



Assessing the Effectiveness of Your Credit Review's Risk Grading System

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A risk-based approach to planning and executing credit review makes good sense in the best of times...and even more so when times get tough. It focuses scarce audit resources on where attention is most needed, thereby building value and credibility and, with it, management and board support.

The standard approach to credit review typically drills in on two areas: classified and criticized loans (or some other definition of weakness); and a sampling of new, generally larger, loans booked since the preceding review. The primary goal is to assess the effectiveness of the risk grading system.

A risk grading system should do two things: a) meaningfully and consistently differentiate between the riskiness of different borrowers; and b) react quickly to changes in a borrower's risk profile. The traditional focus of credit review on problem credits and new loans only goes part of the way to assessing these attributes, as addressed in #1 below. Furthermore, risk grade (RG) review and validation, while certainly important, should not be the entire story, as addressed in #2 below.

1. Examining new loans allows for assessment of the RG assignment at inception: Is all the required information marshaled, thoroughly analyzed and correctly interpreted in accordance with internal credit policy? Examining classified/criticized loans, meanwhile, will determine whether downgrades are timely and appropriate, so as to encourage the effective monitoring and managing of weakened credits. While both these parts of the loan portfolio are worthy of scrutiny, it overlooks the mass of credits in between – i.e., the pass-graded loans that have been on the books for a while.

The integrity of the risk grading system and the institution's credit management process hinges on problems being identified early on so that any required follow-up steps can be taken. Assessing this sensitivity to underlying credit quality changes requires sampling not just from newly-booked loans but from the pre-existing book as well.

This conclusion is reinforced by: the observed stickiness of many institution's RGs; by seasoning effects (i.e., fault lines in a loan or borrower typically won't become discernible till beyond the first 6-12 months); by the tendency to cluster (e.g., often more than 50% of graded loans are in a single RG bucket); and by the fact that credit policies may well have changed (tightened?) over time. At the point in the credit cycle where we now find ourselves, the case for including a sample of previously-booked loans is that much stronger. You know there should be downgrades, but do you know you're going to see them all...and in a timely and consistent fashion?

2. The revolution in credit risk management over the past 10-15 years has centered on a portfolio-level approach that applies the basic tools of Modern Portfolio Theory (MPT) to managing a loan portfolio. It recognizes the fact that it's correlated credit losses (i.e., systematic risk factors, in MPT parlance) that can pose the gravest threat – not the default of individual borrowers due to company-specific risk factors like bad management decisions, product failure, etc. Monitoring and catching those one-off problems certainly matters, but for profitability rather than solvency.

Correlated credit risk can mean broader losses across a portfolio due to a common factor or factors. They arise from loan concentrations, along various possible dimensions. Commercial real estate is now getting consideration, thanks to a) its current cyclical vulnerability, and b)

the December, 2006 Interagency Guidance Statement on this matter. But other concentrations should not be ignored: vulnerabilities by major industry focus, for example, or by major geographic markets and sub-markets, or by customer industry such as a large outsourcer or retail buyer.

Look at the institution's exposure to cyclically-sensitive industries like housing, autos, capital goods – those with high betas, going back to MPT terminology. Look at the institution's house limits: do they encourage a sufficiently granular portfolio? Consider a tool like migration analysis; downgrades within pass grades may not seem worrisome today, except that those are the loans more likely to produce future downgrades. Likewise, stress-testing: Is it being done, not just on an individual borrower's ability to sustain debt-servicing under adverse conditions but across the whole portfolio? For the latter, the tools are different and less easy to use. But again, while a single default won't be disastrous, if whatever caused that default might also cause others, then you've got the makings of a real problem.

It bears emphasizing that portfolio analysis builds on the assumption of an effectively functioning risk grading system. Reviewing individual loans helps establish the system's bona fides; assuming the RGs are reliable, the next step is to use them to figure out what they're saying about your portfolio and its embedded risks.

A consideration of risk drivers is a critical input to the design of an effective and efficient credit review program. By broadening scope to sample ratings migration across the *whole* portfolio and by incorporating tools to evaluate portfolio-level risk characteristics, an institution will better position itself to recognize and respond to adverse changes – before they become trends.

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