Credit Risk Ready Podcast

Host Linda Keith, CPA, With Rob Newberry

Bottoms Up Stress Testing: How Front Line Lenders Can Reassess Current Loans

This is Linda Keith, CPA, with Credit Risk Ready, a podcast where we interview senior credit and lending professionals from community and regional financial institutions across the United States, their regulators, and banking advisors to better understand and mitigate credit risk in any environment.

In this episode, we are keying in on how a lender can and must apply stress testing to each loan in the portfolio or not. Our guest, Rob Newberry, will help us figure that out. Rob has over 20 years experience in the financial services industry, including 15 years at Wells Fargo and strategic and leadership roles. He is a senior advisor at Abrigo, formerly known as Sageworks, Farron, Mainstreet Technologies, and Banker's Toolbox. Rob is very involved in Abrigo's various credit risk solutions.

Rob, welcome back to the podcast.

Rob Newberry:

Hey Linda, thanks for having me back again.

Linda Keith:

So loan-by- loan stress testing. It seems that in our 10-year, low interest rate, high credit quality environment, this has not been a skill set individual lenders and credit analysts have had to apply for some time, but as we descend into the pandemic recession, more and more lenders are going to have to put their special assets hat on and look at their loans in a new way. And then you add to that many of our frontline lending and credit professionals, they were in high school or even middle school during that last recession. And in fact, one of the participants in my online training on tax analysis class this week said she was in fifth grade in 2008. So, is our frontline ready for this, Rob?

Rob Newberry:

That's a great point. So, the interesting thing about two things: one, the volatile rates we've had that impact the credit risk and two, is just the cycle in general is, we do have a lot of young new bankers that

have never experienced this before. And when you're in a flat rate environment with high credit quality risk, you don't really have to stress test your loans on an annual basis because you're not really worried about them. You're worried about getting the next deal in and growing your institution. So yeah, we're in a new world for sure. And in exciting times for financial institutions.

Linda Keith:

Well, it's a great time actually to come into banking. Talk about school of hard knocks. They will have a much better understanding of credit risk if they are coming in now. And I might add that the regulators are also bringing in newer examiners who also have not been in a credit disruption like this is. So there's newness all over and yet I guess I should point out that this pandemic recession, what's caused it, how global it is, and the impacts it will have, is actually even to those of us who have had two, three, four or five recessions under our belts, this recession is different.

Rob Newberry:

It is, yeah. Especially from a credit side. And I like to think of credit in two ways. You have your pay strategies, which is how is this customer going to pay me back? And you have your save strategies, which is when he quits paying me back, do I have enough guarantees or collateral to cover the loan that is still outstanding? In a lot of the other recessions we're impacting the save strategies, not necessarily the pay strategies. And this one is really directed totally at cashflow debt service coverage and that pay strategy and it’s kind of a short-term blip, right? And maybe not as short term.

Linda Keith:

Don't know how short term it's going to be. We'll see.

Rob Newberry:

Yeah, exactly. And that's the interesting thing is depending on where you're at and what state you're in and the industry you fall in. If you're a restaurant and you have to have your tables six feet apart, but you're in a very long narrow place, you might've lost 70% of your capacity, right? So it's an interesting time and all customers will be impacted differently. And that's why it's important to look at stress testing each individual customer in your portfolio.

Linda Keith:

Well and I think some of those save strategies were damaged a little bit because one of the things I have people asking me often is, do we really need to have the guarantors? Do we really need to get all the K1s? There's been some retreat from some of the prudent lending practices that probably got better after the last recession and saying, well, maybe we don't need as many protections. And now we're seeing why we do need those protections.

Rob Newberry:

You're right. After the great recession and people kind of locked down and made sure we had higher collateral LTV values, they tried to get guarantors. But as time passed, once again, those credit standards probably softened a little, or maybe they did more exceptions to get some deals in the door. And maybe we've lost some of those save strategies, which once again, they're very important because if the

pay strategies fail and the loan does go bad, do you have enough to cover your losses or at least limit your losses so that you're not impacting your capital position at your financial institution?

Linda Keith:

Or maybe even do you have enough in the save strategies that you can work with this borrower a little bit longer, because you have confidence in the possible save if you need to back up and get it?

Rob Newberry:

Yeah. It's like a jumbo jet trying to take off a runway, right? I think a lot of these businesses could make it if they had enough runway. And the question a lot of lenders are going to have to ask is, “Are you comfortable extending the runway? Or do you think the plane is going to crash anyway?” Right?

Linda Keith:

The length of the runway and whether they have enough fuel in the tank. Can they land somewhere when they get there?

Rob Newberry:

If they got off the ground, yes.

Linda Keith:

That's a great analogy. So I came up with this idea and in fact, one of the reasons we even have this Credit Risk Ready podcast is that one of my readers of my blog and the tax return analysis “Ask Linda” questions said, "I've been following you for a long time. We just had our meeting with our board of directors and our senior lending management. One of the things we're trying to decide is, how do we change how we look at these loans when the historical cashflow is not going to predict the future, at least near term?" So I came up with an idea and, keeping in mind that loan stress testing is not where my depth of expertise is, this might be a good idea, or it might be a little bit nuts, which is why you're on the phone to take care of it.

Rob Newberry:

Sure.

Linda Keith:

So it's a matrix approach. And this matrix idea for me was what if we identify what are the factors that we should consider, and then do a one-to-10 on each of them and start looking at it that way, partly as a framework to consider whether this loan is still solid or whether there is enough runway, that would be one. But secondly, for bank management, lending and credit management, to give the frontline lenders a tool that we could then improve some consistency. You're not doing so much just gut feeling, but you're actually giving them specific things to look at that we could talk about in our writeup or explain to loan committee why we still want to work with this one. So here are the factors I came up with and I'd like your feedback on whether it makes sense or whether this is just a little bit crazy.

Rob Newberry:

Sure.

Linda Keith:

The first one is where I live and that is, do you have a good cashflow, global cashflow, analysis that is recent that goes back three years, if it is business related, that tells you historically what they've been doing? And usually we'll do a projected cashflow. But I think in this environment, we need a strong historical first to say, what is their experience when we aren't in COVID-19? So that would be one. And then sector would be another. So is it hospitality, restaurants, gas stations? Is it essential or a nonessential business? So were they still open or even is it a business that when it comes to sector, is it a business that actually will benefit? I think Home Depot is doing really well right now because people stuck at home like replacing their fence or something. So might it be a business that would benefit? We've got geography, makes sense to me. We might have how they fared in the last recession, if they're a longer term client.

And my idea is we'd come up with those factors and then invite our frontline lender that's doing the initial loan review of this particular loan to just do a 1-to-10 in these factors and then start putting the bigger picture together. Is that a good idea? Is that nuts? And if it is a good idea, what other factors should we throw in?

Rob Newberry:

Yeah, actually that's a great idea, Linda. And even prior to today's environment, right? I've always been a proponent of really what I would call a dual long grading system, which looks at some subjective components that you know about the customer. And then really a big chunk of it is objective on a previous cashflow, current cash position, maybe quicker current ratios to see what is their cash position. How much reserve do they have or margin to make it, as we talked earlier, take the plane off, get it off the runway? I do like having some collateral evaluation in there, so we understand the save strategy. So how much more am I willing to work with that client? Is there a value there or margin for us, as a lender?

Linda Keith:

Would that also include some statement as to whether you think that collateral value is going to hold or if that's the kind of collateral that might continue to deteriorate? Do we want our lenders thinking that way?

Rob Newberry:

Yeah, absolutely. So, the interesting thing, especially if you look at commercial real estate, with people working from home, a lot of people in the industry think, well, maybe your business space will decline because people just not bring their employees back. But with social distancing, I used to work at Wells Fargo and it used to be like cubeville. Everybody had their six-foot cube. It might go back to that where businesses need more space versus the coffee shop feel that a lot of businesses went to. So you might actually see the same amount of space requirements, just only half the people are there and half of them are working from home. And so it'll be interesting to see how all those different valuations from a collateral perspective play out.

Linda Keith:

We can't know that. I mean, these are just some examples that you're pointing out of those uncertainties that we will actually have to continue to pay attention to so that if you've already done a review on a particular loan, and then you realize some assumptions you made about whether the office space would or would not be changed, then maybe we need to go back and revisit that one sooner than we plan to.

Rob Newberry:

Yeah. When we talk about low-level stress testing, Linda, a lot of times what we're talking about is doing that exact same thing, even in the writeup. So maybe say what if the LTV was 80%? Well, what if the LTV was actually 90% or what if their cash flow or their debt service coverage ratio changed from one-and-a-half down to 1.2? And so when we talk about low-level stress testing at the lender level, especially in today's environment, if you're going to renew a line of credit or you're looking to maybe steal a high-quality credit from another financial institution, I think you're going to want to do some what if, or some stress testings, as you're doing the underwriting piece of it, just to at least get your arms around, "What if I'm wrong in my assumption? How much wiggle room do I have based on some of those past performances and as we go into the new COVID-19 world?"

Linda Keith:

Well and this is part of the training that I do. And on-the-job training, that's critical is to make sure that you're passing on the knowledge to our frontline folks of not just how do you do the calculations, but also what do they mean? What's going on with this business? How do you understand the business? So you can ask good questions and ultimately make some judgments about the business rather than just be able to say, yes, they meet our current debt coverage ratio. We need to get beyond the numbers to understanding.

Rob Newberry:

Yeah, absolutely.

Linda Keith:

What are some really good questions that a lender should ask a current or even a prospective borrower to assess how well they are planning during the recession? In other words, we don't have to guess what might happen to them all by ourselves. We could ask them, "What are you expecting?" So do you have any questions that lenders could have in their tool box to ask those borrowers, which will help them understand whether the business, even as looking at their gas gauge or the length of their runway, what are they thinking is going to happen?

Rob Newberry:

Yeah. A couple of them really relate to that debt service coverage ratio. Are they able to generate enough cash to pay the debt that they currently have? Because if they have that, it opens up opportunities for them, right? If they needed more funds, they could get more funds. If you're already tapped out, now you're kind of, I don't want to say you're on your own, but I think that's where you run into a few more problems. If you're not willing to give them, as a lender, more funds to survive the alternatives, are you going to help them find other financing? Are you going to let them be healthy

turnover and move to another institution? What are your solutions in that point? So asking them what their cashflow position is based on maybe the current environment, have they seen a change in the ability to generate cash based on their main cashflow generating business, whether it's a restaurant, hotel, ag, what is their forecast for the next 12-to-18 months?

Do they have any other big equipment or purchase needs that the cashflow is relying on them to do, right? Because if they don't have money to buy new equipment or replace equipment, it's going to impact their ability to pay you back, right? So those are some pretty simple questions. Other ones might be, if they are pretty tight, you might ask, are they willing to guarantee the loan? Are they willing to do some of these other things to help build in some of those safe strategies that might entice the lender to go ahead and give them more funding.

Linda Keith:

Right? Because owners who in the past might not have been interested in or willing to guarantee the loan or very resistant to that might, in this environment, realize that in order to save their business, they need to be willing to do some things that normally they wouldn't feel the need to do. And one of those might be a stronger guarantee, at which point the lender needs to know how to look at a global analysis to see what other resources truly are available from repayment capacity from operations, but also what liquidity does the guarantor have access to that could come in to play.

Rob Newberry:

Correct.

Linda Keith:

All right. What changes regarding liquidity levels do you think might be required?

Rob Newberry:

Well, it kind of depends on the borrower and the industry they're in. Hopefully we're through the worst part, maybe. I don't know. I could be wrong. Maybe it'll recycle back in the winter.

Linda Keith:

[Laughing] I'm sorry for laughing really loud at that. But it's like, oh, I mean, I... hope is hope… I'm not sure if it's ...

Rob Newberry:

Well, it's not strategy for sure.

Linda Keith:

...strategy. But I'm hopeful also. I'm optimistic, but I don't think we should be planning optimistically actually.

Rob Newberry:

Yeah. And so it depends on what your customers have done, right? In the recent event, did they get a PPP loan, right? Did they get some support? Did they apply for a grant? There was a lot of opportunity for them to help themselves that maybe were outside the financial institution's ability. There were a lot of states that were giving grants out if they could have got $10- or $15,000, that would really help them from a liquidity perspective. Once again, building up those coffers a little in case we do have a relapse and go another four months without cash flow. So what are they planning? It's just like a lot of other industries. My daughter is a high schooler and the last three months she had online school. Well, our school has a backup plan, right? If there's another relapse, here's the plan. Here's what we're going to do online.

And so these businesses really should have a backup plan in case there is a relapse. What are we going to do for three months or four months if we have to shut back down again? And do I have enough liquidity to last, or are we going to rely on government subsidies and something like the CARES Act to pull us back through that? Because my guess is a lot of lenders might not want to throw good money after bad money if these customers are teetering on the edge. There's this balancing point, right? You don't want to push them off the tightrope, but you might not want to connect yourself to them, either. So it'll be interesting as we go through the next couple of quarters here.

Linda Keith:

Well, I remember during the Great Recession, I had staff and my business is training banks. So one of the things banks did to save money was to cut back on training. So we definitely had a dramatic reduction in revenue. And I remember trying to make those decisions at the time at the business level, do I lay off staff yet? Do I not? They're the same kinds of decisions the banks are needing to make about their borrowers. Do we continue to work with them? And where's the stop button, at which point we say this has gone from short-term setback to a business that probably won't survive. And how do we somehow untangle from that and do it in a way that is as helpful as possible to the borrower? Because people who own one business that goes down often will come back with another business and be a strong borrower again or a referral source. So it's the right thing to do to help them unwind. But it also is good business to not burn bridges if we can help it.

Rob Newberry:

Oh yeah. And that's what I've been recommending to a lot of our clients. I say, “Hey, even if you're not willing to put future funds with that customer, at least help them understand other funding sources that might be available to them through grants, CARES Act, and other programs that might help them. Because if you help them, you're really helping yourself with that liquidity issue. And so just because you might not want to fund more, don't shut the door on them. Actually, if you're a lender, you should be up to speed on any grants, CARES Act, any subsidies that your borrowers might qualify for to help them out is a huge win. To your point from a relationship perspective, they'll remember that forever. And the next time, if they are a good borrower, they'll come back and you have another opportunity.

Linda Keith:

Absolutely. Well, thank you so much for this help with that bottoms up approach and helping the loan originators, who really are new to bad recessions, have some structure in how they can start looking at

these loans and recommending, do we stick with them? Do we make a change? And then strengthening the relationship at the same time. Thanks, Rob.

Rob Newberry:

Yeah. Thanks for having me back again.

Linda Keith:

In the show notes for this episode, you'll find links to two white papers from Abrigo: *Coronavirus Survival Guide: Loans Under Pressure*, and *Portfolio Management in Crisis: Coronavirus Implications for Lenders*. Both offer specific strategies and actions you can take as this recession unfolds. You'll also find a link to the knowledge center at Abrigo, a company that helps over 2,500 community financial institutions manage risk and drive growth. Sounds good to me.

Thanks for joining us on the Credit Risk Ready Podcast. Subscribe, comment, or share on social media to stay connected and spread the word. Join me next time as we bring our bank, our customers, and our communities through the recession, safe and sound. Take care.

About Rob Newberry

Rob Newberry has over 20 years' experience in the financial services industry including 15 years at Wells Fargo in strategic and leadership roles. He is a Senior Advisor at Abrigo, formerly known as Sageworks, FARIN, MainStreet Technologies, and Bankers Toolbox. Rob is instrumental in developing and assisting community financial institutions with Abrigo's various Credit Risk Solutions.

Rob's LinkedIn - https://www.linkedin.com/in/rob-newberry-0199544/

About Linda Keith

Linda Keith CPA draws on her 30+ years of experience consulting with and training lending institutions, background in public accounting, 15+ years as CFO of the family residential construction company, experience as an Examiner with the Washington State Auditor's Office, and as adjunct faculty in Accounting Principles and Managerial Accounting to help lending and credit professionals say, "Yes," to good loans.

Of course, you know those are not consecutive years or she'd be over 100 by now!

Credit Risk Ready Podcast With Rob Newberry

Bottoms Up Stress Testing: How Front Line Lenders Can Reassess Current Loans

Linda is known by her clients to be both practical and funny. In fact, there is a move afoot to change the 'P' in CPA to stand for 'Playful'. The fact is, people absorb ideas and learn better when they are having a little bit of fun. So, Linda brings the fun along with her practical knowledge and depth of understanding to provide credit analysis training and presentations that make a difference.

She is the founder of Lenders Online Training, a virtual classroom approach to improving tax return and financial statement analysis capabilities; the host of the Credit Risk Ready Podcast; and a consultant/trainer on credit risk to banks and credit unions across the country.

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