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FEEDBACK

Small Banks Can Manage C&I Risk Without Aping Megabanks

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While offering many helpful risk management tips, last week's *American Banker* article "How Small Banks Can Manage Commercial Lending Risk" by Jackie Stewart was a bit disconcerting from an industry perspective.

Among other points, the article implied the only way for a community bank to effectively manage its Commercial & Industrial credit portfolio is to incur a disproportionately large expense and effort from copying methods and analytics used by bigger banks. We believe this is simply not true.

We have been partnering with community banks for more than two decades to improve their risk management processes. In our experience, regulators want banks to identify, measure, monitor and control credit risk, whether that risk takes the form of mortgages, commercial real estate or C&I loans. That message has not changed.

Identifying the risk at origination is the specialty of lending and credit officers, who use their estimate of that risk to help price the loan. This process, and the ongoing monitoring of each loan, has been done well for years by community banks. A "new" twist is the increased emphasis on portfolio management; in addition to loan-by-loan monitoring. ("New" is in quotations as the Office of the Comptroller of the Currency's Handbook on Loan Portfolio Management was published in April 1998)

Regulators have concluded that credit concentration is the single largest contributor to community bank failures. One regulator even told us that he feels that "concentrations are bank killers". The best way for a bank to identify and measure concentration risk is to code their portfolio loans adequately and create management reports of their portfolio by a variety of concentration criteria. This process is not difficult nor does it require extensive resources for a community bank, and the result is the foundation for enhanced community bank credit risk management. These concepts are outlined clearly in the updated OCC handbook on concentration management published in December 2011.

A static portfolio review only measures the risk as it exists at a point in time, so some scenario analysis of how the risk might change due to market volatility is an important practice. Common scenarios for a concentration evaluation include what happens to risk if interest rates were to go up substantially, or if the cost of a particular industry's inputs were to spike.

Of course, this particular exercise is known as stress testing, a popular concept with regulators particularly in regard to community bank's commercial real estate portfolio and now other

segments. The regulators have been clear about the value of stress testing – particularly for community banks:

Per the OCC's Guidance on Stress Testing Community Banks, "Community banks, regardless of size, should have the capacity to analyze the potential impact of adverse outcomes … The OCC encourages community banks to adopt a stress test method that fits their unique business strategy, size, products, sophistication and overall risk profile."

Regulatory agencies have also made it clear that community bankers' application of stress testing need not be highly complex.

"Simple, straightforward stress tests can provide useful insight into concentrated credit portfolios held by community banks," the Federal Deposit Insurance Corp. wrote in 2012.

Advanced analytic systems developed for big banks are needlessly expensive, data-intensive and not really the answer for most community banks. Instead, using the data commonly available on most core systems, a relatively simple, inexpensive concentration stress testing model can bring value.

Community bankers can sort the portfolio by industry, or other variables, then measure the results on interest rates, cost of goods or other scenarios deemed appropriate by management. These results provide valuable insight into segments of the portfolio not always apparent from a loan-by-loan perspective.

Through the application of sound credit concepts, using accessible borrower and loan financial data, a community bank can apply stress testing models successfully with a spreadsheet or a simple, inexpensive web-based tool. Advanced "big bank systems" will not automatically provide advanced useful results. Applying simple stress testing models to the C&I portfolio can result in meaningful and insightful credit information for bank management, the board and regulators.

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