BankersHub
Getting from Here to There

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MOVING FROM OLD TO NEW CULTURE: MEASURING UP TO NEW RISK PROFILE (PART 6 OF 8)

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Introduction

In the previous articles in this series, we've explained what it takes to have a values driven culture. Now let's consider how to move on up in the world. As a refresher, consider this comparison of the risk adverse culture to the risk management culture:

- **Risk adverse culture**
  - Transaction risk oriented
  - Risk avoidance
  - Process/regulatory driven
  - Manage problem portfolio
  - Strong lending controls
  - Cyclical credit management
  - Limited predictability
  - CCO as the final loan decision maker
  - Credit is gatekeeper
- **Risk management culture**
  - Portfolio risk oriented
  - Risk management
  - Customer oriented
  - Manage "Pass" portfolio
  - Clear lending guidance
  - Consistent credit mgt
  - Improved predictability
  - CCO as the proactive communicator
  - Credit is partner with line

The advantage of having a risk management culture is obvious; but less apparent is how we move a bank from one culture to the other. Managing this move is the subject of the upcoming articles in the series. First, let's review why banks get into trouble. A bank's credit problems can be traced to one or more of these reasons:

- Poor risk assessment
- Too many risky borrowers
- Lend too much to individual borrowers
- Excessive exposure to risky types of lending
- Concentrations of aggregate risk

ABOUT BankersHub

BankersHub was founded in 2012 by Michael Beird and Erin Handel, 2 Financial Services professionals dedicated to educating and informing banks, credit unions, solution providers and consultants in the U.S. and worldwide. BankersHub delivers best practices, research insights, opinions, economic trends and consumer views through online web education, virtual events and conferences, live streaming activities, custom training and content development.

Risk Assessment

To avoid problems, a bank must be able to detect them with appropriate risk preventive maintenance. Three timesensitive groups of predictive indicators are commonly employed:

- **Short-term indicators**
  - 30-day and 90-day past-dues
  - NPA's
  - Criticized
  - Classified
  - NCO's
- **Medium-term indicators**
  - Watch lists
  - Past-due and Loss trends
- **Long-term indicators**
  - Risk rating distribution
  - Exposure to high risk types of lending
  - Concentrations

If a bank is relying on using the short-term asset quality ratios as circuit breakers to stop risky lending when these ratios exceed pre-set limits, it will have relatively little time to respond. If the bank is monitoring the trends in these ratios along with watching loans with declining performance, then it has pushed its early warning radar out a little farther. Prime candidates for nomination to watch lists include those with significant policy exceptions such as high loan-to-value collateral ratios, limited or no guarantees, and high debt/income ratio, and declining individual credit bureau scores. Longterm measures give the bank even more response time, so monitoring risk rating distribution changes, exposure to risky types of lending, and various types of portfolio concentrations are key components of long-range risk radar. In fact, the lack of these components can lead to the three mortal sins of banking:

- **Poor risk rating distribution**
- **Excessive exposure to high risk types of lending**
- **Excessive concentrations**

  - One customer
  - One industry
  - One geography
  - One product or service

However, before any of us dies for the sins of our founders, we should think about how much risk any of us can handle or tolerate.

Risk Tolerance

In the beginning, we all begin with good intentions, but over time we sometimes get used to life in the fast lane. Our risk tolerance moves from low to medium to high as we convince ourselves that we can handle it. The result is an upward drift in risk:

Measure	Year 1	Year 2	Year 3	Year 4
30 days pd	0.50	0.60	0.75	1.25
90 days pd	0.01	0.10	0.12	0.25
Criticized	1.25	1.30	1.50	2.60
classified	0.50	0.60	0.80	1.50
Non-accrual	0.02	0.04	0.10	0.35
NCO's	0.02	0.05	0.35	0.75

The aggregate rise in risk probably reflects a combination of the three deadly sins; so to stay on course, we should look at ways to measure, monitor, and manage risk rating distributions, exposure to risky types of lending, and excessive concentrations:

Type of Risk	Definition	Measurement
Transaction (T)	Risk in individual transactions	Measured by risk rating system
Intrinsic (I)	Risk associated with LOB's	Measured in LOB sub-segments by risk scoring process
Concentration (C)	Risk from aggregated exposures by borrower, LOB, industry, geography, etc.	Measured as % of capital

Using the risk rating system above allows us to measure the transaction risk, the intrinsic risk of various types of lending, and the concentration risk (C) in the portfolio. The result will be a useful risk profile for which there are a range of strategies available to change your bank's risk profile.

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