

TRIAGING FOR YOUR INSTITUTION'S CREDIT & LIQUIDITY HEALTH

Earl Charneske, SVP, Midwest Regional Manager
PCBB

Being a member of the C-suite can be demanding, as you are responsible for the health and resiliency of your institution. The challenge in leading any organization is ensuring that the right questions are asked, the right priorities are set and the right amount of resources are allocated. Choosing the right priorities is not unlike triaging patients in a busy emergency department on a Saturday night. Make the right choices, in the right order and people thrive. Miss an important symptom and the consequences may be dire. In this credit cycle, how do you triage quickly? This will depend on your institution's current situation.

Address regulatory orders. First and foremost, you will want to respond to any regulatory orders or any open examination issues. Are examiners asking you detailed questions about debt coverage ratios or changes in your customers' FICO scores since the start of the pandemic? Are you being asked repeated questions about certain segment concentrations? If that's the case, this is urgent and needs to be handled ASAP.

So, how do you best handle it? With a loan portfolio bottom-up, detailed stress test — one that will provide you and your institution with specific, supportable results by showing the different stressed scenarios and their impact on your capital. You should also dig deep into cash flows, the borrowers' statements, and their supply chains. If you have the resources and the time, then this is your top internal priority. If you don't have time or you're missing information, then a third party can help.

Demonstrate resiliency. Triaging to the next level, urgent but not critical, you will need to be prepared to satisfy examiner expectations for institution resiliency. Examiners are going to ask specifically about the effects of the pandemic on your institution. While this can be answered with a bottom-up loan portfolio stress test, a faster alternative is a complete, quick top-down test. This approach uses the historical relationship between unemployment, GDP, and industry data loss rates. Using multivariate regression combined with future forecasts, you can quickly generate estimated loss rates. If the relationship between GSP (gross state product), state unemployment, and loss rates remains highly correlated, state data can be used instead of national data. Loans can also be segmented by industry classifications.

Recovery scenarios. The next step is to decide which recovery scenarios are the most likely to show adequate stress on your portfolio. With the large banks, the regulatory agencies asked that they simulate stress under V-, U-, and W-shaped recoveries. Other types of recoveries to consider are the L-shaped (a long, slow recovery with high unemployment) or the K-shaped (a recovery where certain customer segments remain adversely impacted longer than others).

When you're asked about your resiliency — that is how future events affect your portfolio — you will know the answer with this swift top-down approach. Using the same regression model, the economic metrics forecast is adjusted to simulate the different types of recoveries resulting in different estimated loss rates. You can tweak the answer by adjusting the confidence factor as well.

Ohio as an example. Unlike most other states, in Ohio,



Source: PCBB

quarterly loss rates for banks under \$1 billion in assets for the Consumer loan segment are not as highly correlated to the national GDP and unemployment data. Also, we see slightly lower correlations with national data for the Commercial and Industrial segments than in other states, while Other and Agriculture are slightly more correlated. The stronger correlations are in Land & Construction and Commercial Real Estate, with the strongest in single-family (both senior and junior liens) and HELOC. Knowing which segments of your portfolio are more likely to be historically related to national or state data can help you more objectively estimate future losses.

However, when actual losses will occur remains less known, given the delayed effect of deferments and the impact of the PPP, other lending programs, and the trillions of dollars that have been injected into the economy.

Your actual results also depend on a number of other factors, including the variance between your local economy and the average for Ohio, your actual forecasts, tax rates, eligibility for loss carry backs, in addition to the timing of the recovery, and future government actions. However, by triaging effectively, you can focus your institution on the most needed activities. Once you have a top-down view, you can decide if it makes sense to spend time on more detailed activities.

If you are interested in learning more about the top-down loan portfolio stress model or need help with a detailed, note-driven bottom-up loan stress solution, please contact Earl Charneske.

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Dedicated to serving the needs of community banks, PCBB's comprehensive and robust set of solutions includes: cash management, international services, lending solutions, and risk management advisory services.

For more information, please contact Earl Charneske at (847) 531-0890 or echarneske@pcbb.com

