

Credit Risk Management Practices: The Trickledown Effect of Dodd-Frank



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The Dodd-Frank reform law had its first anniversary this summer, and many details still remain to be worked out by regulators over the coming months. However, the issues it has raised — risk management, accountability, transparency and uniformity — give us insight into where examiners will be focusing ahead. Although the law will most directly affect commercial lending institutions with assets of \$10 billion and above, there will be a trickledown effect on smaller institutions. Examiners will be using Dodd-Frank as a guideline for best practices that will apply to banks of any size. Credit risk management will definitely be placed under the looking glass. In the meantime, lenders have an excellent opportunity to get ahead of the game.

First trickledown from Dodd-Frank

To rebuild the fund to adequately cover future losses, the FDIC now charges significantly heftier insurance premiums for banks in higher risk categories. The insurance assessments can vary from 7 to 77.5 basis points. These premiums are affected by two key factors: a bank's supervisory rating and its capitalization. If a bank's CAMELS rating improves and its capitalization is high, it will be placed in a low-risk category and will pay lower insurance premiums.

This is significant for commercial lenders because asset quality plays a significant part in the CAMELS rating equation. Effective credit risk management practices help banks strengthen asset quality by putting good loans on the books that generate positive returns. This, in turn, improves institutions' CAMELS ratings — and they can realize big savings in insurance premiums.

This is just one area where we're seeing the law's effects and more will come. But the bottom line is that banks must start lending again to make money. That's why there's so much emphasis on the asset side of the balance sheet. To make good loans that generate expected earnings, institutions must follow sound lending practices and take a proactive approach to credit risk management and building their portfolios.

Establish uniform processes

Generally, commercial lenders have a modest number of issues to address as a direct result of Dodd-Frank. However, if lenders establish best practices today for complex credit analysis and portfolio risk management, they will be able to tackle examiners' expectations head on. Technology is essential to that effort. Innovation is coming to the rescue to help lenders effectively assess and mitigate complex credit risk (e.g., commercial real-estate, commercial and industrial, small business, construction, and agriculture loans) in ways not possible before.

Here are three key areas where institutions should be focusing moving forward:

1. Organization. It will be crucial that banks more uniformly manage lending processes across all commercial loan disciplines. Technology has evolved that aggregates data into one system of record for the lending area, similar to what the core processors provide. Lenders can now obtain a clear view into the risk that lies across all loan disciplines, and down to individual credits. Examiners will expect banks to break down data silos and take advantage of technology to put a repeatable process in place for identifying risk and consistently managing all loans, from origination through payoff.

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2. Visibility. Examiners will expect banks to have greater visibility into each loan so they can take a more proactive approach to each borrower relationship. The only way to evaluate risk is to get a complete picture of customers at macro and micro levels; some may no longer fit the bank’s risk profile and actions are necessary to make them a better fit. Lenders must also be able to see the overall risk make-up of their portfolios in order to identify where to attract new borrower relationships. Utilizing advanced reporting and analysis tools, banks can gain the visibility — all the way up to the board — that’s crucial to making sound, profitable loan decisions that will improve the bank’s overall performance.

3. Stress Testing. To truly be proactive, banks will need to stress test loans at individual and portfolio levels using variances in credit decision variables. One of the most compelling advances in technology is the predictive power offered by new risk management tools that provide modeling and pre- and post-approval stress-testing capabilities. If commercial lenders can identify problematic loans early, they have a much better chance of maintaining a healthy asset. Examiners will place heightened emphasis on stress-testing and risk-rating systems that will allow thorough portfolio analysis. Innovations enable lenders to look at loan risk overviews by interest rate and risk rating, to evaluate risk concentrations, and to run sensitivity analyses — all to actively manage borrowers’ risk.

Take action now

With the reform law, we can see what regulators will be scrutinizing moving forward. By embracing automation and applying best practices now to some key areas, institutions will not only be able to confidently meet future regulatory requirements for credit risk management, but also drive more profitable loan businesses. ■

About the Author

Doug McGregor is a software industry veteran with more than 30 years of experience. As the CEO of WebEquity he has helped grow its customer base to over 700 financial institutions. WebEquity is the ICBA Preferred Service Provider for Commercial Lending Software.



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