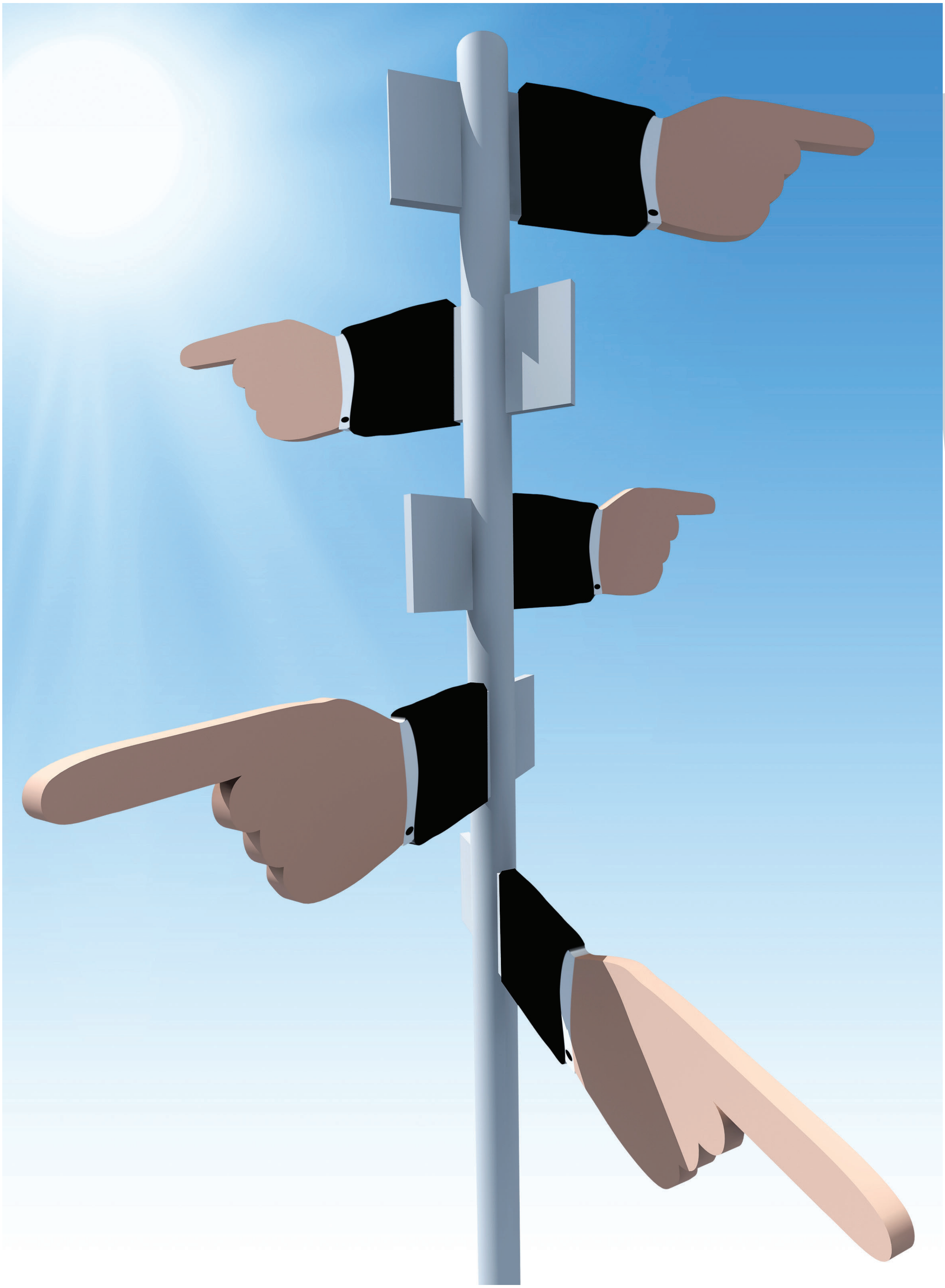

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Policy Exceptions Matter as a Rule

••Policies are the guardrails that keep banks on the road. Exceptions must be infrequent and properly mitigated.

BY DEV STRISCHEK

ROCK MUSICIAN FRANK Zappa once observed, "Without deviation from the norm, progress is not possible." But before we unequivocally equate exceptional behavior with progress, let's remember Ambrose Bierce's definition of "exception" in *The Devil's Dictionary:* "A thing which takes the liberty to differ from other things of its class, [such] as an honest man ... the exception tests the rule, puts it to the proof, not confirms it." In that spirit, we bankers try to set rules for lending based on prior experience that helps us steer clear of past errors and make profitable, prudent loans.

It's important to understand not only why a bank tracks exceptions to credit policy, but also how to monitor and manage them. After all, banks expend considerable time and effort on credit policies, and deviations from those policies generally lead to increased risk that can turn into problem loans and losses. Further, implicit in a sound credit culture is the expectation that credit policy reflects the risk tolerances of the institution. A bank with a conservative credit culture and a moderate risk tolerance is likely to accommodate exceptions to policy for very creditworthy customers, as long as prudent underwriting properly mitigates risk and yields a satisfactory return through support from other cash flow, collateral, guarantees, and additional protection.

Accordingly, banks need to identify policy exceptions in order to document the thought process, assess underwriting practices, and provide accountability for the credit decision. Additionally, the frequency of policy exceptions is monitored as part of portfolio management to track frequency

Table 1 Examples of Trackable Policy Exceptions		
TPE#	B/T*	Examples of Typical TPEs
01	B	Guarantor related risk: individual or corporate guarantee fails to comply with guarantee policy • WHL 211 - Guarantees (Commercial)
02	B	Unsatisfactory credit history: individual or corporate borrower is unsatisfactory, defined as frequent delinquency or slow pay, is in bankruptcy, or is an underwriting center client with a scorecard score below policy criteria • WHL 266 - Underwriting Center for Lending to Business Banking and Eligible Private Banking and Commercial Clients
03	B	Debt service coverage below policy minimum (also applies to the debt service covenant requirement for certain loans secured by real estate) • WHL 250 - Agricultural Lending • WHL 260 - Commercial Real Estate • WHL 266 - Underwriting Center for Lending to Business Banking and Eligible Private Banking and Commercial Clients
04	T	Loan term exceeds policy maximum • WHL 265 - Lending to Religious Organizations • WHL 240 - Unsecured Credit Accommodations • WHL 244 - Accounts Receivable and Inventory Lending • WHL 246 - Loans Secured by Equipment, Fixtures, and Other Capital Assets • WHL 250 - Agricultural Lending • WHL 258 - Lease Financing • WHL 260 - Commercial Real Estate • WHL 266 – Underwriting Center for Lending to Business Banking and Eligible Private Banking and Commercial Clients
05	T	Amortization exceeds policy maximum • WHL 265 - Lending to Religious Organizations • WHL 246 - Loans Secured by Equipment, Fixtures, and Other Capital Assets • WHL 250 - Agricultural Lending • WHL 260 - Commercial Real Estate • WHL 266 - Underwriting Center for Lending to Business Banking and Eligible Private Banking and Commercial Clients
06	B	Required business and/or personal financial information fails to comply with policy • WHL 210 - Financial Statement Requirements
07	B	Total borrower exposure (TBE) exceeds concentration limit for individual, risk rating, or other measure • WHL 101 - Enterprise Credit Risk Policy
08	B	Higher-risk industry: borrower's line of business is either 1) prohibited or 2) specialized industry (the transaction is not underwritten in the appropriate lending unit) • WHL 101 - Enterprise Credit Risk Policy • WHL 110 - Credit and Lending Authorities
09	T	Unacceptable collateral: type is 1) undesirable or 2) prohibited • WHL 101 - Enterprise Credit Risk Policy • WHL 242 - Cash, Securities, and Other Investment Instruments • WHL 244 - Accounts Receivable and Inventory Lending • WHL 246 - Loans Secured by Equipment, Fixtures, and Other Capital Assets • WHL 260 - Commercial Real Estate • WHL 266 - Underwriting Center for Lending to Business Banking and Eligible Private Banking and Commercial Clients
10	T	Loan-to-value (LTV) exceeds policy maximum • WHL 242 - Cash, Securities, and Other Investment Instruments • WHL 244 - Accounts Receivable and Inventory Lending • WHL 246 - Loans Secured by Equipment, Fixtures, and Other Capital Assets • WHL 260 - Commercial Real Estate • WHL 266 - Underwriting Center for Lending to Business Banking and Eligible Private Banking and Commercial Clients
11	T	Lack of appraisal/evaluation; appraisal/evaluation is unacceptable to bank • WHL 264 - Commercial Real Estate Valuation (Appraisal) Policy
12	T	Lack of environmental checklist/audit; environmental/checklist/audit is unacceptable to bank • WHL 263 - Environmental Risk Management
13	T	Loan's purpose is defined as speculative, no defined source of payment • WHL 101 - Enterprise Credit Risk Policy
14	T	Line-of-credit (LOC) cleanup period less than policy minimum • WHL 240 - Unsecured Credit Accommodations • WHL 266 - Underwriting Center for Lending to Business Banking and Eligible Private Banking and Commercial Clients
15	T	Unsecured credit liquidity or tangible net worth less than policy minimum • WHL 240 - Unsecured Credit Accommodations • WHL 266 - Underwriting Center for Lending to Business Banking and Eligible Private Banking and Commercial Clients
16	T	Preleasing/presale less than policy minimum • WHL 260 - Commercial Real Estate
17	T	Occupancy rate less than policy
18	T	Release prices below policy minimum • WHL 260 - Commercial Real Estate
19	T	Loan-to-cost (LTC) exceeds policy maximum • WHL 260 - Commercial Real Estate
20	T	Equity below policy minimum • WHL 260 - Commercial Real Estate • WHL 260 - Commercial Real Estate

*B = TPE applicable to borrower; T = TPE applicable to transaction.

trends, identify potential training topics, monitor underwriting issues in the market, and assess the potential impact on asset quality.

Roles and Responsibilities: Exceptional People

Typically, banks expect their relationship managers in the line of business to be responsible for risk-rating their loans and identifying their policy exceptions at inception and over the life of the loans. Usually, credit approvers concur with the relationship managers' recommendations or have the power to change the recommended citations—that is, to add or delete. Of course, the loan review function usually can override the line-credit decision, and outside examiners trump everyone. Therefore, the two key players in policy exception governance are:

Final credit approver: Responsible for the final decision on the citation of a policy exception in a given transaction.

Line of business (LOB) team: Team members from the line responsible for managing the client relationship—for example, the relationship manager (RM) and the portfolio manager (PM). Because they are closest to the relationship, the LOB team is responsible for identifying and recording any policy exceptions in every credit request as part of the approval, review, and renewal process. Credit approval constitutes approval of cited policy exceptions.

If additional policy exceptions are noted by the final credit approver, by the bank's internal risk review function, or by external examiners, the LOB team usually is also responsible for recording the additional policy exceptions. Conversely, if the final credit approver, risk review, or examiners decide that a policy exception should not be cited, the LOB team is responsible for removing the exception.

Descriptions of Policy Exceptions: Exceptional Definitions

To ensure consistent application of trackable policy exceptions (TPEs) across a bank's portfolio, all lines of business typically are subject to a stand-alone policy that describes and explains each TPE. Many banks have their credit policies online, so each TPE can be linked to the underlying policy for ready reference. The electronic linkage avoids redundancy in the TPE policy and induces readers to reacquaint themselves with the appropriate policies. In this way, all TPEs are enumerated and can be tracked for data management reporting.

Table 1 offers an example of some typical TPEs. Generally speaking, a TPE is cited whenever the item 1) fails to meet some specific minimum; 2) exceeds some specific maximum; or 3) is inadequate, unsatisfactory, or lacking. The efficiency and effectiveness of a TPE depend on how well it is defined, so quantitative measures (such as minimum or maximum) or heuristic measures (satisfactory or unsatisfactory, yes or no) work better than exceptions couched in such terms as "should," "prefer," "encourage," or "discourage." So it is a good idea to avoid defining a TPE as "The bank prefers that the LTV should be no more than 75%." Far less ambiguous is, "A transaction with a LTV of 75% or more must be cited as a TPE."

How many exceptions should a bank track? In a perfect world, the risk rating might be one approach for those banks that prefer not to track any exceptions at all. But encapsulating TPEs into a single point value tends to hide them and diminish their value as a red flag. Moreover, the risk-rating system may not be granular enough to take into account all the mitigating factors. Still, at the other extreme is the bank's credit eyesight—how many red flags can bank management really monitor from day to day? Hundreds seems too many; none is probably too few. An expedient solution is to convene a group of experienced officers from workout, loan review, credit, and the line of business. The result is likely to be a list similar to that in Table 1, which itself was generated in such a manner. Best of all, this approach is collaborative: All the vested parties reach consensus and buy into the results.

Table 1 is offered as a starting point for readers. No doubt other TPEs merit being included and current ones might need replacing. The list does not distinguish between major and minor exceptions because of the additional layers of governance required and the philosophical challenges of distinguishing between the two. Neither does the list differentiate between guidelines and standards—again, because of the temptation for tracking both the softer guideline and the harder standard.

An example of the conundrum is a guideline for a 75% LTV on receivables and an 85% LTV as a trackable policy exception. For banks that have the resources to track both, the guideline may be supportable, but for banks with more limited personnel, time, and systems, the standard may be good enough.

Policy Exception Management: Exceptional Leadership

Bank management expects policy exceptions to be kept within acceptable tolerances and periodically reviews them. Bank management also expects approval of policy exceptions to be given only when sound underwriting techniques have been employed to mitigate the increased risk. Some banks formalize the exception rates at some stated percentage—for example, no more than 10% of all loans booked in a current month. Others prefer a more informal approach to exceptions, watching for certain trends (such as when a TPE increases or runs in the range of 10% to 20%).

> As policy exceptions are cured, banks generally remove them so that the loan portfolio reflects the current exceptions and rewards lenders for improving their underwriting.

Additionally, the LOB team usually is expected to explain how each policy exception's credit risk has been mitigated by the underwriting or offset by relevant strengths of the borrower. For example, an RM may explain that the lack of personal guarantees has been mitigated by the owners' offer of cash collateral. Or an excessive loan term may be offset by a strong, well-documented debt service coverage (DSC) ratio. Mitigation is not intended to waive and remove the TPE; it explains how the RM has underwritten the loan to lessen the risk associated with the exception. Waiving a TPE diminishes its value as an early warning of the transaction's deviation from policy.

As policy exceptions are cured, banks generally remove them so that the loan portfolio reflects the current exceptions and rewards lenders for improving their underwriting. For example, a loan-to-value exception at the inception of a real estate loan may be cured over time as the loan is amortized. So at its periodic review or at renewal, the policy exception no longer exists and is not cited again. On the other hand, at review or renewal, new policy exceptions may be present, and these new exceptions are cited. This approach favors policy exception reporting that reflects the current underwriting of the credit transaction rather than its historical underwriting.

Reporting exceptions this way provides management with a current assessment of underwriting and offers immediate feedback on how close or how far from the bank's policy lending activity actually is. Increased LTV exceptions may suggest stiffer competition in the marketplace, and management may want to consider reassessing the LTV maximums, offer supplemental training to explain why the LTVs are critical to the bank, or impose "one up" approval. One-up approval raises the final approval one step above the normal level and is generally very effective in reducing

Table 2

Percentage of TPEs by Lines of Business for Left Bank as of 12/31/2011

TPE #	Description	Comm	Corp	CRE	PB	Bank
01	Guarantor	10	5	6	12	10
02	Credit history	4	0	0	2	3
03	Min DSC	6	0	4	6	5
04	Max loan term	2	2	4	1	2
05	Max amortization	1	1	3	0	1
06	Financial information	8	3	6	11	9
07	Max TBE	0	2	0	0	0
08	Higher-risk industry	4	0	0	4	3
09	Collateral type	2	2	0	5	2
10	Max LTV	2	1	0	5	2
11	Appraisal	0	0	0	0	0
12	Environmental audit	0	0	0	0	0
13	Purpose	0	0	0	0	0
14	Min LOC cleanup period	2	0	0	3	2
15	Min unsecured liquidity & NW	1	0	0	0	0
16	Min preleasing/presales	0	0	0	0	0
17	Min occupancy rate	0	0	0	0	0
18	Min release prices	0	0	0	0	0
19	Max LTC	0	0	0	0	0
20	Min equity	0	0	0	0	0

the occurrence of a specific exception. Another approach is to permit higher levels of loan authority for approval of loans with no policy exceptions as an incentive to lenders who underwrite within the bank's policy.

Counting exceptions accurately is critical to reporting, and accuracy depends on distinguishing between borrower exceptions and transaction exceptions. For example, unacceptable financial statement data is a borrower exception, but an excessive LTV is a transaction exception. Suppose Parisian Bread Company has four loans with Left Bank and has provided only company-prepared financials instead of the audited financial statements required of a borrower with its total level of exposure. Meanwhile, two of the loans have excessive LTVs. The total number of exceptions is three: one for the financial statements and two for the LTVs. Table 1 contains a column that discloses whether a TPE is applicable to the borrower (B) or to a transaction (T).

There are many ways to report and depict TPEs, but one approach is to report them for the bank as a whole, by LOB for the most recent month, and then on a rolling 12-month basis for the bank as a whole and by LOB. Table 2 illustrates a point-in-time approach to reporting on Left Bank's four LOBs—commercial (comm), corporate (corp), commercial real estate (CRE), and private banking (PB)—and on the bank as a whole. Table 3 discloses a 12-month format for Left Bank. Table 4 shows that Left Bank's most frequent TPEs over time are led by guarantee and financial information exceptions. And Table 2 reveals that the commercial and private banking LOBs are the drivers of these two exceptions.

Remedial training and more underwriting discipline may be possible solutions, or the exceptions may be signals of pressure from competitors who have less stringent guarantee and financial statement requirements. If the latter is the case, Left

Table 3

Left Bank TPE Trends over the Most Recent 12 Months

TPE #	Description	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
01	Guarantor	14	13	13	12	12	10	11	14	13	12	11	10
02	Credit history	3	2	4	3	3	3	2	3	4	1	2	3
03	Min DSC	8	7	6	6	6	6	4	7	5	6	5	5
04	Max loan term	4	4	4	3	3	3	3	2	2	2	2	2
05	Max amortization	4	4	4	4	3	3	3	2	2	2	1	1
06	Financial information	9	10	11	12	13	14	13	13	12	11	10	10
07	Max TBE	0	0	0	0	0	0	1	0	0	0	0	0
08	Higher-risk industry	2	3	2	3	2	3	2	3	2	3	3	3
09	Collateral type	0	1	0	2	1	1	1	0	2	3	2	2
10	Max LTV	4	3	5	3	2	3	2	1	2	1	2	2
11	Appraisal	0	0	0	0	0	1	0	0	0	0	0	0
12	Environmental audit	0	0	0	0	0	1	0	0	0	0	0	0
13	Purpose	0	0	0	0	0	0	0	0	0	0	0	0
14	Min LOC cleanup period		4	3	4	3	2	3	2	1	2	2	2
15	Min unsecured liquidity & NW	0	0	0	2	2	1	0	0	0	0	0	0
16	Min preleasing/presales	0	1	0	0	0	0	0	0	0	0	0	0
17	Min occupancy rate	0	1	0	0	0	0	0	0	0	0	0	0
18	Min release prices	1	0	0	0	0	0	0	0	0	0	0	0
19	Max LTC	0	0	1	0	0	0	0	0	0	0	0	0
20	Min equity	0	0	0	1	0	0	0	0	0	0	0	0

Bank has to decide whether to compete on these nonprice terms. Table 3 also indicates a certain seasonality to these two exceptions—especially in the second quarter, when many relationships are triggered for annual reviews and annual renewals.

Another view of TPEs is how they differ between new and renewed loans to see if existing transactions and borrowers are complying with policy as well as, better than, or worse than new loans. Long-term relationships may have matured enough to merit more generous treatment, but even treasured clients sometimes tarnish over time. Conversely, new clients may enjoy more liberal terms than existing borrowers—and that condition may be indicative of newer lenders who have not yet embraced the bank's risk-tolerance objectives, as well as the veteran lenders who usually have the more mature loan portfolios. The point of these examples is that TPE reporting and monitoring provides considerable information that, in its absence, would not be available.

Some banks opt to dollar-weight policy exceptions to determine which exceptions the largest exposures have. On the other hand, banks with several LOBs may find that dollar-weighting tends to obscure trends across LOBs when one LOB makes much larger loans than the others. For example, suppose Left Bank's private banking has a loan portfolio only one-third the size of corporate banking, and that reduces private banking's guarantor TPE to 4% versus corporate banking's 5%. Private banking's high guarantor exception rate is diminished and obscured. If the purpose is to compare exception rates among LOBs, dollar-weighting is more likely to distort comparisons.

Conclusion

Niccolo Machiavelli offered this counsel on policy five centuries ago: "The one who adapts his policy to the times prospers, and likewise the one whose policy clashes with the demands of the times does not."

As a rule, a bank sets credit policies to keep on course toward its goals. These policies serve as the guardrails and signs on the road, and without them, the bank may not know if it is on the right course or even lost. It must avoid rationalizing exceptions as acceptable behavior without validating the consequences.

There will be market pressure to deviate from time to time. But if the bank's lines of business and its credit approvers have agreed on the institution's credit risk goals and the policies to achieve them, then exceptions to policy should be infrequent and properly mitigated.

Keeping track of key exceptions to policy helps the bank stay on course by ensuring that trackable exceptions are identified and mitigated. Chances are that a few lenders and a few borrowers generate the most exceptions. Often, tighter management of these concentrated groups keeps overall exceptions to acceptable levels.

Journalist Charles Osgood observed that there are no exceptions to the rule that everyone likes to be an exception to the rule. Tracking exceptions does give everyone a chance to be exceptional sooner or later—but, hopefully, not for long. ❖

Table 4

Left Bank's Most Frequent TPEs (%)

TPE	Dec 09	Dec 10	Mar 11	Jun 11	Sep 11	Dec 11
Guarantee	13	9	10	14	13	12
Fin info	8	12	11	8	13	10
DSC	3	6	5	4	5	5
Higher risk	2	4	5	6	6	3
LTV	4	3	5	5	5	2
Credit history	1	4	4	3	4	3
Cleanup period	1	1	3	2	3	2

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