2023 | ISSUE 5

THE ONSIDE

OakNorth's Credit Intelligence Magazine for Commercial Banking Leaders

Old National Bank: Setting the tone for a strong credit culture in M&A

Meet Chief Credit Officer Corporate & CRE, Steve McGlothlin

RECESSION

Protecting your downside by playing for the upside

CLIMATE RISK

US bank policy is heating up

OakNorth
CREDIT INTELLIGENCE

BANK BOARD PRIORITIES FOR 2023

What are bank boards and risk committees prioritizing in 2023 in terms of risk, regulation, and recessionary resilience?

SPEAKER
BRUCE T. RICHARDS

Vice Chairman of the Board of Credit Suisse Holdings (USA) and formerly of the Federal Reserve Bank of New York

HOST
JING ZHANG

Head of Climate Research at ISSB, Managing Principal at Apricus Climate Ventures, and an Advisory Board Member at OakNorth

ON DEMAND

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CONTENTS

04 **FROM THE CEO: INSIDE THE ONSIDE**
Being a trusted funding partner through the good times and the bad

05 **HOW BANKS CAN BETTER ASSESS CREDIT RISK TO REDUCE UNCERTAINTY**
The value of foresight for smarter. faster lending

06 **OLD NATIONAL BANK**
Setting the tone for a strong credit culture in M&A

08 **ON CREDIT INTELLIGENCE**
Identify risk up to 12 months earlier

09 **CLIMATE RISK**
US bank policy is heating up

10 **PROTECTING YOUR DOWNSIDE BY PLAYING FOR THE UPSIDE**
Preparing for the downturn

FROM THE CEO

INSIDE THE ONSIDE

RISHI KHOSLA

As Heraclitus famously said "change is the only constant in life" – so the ability for commercial banks to factor those changes into their commercial loan book view, down to the individual loan level, has never been more critical.

My co-founder, Joel Perlman, and I launched our UK-based neobank, OakNorth Bank, in September 2015 - despite having grown in a bull market, we're no strangers to uncertainty.

Over the last seven years since we launched, we've experienced not one, but three unprecedented events – Brexit and the withdrawal process that followed, COVID, and the cost-of-living crisis in the UK – and we continued profitably growing our loan book and supporting commercial customers through each. Even with challenging economic times ahead, we're confident in our ability to continue doing this because of our ability to get incredibly granular when it comes to risk management.

Where most banks will take a macro view and apply this across a dozen or so sectors to determine the risk in their book, the ON Credit Intelligence Suite enables us to go several layers deeper – from macro, to sector, to sub-sector, to industry, to company level – and turn these insights into action. This means we're able to incorporate stress-testing into how we originate, monitor, manage our portfolio, and reserve – all driven under one commitment framework. It also means we're able to build a much more granular picture of risk, assigning each customer an ON Risk Score from 1 to 5 (1 being the least vulnerable and 5 being the most).

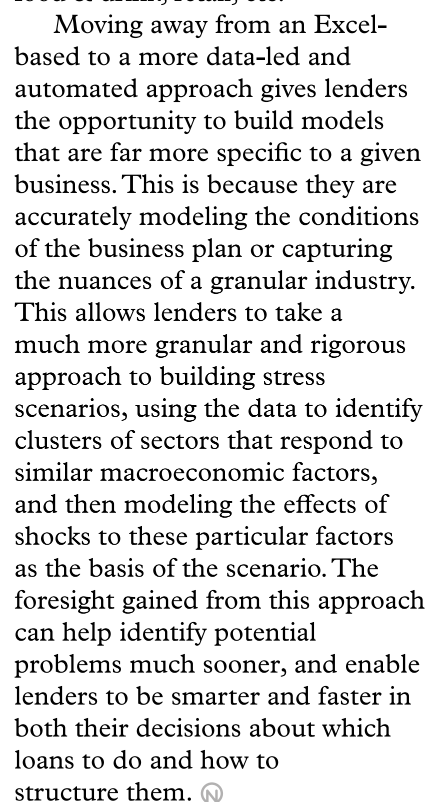
At any given time irrespective of changes in the economy, we know exactly which businesses in our loan portfolio have the capital and business models to withstand the challenges ahead, and which are going to need additional support. We can identify the needles in the haystack - i.e. potential credit issues – up to 12 months in advance, and as such, confidently support our commercial customers and continue profitably growing our loan book through difficult economic environments.

Through partnering with banks such as Old National, the focus of this issue's cover feature, we're enabling them to do the same, so it's great to hear feedback from Steve McGlothlin about the ON Risk Scores being "strikingly reliable" and becoming one of the backbones of what they do from a commercial credit risk perspective.

These insights enable banks like us to have conversations with customers earlier and continue being the trusted funding partner we've always been regardless of what the economy throws at us.

We hope you enjoy this latest issue of the ONside and if you have any feedback about our magazine, please email **ONside@oaknorth.com**

How can banks better assess credit risk to reduce uncertainty?



THE LAST TIME THERE WAS A deterioration in the credit cycle was 15 years ago, during the '08 financial crisis, so it's been an exceptionally long bull market considering the average economic cycle in the US has lasted roughly 5.5 years since 1950. Over the last decade in particular, we've seen historically cheap credit, and despite numerous challenges, including a global pandemic, a tightening labor market, and a war in Europe, economies in the West have continued to grow. However, it's now clear the tide is changing - IMF managing director, Kristalina Georgieva, recently warned that a third of the global economy will be hit by recession this year. Even if the US manages to avoid this, the expectation is that there will still be a significant slowdown in its economic growth for the next 18-24 months.

As an industry, how prepared are commercial banks for the turn in the credit cycle? How can we satisfy our boards, our regulators, and ourselves that we have a strong forward looking view of risk, and that we won't stop lending to customers once the economic situation gets tougher?

The '08 financial crisis accelerated the use of stress testing by regulators with the largest banks needing to conduct supervisory stress tests on an annual basis. This stress testing, when carried out at an individual borrower level, takes a fundamental approach– i.e. a credit analyst constructs a financial model (usually using Microsoft Excel) to simulate the cash flow, balance sheet and income statement of the business. They then project these forward for the lifetime of the loan and use assumptions to 'sensitize' or stress this model to observe the performance of the business under adverse circumstances. This modeling is "augmented" by peer group analysis at a macro and sector-level (typically looking at a dozen or so sectors), where a prospective borrower is compared with other similar businesses in order to establish reasonable expectations for future performance.

> "Moving away from an Excel-based to a more data-led and automated approach gives lenders the opportunity to build models that are far more specific to a given business."

The issues with this approach are two-fold: firstly, it assumes that tomorrow will be a lot like yesterday which is unhelpful given every recession is different. And secondly, that most businesses are more or less alike, which misses the unique differences between them. In a recessionary scenario where consumer spending is tightened, the experience of a budget city-center hotel for example will likely be very different to a luxury resort. The same can be said for businesses in food & drink, retail, etc.

Moving away from an Excel-based to a more data-led and automated approach gives lenders the opportunity to build models that are far more specific to a given business. This is because they are accurately modeling the conditions of the business plan or capturing the nuances of a granular industry. This allows lenders to take a much more granular and rigorous approach to building stress scenarios, using the data to identify clusters of sectors that respond to similar macroeconomic factors, and then modeling the effects of shocks to these particular factors as the basis of the scenario. The foresight gained from this approach can help identify potential problems much sooner, and enable lenders to be smarter and faster in both their decisions about which loans to do and how to structure them.

Assess credit risk better today

CUSTOMER STORY

Old National Bank: Setting the tone for a strong credit culture in M&A

FOUNDED IN 1834 ON THE SHORES OF THE OHIO RIVER, OLD NATIONAL BANK STARTED its journey by providing financial solutions for community residents and local merchants. In 12 years' time, it will have been operating for two centuries, successfully navigating through challenges such as: the Panic of 1837, the 1929 Wall Street crash, the 2008 Financial Crisis, and the COVID-19 pandemic – and helping its customers do the same. Today, Old National is a top-35 U.S. bank, and with the completion of its merger of equals with First Midwest Bank earlier this year, it is in a prime position to support its customers through the economic challenges that lie ahead.

We sat down with Steve McGlothlin, Old National's Chief Credit Officer, Corporate Lending, to learn more about his role, the impact of the merger on the bank's credit and risk functions, and how Old National is partnering with OakNorth to lend smarter, lend faster, and lend more to businesses.

Q: Steve – great to speak with you. To kick us off, can you please share a bit about Old National's M&A strategy to date, and the recent merger with First Midwest Bank?

A: We've always had a strong credit culture at Old National Bank, and one of the benefits of this was that after the financial crisis of 2008, we were in a better position financially than a lot of our peers. As such, we had the capital available to form strategic partnerships. So, we've done quite a bit of M&A over the years, acquiring 13 organizations since 2008 when we saw good alignment and synergies in terms of people, processes, and technologies.

We recently completed a merger of equals with First Midwest Bank, a relationship-focused financial institution headquartered in Chicago, with other locations in southeast Wisconsin, northwest Indiana, central and western Illinois, and eastern Iowa. Through the merger, we'll be able to leverage our combined talent, expertise, and increased scale and market presence to benefit our customers, teams, communities, and shareholders.

The merger makes us the sixth-largest commercial bank headquartered in the Midwest in terms of assets, with more than $46B of combined assets, and provides us with even stronger commercial banking capabilities, a robust retail footprint, and a significant wealth platform.

It puts us in a prime position to continue our expansion, investment, and innovation in talent, capabilities, and services, and means we can further build on our strong legacy of supporting customers through the good times and more challenging times.

Q: What did this merger of equals mean for your day-to-day role?

A: Pre-merger, the corporate portfolio that I managed was about $5B of assets, and the one I acquired following the merger was $4.8B – so the portfolio essentially doubled from $5B to $9.8B.

Within the First Midwest portfolio, several additional C&I industries provided greater diversification in the C&I portfolio than we had at Old National, so I needed to wrap my head around that quickly. The priority for me was to be able to understand the risk in the portfolio and where the most vulnerable credits lay, so I could ensure my team and I were prioritizing in the right order and being efficient.

Q: How did OakNorth help with this?

A: I initially provided OakNorth with a test of 100 credits to look at. They uploaded these into the platform (the ON Credit Intelligence Suite), and within 48 hours, had provided me with a ON Risk Score for each of them. The score was on a scale of 1 to 5, with 1 being the least vulnerable and 5 being the most, and these ratings have proven to be strikingly reliable. The ON Risk Scores have become one of the backbones of what we do from a commercial credit risk perspective, and they're now preparing these for us every quarter. This means we're able to look at what the changes are in the overall risk scores quarter-by-quarter and create a trend analysis against this, which is incredibly helpful for our conversations with our various stakeholders.

Not only do they look at the portfolio at a very holistic level, supporting us with conducting forward-looking scenario analyses on big regulatory announcements and macro-economic changes such as changes to interest rates, house prices, unemployment, etc., but they can also get incredibly granular, looking at individual credits and providing early warning indicators for any that might need a closer look.

The ability to easily and efficiently identify risk in the portfolio has been critical. I'm not able to look at every single loan in a timely manner, so to have an extremely accurate early identification tool from OakNorth is enormously valuable.

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>
> STEVE MCGLOTHLIN, OLD NATIONAL CHIEF CREDIT OFFICER

Q: What would have been different for you during this merger if you weren't partnered with OakNorth?

A: Three words - manual, manual, manual! With OakNorth, my team is able to generate risk analysis very quickly, easily, and accurately. The need for commercial banks to use more technology, data science, and ML models has been driven home with me following our work with OakNorth in this recent merger.

This is the only way forward for commercial banks – we can't rely on the old ways of doing things. Technology, data, and analytics provide us with the tools to service our customers more effectively and more efficiently, so we owe it to them to invest in these and not be afraid to embrace change.

Q: And finally, what does the future hold for the partnership?

A: What's interesting about OakNorth compared to other fintech partnerships we have is that OakNorth, with its own commercial bank in the UK, speaks the same language as us and understands what the different priorities are for different teams. Like us, they have commercial customers in their UK bank who are concerned about what the next 18-24 months will bring, and like us, they want to be a trusted funding partner through economic cycles. So, I'm excited about working with them from this perspective.

They also bring a lot of insights as a partner via platforms such as their ON Climate Consortium which has proven to be very interesting as we look to build out our climate change risk management capabilities.

Change the future of your bank

ON CREDIT INTELLIGENCE

Identify risk up to 12 months earlier

274
Forward-looking ON Industry Forecast Models

20x
More granular analysis than most banks

80k
Regression models run on each industry forecast

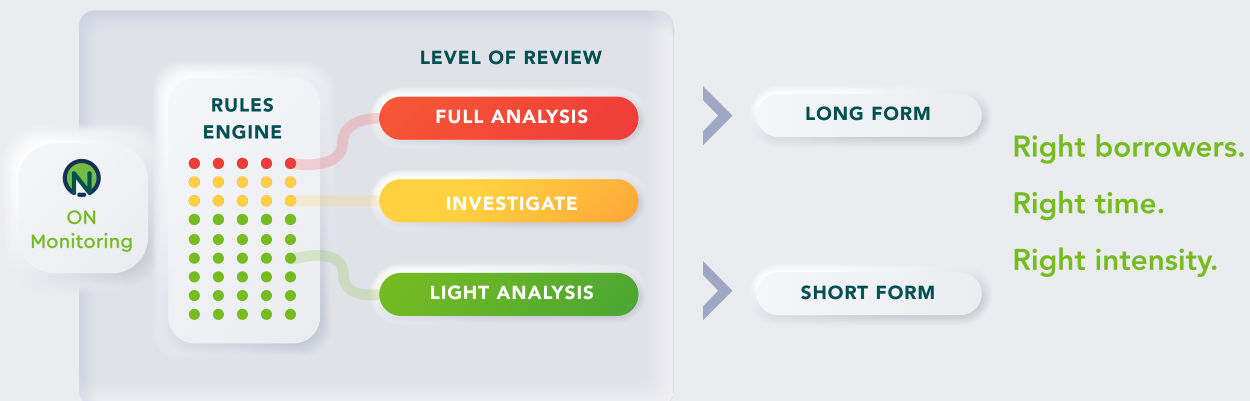
Informed by

$420B+
of proprietary C&I lending data

+

400M
data points derived from alternative third party & economic data

Reduce time spent on reviews by 33%



Right borrowers.
Right time.
Right intensity.

Lend smarter. Lend faster. Lend more.

US Bank Policy is heating up

CLIMATE CHANGE IS AN AREA OF RISK MANAGEMENT THAT IS CLEARLY at the top of the regulatory agenda and is only going to continue gaining momentum. Those banks that choose to act now will be that much better prepared for the challenges and opportunities it presents.

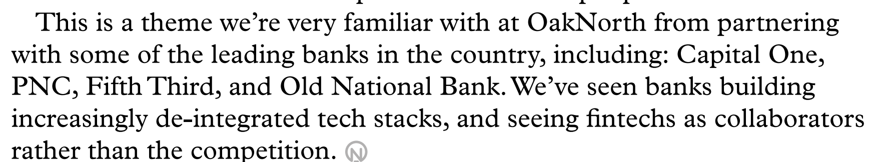
At OakNorth, we've launched a Climate Consortium made up of 30 innovative, climate-forward financial institutions that represent $14T of assets collectively. Working closely with these banks, we have developed ON Climate as part of the ON Credit Intelligence Suite, providing lenders with insights on climate risk in their commercial portfolio. The solution helps inform banks' approach at every stage of the credit lifecycle: from monitoring and conducting portfolio-level scenario analysis, to responding to investor, board, and regulatory requests, as well as setting credit strategy.

FROM COMPETITION TO COLLABORATION

In a speech on the 7th, Acting Comptroller of the Currency, Michael J. Hsu, discussed bank and fintech partnerships, explaining how by partnering, "banks can gain speed to market and access to technological innovation at lower cost, while fintechs seek to benefit from banks' reputations for being trustworthy, longstanding customer bases, and access to cheaper capital and funding sources."

Historically, banks and commercial lenders have relied on a small number of monolithic suppliers and systems to provide them with broad capabilities, augmenting their own internal development, to provide all their infrastructure. These systems are patched to add features as banks grow and markets evolve. Mergers can lead to overlapping, incompatible systems; the bank's infrastructure can make these systems brittle, costly and time-consuming to change. The economic environment and policy responses by the federal government mean banks are going to have to be able to act with more resourcefulness and agility in the months and years ahead. To do this at speed and at scale, they have to look beyond the short list of traditional vendors and implementation partners more accustomed to project timelines of several years, to a constellation of smaller, more agile fintechs that are able to meet specific needs at a rapid pace.

This is a theme we're very familiar with at OakNorth from partnering with some of the leading banks in the country, including: Capital One, PNC, Fifth Third, and Old National Bank. We've seen banks building increasingly de-integrated tech stacks, and seeing fintechs as collaborators rather than the competition.



Discover what ON can do for your bank today

SEPTEMBER 6, 2022

NGFS released updated set of climate scenarios

For the first time they consider the impact of potential losses from extreme weather events and chronic climate changes on the macroeconomy. These scenarios are the clear preference used by many banks given broad regulatory acceptance.

SEPTEMBER 12, 2022

OCC appointed new Chief Climate Risk Officer

Dr. Yue (Nina) Chen will lead the agency's climate risk efforts. This reflects an increasing importance regulators are placing on climate-related financial risk management.

SEPTEMBER 29, 2022

Fed announced pilot climate scenario analysis exercise

Six of the US's largest banks will participate in pilot climate scenario analysis launching in 2023. Enable them to analyze impact of climate scenarios on their loan portfolios and business strategy.

OCTOBER 3, 2022

FDIC expects community and mid-size banks to develop climate risk management

Martin J. Gruenberg, Acting Chairman of the FDIC gave a speech at the American Bankers Assoc. Annual Conv. focusing on financial risks or climate change. The FDIC now expects community and mid-size banks to develop climate-related financial risk mgmt. practices.

DECEMBER 2, 2022

The Federal Reserve Board requests comment on draft principles for climate risk

The Federal Reserve Board invited public comment on proposed principles providing a high-level framework for the safe and sound management of exposures to climate-related financial risks for large banking organizations.

Protecting your downside & playing for the upside

How OakNorth is helping commercial bankers prepare for the downturn

"IF YOU'RE LEFT IN A SITUATION WHERE YOU'RE DEFENDING, WHERE you're shrinking your balance sheet, where you're worried about your capital, where you're continually cajoling shareholders or clients to stick with you, you're not focused on growing."

Wise words from Bill Demchak, Chief Executive of PNC, one of the US' largest banks and an OakNorth customer.

He said this in an interview with the Financial Times in May 2020 – a couple of months after the country had gone into lockdown and the full force of the pandemic was being felt. At the time, he was discussing PNC's rationale for selling its stake in BlackRock and how it was prompted by increasing fears about the US economy as a result of the COVID-19 pandemic.

But fast forward the clock 18 months and he could just as easily be speaking about the economic situation in the US today. With the country on the precipice of a recession and rates at their highest point since the financial crisis, many commercial bankers are focused on protecting their downside risk, and as a result, are likely missing the upside opportunity.

At OakNorth, we're helping them do both.

PROTECTING YOUR DOWNSIDE RISK

1. **GRANULAR DATA:** most banks tend to lump businesses into one of a dozen or so categories – all restaurants, bars, hotels, golf clubs, and spas for example, are classified as "Hospitality and leisure" which misses the fundamental differences between how these businesses operate and how their capex and opex may be impacted by changes in the economy. With ON Scenario Analysis, bankers have access to 274 ON Industry Forecast models, covering 960 NAICS industries, meaning they can get incredibly granular insight into their commercial loan portfolio, and quickly identify where their most vulnerable credits lie.

2. **FORWARD-LOOKING SCENARIO ANALYSIS:** ON Scenario Analysis provides commercial bankers with the ability to run multiple macroeconomic scenarios on their loan book using forward-looking ON Industry Forecasts, and get projections of how a borrower would perform under various scenarios at a financial metric level. This means they can plan ahead for market changes such as rate rises and changes to house prices, formulating targeted risk mitigation strategies to reduce defaults and charge-offs, and better manage capital requirements.

3. **PROACTIVE MONITORING:** ON Monitoring enables bankers to identify potential credit issues faster and earlier, so they can take proactive steps to reduce the chances of negative outcomes during a downturn for both themselves and their borrowers. Our targeted signals enable bankers to adjust their lending and review strategy to gain efficiency throughout the economic cycle, without sacrificing credit quality.

EFFECTIVELY NAVIGATING UPSIDE OPPORTUNITIES

1. **GRANULAR DATA:** in an economic downturn, there are always winners and losers that emerge, and more often than not, it's specific businesses or industries rather than entire sectors. As consumer confidence wanes and inflation causes purse strings to tighten, it's likely that budget retailers and discount stores such as Family Dollar, Marshalls, for example, will see increased demand, while their high-end alternatives experience the opposite. Both are classified as "retail" but will have dramatically different experiences in an economic downturn. ON Scenario Analysis provides commercial bankers with the data and tools they need to identify businesses who may need additional capital to make it through the challenging economic period, and those who may need additional capital to invest in pursuing potential growth opportunities arising from it.

2. **FORWARD-LOOKING SCENARIO ANALYSIS:** ON Scenario Analysis enables commercial bankers to create configurable scenarios that reflect their internal economic outlook by adjusting macroeconomic variables (interest rates, inflation, etc.) in the ON Credit Intelligence library. This means they can make more informed decisions about high-risk, high-opportunity industries and borrowers in their loan book, and adjust their activities accordingly. With the capacity to rapidly model multiple scenarios, our solution enables banks to lend with confidence throughout economic cycles and earn "trusted partner" status from their borrowers who will be grateful for their ongoing support through tougher times.

3. **PROACTIVE MONITORING:** in times of turmoil, most banks tend to segment their portfolio from highest to lowest exposure, starting with their largest first and working their way down. Not only is this approach incredibly time consuming, but it also means a lot of team time is spent running analysis and reviews on credits that don't end up presenting an issue – irrespective of their size. With ON Monitoring, bankers are able to segment credits on a high to low-risk spectrum within a matter of hours, so they can identify which require long form vs short form reviews, freeing up resources to pursue new loan origination and support businesses at a time when many of their peers will be retrenching from the market.

Reduce time spent on annual reviews by

33%

ON Monitoring enables banks to minimize credit losses by maintaining a proactive and ongoing underwriting view of their commercial loan book.

Lend smarter. Lend faster. Lend more.

- **Reduce time spent on annual reviews by 33%** with an "always on" approach to portfolio monitoring enabling stronger borrower relationships and increased wallet share
- **Identify and mitigate risk up to 12 months earlier** thereby reducing the cost of servicing C&I books
- **Confidently lend through the cycle** and support borrowers even in turbulent economic cycles making your lending process less restrictive

Request a demo today