

Best Practices for Middle-Market Lending

By John A. O'Connor

Larger loans, automation and a focus on retaining customers are hallmarks of successful banks.

Long seen as a consistent, stable income provider, the middle-market segment of commercial lending is beginning to strain under ever-expanding competition, compounded by shrinking margins and a diminishing client base. Realizing that traditional revenue sources have become fatigued, institutions are searching for alternate methods to maintain competitive position and viability.

Our most recent benchmarking study analyzed the lending practices of top U.S. banks whose aggregate outstandings represent more than one-third of the commercial outstandings in the United States. This study revealed the continued trend among forward-thinking institutions toward more centralized processing, increased automation and more disciplined, standardized pricing.

As part of the middle-market benchmark program, we analyzed product profile, product delivery configuration, prospecting and relationship management, credit analysis, credit decisioning, collateral valuation, document preparation, review, booking, portfolio management, loan servicing, collections and recovery.

As data about each organization is collected, the functional duties within the organization are aligned with relevant core processes. For example, the duties and behaviors of one underwriter within a particular organization may be very different from the duties of an underwriter in a comparative organization. We examine the detailed work flow for every relevant position within each organization in order to determine the unique drivers that make that organization successful, whether they are policy, practice, technology or division of duties among staff. This provides a clear picture of an organization's investments, processes and policies.

Using the benchmark data, participants can make decisions based on real-world information.

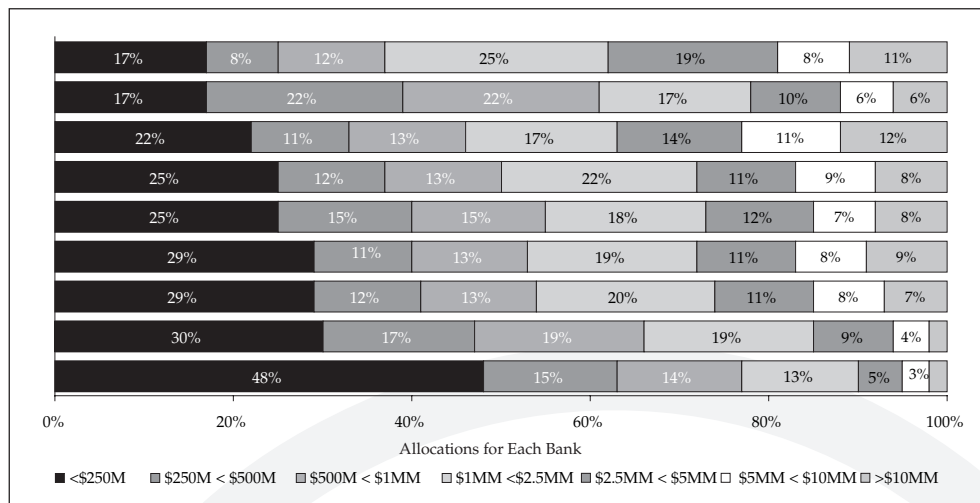
Aligning Human Assets to Bank Assets

When we examined commitments, we found, consistent with our findings in our small-business lending benchmark program, that middle-market units were very bottom-weighted while the dollars are top-weighted (Exhibit 1). The most recent middle-market benchmark showed that, on average, 70 percent to 80 percent of participants' commitment units were under \$2.5 million; the remaining 20 percent of these units accounted for 80 percent of the total dollars. For these institutions, 20 percent of the portfolio is driving the majority of the revenue; therefore, retention and good credit quality of these loans is especially important. In addition, we found that many organizations' due-diligence process for new credit, renewal credit and review credits are strikingly similar—meaning the same effort and expense that is applied to very large credits is applied to very small credits.

Banks should thoroughly examine their approach from a policy and process perspective across their portfolios, understand where the bulk of their allocations are distributed and align processes and policies accordingly. In addition to being an exercise in risk management (align human effort to where the largest risk pool lies), this effort

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Exhibit 1
Portfolio Units by Dollar Size



Source: 2003 Middle Market Lending Benchmark, BenchMark Consulting International

This shift is just the initial step in a much-needed review of the cost structure for middle-market loans and services. The next step is for banks to address inclusions in the pricing model, examining the entire bank relationship and evaluating how much value should be designated for each particular loan and in what amounts. To gauge the value effectively for each loan, institutions must first look at the cost of credit granting and the ongoing maintenance (portfolio management).

will assist with pricing and return on investment (ROI) calculations. If institutions are allocating the same maintenance and servicing effort and cost to lower-value loans as they are for the higher-level commitments, where is the ROI?

Our research does show that middle-market lenders have become more disciplined with pricing structures in recent years, in part due to use of models such as risk-adjusted rate (RAR). As a result, banks are beginning to focus on higher credits for larger companies. Traditionally, the middle market has been defined as customers with revenue between \$10 million and \$500 million, with some defining the top end as \$1 billion. As lenders have become more strategic and more aware of pricing considerations, this low-end threshold is gradually increasing.

Today, we're seeing many organizations adopt a floor of \$20 million (some have gone as high as \$50 million), leaving smaller companies to small-business banking. Many banks are realizing that companies under this \$20 million mark simply do not have the returns when a middle-market approach is applied to them, because they do not require all the credit services middle-market bankers provide. If the services are not needed, the bank cannot charge the associated fees; thus, the ROI for these accounts is negligible or, even worse, negative.

Mechanization of the Credit Process

Bankers have automated the lending process for credit card, auto finance, consumer and small-business segments and some are just now beginning to look at the middle-market segment. The varying risk appetites among branches within a single organization—and the resulting inconsistency in portfolios—are fueling this need for automation.

Our work with middle-market groups revealed that the most forward-thinking organizations are addressing this lack of control by moving away from the traditional one-by-one loan approach and embracing a more mechanized and scientific approach to the credit process. Traditionally, banks have had decentralized credit groups that complete the financial spreads, ratios and analytics, but the results of benchmarking indicate the beginning of an evolution to either fully centralized or fully regionalized processing of these tasks. Consolidation of tasks does not necessarily imply staff reductions. For instance, we found two basic models around origination and portfolio management representing the same staff allocation but unique *task* allocation.

The first is the traditional model, where a single relationship manager is responsible for origination as well as underwriting and portfolio management.

The second model divides these duties between two roles, a sales executive and a portfolio manager (both in the same location). The sales manager is solely responsible for the originations, while the portfolio manager is dedicated to underwriting and managing the credits while the loan is on the books. Freeing up the sales manager to focus entirely on sales ultimately drives more activity. Many of the next-generation banks are taking this one step further by centralizing some of the more basic portfolio manager activities. Dividing duties between a sales executive and a portfolio manager has advantages, but successful execution can be difficult. There is the potential for additional handoffs and duplication of adjudication effort. The higher-performing banks integrate incentive plans and ensure both positions are given equal weight in the process. Attracting the right personnel and skill sets is a key to success with this model.

In 2005, we will perform another syndicated benchmark. We are certain that it will reveal a great deal of activity in this area and expose a more singular, unified underwriting discipline that will empirically demonstrate results for these organizations, whether they embrace a regionalized or centralized approach. The industry continues to improve and change; banks that stand still will fall behind.

Belt-and-Suspenders Approach

Despite a growing awareness of the benefits afforded by more mechanization, most middle-market institutions still struggle with redundancy of effort and a belt-and-suspenders approach to decisioning of credit. While many have taken on projects to streamline servicing and operational areas, a good deal of improvement remains to be gained in originations and portfolio management. Some organizations are reluctant to attain some of these efficiencies because the dollars on a credit-by-credit basis are larger for middle-market loans. These institutions fear that by reducing steps in the credit-decision process, their book of business will become riskier. The thought is, "Why not take 3X steps to ensure diligent underwriting, rather than risk a million-dollar loss because only X steps were used?" We have seen banks with vastly different requirements for decisioning similar loan amounts; in most cases, redundancy of effort exists. In some environments, a \$2 million to \$3 million dollar loan requires five to seven signatures, with the last two

signatures being committee structures. In our consulting and benchmark program, we have seen that effort does not translate into a quality book of business. For top-performing institutions, it is more about *what* is done than it is about *how much* is done.

Adding to the number of steps in the approval process is the relatively small credit authority limits for seasoned middle-market calling officers. Authority levels are often not much greater than those found in small business. This drives the need to incorporate multiple approval levels and slows the approval process. The more successful banks empower credit authority at the officer level. An interesting point for consideration: In our research we found an institution that was requiring only two signatures for a \$15 million loan renewal, those of the regional manager and the credit officer. Interestingly, this institution had the lowest past-due and the lowest charge-off rate, with totals one-third that of other participants.

At the moment, this example may represent an extreme end of the spectrum. However, current and past research has revealed a growing interest among industry leaders in the continued streamlining of the process, including more efficient write-ups. In a very traditional, nonautomated process, the approaches to granting credit may vary from underwriter to underwriter. Streamlining policies and processes enables the underwriting process to become more standardized. Once processes are standardized, technology can be applied to drive and script underwriter comments, thus enabling middle-market bankers to decrease redundancy, create a more scalable process, increase the relationship managers' effectiveness and reduce the number of steps while retaining the integrity of the due diligence.

Customer Relationship Management Systems

One of the most significant revelations was in the use of customer relationship management (CRM) systems. While millions of dollars have been invested in these systems, they are not being used to their full potential. We found these tools are not being used accurately or consistently or, in many cases, used at all. When the systems are used, the staff often inputs only the information that is most desirable to display to managers, instead of the actual activity that is taking place.

Often when institutions attempt to use CRM systems, they have multiple inputs and tracking of data for call reporting, deal creation, pipeline, incentive, document requests, booking requests and others. Despite this apparent depth of information, we still find a great deal of subjectivity being applied to incentives and other officer measurements—which is distinctly different than other groups within the bank. Some of the middle-market groups that have installed tracking and adopted empirically driven incentive plans now look back and call their old incentive plans “entitlement plans.”

Another reason for inconsistency in CRM usage is the difference in information required for the calling officers and that required for monitoring sales activities. Calling officers typically need basic information documented, such as whom they called on, when the call was made and what products were offered and/or sold. Simple notes and a personal database are the preferred method of record keeping for many. Incentive programs are often driven by a series of customer activities that require diligent (and sometimes redundant) data entry into the CRM. One of the most common complaints was the time devoted to CRM maintenance. It was for this reason that we often observed data being tracked manually.

Middle-market units are struggling with the policy for CRM systems, specifically how to set the empirical standards needed to quantify and effectively analyze the activity taking place. Perhaps the biggest challenge in addressing this is overcoming the

outdated philosophy that “if the client is happy, then we must be making money.” Next-generation banks are realizing that measurements do matter.

Were these million-dollar purchases an unwise investment? No—the high-level analysis afforded by these technologies still offers great potential. However, technology alone is not the answer—it can only enable the process. Policy drives the results, and many of these systems still require work to truly support the different groups that are being asked to use these systems.

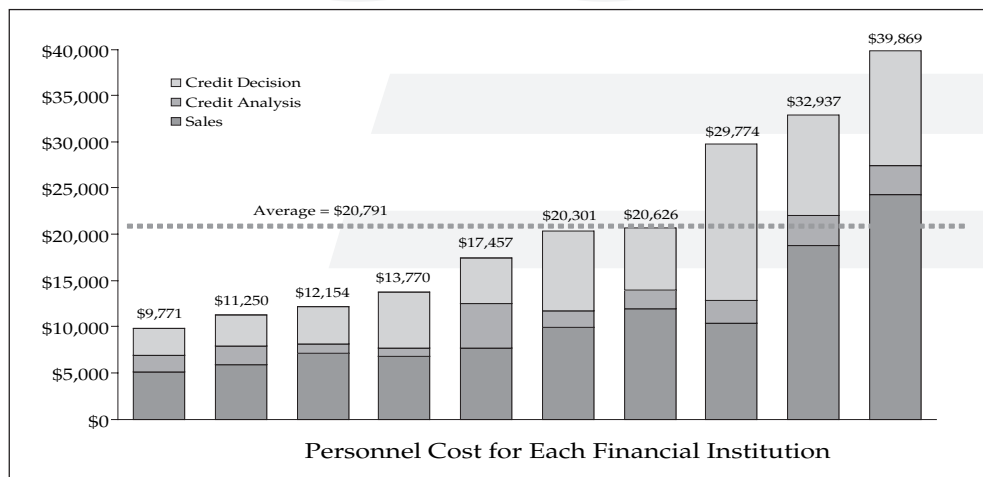
Examination of the Cost of Lending

In addition to a weak economy, income has been depressed for the middle-market business model for a host of reasons, such as the expansion of the competitor market, cutthroat margins, a reduction in borrowing and an increase in nonbank competitors. To compensate for lost revenue, these middle-market lenders typically raise borrower fees. These fee hikes are becoming abrasive to consumers and may no longer be tolerated; thus, other revenue sources need to be identified. Forward-thinkers are focusing on the cost of lending—shrinking their expenses by dramatically rethinking their approach to traditional duties and where these are being performed.

For example, a bank’s credit policies dictate a process that may cost as much as \$8,000 to \$10,000 (even as high as \$25,000) for a new credit. Many

replicate that same process (and expenditure) for renewal/reviews. Clearly, when this effort is applied against smaller credits or relationships, there are customers that cost rather than create money for the institution. Our most recent benchmarking study found that the cost of origination varied by almost 200 percent (Exhibit 2). We have worked with institutions that compete against each other in the same marketplace, with

Exhibit 2
Personnel Cost to Originate a \$10 Million Loan



Source: 2003 Middle Market Lending Benchmark, BenchMark Consulting International

relatively the same asset size, that have cost structures six to 10 times different. It is not unusual to find this multiple even higher.

Organizations moving to more streamlined models have seen very high performance gains, reflecting how the business model is slowly evolving from more of an art form to a more pragmatic, scientific approach. Time and time again, we see that policy drives process, which in return drives profitability. The key success is the ability to simplify the process and to still keep one's credit appetite within the same range. Successful organizations have found it is not how much you do but what you do in both the initial credit due diligence and the review and renewal process.

Applying Benchmark Data

In determining how best to apply benchmarking data, it is imperative first to acknowledge the variances in corporate cultures of different institutions. Corporate culture is formed by many drivers, including the bank's credit policies, incentive plans, customer interactions and customer profiles.

Because cultures vary among banks, best practices in one middle-market organization may be different for another. When using benchmarking information, we advise participants first to consider their corporate culture. In some instances, it is simply a matter of identifying how to improve operations within those corporate guidelines. On other occasions, it may be that challenges in the organization are actually created by the culture. We have also found situations in which the solutions needed to address the identified challenges are prevented by the current corporate or credit choices. Thus, a solid understanding of the institution's culture is a prerequisite to identifying and implementing any solutions.

For example, "Bank A" has identified that its loss rates are unacceptable and wishes to improve in this area. Looking to the top-performing competitor within this segment may or may not assist Bank A in creating a solution. The top performer in this group may use a customer approach that is not palatable for Bank A. Bank A may then look to other work flow and process performance areas to determine another way to improve loss rates.

Continued Evolution Toward a Data-Driven Approach

Based on findings from our previous middle-market benchmark and our extensive consulting work in the industry, we believe the dominant trend for 2005 will be the continued evolution of the business model from an art to a science.

As avenues for top-end growth decrease, middle-market organizations will be increasingly charged to do more with less. Just as automation and mechanization have taken place throughout small business, auto finance and corporate lending, middle-market groups will begin to assimilate these refinements and enjoy the benefits of increased efficiencies. The most forward-thinking banks are already beginning to explore options for more centralized operations. As word of gains in efficiencies and economics spreads, more and more institutions will move from traditional one-to-one client interactions and overly bureaucratic decision making to a more rigorous, scientific approach to commercial lending. Going forward, we expect to find an increased emphasis on customer retention versus acquisition. This will be reflected in the scrutiny of portfolio management processes and better use of CRM systems to support these initiatives.

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