CREDIT REVIEW SYSTEMS: DOES YOUR SYSTEM MAKE THE GRADE?

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INTRODUCTION: PRACTICE MAKES PERFECT?

Comedian Steven Wright recalled, "When I was in school, the teachers told me practice makes perfect; then they told me nobody's perfect, so I stopped practicing." We all recognize that we're not perfect, so maybe that's why so many of us are out of practice. Nevertheless, we hope our credit review systems have been perfected to meet regulatory expectations, and in my introductory article on credit review systems, I shared with you the regulatory expectations for an effective loan review system objectives:

- identifying promptly loans with well-defined credit weaknesses so that timely action can be taken to minimize credit loss;
- reporting essential information for determining the relevant trends affecting the collectability of the loan portfolio and isolate potential problem areas;
- evaluating the activities of lending personnel;
- assessing the adequacy of, and adherence to, loan policies and procedures, and to monitor compliance with relevant laws and regulations;
- providing the board of directors and senior management with an objective assessment of the overall portfolio quality; and
- providing management with information related to credit quality that can be used for financial and regulatory reporting purposes.

The first objective's call for prompt identification of weak loans infers that these loans are being monitored regularly, and a critical element of monitoring is an organization's risk rating system, so let's examine credit grading in more detail.

RISK RATING SYSTEMS: WHO PICKS THE NUMBERS?

Accurate and timely credit grading is a primary component of an effective loan review system. Credit grading usually integrates assessment of credit quality, identification of problem loans, and the assignment of risk ratings. An effective system gathers data for use in setting an allowance based on the aggregation of individual loans' credit risk estimates for loans and leases, as appropriate.

Credit grading systems often place primary reliance on loan officers for identifying emerging credit problems because they are typically the closest to the borrowers. The initial credit grade may change as it moves through the approval process, but many organizations hold the account officer, relationship manager, or the lender responsible for the initial rating. However, given the subjective nature of credit grading, a loan officer's judgment regarding the assignment of a specific credit grade should generally be subject to review. Reviews may be performed by peers, superiors, loan committee(s), or other internal or external credit review specialists.

LENDER WRITES A NUMBER: INDEPENDENT LOAN REVIEW DETERMINES IF IT'S THE RIGHT NUMBER

Credit grading reviews performed by individuals independent of the lending function are preferred because they can often provide a more objective assessment of credit quality. A loan review system builds on the credit grading system and typically includes the following:

- A formal credit grading system that can be aligned with the framework used by federal regulatory agencies, especially the criticized (special mention) and classified (substandard, doubtful, non-accrual, and loss) categories;
- An identification of loans or loan pools that warrant special attention, particularly in terms of watchlist loans (usually the loans in the lowest pass grade), concentration concerns (largest individual borrowers, industry, geography), specialized lending needs (agricultural lending, asset-based lending, commercial real estate, energy lending);
- A mechanism for reporting identified loans, and any corrective action taken, to senior management and the board of directors (consider a monthly problem loan-loan review credit quality report to management and the board;
- Documentation and reporting by credit risk management or other appropriate organizational function of an institution's credit loss experience for various components of the loan and lease portfolio (information needed for maintaining and calibrating loan loss reserve, anyway).

CLOSING: TAKE A NUMBER

Groucho Marx confided, "Those are my principles, and if you don't like them . . . well, I have others." Despite Groucho's flexible standards, we need a loan's credit grades to sum up its current credit condition as consistently and objectively as possible. So, to ensure your own organization's objective assessment of credit quality, consider this checklist:

Credit Quality Assessment	Yes/No	If no/who to fix?	Deadline	Update
1-formal credit grading system aligned with regulatory agencies				
2-loans or loan pools warranting special attention				
3-reporting of problem loans and corrective action taken				
4-reporting of credit loss results for loan portfolio elements				

Remember, loan grading is more than picking number; those numbers add up to big payoffs in monitoring and managing your loan portfolios.