AuditOne LLC

Internal Audit Expertise For Financial Institutions™

AuditOne Advisory

From Bud Genovese, Chairman

In case you may have missed it, below is a recent column on **managing your loan portfolio** written by AuditOne President Jeremy D. Taylor. It appeared in the January 2011 issue of WIB's *Lending & Credit Digest*. Please feel free to forward it to the appropriate loan and credit review people in your bank. And remember, when you need true expertise for internal audit and credit review, contact AuditOne. Thank you. –Bud

Western Independent Bankers | Lending & Credit Digest

A Community Bank Credit Professional Advisor | Issue #12 - January 2011

Staying on Top of Your Loan Portfolio

By Jeremy Taylor, AuditOne LLC

When you already have too many balls in the air, why throw in more? Some tasks look like work for its own sake, so it's reasonable to question their priority. Annual reviews of termed-out facilities may look like that. The money's already out there, there's no contractual annual renewal, and if the borrower is making all the payments when they're supposed to, then what's the point? Save the time, save the paper.

But in our experience of performing scores of credit reviews every year for a wide variety of banks – from stellar on down – this topic stands out as a differentiator. Strong performers are typically those having a formal requirement for annual reviews of all credits (above a certain dollar threshold) and a disciplined approach to managing it. Before looking at the key elements, let's consider why it's worth the bother.

1. *Early intervention:* Loan agreements normally – and should – have various covenant requirements that provide the bank with some leverage to both recognize and address situations of deteriorating credit quality. If a financial covenant (such as a debt service coverage test) is being breached, then the bank has options available to it – up to and including calling the loan. It can demand additional collateral, for example, and/or a penalty interest rate. If the review of a loan reveals a downward trend but short of a covenant violation, that's still valuable information. Discuss with the borrower, step up your monitoring, and consider your options. Negotiation is easier when backs aren't against walls. Options may even include loan sale – again, easier to contemplate if the loan is still performing as agreed. Recognize, too, the risk of being the last bank standing in the game of musical chairs that sometimes plays out in multi-lender situations; when there are limited liquid assets available, the first bank to ask for pay-down may be the (only?) one to get it.

   All this is in turn predicated on an important set of non-financial covenants: the requirement that the borrower submit regular (at least annual) financials, tax returns, rent rolls and other such information. Get the borrower to sign and date them first. We often hear laments about the difficulty of getting this information from recalcitrant borrowers once the initial underwriting and funding is past. But it's so important to recognize the correlation between the borrowers ignoring your requests and the borrowers more likely to pose repayment problems down the road. We have some suggestions below for beefing up this process internally. The key point here: Be disciplined about getting the information, about analyzing it, and about acting on it. The purpose of covenants is to give you a window – and a lifeline when needed.

2. *Loss reserving:* The adequacy – indeed, the integrity – of your ALLL process hinges critically on a disciplined approach to risk grading. If there's migration (down or up) going on in your portfolio, it should be reflected in increases or decreases in your reserve amount. We're not just talking here about downgrades from a Pass to a Criticized or Classified grade. Movement within Pass grades is also relevant – directly so if your SFAS 5 reserve factors are set by risk grade, but even otherwise, you need to know which way your portfolio (and especially your larger credits) are drifting. Migration analysis is valuable, again across all risk grades.
3. *Feedback to new loan originations:* Annual reviews will highlight emerging weaknesses in types of loans or borrowers that should be reflected in the structuring and pricing of new such loans.

We've used the word "disciplined" to describe the approach needed. Here are a few suggestions for key components:

- A Credit Policy requirement for annual review of all credits above $x within y days of the review date.
- But don't overdo it: A standardized one-page form should suffice, to address key financial information and trends, covenant compliance, any concerns. For CRE, indicate property status (e.g., condition, lease-up). Confirm annual site visit (with photos). And then the key pieces: confirmation (or adjustment) of risk grade, and sign-off by the preparer and a reviewer.
- Tickler system – for upcoming reviews, as well as for receipt of required borrower information and for reporting on other covenant compliance.
- To get borrower information: Persistence and escalation. Document your requests. Back it up with default rate of interest provisions in loan agreements, and be prepared to act on them.

We'll finish with a fourth reason for going through all of this: keeping examiners (and credit reviewers) happy. Not that we suggest you manage your bank to this objective, but the fact is that an effective program of annual reviews is the kind of credit administration practice that will have just that effect. And if circumstances justify the downgrading of a loan, you'd rather uncover that internally than having external reviewers or, worse still, examiners find it for you.

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