Six Strategies to Navigate Credit Stress

stress testing industry update

Summary: Between inflation and higher interest rates, businesses need to charge more for goods and services, while also worrying that they'll lose price-sensitive customers. As a result, CFIs are likely to see increased credit stress soon. We discuss six strategies CFIs can use to manage credit risk challenges in a volatile environment.

On the surface, it would have seemed like Michael Burry, the hedge fund manager whose story is featured in the "Big Short," could predict the future. He foresaw what many people could not see back in 2003-2004, that the housing market was extremely unstable and on its way toward a collapse. Burry wasn't a psychic — he meticulously analyzed and researched patterns and irregularities, which pointed him toward seeing the eventual 2008 housing market crash. Staying ahead of the curve and being better prepared during current economic conditions is a page worth taking out of Burry's playbook.

Between the pandemic and rising inflation and interest rates, the last two years have taken community financial institutions (CFIs) on a wild ride. Rising inflation and the higher interest rates designed to bring inflation back to earth have influenced cash flow and the cost of goods, which can create financial stress for borrowers. Financial stress can then lead to credit stress, a problem for both CFIs and their customers.

Multiple challenges in credit risk

The problem isn't just that economic circumstances may push some borrowers towards payment tardiness or default. CFIs are seeing:

- **Varying credit quality** by market sectors and subsectors. Some business areas have been hit hard by the pandemic, rising inflation, and/or higher interest rates. Other sectors, like those that were deemed essential businesses, have remained remarkably unscathed.
- **Difficulty in discerning the creditworthiness** of different potential borrowers in those sectors and subsectors. For instance, businesses in travel and tourism found pandemic-related lockdowns in 2020 and 2021 very challenging. Some of those businesses have rebounded since then, such as cruise ship traveling, which saw share prices jump after pandemic safety protocols were removed earlier this summer. Other travel-related industries haven't been as lucky, such as the hotel sector, with lingering staff shortages that caused some hotels to close or leave a portion of rooms unsold.

The challenge, then, is to determine which individual businesses are good credit risks. A firm's business sector matters, but it isn't necessarily the last word on whether a CFI should lend to it.

How can your CFI assess risk in ways that encourage safe growth during a volatile economic time? **Here are six strategies to help**:

1. **Notice the industry concentrations that are already in your loan portfolio.** Use real-world observation and what-if analysis to determine the effects of rising interest rates on the sectors and subsectors where your CFI is invested. Don't forget the importance of factors such as region and business size.

Commercial real estate companies in New York, for instance, might be experiencing different conditions than commercial real estate companies in Chicago, while still having long-term tenant contracts in common.

2. **Collect current financial information from borrowers more frequently** — at least every six months. Annual updates are no longer sufficient. Consider all your possible information sources, which might include credit scores, payment history, debt-to-income ratio, net cash flow variables derived from customer-level income, utilities, rental payments, and other debt servicing. Some financial institutions are even moving toward using real-time data to get the clearest, most up-to-date picture of a customer's financial standing.

3. **Analyze sectors and subsectors of industries to anticipate economic patterns.** For instance, the pandemic affected agricultural borrowers differently. Even though both groups are in the same agriculture sector, farmers who sold to grocery stores did well, while farmers who sold to restaurants often had significant financial problems.

By the same token, some businesses might find it easier than others to pass along some of their costs — a key ability to thriving when inflation trends higher. You might find that an entire sector has this ability, or you might see that within a single sector, some businesses can pass along costs and others can't. Advising the customers who aren't seeing as much profit of some strategies they can leverage to increase margins will help both them and your CFI.

4. **Proactively monitor your higher-risk portfolio concentrations** and downgrade at-risk loans, when appropriate. The earlier you see credit risk, the more you can limit nonperformance and help commercial customers restore their credit quality.

5. **Stress test your portfolio.** CFIs are anticipating potential deterioration in borrowers' debt-servicing capacity, collateral values, and credit quality of their loan portfolios due to exposure to interest-rate risk and inflation risk. There will be more scrutiny from regulators around credit stress, especially those institutions that are exceeding regulatory guidance on commercial real estate and construction concentration.

6. **Think about Current Expected Credit Losses (CECL).** Consider what your loan portfolio's credit risk profile will mean to CECL compliance, which becomes mandatory for most CFIs next year.

Taking a holistic approach toward your borrowers' circumstances and patterns of financial behavior affords you the ability to see potential problems, such as credit stress, before they occur. Assessing these potential risks will help you make more informed decisions for the health of your portfolio, as well as weather the current economic times.

TWO APPROACHES TO STRESS TEST YOUR LOANS

Now more than ever, it is important to stress test loans of all types from multiple perspectives. Choose your approach and get expert help, as needed. Learn more about credit stress testing today.

ECONOMY & RATES

Rates As Of: 10/20/2022 11:41AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	4.07	0.74	4.01
6M	4.45	0.53	4.26
1Y	4.64	0.63	4.26

2Y	4.60	0.31	3.86
5Y	4.43	0.33	3.16
10Y	4.21	0.38	2.69
30Y	4.20	0.42	2.30

FF Market	**FF Disc**	**IORB**
3.08	3.25	3.15
SOFR	**Prime**	**OBFR**
3.04	6.25	3.07