

Independent Loan Review

An Essential Tool



CEIS REVIEW INC.



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“Loan review is a mainstay of internal control of the loan portfolio. Periodic objective reviews of credit risk levels and risk management processes are essential to effective portfolio management.”¹

INTRODUCTION: A CLOSER LOOK AT YOUR LOAN PORTFOLIO

It's always better to uncover problems sooner rather than later. A perfect example could be one's own daily car: an annoying noise that you are unable to identify could be nothing at all, but it also could be a sign of something worse to come. Without investigating the source of the noise, you are opening yourself up to potentially being stranded on the side of the road. Just as a good mechanic can regularly service and assess the health of your car, a qualified Loan Review program can do the same for your financial institution's loan portfolio.

The Loan Review function serves many purposes, but the fundamental purpose of the program is to monitor the risk and administration of an institution's largest financial asset—the loan portfolio—and to make sure that the loan portfolio is staying on course with the direction set forth by senior management and the board. Loan Review is a powerful quality control instrument to be utilized by active bank management to monitor both new lending activity and the quality of an established loan portfolio.

¹ OCC Comptroller's Handbook, Loan Portfolio Management, April 1998



FOUR COMPELLING PURPOSES OF A COMMERCIAL LOAN REVIEW

Before we go into further detail about the importance of a Loan Review program, it may be helpful to understand the four overarching purposes of a Loan Review:



HOW A LOAN REVIEW PROGRAM EMPOWERS BANK MANAGEMENT

By having a sound and objective Loan Review program in place, an institution is in a far better position to proactively manage their respective portfolios in regards to risk and overall direction. An example of this would be if management observed more new loans being booked within a specific segment, or with looser credit standards. With the knowledge gained from a Loan Review program, management would be empowered to adjust the course of ongoing lending and management ahead of any potential losses. Or, at the least, management would now have the option to reinforce a reserve cushion if the risk was migrating in a strategically acceptable direction.



VITAL INFORMATION FOR MANAGEMENT AND THE BOARD

The primary purpose of a Loan Review program is to objectively monitor and evaluate the quality and administration of a loan portfolio for senior management and the board of directors. This evaluation provides management with actionable insights regarding:

- Present and emerging risk trends within specific portfolio segments or portfolio-wide
- Portfolio-wide exception levels that can be drilled down to specific segments & lenders if needed
- A truly objective assessment of overall portfolio asset quality

In addition to delivering these valuable portfolio metrics, a Loan Review program helps management and the board to drill down on areas such as:

- Review the quality of credit underwriting
- Review the accuracy of the risk ratings assigned by lenders
- Identify any problem loans/relationships within the portfolio
- Identify borrower-level loan policy exceptions
- Evaluate loan portfolio quality by segment
- Evaluate the effectiveness of the credit administration function
- Ensure compliance with banking laws and regulations
- Benchmark an institution's portfolio against similar institutions' portfolios to enable insight on portfolio performance

LOAN REVIEW PROGRAM DETAILS

The Loan Review function is a tool that monitors the quality of the respective institution's loan portfolio as it relates to internal lending policies and the effectiveness of the credit administration function. This is a powerful resource for senior management and the board to utilize. After all, the loan portfolio is typically the asset that presents the greatest potential risk for loss exposure to banks, especially community-based lending institutions.

In addition, the board of directors and senior management of each financial institution has the legal responsibility to approve appropriate lending policies and then to supervise their ongoing implementation. In the not not-so-distant past, we have observed bank directors, as well as management, held financially—and occasionally criminally—responsible for an institution's failure. In this respect, the Loan Review again acts as a safeguard for the board and senior management. Although smaller institutions are not expected to maintain separate loan review departments, it is essential that an effective Loan Review program is in place at all regulated financial institutions for the reasons previously mentioned.



OBJECTIVE INFORMATION

A truly objective Loan Review program will provide vital information to senior management and the board regarding overall credit quality, trends in the various portfolio segments, adequacy of the ALLL, identification of loans with well-defined weaknesses, and adherence to and/or deviations from established loan policies and procedures. This information is critical for financial and regulatory reporting purposes. The Loan Review function should be structured to remain autonomous from the origination and management of the portfolio, and should report either to a designated committee or directly to the board.

This continuous evaluation of the quality of the bank's loan portfolio must be specifically outlined within the bank's lending and collection policies, as approved by the board.

THE EVER-EVOLVING LENDING POLICY

A lending policy should not be a static document, but rather one that is reviewed periodically and revised accordingly to reflect changing conditions within the community served, as well as any strategic initiatives the institution undertakes. While the loan review policy is separate from the lending policy, it should be incorporated as a section within the lending or credit policy manual.

The document should contain descriptions of the following specifics:

- A written description of the overall credit grading process
- The frequency and scope of reviews
- The qualifications of the Loan Review personnel
- A clear separation between the Loan Review department and Lending department

Generally speaking, the Loan Review policy should provide for reviews of all the new loans at a certain dollar threshold that have been made since the previous review. Additionally, the loan review policy will provide a sampling of the entire portfolio that results in an appropriate coverage percentage. That percentage of coverage differs from region to region, but no less than a meaningful sampling should occur if gaining a conclusive indication of the portfolios health and risk direction is to be achieved.



LOAN REVIEW OBJECTIVES

Any loan review's function, whether it is internal or conducted via an independent Loan Review service such as CEIS, should be designed to address the following objectives:

- Promptly identify loans with well-defined weaknesses so that timely action can be taken to minimize the bank's credit loss
- Provide essential information to assess the adequacy of the bank's ALLL
- Assess the adequacy of and adherence to the bank's loan policy and procedures and that the loan portfolio is in compliance with Federal and State regulations
- Provide management and the board of directors with an objective assessment of the overall portfolio quality
- Identify relevant trends that might affect the collectability of the loan portfolio and isolate potential problems
- Provide management and the board accurate and objective information related to credit quality that can be used for financial reporting and regulatory purposes
- Identify weaknesses in loan documentation and credit file reporting and provide appropriate corrective recommendations
- Monitor collateral on secured loans for adequacy thereon (based on the guidelines set forth within the bank's credit policy) and for perfected collateral liens
- Ensure that appraisals on troubled real estate and other secured loans are maintained on a timely basis
- Review all troubled problem loan reports for appropriateness of the plan of action, risk rating designation and loan loss reserve allocation



INGREDIENTS FOR A SUCCESSFUL LOAN REVIEW PROGRAM

A Loan Review program should include all of the aforementioned essential elements. These can then be formulated into a comprehensive report on the business practices and resulting credit quality of the respective institution. Across the U.S., many community and regional banks are not sufficient in size to maintain a separate and distinct Loan Review department, and choose to outsource this function.

When Loan Reviews are outsourced, an institution should ensure that they are conducted by experienced professionals who have senior- or executive-level banking experience, as opposed to junior-level individuals who may not recognize potential issues before they arise. Loan Review programs should always be customized to an institution's needs and should prescribe a portfolio coverage percentage to be achieved. Typically, CEIS sees this as being 60-75% of the average outstanding loans over a twelve-month period.

Sections of the portfolio which should be included in the review should be the criticized/classified and/or watched portfolio segment, and then a substantial sampling of "Pass"-rated credits in order of potential risk and exposure—to meet the coverage requirements designated. Further "drill-down" is included at CEIS' recommendation or at the institution's request.

PROCESS

When engaging with an outside Loan Review provider, there should always be open communication between the onsite review team and the lending staff. This way, any material findings may be discussed while the team is present. This can be especially helpful where there may be a material difference with respect to a final risk rating grade determination. Additionally, a meeting with the appropriate management at the end of the on-site review should be available so that observations regarding the lending and administrative process can be presented. This meeting can also be used to present any differences on open items, as well as observations regarding the lending and administrative process.

Subsequently, a written "draft report" should follow. This is not only for management's review, but also to afford them the opportunity to submit any recent developments that have occurred since the end of the review that might impact final risk rating assignments.

Whether the Loan Review is completed by an internal or external department, that department should be able to produce professional and decisive reports management can utilize to better guide their respective institutions. In order to do so, the reports should elaborate on the overall portfolio's quality, trends, administrative process, and policy adherence.



CALCULATION OF ALLOWANCES OF LOANS AND LEASE LOSSES

Additionally, the Loan Review function should pay particular attention to the organization's method of calculation of the Allowance for Loans and Lease Losses. This goes to the heart of senior management's understanding of the entire portfolio, to include an effective action plan for troubled loans and the establishment of a reporting mechanism for "watch assets" and non-accrual loans.

Depending on the size of the financial institution and the profile of its loan portfolio, an independent confirmation or validation of the ALLL process by an experienced professional firm is beneficial to senior management and the board and benefits accountant firms and regulators as well.

AUDITORS

It's important to note here that accountant auditors and Federal and State auditors will always request a copy of the most recent independent Loan Review Report in their respective initial request for information. There is great reliance on these independent reports, because they are not generated by management and represent a completely objective analysis of the quality of the bank's loan portfolio. This is important to note because a bank's loan portfolio is the single most vulnerable asset that can be affected by economic recessions or changes in local environments.

This Loan Review Report is necessary and essential to the ongoing safety and soundness of the financial institution in question. Regulators mandate that a written response from management with the outline of a corrective action plan should be provided to address any substantive criticisms or recommendations.

ESTABLISHMENT OF CREDIBILITY

In summation, a Loan Review audit by an independent professional firm experienced in the business is not just another internal management tool but is a necessity for the establishment of credibility to those external entities that review and supervise the respective organizations.

Financial institutions that strive for ratings of "satisfactory" or better should not be restricted in their individual business models or platforms used on an ongoing basis to serve their local communities.



ABOUT CEIS REVIEW, INC.

CEIS Review was established in 1989 for the specific purpose of providing professional services to banks and other financial institutions. CEIS Review services include:

- Loan review
- Validation of loan loss reserve methodology
- Methodology refinement or development
- Portfolio stress testing
- Portfolio acquisition review
- Credit risk management process review
- Loan policy maintenance
- Loan and credit workshops and seminars
- Specialty reviews

The CEIS client base currently includes national and global bank holding companies, commercial banks, agencies, branches, credit unions, specialty finance organizations and savings banks.

To learn more, visit www.ceisreview.com or email justinh@ceisreview.com.