CREDIT RISK MANAGEMENT

Understanding New and Emerging Credit Risks

The crisis may be over, but the challenges of managing credit risk in a low interest rate environment and increasingly competitive marketplace are not. Traditional credit metrics improved significantly in 2013, including net charge offs and the allowance for loan losses. Similarly, the federal banking system set a new record level of net income in 2013. So, shouldn't boards of directors be able to breathe a sigh of relief, knowing that their credit risk management systems have worked? Why then, do regulators, such as the Office of the Comptroller of the Currency, see signs of increasing credit risk and warn examiners to focus on underwriting standards, new product plans and risk management systems? David Shaw, director, Credit Risk Management Services at WeiserMazars LLP, discusses new credit risk concerns, the forces driving them and the need for enhanced risk management programs.

What are some of the factors in today's banking environment causing increased credit risk?

In essence, banks feel a need to increase revenues and interest income in the face of a continuing low interest rate environment and an increasingly competitive marketplace. For larger institutions, this means competing first on price, then offering longer terms and eventually relaxing covenants for commercial loans. Community banks are also becoming more involved in the highly active commercial and industrial (C&I) loans market because many of them are seeking to diversify loan portfolios away from commercial real estate by adding other, less familiar loan types.

What are some of the signs or signals that have caught the attention of examiners and loan review providers?

Some banks are loosening underwriting standards, as evidenced by increases in exceptions to policies, including extending loan terms, excluding or weakening loan guarantees, increasing collateral advance rates, loosening reporting requirements, and offering fewer and less stringent covenants (sometimes known as covenant lite). Regulators are also reviewing new product offerings because they increase credit risk, either because the bank may not have experience with the offering or may not have considered its full impact on the bank's risk profile.

Are there other signs that WeiserMazars has seen?

Yes, particularly in the community banking sector, there has been increased C&I lending, most notably commercial lines of credit supported by working capital assets. Of particular concern is the fact that many institutions have not recognized or adopted new policies, procedures, underwriting standards and monitoring systems for these types of loans. For example, many institutions continue to use EBITDA (earnings before interest, taxes, depreciation and amortization) as the sole measure of cash flow, ignoring the balance sheet and cash flow from operations, as if they were doing a commercial real estate loan. It is important to analyze periodic accounts receivable. Additional concerns include the level of experience of loan officers and the added resources and infrastructure needed to adequately monitor these loans.

What are the roles and responsibilities of directors to oversee these issues?

First, boards need to understand that new or expanded product lines add to strategic risk as well as credit risk. As a strategic decision, expansion of product lines will impact other areas of the bank, including capital requirements and ratios, risk thresholds, provisioning and the allowance for loan losses, as well as create a need for different and unfamiliar forms of stress testing. Second, boards need to ensure that the bank's technology and staffing are adequate, and determine whether additional investments will need to be made in these areas. Finally, boards need to examine and understand any revisions to commercial underwriting policies and procedures, and track their impact on volume and credit quality metrics.

Should banks consider outsourcing some of the processes and administrative functions?

Banks can consider outside resources to draft or review new or revised underwriting standards and policies. A loan review firm or other consultants can review the underwriting documents to assess the analysis and compliance with policies. There are also outside firms that can perform the back-office functions of ongoing monitoring of commercial loans.

__David A. Shaw__ is a director at WeiserMazars with more than 26 years of experience as a commercial banker, CFO and management/ financial consultant.

WeiserMazars

Accounting | Tax | Advisory

As seen in the 4th Quarter 2014 issue of *Bank Director*