Commodity Valuations & Black Swans—*How they impact credit quality*

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As a seasoned credit guy who helped community institutions wean away from the "collateral lender" moniker of years past to shift their focus towards cash flow lending, there's some trepidation in writing about the first cousin of collateral, commodity valuations. So forgive the back-to-the-future moment, but credit quality is still critically impacted by a given borrowing industry's underlying and directional commodity value. For example, it was the collapse of 1-4 family residential housing values that led us into the credit crisis of the great recession. Moreover, during the same period, the credit environment in regions with stronger commodity values, such as energy, experienced much less credit stress.

Pick an industry (and its economic vulnerabilities): *agriculture* (weather / tariffs & trade); *oil & gas* (geo-political disputes / plummeting demand); *taxis* (Uber & Lyft); even *non-profits* (unanticipated negative impact of the tax reform act de-incentivizing charitable deductions). Industries' attractiveness to bankers rises and falls based on economic forces affecting their underlying value and abilities to generate profitable revenues. **This brings us to the *Black Swan*.**

By definition, a Black Swan is an unexpected, but very impactful, negative event. It accelerates, exponentially, the routine economic trends and cycles alluded to above. Arguably, in the great recession it was the collapse of the bundled securities financing the housing-related lending mania. We now have our latest version of a Black Swan: *the coronavirus pandemic.*

At first glance, the service-related industries are ground zero for valuation hits. But as the crisis grows, and the economic shutdowns expand, there will be few industries left unphased. There's also the sense that this event is existential, widespread in effect and beyond our control; but unlike before, it cannot be laid at the feet of the financial industry. Unlike before, our industry shouldn't expect a rush of punitive measures. That's where we are; **what, as community institutions, do we do about the likely growing credit risk in our portfolios?**

First and foremost, we can't afford to wait to see how deep the crisis goes or to get clarifying regulatory guidance on how to respond. A lesson learned long ago: **be captain of your own fate**. What this means in any crisis is: 1) understand your own position; 2) quantify it; 3) and write your own narrative—before a regulator does it for you.

Determining / quantifying your credit risk profile

Deep dives are recommended on the following key portfolio metrics:

- *Concentrations / Correlations* – We learned from the great recession that portfolio concentrations, like speed, can kill. Concentrations, beyond just real estate, need to be assessed by peeling the onion down to subsets of loan types on all matters of growth, yield, and quality. Often overlooked when thinking of concentrations is the degree the institution has correlations (or related businesses) that may become vulnerable to certain industry-specific economic blows. For example, it wasn't just the direct housing and tract development loans that ushered in so many bank failures in the last crisis; the losses were exacerbated by loans to all housing-related industries.

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- *Industries* – Using NAICS codes, institutions should quantify and prioritize their concentrated exposures to most likely impacted industries. While, again, the service industries, other than perhaps grocery stores, in the current crisis appear the most obvious, each bank or credit union has its own profile to create.
- Vintages – Another lesson of the last crisis was the risk distinctions embedded in loan vintages. Loans made in the late stages of a credit cycle are prone to be the most toxic. And given the length and benignness of the current credit cycle, including the pressures for loan growth, there is ample reason for you to begin to create vintage-specific risk profiles.
- *Risk Grade Migrations (within Pass)* – Every credit professional knows that the real art of portfolio credit risk mitigation is the focus on credit degradation within Pass categories. Waiting until the Criticized/Classified thresholds are met is too late. Somewhat because of the structural bias of the published call report standards, institutions can be caught up in the illogical phenomenon that all loans are good loans, *until they're bad loans*.
- *Loan Review and Servicing* – Now is not the time to curtail loan review due to perceived good credit, impact on efficiency ratios, or recent regulatory validations of risk grading. Now is the time to increase and improve periodic servicing and annual reviews based on some risk-adjusted measures suitable to your institution.

Adopting and documenting your game plan

Finally, it's important to write out your own narrative and game plan for dealing with your institution's embedded credit risk profile. You'll need to use diagnostic tools that can *quantify* the above metrics—well beyond the bluntness of being at or near certain dollar or percentage portfolio exposures. Senior management and the board—and most assuredly the regulators—should be provided dashboards and trend analyses. But, as importantly, you must *qualitatively* interpret your own risk profile and game plan.

No one can predict accurately the ultimate level of heightened credit risk that will be created by this latest Black Swan; but no one should be complacent either in assuming this is of such magnitude that it's beyond our control. One final lesson learned in the last crisis—proven by empirical data—was that institutions that were late to the game in identifying their weaknesses always incurred greater losses.

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