

Lender beware: Emergency relief efforts are inherently risky

By Greg Feldberg and Sabeth Siddique

Original post [here](#).

The coronavirus response puts American bankers in a tight spot.

More so than most developed countries, the government has put bankers in charge of life-or-death decisions about private businesses. Banks and nonbank [lenders have been allocating](#) what are essentially government grants [through the nearly \\$660 billion](#) Paycheck Protection Program.

They will soon be expected to allocate hundreds of billions [more through Fed](#) and Treasury programs that will require them to take more risk.

But banker-as-government-agent is not an enviable role. Lend too conservatively, and the banker will be (or has been) criticized for putting shareholders, or favored clients, ahead of the common good. Lend too freely, and losses may be higher than expected, leading to a need for capital from the government before the end of the year.

To solve this dilemma, bankers and nonbank lenders can rely on the principles of risk management and governance that they relearned the hard way during the last financial crisis.

To protect their institutions, bankers need to, first, provide clear guidance on risk appetite. Even today, bank boards have an important role to play in [reconfirming a bank's strategy](#) and risk appetite — the level of losses that board members can endure and justify to stakeholders — and making sure management prudently follows policies and procedures.

To be sure, risk appetite remains relevant. A bank can do its part to support the real economy even if its board decides it will only extend credit through lending programs in which the government has committed to take much of the risk. Or if it decides not to extend new credit at all, but to focus on helping existing borrowers.

Bank risk managers aren't epidemiologists. They don't have special insights into how long the health crisis will last.

However, their expertise should allow them to differentiate between borrowers with persistent foundational issues and borrowers with only temporary issues. Authorities have acknowledged this with clear guidance that banks should not automatically downgrade borrowers who miss payments.

Lending or restructuring decisions should be based on sound underwriting criteria, with a clear understanding of the board's risk appetite while paying attention to the current environment and the mitigating effects of government assistance.

Management can expect elevated losses and depletion of capital buffers. The challenge is to not allow those losses to put the safety and soundness of the institution at risk. Specifically, operating at or near the institution's post-stress capital target should be consistent with the board's risk tolerance in this environment. Some banks have already warned that capital ratios are likely to decline from recent high levels.

The depth and length of this recession are very uncertain, depending on public-health variables that no one can predict. Banks should be vigilant in identifying, assessing and reporting risks commensurate with the speed and magnitude of the changing-risk environment.

Banks need these ongoing assessments to translate risk appetite into tangible metrics such as exposure limits and underwriting criteria. Risk managers should scrutinize the reliability of model outputs, mitigating model risks with qualitative factors when applicable.

Data on historical loan losses and backward-looking statistical scoring models won't be very helpful. Judgment will likely play a greater role.

Bankers should also carefully balance “micro” and “macro” pressures. Supervisors have focused increasingly on banks' [responsibilities to the public](#) since the financial crisis.

In its annual stress test, for example, the [Federal Reserve says it expects every](#) bank's management to “establish post-stress capital goals that are aligned with its risk appetite and risk profile, its ability to act as a financial intermediary in times of stress, and the expectations of internal and external stakeholders.”

Governments today are striking a delicate balance between their “microprudential” role (to keep banks solvent), and their “macroprudential” role (to support the real sector). In a crisis, the macroprudential role must take center stage. But bankers, backed by good governance, should know best how to strike the balance.

In the early stages of this crisis, no decision of each bank's board has been more sensitive than the question whether to suspend the payments of dividends to shareholders. In the U.S., supervisors have so far hesitated to tell banks to suspend. And, so far, banks have not done so.

In contrast, there was a diversity of responses to supervisors' guidance on the allowance for loan losses. Some banks took advantage of the forbearance to conserve capital by delaying their application of the new “lifetime loss” standard.

Others held to the standard, conservatively reserving for the worst. Both answers may be appropriate, based on each bank's unique business profile.

Finally, don't forget reputational risk. Of course, bankers entered this crisis with more goodwill than last time. But, like the liquidity and capital buffers they have built since the 2008 financial crisis, that goodwill can be quickly spent if not managed.

Already, it is clear that the public will be very sensitive to credit allocation decisions that appear unfair or prejudicial, especially when bankers are allocating taxpayer funds. There are also the matters of compensation, bonuses and shareholder dividends while so many are suffering.

In summary, banks have the tools to determine their fate this year. Their public-service role — the justification for both the benefits and the costs of their unique regulatory framework — is never more clear than in the depth of a crisis like this.

Following risk-management principles and knowing when to say “no,” bankers may be able to get through this early phase of the coronavirus-triggered recession intact.

It won't be easy. It will require hard-headed analysis of risks amidst extreme uncertainty and constant reevaluation of the conflicts and complements between stakeholder and public

interests. It will also require the fortitude to make decisions backed by sound judgment and leadership, consistent with each bank's risk appetite.