Revisiting Loan Portfolio Management Fundamentals

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As the economic environment shifts with increased interest rates and credit weakening projected while liquidity sources are highly scrutinized, it is important for financial institutions to revisit the significance of loan portfolio management fundamentals.

Effective loan portfolio management involves a comprehensive approach to managing the various types of risk in the loan portfolio. The risk landscape of your loan portfolio has changed as borrowers, individually or commercially, have been impacted in one way or another by economic changes. So, when was the last time management assessed the types of risk that are collectively showing up in the portfolio currently? Currently, most financial institutions are focused on the repricing risk represented in the loan portfolio, and rightfully so. However, what other risks have come to the forefront? This evaluation should also prompt management to consider the credit culture and risk appetite. Given the current loan portfolio composition and economic environment, has your credit risk appetite changed and what is the resulting impact on the credit culture, or vice versa? To effectively manage credit risk, financial institutions must have a strong credit culture that emphasizes sound underwriting practices, risk-based pricing, and ongoing monitoring of borrower creditworthiness.

As a next step, consider the risk strategy and approach to loan underwriting. Effective underwriting practices are critical to managing credit risk and, as risks have evolved in the post-pandemic years, underwriting practices should be revisited and adjusted accordingly. Loan
policy requirements are another important aspect of loan portfolio management. Financial institutions must establish clear policies and procedures for loan origination, underwriting, and servicing. These policies should be regularly reviewed and updated to ensure that they remain effective in the current economic environment. Additionally, stress testing practices also help financial institutions identify potential credit risks and develop strategies to mitigate them. How have your loan portfolio stress testing practices changed in light of increased interest rates, potential collateral value changes, and other geographic considerations that may impact borrowers?

Risk-based capital limits and plans are another essential strategy for managing credit risk. Financial institutions must establish clear limits on the amount of risk they are willing to take on and develop plans to manage risk within those limits. Regarding concentration risk, financial institutions must be aware of the risks associated with having a large concentration of loans in a particular industry or geographic area. To manage this risk, financial institutions should consider viable diversification opportunities for the loan portfolio and establish clear limits on the amount of risk they are willing to take on in any one area. Most recently, regulatory emphasis has been placed on the total commercial real estate (CRE) concentration exposure and not just on non-owner occupied properties. What total CRE concentration limit has your board of directors approved? Has that limit been revisited lately given some of the projections for weakened conditions with impacted CRE segments?

Lastly, effective problem loan management is also critical to managing credit risk. Financial institutions must have clear policies and procedures for identifying and managing problem loans. This may involve developing workout plans for borrowers who are experiencing financial difficulties or pursuing legal action to recover losses. Given the updated “Interagency Policy Statement on Prudent Commercial Real Estate Loan Accommodations and Workouts”, issued this past June, it is clear that the regulators are thinking of and planning for potential problems in the CRE space. The question is: has your management team also considered potential weakening in the CRE portfolio and other segments of the loan portfolio that may be showing signs of distress (i.e., consumer)? If so, has
your approach to problem loan management be updated or revised to address current concerns or challenges?

By taking a comprehensive approach to loan portfolio management, financial institutions can effectively manage risk and meet their obligations to their stakeholders. It is a relevant exercise to reconsider these key elements of loan portfolio management at your institution and make adjustments as necessary to reflect current processes, procedures, and risks posed from the evolving economic environment.