Scoping Your External Loan Review

By Dan Huston and Kim Epskamp, Moss Adams LLP

Financial institutions are required to have some type of loan review system. This is for good reason. Early identification of credit problems relies on an effective internal and external review system for accurate and timely loan classification and current grading.

While large institutions normally establish a separate department staffed with credit review specialists, costs and volume considerations may not justify such a system for smaller institutions. As such, some may choose to outsource the credit review function to an independent outside party.

The task of obtaining an independent external loan review often falls to an institution’s internal audit department so as to keep the selection outside the credit approval process. Correctly defining the scope and depth of your loan review will have an impact on both what is analyzed and the cost of the review.

An institution’s loan review policy is the first place to look for defining a loan review’s scope and depth. As such, a well-written loan review policy should contain both scope and depth requirements. If your policy doesn’t contain such information, steps should be taken to modify the policy so that it does.

One of the goals of any loan review is to assess the overall credit quality of the portfolio. Yet reviewing 100 percent of the loan portfolio is neither practical nor cost efficient. Instead, the scope of the review should ensure that the percentage of the portfolio selected for review provides reasonable assurance that the results of the review identify credit quality deterioration, reveal any negative trends in the portfolio and reflect the portfolio’s credit quality as a whole.

The percentage of the portfolio to be reviewed shouldn’t necessarily be static from year to year. Increases or decreases should reflect economic conditions and the institution’s risk profile at the time of the review. For the smallest of institutions, an annual review is likely sufficient. However, for all other institutions, routine periodic exams are preferable in that they verify that credit monitoring systems are maintained on a constant basis and emerging issues are identified earlier. They also spread out the workload so that the best, most experienced review staff is engaged on any given project.

The review scope typically includes:

- A percentage of the portfolio that should be reviewed, expressed in dollars
- Loans, or loan relationships, over a predetermined size
• Past-due, nonaccrual, renewed and restructured loans

• Loans constituting concentrations of credit risk and other loans affected by common repayment factors. For example, a loan review at the beginning of the economic turndown may have included a large sampling of negatively impacted residential development loans, land loans or hospitality loans in an institution's portfolio. Sampling may also be targeted by geographic location, branch, loan officer, industry group or other portfolio segments

• Loans to insiders

• Loans previously criticized or classified or designated as meriting special attention

• A sufficient sample of smaller loans

The depth of a review reflects the institution's expectation of what the reviewer will analyze in arriving at a credit quality assessment. The review should analyze a number of important aspects of the loans selected for review, including:

• Credit quality that encompasses underwriting, the borrower’s financial performance and ability to repay debt, as well as accuracy and timeliness of credit grades assigned

• Adherence to covenants, as applicable

• Sufficiency of credit, loan, and collateral documentation, including lien perfection

• Compliance with policy, procedures, laws and regulations

• Review of loan files for appropriate information, documentation, evidence of servicing, monitoring and organizational quality

• Overall appropriate management of the loan portfolio by loan officers, credit administration and management as well as checking for proper approval authority

• Identification of impaired loans, measurement of impairment and timeliness of charge-offs

After the scope and depth of the review are defined, the next step is to define the institution’s expectation with regard to reporting. A typical loan file review report format used by most review firms details:

• What the assignment called for (depth)

• What was looked at (scope)

• Findings and recommendations

• Process improvement recommendations, if any

Typically, an exit meeting is conducted at the end of an on-site review, followed by a preliminary finding and recommendation draft report. An institution will usually prepare written responses to findings and recommendations made by the reviewer, and these are incorporated into the final report. The response
comments should include follow-up time frames for corrective action or implementation. The final report is communicated to the institution’s board of directors.

[back to April 2015 Lending & Credit Digest]

Dan Huston is a director with Moss Adams LLP (www.mossadams.com). He directs the firm’s internal audit and regulatory compliance services for financial institutions. He can be reached at 503-471-1291 or dan.huston@mossadams.com. Kim Epskamp has more than 30 years of banking experience covering all aspects of commercial credit.