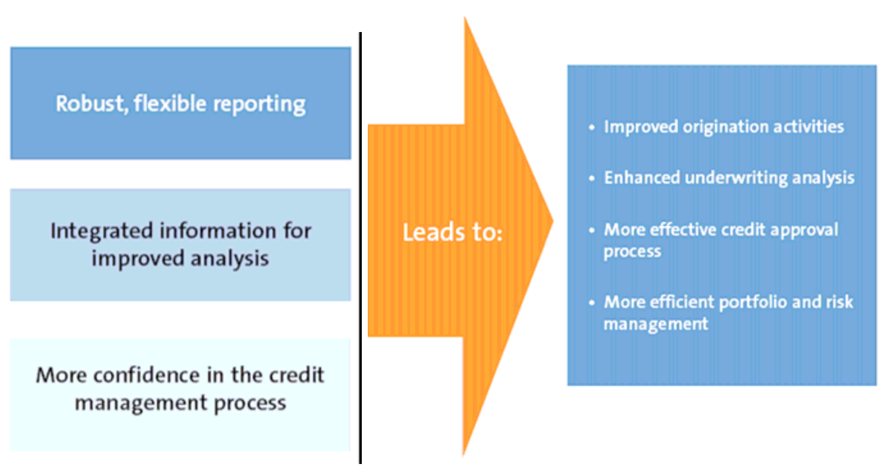

Figure 2: The benefits of effective credit management.

USING INFORMATION TECHNOLOGY TO IMPROVE CREDIT MANAGEMENT: A CASE STUDY

Beyond "Credit Management by Spreadsheet"

Lloyds TSB Group is a leading U.K.-based financial services group that was created in 1995 after the merger of the TSB Group and the Lloyds Bank Group. Its businesses provide a wide range of banking and financial services in the U.K. and overseas. Lloyds TSB Group's activities are organized into three businesses: U.K. retail banking, insurance and investments, and wholesale and international banking.

The Acquisition Finance division of Lloyds TSB Group was interested in improving the data and analysis behind its major investment and lending decisions. As a result, the division invested in the Hyperion corporate credit management solution. At that time, Lloyds TSB Group's total group assets were £309.8 billion and it had 70,000 employees.

According to Jon Herbert, head of the Acquisition Finance division at Lloyds TSB Group, rapid growth and the proliferation of management by spreadsheet necessitated a change in the division's information architecture.

"The business was established 11 years ago and has become very successful, achieving rapid growth in the last few years on the back of a clearly focused strategy," says Herbert. "We provide highly leveraged debt in the European buyout market, and it's vital for us to be able to model deal structures and borrower financial projections in a timely and effective manner. Our existing spreadsheet-based systems have served the business well in the first stage of its development, but we need something more sophisticated to support the next stage."

Integrity and Transparency of Information

Hyperion Strategic Finance is a powerful strategic financial modeling application that lets executives quickly assess the full financial impact of alternative strategies.

The Hyperion corporate credit management solution, including Oracle's Hyperion Strategic Finance, met the division's requirements. Hyperion Strategic Finance is a powerful strategic financial modeling application that lets executives quickly assess the full financial impact of alternative strategies.

Rather than spending valuable time on building and maintaining spreadsheet modeling tools, Hyperion Strategic Finance delivers packaged financial modeling and forecasting. This allows employees to better spend their time evaluating lending strategies, investigating contingency plans, and understanding the impact of these strategies and plans on the division's long-term investment performance. When Lloyds TSB Group implemented the solution, about 60 users benefited from the software's capabilities.

Hyperion Strategic Finance allows organizations such as Lloyds TSB Group to produce financial models with integrity and transparency, minimizing risk and improving efficiency.

"We want to have all the data in one place—and to use this information more effectively. We gained excellent references from other banks that were using the software."

—Jon Herbert,
Head of Acquisition Finance,
Lloyds TSB Group

Better Decisions, Better Strategy

Herbert continues, "Rather than have information scattered amongst a large number of spreadsheets, we want to have all the data in one place—and to use this information more effectively. We gained excellent references from other banks that were using the software. It has opened up new vistas for us."

Hyperion Strategic Finance and Oracle's Hyperion Essbase – System 9 replaced the Acquisition Finance division's existing systems for portfolio monitoring and trend analysis. Says Herbert, "Our current systems don't easily support such analysis—we have a lot of valuable data, and want to make smarter use of it to support decisions on individual deals, the mix of our portfolio, and the overall business strategy. Ultimately, we want to be able to prepare a detailed portfolio report in seconds.

"We gave representatives from across Acquisition Finance the opportunity to evaluate the software before we purchased. The feedback was very positive: It was collectively agreed that Hyperion Strategic Finance would strengthen our credit assessment and monitoring processes. And, as Lloyds TSB prepares for Basel II accreditation, a deeper understanding of the historic trends in our portfolio will help us enhance the design and calibration of our rating tool. Our goal is to integrate Hyperion Strategic Finance seamlessly with the rating tool—something we couldn't do previously. Overall, we're excited by the possibilities this software will open up, and we look forward to working with Oracle as we continue to develop our business."

THE CREDIT MANAGEMENT SOLUTION FROM HYPERION

The Hyperion corporate credit management solution, including Hyperion Strategic Finance and Hyperion Interactive Reporting – System 9, allows banks to reap the benefits of successful credit management.

Hyperion Strategic Finance

By integrating Hyperion Strategic Finance into the origination, underwriting, account monitoring, and credit approval processes, companies can increase productivity, reduce costs, improve risk profiles, and gain greater insight.

Hyperion Strategic Finance software delivers financial modeling and analysis to banks that want to improve profitability through more-efficient credit and risk evaluation. By integrating this tool into the origination, underwriting, account monitoring, and credit approval processes, companies can increase productivity, reduce costs, improve risk profiles, and gain greater insight with enhanced modeling capabilities.

- **Origination.** Hyperion Strategic Finance enables users to link data from financial data providers. It provides the capability to immediately verify historical financials using spreading, with balancing functions. Using automatically generated or customized forecasts of fully integrated financials, analysts can uncover accounting irregularities or unhealthy trends. They can also perform an analysis of prospective customers' capital structure to evaluate recapitalization alternatives, as well as evaluate additional availability that preserves the same debt rating.

- **Underwriting.** Underwriters can employ robust scenario analysis that includes expected, downside, and upside cases, as well as the ability to create unlimited additional scenarios within the same model. They can quickly add, delete, or change time details using time-period intelligence and tools.
- **Account monitoring.** There is also enhanced flexibility in the account and reporting structure. Portfolio managers can monitor and manage all facets of the account by customizing and changing account details, covenant terms, and the report structure.
- **Credit approval.** Credit officers can have complete transparency into all models using a built-in analysis trail that allows all outputs to be described in words and numeric calculations. They can avoid performing extraneous calculations through the standardized application engine. They can also standardize account definitions and modeling assumptions across entities—easily and quickly.

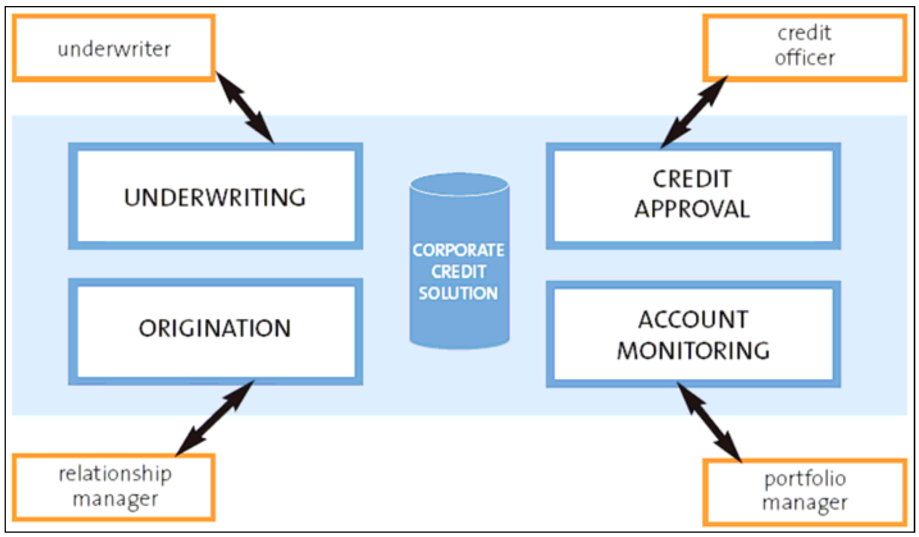

Figure 3: Hyperion Strategic Finance is a key component of the corporate credit management solution.

Hyperion Interactive Reporting

Hyperion Interactive Reporting provides portfolio managers with the most intuitive user-directed query and analysis capabilities available today for portfolio and risk management.

Hyperion Interactive Reporting – System 9 provides portfolio managers with the most intuitive user-directed query and analysis capabilities available today for portfolio and risk management. It delivers powerful capabilities through an easy-to-use interface that lets users design their own dashboards, then quickly monitor and evaluate information.

Portfolio managers can create and adjust alternative scenarios to better understand the risks and rewards of their portfolios. They can easily update actuals, use them for reforecasting, and quickly generate reports to compare original underwriting cases against the company budget and actuals—all within the same model. They can also more-thoroughly evaluate portfolio risk with flexible report generation. Reports can be created using multiple variables for all assets or a cross section of portfolio assets.

CONCLUSION

In these uncertain economic times when business fortunes can quickly change, it is a daunting task just for banks to maintain profitability. To bolster profitability and grow their business, leading banks are reevaluating the way they manage their commercial credit portfolios. These banks are intent on finding ways to improve their credit management performance and strengthen their portfolios. More and more, they are relying on technology such as the Hyperion corporate credit management solution from Oracle as an enabler—a partner in the quest to better understand and manage their performance. These technologies give them three things:

- Confidence in the credit management process via automated spreading of financials and more accurate loan write-ups
- Integrated information to enhance the financial modeling and analysis process
- Robust, flexible reporting that's packaged with an intuitive interface that lets users see the information they need in the way they need to see it

Banks that choose these technologies will gain the ability to more effectively monitor and enhance their credit management performance. Banks that don't will risk getting left behind. What will your bank choose?

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