5 Current and Future Credit Risk Trends at Community Banks

Problem loans have declined—but anxiety over credit quality is building.

BY GIULIO CAMERINI AND SCOTT MILLER

According to the Office of the Comptroller of the Currency, credit risk continues to be the root of the most matters requiring attention issued by federal banking regulators, ranking as the top type of MRA at community banks for most of the previous 12 months. The mounting credit risk—along with the increased cost of compliance, low interest rate environment and general uncertainties—has made for anxious bankers. Five credit risk trends in particular warrant attention from community banks.

1 The Easing of Underwriting Standards

Loosened underwriting standards have been the dominant trend for some time, as reflected in semiannual OCC reports. The intense competition for loans is pushing some banks to ease their standards for high-growth loan products. Such action can seem near-mandatory in the changing lending arena. Educated loan shoppers have countless avenues to pursue favorable rates and niche offerings, with marketplace lenders and nonbank fintech firms rapidly picking up steam.

To make matters worse, the days of institutional loyalty among borrowers are fading fast.

Real estate developers long have devalued relationships with institutions and newer-generation borrowers are following their lead in traditionally relationship-based areas of lending. Middle-market, small business and agricultural borrowers often value products, convenience and terms over a history of working with a single institution.

But savvy banks have begun to selectively tighten their underwriting on certain products, including oil and gas loans and multifamily loans. They also are trying to put data to work to identify early indicators that could help mitigate risk. Banks with strong data reporting on their loan portfolios can uncover the areas of greater risk and adjust accordingly. For example, community banks might compile data on default and waiver trends, track financial covenant defaults, or track an increase in loan grade deterioration.

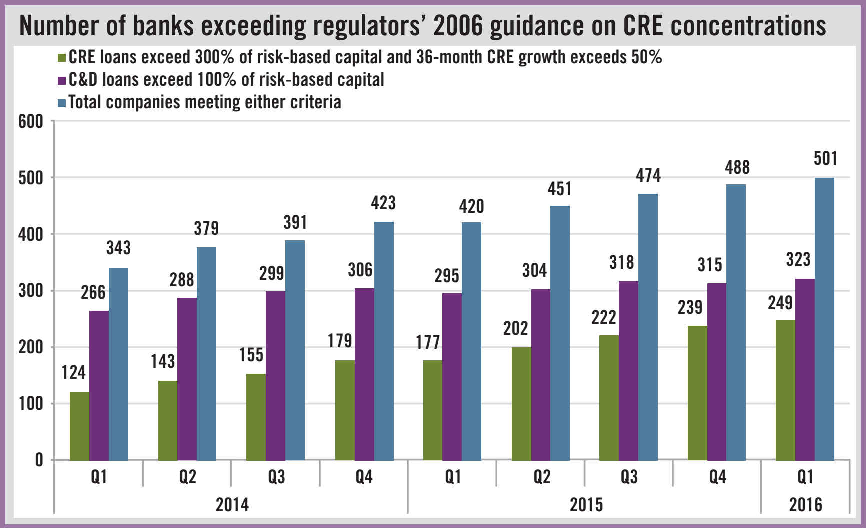
Banks continue to seek ways to improve efficiency as well. Although essential in a low-rate and high-regulatory-cost environment, banks can find it a challenge to boost efficiency without compromising credit quality or exceeding their risk appetite. Most banks already have made adjustments to staffing, branches and vendor relationships to offset low rates. If rates rise, though, some of the resulting efficiencies could temporarily disappear in the lag before loan volumes catch up.

2

Portfolio Composition

Community banks are facing several risk issues related to their loan portfolios, including growing concerns related to commercial real estate loan concentrations, certain stressed commodities and new products.

In 2006, the federal banking agencies issued guidance on sound risk management for banks with high and increasing concentrations of CRE loans on their balance sheets. The regulators issued a new joint statement in December 2015 to reinforce the importance of prudent risk management practices for CRE lending.



The latest statement stems from the substantial growth the agencies have observed in many CRE asset and lending markets and, in turn, rising CRE concentrations in banks. The statement also notes certain risk management practices that have caused concern, including a greater number of underwriting policy exceptions and insufficient monitoring of market conditions to assess the risks associated with these concentrations.

Meanwhile, certain commodities are experiencing problems that have resulted in higher reserves for loans involving those commodities. For example, oil and gas prices have been depressed for about 18 months, causing strains for banks that lend directly to oil and gas companies, oilfield services firms and to oil patch communities. Similarly, the agriculture industry—particularly the grain sector—has seen prices fall after posting record levels only three years earlier. The average farming operation soon will be saddled with three straight years of losses, which will make it difficult to meet their loan obligations if they do not have working capital or equity reserves to dip into.

Finally, in an effort to drive revenue and locate new revenue sources, community banks have begun to offer products they historically might not have had in their portfolio. Products that were in hiding—such as subprime, student and mezzanine loans—are reemerging. Many banks are even entering broker arrangements to source deals within or outside their typical lending footprint that result in new areas for potential risk.

3

Staffing Concerns

Staffing is a concern in terms of both quantity and quality. Many community banks have eliminated their training programs, leading to a shortage of entry-level and junior resources for the industry. Staffing concerns exist across the board, from new college hires to executive management and the specialty hires needed to comply with ever-changing regulations, such as model development and model management. As current employees with the necessary expertise in commercial lending and specialty products are lost to retirement, banks are coming up short with suitable replacements. In addition, given the emphasis on revenue, much staff attention has been diverted from monitoring existing portfolios to landing new loans.

4

Credit Culture

The pressure for more volume, coupled with the high number of mergers and acquisitions in community banking, has stirred worries about the credit culture within organizations. Fewer community banks are demonstrating a strong credit culture that makes them unwilling to bend on their historical credit practices. Those with weak cultures are more prone to easing underwriting, offering new products, or worse, to simply pumping up their loan volume.

5 Data Management and Reporting

The final notable credit risk concern looms on the horizon. Banks are only beginning to struggle with how to better pull together data such as loan origination data, and exception and tracking data to improve credit portfolio management and reporting for management. The ability to pull data will become even more critical as banks prepare for compliance with the current expected credit loss standard in the future.

To manage these credit risks, community banks must step back and formulate an appropriate response for each. It might be tempting to bend from a strong credit culture, but banks almost certainly will be better off in the long run if they gather all of the relevant data and actively measure their portfolios using their risk appetite statements, quality portfolio and macroeconomic data, management reports and a strong and effective loan review function. These tools allow institutions to stay true to their organizational mission and culture.

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