

POINT LOMA ADVISORY PERSPECTIVES

When Credit Risk Depends on Flawless Execution

BY KENNETH G. BAUER | SEPTEMBER 17, 2026

KEY TAKEAWAYS

- Credit risk and operational risk do not simply add together. They compound.
- Covenants, collateral controls, and reporting requirements protect the lender only when the institution consistently administers them.
- A loan can satisfy every numerical requirement and still fall outside the institution's practical risk appetite if it exceeds its ability to execute.

Lending institutions are paid to take credit risk. That is the business we are in.

Every loan carries some possibility that the borrower will not perform as expected. Good lenders identify that risk, decide whether it is acceptable, structure around it where possible, and price it appropriately. Avoiding credit risk altogether is neither realistic nor desirable.

Operational and administrative risk are also part of lending, albeit one that many lenders either forget or treat casually. Documents might contain errors. A covenant might not be tested on time. A tickler may not be collected. A loan may require a manual process because the system cannot accommodate something unusual. No lending operation eliminates every mistake or exception.

A bank or credit union can absorb some credit risk. It can also absorb some operational risk.

What it cannot safely do is take both.

Risk does not simply add up

Consider a loan with marginal repayment capacity, limited guarantor support, or collateral that might be difficult to liquidate. The institution may still decide that the risk is acceptable based on a strong structure, tight monitoring and reporting requirements, carefully controlled disbursements, or specific covenants. Oftentimes these loans present great opportunities to generate a solid margin while potentially building a long-term relationship with a borrower.

In that case, the loan administration is not just paperwork; it is part of the credit decision. If the loan deteriorates, disciplined administration is what preserves the lender's options when it comes to getting out of the credit.

If the institution does not properly document the loan, verify the use of proceeds, perfect its collateral position, collect and review required reporting, or respond when a covenant is violated, it compromises the protections that made the credit risk acceptable in the first place.

The same is true in reverse. An administratively complicated loan may be manageable when the borrower is financially strong, the collateral is liquid, and multiple repayment sources are available. But when a complex structure is paired with a marginal borrower, weak collateral, or an uncertain repayment source, even a relatively small operational failure can have serious consequences.

The risks do not simply add together. They compound.

The problem often begins with a good loan

These situations rarely begin with someone knowingly approving a bad loan. More often, the opportunity looks attractive. The borrower has a compelling story, the projected cash flow is strong, and the lender has confidence in management and the collateral.

Because the lender is convinced the loan is sound, it may focus on whether the borrower can repay while giving too little attention to whether the institution can administer the structure on which the approval depends.

Can operations properly book and service the loan? Will the collateral be perfected? Can the loan system track the covenants and reporting requirements? Is someone clearly responsible for monitoring performance and addressing exceptions?

If those answers are uncertain, the institution is taking more than credit risk. It is relying on a weak operating model to execute properly when the loan needs it most. That is not a reasonable bet.

Strong borrowers can hide weak processes

Operational weaknesses are difficult to see when borrowers are performing. A missing document appears harmless until the institution needs to enforce it. An unperfected lien may go unnoticed until another creditor appears. An untested covenant does not seem important until financial performance deteriorates.

As long as borrowers continue paying, the portfolio can appear healthy while these weaknesses remain hidden. The real test of a lending operation is whether the institution has preserved its rights and options when a loan does not perform as expected.

By the time the weakness becomes visible, fixing the process is usually too late for that particular loan.

Risk appetite must include execution capability

Most institutions describe risk appetite primarily in credit terms. They establish concentration limits, loan-to-value requirements, debt-service coverage expectations, policy limits, and approval authorities. In most institutions I've worked with, risk appetite is built around credit and portfolio risk, with little more than a passing acknowledgment to administrative risk. I've been guilty of it myself.

Those things matter. But they do not fully answer whether an institution should make a particular loan.

A transaction can comply with every numerical requirement and still be outside the institution's practical risk appetite because it requires expertise, systems, monitoring, or servicing capabilities the institution does not possess.

This is especially important when entering a new market, launching a new product, pursuing rapid growth, or approving a transaction significantly more complex than the institution's normal business. The question is not simply whether the loan is permissible or meets credit policy guidelines. It is whether the institution is prepared and able to manage it for its entire life, including when circumstances turn against the borrower.

Sometimes the right response is to strengthen the structure. Sometimes it is to add expertise, improve the process, or slow the growth until the supporting operation catches up.

And sometimes the right answer is to pass on the deal.

That does not mean the loan is bad. It means the loan is wrong for that institution at that time.

Take risk deliberately

Good lending is not about eliminating risk. It is about understanding which risks the institution is taking, why it is taking them, and what must go right for those risks to remain manageable.

If a loan carries meaningful credit risk, the institution's execution needs to be exceptionally strong. Documentation, closing, collateral control, servicing, monitoring, and problem recognition all become more important, not less.

If the institution knows its processes or capabilities are not yet strong, then the underlying credit needs to provide enough room to absorb mistakes and unexpected developments. Remember, performing loans tend to mask operational weaknesses.

What an institution should never do is approve a credit that requires near-perfect execution when it already knows its execution is anything but perfect.

Take credit risk when the return and structure justify it. Accept operational complexity when the institution has the ability to manage it. But do not stack credit risk on top of weak execution and call it prudent lending.

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