CREDIT RISK REVIEW

MEANINGFUL OR MEANINGLESS?

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For over 30 years, the regulators have advocated, or required, an independent validation of credit risk. There is a good business reason for this function if well-managed. You spend a lot of money on credit risk review, and in today's heavy-cost, heavily-regulated banking world, you need to get optimum value for every dollar spent. There are key questions you may ask to ascertain whether that value is there:

- Is the Board getting what it needs from credit risk review to influence decision-making on strategic direction, personnel management and other key lending components?
- Are you getting a mixed message from your regulator on credit risk review?
- Do you view credit risk review as largely necessary to satisfy regulators and external auditors?
- What questions does your Board or management team ask about the value added?
- Is your credit risk review function risk-based?

We want to bring to light common misconceptions and deficiencies in credit risk review functions we have observed in our roles as former regulators, bankers and independent consultants. We hope these reflections assist you in proactively managing your credit risk review function. We routinely – yes, routinely – see such weak performance of credit risk review that it provides no reliable validation of loan risk ratings, overall portfolio quality or credit administration. By order of impact, here are our primary observations:

- Hiring a credit risk review vendor to perform the function, then failing to police its performance or manage the process. This failure, far and away, contributes to the biggest loss of value. It is unwise to hand off planning and execution to a vendor and assume it is handled well. Deficiencies may include:
  - A poorly conceived scope coupled with a weak or non-existent risk-based focus.
  - Excessive coverage. Period. Over time, a paradigm has evolved that more coverage is better and is favored by the regulators. It is common to see annual credit risk review file review coverage of 60-80% of outstanding and committed extensions. The same borrowers and categories are reviewed year after year. While a hefty coverage ratio looks good to show to your Board, regulators and auditors, the benefit is illusory and here's why:

    We have found that such penetration imbues production pressure on the people performing the file work, which leads to a rush through files and, sometimes, failure to even discuss the credits with loan officers to ensure a sound evaluation of the

borrower. Tests of this work find shallow analysis, unsupported risk ratings, factual errors in calculations leading to incorrect conclusions, missed documentation defects, poor appraisal reviews and weak collateral analysis – all leading up to unreliable systemic findings of your credit universe.

To put this into perspective, coverage of 60-80% is typically required only when a bank teeters on failure and the regulators require this level of penetration to verify the extent of loss exposure in the portfolio. Conversely, a good risk-based approach should not target a specific coverage ratio, but rather focus on key areas of credit risk and overall account and risk management. Coverage ratios can vary from year to year, depending on the solidity of your credit function.

- Conclusion-oriented observations get lost in the bulk of that thick binder that is delivered to the Board after each review. The report is often full of loan portfolio statistics that simply restate what is already – or should be – in routine Board reports. In other words, you are paying for information you already have. A Board member does not have time to sift through the detail to find meaningful conclusions.
- Conclusions tend to be generic statements that provide little insight on validating the bank's credit risk management, which can provide false comfort to the Board. Remember, it is critical that your credit risk review function identify systemic problems prior to the regulators doing so.

- Inattentiveness of the Board or Audit Committee in managing the process. While credit risk review and internal audit are designed to be independent validation tools, it is often clear, through discussions with Board or Audit Committee members, that they are not focused on where the risk is when providing direction on coverage or reviewing results of the work performed. This is usually due to inadequate training of Board or committee members on risk-based approaches, which can lead to inordinate participation by executives in administering the process, thereby diluting the independence factor.
- Using unqualified or unmotivated personnel to perform in-house credit risk review. We typically see this when a bank is merely showing regulators and auditors that is has a credit risk review function (i.e. going through the motions), attributing to many of the shortcomings we discussed above. In many of these cases, the tone from the top does not illuminate the importance of the function. Without a solid commitment from the top, coupled with sound execution, value is tepid or absent.

This article is not intended to devalue or diminish the importance of credit risk review – just the opposite – the observations above are cautionary tales, designed to help you avoid pitfalls and to proactively, effectively manage your credit risk review function and by extension, your credit risk. To that extent, we have similar observations when it comes to internal audit and would be happy to discuss one or both functions with you. It is very possible that you could cut the costs of these functions while providing more concise, risk-based and meaningful feedback to your Board that then feeds into sound decision-making.