

Complacency creep in lending: The subtle erosion of credit discipline in community banking

Since the Great Recession, marked by widespread losses and bank failures, most institutions have operated in a prolonged period of relative stability. While risk management practices have improved, many professionals lack firsthand experience with sustained credit stress, leading to an underestimation of how quickly conditions can deteriorate.

That environment is beginning to change. Early indicators in 2026 show rising delinquencies and increasing levels of non-performing loans, alongside weakening reserve coverage, particularly among community banks. In the wake of the 2023 bank failures, regulators and investors are on high alert, with an increased focus on how quickly institutions identify and address risk. For community banks, disciplined credit administration is especially important as economic conditions change.

How Credit Deterioration Begins

Credit deterioration does not start with a single bad decision. It emerges through a series of small, rational decisions that, in isolation, appear justified. A marginal debt service coverage ratio is approved with explanation. Financial information is slightly outdated but considered acceptable. Policy exceptions are granted in support of a relationship or perceived borrower strength.

Individually, these decisions rarely raise concern. Collectively, they shape the portfolio. Performance appears stable, delinquencies remain manageable, and the portfolio continues to generate income. Nothing appears broken—until it is. By the time weakness is visible in reported metrics, the underlying risk has already been embedded.

This gradual buildup is what can be described as complacency creep.

What Is Complacency Creep?

Complacency creep is the slow erosion of credit discipline that occurs not when conditions are weak, but when they are strong. Policies remain in place, but their application becomes less consistent. The accumulation of underwriting exceptions, documentation gaps, and structural compromises introduces compounding risk.

Several forces contribute to this dynamic in community banks. Sustained portfolio performance can mask underlying weaknesses. Production expectations and competitive

Jason Price, Managing Director
Elliott Davis Advisory, LLC

pressures encourage flexibility. Operational strain reduces the consistency of monitoring and follow-through. Taken together, these factors gradually move behavior away from structured underwriting toward increased reliance on judgment and accommodation.

Complacency creep often goes unnoticed when performance looks strong, creating a false sense of security as discipline weakens.

Recognizing the Signals

The warning signs of complacency creep emerge in patterns, not isolated issues. Underwriting becomes less consistent, with similar credits receiving different levels of analysis. Cash flow discipline weakens, with increased tolerance for marginal coverage and greater reliance on guarantor support.

Monitoring practices begin to slip. Teams may rely on outdated financials, delayed reviews, and renewals based on prior analysis instead of current borrower performance. Risk identification also lags. Ratings remain stable despite early signs of stress, and performing loans are treated as healthy without deeper validation, allowing assumptions to go unchallenged and standards to drift.

By the time deterioration shows up in reports, it already exists in decisions.

Breaking the Complacency Cycle in Portfolio Management

Do:

- Recognize that strong portfolio performance can mask underlying weakness and growing risk.
- Reassess higher-risk segments, including credits with exceptions, weakening cash flow, or outdated financials.
- Base decisions on current conditions by validating repayment capacity with updated information and realistic assumptions.
- Use forward-looking risk ratings that emphasize cash flow, liquidity, and borrower or industry trends.
- Strengthen discipline and oversight through consistent standards, rigorous monitoring, and independent loan review.

Don't:

- Assume stability equals strength or that current risk reflects original underwriting.
- Rely on legacy underwriting without revisiting key assumptions.
- Treat steady payment performance as a proxy for credit quality.

Jason Price, Managing Director
Elliott Davis Advisory, LLC

- Let exceptions, outdated information, or inconsistent monitoring go unchallenged.
- Wait for clear deterioration in reports before taking action.

Aligning Borrowers with Risk Tolerance

Once the portfolio is reassessed and controls are reestablished, the next step is aligning borrowers with current risk tolerance. This process will surface credits that no longer meet underwriting standards. The objective is deliberate alignment with the institution's current risk tolerance, not immediate exit.

- Set clear expectations for financial reporting, performance, and structure through early, direct communication.
- Strengthen credits where possible by improving cash flow, enhancing collateral, and tightening structure.
- Establish a path forward when alignment is not achievable and act with intent.

Consistent execution restores discipline and supports a more resilient portfolio through changing credit cycles.

Final Thoughts

Complacency creep is not the result of a single failure, but the accumulation of many small, rational decisions that gradually weaken credit discipline. Left unchecked, these patterns become embedded in the portfolio long before they are visible in performance metrics.

Institutions that recognize complacency creep early, reassert underwriting discipline, and take a proactive approach to portfolio management are better equipped to navigate changing credit conditions. Those that don't risk discovering too late that what appeared stable was, in fact, steadily deteriorating.