INSIGHTS FROM THE BDO FINANCIAL INSTITUTIONS & SPECIALTY FINANCE PRACTICE

Bank POV: Forecasting Loan Portfolios in a High Interest Rate Environment

SUCCESSFULLY STEERING YOUR PORTFOLIO AMID A HIGH INTEREST RATE ENVIRONMENT WILL BE CRITICAL FOR FINANCIAL INSTITUTIONS

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The U.S. interest rate has increased by 5.25 percentage points since March of 2022, with the Federal Reserve announcing the most recent quarter-point rate hike at the end of July—bringing the current rate to its highest level since 2001. These increases are putting more companies at a greater risk of default, which has a tremendous impact on lenders' loan portfolios.

While economists believe that interest rate increases will conclude as inflation slows down, there is no certainty around when rates will actually begin to decrease and what a "normal" rate will look like going forward.

With increased interest rates comes a likely increase in loans defaults. Banks should prepare to build resiliency into their loan portfolios, such as diversifying portfolio holdings, and should develop strategies for appropriately forecasting portfolio performance based on potential default risks and macroeconomic headwinds. A lack of proper forecasting could lead to increased bad debt expenses, an outcome both banks and their stakeholders are keen to avoid.

Keep reading to learn about some of the key considerations for forecasting your loan portfolio in a high interest rate environment.

Everything Comes Down to Data

Banks will benefit from gathering as much information as possible on the companies in their loan portfolio. Information can include macro and microeconomic data on the borrower, audited financial statements, monthly reporting packages, borrowing base reports, sales trend reports, and other key performance indicators. Doing so will enable them to more accurately forecast how economic headwinds will impact those companies and likelihood of default—and therefore the bank's portfolio. These forecasts can then inform scenario analyses and continuity planning to help increase portfolio resilience and support future success.

All data should flow into one centralized location to simplify analysis. Sources for this data could include:

- Historical analyses (past default rates, prepayment rates, and delinquencies)
- Stress tests to identify potential risk
- Overall macroeconomic trends (I.e., how interest rates are trending, inflation)
- Creating multiple scenarios showing the financial impact of altering interest rate assumptions, including varying levels of severity

Ideally, this analysis should go deeper than looking at the portfolio as a whole. Banks should analyze default risk not only of the companies whose debt they own, but also of the industries those companies are in. Banks should also analyze default risk based on the size of the loans, size of the borrowers, and risk level of the loans, among other parameters.

Since different industries are responding to interest rate increases in different ways, segmented analysis may provide a better understanding of the health and/or distress of the various industries comprising a bank's loan portfolio. Industries are also contending with inflation, GDP, and consumer debt levels in different ways. While the fiscal health of some industries may be hit particularly hard (retail and auto, for example) and are, therefore, more likely to default, others may not be struggling to the same degree and may still be able to make consistent payments. Analyzing each industry subsegment separately allows banks to better understand how a change in interest rates could impact their portfolios.

To this end, banks should also consider creating teams of industry-focused professionals to monitor industry trends and provide insights, which can then be overlaid on company-specific risk. This layered approach will help build a holistic view of portfolio health, informed by industry-specific data, enabling banks and lenders to confidently forecast ahead of continued economic uncertainty.

The Importance of Portfolio Diversification

A diverse portfolio is a healthy portfolio, and diversification of investments is a crucial way that lenders can build resiliency into their portfolios.

Oversaturation in one sector was a key contributor to the **bank failures** that made headlines in the first half of 2023. Approaches such as this introduce an inordinate amount of risk to a lender's portfolio by causing them to become too dependent on the performance of companies within a specific industry or sub-sector.

If this sector is hit particularly hard by economic headwinds – and ends up with a high number of defaults – this can have significant repercussions for the overall portfolio. Diversification helps keep risk from concentrating around individual sectors or industries that may be more vulnerable to high interest rates.

But diversification does not only apply to industries and sectors – especially since this kind of diversification can be difficult and/or time consuming. It can also include a wider array of geographies and business sizes. Banks could also consider credit risk diversity, including both higher and lower creditworthiness. Higher-risk loans offer potentially higher returns, but they also come with a greater risk of default. A balanced portfolio with a balanced amount of risk helps to maintain overall portfolio health.

While diversification will not eliminate all risk, it will help reduce the potential impact that any individual default could have. Properly assessing and monitoring existing portfolio risk as banks strategize and diversify will be essential to ensure success and help maintain alignment with the institution's overall, established risk management practices and risk tolerance.

Risk Appetite Varies by Bank

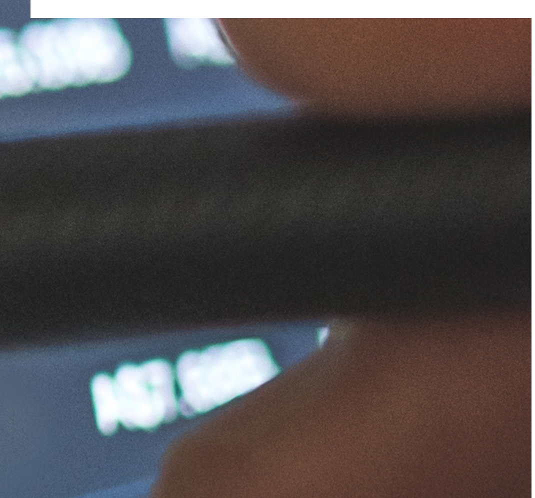
There is no one-size-fits-all solution for balancing risk appetite and no universal ratio for optimizing risk and reward. As competition for borrowers increases, it may be tempting to relax lending standards to attract borrowers, maintain growth, and ultimately, boost revenue. Relaxing lending standards, however, brings inherent and heightened risk of default in a high-interest rate environment: if the cost of debt does not come down in the near-term, borrowers may not be well positioned to pay back their loans. This can result in potential losses for the bank.

In a high interest rate environment, banks will need to balance their risk tolerance with mitigation efforts in order to keep pace with competing institutions – while also ensuring they are able to pass government stress tests and meet reserve requirements.

Steering Portfolio Performance Requires the Right Staffing

Underperforming companies were able to stave off default over the past few years thanks to an abundance of government stimulus funds and low interest rates. Now that those funds are mostly dried up and interest rates are at a 22 year high, banks are preparing for an increase in defaults. The market has already seen **defaults surge** in the past year, which increases the amount of stress on loan portfolios and results in more at-risk loans being placed into special asset groups.

Due to the low level of defaults over the past several years, however, banks have a smaller number of experienced distressed loan officers. Additional employees — dedicated to special asset groups and/or workout departments — will be needed to manage this influx of at-risk loans. Additional training for these employees will also be needed. However, with so many loans being moved into this designation, there is a higher demand for staff to fill out these teams than there is availability in the labor market. The banks who are best positioned to steer their portfolio through a high-interest rate environment will be the ones who act now to properly manage their employee allocations. This could include revisiting workforce strategies, upskilling current staff, and/or hiring to expand existing teams.



Conclusion

High interest rates, inflation and other macroeconomic issues are here to stay, at least for the time being. Forecasting in this environment—and ensuring continued portfolio health—will require comprehensive planning and vigilant risk management practices to spot threats before they can cause too much damage.

Banks looking to improve their loan portfolio forecasting may benefit from working with an external advisor. At BDO, we can help you better prepare for economic uncertainty with analytics and advanced modeling tools that quantify and validate risk, including the ways in which interest rates could impact your specific loan portfolio.

Our team of turnaround and restructuring professionals can assist banks and non-bank lenders with a variety of financial and operational restructuring initiatives for borrowers, offer creditor advisory services, and execute loan workout strategies that may help improve the performance of your portfolio.

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