rma®
THE RISK MANAGEMENT ASSOCIATION

ADJUSTMENTS

THE RISK RATING RESPONSE TO PANDEMIC-DRIVEN ECONOMIC TRENDS

Enterprise Risk • Credit Risk • Market Risk • Operational Risk • Regulatory Affairs • Securities Lending • Internal Audit

Introduction: Risk Rating in the Current Environment

It is said that a rising tide lifts all boats. During the longest bull market in history that took place from March 2009 to March 2020, this was certainly true as most businesses were buoyed by the booming economy and seemingly endless expansion. Now, months into the COVID-19 pandemic-driven recession, everything has changed.

Contents

Introduction: Risk Rating in the Current Environment 1

How Adjustments Fit into a Next-Generation Risk Rating System 2

Adjustments vs. Overrides: What You Need to Know 4

When & Why Leading Institutions Use Adjustments 5

Two Cases of Adjustments in Action 6

Considerations for Building Adjustments into Your Institution's Risk Rating System 8

While the rising tide lifted all boats, the receding tide is not lowering all boats at an equal pace. Previously, defaults were sporadic, and the performance of individual companies and industries was not as critical to monitor given the fact that such a high percentage of loans would make good at the end. Now, we see sectors like transportation, hospitality, oil & gas, and others struggling as big tech firms report record earnings. So, how do we rate credit risk in an environment where the economic recovery is expected to remain uneven and unpredictable?

Basic risk rating systems that provide a simple assessment of pass- or fail-rated credits tend not to show weakness when used in favorable economic conditions. With market conditions changing rapidly, however, institutions need a risk rating system with additional flexibility, granularity, and transparency to not only ensure the soundness of new commercial loans, but to potentially regrade the existing portfolio to account for client and industry changes as they occur.

One of the best ways to increase this much-needed flexibility and transparency is through the introduction of adjustments within a risk rating system. Read on to explore where adjustments fit into a next-generation risk rating system, learn when leading institutions use adjustments most often, see a couple examples of how adjustments can impact risk ratings, and discover what considerations an institution should make as it builds adjustments into its risk rating system.

HOW ADJUSTMENTS FIT INTO A NEXT-GENERATION RISK RATING SYSTEM

> Now, we see sectors like transportation, hospitality, oil & gas, and others struggling as big tech firms report record earnings.

Before diving into how adjustments work, let us define the term "next-generation risk rating system" using RMA Dual Risk Rating – the Risk Management Association's (RMA) turnkey, technology-driven risk rating system – as an example and examine where adjustments fit into this system.

To start, let us look at the rating scale. Unlike a narrow single risk rating scale where many ratings tend to end up as pass-rated credits (grade 3-4) due to a lack of granularity, our dual risk rating scale expands the number of pass categories on the borrower rating scale, providing a way to spread those pass ratings across five or more buckets to better stratify risk. The "dual" part of dual risk rating refers to the second dimension of risk – the risk to the facility or institution. The facility rating scale separately evaluates the riskiness of the loan by assessing the collateral value.

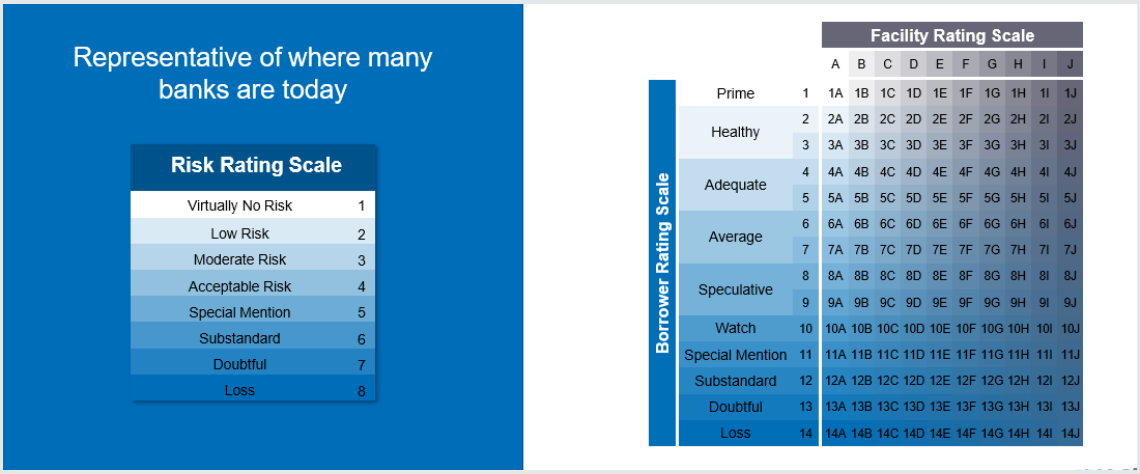

Figure 1. A common single risk rating scale compared to the RMA Dual Risk Rating scale

This more sophisticated system creates a framework for jointly evaluating borrower creditworthiness and loan riskiness more consistently, with the rating scale providing the key output of RMA Dual Risk Rating: the risk rating itself, such as 4B or 6D or 8F. But how do we arrive at this easy-to-understand two-dimensional rating? That is where the scorecards and subsequent adjustments come in.

RMA Dual Risk Rating comes with six expert-judgment scorecards designed for rating different kinds of credits: C&I, CRE, and General Purpose, for example. Users input client financial data in 15-20 categories on the front-end, and the scorecards calculate a risk rating on the back-end based on quantitative and qualitative factors.

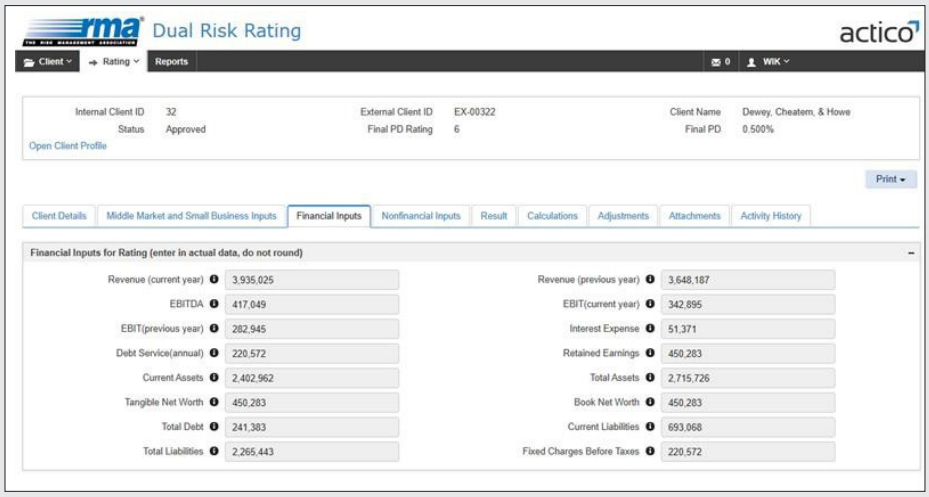

Figure 2. An overview of the financial inputs that determine a risk rating

ADJUSTMENTS VS. OVERRIDES: WHAT YOU NEED TO KNOW

Adjustments and overrides can both result in significant changes to the risk rating, but they are very different in where they occur in the scope of the risk rating process. Adjustments occur inside the rating process as a structured modification to the quantitative rating. They are used to incorporate specific attributes of a loan, borrower, or economic landscape, and they work to *adjust* the factors that lead to the risk rating in situations where the quantitative output does not pass expert judgment.

Overrides invite more scrutiny – and rightly so – as they can contradict both the output of the risk rating system and the bearing of current economic factors. They occur outside of the quantitative process and are characterized by a management decision – an override – to assign a risk rating that ignores the recommendation of the scorecard or model. This rating is created based on a combination of factors, including intuition, bank policy, and/or external information.

Like overrides, adjustments are ideally documented with a transparent audit trail that is stored in tandem with the final risk rating. This provides a ledger that speaks to how the adjustment decisions were made and how they impact the perception of future performance.

WHEN & WHY LEADING INSTITUTIONS USE ADJUSTMENTS

Past performance is not indicative of future results. In periods of economic change, there is a lag between financial fundamentals that drive quantitative risk ratings and a borrower's current performance and future expected performance. Furthermore, the underlying methodology and data of many risk rating scorecards and models also lag actual economic conditions.

Still, an institution must continue to grow and manage its lending portfolio. Instead of significantly narrowing the pool of borrowers to those who are prime and largely unaffected by the pandemic, institutions can utilize adjustments in a next-generation risk rating system to rate new loans appropriately by introducing the most current information into the calculation.

Organizations rely on a combination of expert judgment, institutional knowledge, current economic data, and industry/peer company benchmarking to determine when and how to apply adjustments. Here are the two common situations in which adjustments are beneficial:

1. When wholesale changes to the risk rating are necessary

Every economic crisis is different. The current crisis is widespread, with certain sectors hit harder than others. As mentioned in the introduction, we see hospitality, transportation, recreation, tourism, manufacturing (apparel), brick and mortar retail, and commercial real estate losing ground faster and for longer than other industries.

With a good sense of how different parts of the economy are being impacted, you can use the adjustments process to account for this for borrowers in different industries and with different financial positions. RMA Dual Risk Rating embeds an adjustment worksheet to enable the credit analyst to modify the calculated rating.

2. When a facility, loan, or borrower has unique attributes

Broadly speaking, having adjustments in a risk rating system such as RMA Dual Risk Rating creates a product that is both generally applicable and able to meet the needs of specific institutions, types of loans, and individual borrowers.

With the unique attributes of a loan and its involved parties pinned down, an institution can use adjustments to account for all sorts of different elements, as we'll show in the next section.

TWO CASES OF ADJUSTMENTS IN ACTION

Factoring in foot traffic at home improvement stores

According to the *Wall Street Journal*, Home Depot reported that 2020 Q3 individual transactions rose 13% year-over-year. As the U.S. spends more time at home, home improvement stores have demonstrated steady growth through 2020. RMA Dual Risk Rating includes an adjustment to incorporate trends in sales growth. In our example of a loan to a small home improvement store, we would make the following adjustment:

Category	Adjustment Description	Adjustment	Comment
Business Environment	Sales Growth Trend	1 Grade Upgrade	Stable YoY growth

Accounting for how office space occupancy impacts surrounding businesses

An August 2020 forecast from Moody's Analytics projects that vacancy rates for office space will near 20% nationwide in 2021. This impacts not only CRE developers, owners, and property managers, but the retail tenants that count on the weekday flow of commuters to sustain their business. In our example of a non-owner-occupied commercial real estate loan, lessees are under severe financial hardship and are on a partial payment plan. We would make the following adjustment to the loan:

Category	Adjustment Description	Adjustment	Comment
Quality of Cash Flow	Rent roll rate	1 Grade Downgrade	Anticipated rent roll of more than 75%

> [Adjustments] work to adjust the factors that lead to the risk rating in situations where the quantitative output does not pass expert judgment.

CONSIDERATIONS FOR BUILDING ADJUSTMENTS INTO YOUR INSTITUTION'S RISK RATING SYSTEM

Looking forward, your institution and the economy as a whole cannot afford to have every hotel and restaurant loan denied due to the current environment or treated as a watch loan. Instead, you must adapt to preserve and grow your portfolio, knowing that the economy will eventually recover. In closing, here are four things to consider:

1. If you don't have a way to make necessary adjustments within your current risk rating process, making reactive overrides could lead your institution from something bad to something worse. Avoid this path at all costs.

2. As a counter to reactive overrides, introducing pragmatic adjustments as a feature of your risk rating system could be the key to handling not only the present crisis, but also establishing a repeatable process.

3. Keep a transparent audit trail of adjustments made for each risk rating and make it part of the loan review documentation. This way, it will be easier to explain these changes and adjust further in the future.

4. If introducing adjustments into your risk rating system proves too difficult or is not possible, consider a turnkey, proven solution that already offers this extra layer of risk rating flexibility.

To start benefiting from the controlled flexibility of adjustments in your risk rating process without investing months of time and resources, contact the RMA Dual Risk Rating team today to schedule a discovery call.

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About RMA

The Risk Management Association (RMA) has been at the forefront of the development of the operational risk discipline in financial institutions since 2003.

The definition of operational risk is: *the risk of loss resulting from inadequate or failed internal processes, people, and systems, or from external events, but is better viewed as the risk arising from the execution of an institution's business functions.* Operational risk exists in every organization, regardless of size or complexity, from the largest institutions to regional and community banks.

For much of the past decade, the industry has been focused on measuring operational risk losses for capital allocation purposes, but in recent years has increased the focus on the process of managing operational risk.

RMA serves operational risk practitioners in large financial institutions, as well as regional, mid-tier, and community banks, at both the corporate level and the business line. RMA provides peer sharing, professional development and networking opportunities for our members through discussion groups, conferences, round tables, forums, courses, webinars, publications, and podcasts.

RMA also conducts surveys, benchmarking studies, and range-of-practice papers. In addition, RMA's Advanced Operational Risk Group shares industry views on aspects of AMA implementation with the U.S. financial services regulatory agencies toward a goal of successful AMA implementation. *The RMA Journal®* also regularly carries articles on operational risk topics.

RMA's operational risk activities are driven by the Operational Risk Council, whose mission is to promote sound practices in the management of operational risk in financial service institutions worldwide. It promotes understanding of the causes, events, and effects of operational risk through dissemination of management methods, sound practice tools, and materials. The Operational Risk Council is focused on the needs, challenges, and opportunities of all member institutions, including community, mid-tier, regional, and large banks, as well as non-bank financial institutions.

Major issue(s)/risk(s) within the market are listed below. COVID-19 has amplified all them:

- Technology
- Cybersecurity
- Information Security
- Third-Party Risk
- Fraud
- Succession/Talent challenges
- Challenge of returning to work
- Challenge of the possibility of second major outbreak
- Reputational risk in the event of second major outbreak

To learn more about RMA or our operational risk thought leadership pieces, contact Sylwia Czajkowska at sczajkowska@rmahq.org.