CREDIT QUALITY BULLETIN

Proactive Portfolio Management:

Looking ahead can help your bank survive and thrive in a tough credit environment

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Credit risk management has historically been a reactive business: portfolio managers would adjust the bank's loan policy or portfolio appetite based on changes that had already occurred in the economy or based on specific portfolio deterioration.

The nature of credit risk, however, has changed and credit risk managers must change as well. In today's environment, risk mangers need to be able to better anticipate problems before they occur, consider ancillary areas of the portfolios that could be impacted, and manage the credit risk function accordingly.

Yogi Berra could have been talking about credit risk management when he said, "It's tough to make predictions, especially about the future." But technology tools that aggregate and consolidate credit data make it possible not only to anticipate the future, but to act on that information as well.

Rippling Under Pressure

The state of today's credit environment illustrates that simply reacting to specific economic events is inadequate in mitigating "ripple effect" risk that occurs when a downturn hits one part of the market. For example, the credit crisis is forcing banks to raise underwriting standards, making it difficult for businesses to secure the operating capital they need to move their business forward.

In many cases, the ripple effect of tightening credit is negatively impacting consumer spending and, as a result, retail stores are forced to close. This in turn puts stress on commercial real estate property. Auto manufacturers are hit by consumer's inability to tap into their homes' equity to purchase a new car. The ripple effect impacts businesses involved in the manufacture and transportation of new vehicles.

As a result of this interconnectedness, most banks are surprised to find themselves with a greater level of risk in their portfolios than they realized. At any given time being current on a loan does not insure that a borrower will make their next payment. It is fundamental that if you can identify "early warning signs" (borrower's debt service coverage is marginal or their industry has shown deterioration or is expected to) you improve your opportunity to mitigate the risk or strengthen the bank's position.

> "Well-managed banks anticipate and manage risk."
>
> *Paul Stark, Senior Vice President*
> *FirstMerit Corporation*

Now, more than ever, banks need to truly understand these risks so they can effectively manage them.

Seeing Around the Bend in the Road

While predicting increasing levels of risk in the loan portfolio is critical, risk mangers also must be willing to act on that information, says Paul Stark, senior vice president of Credit Risk Management at FirstMerit Corporation (Akron, OH). "The challenge is to look over the hill, predict the downturn and then do something about it," he says.

For example, FirstMerit reviews their portfolio for loans to industries related to the building industry feeling the squeeze of the housing downturn such as cement contractors, electricians, and siding manufacturers within FirstMerit's loan portfolio.

"We compile a list of loans from related industries and analyze emerging problems," explains Stark. "The bank will work with the customers and may reduce lines of credit available or require a pay down to reduce the bank's risk. It is critical to have loan data accessible. Our loan managers have the ability to drill down into the data and see a more granular and detailed view than they had in the past."

Cleaning Up

Data is obviously a critical component to becoming more predictive in credit risk management. Although data integrity is an ongoing struggle, the industry worked hard over the past several years cleaning and scrubbing data. Stark notes that data integrity can be compromised because the data is typically touched by a number of people. Training is critical for line staff to provide accurate and consistent input to the loan systems.

For example, data entry of incorrect industry codes makes the analysis of industry concentrations within the portfolio very difficult.

"We have worked hard to address not only the incorrect data, but the underlying processes to prevent the problem from reoccurring," Stark notes. "As a result, data quality overall has improved dramatically."

Improving Intelligence

The risk manager will need to create and run models presenting unique views and comparisons of data and isolate potential areas of risk. On a macro level, the manager can evaluate concentrations and adjust portfolios through tightened policies or modify underwriting standards to restrict lending to that segment of borrowers. On a micro level, they can analyze exposure at the individual credit level and adjust loan structure and terms or entice the customer to leave the bank.

Technology plays a large role in a bank's ability to consolidate this information and put it to work. Although this sounds like a simple concept, the execution is more complex. Disparate data elements need to be aggregated. Tools such as data warehouses that serve as credit information repositories need to be easy to use so the information is accessible not only by analysts well versed in the nuances of the software, but by other credit risk staff as well.

For Stark, slicing data in different ways to determine concentrations of risk is vitally important. "You can look at concentrations in lots of ways: by customer, by industry, geography or by type of collateral such as real estate. You want the ability to drill down into categories to determine where your segments of risk are located."

"The better intelligence you have, the more opportunity you have to manage risk and affect change," says Stark. "Well-managed banks anticipate and manage risk. They are constantly vigilant."

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Credit Quality Bulletin is published by DiCom Software, the leading provider of credit risk management technology solutions for financial institutions nationwide. The company's Credit Quality Solution (CQS), a suite of products consisting of Portfolio Analysis, LRS Enterprise and Portfolio Management, enables banks to efficiently analyze, review and manage their loan portfolios while minimizing risk. DiCom's solutions are the preferred choice of today's best credit risk personnel at banks across the U.S.

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