

Getting the Most Out of Portfolio Reporting

by John Barrickman and Gary D. Stein

Improved reporting can help bankers monitor and manage their portfolios more effectively. Steps to getting the most out of portfolio reporting include knowledge of 1) weaknesses with traditional portfolio reporting; 2) required types of portfolio reports and report content; 3) reporting frequency; and 4) keys to formatting and presenting portfolio reports. These four areas are discussed in this article.

Shareholders, regulators, and industry analysts are increasingly demanding clear, comprehensive, and timely reporting to be able to gauge risks at individual financial institutions accurately. Internally, bank managers and directors need to be educated sufficiently on how to interpret risk management reports for new lines of businesses and identify potential issues. While banks tend to generate a great deal of loan portfolio *data*, they often stumble at organizing, analyzing, and presenting portfolio *information*—that

is, findings, implications, explanation, and recommendations to provide insight and guide decision making.

Importantly, the implications of these shortcomings extend beyond credit quality. Proper perspective and understanding is required to ensure banks are compensated fairly for the risks they take. Furthermore, banks that monitor and understand portfolio risk well are better informed to create competitive advantage, respond to market opportunities, and enhance profitability.

Weaknesses with Traditional Portfolio Reporting

At least four fundamental weaknesses limit the effectiveness of traditional portfolio reporting: a focus on outcomes, a failure to adapt, point-in-time visibility, and using numbers without analysis.

1. Focus on outcomes and not causes. While they are important, summaries of portfolio credit quality that identify delinquencies, nonperforming and nonaccrual loans, criticized/classified assets, and losses reflect the results of lending decisions made

© 2005 by RMA. John Barrickman is President of New Horizons Financial Group, a firm specializing in training and risk management consulting. Gary D. Stein is a partner with Capital Performance Group, LLC, a financial services consulting firm headquartered in Washington, DC.

three, four, or even five years ago. Current credit quality measures shed little, if any, light on what to expect in the future, and are even weaker future quality predictors for banks that have embarked on changes in strategic direction, experienced a change in management or ownership, or entered new markets or lines of business.

2. Failure to adapt. Banks often develop good tracking and reporting systems but fail to augment these capabilities as their lending businesses evolve. This oversight is particularly troublesome as the more advanced forms of lending require unique and often more complex monitoring. For example, banks engaged in leasing should track residuals. Syndicated lenders need to understand the size of their exposure relative to the overall deal and that of other lenders. Residential construction lenders should assess concentrations by property price point and subdivision as well as by market and borrower (i.e., builder). Banks that apply the same reporting processes and structure to all lines of business cannot possibly recognize all relevant risks in their portfolios.

3. Point-in-time visibility. Traditional portfolio reports often provide present day measures only, with no comparable benchmarks. This limited focus lacks perspective and can lead to “surprises” in portfolio performance. Banks instead should report historical trends and variances with their model portfolios to highlight shifts in credit quality and portfolio composition and potential

changes in the source or magnitude of assumed risk.

4. Numbers without analysis. Banks often report a lot of data but very little information. Most traditional portfolio reports do not include interpretation of results and recommendations for action. Readers of the reports—including executive management and the board of directors—frequently do not have the training to understand raw output in isolation. The failure to provide recommendations can result in a delay or lack of focus in addressing problems and issues.

These weaknesses can mislead management and the Board about the risks in the portfolio and the potential for volatility in portfolio credit quality and earnings. Banks should structure their monitoring and reporting practices and capabilities to help them anticipate these issues, determine the potential impact to portfolio credit performance, and provide guidance for problem avoidance and resolution.

Types of Reports

Banks should produce at least five fundamental types of portfolio reports to manage the performance of most lending businesses effectively:

1. Portfolio composition.
2. Portfolio risk.
3. Portfolio profitability.
4. Portfolio credit quality.
5. Loan officer assessments.

More complex lines of business, such as land development and construction and income property lending, present additional, unique risks and require a sixth set of specialized reports.

1. Portfolio composition.

First and foremost, for assessing portfolio composition, banks should report stratifications of the total portfolio by both relationship size and loan size (see Table 1). In addition, banks should produce similar stratification reports for each major line of business. These reports quantify the number of loans/relationships and total balances outstanding within each size

Table 1

Bank XYZ
Portfolio Stratification of Accounts by Line of Business: 3-31-05

Face Amount	Bank		Commercial		Residential		Consumer	
	#	\$	#	\$	#	\$	#	\$
\$0 - \$50M	86.5%	24.7%	52.0%	5.5%	58.4%	22.7%	97.2%	82.9%
\$51 - \$100M	6.6%	10.9%	16.4%	6.2%	25.0%	28.8%	2.2%	9.9%
\$101 - \$250M	4.2%	15.0%	16.1%	13.6%	13.8%	32.4%	0.5%	4.9%
\$251 - \$500M	1.4%	10.7%	7.3%	13.5%	2.2%	11.4%	0.1%	0.3%
\$501 - \$1000M	0.7%	10.5%	4.4%	15.8%	0.5%	4.0%	0.0%	0.1%
\$1001 - \$5000M	0.5%	21.6%	3.5%	34.7%	0.1%	0.7%	0.0%	0.0%
\$5001M+	0.1%	6.6%	0.3%	10.7%	0.01%	0.04%	0.0%	0.0%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

The tables in this article are meant to be illustrations to help explain concepts in the article and are excerpts from actual bank reports. In some cases, history and other details have been omitted to ensure key points are clear.

Getting the Most Out of Portfolio Reporting

stratum. This information is critical to ensuring efficient credit analysis and portfolio monitoring.

Banks should consider smaller credits—those below the level at which management would consid-

er a 100% loss material (the bank's "threshold for pain")—as candidates for streamlined underwriting and exception-only monitoring.

Other portfolio composition reports should, at a minimum, mirror the parameters of the bank's model portfolio and detail concentrations by line of business as well as by industry, property type, and agriculture type (see Table 2). Additionally, banks should monitor borrower and aggregate borrower concentrations and report these findings with borrower asset quality ratings and NAICS codes (see Table 3). Furthermore, to help forecast potentially dangerous concentration risks, banks also should report composition by collateral code, and within the consumer and mortgage portfolios, by employer—especially if one industry or a small group of employers dominates the bank's market.

Banks that engage in construction lending also should report portfolio outstandings by:

- Builder/developer and related entities.
- Property price point.
- Market, submarket, and often, subdivision.
- Speculation vs. contract development.

In addition, banks specializing in income property lending need to track and report portfolio composition by market, property type, and property grade. Importantly, income property borrowers often establish separate management companies for each individual property, and as a result, borrower concentration rollups for this business should be

Table 2: Bank XYZ's "threshold for pain"—determined through management interviews—is \$250,000. The bank has an opportunity to employ differential (streamlined) analysis to credits in the commercial portfolio below this threshold (i.e., 84.5% of accounts and 25.3% of balances outstanding) without significantly increasing the potential for volatility in portfolio credit quality and earnings.

Industry	Current Outstandings (\$000)	% Total Commercial Portfolio	Internal Industry Rating ¹	% Criticized/Classified
Lessors of nonresidential buildings ²	461,292	11.8%	3	10.0%
Lessors of residential buildings ³	375,711	9.6%	2	7.5%
Crop farming	209,750	5.4%	2	16.4%
Hotel and motel	131,171	3.4%	3	55.4%
Other RE rental and leasing	120,507	3.1%	2	2.1%
Special trade contractors	117,333	3.0%	3	22.8%
Durable goods	115,818	3.0%	2	18.7%

1 1 = Low Risk, 3 = High Risk
 2 Exceeds policy guideline as a % of capital: 46% vs. 35%
 3 Exceeds policy guideline as a % of capital: 56% vs. 25%

The bank is emphasizing lending to higher risk industries and has ignored its own credit policy. This bank also has large exposures to weak borrowers (see Table 3). This combination will result in significant volatility in portfolio credit quality.

AQR	20 Largest Borrowers		% of Total Portfolio	% of Total Portfolio AQR Stratum	% of Bank Tier I Capital
	Balances Outstanding (\$000)	% of 20 Largest Total			
1—Prime	6,675	3.33%	0.20%	57.01%	0.98%
2—Strong	20,242	10.10%	0.61%	10.14%	2.97%
3—Average	45,610	22.76%	1.38%	4.47%	6.68%
4—Strong monitor	0	0.00%	0.00%	0.00%	0.00%
5—Monitor	52,299	26.10%	1.58%	4.88%	7.66%
6—Weak monitor	10,324	5.15%	0.31%	3.89%	1.51%
7—Special mention	21,749	10.85%	0.66%	10.65%	3.19%
8—Problem	43,496	21.71%	1.31%	23.44%	21.71%
9—Doubtful	NA	NA	NA	NA	NA
Total	200,395	100.00%	6.05%	6.05%	29.37%

Getting the Most Out of Portfolio Reporting

Table 4: Many of the loans to these borrowers were originated when the borrowers were risk-rated “monitor” (AQR 5) and “weak monitor” (AQR 6). The potential for default for a 6-rated borrower is 7 times higher than the potential for default for a “strong monitor” (AQR 4) borrower.

expanded to include all related guarantor and borrower entities.

Bank XYZ Commercial Loans and Leases Distribution of Asset Quality Ratings: 3-31-05								
AQR(Current/Prior to 12-30-04)	12-31-02		12-31-03		12-31-04		3-31-05	
	\$000	%	\$000	%	\$000	%	\$000	%
0—Investment grade / N/A					0	0.00%	10	0.00%
1—Prime / minimal	160,132	4.49%	107,719	3.06%	12,320	0.37%	11,708	0.35%
2—Strong / moderate	753,699	21.15%	566,618	16.09%	168,267	5.02%	199,632	6.03%
3—Average / average	920,203	25.83%	883,246	25.09%	1,120,029	33.39%	1,020,944	30.84%
4—Strong monitor / monitor	1,110,501	31.17%	1,307,580	37.14%	228,206	6.80%	257,517	7.78%
5—Monitor / N/A					1,115,405	33.25%	1,070,677	32.34%
6—Weak monitor / watch	317,168	8.90%	246,651	7.01%	191,563	5.71%	265,652	8.02%
7—Special mention / N/A					211,601	6.31%	204,280	6.19%
8—Problem / problem	298,605	8.38%	407,395	11.59%	215,944	6.44%	185,586	5.60%
9—Doubtful / N/A					90,149	2.69%	94,121	2.84%
No score / no score	2,853	0.08%	797	0.02%	585	0.02%	202	0.01%
Total Outstandings	3,563,161	100.00%	3,520,546	100.00%	3,354,479	100.00%	3,310,829	100.00%

Table 5: The bank is not being fairly compensated for risk, especially in the C&I portfolio. The chart also demonstrates the perils of relying on spread rather than risk-adjusted return on capital (RAROC) to measure whether the bank is being fairly compensated for risk.

Bank XYZ Commercial Loans and Leases Risk-adjusted Spread and RAROC by AQR and Line of Business: 3-31-05								
AQR—Risk Grade Description	C & I		Commercial RE		Commercial RE Construction		Residential RE Construction	
	Spread	RAROC	Spread	RAROC	Spread	RAROC	Spread	RAROC
1—Prime	1.92%	20.81%	1.86%	21.56%	NA	NA	3.04%	22.69%
2—Strong	1.52%	16.42%	2.69%	26.57%	2.98%	33.00%	3.15%	32.52%
3—Average	1.71%	19.11%	1.66%	20.15%	1.98%	22.25%	4.08%	31.81%
4—Strong monitor	1.81%	17.49%	1.89%	18.50%	2.40%	19.94%	2.50%	21.38%
5—Monitor	2.38%	16.33%	2.40%	20.45%	2.51%	20.29%	3.87%	24.71%
6—Weak monitor	2.52%	15.57%	2.58%	21.20%	2.78%	21.73%	3.86%	27.85%
7—Special mention	2.52%	15.95%	2.33%	18.81%	2.75%	19.61%	3.98%	28.28%
8—Problem	2.17%	10.26%	2.09%	16.39%	2.76%	16.81%	4.31%	27.56%
9—Doubtful	2.38%	10.59%	2.50%	18.46%	2.72%	13.75%	3.32%	20.99%
Total	2.29%	15.48%	2.40%	20.05%	2.58%	19.78%	3.75%	25.06%

2. Portfolio risk. The second group of reports should focus on the credit risk in the portfolio. The key measure of credit risk is the distribution of asset quality ratings for the portfolio and by line of business (see

Table 4). To be effective, the asset quality-rating framework should have sufficient granularity to differentiate adequately among performing borrowers and allow migration analysis among the pass categories. Specifically, banks with portfolios of \$100 million or more should define at least five pass categories plus the regulatory classifications.

The bank should assign risk ratings to individual borrowers and borrower transactions to reflect potential for default and loss given default. The bank also should assess and assign risk grades to industries, property classifications, and types of agricul-

ture (refer back to Table 2). This practice will enable the bank to track and report the distribution of the portfolio by risk grade and assess concentration in high-risk portfolio segments (e.g., industries). The bank's reporting also should focus on covariance, such as loans to high-risk borrowers in high-risk industries, property types, or agricultural businesses.

3. Portfolio profitability.

While portfolio profitability is an important performance objective in its own right, understanding profitability is also critical for risk management. Banks should measure portfolio profitability by asset quality rating to ensure they are sufficiently compensated for the

risks they assume (see Table 5). Profitability analysis also helps managers to determine model portfolio allocations.

Portfolio profitability is simply the aggregation of the profitability of all component relationships. Relationship profitability is best measured by the risk-adjusted return on allocated capital (RAROC). In addition to AQR profitability reporting, and as with composition reporting, banks should tally RAROC summaries by the parameters defined in their model portfolios (line of business, industry/property/agriculture type, and largest borrowers). In addition, to assess productivity and determine what parts of the bank drive overall contribution, banks

should report portfolio profitability by officer and branch/division.

4. Portfolio credit quality.

While the future perspective gained by looking at concentrations is enlightening, banks can ill afford to abandon traditional credit quality monitoring and reporting. Banking institutions should publish credit quality reports at the composite portfolio level as well as by line of business. Reports should include

transaction counts, balances outstanding, and total associated relationship exposure for:

- Delinquencies.
- Criticized/classified assets.
- Nonperforming loans.
- Nonaccrual loans.
- Losses.

Banks also need to track and report policy exceptions and variances from procedures, as significant exception activity suggests the bank may have undertaken an unacceptable level of risk, and ultimately, a need for process corrections or possible modifications to the loan policy (see Table 6). Report details should include transaction/relationship counts and balances. Additionally, reports should differentiate and age types of exceptions or variances; i.e., policy, underwriting, or documentation/collateral. Reports should subtotal by line of business, branch/division, and officer. To enable remedial action, banks should be sure to record when exceptions have been resolved.

5. Loan officer assessment.

As indicated above, banks should monitor individual lender portfolio risk and profitability to manage officer performance, and ideally, drive incentive plan compensation. This level of detail, of course, requires banks to be able to assign relationships to individual officers. Because of the complexity of many customer organizations—multiple names, TINs, and addresses—and their multi-product relationships, the assignment exercise typically is manual and done by the officers themselves. Importantly, relationship assignments should be maintained

Bank XYZ Consumer Lending New Production Policy Exceptions (% of \$): 3-31-05			
	Jan 05	Feb 05	Mar 05
New consumer production with policy exceptions	33.5%	36.5%	40.0%
Loan-to-value (LTV)	81.2%	78.9%	76.2%
Debt-to-income (DTI)	8.4%	8.0%	12.7%
LTV/DTI	7.9%	7.0%	5.2%
Payment-to-income (PTI)	1.0%	4.0%	4.2%
DTI/PTI	1.1%	1.0%	1.7%
LTV/DTI	N/A	0.2%	0.0%
Other	0.4%	1.0%	0.0%
Total	100.0%	100.0%	100.0%

The large number of exceptions—especially in LTV, DTI, and PTI—suggest the bank is being aggressive in its underwriting. Management should question whether this practice fits the institution's tolerance for risk and priorities (i.e., asset quality vs. earnings and growth). Management should also consider adjusting the bank's policy if the exceptions more accurately reflect the bank's current approach to underwriting.

Table 7	
Construction and Land Development	Income Property Management
<ul style="list-style-type: none"> Physical and economic occupancy by price point and market (commercial). Sales by price point and market (residential). Aging by price point and market. Permitted construction. Under construction (speculation versus contract). Absorption. Asking versus actual prices/rents. Average sales time. Market data by market and price point. 	<ul style="list-style-type: none"> Physical and economic occupancy. Market data by submarket, property type, and grade: <ul style="list-style-type: none"> Physical and economic occupancy. Permitted construction. Under construction. Absorption. Asking versus actual prices/rents.

regularly to ensure accurate reporting. Loan officer report detail should include total measures of portfolio size (number of relationships and balances outstanding) plus each officer's weighted-average portfolio AQR and RAROC.

6. Specialized reports. Real estate development and income property management business lending require additional specialized reports to assess portfolio risk adequately. The necessary portfolio composition reports associated with these businesses are described above. In addition, banks also should monitor the items shown in Table 7.

Reporting Frequency

Banks need to generate and review portfolio reports regularly to be able to recognize potential issues in a timely manner and make proactive portfolio management decisions. Portfolio profitability and credit quality reports should be run monthly, as they

provide the most insight regarding current performance. Banks also should run specialized line of business reports on a monthly basis due to the variable nature of these businesses and the lead time required for banks to adjust to changes in market conditions. Portfolio risk and loan officer assessment reports should be administered quarterly, while portfolio composition reports can be run semiannually.

Format of Reports

The key to effective use of reports is being able to detect trends and manage proactively the portfolio to avoid adverse performance. Report packages should include at least five years of historical performance plus the current and prior reporting periods. Monthly and quarterly reports should contain annual comparisons with periodic breakdowns of the most recent rolling year. In addition, current portfolio measures should be compared to the model portfolio and to standards

for portfolio performance.

Importantly, reports need to communicate information and not simply convey data. Thus, any variances should be analyzed carefully and explained fully in the reports. The reports also should contain specific recommendations to address issues identified in the analysis.

All recipients of reports should be trained to interpret the reports and understand the limitations of the report information sources as well as the purpose of each report. Users should be questioned periodically to confirm the information is used, identify omissions, and get feedback regarding reporting frequency and formats.

Conclusion

Good reporting is fundamental to assessing portfolio risk and guiding proactive portfolio management. However, while most banks engage in some form of reporting, many fail to provide adequate insight and direction. To be effective, portfolio reports should be comprehensive to help anticipate potential issues; provide timely, benchmarked measures of composition, credit quality and profitability; and be user-friendly by including analysis and recommendations rather than pure data. □

Contact John Barrickman by e-mail at jbarrickman@newhorizonsfinancial.com; contact Gary Stein at gstein@capitalperform.com.