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SUCCESS STORIES FROM TERRY L. BUNNELL OF THE PEOPLES BANK, AND OTHER COMMUNITY BANK HIGH PERFORMERS

Pictured:
Bunnell, chairman, president and CEO, at Legacy Dairy, a Peoples Bank customer in Hiseville, Ky.

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ICBA

FOCUS RISK MANAGEMENT

9 ways to manage credit risk

Effects of the pandemic and other factors creating unpredictability have changed how community banks approach their credit and lending operations. These experts share nine tips and credit risk best practices to offer stability in an ever-changing market. By Judith Sears

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Inflation and rising interest rates to combat inflation are defining the current business environment. Both affect the cost of goods and cash flow, creating a vise for many borrowers and portending increased credit stress in the near future.

Bankers and industry observers have several recommendations for how community banks can come up with risk ratings and rankings that foster safe growth in a volatile economic climate.

1. Stress test your loan portfolio

Community banks are not technically required to stress test, but most routinely assess various repayment scenarios for their portfolios.

David Ruffin, principal of IntelliCredit, which offers cloud-based solutions for credit risk analysis, suggests pairing stress testing with loan reviews. For example, a loan vendor might test a loan that's performing at 1.2 debt service coverage (DSC) to see what happens if DSC goes to 0.85. The results can be extrapolated to the rest of a portfolio. "It's a cost-effective approach," he says.

2. Pay attention to industry concentrations in your portfolio

If you've carved a niche in a sector that is struggling, be sure you're alert to the warning signs. "We have forward indicators that the Fed will raise interest rates four to six times over the next year," says Gary Lewis, managing director of lending and deposit solutions for Jack Henry & Associates. "Understanding the impact of a rising rate environment on a concentrated portion of your lending portfolio is critical."

The commercial real estate sector, for example, is weathering the transition of more remote workers while also facing higher costs. CRE borrowers are routinely locked into

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> —JOHN BELLER, THE BANK OF CAVE CITY

long-term contractual obligations with tenants. If their financing costs go up, they can't renegotiate the contracts. "These are sectors that are not going to be able to immediately move," says Robert Hemsath, CEO of $440 million-asset MCBank in Goldthwaite, Texas. He adds that MCBank's stress testing includes looking at how high interest rates can go before borrowers can't service their debts.

3. Migrate credit risk categories promptly

If your portfolio review turns up weaknesses, change risk grading credits immediately. Ruffin notes that early detection of credit risk reduces levels of nonperformance and gives banks greater flexibility in managing problem loans out of the bank. It also makes a good impression on regulators. "Regulators are fearful of banker complacency," he observes.

4. Aggressively gather up-to-date financial information

Hemsath notes that while updating financial information annually has been an accepted rule of thumb, MCBank now updates financial information every six months. "We're moving to enhanced monitoring and contact with our customers to assess risks," he says.

5. Look beyond financial statements

John Beller, CEO of $160 million-asset Bank of Cave City in Cave City, Ark., says that in the aftermath of the pandemic, his community bank is scrutinizing an array of operational and industry factors. The Bank of Cave City, whose loan portfolio is 60% to 70% agriculture-related, nevertheless found that the pandemic affected ag borrowers very differently. Farmers that sold to commodity or aggregate buyers who sell to grocery stores flourished, while those buyers selling primarily to restaurants have struggled.

"We're not used to thinking about asymmetry of risk in that way," Beller acknowledges. "We're moving away from just thinking about financial statements to thinking about operations a little more fully. There are a lot of risks around operations that we don't always have eyes on. We're looking to gain a more contextual understanding of all the ways these systemic issues impact our customers."

6. Identify which businesses can pass along their costs

Being able to pass along at least some costs is key to surviving an inflationary environment. “Most small businesses will react well,” Hemsath says. “The key is to know which businesses can and can’t pass along costs and at what point they price out where consumers can’t afford it anymore.”

7. Strengthen customer relationships

This is usually a given for community banks, but it’s worth underlining how strong customer relationships add to a bank’s ability to evaluate individual loan risk. Relationship managers who really know their customers may make all the difference. “Our customers don’t just rely on us to facilitate transactions,” Beller says. “They rely on us to bring understanding. The credibility of that relationship has so much value in uncertain circumstances.”

8. Boost employee training

Regular training on how to conduct stress testing, how to do forward-looking cash projections and how to analyze financial statements ensures your community bank offers good guidance.

9. Solicit regulators’ input—before the examiners arrive

Both Hemsath and Beller believe regulators have been constructive and helpful in the recent economic cycle. Both community bankers take the initiative to talk with regulators outside of regular examinations. “It’s a positive interaction,” Hemsath says. “They gather information from the industry and can be more effective as regulators. We’re all in this financial system together.” ■

Judith Sears is a writer in Colorado.