Tightening Your Underwriting - Selectively

by Steve Brown

Bankers and other financial professionals know people are just plain weird with their money. Look no further than a report from BMO Wealth Management around the subject of estate planning. It found a whopping 72% of adults said they did not know any details of their parents' wills or estate distribution plans. In addition to this, 40% of parents surveyed said they have never discussed their estate intentions with their children. As if that weren't enough to think about, consider 25% of married adults said only their spouse knows the location of their will or powers of attorney. Given an aging population, this seems to be a just plain nutty way of doing things.

In the banking industry, suffice it to say that community banks would never be that crazy when it comes to loan underwriting. To combat loosening underwriting standards and increased competition for developers' and borrowers' business, community bank lenders are recognizing that rather than constricting their criteria across the board, they need to be selective in where they tighten loan underwriting.

It is nearly a decade after the financial crash and credit risk is still on the list of regulatory concerns. Rising credit risk, the cost of compliance resources and a long-standing low-interest rate environment have created a perfect storm for concerned bankers.

Hence, some community banks are choosing to selectively tighten underwriting criteria in certain categories, with an eye to more carefully spot early signs of growing risk. By making more use of data and analysis tools, these banks are using their prior experience to better determine what indicators may point to potential loan issues in the future. Tracking defaults, waivers, and loan grades is one way to start monitoring things more closely. By making greater use of automation in select loan categories, community banks can increase efficiencies, protect against emerging risk and even boost revenue.

Several community banks we know are focusing a larger proportion of their attention on exercising more caution when it comes to certain loan types that have a greater historical tendency for problems. This is not to say community banks are not originating such loans, but rather that the underwriting process is tighter and data usage is greater.

Multi-family lending is one such area. There has been long-term growth in this housing segment, as many younger people opt for condominiums or apartments closer to urban areas. Historically, community banks have fared well in this sector with nearly 50% of all commercial real estate loans. But more recently, the cost of urban living and rising rents are driving many people out of the cities again. This could cause eventual volatility and defaults in this segment, so keep vigilant around these loans.

The energy sector is also an area for scrutiny. It is on a roller-coaster ride of uncertainty at present, still trying to recover from a downturn that saw the cost of crude oil drop by more than 75% in the 18 months between mid-2014 and the end of 2015. Oil prices are notoriously volatile, so be sure to monitor loan concentrations and apply prudent underwriting to avoid future issues.

The agriculture lending sector is another one to watch. In the current environment of falling commodity prices, increasing costs for land and equipment, decreasing incomes, and a high amount of carried debt, this sector can be challenging. While farmers typically are not as over-leveraged as they were during the agricultural depression of the late 1970s, there is still plenty of potential for default, so be cautious.

All of this is of course not news to bankers but it might serve as a good time to review concentration risks. When you do, review your underwriting policies to ensure the risks you are taking, and those already in the book, make sense now and in the future. As with your will, talking about things on the loan side too, can help inform and educate those who need to know.

BANK NEWS

Employment

Fed research finds the most frequently cited employment situations for adults are: works for someone else (56%), retired (22%), homemaker (16%), self-employed (10%), student (10%) and not employed and not looking for work (9%).

Strategy Priorities

A Deloitte survey of corporate executives on risk finds the highest priorities for supporting the business strategy right now are: improving reporting and compliance (54%), building a risk-aware culture (35%), and identifying opportunities for loss avoidance or reduction (30%).

Vendor Trouble

Fed research finds some common themes where banks get in trouble with third party vendors, which include: over reliance (responsibility of bank to remain in compliance with all laws and regulations), failure to understand or retain knowledgeable staff (someone at the bank must be sufficiently knowledgeable to understand and oversee vendor's activities), failure to monitor vendor (bank must monitor vendor performance, understand what they are doing, monitor customer complaints), expectations (banks must give vendor information needed to do the job, contract must be clear as to expectations), compliance (bank must verify vendor activities are in compliance with the law).

Almost Junk

S&P and Moody's both downgraded Illinois one notch above junk status and warned the state could become the first US state to receive a junk rating if it doesn't solve its financial crisis and political gridlock.

CREDIT STRESS TESTING SERVICES FOR COMMUNITY BANKS

Community bankers can credit stress test loans of all types from multiple perspectives and on a portfolio basis. Get professional help doing so and learn about credit stress testing here.

Copyright 2018 PCBB. Information contained herein is based on sources we believe to be reliable, but its accuracy is not guaranteed. Customers should rely on their own outside counsel or accounting firm to address specific circumstances. This document cannot be reproduced or redistributed outside of your institution without the written consent of PCBB.