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# What Are the Top Three Risks to Financial Institutions in North America? And how should they deal with them?

## Volatility in the market in a post-pandemic landscape and rapidly changing industry trends call for a more proactive portfolio risk management

We thought we were finally getting out of the pandemic on a growth path with the severity of symptoms and rate of infection declining in most regions. There are still side effects of the pandemic on top of all the new economic events raising the fear of a potential recession. The pandemic has changed the landscape of the overall industry as a result of structural changes to the economy to ride through the pandemic. Quarantine rules and remote work environments have changed where people live and work, causing certain industries and regions to flourish while others were hurting. This was also an era of a new emerging risk such as climate risk as the US government rejoined into the Paris Accord back in 2021, and US regulators and standard setters were publishing literature on the importance of climate risk and/or discussing potential reporting requirements. All of this adds further complexity to portfolio management, which calls for a more sophisticated and flexible approach. The main current risks can be broadly categorized under three headings: post-pandemic industry changes, volatility in the market, and climate risk.

## 1. Post-pandemic industry changes

The response to the COVID-19 pandemic has drastically changed the consumer behavior and economic activities. The pandemic and remote work culture increased interest in homeowner mobility. According to Freddie Mac[1], the trend of moving away from urban areas had been growing even prior to the pandemic. During the pandemic, people were even more motivated to migrate to rural areas for more affordable housing and lower cost of living where we now see a much higher housing price increase and newer developments, resulting in more lending opportunities for those areas compared to pre-pandemic. Also, consumers are changing their spending habits and activities so certain industries like e-commerce, delivery, transportation, etc. having been growing while some industries like leisure, specialty retails, airlines, hotels were on a decline during the pandemic that they are still on a recovery path. Such industries experienced credit distress and downgrades despite the government aids.

With the remote working environment where some companies have announced a permanent remote work policy, the commercial real estate (CRE) market has been changing as well. Higher vacancies are observed in office buildings in urban areas with decreased cash flows. With the migration out of the urban areas, multi-family homes have been experiencing vacancies and/or reduced rents to stay competitive. How do you incorporate the impact of potential credit quality change on such loans on the overall portfolio risk? Should you then start thinking of shifting the current CRE strategy to other CRE types and/or other regions?

Given the fast change in the industry, portfolio managers need to consider:

- With the fast changing economic environment, do you have a way to look at the risk at the enterprise portfolio level?
- Which industries or loans are inherently riskier due to the industry changes post the pandemic in the portfolio?
- Which industries or loans have been contributing the most to the overall portfolio risk due to changes in credit quality and correlations with other industries and economies?
- How should you conduct a fast what-if analysis to see a larger volume of residential loans in a new region to take advantage of the population migration?
- How should you assess the impact of reallocating resources from one industry to another or one CRE type to another to manage the overall portfolio risk while maintaining or increasing the profitability?

[1] https://www.freddiemac.com/fmac-resources/research/pdf/202105-note-rural_home_purchases.pdf

A further major post-pandemic financial risk stems from the loosening of lending standards and government support with an expiration. Much lending during the pandemic was channeled towards the worst-hit sectors and borrowers. Some borrowers are likely to struggle to repay the debts that they took on to survive the pandemic with new challenges of the market volatilities due to supply chain issues, skyrocketing oil price, rising inflation, fear of a recession, etc.

## 2. Volatility in the Market

One of the significant impact of the pandemic was on the overall supply chain, from manufacturing to transporting to distributing. Any issue along the supply chain would snowball and cause a chain reaction of adverse outcomes including the shortage of goods, price increase or inflation, downstream impact on reduced revenue due to the lack of supplies to sell, etc. Additionally, highest interest rate increase of 0.75% since 1994 to combat the inflation and high oil price are fueling a growing anticipation of a recession for the US market. However, financial institutions are still expected to grow by their investors and stakeholders. Prior to and during the pandemic, the name of the game is finding profitability through a large volume of transactions due to the low interest rate environment. Now the game has changed: with the high interest rate but a high uncertainty in the market, how should we carefully re-evaluate the lending strategy? What are the vulnerabilities in the portfolio and which segment is the least risky in the current environment? How sensitive is the overall portfolio risk due to any potential credit quality decrease or further negative economic outlook?

With the volatility in the market, portfolio managers need to consider:

- What are the potential correlated credit downgrades or defaults in the portfolio across or within the same sectors?
- What is the highest name or sector concentration with a high sensitivity to economic conditions?
- What are the segments to watch and the segments to grow?
- Should you consider the current risk limits given the volatility in the market and higher interest rate?

## 3. New normal for risk management: climate risk

The year of 2021 was a significant milestone for ESG and climate risk. ESG and climate risk assessment have been around for decades, but we started to see regulators getting more involved through literature and reporting requirements in recent years. Climate and ESG disclosures were voluntary initiatives mostly for large institutions to live up to the societal and investor expectations. More institutions of all sizes are exploring ways to incorporate climate risk into the overall risk management. Climate risk is quantifiable and can have significant impact on financial impact including credit risk. With more regulations and reporting requirements anticipated from the financial regulators, portfolio managers may need to consider how to implement a regulation-driven scenario analysis to quantify the financial impact on the portfolio and also how to incorporate climate risk into the overall portfolio risk management framework.

Climate risk is considered in two ways: physical risk and transition risk. Physical risk may have a more material bearing on companies and assets that have higher physical presence like manufacturing companies with factories, real estate, construction, etc. Under severe climate changes, such companies and loans may experience a negative financial impact. Transition risk may affect companies that are more dependent on fossil fuels with a higher carbon tax and a mandate to pivot their business to more clean energy based. Transition risk could also have material impact on the company's credit quality. It is also important to note that real estate industry is believed to be responsible for over 30% of the overall carbon emissions. Hence, the transition risk will also play a significant role on the financial assessment of the real estate industry and properties.

Consequently, the question for portfolio managers is how to integrate these factors into the overall portfolio risk assessment and risk appetite. Portfolio managers need to consider:

» How to incorporate climate risk into the overall credit risk assessment through default probabilities or risk ratings?

» Will climate risk change the dynamics of correlated credit migration and defaults?

» Which industry will be more affected by climate risk and have a higher risk contribution to the portfolio under climate scenarios?

## The need for an integrated view and framework

We have discussed what financial and non-financial challenges that institutions are confronting in the US. The scope of risk management is growing beyond financial risks, and also intuitions themselves are growing fast through organic growth as well as acquisitions. Especially in a volatile world with growing risk factors and uncertainties, risk managers and senior managers may need a tool that can incorporate various asset classes to provide a view of credit risk at the enterprise level with ways to incorporate economic views. They will also need some level of forward looking view of potential sources of risk of the portfolio to have a more comprehensive strategic growth plan and risk based limits.

For credit portfolio managers, this means gaining the ability to identify, measure, and manage emerging risks such as climate risk alongside credit risk, market risk, interest rate risk in the banking book and operational risk.

Financial institutions played a vital role in helping companies through the crisis. Now, coming out of it, they must attend to their own good health. They will need to draw on credit portfolio management's unique expertise to show the path to profitability while managing all of these risks on a forward looking basis. To do so portfolio managers will need access to scalable and flexible tools with embedded credit models and data sources to assess and apply various financial and economic scenarios and obtain quick and actionable insights into risks in all their dimensions.



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