

Limiting Losses When Bad Things Happen

By Jeremy D. Taylor, AuditOne LLC

Over the past two to three quarters, we've noticed disquieting signs of the kind of credit conditions last seen in the early 1990s – and of the sharp regulatory response they produced. Many banks are already seeing charge-offs eat into reserves, at the same time as regulators are pressing for increased reserves. In better times, having ALLL sitting at 1-1/4% of gross loans was enough to ward off criticism for most banks, but now it's NPA (non-performing asset) coverage that's the more relevant metric. In this environment, reviewing your ALLL methodology (for compliance with the December, 2006 interagency guidance) clearly is critical...though not by itself sufficient.

No matter how well constructed your loss reserving, it doesn't mean much if your risk grading system isn't doing a good job of discriminating between borrowers with different risk profiles (and loss potential), or of responding quickly to underlying changes in borrower creditworthiness. When there's bad news on a client, is your lending staff reacting to it? A sound credit review program is an important check on the integrity of your risk grade system. While certain internal audits may be considered for deferral in response to bottom-line pressures, credit review is trickier (in a credit downturn). If there are missed downgrades lurking in your portfolio, you'd rather have them uncovered by auditors than by examiners. And then there are correlation effects: If Client X is in difficulty, what about Y and Z if they're in related industries or locations? Credit concentrations can signify savvy marketing in good times – but all the more pressure when times turn bad.

You know problems are likely brewing "out there." What practical steps can your lenders take to flag them and protect the bank's interests? If there aren't attractive new business opportunities for them to pursue (or if the bank's credit appetite has waned), have them instead visit clients to see what's going on – e.g., real estate site visits, inventory inspections, catch-up conversations with management. For the younger officers who haven't experienced a cyclical downturn, tell them what to look for. And if a client sees weakening in the cash flow that represents the primary source of repayment, consider possibilities to enhance collateral coverage. The later that's left, the fewer the bank's options.

Pay attention to covenant compliance, which should act as an early warning system. Not just negative covenants like financial tests – i.e., what levels or ratios can't be exceeded – but also affirmative covenants like delivery of updated financials, A/R listings, etc. If these are late, it should prompt questions and action. Likewise, "clean-up" provisions in revolving loan agreements, requiring full paydown at some point during the year. If these were important enough to put in the agreement, make sure they get monitored and enforced.

Is the Note Department operating smoothly, including timely follow-up on any outstanding loan docs or expired insurance, UCC filings, etc.? If you decide to take action on a delinquent loan, that's not the time to discover that collateral listed on the credit approval and the loan agreement isn't there, or isn't properly executed or perfected. As with Credit Review, an internal audit of the loan servicing function by auditors who know what to look for can provide valuable insights...and peace of mind.

These comments have been general so far, applicable across all borrower segments. But we should recognize that each downturn has its unique characteristics, and that today's culprit – the driving factor – is real estate. Residential, most obviously, though valuation declines on the commercial side have been closing the gap on housing. Construction has been especially hard-hit, and therefore getting particular scrutiny from examiners. Funds control is the most prominent risk factor and control point unique to construction lending, and there have been well-publicized examples of serious deficiencies in this area. Poor oversight, exception approval procedures, interest reserve practices, and other control weaknesses were previously covered up by rising collateral values. But as the curtain is pulled back, regulators are growing concerned, as addressed in the FDIC's recent (Summer 2008) Supervisory Insights guidance.

Appraisals may be particularly difficult to perform and interpret in a volatile environment like this, but they can't be ignored. Ensure that your policies in this area are tight and in line with regulatory guidelines (i.e., the 1994 interagency guidance statement), then ensure they're being followed. There are differences in requirements for type and size of loan, per FDIC 323 (e.g., full appraisal not required for transactions less than \$250,000). Requirements are different again for OREO – which presents other issues, too. As with Special Assets, it's an activity that gets no attention until it does. But when it's needed, it's difficult to ramp up quickly because of a shortage of experienced staff knowledgeable in the financial and regulatory accounting aspects. (The FDIC recently released FIL 2008-62 to provide additional guidance on OREO.)

The common theme running through all these points is monitoring for weaknesses and the avoidance of surprises. Defaults will happen, and more so in a downturn. There are businesses that won't make it through, no matter how prescient or helpful their bankers. But keep in mind that probability of default is only one of three components of dollar losses. The other two are loss given default (LGD) and exposure at default (EAD). The measures emphasized here will help to limit them so as to limit the bank's losses when bad things (borrower defaults) happen.

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