



Getting Loan Risk Grading Right

By Jeremy D. Taylor

Risk grading of commercial loans lies at the heart of banking, yet bank examiners are increasingly concerned that many banks have well beyond 75% of their loans sitting in just one risk grade bucket.

Whether you sit on the Directors Loan Committee, one of the bank's other subcommittees, or serve as a general bank director, understanding how loans should be properly graded is essential to fulfilling your fiduciary responsibilities.

Banks are in business to take on risk – and in particular, credit risk. The competitive advantage of banks, and of strong banks over weaker ones, lies most importantly in their ability to analyze, underwrite and monitor credit risk.

Economic capital models, which attempt to quantify the range of risks facing an institution on a common, capital-at-risk foundation, often find two-thirds of the risk facing a typical bank to be credit-based (the remaining one-third is split between operational risks and interest rate and liquidity risks). Yes, bank failures can result from poor liquidity management or from fraud, systems failures or other operational mismanagement, but particularly at this point in the credit cycle, lending-related difficulties are a far more common culprit.

How do banks measure their credit risk in order to monitor and manage it? The risk grade (RG) system plays – or should play – a critical role, especially for the business loans that dominate most community bank portfolios.

The RG should clearly differentiate between borrowers according to their risk of default. And it should respond quickly and effectively to underlying changes in creditworthiness. Both of these considerations make the typical concentration of RGs a concern. When a very high proportion of pass-graded loans sit in one RG bucket, then clearly the RG system is neither differentiating between borrowers in terms of their risk profile nor responding to underlying changes in borrowers' riskiness.

There's a worrisome inertia that can all too easily produce the nightmare scenario of examiners coming in and forcing large-scale downgrades that slash earnings when the ALLL must be built up accordingly. And it's not just the immediate hit to the bottom-line. It's also the hits to management's credibility with regulators and to Credit Administration or Special Assets groups suddenly faced with an unrecognized and unexpected flood of problem loans.

Getting the RG right is critical to many aspects of the bank's lending business, including:

- the initial credit assessment and approval process;
- the pricing of the loan;
- the attention each loan requires;
- the cross-sell/up-sell efforts warranted;
- the adequacy of loss reserves on the (non-impaired, SFAS 5) general reserve; and
- the amount of capital to be held against worst-case credit losses.

So what's a bank to do to enhance its loan risk identification? It helps to start by recognizing where large and mid-sized banks have already gone, and where small banks can expect to eventually be nudged: segregation of borrower risk (probability of default) from facility risk (loss given default).

Larger banks now grade loans at the borrower level and add a separate rating for facility risk to reflect, most importantly, collateral held and its typical recovery rates. Even if such a transition may currently be too ambitious for your institution, it's never too early to start thinking more systematically about this distinction and to better understand the loss drivers.

What other steps can (more readily) be taken?

Give your lenders and underwriters more concrete guidance. Consider moving away from a purely subjective system to a template approach using quantitative benchmarks (e.g., ranges for key financial ratios) for each RG, with each loan type or borrower industry getting its own template. Or consider a scorecard approach where objective characteristics (e.g., financial measures) are combined with subjective characteristics (e.g., firm's competitive position, management's strength) in a predetermined manner.

Make the RG system more granular. Adding more grades facilitates and encourages the exercise of downgrading step-by-step as a borrower's condition deteriorates – rather than waiting until problems get serious.

Perform independent credit review more frequently. Especially in this credit environment, it should be at least semi-annual, and loan file sample sizes and compositions should be scrutinized closely. It's better than examiners finding the downgrades.

Don't just rely on credit review. Require that lenders or credit administrators review every loan (above some dollar threshold) at least annually to confirm or revise its RG. Have a standard, one-page form that verifies a) receipt of required, updated financial or other information from client; b) all covenants in compliance; c) collateral, insurance and other supporting documentation held and updated as required; d) project status, building rent-up, physical condition, for real estate loans; and e) validity of the RG.

Get all this right and your credit underwriting and monitoring will have a solid foundation. Your examiners may even get bored.

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http://www.wib.org/publications_resources/article_library/2007-08/nov09_loan_grading.html
