Credit Risk Ready Podcast

Host Linda Keith, CPA, With Rob Newberry

Portfolio Stress Testing as the Economy Worsens

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.

Today we are zeroing in on stress testing at the portfolio level in the meltdown to the pandemic recession. And to help us with that, I have invited Rob Newberry. Rob has over 20 years' experience in the financial services industry, including 15 years at Wells Fargo in strategic and leadership roles. He is the senior advisor at Abrigo, formerly known as Sageworks, Farin, MainStreet Technologies, and Banker's Toolbox, all wrapped into one. He's very involved with Abrigo's credit risk solutions, which is why he is here. Now from a LinkedIn recommendation, which means Rob is not bragging about himself, we learn that Rob has four skills that differentiate him from the pack: financially savvy, understands what customers want, very good at innovating, and effectively executes against the strategy.

Rob, welcome to the podcast.

Rob Newberry:

Great to be here, Linda.

Linda Keith:

Does that LinkedIn recommendation describe you pretty well?

Rob Newberry:

I hope so, but it probably depends day-to-day on what's going on.

Linda Keith:

Let's hope that today is one of those days that it describes you exceedingly well. So, stress testing is a fundamental part of loan and portfolio management. But the approach is evolving as we start this countrywide reopening of business after, in many states, a four-month shutdown. So before we talk

about how this changes stress testing the portfolio, how is it the same? I mean, isn't this what stress testing is supposed to prepare us for?

Rob Newberry:

Yeah, absolutely. From a regulatory perspective, it's been a task that financial institutions have been supposed to be doing for a long, long time. But a lot of times it got brushed under the carpet with other issues that were coming up. Understanding the entire portfolio risk and understanding events that could actually impact the capital of financial institutions, is really what stress testing is all about. So yeah, theoretically we should be prepared for an event like the pandemic. Unfortunately, a lot of financial institutions, once again, put this on the back burner as they were preparing for other big things like CECL and some of these other big things that were coming down the pipeline.

Linda Keith:

Absolutely. And you mentioned the "supposed to do" part. We've been in a flat-interest-rate environment for so long and we cleaned up the portfolio at the end of the last recession. So, it's a little bit understandable that the sense of urgency went away with regards to stress testing the portfolio. Or we thought we learned something from the recession and we simply were better at it. Are we?

Rob Newberry:

Yeah. I think sometimes that flat interest rate lulls us to sleep a little. Right after the last recession, we got a little tighter in our credit policy. Banks were shrinking, not necessarily trying to grow as fast, so we regrouped. And then what always happens is, as time goes by, we forgot what happened in the past. And we tend to repeat some of those same things we were doing prior to the last recession that can get us into a little trouble. Right? So, they start relaxing guidelines a little so that they can grow. They start chasing deals, maybe that they wouldn't have chased back in 2008 and 2009. And that leads to some potential risk in the overall portfolio at that point.

Linda Keith:

Well, and when their competitors are chasing for those deals, it starts to feel like you've got to chase them, too, or you're not going to stay competitive.

Rob Newberry:

Yeah. And it impacts the financial institution in a couple of ways. One is just the net-interest margin because you're competitive. A lot of times we're competing in commodity-like products like 520 balloon, or some other product like that, that all our other competitors are offering. And then when you compete on price, it's a lose-lose situation, because now you're competing, and your net-interest margin is squeezed. And then it doesn't allow enough margin in case you do have losses down the road.

Linda Keith:

So, competing on price is almost always a loser approach, whereas what we need to do is compete on something else, usually relationships. My husband was a contractor and I was the de facto CFO for his construction company. We regularly had other banks that were interested in banking us, but we didn't want to change because we didn't want to lose Kathy and John. Right?

Rob Newberry:

Yeah.

Linda Keith:

So, relationship banking does work. We even got offers for better rates, but we never switched because we already had a bank that understood us. So, I agree with that approach. The other distinction I have, unfortunately, was as a shareholder of the 92nd bank to fail in 2009. And luckily not a director, and I should say luckily not a huge shareholder. I did lose $25,000, which was a little bit of a lesson, but I got a great story for my speeches on credit risk readiness.

Rob Newberry:

That's right.

Linda Keith:

So, I guess I paid $25,000 for that story.

Well, let me ask you a real practical question, because I would like our listeners to walk away with some practical things to just go right back to the bank and either check the marks that yes, we're doing this, or look at some things that they could change. Think of a community bank, or a credit union when you've just finished working with them to improve their stress-testing process at the portfolio level. What would be one of the first steps they need to do in the next two weeks after they work with you?

Rob Newberry:

Yeah, a couple things I like to have them do: the first one is I like them to do a reverse stress test. And what a reverse stress test basically is how much money could you lose in your loan portfolio and still not impact your capital ratios and drop them below what their targeted tier-one capital ratio might be. That would be step one, because that gives you the boundaries that I'm playing within from my overall stress test. The second thing is, specifically around the pandemic, is understanding a lot of times when we talk about portfolio stress testing, we look at it from a call report code level.

I really like my institutions to try to dive one layer deeper at least and start looking at industry sector, because some industries are being impacted differently than others with the pandemic. From a credit perspective, debt service coverage and cashflow will be impacted differently based on social distancing and some other things that some of these businesses have to put in place. And so, understanding what percent of your portfolio is concentrated in some of those sectors will really help understand when you start doing your stress testing

Linda Keith:

Well, and in addition to sectors, I imagine that could even be different geographically. You mentioned some states shut down, say restaurants, and some didn't, or they opened up sooner. But I would assume that even within a sector, let's pick manufacturing, your area might have real supply-chain problems where maybe someone in a different state that's closer to the suppliers, or has local suppliers, doesn't. So is industry level sufficient, or do they need to somehow dip even further down?

Rob Newberry:

Yeah. From a starting point, industry's a good start, but yeah. A third layer down, if I was peeling the onion back. Geographically, that's also a great way to look at things, especially if you're a financial institution that is crossing borders or even counties, because depending on where you're located, I'm here in the Midwest, and we actually got to open up probably a little earlier than some of the other states, but at 50% capacity. And if you're only cash flowing at 50%, your revenue and your debt service are drastically impacted, and your credit risk significantly increases. And there's no timetable of when they'll be able to go back full time yet, right? So, it's playing day-to-day and, yeah, geographically keeping your eye on what's happening in those areas and being able to segment your portfolio that way would also be [a] great quiver in your-

Linda Keith:

Bow in your quiver, arrow in your quiver. That's it.

Rob Newberry:

Yes. Absolutely.

Linda Keith:

Got it. Well, and in fact, Oregon. So I'm in Washington State, Pacific Northwest, which by the way, King County, which is the Seattle area, not only did we have the first COVID deaths here, but we also have the Capitol Hill Autonomous Zone related to the civil unrest. So, Seattle seems to be leading the way in credit-disruptive-type activities.

But I'll be talking to Laurie Stewart, who's the chair of the American Bankers Association. Her bank is in Seattle, but also on the Olympic Peninsula. So, it is city and rural. One bank, but very different circumstances in those two markets.

Rob Newberry:

Yeah. I mean, that's [the] interesting thing, because I was in the Midwest, and you would think industries that wouldn't be impacted like some ag were drastically impacted, because some of their factories got infected with COVID-19. And they shut down processing plants that then backed up the pipeline in the inventory, and it drastically impacted things that you just wouldn't have thought about down the road. So, there're some hidden nuggets that will, I think, uncover as we go through the next two to three quarters as we start understanding the true credit impact. A lot of things I think are still unknown at this point. And we'll discover more as we go through like I said, in the next two to three quarters on what the true impact year credit was.

Linda Keith:

So if you think about that, then I'm wondering if the stress testing process that maybe is done quarterly, maybe needs to be done more frequently, or what they would normally do annually needs to be done quarterly. How is this going to affect how frequently they need to revisit this stress testing of their portfolio?

Rob Newberry:

That is a great question, Linda. So typically, the regulatory guidance was at least once a year to do that. With the pandemic, and all the unknowns out there, you really should look, especially a top-down loan portfolio stress test, probably starting to do that quarterly at least until we get our arms around the potential impact to your portfolio would be a great way to do it. Now there's two types and I think we'll talk about a bottoms-up approach, or the actual loan-level stress testing in another session. But being able to alternate those, or at least doing the low-level one once a year in the top-down. Two or three times a year until you're through this pandemic and the world we live in today is a great way to understand your overall portfolio risk.

Linda Keith:

This is on top of the workload increase with things like the PPP loans, and now the PPP loan forgiveness and the transfer to CECL. And for ag lending, we've got the trade war still and the tariffs. So, it's not like this is by itself. This is on top of what was already something that was game-on and time consuming for our lending and credit managers.

Rob Newberry:

Yeah, you're right. I mean, there are other things going on in the utility space with oil. I mean, there's all kinds of things going on that impact your loan portfolio at all times. But the mix of how related COVID-19 and how it impacted some of those other sectors, it doesn't help the situation for sure on that front. But that's the beauty of doing stress testing and why examiners [are] always wanting to do it at the portfolio level is really two things: one is understanding your concentration risk and what capital you'd have to reserve based on your risk appetite, and the concentrations that you carry in your portfolio. That's important, especially as we're in today's world. There were a few clients that I had out on the west coast that were very heavy into oil and gas, and hotels/motels. Well, those two just got crushed in the first quarter of this year unexpectedly. And now we're trying to figure out how do we limit the damage, pull back commitments? What are some of the risk mitigation strategies that help the bank that don't destroy the customer, where you would have to realize unrealized losses from your customer, because you're pushing them over the edge on that side? So, there's a fine line there that you don't want to totally impact your customers and ignore ones that need help that then cause them to go under. Versus maybe trying to help them survive long enough where they can recover and take back off.

Linda Keith:

Well, and on another episode, we're also going to key-in on just what the regulators are thinking in terms of prudent judgment with borrowers that are experiencing short-term setbacks. How do we identify who they are and how do we adjust to it? I always like to end when I can with opportunities and something you just said popped an opportunity to me that I know happened at the end of the last recession. And that was that when banks took a closer look at their concentration risk, some of them needed to cut way back on CRE loans, for example. And so another bank that didn't have a concentration risk there might actually have some opportunities to pick up some customers they've been courting who didn't want to leave their other bank, but now is not getting the help from their other bank that they expect.

Rob Newberry:

Yeah. That's an interesting thought for sure. I mean, I know participation loans are maybe a bad word. They were definitely in 2007 and 2008, because a lot of people bought their problems, but then we had the recession. But coming out of the recession's a little different. And if you do have a lot of concentrations and some financial institutions are concentrated just by where they are, right? If you're in the middle of the Midwest in a small town, you're an ag bank. All you have is ag lending, right? It's hard to get other types of lending products in your door, but I think you're right. I think the opportunity to naturally hedge your portfolio through picking up participation loans, or courting clients that you're not so heavy in your portfolio, it would be a huge benefit and does lower your risk substantially.

Linda Keith:

And it could help you grow out of the recession as you recover.

Rob Newberry:

Yeah, yeah, absolutely.

Linda Keith:

Because you've picked up the people you've been after for a while. Just to wrap this up, I remember when I was speaking at the Bluegrass Bankers Association in Kentucky. And one of the challenges in talking to them about credit risk, and it was their president who said this to me. He says, "Linda, we pretty much skipped the Great Recession. Kentucky wasn't badly hit." And so part of our challenge is we didn't learn lessons from the Great Recession, or if we did, and by "we" we're talking director's bank leadership, if we did it was recessions aren't that bad, or recessions happen on the coast, or recessions happen somewhere else.

So, one of the challenges some banks might have in certain geographic areas is this time, this recession, is not only national but global. And so they have to really up their game in portfolio analysis in ways they didn't need to do in the last recession, as bad as it was, because it wasn't that bad for them. Either because of where they were or, in the case of Kentucky, ag lending didn't take a huge hit during the Great Recession. They have other times when they take big hits. So part of the challenge might be currently that we need to step up our game on portfolio stress testing, even if we've never had to do it in this level before.

Rob Newberry:

Yeah, absolutely. Once again, when you talk to an examiner, they're really worried mostly about your risk appetite and the impact from that stress test on your capital position, because when we looked at the Great Recession, people think it was a liquidity issue a lot of times. But really what happened was all of a sudden, the money quit flowing and we ran into issues with credit. And a lot of credit issues caused liquidity problems. So, when you really look back at it, it wasn't an interest rate issue because we can manage interest rate risk. It was really [a] credit risk issue that people quit paying their mortgages and created a death spiral on the coast in a couple bubble states. So, it was an interesting thing. This one is a little different, because it's more of a cashflow issue than it is what I call a safe strategy, or collateral dependent issues. It's not like property values have dropped, it's more, "My cashflows have stopped for four to six months. Can I survive?"

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Linda Keith:

I can't pay right now, but I think I will. Well, and can I survive? That is really when we look at stress testing at the loan level, that bottoms-up, we'll talk more about how to decide with a particular borrower. Can this business survive or is this just the death spiral? And we need to help them unwind rather than help them continue the damage.

Rob Newberry:

Correct, yeah.

Linda Keith:

I really appreciate your thoughts on this. I think loan portfolio-level stress testing, it's always been important. It's always been a supposed-to-do. At this point it's not just a supposed-to-do, it's a have-to-do in order to protect the bank, protect your borrowers. And because community-level financial institutions also protect their communities, it's game on for everybody and this is an important part of the game. Thank you for joining us, Rob.

Rob Newberry:

Thanks, Linda.

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.

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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!

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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