Loan Review Best Practices: Key to Combatting Credit Risk in Stressful Times

Uncertainty seems to be the only constant on the economic horizon these days.

Despite benign risk metrics across the country's credit portfolios, there is an almost industry-wide sentiment that credit stress looms ahead. According to the Risk Management Association (RMA) Annual Community Bank Survey, 84% of community bankers indicated that credit risk was a top concern.

One thing we do know is that effective and efficient loan reviews can help you understand your portfolio and identify potential risk exposures. And — more importantly — risk that's already emerging. It's this early detection that helps institutions minimize losses. Also encouraging is that automated technology is making it possible to achieve these goals with amazing agility.

Now is the time for community banks to move from a sluggish, decades-old loan review process to an approach that will help you proactively identify potential credit weaknesses, gain deep knowledge about the subsegments of your portfolio, learn where the vulnerabilities exist, and act to mitigate risk at the earliest opportunity.

It's time to consider credit review approaches that facilitate an expansive range of best practices like the ones outlined below.

1. Trust your reviews to professionals with deep credit experience — not just junior CPAs.
Your reviewers should be seasoned experts skilled in the *qualitative* and *quantitative* axioms of credit, with hands-on experience in lending and risk management. Because their experience will drive better reviews and deliverables, it's a good idea to ask for bios of people assigned to your institution.

2. Confirm your review includes paralegal professionals to conduct separate documentation reviews.
With growing evidence of degradation in back-shop support, it is essential that your loan reviews include specialists with technical expertise in regulatory/legal compliance, lending policy adherence, policies, collateral conveyances, servicing rules, etc. — working in tandem with seasoned credit professionals.

3. Insist on smart, informed sampling.
Relying solely on random samples and reviewing only the largest credits is insufficient today. To uncover vulnerabilities in specific segments of your portfolio, rely on a selection process that helps you choose very informed samples indicating possible emerging risk.

4. Segregate and differentiate exceptions in documentation, credits and policy.
These exception types all have diverse characteristics, and they need to be quantified separately in order to correct the various deviations effectively.

5. Quantify both pre- and cleared exceptions.
In the best of times, many loan reviews show almost no bottom-line degradation in loan quality for the portfolio as a whole. But on close examination, you may find significant numbers of technical and credit exceptions indicating that the quality of your lending process itself may need to be tweaked.

6. Understand your own bank's DNA.

In this complex economic environment, it is imperative for institutions to analyze their own idiosyncratic loan data. Arm your loan review team with the ability to automatically drill down into your portfolio and easily examine trends and borrower types — to inform risk gradings, assess industry and concentration risk, etc. Seasoned reviewers will be incredibly valuable in this area.

7. Observe pricing based on risk grades, collateral valuations and loan vintages.
Common risk characteristics are shared by loans originating around the same time and credits that tend to migrate as a group. Isolating and analyzing those can answer the important question, "Are you being paid for the risk you're taking?"

8. Pair loan reviews with companion stress testing.
Lately, regulators are encouraging stress tests as a way to learn where risk may be embedded. Companioning the tests with loan reviews is a productive way to gain this knowledge. Start at the portfolio level and do loan-level tests where indicated.

9. Transparently report and clear exceptions in real time.
Benefit from using fintech efficiency to remove huge amounts of time, team meetings and staff intrusions from the traditional approach to reviewing loans. Using an online loan review solution, teams can see exception activities and clearances as they happen.

10. Ensure that reviewers interpret risk grade parameters according to your institution's definitions.
Measures used to qualify credits in the "pass" risk-grade category are specific to your institution. Reviewers should use only this touchstone to interpret pass grade requirements for any credit — without interjecting personal biases.

11. Comply with workout plan requirements prescribed by interagency regulators.
Workout plans are typically designed to rehabilitate a troubled credit or to maximize the repayment collected. Regulators now require institutions to examine these plans independently as a standard loan review procedure that reflects a healthy degree of objectivity.

12. Deliver comprehensive management reports and appropriate high-level board reports with public/peer data.
Management should receive prompt and thorough loan review reports and board members should be provided high-level reports with appropriate, but less detailed, information. Public data or analyses of your institution's performance as compared to peers should accompany reporting.

13. Conduct loan reviews as a highly collaborative and consultative exercise — counter to "just another audit."
An effective loan review is not an internal audit experience. It's an advisory process, and this approach is extremely important to its ultimate success. Substantive dialogue among participants with differences of opinion is key to favorable outcomes for the institution.

14. Take advantage of a technology platform to automate every possible aspect of the loan review process.
Best practices call for the efficiency that comes with automating the loan review process to the maximum extent possible, without sacrificing substance or quality. Today technology drives the race against loan risk, making early detection of vulnerabilities faster, easier and more complete.

In Summary

Loan reviews that adhere to industry best practices are critical to an institution's risk-management strategy and should be regarded as such. It's a one-two punch: (1) deeply qualified reviewers and (2) automated technology that, when combined, deliver a more efficient, less intrusive loan review process that will help combat the looming credit stress ahead.

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