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External or Internal Loan Review: Why Not Both?

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Your institution's loan review function should be designed to ensure proactive identification of problems in the loan portfolio and the proper grading of those loans. Early identification of credit problems relies on an effective internal and external review system, which can employ components of a traditional loan review function but should be independent of the lending process. This can be performed by a separate department staffed with credit review specialists or, more often for smaller institutions, an independent outside party.

Both are considered external loan review systems, which are an important risk control element because they usually provide a more objective assessment of credit quality. However, internal loan review systems are also important and shouldn't be neglected.

Loan classification or credit grading generally places primary reliance on your institution's lending staff to identify emerging loan problems. This reliance falls on loan officers, credit administration, loan administration, a problem loan workout group or other departments. Ideally you want your internal process operating reliably such that your external loan review function confirms that operating controls are in place that ensure the orderly conduct of business, the safeguarding of assets, sound lending decisions, proper perfection of collateral, and compliance with regulatory and policy requirements.

Your institution can enhance its credit risk management process by including internal early-warning activities as part of its internal loan review system. Let's look at three examples that help illustrate this point.

Example 1: Periodic Informal Review of Loan Officers' Portfolios
One institution uses this dual process as a way to identify problems or potential problems early on. The team leader of a lending unit has semiannual meetings to review each loan officer's loan portfolio. Those attending the meeting include the team leader, the loan officer and the lending team's credit administrator. The meeting is informal and covers all loan officer portfolios on the team.

During the process each individual loan, borrower and relationship is reviewed at a high level to identify current, expected or potential issues. Since all three individuals attending the meeting have different levels of familiarity with the loans and borrowers, the discussions are interactive rather than just the loan officer talking about his or her loans.

Loan grading discussions include upgrades as well as downgrades, perhaps establishing a framework or triggers for current or future grade changes. Usually the credit administrator uses this forum as an opportunity for training, illuminating best practices, or providing an update on credit issues observed in the institution's portfolio.

Example 2: Borrower Early-Warning Triggers

At another institution a team leader uses a different approach to increase the lending staff's awareness of potential loan repayment issues. At the weekly loan meeting, a loan officer is asked to present an overview of one of his or her "heartburn" borrowers. The overview includes a brief description of the borrower's business, management and a summary of the loan relationship with the institution.

The loan officer is also required to describe negative external events that may cause this borrower to have loan repayment problems. This might be a marked increase in the price of oil for a trucking company, drought or commodity price changes for a farm or supplier issues for a manufacturer.

These early-warning triggers are meant to detect repayment issues prior to receipt of financial information, heightening awareness of things that may trigger grade changes. It also helps familiarize the lending team with elevated risk borrowers in the team's portfolio.

Example 3: Loan Monitoring Systems

Another control that serves as an internal warning system is monitoring a particular event or outcome. At one institution with significant exposure to residential development loans, the chief credit officer has set up a system to track and monitor the progress of each development loan.

Whether it's a lot or residential development, a benchmark is established based on the property's appraisal. The appraisal defines the absorption rate and expected average sale price. This benchmark data is then compared with actual sales data monthly to determine whether the project is above, below, or proceeding according to plan. Those falling below plan would prompt further investigation. This same type of monitoring could be applied to borrowers with secured lines of credit, tracking for borrowing base availability or percentage of line use.

The Bottom Line

No two financial institutions are alike. They differ in size, portfolio type and risk tolerance. When it comes to internal credit review and risk monitoring, one system doesn't necessarily work for all institutions. Establish the internal and external review system that best suits your institution's credit and cultural needs.

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