How to Avoid Choking on Credit

lending stress testing credit underwriting

Dr. Henry Heimlich, inventor of the Heimlich maneuver used to help choking victims, passed away in December of last year. He was 96Ys old. Given there are 4,000 choking fatalities each year, Dr. Heimlich realized something needed to be done. He developed the Heimlich maneuver in the 1970's and eventually, its success paved the way to a new standard procedure throughout the US. Ironically, Dr. Heimlich only used the procedure once to save an 87Y old woman and that was just last year. Just as the Heimlich maneuver saves people from small mishaps turning into big consequences, looking at credit more closely during a changing rate environment can save bankers from bigger consequences with customers. Along those lines, here are a few suggestions.

First, there is a built-in way to provide you with pre-payment penalty income which should be captured. The standard clause ensures that if a borrower pays off more than 20% of the principal balance per year, there is a penalty fee due. Remember that this is not cumulative, but year by year. This is considerable income if the borrower wants to refinance at another bank or simply pay off the loan. However, oftentimes this penalty option is turned off or it is waived. The pre-payment clause in your core documentation system should be reviewed. If you feel that the standard penalty clause is not competitive, then it is always customizable for your market. This is an area to review before processing your loans since it is an easy area to recover fees and increase income.

Second, you will want to stress test robustly both at the loan and portfolio level. The testing should take one day with the correct tools, and it should be done quarterly to ensure that any changes do not negatively impact the bank's bottom line. Once you have the data, it should also be applied to capital to surface trends in capital adequacy. Regular stress testing and review help protect the bank and provide an opportunity to take additional action if capital levels appear to be heading in the wrong direction.

Next, consider that when you are doing stress testing, frequency is important but so is the regular update of loan information. Keeping data current, including additional owners, change in owners' information and the value of underlying property (in the event of major market changes, re-zoning or renovations) for example, helps ensure your results are up to date and can be leveraged better. Debt service coverage ratios should be updated at least 1x each year to ensure continuing loan performance. Too often we see that once a loan is approved and funded, it is forgotten unless there are problems. Keep your systems up to date to have the best data available.

Fourth, consider that new loans should also be interest rate stress tested up to 400bp when underwriting them. This is good regular practice to understand risks and exposures, but with the latest low rate environment, it has been tempting to let this slide. Bankers should revisit this and also consider adding a few other important factors such as cash flow, LTV, loan type, guarantor strength (more on this next) and industry.

Lastly, contingent liability is an important element of underwriting. Look at the guarantor to see what other debt they may have through other property loans, lines of credit etc. If there are other loans held by the guarantor, due diligence should be carried out to find out when those are due and how much they owe on a global basis. Ask whether a higher rate environment will result in problems with these loans as you underwrite the latest one for consideration.

The OCC recently reported that 2016 was the 4th consecutive year of underwriting leniency among 93 national banks and federal savings associations it reviewed. So, to stay fiscally fit and avoid choking on credit issues (even if minor), bankers should be preparing now. It is a good time and a good idea to review your underwriting practices and stress testing measures to be sure they work in this environment.