Credit Risk Ready Podcast

Host Linda Keith CPA with Tim Harrington CPA

Gauges the Board and Management Should Be Watching While Emerging from the Recession

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

As we start pulling out of the recession, and as we do this interview… By the way, we are just passing the one-year mark for the World Health Organization saying we were in a pandemic recession. We are starting to emerge. As we do, both the board and management need to be watching gauges or indications that tell us what we should be doing now and what we should be getting ready to do.

So, let's focus on what we're doing now/what we should be getting ready to do. To help us with that we have Tim Harrington. He's president of TEAM resources, a firm providing consulting, strategic planning, and training to credit unions. He is the author of *A Credit Union Guide to Strategic Governance*, and for five years was Chairman of the Board of a $150-million credit union in Tucson, Arizona. Prior to that, Tim was a partner with the nation's third-largest auditor of credit unions known today as CliftonLarsonAllen.

Boy, uncertainty, Tim, has been the name of the game for the last year. Frankly, we're still in high levels of uncertainty. But there are indications between the number of vaccines out there, the number of people actually have had and recovered from COVID, some of the opening that's going on, and the change is afoot. How do we tell what to do now and what to plan for soon as we come out of this recession?

Tim Harrington:
Sure. I think we're in a much better place than we were in March 2020. Because we do know that some things are getting better. 2020 financially and loan losses; that just wasn't as bad as everybody anticipated it was going to be. We're starting at a decent amount of capital in the credit union and banking industries. But we don't know what's hidden. A lot of folks are still suffering and struggling. A lot

of folks who are renting don't know if they can make that next rental payment. That obviously will have a huge impact across the entire spectrum of the marketplace. There are things that the board management team still need to keep watching.

The very first thing, Linda, is project and preserve your capital position. One of the things that got hit pretty hard, and it gets hit every recession, is the net-worth ratio, the capital-to-asset ratio, the equity-capital ratio of financial institutions that goes way down. Many years ago when I studied this I thought, "Wow!" If I just looked at the graph, it would rise during the boom time, then slowly, over five, six, seven, eight years rise up, then crash down in one or two years during the recession, then rise slowly. My thought was, "Oh, the loan losses must be enormous during those recessions." Then I began to study it. I realized no, it had nothing to do with loan losses, or very little. It had everything to do with the rise in deposits. Deposits cause assets to grow. Then your capital-and-asset ratio gets thrown out of whack. Those who don't control the deposit growth are the ones who often are seeing their capital drive down the farthest. If you aren't in a good position today, and you bring in too much in deposits, you drive down your ratio. The regulator's get you in their sights, or you endanger your organization. Capital did take a pretty big hit in 2020.

Linda Keith:
Yeah.

Tim Harrington:
Not because of financial losses, or loan losses. It took a big hit because of deposit growth. What's going to happen in 2020? We're going to get another big bunch of checks come in. Deposits are going to rise again. The ratio is going to get worse. You have to keep watching that and not attract deposits that you can't turn around and invest or loan at a decent rate. So, watch capital. Watch your deposit pricing. Control your growth as much as you possibly can.

Linda Keith:
Let me ask a neophyte-kind-of question here. I would think, if I didn't hear what you just said, I would think it's a positive thing that you have customers or members who are still in good enough shape they actually can save. Right?

Tim Harrington:
Yeah.

Linda Keith:
We have this really weird K-shaped recovery where those of us who weren't hit hard haven't been able to spend the money we normally spend. But that does mean we're in a better position with pent-up demand and all those sorts of things to move forward. And yet, what I'm hearing you say, is that from the financial institution's point of view, the fact that you've got really financially healthy depositors becomes your problem.

Tim Harrington:
What happens during a recession is it's a flight to safety. People don't want to put their money into equities necessarily, although they did in this recession. Or real estate, they did in this recession. They want to put it into an insured savings account.

Insured savings accounts tend to really grow during a recession.

Linda Keith:
Yeah.

Tim Harrington:
People hold back on spending. Obviously, if you bring us deposits and they cost you money. You turn them around, you loan them out, or more likely invest them at almost nothing, you really gained very little in the short-term by those deposits.

Now, Linda, on the other hand, they are an opportunity for you. Because you've just reached another financial plateau, your bank or credit is now this large. It's probably not going to shrink down much from that. That's your new starting point. You have all that money to loan out when the economy turns around and goes into its thrive session again. Those deposits can be an opportunity, too, of course. You have to really know and understand your asset liability management to know, "Are we getting ourselves into trouble here? Or are we doing a good thing by attracting these deposits?"

Linda Keith:
Well, and the fact that you're sitting on more deposits than normal. Doesn't that set you up to be able to look at… In another episode, we've talked about C credits and maybe less-prime kinds of members, or customers, or borrowers. Maybe it gives you the leeway to do some things that you might not have done if you hadn't been sitting on so much cash.

Tim Harrington:
Well, you've got to do something with that cash, don't you?

Linda Keith:
Yeah.

Tim Harrington:
If you're going to invest it, you're going to invest it into a one-year CD at 80 basis points or overnight funds for eight basis points.

Linda Keith:
Right.

Tim Harrington:
Obviously, a C-paper at eight or 14% looks pretty good. If you do it wisely —and we're going back to the discussion of risk appetite, which we had before — you do it wisely, and with an appropriate risk appetite, it can really benefit the organization. So yeah, if it's used wisely, it can be a boon. If it just costs

you money, it's a danger. And it affects capital. By the way, if your capital ratio has been driven really low by your growth in assets, then when your capital is low, you can't take risks.

Linda Keith:
Right.

Tim Harrington:
You can't risk it falling even lower. One of the benefits of having a lot of capital is it gives you the opportunity to take risks, and live with negative consequences.

Linda Keith:
I know that the regulators have told us that they are going to not criticize us for prudent judgment calls in lending related to short-term setbacks of our borrowers. Are they also going to be less critical of lowered capital levels that are primarily driven by these higher deposits?

Tim Harrington:
They are. They've said that. Now, whether it's actually happening in the field, I haven't heard yet.

Linda Keith:
Yeah.

Tim Harrington:
They have officially said that, yes. If the hit-to-capital ratios was caused by deposit growth, they're less concerned about that.

Linda Keith:
Yeah. Okay.

Tim Harrington:
Another area to keep watching, too, is what's hidden in your portfolio? Right now, delinquency and charge-off rates are really low.

Linda Keith:
Right.

Tim Harrington:
People didn't get hit with all these delinquency and charge-offs. But there's still a bunch of TDR sitting there, the troubled debt restructurings, either official or unofficial ones. One of the things we tell our clients is, "If you have any TDRS, take them out of your portfolio and segregate them." So you don't fool yourself. You're not hiding from yourself mortgages, auto loans that have been modified or unsecured, or commercials that have been modified. Make sure you monitor all your modified loans.

Then look at everything you can about your entire portfolio to see if there's any weakening of borrowers’ behavior through the commercial process. You can do it through the irregular systems of risk scoring and financial analysis. Even visiting the commercial borrowers’ businesses to see what on Earth is going on.

Linda Keith:
Right.

Tim Harrington:
On consumer lending, you can look at the high-value consumer loans. The Mercedes, the big Lincolns, the large unsecureds. Follow them and see if there's any negative cycle migration, or a change in payment history. With mortgages, same thing. Cycle migration and payment history. You always want to see, if by chance your loans look good people, are paying on time? Or they're not getting 60 days past due? Is there anything in here that's hidden that could catch up to us?

One of the things that was really evident in the 2007-8-9 recession was that troubled debt preceded delinquency by about eight or nine months.

Linda Keith:
Okay.

Tim Harrington:
That the troubled debt restructure, most of them were able to pay it back. But there were those who couldn't. It was predictable. Eight or nine months later, we're going to see the other shoe begin to fall.

Linda Keith:
Right.

Tim Harrington:
There's even some funny little things that I've learned from my clients over the years. One of them is if you have a big auto loan portfolio, which many credit unions do, it's to monitor the trends and collateral insurance. Get a baseline of how many of your loans normally you see expiration of collateral insurance that's not repurchased.

Linda Keith:
Oh.

Tim Harrington:
See if it begins to change. Because borrowers, when they begin to suffer financial stresses, will stop paying insurance before they'll stop paying their car payment.

Linda Keith:
The lender gets the notice of that. Right?

Tim Harrington:
Exactly. Yeah. You can track that and begin to see if there's a trend. Certainly with that individual borrower and then with your portfolio as a whole.

Linda Keith:
It sounds like you need to have a strong tracking system in place that allows you to get that micro-level.

Tim Harrington:
You do. It's developing a whole process. The frustrating thing about it is it's a process you probably won't need to pull out again for another seven or eight years till the next recession. A lot of folks did pull out these processes that they created in 2007-8. Put them away until 2020, and then pulled them out again. All the technology had changed by then. They had to recreate a lot of the databases. But if you can do it with technology, it's fabulous. If you do it manually, it's an absolute pain.

Linda Keith:
Now, I do know that some financial institutions were really liberal with restructuring offers, forbearance offers. I know one financial institution; they have a real strong credit culture, so they have that going for them. Basically, they just said to their clients early on, "If you have a COVID-19-related problem, we will allow forbearance for up to six months." Pretty much no questions asked. All they had to do was ask for it and they got it.

What they did find, though, was a lot of individuals and businesses that asked for it, they did it early on, when they weren't sure how hard of a hit they themselves were going to take. When they realized that they, their business, or they were going to be fine, they actually went right back to making payments within a month or two. They just took that as a time to assess.

What is the impact of any restructures, or forbearance, and so forth, that have already been allowed that now is going to come back in as we emerge from the recession and we're going to find out whether those folks are able to pick it right back up or not?

Tim Harrington:
Yeah. They ended up being just a skip-a-pay?

Linda Keith:
Yeah.

Tim Harrington:
Where it wasn't really a financial difficulty forbearance? It probably never stopped acting normal.

Linda Keith:
Yeah. That's right.

Tim Harrington:
The normal behavior that long will be predictable as normal behavior in the future. If it was a financial issue… I hadn't even thought of that. I have clients who've actually given two months to pay for their entire loan portfolio.

Linda Keith:
Yeah.

Tim Harrington:
The cut-the-interest income, it actually worked out to their benefit.

Linda Keith:
Right.

Tim Harrington:
But those are not a troubled debt restructuring or a modification due to financial difficulties. It would be interesting to go through, and dig through, and say, "This actually was modified." "This was a financial issue." "This was a pre-emptive concern that never panned out as being negative for the borrower."

Linda Keith:
Right.

Tim Harrington:
Separating those. Then the truly troubled ones, segregate those. Because their future repayment behavior is no longer predictable. Like, as if they were never troubled.

Linda Keith:
Yeah. Well, am I correct that the regulators allowed for a lot of "restructuring" without having to identify it as a troubled debt restructure because of COVID?

Tim Harrington:
They sure did. Yeah. They made that really clear you don't have to call these TDRS. I just say, whether it's called a TDR, legally, or through accounting parlance, or it just was modified, it doesn't matter. It's no longer behaving like the loan you contracted originally.

Linda Keith:
So, we need to know what it is regardless of what the regulator's or somebody else actually calls it?

Tim Harrington:
You bet.

Linda Keith:
Right.

Tim Harrington:
Because we don't want to get fooled. That's the whole thing here. Watching your capital. Watching your deposits. Watching what might be hidden in your portfolio. Watching those modified loans. It may all be that, “Hey, we had to worry about nothing. They all went just fine.” We just don't want to get fooled. This is one of those periods where it could be a slow slog out of the recession. It could be fast. But we're still going to have a lot of folks who just are so much on the edge right now that they aren't going to make it financially no matter what happens.

Linda Keith:
Right.

Tim Harrington:
You just don’t want to be left holding the bag.

Linda Keith:
Exactly.

Tim Harrington:
I had one other thing that a couple of clients would want monitoring, too. That's they’re monitoring their new loans coming into their portfolio by average credit score. You don't typically see this. I saw it, again, in 2008-9. But looking to see if in their attempt to get a higher yield or more volume, either one of those, are they lowering their standards? Sometimes it could be intentional. A lot of financial institutions are saying, “We need the yield. So, we're going to lower our standards a bit to get more yield.” That's intentional. It allows you to say, “Okay. We're seeing our FICO scores drop a little bit on average. These are new loans coming out.”

Linda Keith:
Yeah.

Tim Harrington:
“That's what we intended.” But what if you didn't intend that and you're seeing your loans go out? That means you're going to see an uptick in delinquencies. There's no direct correlation as to how much. It's just feedback. It's information.

Linda Keith:
Right.

Tim Harrington:
It's important to know that. You can break it out by loan type. You can break it out by loan officer. You can break it out by dealership through indirect. Just monitor the quality of the loan by FICO score in portfolios every month. The average monthly FICO score in those portfolios. Some do it weighted. Some do it just straight FICO score.

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Linda Keith:
So, these are steps that the management can be taking to monitor. Then the directors, if you haven't heard recently from your management on some of these issues, these are good questions to ask the CEO. "How are we doing this?"

Tim Harrington:
Right. These were reports that I think, maybe on a quarterly or semi-annual basis, maybe come June, share this with your board of directors and say, "Here's what we found out. We have a bit more risk here than we had anticipated," or "We checked in here. We don't have any risk at all."

We actually have a number of reports that we're suggesting directors look at during the recession. I've mentioned some of them to you. But we have them marked as permanent reports and temporary reports. A permanent report would be monitoring your capital position. But that report on the insurance, the collateral insurance that wasn't paid, as a temporary report.

Linda Keith:
Right.

Tim Harrington:
Once this emergency is over, I can review that on a regular basis. No point in that. But, come next recession, you pull it out and fire it up again.

Linda Keith:
Right. Well, Tim, thank you so much for helping us with some of these things that we should be keeping a close watch on. Because we are emerging. We just want to emerge strong for our customers and our members.

Thanks, Tim.

Tim Harrington:
Linda, thank you very much.

Linda Keith:

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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Resources

- Book: *A Credit Union Guide to Strategic Governance*: https://forteamresources.com/products/books/
- Book: *Eisenhower on Enlightened Leadership*:

  https://forteamresources.com/products/books/
- Blog:

  https://forteamresources.com/tims-blog/
- Lenders' Tax Analyzer Software:

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About Tim Harrington

Author, consultant, and international speaker Tim Harrington has worked with credit unions in all 50 states, Canada, Mexico, Jamaica, the Dominican Republic, the US Virgin Islands, and Puerto Rico. His progressive ideas and broad knowledge of credit union issues has made Tim a valuable resource for credit unions nationwide. Tim has spoken to tens of thousands of credit union volunteers and staff and continues to inspire them to improve their credit unions.

Since 1996, Tim has been President of TEAM Resources, a firm providing consulting, strategic planning, and training to credit unions from coast to coast. TEAM Resources' clients range from a few million to the billions in assets.

Tim is the author of several books including *Eisenhower on Enlightened Leadership* and co-author of *A Credit Union Guide to Strategic Governance*. His books inspire boards and leadership teams to lead effectively with high integrity.

From 2001 to 2006, Tim was the chairman of the board of a $150 million credit union in Tucson, Arizona. He was appointed to the board of this troubled credit union in 2001 and served until 2006. During his tenure on the board, the credit union evolved from losing over $2 million per year to earning a profit of nearly $2 million by 2006.

Tim was formerly a partner with the nation's 3rd largest auditor of credit unions, known today as CliftonLarsonAllen. He has been working with credit unions since 1989 when he directed the internal audit of a large credit union in Tucson, Arizona. Prior to that, he was with a national accounting firm and has been practicing accounting and consulting since 1980.

Because of his knowledge, wit, and unpretentious delivery, Tim is a much sought after speaker in the credit union movement. Tim has made presentations at conferences for CEOs, directors, supervisory committees, lenders, marketers, and many more. Tim is on the faculty of the CUNA Finance for Non-Financial Managers and Volunteers School, CUNA Volunteer Certification School, and CUNA Management School.

Tucson, Arizona, has been home for Tim since 1980, but he is a native of Montana. He holds a BBA in Accounting from Gonzaga University in Spokane, Washington. He has also attended universities in Morelia, Michoacan, Mexico and Florence, Italy, and speaks several languages.

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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; and 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!

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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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