Credit Risk in a K-Shaped Economy

What community banks need to know, and do, as economic divergence reshapes credit portfolios

A REPORT BY OPTIMAFI — JULY 2026

The credit risk landscape has already changed

The conditions that have kept credit quiet for over a decade are no longer holding. In a growing economy with unemployment below 4.5%, Family Dollar closed 350 stores in 2026, not because demand for discount retail disappeared, but because the consumers who depend on it have exhausted their financial cushion. Its parent company called the pressure structural. That distinction matters enormously for any bank with exposure to the lower half of the income distribution.

The K-shape is structural, not cyclical

Federal Reserve Bank of New York research published in May 2026 confirms a persistent, widening divergence between higher-income and lower-income households: since 2023, real net worth has grown by more than 25% for the top income percentile, while the middle 40% has seen less than 10% growth. Meanwhile, lower-income households have faced above-average inflation consistently since late 2022, directly restraining their spending and repayment capacity. The divergence isn't confined to consumer data; fixed-income analysts now describe a credit loss cycle taking hold across credit markets broadly.

Concentration risk is hidden in plain sight

A portfolio can look fine on average and still be in real trouble underneath it. The FDIC's most recent Quarterly Banking Profile acknowledged for the first time that community banks are showing more credit stress than the banking sector as a whole, alongside a first-quarter spike in non-performing loans and charge-offs that confirms the trend is no longer theoretical.

Complacency is the enemy

Fifteen years without a real downturn breeds rust, not discipline. Historically tight credit spreads right now reflect complacency more than strength, a diagnosis that applies just as well to community banks that haven't had to exercise a defensive muscle in over a decade.

Early detection is the only proven lever

Institutions that catch deterioration early have options: time to engage borrowers, build reserves, and adjust before a problem compounds. Institutions that wait lose all three. The pattern holds across every credit cycle on record: early action minimizes losses, and avoidance always makes the eventual cost larger, never smaller.

> "It's been my experience: early detection minimizes or reduces losses. But ignoring problems…they always get much, much bigger."

David Ruffin
OptimaFI

Credit card delinquency

↑ 40 bps year-over-year

Subprime auto delinquency

5.5%

Consumer Sentiment

53.3

What is the K-shaped economy, and why should bankers care?

Defining the divergence

The K-shaped economy describes the growing distance between the paycheck-to-paycheck consumer and the well-heeled one, and that distance reaches well beyond consumer lending. Most commercial borrowers depend on consumers as their customers, so stress at the bottom of the K eventually reaches every business that relies on discretionary spending, regardless of how that loan is classified on a bank's books.

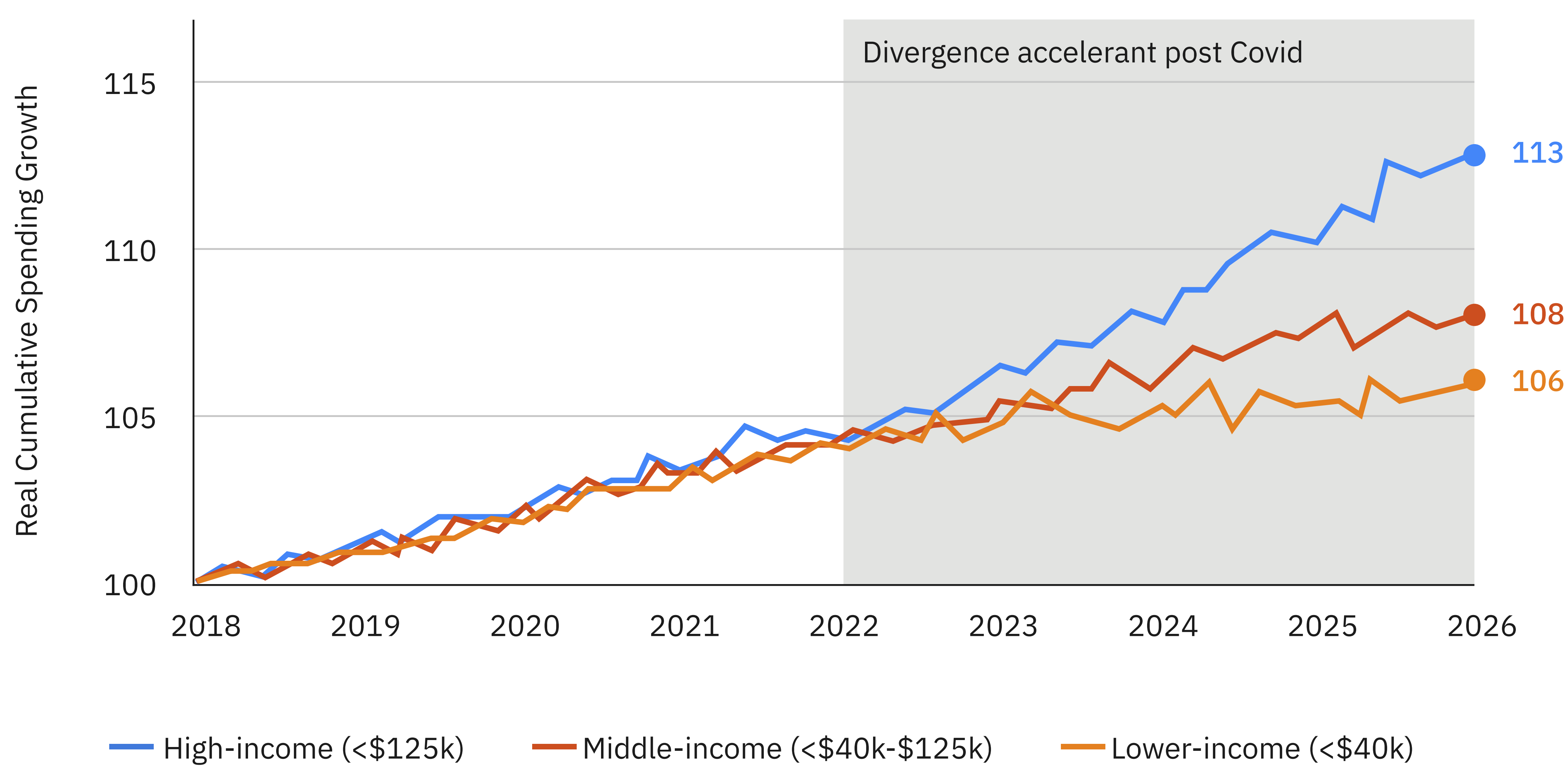
A community bank in Maryland, heavily dependent on tourism in its local market, illustrates the mechanism clearly: discretionary spending pressure is already building among the consumers who drive its borrowers' revenue, well before that pressure shows up in any loan performance metric.

Equity markets have continued setting records even as energy costs spike and inflation pressure builds, largely on the back of AI and technology enthusiasm. Meanwhile, the more mundane fundamentals of the economy, like manufacturing, durable goods, discretionary spending, are under mounting pressure. That split looks like a contradiction at first glance. Look again and it's the clearest evidence yet of the K-shape in action: two halves of the same economy, moving in opposite directions, both visible at once.

> “The aggregate masks the risk. Portfolio-level metrics can look stable while deterioration concentrates in specific segments.”
>
> **David Ruffin**
> OptimaFI

New York Fed research published in May 2026 confirms a persistent, widening gap in inflation exposure and wealth accumulation between income tiers. Bank of America Institute's February 2026 commentary extends the point: the divergence is now reaching middle-income consumers, a group that had largely been insulated until recently.

K-shaped economy



Sources: Federal Reserve Bank of New York Liberty Street Economics, May 2026; ProSight Financial Association, "2026 and the K-Shaped Economy," March 2026; Equifax April 2026 Market Pulse.Figures are directional representations of published trend data, not exact reported values.

What you're watching vs. what you should be

The right-hand column of this table rarely shows up on a standard call report or core system dashboard; those tools were built to produce portfolio-wide averages, not segment-level movement, which is exactly why the leading side takes deliberate effort to see.

Lagging	Leading
Call report delinquency rates	Internal payment velocity trends — are borrowers paying later each month, even before missing a payment? A 60–90 day head start on default.
Call report delinquency rates	Credit utilization acceleration — borrowers maxing revolving lines signals cash flow stress before any delinquency event appears on a report
Call report delinquency rates	Post-origination score migration — the score on the day a loan is booked tells you almost nothing about the score today.
Examiner risk ratings	Risk-grade migration — testing whether internal risk grades are quietly drifting weaker at the borrower level is one of the clearest signals available.
Call report delinquency rates	Risk-based, informed sampling — a $1 million loan rated a 5 should jump the review queue ahead of a $3 million loan rated a 2. Loan quality sets the order, not loan size

> "The reporting OptimaFI provides has raised the bar for what we expect when we track campaigns internally. I've told my business intelligence team I want everything tracked the way OptimaFI tracks it."
>
> **Adam Koishor**
> Chief Strategy Officer, Dort Financial Credit Union

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The credit cycle bankers aren't allowed to ignore

A cycle long in the tooth

The recovery from the Great Recession produced 14 to 15 years of benign credit. 2026 marks the first tangible uptick in stress across that entire stretch.

The industry saw a warning sign once already. Before the pandemic hit, the yield curve inverted; historically a reliable precursor of recession. Then COVID arrived, and an unprecedented wave of federal stimulus hit the streets; a band-aid over credit deterioration that might otherwise have surfaced earlier. The cycle didn't reverse course because of the stimulus. It got postponed, and an entire generation of bankers got used to conditions that were never going to hold.

The complacency trap

After fifteen years without real stress, banks get fat and happy. Plenty of analysts and credit staff working in banks today have never personally lived through a downturn. They don't know how to act in one, not because they're undertrained, but because they've never had to.

There's a second-order risk worth naming too. Once stress does appear after a long quiet period, the reaction tends to overshoot. Boards, investors, and regulators alike can swing toward panic, less because the problem is unprecedented, more because nobody currently in the room has personally lived through the last one.

The countercyclical reality

OptimaFI's credit risk advisory business is countercyclical: demand rises precisely when stress surfaces. Ruffin's proven axiom — early detection prevents larger losses — holds across every cycle he has witnessed. The banks that engage rigorous credit risk review before stress compounds have options. Those that wait discover losses are already baked in.

> "It just behooves the banks to live by your own wits. That's what a banker should be."

David Ruffin
OptimaFI

Regulators are expected to lean more heavily on call report data as a triggering mechanism going forward, when the public numbers show deterioration, that's when more intensive examination resumes.

Every cycle is different, but the blind spot never is

Direct historical parallels can be misleading. As the analogy goes: the generals are always fighting the last war. 2008 was a housing oversupply crisis. Today, in some markets, there's a housing shortage. Triggers never repeat exactly. Banking has moved through several distinct credit cycles over the past four decades, and each one has been shaped by conditions specific to its moment rather than a repeat of the one before it.

What repeats is the blind spot. Institutions, and the people inside them, who haven't personally lived through credit stress don't recognize it until it has already arrived.

The guardrails put in place after 2008 are real: higher capital requirements, and a genuine enterprise risk management discipline that didn't exist before Dodd-Frank.

> "We've been in the longest benign credit cycle in my career, and I've been around a long, long time — 53 years in this business. This is the first tangible uptick in credit stress that we've seen in these many years."

David Ruffin
OptimaFI

The cycle in context
2008–2026

2008

GFC Peak

Crisis-level stress; bank failures surge.

2010

Recovery begins

Dodd-Frank arrives. Higher capital requirements and the creation of enterprise risk management as a genuine discipline — a holistic view of the whole balance sheet, not just credit risk in isolation.

2015

Extended Calm

Crisis-level stress; bank failures surge.

2019-20

Pandemic + Aid

The yield curve inverts. The pandemic hits soon after, and an unprecedented wave of federal stimulus buries the signal under a wave of liquidity.

2022

Inflation/rates

Rate hikes land. The band-aid begins to peel.

2026

Now

The first real uptick in credit stress in 14 to 15 years. The FDIC says community banks are now under more stress than the industry at large. Consumer sentiment sits below the Great Recession trough.

WHERE RISK IS CONCENTRATING

How the k-shape creates specific credit risk for community banks

Industry risk is the single biggest driver in the current environment. Which industries depend on consumer spending, and which of those industries are most exposed right now; that's the specific question underneath the general anxiety.

Consumer lending

Credit stress is concentrating in non-prime households. TransUnion's Q1 2026 Credit Industry Insights Report shows super-prime consumers holding steady while strain rises at the bottom — and Equifax data confirms credit card delinquencies are up 40 basis points year-over-year, driven by lower-income consumers whose pandemic-era savings are fully depleted.

Commercial real estate

What's commonly described elsewhere as "extend and pretend" is more precisely a repricing problem. See the case study below for the accurate framing.

Self-governance

With the OCC down 40% in field examiners [VERIFY], institutions can no longer assume an external party will catch deterioration before it compounds. Responsibility has shifted to the institution.

THE CRE EXTEND-AND-PRETEND PROBLEM

When avoidance becomes the risk

The challenge

Most CRE loans carry a balloon call every three to five years despite amortizing over 20 or 25. When one matures into a higher-rate environment, re-underwriting at market rates can push debt service coverage into problem-loan territory. Many banks sidestep this by modifying instead — holding the rate flat, keeping the loan off the criticized list, and leaving money on the table. The accurate term for it: deflection.

The response

Best-practice loan review treats loans approaching balloon maturity as a priority sampling category, not a routine renewal. Risk-grade migration gets tested at the transactional level on a recurring basis, and debt service coverage gets stress-tested against today's rates, not the rate the loan was originally written at.

> “Nothing is more toxic to boards, regulators, or investors than too many credit surprises.”

David Ruffin
OptimaFI

Institutional Divergence: The Reserve Gap

The clearest evidence that some institutions are seeing this clearly and others aren't is sitting in current reserve data. A meaningful disparity exists between Northeast and Pacific Coast bank reserves under current CECL calculations, with reserve calls a reasonable expectation industry-wide if credit stress continues building.

What the aggregate is hiding

GDP growth reading as healthy.

Beneath it: spending strength is concentrated, not shared. ProSight Financial Association's 2026 analysis notes that the top 60% of income earners account for 75%–80% of consumer spending, meaning aggregate GDP growth masks deepening strain among lower-income households whose purchasing power is actively shrinking.

Unemployment below 4.5%.

Beneath it: a stable headline figure conceals a "no-hire, no-fire" static job market, particularly in transportation, manufacturing, and warehousing. The 18–29 cohort, which ProSight notes carries historically higher delinquency rates, faces rising underemployment and the most acute credit stress.

"Stable" portfolio metrics

Beneath it: the FDIC's own data tells a different story. For the first time, community banks are showing more stress than the broader banking sector. Pair that with the first-quarter spike in non-performing loans and charge-offs, and "stable" stops fitting.

Consumer sentiment at 53.3.

Beneath it: a figure that sits below the Great Recession trough of 55.3, and below even the 2022 inflation-driven low of 50, confirmed by the University of Michigan Consumer Sentiment Index and cited in Equifax's April 2026 Market Pulse analysis.

BEST-PRACTICE RISK MANAGEMENT ACTION AGENDA

What best-practice credit risk management look like

Six principles

01 Move beyond the aggregate

Industry concentration is the single largest risk driver in the current environment. Start there.

02 Use informed, not random, sampling

A $1 million loan rated a 5 should outrank a $3 million loan rated a 2 in the review queue. Loan quality sets the priority, loan size doesn't. Arbitrary size-based thresholds are one of the most common ways risk gets missed before it surfaces.

03 Tie stress tests to borrower action

A stress test that doesn't produce a named list of borrowers is an academic exercise. Treat the output as a queue, not a slide

04 Demand real-time transparency

Real-time exception visibility changes a bank's posture from reactive to proactive. Deterioration shouldn't be a quarterly surprise.

05 Preserve human judgment at the apex

The quantitative analysis, featuring ratios, financial statement calculations, is largely objective, and exactly where technology and AI add genuine efficiency. The judgment call that caps it — does this borrower deserve credit despite what the numbers say — stays experience-based. That's the part no model reliably replicates.

06 Act on weakening credits — now

Avoidance is not a risk management strategy. Early identification of problem credits is the single most proven lever for minimizing losses.

Action agenda · start here

Audit your K-exposure

Map your borrower base by industry, income segment, and credit tier to identify where K-shaped stress is concentrating in your portfolio.

Review your sampling strategy

Prioritize loans by risk grade, not loan size. A $1 million loan rated a 5 jumps the queue ahead of a $3 million loan rated a 2.

Connect stress tests to loan review

Every stress test output should produce a named list of borrowers for priority review, not a portfolio-level sensitivity number.

Elevate internal analytics

Track risk-grade migration at the borrower level on a recurring basis, not just at renewal or exam time

Engage trusted third-party expertise

Credible external loan review, stress testing, and portfolio analytics are core risk management investments, not optional add-ons.

Set an honest risk appetite

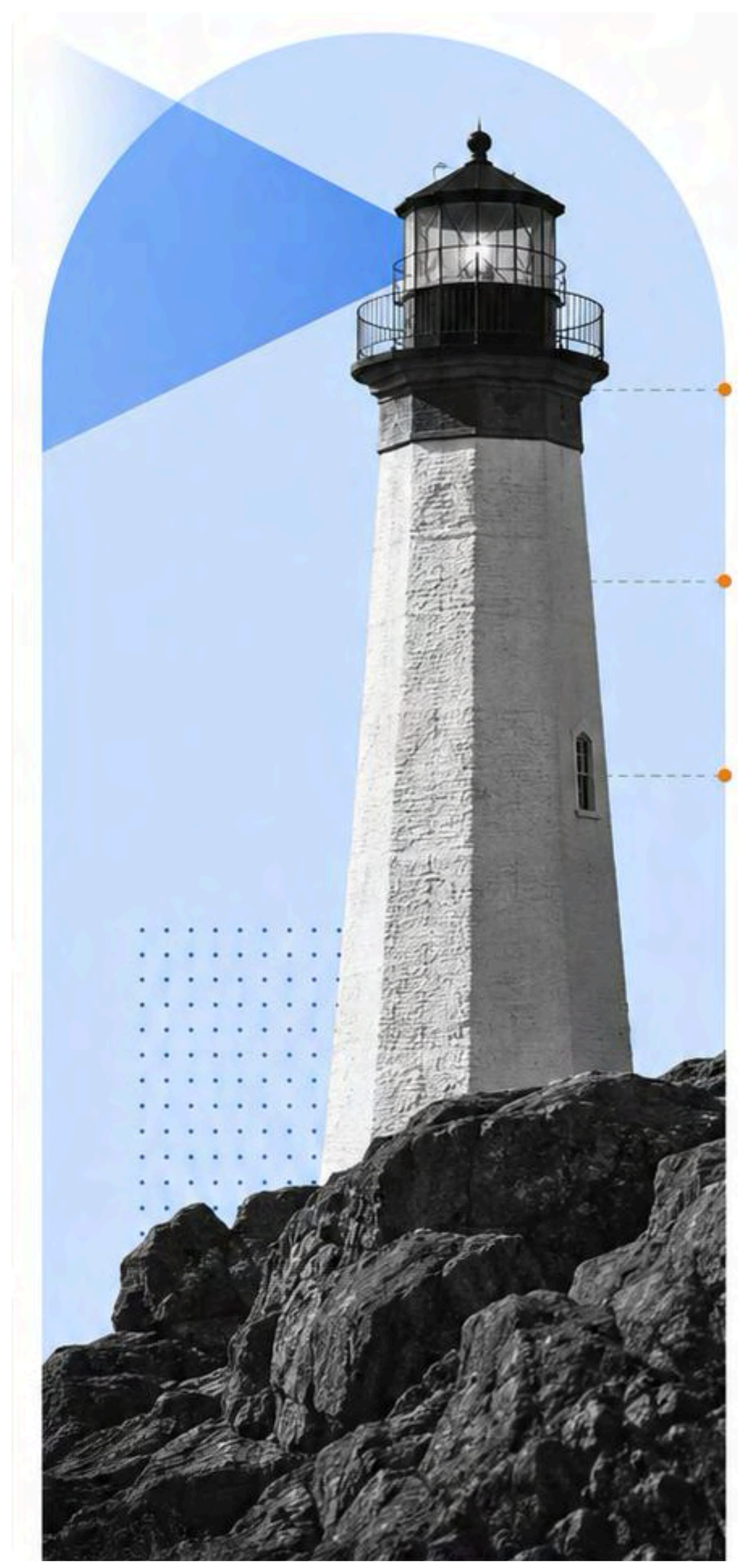
Match loan types to your actual underwriting and servicing capability, and document it clearly at the board level.

Surface stress early

Establish internal triggers that require credit committee review before a loan reaches delinquency, not after.

Early warning signals to watch

- Payment timing drift — paying later every month, before ever missing one. A 60–90 day head start on knowing.
- Revolving debt acceleration — maxed-out lines signal stress before any delinquency report does.
- CRE repricing wall — map every maturity by quarter. Know which loans are walking into a balloon call before they get there.
- Risk-grade migration — the most trusted signal in loan review. Pass grades quietly weakening at the transactional level, caught through real loan review.
- Local unemployment uptick — even a modest local layoff concentrates fast in the non-prime borrowers most community banks actually carry.
- Exception clearance slowdown — exceptions that sit too long are a governance problem before they're ever a credit problem.



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BOARD GOVERNANCE TOOL · DESIGNED TO BE SHARED WITH DIRECTORS

Questions your board should be asking about credit risk right now

In a K-shaped economy with lighter regulatory oversight, board-level credit governance has never mattered more. Use these questions to prompt honest dialogue between directors and management.

01 **What percentage of our loan portfolio is exposed to borrowers in the lower arm of the K-shaped economy, and how is that segment performing relative to 12 months ago?**

02 **Are we managing CRE loans approaching balloon maturity at current market rates, or modifying them at original terms to keep them off the criticized list? If the latter, why, and what's the real risk we're carrying?**

03 **Are we watching internal risk-grade migration, or are we still gauging credit health by the call report, that is, data that's already months behind reality?**

04 **When did we last run loan-level stress testing that produced a specific list of borrowers for review, not just a portfolio-wide sensitivity number?**

05 **With reduced regulatory examination frequency expected, how are we ensuring internal credit discipline matches or exceeds prior regulatory standards?**

06 **Do we understand that we are at the end of the longest benign credit cycle in modern banking, and are we acting like it?**

07 **Do we have outside expertise in place that can tell us the truth about our portfolio, independent of internal relationships and internal blind spots?**

> "Tell us — being intellectually honest about where credit is going. The last thing we want is too many credit surprises."
>
> **David Ruffin**
> OptimaFI

What does your portfolio look like beneath the surface?

The analytical infrastructure to answer that question exists now. Most institutions are waiting for an exam cycle to find out. The ones that aren't are already ahead.

Portfolio review

Loan-level sampling that surfaces risk before it reaches the call report.

Loan-level stress testing

Scenario outputs tied to specific borrowers

Portfolio analytics

Real-time migration tracking that sees what standard dashboards can't.

Request a Portfolio Conversation →

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