Credit Risk Ready Podcast

Host Linda Keith, CPA, With Rob Newberry

Regulators and the Pandemic Recession: Guidance with Flexibility?

Hi, 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 focus on the regulators. What will they expect in order to demonstrate that we are making prudent judgments and identifying which borrowers or perspective borrowers are experiencing a short-term setback rather than a complete meltdown? And what else are the regulators paying attention to and helping us with?

Our guest, Rob Newberry, has his ear to the ground and he will share what he is hearing. Rob has over 20 years' experience in the financial services industry, including 15 years at Wells Fargo in strategic and leadership rolls. He's a senior advisor at Abrigo, formally known as Sageworks, Farin, MainStreet Technologies, and Banker's Toolbox, all now wrapped into one company. Rob is very involved in Abrigo's various credit risk solutions.

Welcome back to the podcast, Rob.

Rob Newberry:

Hey, Linda, thanks again.

Linda Keith:

So, to start us off: let me share some findings from the 2018 Credit Risk Ready study and survey that my company commissioned. I will have the link in show notes so you can get ahold of it. I interviewed 30 senior lending and credit professionals and then surveyed 250 bankers from around the United States. We found that just because they get along with the regulators, that didn't mean they agreed with the regulatory environment.

So, to the statement, "The regulatory environment is reasonable, clear, and well executed," only 23% agree, both before and after the recession. After the recession, the percentage who disagreed with that statement, that the "environment was reasonable, clear and well executed," grew from 30% disagreement to 47%. So, basically, not even half thought the environment was reasonable, clear, and well executed after the recession.

Now, the good news is only 2% disagreed with the statement, "My institution has a strong relationship with regulators." So the regulators, themselves, were doing a great job working with the banks, but working in an environment the banks didn't feel was reasonable, clear, and well executed.

So, as we record this interview, it is June 2020. Most states shut down non-essential businesses for as much as 4 months. All states are in some phase of reopening and we are watching closely for a rise in COVID-19 hospitalizations and deaths as we do so.

Both the regulators and the bankers are dealing with a situation that is not in anyone's experience in some ways, but it's not our first recession. For some of us, it's not our second, third, or fourth. So, Rob, what are you hearing and seeing as the regulators step in to provide guidance, but also flexibility?

Rob Newberry:

Yes, there are a couple things that are kind of repetitive as I talk to different clients. One is just the clarification. You know they rolled some of these programs up pretty fast, like PPP. The rules seem to be changing a little on the fly. Or they're trying to clarify them on the fly. I think some financial institutions are getting a little frustrated or concerned that they think they are doing the right thing.

I was on a lot of podcasts or webinars and the materials I prepared two days ago was outdated because they changed the rules or new information came out and, so, this is what I do all the time. For someone on a bank management team to try to stay current in all these things that are going on would be very hard to do, right?

So, I think there's a lot of concern. One is just understanding what the expectations of examiners are coming through COVID-19. There's been a lot of news out there, right? And they hear what they want to hear when they listen to those news clips, right? Sometimes they pick the one sentence out of a manuscript; it's just not the full scope, right? So, I don't see that there's distrust, but I think they are a little concerned even when an examiner says, "Hey, do what you can for these customers who have been impacted by COVID-19. We will kind of give you a free pass as long you were trying to help that customer." Financial institutions are a little leery of that.

Linda Keith:

Well, and as well they should be. I agree with you: I'm not saying that's a negative statement against the regulators, it's just that the regulators are in a state of major uncertainty. They can't provide more guidance right this minute, and yet they're trying to reassure the banks that it is okay to do what you need to do and we will help you figure out whether it was okay later. That's scary!

Rob Newberry:

It is, because, you know, a lot of times when you are going through an exit interview on an exam, a lot of times they're not really complaining about the number but it's the documentation and how you got to that number that they're not really satisfied with. So I think some of the keys, from the examiner perspective, will be to make sure you document whatever you are doing today with your customers.

Make sure you are identifying customers you've been trying to help with COVID-19. I know that seems pretty simple, but find some field on your core somewhere you can pull these up when these examiners come in or you have to send them your information. It is evident that, hey, this was a COVID-19 impacted customer. "I did a note modification and here's where they are at, and I had to change the term," or, you know, whatever you might have done to help that customer survive.

Just make sure you've documented it really thoroughly so that there are no questions when examiners come in two years from now. We forget the past pretty quickly, right? So, two years from now when new examiners that weren't examiners when COVID-19 happened are going, "So why did you do this TDR?"

Linda Keith:

Right.

Rob Newberry:

And so I think it's important to be very specific on your documentation to help examiners out on that space.

Linda Keith:

Well, we talked in another episode about how to do a bottom-up review and a loan-level review, and one of the things we talked about was sort of this matrix approach to identify and, as you say, document, what are you thinking? Why did you think this would recover? So, you thought about the sector, you thought about the geography, and you thought about these different things. You can't just think about them, you have to write down what you were thinking. Not only will the regulator not know what you were thinking, but truly one week from now you may not know what you were thinking.

Rob Newberry:

Correct.

Linda Keith:

So much is happening, you've got to write it down.

Rob Newberry:

In every industry, we have turnover. We have a lot of young lenders that become crediting officers or go to another institution and they may not be here. So, it's really that lack of documentation that get most financial institutions in trouble in the long run. It is not what they're trying to do to help the customers, it's just that it's pretty easy. One person leaves and you don't know what they did and the customer doesn't remember. Yeah, it's easy to get in trouble that way.

Linda Keith:

Well, and when you don't have clear documentation of your thinking, another danger, which isn't exactly right now, but it will be a problem for us as we come into recovery, which I fully expect us to do, is that junior lending and credit professionals often, when they are first learning, kind of copy what was done before, right? "This is the analysis that was done before and, gee, the coverage ratio was okay that year so that must be an okay debt coverage ratio." When in fact, it was just one that you were willing to accept because of the COVID-19 as a short-time issue. And if you don't say that, they will copy what you did, not knowing why you did it.

Rob Newberry:

That's a great point. This would not be a great year to use financials to train young bankers in the future.

Linda Keith:

Unless what you are training them on is what you shouldn't normally do, but sometimes there are exceptions.

Rob Newberry:

Right.

Linda Keith:

So, with regards to the regulators then, what I'm hearing you say is, "They don't, either," right? They don't know, either, and they can't know, either. I mean, right now as far as really knowing what would be prudent and how do you tell short term from long term, they're also guessing, and I'm quite certain that they are doing everything they can to provide productive guidance.

But things are changing so quickly we don't know. In fact, if you think about what we know now, and you look at decisions we made even just three months ago, you'd say, "Why in the heck did we do that?" And then you'd go, "Oh, that's right, back then we didn't have any idea what was going to happen with regards to the transmission of this disease or how it would affect people. Even in the state of Oregon, they had started reopening and they've pushed the pause button because they got a big surge of cases.

So, you don't know how quickly things will come back. Yet, we've been in recessions before and we do know some of the steps to take and we've mentioned in a different episode we know we need to do a portfolio-level, very serious stress test at a variety of levels to see when we will get in trouble for concentration risk and when we will get into trouble for capital. We want our businesses to be doing the very same thing. "How far could your revenue drop and you would still be able to meet our loan covenants?" for example.

So the regulators, I don't know how they could do anything better right now than they are doing, because of the uncertainty.

Rob Newberry:

Yes, and I agree that the other thing we should keep in mind, as a financial institution, we are coaching them to directionally correct. Because you don't have all the answers, right? There are some things you know, right? Your credit risk is higher than it was in February, so your reserve should probably be higher. So, making common sense decisions that a lot of people freeze, because they don't know exactly what the rules are, so they do nothing.

I think a way to partner with your regulators is to document. Be directionally correct in what you do, even if you don't know. The amount might not be right, but if you're showing examiners you're making good decisions based on the limited information you have, be directionally correct in those decisions, and that will go along way when they come into your institution, probably 18 months from now, saying, "Yeah, we raised our reserve by $2 million in the second quarter, because we knew our credit was not quite as high. We figured things out in the third quarter and adjusted it by then."

So, little things like that go a long way in the relationship with your examiners and minimizing those findings in the future.

Linda Keith:

Well, that sort of sounds like the definition of prudent in that you are making decisions that are based on something that you can see and that is direction, even if you aren't sure about the dollar amounts. And also putting with directional correction the idea of the frequency of your reviews. That we are looking at this more frequently and this is how we are doing that, then these are the actions we've taken. Because everybody's going to be wrong at some point and everybody's going to be right at some point; the fact that you have the reasoning behind it that's clearly documented is a real key.

Rob Newberry:

It is, yes, and understanding that, you know, when we talked about bottom-up stress testing, is understanding those industries that are going to be more impacted than others, right? So, lodging, restaurants, entertainment, and utilities, some of those things that have been greatly impacted. Getting your arms around those first. So, doing a bottom-up or top-down by sector and keeping your eye on the ball the next three-to-four quarters will be key when examiners come back in to help you understand, one, is your concentration in those mostly impacted industries? Two is just showing, to your point, the prudence of, "Hey, I understand I have some additional risk here in my loan portfolio and I'm trying to figure it out each quarter as I get more information."

Linda Keith:

So, being able to demonstrate that you are more granular in the way you're segmenting your sectors is another way to show the examiners that you are making prudent steps to manage your risk.

Rob Newberry:

Yes, you know, the great thing about that, Linda, is when we report our information, we report it at pretty high levels, right? So, we are reporting at the C&I level. We don't typically report NAICS Code so you have information that your examiners won't when they come in, and if you can wow them with, "Hey, look, I did industry sector volume on this NAICS Code industry to make sure that we understood the credit risk," you are taking a step further than the examiners are doing in their prep work. And I think it will be expected when they are coming in the next time to make sure that, you know, the financial institutions we are looking at, some of those most impacted businesses, as they do their next exam.

Linda Keith:

I like the idea of wowing the examiners. I have a background as an examiner, not in banking, but for the Washington State Auditor's Office, and it was always a good thing if I was pleasantly surprised when I came in. A little confirmation bias. You see one thing they are doing right and you go, "Wow, good! It looks like they are covering their bases." And this is a time when we like confirmation bias. We actually would like the regulators to decided early on that we are doing well and then keep that thought.

Well, Rob, thank you so much for helping us a little bit with some of the very specific things we can do in terms of documenting what we are doing, being directionally correct, frequency of how often we are doing reviews, and ways to revisit as things change and then show the regulators that we are shifting as we get better information throughout this pandemic recession. Thanks for being here.

Rob Newberry:

Yeah, thanks again, Linda. I appreciated the time.

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.

If you would like to know what the bankers are thinking, or were thinking, about the regulatory environment, working with regulators, and whether they understand the portfolios, that's one of the one of the four sections in the Credit Risk Ready Report that you also can access in the show notes.

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.

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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 Financial Risk Management, MainStreet Technologies, and Banker's 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-plus years of experience consulting with and training lending institutions; background in public accounting; 15-plus 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 movement 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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