SLICING UP LOAN REVIEWS

by Steve Brown

A high-quality commercial slicer can cut 50 pieces of meat per minute. In similar fashion, it has become more and more common in banking to hire a 3rd party to come in and slice up the loan portfolio. Whether it is an interest in gaining an objective assessment of the risks of the portfolio, volatility in the market, competition, collecting comprehensive data, or simply improving risk management; independent loan reviews can be very beneficial. Such reviews not only help monitor credit exposures, but also provide bankers another way to identify credit process strengths and weaknesses.

A good independent loan review has many components, but some of the most crucial include the following:

1) Risk Assessment. Reviews should take a close look at portfolio mix, grade trends, delinquencies, policy exceptions and missing or outdated borrower information. These components can provide early warning signals to management.

2) Large Exposures. It is typical for loan reviewers to examine documentation on the largest outstanding or committed exposures (often the top 25% of credits are examined). Borrower linkages between credits, exceptions to policy, missing or incomplete credit data and stale/outdated information are all common areas of review. Highlighting exposures not only based on outstanding principal amount, but also by sector(s) under stress (i.e. construction, development, etc.) can give management additional time to correct deficiencies prior to the next regulatory examination.

3) Risk Ratings. One thing we recommend community bankers consider is having the 3rd party loan review team also take a hard look at risk ratings. Are the ratings granular enough, do they include enough criteria (i.e. DSCR, leverage, liquidity, etc.) to support ratings classifications or are loans "bunched" among 1 or 2 categories? Getting an outside perspective and increasing ratings categories over time to about 20 will enhance monitoring and credit granularity.

4) Risk Management. To better quantify the ALLL, bankers should also have loan reviewers take a hard look at estimated default probabilities along the risk spectrum. Loans should be classified by risk rating and then by delinquency, type and subtype. Making sure this information is accurately captured in the systems is important to managing overall portfolio risk.

5) Problem Loans. Review teams should closely examine problem credits to make sure an action plan has been created and that it is workable. Information in the file should be tested to be sure it is up to date and accurate, and the plan should be examined to ensure it will likely achieve desired results. Reviewers should also highlight loans they believe may soon become problem credits.

6) Cash Flow. Loan reviewers should recalculate the cash flow underlying major loan exposures to spot any inconsistencies. Loan department turnover, new systems and other issues can lead to mistakes, so this step is critical. Remember also that cash flow is not static and borrower ability to repay changes continually. Reviewers should recalculate cash flow and debt service capacity to ensure it has been accurately captured and reported to management and the board.

7) Quality Review. Loan reviewers should take a close look at the quality of appraisals, property inspections, monitoring programs, financial statement accuracy, loan officer comments, management changes and other factors. It is critical for loan files to be as accurate and thorough as possible and for key data to also be captured on the core system.

8) Concentrations. We don't have to tell bankers that concentrations in CRE will bring additional regulatory scrutiny. Loan reviewers should take a hard look at concentrations to ensure the bank has appropriate policies, procedures, board/management oversight, portfolio management, information systems, market analysis, underwriting standards, stress testing and sensitivity analysis.

Periodically bringing in an independent 3rd party to review the loan portfolio is a good idea, no matter how you slice it.

Related Links:
Basel Committee Liquidity Risk Position Paper

BANK NEWS

Wealth Value

UBS said they will sell a 30% stake in their wealth management division. Banks with private banking arms will pay close attention, as this gives a good valuation point. Oddly, UBS's stock traded up after the announcement indicating investors don't see much value in the division.

Liquidity Risk

The Basel Committee released their position paper on liquidity risk, which serves as an overview of regulatory developments in light of recent events. In particular, the report highlights the need for increased stress testing, disclosures and contingency planning. To get the report click on the 'Basel Committee Liquidity Risk Position Paper' link below.

Consumer Debt

A recent poll by Bankrate found 61% of Americans are carrying some credit card debt.