

AuditOne Advisory

From Bud Genovese, Chairman

As banks rebound from the housing loan crisis and prepare for commercial and real estate loan uncertainties, it is abundantly clear, especially to regulators, that attention must focus on credit risk. AuditOne President Jeremy D. Taylor recently wrote an article on that subject published in the July-August 2009 issue of *Western Independent Banker* magazine. In case you haven't yet seen it or wish to forward it to colleagues, here is that article.

Fine-Tuning Credit Risk

By Jeremy D. Taylor

In today's volatile economic and regulatory environment, it's critical that risk management be recalibrated, especially with regard to credit risk.

Here are ten practical fine-tuning steps any bank can take.

1. Review risk-grading policies, procedures and practices. Risk grades serve two critical functions: they should clearly differentiate loans by risk of loss, and they should be responsive to underlying changes in creditworthiness. A high concentration (say, more than 50%) of loan exposure in one risk grade bucket may indicate that the system is not functioning as it should. This threatens the integrity of the ALLL process, of loan pricing guidelines, and of various credit administration practices. Addressing this requires clear credit policy guidelines, and at least annual review of every loan (including term loans not subject to annual renewal) by a lending or credit officer, validated by a sample-based, independent credit review.

2. Conduct more frequent and rigorous credit reviews. This isn't a place to skimp. Most institutions currently conduct at least semi-annual credit reviews and have expanded sample sizes. Look for patterns – weak underwriting, ineffective monitoring – and for emerging trouble areas. Loan problems started in residential lending, have spread to CRE, and are now showing up in general C&I. Recognize that credit review should also consider portfolio effects such as loan concentrations. Use the enterprise risk assessment (ERA) process to adjust priorities. If credit calls for more attention (and audit spending is tight), then the ERA should reveal areas of internal audit that can be more safely trimmed this year or deferred till next.

3. Conduct adjunct loan documentation reviews. When a loan defaults is not the time to find out you've got collateral deficiencies. Are the boarding, documentation, monitoring and other loan operations processes subject to clearly-written procedures that are regularly reviewed and updated? Critical elements of the internal control environment such as segregation of duties, dual control, and review and reconciliation (with management sign-off) should be codified.

4. Put teeth into your covenants. Building covenant protection into loan agreements isn't much help without tight monitoring ... and forceful action when circumstances warrant. Late financial or other information from a client can be a useful early-warning signal (EWS). Ditto for a failed financial test. Yes, the client may still be current on their payments and returning your phone calls, but don't let the early-warning role of covenant protection be one of those things you only recognize in hindsight.

5. Ensure other loan policies and procedures are current and clear. OREO, for instance, isn't something banks have had to pay much attention to for a while. But as holdings have climbed, new regulatory guidance was recently released (FIL-62-2008). ALLL is another obvious example (i.e., the 2006 guidance statement). Make sure your policies are compliant and being followed. Subject the full credit policy document(s) to annual Board review and approval, and encourage Directors to do more than rubber-stamp.

6. Implement stress-testing, concentration limits and other portfolio-level tools. These are spelled out for CRE loans in the 2006 Interagency Guidance on CRE Concentration Management. But banks should be looking at them for other loan concentrations as well – e.g., major industries, geographies. The point is that you can miss a loan here or a loan there, but the real danger comes if you’ve got correlated credit exposure (i.e., portfolio concentrations) and a common loss factor at work, which can truly "bring down the bank."

7. Upgrade portfolio data and reporting. Make sure new loans (and to the extent possible, back-filling on existing loans) capture requisite client- and loan-level detail. Map out these requirements, especially for CRE loans. Make sure your MIS infrastructure can accommodate, manipulate and report the necessary summary information.

8. Refresh appraisals. Standard practice may no longer suffice in this environment. Consider more frequent updates than FIRREA requires, and perhaps second opinions or other safeguards. Setting lower acceptable LTVs (loan-to-value) is a natural corollary.

9. Train and mentor junior lenders. Many of a bank’s more junior lenders have never gone through a credit downturn, or at least one as severe as we face today. It’s critical that experienced lending officers take time to “teach the ropes,” including identifying EWS and appropriate responses. Supplement with outside training if necessary.

10. Keep the Board informed and involved. Good governance and control starts with the Board. Are they getting more than just the Problem Loan Reports? Trends in portfolio credit quality, comparisons with peers, emerging areas of stress, concentration management (including limit compliance), exceptions tracking – all these are critical components of Directors’ Loan Committee reporting (and in summary form to the full Board). But it shouldn’t be an indiscriminate dump of data. Prune, hone, explain. When it’s time to review policy documents, highlight what’s changed and why. Encourage substantive discussion, not just on individual credits but on the portfolio-level issues that determine credit appetite and strategy.

Jeremy D. Taylor is President of AuditOne LLC (www.audit-one.com), a California-based independent internal audit firm specializing in banks and their service providers throughout the United States. Jeremy has extensive banking experience spanning credit, lending, marketing, IRR/ALM and strategic planning, with a particular focus on risk management. He studied economics at Carleton University, the London School of Economics and UCLA, taught economics and finance courses at various US and Canadian universities, and is currently on the faculty of the Merage School of Business at UC Irvine. He served as an executive responsible for risk management at a large California business bank, holds Certified Bank Auditor and Chartered Financial Analyst designations, and has published numerous articles in banking journals. Jeremy can be reached in AuditOne’s Southern California office at 562-802-3581 or at jeremy.taylor@audit-one.com.

AuditOne would be honored to discuss in greater depth steps you and your bank can take to fine-tune and document your credit risk procedures. Please contact me or AuditOne CEO Kevin Watson (kevin.watson@audit-one.com) or AuditOne President Jeremy Taylor (jeremy.taylor@audit-one.com). Thank you.--Bud

*Bud Genovese is Chairman 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 and credit review services by gathering wide-ranging, extraordinary expertise within one firm. AuditOne now serves over 160 clients throughout the Western United States, and **nationally**. Contact Bud Genovese at 408-980-8099 or bud.genovese@audit-one.com*