2021 | ISSUE 2

THE N SIDE

OakNorth's Credit Intelligence Magazine for Commercial Banking Leaders

OakNorth Bank: Fast & Forward-Looking Lending Decisions

THE DOCTOR WILL SEE YOU NOW

Turning the Annual Review into an Active Preview

EXPECT THE UNEXPECTED

The Credit Competitive Advantage of Being Prepared

DON'T MISS

Insights from Credit Leaders & ON Customers

WEBINAR

PNC and Credit Intelligence

Why is PNC so bullish on the use of tech in commercial lending? How is Credit Intelligence fueling growth and better credit outcomes of PNC's C&I and CRE portfolios?

MIKE LYONS
EVP and Head of Corporate & Institutional Banking at PNC

RISHI KHOSLA
OakNorth Co-Founder and Group CEO

BLOG

SMBC on Building the Commercial Bank of the Future

SMBC has been at the forefront of the digital revolution for the last decade. How is investing in AI/ML best supporting the needs of its customers?

SUNIL DAYAL
Head of Innovation and Fintech, Americas Division, at Sumitomo Mitsui Banking Corporation (SMBC)

WEBINAR

Climate Change, Covid, and Commercial Credit Risk

Traditional risk models are based on historical data, but in a rapidly-changing world, extrapolating from the past is no longer sufficient. American Banker hosted a thought-provoking session on how first and second line credit teams can prepare for the unprecedented.

STEVE MCGLOTHLIN
EVP, Chief Credit Officer Corporate & CRE Old National Bank

BRUCE RICHARDS
Former Head of Supervision of Complex Financial Institutions, Federal Reserve Bank of New York

RISHI KHOSLA
OakNorth Co-Founder and Group CEO

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FROM THE CEO

INSIDE THE ONSIDE

RISHI KHOSLA

IN EARLY 2021, A MEMBER OF OAKNORTH'S leadership team who lives in Texas lost power in her home for three days as the deep freeze forced the state's electric grid operator to impose rotating blackouts. A few months later, our colleagues in California baked in temperatures of over 120°F (49°C), marking July as the hottest month ever recorded. By September, our team in New York City was experiencing flash floods on their morning commute.

Events like these should be rare and unprecedented, but instead are becoming regular occurrences that leave damage, disruption, and in some cases, death, in their path. President Biden's Executive Order on Climate-Related Financial Risk will likely mark the start of a new wave of climate-related regulation for the banking industry.

> "The more that banks can share experiences, data, and methodologies around climate change with one another, the easier it's going to be for the industry to create some consistency around measuring it, and the better prepared we will all be to support our customers."

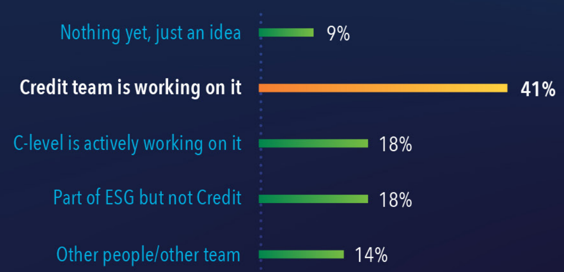
In September 2021, we hosted our inaugural ON Climate Consortium with leaders from 16 innovative banks from across the country, ranging from $3.5B in assets to over $2.5T in assets. We had a very insightful discussion on climate risk, sharing best practices, priorities, concerns, and areas of opportunity. There were several helpful takeaways from the session (captured on the right), but one that stood out for me personally was that industry collaboration will be key. The more that banks can share experiences, data, and methodologies around climate change with one another, the easier it's going to be for the industry to create some consistency around measuring it, and the better prepared we will all be to support our customers.

While much of the rhetoric around climate change tends to be negative, it's important to realize that it also creates a unique opportunity for banks to support customers and develop deeper and more consultative relationships with them. If an institution can demonstrate industry and community leadership on climate change risk, it will be able to better serve its customers in their transition to greener operations. This in turn, will benefit both the bank's bottom line and its reputation.

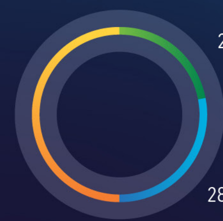
We hope you enjoy this latest issue of the ONside and please feel free to send any feedback to **ONside@oaknorth.com**

How Top US Banks are Thinking About Climate Risk in Commercial Lending

What's your bank doing about the potential impact climate risk could have on your commercial loan book?



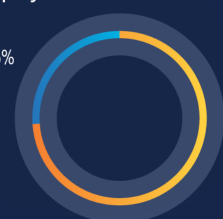
When examining transition risk, are you primarily concerned about **Direct Impact** sectors (ie. cement, steel, coal) or **Indirect Impact** sectors (ie. automotive manufacturing, construction)?



Regarding physical risk, what are your top priorities?

1. **Your borrowers' physical assets**
2. Your bank's assets
3. Disruption to supply chains

Given your commercial loan portfolio, which is your top priority - physical risk or transition risk?



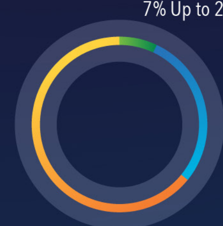
Transition Risk - Accounts for changes in climate policy, shifts towards clean technology, the capital required for such shifts, and changing consumer sentiment during the transition to a lower-carbon economy

Physical Risk - Accounts for impact of severe, event-driven perils, including wildfires, floods, droughts, etc. Long-term changes such as rising temperatures, sea levels, etc.

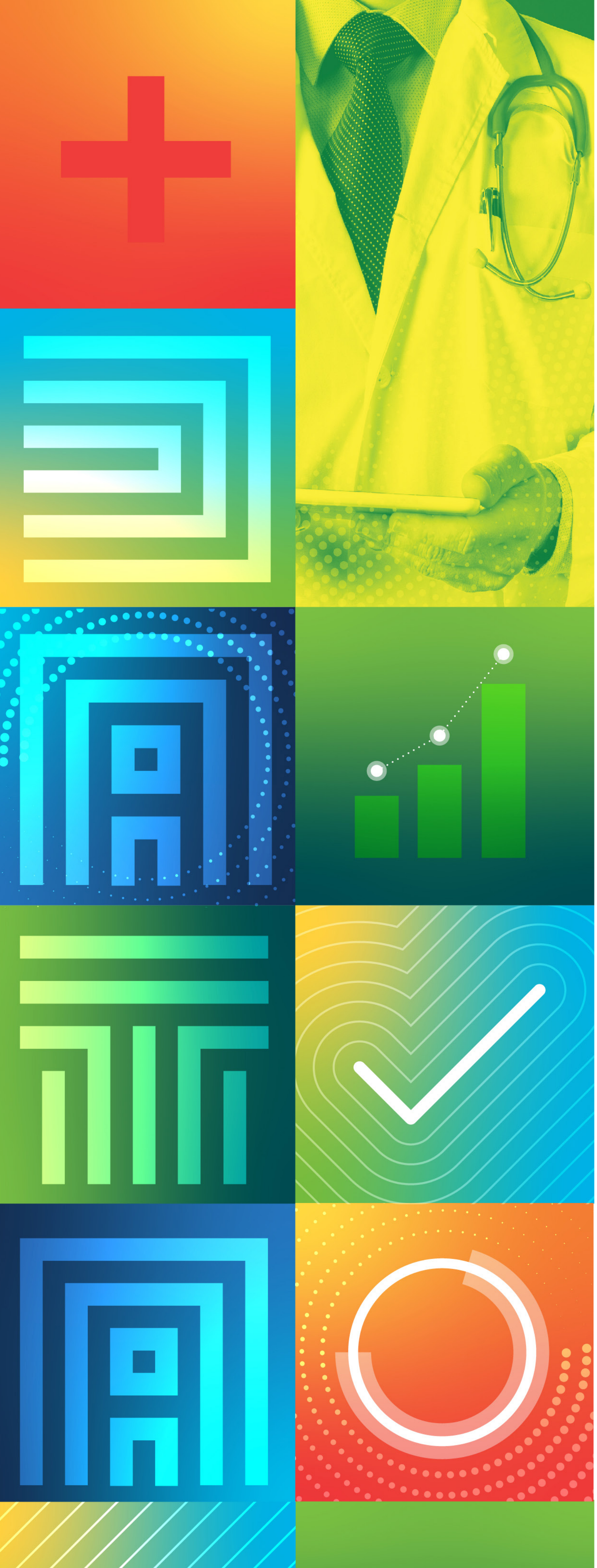
Where are you along the journey of assessing climate risk in your commercial loan book?

- 0% We have a great plan around both transition and physical risk to our bank and our loan book
- **59% We have started creating a plan to mitigate climate risk in our commercial loan book, but have a lot more work to do**
- 6% We have a plan for transition and physical risk as they relate to our bank's assets, but not for our loan book
- 35% We have barely started thinking about climate risk, but we are interested in doing so
- 0% Unless mandated by the regulators, climate risk is not a current priority

How soon do you plan to start addressing climate risk in the commercial book?



Download the OakNorth framework to address climate change risk



The Doctor Will See You Now

Turning the annual review into an active preview

THE ANNUAL REVIEW IS LIKE AN ANNUAL CHECK-UP WITH THE DOCTOR - for the majority of patients, results come back with no issues or cause for concern. For others, there may be something that raises a red flag, and on occasion, there may unfortunately be a patient who gets bad news. If they're lucky, the issue was caught early enough that it can be treated. There are two key challenges: the first is that many critical illnesses are diagnosed too late - even in countries with optimal health systems and services. The second is that even if a patient's health looks fine today, there are external and environmental factors that can impact their future health and life expectancy. If doctors knew exactly which patients were going to develop health issues in the future, they could spend more time with those patients, rather than doing time-consuming annual check-ups with all of them.

Continued...

This is a conversation we at OakNorth have time and again with commercial banks - every year, they're required to conduct an annual review on each of their borrowers and every year, the majority of cases come back in good health. The business is healthy, yet first line credit teams are still expected to review their financials, determine their risk rating, and prepare the credit write-up. This takes almost as much time as performing a full credit assessment - time that could be spent originating new loans or working with the borrowers which are clearly in financial distress and present the most risk to the bank.

This is compounded by the fact that a seemingly financially healthy borrower today could become stressed or default in the future, but the bank either has outdated data or not enough of it, to discover this before a credit loss becomes inevitable. Despite sound initial due diligence and credit analysis, a number of things can happen both internally within a business, and externally within the macro-economic environment (climate change, trade wars, pandemics, regulatory changes, etc.) which can impact its credit profile from one year to the next. Receiving these early warning indicators is critical as it enables the bank to address the increased risk in its book. If not captured early enough, the bank's options for remedying the situation become more limited - much like a doctor diagnosing a critical illness too late.

Many banks still rely on excel spreadsheets, manual methods of gathering data, and human analysis. A solution such as the Portfolio Insights tool within OakNorth's Credit Intelligence Suite can help plug this gap by enhancing risk management capabilities and increasing efficiency. The software creates a forward-looking, 360° view of a bank's entire credit portfolio at the granular borrower level, enabling the bank to conduct scenario analysis, proactively minimize credit losses, and identify opportunities for growth. It aggregates data from multiple sources to create a unique and insightful view of a bank's loan book. By taking a subsector-specific, forward-looking view, OakNorth enables banks to quickly understand the overall financial health of their borrowers, drill down to potential problem areas, and take corrective action before they become detrimental to the portfolio. Banks no longer need to wait for their borrowers' updated financials, as they always have a clear view of which loans have performed, which haven't, and which may not in the future. This transforms the annual review from a process banks do once a year, to something active and constant, connecting analytics to action.

> "Many banks still rely on excel spreadsheets, manual methods of gathering data, and human analysis. SaaS solutions such as the Portfolio Insights tool within OakNorth's Credit Intelligence Suite can help plug this gap by enhancing risk management capabilities and increasing efficiency."

Schedule a consultation to learn how you can transform your bank's annual review process

OakNorth Bank

Fast & Forward-Looking Lending Decisions

The secret sauce that launched OakNorth Bank to the top 1% of global commercial banks

NEIL EVANS
Head of Credit Risk at OakNorth Bank

BEN BARBANEL
Head of Debt Finance at OakNorth Bank

150 years.

Prior to 2010, that's how long it had been since a new banking license had been granted in the UK. Since then, dozens of new licenses have been awarded – the third was to OakNorth Bank in 2015.

BUILDING A BANK FROM SCRATCH

In 2014, Ben Barbanel was working as the Divisional Head of Business Development for London and the South East at Santander. He'd been with the bank for

Continued...

> “There were a few things that stood out to me about the OakNorth proposition but the main one was how Rishi and Joel wanted to leverage data to build a much more granular credit picture of a borrower.”
>
> **BEN BARBANEL**
> **HEAD OF DEBT FINANCE, OAKNORTH BANK**

five years and was keen for a change but wasn’t sure what his next move should be.

One afternoon, he got a call from a headhunter about an opportunity that sounded a bit out of left field: two entrepreneurs – Rishi Khosla and Joel Perlman – were applying for a license to launch a new bank in the UK focused on commercial lending. Neither had ever worked in banking before, but were convinced they could make business borrowing better. “When I first met Rishi and Joel, I was skeptical to say the least: they wanted to lend £1B ($1.4B) within the first five years of launch, which I thought was very ambitious considering they had no brand, no customers, and no banking license!” However, after hearing about the experience they’d had and how that led to the idea for OakNorth, Ben soon came around.

In 2005, Rishi and Joel had been looking for a working capital facility to support their growing business, Copal Partners, a financial research firm they’d founded three years previously. They approached numerous traditional commercial banks in the UK and kept getting variations of the same response – “the computer says no.” Despite being a profitable business with strong cash flow and retained clients, none of the commercial banks were willing to lend to them. It was too small a ticket to offset the costs the bank would incur in doing a fundamental assessment of their business and structuring a finance facility for a high-growth business. A few months later through one of their institutional client’s special situations desk, they managed to secure 100x the amount of debt for a dividend recap. So, an institutional division of a bank was able to support them, but the commercial lending part of the bank was not. This experience stuck with Rishi and Joel and the idea for OakNorth began to form.

“There were a few things that stood out to me about the OakNorth proposition but the main one was how Rishi and Joel wanted to leverage data to build a much more granular credit picture of a borrower.” Ben had been working in traditional banking for 15 years so had experienced first-hand how legacy systems and processes could delay decisions and lead to frustrated borrowers, off-the-shelf “solutions,” and computer-says-no decisions. “Typically, banks only look at backward-looking, historic data. However, using the ON Credit Intelligence Suite, we’d be able to create a 360-degree, forward-looking view of borrowers by aggregating near real-time data from traditional and alternative data sources.” This would enable OakNorth Bank to cross-reference vulnerability with market sector concentration: “We’d be able to make more accurate credit decisions and shape our credit strategy based on a future view of our current book. I was sold.”

OakNorth Bank offers a fundamentally better borrowing experience, at a lower cost, and with superior credit outcomes.

OakNorth Bank is powered by

OakNorth CREDIT INTELLIGENCE

- With this data at their fingertips, OakNorth Bank originates higher quality and a higher quantity of deals
- Able to develop much deeper relationships with borrowers
- Over two-thirds of their qualified deal flow comes from customer referrals
- 7 out of 10 of their borrowers are repeat customers

CUSTOMER FEATURE

> “We’d be able to make more accurate credit decisions and shape our credit strategy based on a future view of our current book. I was sold.”
>
> **BEN BARBANEL**
> **HEAD OF DEBT FINANCE, OAKNORTH BANK**

Meanwhile, at another traditional UK bank, Neil Evans was a few months away from completing his 34th year at RBS where he was Head of Credit Policies. He didn’t have a desire to leave but was intrigued when he first met Rishi and Joel: “I found the concept of bringing credit insight about borrowers’ businesses back to the front line very compelling. Having access to more data and better data completely changes the way processes, such as the annual review have traditionally been done.”

Fortunately, like Ben and Neil, the UK regulators were willing to give OakNorth Bank a chance, granting it a provisional license in March 2015. The bank launched six months later.

FROM ACORN TO MIGHTY OAK

Now six years from launch, Ben and Neil have helped lead the bank to achieve performance metrics that place it among the top 1% of commercial banks globally. Since its September 2015 launch, the Bank has lent over $9B (£6.5B) with only 10 cumulative defaults, despite experiencing not one, but two unprecedented events – BREXIT and COVID-19. In 2020, its pre-tax profits reached $107M (£78M). It has an efficiency ratio of 25%, an RORE of 29%[1], a net promoter score in the 70s, and its relationship managers complete 25 deals on average each year, compared to 5-8 in previous roles at other banks. Discussing how the ON Credit Intelligence Suite supports the Bank, Ben says: “With this data at their fingertips, my team not only originates a higher quantity and higher quality of deals, but are also able to develop much deeper relationships with borrowers. Over two-thirds of our qualified deal flow comes from customer referrals and seven in ten of our borrowers are repeat customers.”

Casting an eye to the future, Neil and Ben are excited about OakNorth Bank’s prospects: “The bank has already achieved more than any of us ever thought would be possible in this space of time” says Ben. “A big part of that is down to the competitive advantage the credit intelligence approach gives us – the moat surrounding us is already pretty wide, and with new features and capabilities being added all the time, that moat will keep getting deeper and wider.”

Watch Ben Barbanel explain how Credit Intelligence makes OakNorth Bank stand out

29%

RORE

25

DEALS COMPLETED BY RMs PER YEAR (VS 5-8 SEEN AT OTHER BANKS)

70

NET PROMOTER SCORE

$9B

LENT TO DATE

[1] Return on Required Equity, as we are overcapitalized today to support growth

EXPECT THE UNEXPECTED:

The Credit Competitive Advantage of Being Prepared

AS DEMONSTRATED BY THE COVID-19 PANDEMIC, when it comes to adverse events, the traditional approach to commercial lending – using historical data, financial modeling of a base case, worst case and best-case scenario, and conducting annual reviews – is an approach that is not fit for purpose.

In uneventful times, these models are fine. However, for unprecedented events such as the pandemic, the traditional models proved useless. As OakNorth customer, Bill Demchak, CEO of PNC, told the Financial Times in May last year: "We're in this economy where everybody bases their models predicting the future on the past and of course we've never been in a situation where we effectively have been forced to shut down the economy with this much fiscal stimulus."

The pandemic is an unprecedented event on a global scale, but there are still numerous other adverse and unprecedented events that could occur at a national, state, or local level, where limited data is available, and where the viability and profitability of several industries could be threatened.

Let's take poultry for example – key players in this supply chain are poultry farmers, meat processing businesses, food wholesalers and retailers such as grocery stores and butchers, restaurants ranging from high-end dining to fast-food chains, and users of poultry by-products such as the pet food industry, pharmaceutical industry, chemical industry, and many others. Each of these sectors and sub-sectors will react to events differently, and even each business within each sub-sector will react differently.

How many lenders would be prepared for an event such as an outbreak of avian influenza virus – also known as "bird flu" for example? During the Spring and Summer of 2015, the disease spread through the Midwest, leading to the loss of over 50 million birds and the ban of US poultry from export from several countries including Mexico, Japan and Singapore. Most lenders would react to an event like this by mapping out the sectors in their portfolio that are likely to be impacted and prioritizing activity based on exposure. They would waste valuable time on loans that don't end up presenting much risk, and potentially miss some of those that do.

The same concept applies to an event resulting from climate change such as drought which could lead to regional corn grain shortages – a vital commodity in poultry production. Or changing consumer attitudes towards the consumption of poultry, which could see a dramatic and permanent reduction in demand. In a scenario like this, food retailers and restaurants could switch to plant-based alternatives and would be less impacted than other sub-sectors such as poultry farmers and users of poultry byproducts. However, this wouldn't be a possibility for all businesses within a particular sub-sector – what would happen to fast food chains whose models focus on poultry? They would need to consider rebranding, changing most of their menu and pivoting their business model.

ON Portfolio Insights does a "bottom-up" evaluation of banks' entire loan books, assigning each business a vulnerability rating based on a subsector-specific, forward-looking credit scenario taking liquidity, debt capacity and profitability into account. It enables lenders to prioritize activities (review, doc collection, renewals, etc.) far more effectively than manual processes, creating operational efficiency by targeting efforts at the relationships where this will have the greatest impact. OakNorth's forward-looking vulnerabilities don't become obsolete in a market shift, they update, and banks' priorities update accordingly. This more dynamic view of risk is still valuable in a more stable economy because we can update risk inside a lender's review cycles, allowing them to take a critical view of their loan book and maintain constant focus on the items of highest impact.

Lenders gain a competitive advantage when it comes to commercial credit as they're able to react far more quickly and effectively if an unexpected event occurs. The realization that many industries experienced through COVID-19 is the same: we can't predict the future but must be better prepared for the unknown and reduce risks across our businesses with an ability to adapt quickly with data-driven decision making.

Get the ON Edge

Discover the return on investment your bank can expect with our six-step interactive calculator.

Get started now: intelligence.oaknorth.com/roi-calculator

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