AuditOne LLC

Internal Audit Expertise For Financial Institutions™

AuditOne Advisory

From Bud Genovese, Chariman

AuditOne's President Jeremy D. Taylor has written below important information about how we've improved and strengthened our Credit Review services. Since this subject is especially critical today, please take a moment to forward this email to the people in your bank who are responsible for credit review.

Thank you. --Bud

Credit Review: New Focus, New Format

In the current environment, Credit Review is getting even more attention than usual – from senior management, from Boards, from examiners. There's broad recognition of the role it can play in reinforcing the discipline of sound credit policies, procedures and practices.

Credit Review typically revolves around the risk-grading exercise: selecting a sample of loans to review for the appropriateness of the assigned grade. Sampling traditionally focuses on two areas: 1) adversely-graded (e.g., classified, criticized, some watch-list) loans, to verify due monitoring; and 2) newly-originated loans, to verify correct assignment of risk grade at the initial underwriting. We feel it's important that the sample also include a third area of the portfolio: existing pass-graded loans, to ensure timely downgrades in response to deterioration in credit quality. But at AuditOne, we've recently overhauled our Credit Review structure to go well beyond this.

In particular, it's critical to recognize that if a bank misses the odd credit here or there, losses will result, never pleasant, but assuming they're isolated and independent, the bank will go on. However, what can literally "bring down the bank" is portfolio effects – in particular, correlated credit exposure where a common loss factor (like the oil price, for many Texas banks in the 1980's) can wreak losses across a portfolio or significant portions of it.

We have revamped our Credit Review to include not just the requirements of the December, 2006 Interagency Guidance on the Management of Commercial Real Estate (CRE) Concentrations (for those banks whose CRE exposure exceeds thresholds stipulated in the Guidance) but also other kinds of concentrations such as industry, geography, A/R. Single-name as well, particularly if house limits aren't set any lower than the Legal Lending Limits. The dangers of concentrations underline the importance of having limits, suitably disaggregated Board reporting, and other risk management practices along the lines of what the 2006 CRE Guidance statement lays out.

We've also recognized that while the number of recommended downgrades in the loan file review sample is important, as is the incidence of documentation and other deficiencies across the sample, that's certainly not all that the Board needs in order to understand portfolio credit quality. With this in mind, we've added a section that addresses loan portfolio trends and peer comparisons, based on a limited number of key variables like non-performing assets and charge-off rates, working from FDIC data. These are charted and interpreted according to: trend over recent quarters, latest-quarter slicing by loan type, and comparison with UBPR peers and/or a customized group of more local and similar institutions. With this information, we can highlight portfolio patterns, both favorable and otherwise, deserving of senior management and Board attention.

In addition, our new format is broad enough in its focus to take in: the structure and operation of the risk-grading system (including the extent and implications of risk grades being overly clustered in one bucket); the adequacy of the bank's credit policy and related documents vis-à-vis FFIEC requirements; Board governance and control considerations; and past exams, reviews and audits and the bank's remedial actions on any outstanding findings.

One final comment: The December, 2006 Interagency Guidance on the ALLL stipulated regular review of the ALLL methodology. Most banks perform this annually. This does not have to be conducted together with a Credit Review, but there are advantages to doing so. There are potential efficiencies from having auditors on site who can get up to speed on both fronts and use some of the same information. But also, under our new format, combining the two exercises allows the collection and analysis of portfolio data, as described above, to also take in the question of ALLL adequacy, which we have recently added as a standard, additional scope item in our ALLL Validations.

I hope this gives you an overview idea of the improvements we've made in our credit review process, and I would be happy to share with you a sample copy of our new Credit Review format to give you a better idea of how these changes have been implemented. Just send me (jeremy.taylor@audit-one.com) or Bud (bud.genovese@audit-one.com) an e-mail. Thank you.

Bud Genovese is founder and CEO of AuditOne LLC, a California-based internal audit firm that focuses only on banks and their service providers. Mr. Genovese pioneered the concept of providing comprehensive, affordable, independent internal audit services by gathering wide-ranging, extraordinary expertise within one firm. AuditOne now serves over 140 clients throughout the Western United States, and nationally. Contact Bud Genovese at 408-980-8099 or bud. genovese@audit-one.com