IntelliCredit Insights

Navigating The New Credit Cycle

COVID-19 Loans and Emerging Credit Risk

by: David Ruffin, Principal, IntelliCredit

The COVID-19 virus has brought on the advent of a new and likely treacherous credit cycle. Fortunately, the financial industry has much more capital, more liquidity and better risk management systems than when our previous economic crisis began. Nevertheless, this current sea change will not exempt banks and credit unions from potentially serious economic, operational and credit risks.

Making the Formidable, Navigable

Community banks and credit unions should not assume that the COVID-19 crisis is so impactful, so largely beyond their control, that they can do little to curb their institution's exposure. Instead, they must monitor, measure, track and proactively deal with credit risk on a day-by-day, month-by-month basis. This cycle requires a totally new approach for managing credit risk and mitigating potential losses going forward. A good way to begin that voyage is by studying danger signals in portfolio segments and credits.

Detecting Red Flags Within the Portfolio

As the adage goes, *all loans are good loans until they're bad ones*. Emerging credit risk must be recognized for what it is – budding anomalies that can potentially lead to loss – as early as possible.

- **Vintages.** Empirical evidence from the Great Recession confirmed that loans made late in a credit cycle tend to be the most toxic. The ability to aggregate and segregate portfolio holdings based on vintages will help to identify credits possibly headed for trouble.
- **Concentrations and Correlations.** It's vitally important to weigh the valuations of commodities that institutions are lending into when quantifying their credit risk profiles. Remember the fate of 2008 portfolios with C&I credits too heavily concentrated on all things correlated to housing?
- **Immediate Concerns.** Consider industry classifications presently exhibiting inordinate stress. Right now, these are services, conventional retail, leveraged financial transactions, non-profits, agriculture and commercial real estate.

In addition, lenders can uncover red flags by comparing three fundamental measures of their credit quality to national averages derived from public call-report data:

- **Ratio of non-performing loans (NPL) to total inventory**, nationally in a four-year decline due to legacy loans from the previous recession
- **Charge-off percentages**, showing a shallow upward spike among smaller institutions in 1Q 2020
- **Allowances for loan and lease losses (ALLL)**, reported rising in 1Q 2020, probably in anticipation of the oncoming pandemic credit fallout.

continued ›

Now is the Time to Assess Credit Quality

By the time the CARES Act was signed into law in March, community institutions were almost overwhelmed with requests for modifications and restructures of existing credits, on top of high demand for the new relief loans. While the booking and coding crunch is waning, we can't forget that these credits remain a hotbed for potential foreclosures and loss well into the future. Now is the time to launch ongoing assessment, analysis, recording and reporting on the quantity and quality of COVID-affected inventory.

Don't Look for Hints of Trouble in All the Wrong Places

The real art of understanding and detecting emerging credit risk and minimizing potential loss does not reside in the classified- and criticized-rated portions of an institution's holdings. It lies in the ability to analyze risk-rating migrations within the pass categories. That's the heart of what a high-functioning credit risk management and loan review system is all about. Regulators have even issued Interagency Guidance on what the systems should accomplish: identify loans with credit weaknesses, validate risk ratings, define relevant portfolio trends, help ensure regulatory compliance and much more.

Structured to Maximize Efficiency

Fortunately, a few of today's credit risk management solutions are more robust and probative than they were a decade ago. For one thing, newer technology simplifies the ability to quantify and analyze holdings at the portfolio level. The technology also provides instant segmentation (i.e., allowing users to quickly examine all SBA loans, all COVID-affected loans, all PPP loans, all loans in a specific industry, etc.). In addition, a newer solution gives users the ability to merely click and drill down to individual loan details at the transactional level, helping lenders track, classify, report, manage and ensure the regulatory compliance of their COVID-19 loans.

Timing is Critical

In the next 30, 60 and 90 days, financial institutions will be required to provide the customary regulatory reporting expected for each COVID-affected loan. The lenders will also need to provide the perspective of a credit risk professional who recognizes that the loan is a possible breeding ground for potential default, and who is carefully tracking everyday developments and updating the loan's impact on portfolio quality.

The temporary regulatory relief for tracking COVID-affected loans will ultimately revert to a more traditional safety and soundness mindset. It's imperative that lenders shift as well to managing these loans and maintaining accurate records of every credit to satisfy regulatory expectations. Financial institutions that prepare now will be able to deliver their information on time — and, most importantly, better manage their exposure in the process.

David Ruffin *(david.ruffin@intellicredit.com) is a credit risk management expert with extensive experience in loan reviews, M&A/capital raise due diligences, and credit policy and process assessments. He frequently speaks and authors commentary on these and other industry topics. As principal of IntelliCredit™, David spearheaded the development of a next-generation credit risk management solution, the IntelliCredit Portal, an innovative and timely approach for detecting emerging risk in the new credit cycle effected by COVID-19. For more information or to request an IntelliCredit demo, visit www.intellicredit.com.*