Credit Analysis and Credit Losses:

The Role of Financial Information

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I believe that it would not be unfair to characterize the state of the credit world today as unsettled. Some might even feel that turmoil would be a better description. Lenders, particularly banks, are experiencing a series of loan losses which are unprecedented in the postwar era. Reserves for loan losses are being increased at a rate substantially in excess of the five-year moving average basis which traditionally has been used by most banks to accrue for such losses. In the case of many major banks these increased loss provisions are largely or totally offsetting the favorable effects on earnings of the unusually large spreads between borrowing and lending rates that we have recently experienced.

I am sure that most of you would accept these statements on the basis of your experience without specific empirical data to prove them; nevertheless, for emphasis, let me cite just a few numbers. During the five year period from 1969 through 1974, the total assets of all commercial banks in the United States has increased from $530 to $912 billion; an increase of 72%. The stockholders' equity of these banks has similarly increased from $37 to $59 billion, a 60% increase. And total operating income has gone from $30 to $68 billion, an impressive increase of 125%. However, and here's the rub, net loan losses have gone from $489 million in 1969 to nearly $2 billion in 1974, an increase of 300%. In other words, while total operating income in 1974 was twice that of 1969, net loan losses were four times as great. Indications are that 1975 results will be even more startling.

The Effect of Uncertainty on Financial Statements

It seems safe to say, therefore, that there is substantial uncertainty abroad in the credit world and in the general economy. This degree of uncertainty raises problesm in financial reporting which are of special significance to bankers and which I would like to touch upon briefly even though this is not the focus of my remarks today. In the first place there is the general problem of the effect of increased uncertainty on the usefulness of financial statements. And secondly, there is the more specific problem with which I am certain you are all too familiar and that is the problem of how to measure and when to recognize loan losses.

Considering first the effect of increased uncertainty on the usefulness of financial statements, it is necessary to recognize that any degree of uncertainty creates problems in financial reporting. In large part, this results from the fact that financial data are traditionally presented in single valued form. One number is intended to communicate the reality of a business situation, whereas, only a probability distribution can reflect reality under conditions of uncertainty.

Judgment plays a significant role in selecting the single numbers which represent the probability distributions. Under conditions where reasonably probable results very widely, the role of judgment is particularly important. In such situations, disclosure of the basis for judgments reached is an important part of financial reporting. How did the management decide, for example, that it should add $30 million to the loan loss reserves, as opposed to $50 million or $10 million? It is important that investors have such information to assist them in making their own judgment and evaluations of the financial enterprise.

In addition to disclosing the basis for selecting a single value within the spectrum of uncertainty, the financial statements must communicate the magnitude of uncertainty. In otherwords, the spectrum of uncertainty must be described in some fashion. This does not simply mean the presentation of the worst case and best case, but rather some description of the various outcomes that may reasonably be expected to occur. It is obviously important that such communication take place in a fashion such that the data can be absorbed by investors without provoking unreasoned fear or unrestrained optimism. I wish I could tell you that this problem has been solved but I can only assure you that it is receiving considerable attention at the present time.

Turning now to the more specific accounting problem which results from the degree of uncertainty in the current economy, it is clear that banks are facing some tough decisions as to how to measure and when to recognize loan losses. There are differences of opinion as to what evidence of unrecoverability should evoke the recognition of loss. Furthermore, there are questions as to what elements of the losses are to be recorded. For example, the conventional wisdom in banking today seems to suggest that a loss is incurred only if some portion of loan principal, as legally defined, is determined to be unrecoverable. The renegotiation of a loan on substantially less favorable terms is not deemed to give rise to a loss even though in terms of economic reality it is quite apparent that a substantial amount of loan value has been given up. In order that financial data be of benefit to users, accounting practices should not be inconsistent with economic reality. It is not clear that bank accounting for renegotiated loans meets that basic test.

When accounting does not reflect reality, there is great danger that both management and investors will respond to accounting incentives rather than economic forces. Management decisions which are not economically sound are sometimes made because of their accounting results. This is not in the best long run interests of stockholders. In the credit area, for example, probably the most difficult professional decision that must be made is whether it is in the economic interest of a lender in a work out situation to pull the plug on a credit as opposed to exercising patience, renegotiating on less favorable terms, or sending more money. It is important that this judgment be made on economic grounds and not because of a desire to avoid an accounting write-off for one more year. I have the impression in this and other cases that decisions are significantly affected by considerations of accounting results which in some instances fail to reflect economic reality.

Credit Analysis and Credit Problems

These accounting problems--both the general problem of the usefulness of single value oriented financial statements and the more specific problem of measuring and reporting loan losses--are intensified during periods of increased uncertainties. They are fascinating and important problems. At least, to an accountant they are fascinating. Today, however, I would like to focus upon a different although related topic--the role of credit analysis in the credit problems currently being experienced.

In looking seriously at the reasons for our credit problems, it is apparent that broad economic factors must bear the brunt of the blame. The combination of recession and inflation have put unexpected and major pressures on borrowers. It is not surprising, therefore, that latent weaknesses in some enterprises were exacerbated and created credit problems.

Credit analysis, however, is not blameless as we search for causes of credit problems. Lenders must be willing to take risks but it is the job of the credit analyst to know what the risks are and monitor them carefully. Nearly three decades of stability and prosperity dulled the critical facilities of credit men to a significant degree. Throughout this period the hero in the bank was the man who said yes. Pressures for volume and profits tended to become paramount for bank managements. In too many cases money was made available to borrowers when it should not have been even based on the optimistic economic assumptions of the times.

The real estate area, for example, which today is probably the biggest problem faced by credit grantors, became such in large part because money was thrown at real estate operators who were only too willing to take it. Banks found real estate financing a profitable operation and they tended to lower their standards and accepted optimistic projections from developers. In addition, the developers found a whole new source of capital in the Real Estate Investment Trusts which competed aggressively with the banks making loans to marginal credits. In many cases banks were prepared to sponsor and lend to REITs whose portfolios were made up of credits that could not meet bank standards. As with the Monday morning (or Tuesday morning) quarterback, these calls are much easier to make now, in retrospect. But the point is that good credit analysis should have focused attention upon the direct and indirect loosening of credit standards. This criticism is not just directed to the quality of credit work that was done or not done, but also at the tendency of managements to deemphasize the role of credit analysis in the decision process.

Increased Professionalism Needs

If credit analysis can be blamed for elements of our current credit problems, what actions are called for to improve future performance? It seems to me that the key element is increased professionalism in this area. Both managerial emphasis and credit training are major factors in the development of such professionalism.

Increased managerial emphasis means that more resources must be devoted to the credit function both in terms of pre-loan analysis and monitoring the loan on a continuing basis. While increased analysis and monitoring will not always avoid losses, it will nearly always help in reducing the magnitude of such losses. Furthermore, the knowledge gained can enhance significantly the relationship between borrower and lender. The good credit officer offers far more than money to his client. The best borrower-lender relationships today include substantial exchanges of information. An expansion of data analysis should improve the services and counsel offered by the lender.

There are a number of elements involved in increased analysis. First, there must be a better understanding of what financial statements can and cannot do. Secondly, the task of gathering financial information from borrowers must be approached with more expertise and sophistication. And, finally, banks must develop better systems to monitor their aggregate portfolios.

A Better Understanding of Financial Statements: The Accounting Model

As to the requirement for an increased understanding of what financial statements can and can't do, there have been many misapprehensions about financial statements due to a lack of knowledge on the part of users about the "accounting model." This is particularly true of creditor users who sometimes seem to think that financial statements are primarily designed for them. Creditors must recognize that while statements prepared in conformity with general accepted accounting principles may be useful to them, they are not designed for creditors. Anyone who forgets this when writing a loan agreement does so at his peril.

There are two elements of the accounting model that seem to be most misunderstood by creditors. The first is that the model is oriented toward the income statement with the balance sheet treated largely as a residual. Balance sheet numbers arise from income statement treatments, not from valuation procedures applied to assets and liabilities. A banker using balance sheets must be very much aware of this fact.

In addition, the income model used by the accountant is not based on economic income or current cash income. It is designed to measure the long run average net cash inflow at current activity levels.

The implications of these facts for lenders are significant. First, neither current nor liquidation asset values are generally reflected in the financial statements. Second, liquidity is generally poorly measured. Finally, the long run averaging, or matching, approach may provide the most useful information for those interested in long term cash flows but they may mislead the person with a shorter time horizon. In most cases, long run averages as used in the income statement have a different time horizon then that of the creditor. Furthermore, the current level of activity, which is the other key variable may not be sustainable over a long enough period to make averages relevant. The creditor, therefore, is subject to the same risks as the legendary statistician who drowned in a river averaging two feet deep.

These characteristics of the “accounting model” together with the fact that financial statements tend to obscure uncertainties by the single valued format discussed previously affect the usefulness of such statements, but do not mean that they are without value to creditors. Such statements do provide useful information as long as their inherent limitations are recognized and they are not treated as Fundamental Truths. What is needed, therefore, is substantial training in the dimensions of the model so that the communication of the accountant can be effectively received by the credit grantor. This should certainly include course work in footnote-eze. While footnotes are generally not the most exciting reading, they are an important means by which the accountant communicates, and the creditor should study them and understand them.

<u>Better Data Gathering</u>

The second element in this series of professional development ideas is the need for a more comprehensive approach to data gathering. I see two parts to this point. The first is for lenders to develop a greater awareness of public information which is regularly available and its use. In recent years the quality of information available to lenders and other users has improved considerably more than the quality of its use. Bankers must know what, how and when corporations are required to report.

In this connection some knowledge of SEC requirements seems necessary. Two recent trends in the SEC's approach to reporting are worth noting both because of their significance in general and because of their value to lenders.

The first of these is the concept of differential disclosure which has been articulated in a number of releases and implemented in several of the Commission's rules. This approach implies increased requirements both for more detail and for greater summarization and analysis. It suggests that the annual Form 10-K Filing should be primarily a document aimed at financial analysts rather than at the "average shareholder." At the same time the Commission has indicated that the 10-K should be available to any shareholder who wishes it on a no-charge basis and that certain significant information in it should be included in annual reports to shareholders.

Differential disclosure means that the person who wants to dig into a company to develop an in-depth understanding of its operations will have the information available to do so. This presumably should be of interest to lending banks. At the same time, a responsibility will be placed upon management to analyze financial data and provide users with a summary in an understandable textural format of those elements which it believes are most important in understanding the results of operations.

A second development which is important is the move in the direction of a continuous disclosure system. This means that financial information of public companies will be more frequently available in greater detail. There are two elements to this. The first is the recently expanded rules for quarterly reporting on Form 10-Q. These rules require presentation of a full income statement, balance sheet and source of application of funds statement each quarter, although without the notes attached. In addition, the Commission has required full and timely disclosure on Item 10 of Form 8-K of all material unusual charges and credits to income and other material items. Independent accountants are involved with both these elements, although not on a audit basis. This involvement is designed to add additional professional expertise to the reporting process but not to encourage the too prevalent game of sue the auditor rather than analyze the statement.

There is a significant amount of financial information available in SEC filings, some of which has had relatively little use by analysts. It would seem, as a matter of routine, a lender should require borrowers to furnish to it all copies of Commission filings at the time they are filed.

In addition to the SEC filings, other data are frequently publicly available and can be part of the credit analysis process. Stockholder communication on both an annual and quarterly basis are of course important elements. In some circumstances supplemental data furnished analysts, presentations to analysts groups and data submitted to trade associations may also be useful information. Too often these possible sources are not explored by lending officers.

While knowledge of data currently available through public sources is of great importance, it must be recognized that lenders have needs beyond those served by standard data sources. Accordingly, it seems desirable that there be developed some form of “creditor package” of data tailored to creditor needs. Such a package might be developed in general with perhaps subpackages for particular industries.

Robert Morris Associates could certainly make a significant contribution in the development of such packages. The organization has done so in the case of the finance company questionnaire and it would seem appropriate that it move beyond this in the light of that questionnaire’s success. RMA can bring widely diversified expertise to bear on the problem of creditor information which will both assure that importance items are not overlooked and will focus the best credit minds on the general problem.

The development of the creditor package would have many advantages. First, it could achieve comparability of disclosure among borrowers and lessen the burden on borrowers who otherwise might be confronted with a multiplicity of data demands from a group of lending banks.

A standard package would reduce the temptation on the part of banks to compete for business by lessening data requirements. Unfortunately, in times of easy money there has been some tendency in this direction. There must be a commitment on the part of all bankers to negotiate the information package as an integral part of loan agreements, not as an afterthought. Too often in the past banks have been willing to make loans without agreement as to the information which will be provided to them They are then reduced to ad hoc solutions to the information problem after the credit problem has become apparent. If borrowers knew that particular package of data would be required by all lenders they would cease to try to short cut the data needs of such lenders and they could reduce cost by developing appropriate internal systems to meet these requirements as finance companies have done.

While I have not attempted to design a creditor package, there are certainly some elements which would appear to have general applicability. First in line would be the requirement for cash flow and operating forecasts with regular reporting of variations and analysis of any changes in such forecasts on a timely basis. An important element in any appraisal of results is a timely analysis of the reasons for variations between historical results, current results and forecast results. Analysis of the difference between budget and actual data has long been an important tool in managerial information systems. Some form of such analysis should be made available to lenders. Banks today frequently get forecasts and “budget us actual” analysis but the practice is by no means universal.

A second element which should be included in the creditor package is improved liquidity disclosure. This would relate closely to cash flow forecasts but would also include some measures of potential liquidation values associated with readily salable assets of the business with particular emphasis on receivables and inventories. It is probably not realistic to insist upon forced sale liquidation data with regard to fixed assets on a frequent basis but where the sale of significant assets has the potential for generating cash in amount totally unrelated to balance sheet figures, it would seem that the potential for generating cash in a amount totally unrelated to balance sheet figures, it would seem that lenders should have some approximations of the amounts involved on a regular basis.

Finally, it is clear that the creditor package should include considerably more detailed breakdowns of business segments then is presently the case. Where a particular part of the business is utilizing a major portion of an enterprise's cash, this should be known to creditors. Similarly when a business segment is producing a lot of profit but very little cash this should be a source of knowledge and concern. In many situations we have observed one disastrous line of business pulling down others with it or at least obscuring potentially excellent results through a netting process. This information should be available to credit analysts.

It may be of course that several of these items in the creditor package also have relevance to stockholders. Many of the problems associated with supplying these data to stockholders, however, do not exist when lenders are involved. Lenders are insiders who can receive information on a confidential basis, and potential liabilities associated with legal actions are not as great.

I am certain that careful study by a group of credit analysts can come up with a more comprehensive creditor package then these few suggestions which I have offered. It does seem to me, however, that the job should be started since the need for action is substantial.

No matter how carefully a general information package is put together, however, there will always be a need for creative judgment on the part of lending officers about information needs tailored to the situation of a particular borrower. There is no way in which a generalized system can substitute for creditor judgment as to what data may be necessary in the case of a specific borrower since each borrower has some unique characteristics. The creativity and talent of a loan officer in developing this individual information package is vital.

In this connection, it may be important for a lending officer to designate certain key business variables for a particular enterprise which must be reported on a very frequent basis. For example, a company in the agricultural world may find certain weather conditions at particular points in the year the key element in determining whether or not they can pay their bills. Similarly, a department store may find sales figures throughout the crucial Christmas season to be the primary determinate of the success of an entire year. In such cases creditors do need timely information and I believe that such needs can be identified in the case of particular borrowers and particular situations.

Monitoring Loan Portfolios

The final element in this series of ideas of increased emphasis on more professional credit analysis is the need for banks to develop better systems to monitor their portfolios. I have been astounded to hear bank after bank tell the Commission staff that they do not develop aggregate data on a regular basis about changing loan portfolio quality. It does not seem possible to me that a loan portfolio can be managed without some aggregate data that reflect its risk characteristics at different points in time.

It appears that bank managements place substantial reliance upon bank examinations and examiners to bring loan problems to their attention. While bank examinations play a significant role, for management to rely upon them as the major or only means of monitoring credit quality is an abdication of management responsibility. Management must have a handle on what is happening to their most important asset. A portfolio must be managed, not simply dealt with on a crisis by crisis basis.

Any monitoring system will inevitably involve judgment as to the quality of various loans. This, however, is not an indication that the system will be based on casual and arbitrary judgments, but rather upon the evaluation of a professional. The ability to make credit judgments both prior to making the loan and while the loan is outstanding is a key element in loan officer performance.

Conclusion

While I have emphasized the availability and use of financial information, I believe we all recognize that information is not a panacea which will magically make losses disappear. Requirements for additional data must be adopted after careful consideration of the costs involved. These include both costs to borrowers of supplying information and the costs to lenders of utilizing it effectively. It must be recognized that financial analysis is work and if well done, it leads to more work since it raises questions which need answers. In addition, if substantial data is routinely presented to lenders it is essential that systems be developed to monitor and use the information. We do not want to see more reports rendered for the credit files of banks without a recognition that some top level talent would have to be devoted to analysis.

Finally I should not imply that credit analysis is entirely oriented toward individual companies. The analysis of fundamental economic trends in the economy and in particular industries is still an essential element of credit management policy. The creditor must be able to make strategic judgments about broad market forces as well as judgments in regard to particular enterprises.

You may note that I have said remarkably little about the Securities and Exchange Commission here today despite my usual proclivity to speak about my employer. I have even largely avoided mention of our proposals for improved disclosure by banks which no doubt you view with unalloyed joy and support.

I do believe, however, that it is occasionally useful to shift attention from our continual pursuit of improving the quality of information reported and to focus on the quality of analysis applied to that information by the users. Efficient use of information is a key to efficient allocation of capital, and that is a basic objective of both our efforts and yours.