

6 PRINCIPLES YOU CAN BANK ON

Move over, 5 Cs, and make room for 6 Ps

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By Cheryl Anderson, senior compliance analyst, Harland Financial Solutions

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UNconventional Wisdom is a periodic guest blog, where authors hold up the so-called conventional wisdom to a fresh perspective, or apply common principles in new ways. To propose a guest blog, email Steve Cocheo, executive editor & digital content manager. Opinions expressed in UNconventional Wisdom articles are not necessarily those of the American Bankers Association nor its affiliates.

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Today, more than ever, financial institutions need to assess customer relationships in their entirety, which includes both deposit and lending relationships. Much ado is made of the traditional “Cs” of credit.

- Character (integrity)
- Capacity (sufficient cashflow to service the obligation)
- Capital (net worth)
- Collateral (assets to secure the debt)
- Conditions (of the borrower and overall economy)

While the Cs are pillars for credit underwriting, they are not particularly adapted to other lines of business like deposit origination. Banks need to look beyond business as usual and examine relationships in more comprehensive ways.

There are “Six Principles of Financial Transactions”:

- Purpose
- People
- Performance
- Payment
- Protection
- Prospects

The Principles can be used to assess a complete customer relationship consisting of one or more transactions across multiple lines of business. Banks are finding greater profitability in multi-product relationships and are looking for more ways to increase that share of wallet. Let's review how we may apply these principals to help financial institutions reach these goals.

1. Purpose

Purpose is the foundation of any transaction.

For a loan this would be the intended use of the borrowed funds. For a deposit account, it would be the intended deposit or service relationship and understanding their needs to manage their funds.

While purpose is typically known, and often required under bank secrecy law, it is frequently overlooked for its importance. Purpose sets the ground rules for process and dictates compliance requirements. If the purpose for your transaction is a home purchase loan, you know that you will be heading down the happy path of Home Mortgage Disclosure Act reporting, Good Faith Estimates as required under the Real Estate Settlement Procedures Act, disclosures for Truth in Lending, applicable state or other disclosures, and more. And this is all in addition to following your own lending policy for a mortgage loan. Only when purpose is known do the requirements start the clock ticking and next steps become apparent.

Purpose gives you opportunities to cross-sell in order to expand the relationship further. Take that home purchase loan. If this is a first-time home buyer, the obligor may need additional funds for appliances or furniture. Now might be the time to consider additional loans, and if not, time to plant the seeds for a future discussion when the obligor is ready.

Purpose determines if you need to involve other departments for additional expertise. Front-line representatives may need to call on others for information or direction for mortgages, individual retirement accounts, small business administration loans or other highly specialized products.

Finally, purpose will determine the data and depth of review for the other five principles. Some transactions will have a more in-depth review of the principles than others. Gathering purpose can be as simple as "how can I help you?" with the answer you are given a regulatory roadmap and opportunities as to how you can help your customer.

2. People

People (or parties) is the identification and understanding of the people or legal parties engaged in the transaction or relationship.

This starts with the collection of demographics like name, date of birth, social security/tax identification number, and address. Identity authentication and verification, fraud checks, customer information profile, red flag reports, and OFAC checks are all part of this principle. Depending upon the initial purpose, you may also collect education level, length of employment, and home ownership status, among other relevant data.

If your customer is a legal party or business, other types of information are needed. Is the party type a corporation, partnership, limited liability company, association, or other legal entity? If it is a business loan, you will typically identify the industry, age of the business, and number of employees. With a legal party you will also need to identify and understand the people in control, often referred to as owners, managers, or officers. This will provide vital information on how that business runs in addition to giving you more opportunities to expand upon those relationships.

People is the identification and determination of who is the responsible party for the transaction.

3. Performance

Performance is the identification and analysis of the current condition and historic financial performance of your people and parties. Depending upon the purpose you may look at credit reports, overdraft history, or spread financial statements over a number of years.

The most common measure of past performance is credit score. It is a current snapshot of performance characteristics including payment history, amounts owed, length of credit history, recent activity, and credit mix. If you have an existing relationship, that history should be reviewed as well.

Performance provides a clear indicator in starting, continuing or expanding a relationship. It provides a comfort level that the relationship will be mutually beneficial even if market conditions deteriorate. Risk of default or serial overdraft should be identified in performance review.

To quote Shakespeare, "What's past is prologue."

Performance answers the questions, "Where have you been?" and "How have you handled your financial responsibilities?"

4. Payment

Payment considers the terms of the transaction.

For certain savings or certificates of deposit, it could mean the interest or dividend payment for your customer or for a business customer the fee structure for commercial accounts. More critically for loans, it means the ability to repay at the specified terms.

Characteristics reviewed for payment of consumer loans may include monthly income, current debt-to-income, proposed debt-to-income, and debt-to-income at maximum payment level. Mortgage lenders look at these front-end and back-end ratios to determine the level of the applicant's debt. Additional consideration needs to be given to how any balloon payment would be met.

For business loans the lender would look at liquidity ratios to measure quality and adequacy of assets. Debt coverage ratios help to measure ability to service debt and leverage ratios provide guidance on debt vulnerability.

Ratio assessment can vary greatly depending upon a particular industry. The use of industry or historical benchmarks, like the Risk Management Association Annual Statement Studies Financial Ratio Benchmarks Data, can be put to use for peer analysis, or measuring the probability of repayment.

Payment is a picture of investment and repayment.

5. Protection

Protection identifies what can be relied upon to protect your financial institution or your customer. For a depositor, this could easily mean an overdraft protection program, deposit insurance, or security processes to keep their deposit safe from fraud. And don't forget the ability to quickly move funds for business customers through ACH, wire transfers, or sweep accounts to protect against quickly changing market needs.

Protection is more often that extra security taken to make sure a loan will be repaid in a worst-case scenario. Collateral, and level of security interest perfection, is the most recognized form of protection. The age and value of the collateral, with the down payment, are taken into account.

Recourse obligors (guarantors) can be another backup plan for repayment. Each guarantor will need to be reviewed for each principle before deciding if this person or party is up to the task to add protection to the loans. Lastly, certain forms of insurance are a form of protection to ensure repayment upon borrower death, unemployment, collateral damage, or foreclosure.

Protection is your backup plan for a worst-case scenario.

6. Prospects

Prospects is an assessment about the future.

What are the prospects for this customer, this business, this transaction or this relationship? You will look at any existing relationship this customer has with your institution and estimate your combined relationship going forward.

For a student opening a first checking account for college, the bank's prospects could be a lifetime relationship. If the matter at hand is a loan to a business party, the bank needs to determine the prospects for that business, including expansion, or even, the very survival of that business. What is the business environment that your obligor exists in? If this is the proverbial buggy whip manufacturer during the automobile revolution, prospects may not be so good.

Prospects--together with the other five principles of purpose, people, performance, payment, and protection--will help determine if this will be a mutually profitable association.

Prospects poses the question, in other words, "Can we have a successful relationship?"

Practical application of the principles

The principles are intended to guide any financial institution with relationship building. They will often blend with one another and can sometimes be interchanged with the Cs of Credit. For instance, people will pair with Performance for a lender to review the Cs of Credit principle of Character.

Some characteristics can be associated with more than one principle. For instance, a review of current accounts with your customer will be done with People, Performance, and Prospects.

The biggest benefit of the principles is their use in regard to ongoing relationships. The principles can be used to assess, initiate, increase, and maintain a mutually profitable relationship. There are numerous tools available on the market that will help with the application of one or more of the principles and tie them all together.

The principles are not intended as hard and fast rules; they are intended to be used together to help you with an overall picture of your relationships.