Loan Review Policy

Loan review has become a mainstay third line of defense for loan portfolio risk management in financial institutions of all sizes. Loan review has also taken on increased significance as it is used both to ensure appropriate credit grading and to assist in the determination of loan loss allowance. Regulators often assess an institution's loan review program in reviewing the appropriateness of the loan loss allowance.

The increased visibility of loan review has led to greater expectations for financial institutions to have a sound loan review program. Loan portfolio composition can vary widely between community based financial institutions with different risk factors to consider. The number of factors that impact the loan portfolio may challenge management in their determination of how to best define the loan review process. Fortunately, there is more than one right approach to a loan review program.

During 2020, the Interagency Guidance on Credit Risk Review Systems (Guidance) was released by the agencies to provide an update to Attachment 1 of the 2006 Interagency Policy Statement on the Allowance for Loan and Lease Losses. This Guidance replaces Attachment 1 as the agencies' guidance on credit risk review.

The Guidance states, "an effective credit risk review system accomplishes the following objectives:

- Prompt identification of loans with actual or potential weaknesses so that timely action can be taken to strengthen credit quality and minimize losses.
- Appropriately validate and, if necessary, adjust risk ratings especially for those loans with potential or well-defined credit weaknesses that may jeopardize repayment.
- Identify relevant trends that affect the quality of the loan portfolio and highlights segments of those portfolios that are potential problem areas.
- Assess the adequacy of and adherence to internal credit policies and loan administration procedures and monitors compliance with applicable laws and regulations.
- Evaluates the activities of lending personnel and management, including compliance with lending policies and the quality of their loan approval, monitoring, and risk assessment.
- Provide management and the board of directors with an objective, independent, and timely assessment of the overall quality of the loan portfolio.
- Provide management with accurate and timely credit quality information for financial and regulatory reporting purposes, including the determination of an appropriate ACL or ALLL, as applicable.

It is also noted an effective credit risk review system starts with a written credit review policy that is typically reviewed and approved on an annual basis.

Policies can be difficult and time consuming to develop and implement. Many factors need to be considered specific to the financial institution to develop an effective credit risk review policy. The Guidance provides for a broad set of practices and principles to consider in developing and maintaining an effective Credit Risk Review system. These elements include:

- Qualifications of credit risk review personnel
- Independence of credit risk review personnel
- Frequency of reviews
- Scope of reviews
- Depth of transaction or portfolio reviews
- Review of findings and follow-up
- Communication and distribution of results

Each of these points include details in the Guidance to provide further clarity. It is important to note that institutions continue to maintain flexibility in the determination of the methodology to employ for credit risk review. The Guidance provides a framework within the safety and soundness principles to craft a policy and a plan without mandating specific requirements for the financial institution. The approach to credit risk review should be based on the size of the financial institution, complexity, loan types, risk profile and risk management practices.

The full Guidance can be found here: 2020-10292.pdf (govinfo.gov)

While many community based financial institutions actively utilize a loan review program, the policies may not always reflect the nature of the actual credit risk review program. We encourage management to implement a credit risk review policy in line with the current credit risk review practices. Further, we encourage management, if necessary, to align the policies and practices more closely with the Guidance. We believe the key to a successful loan review program starts with a sound loan review policy. The policy should serve as the roadmap in which management, the board and regulators can point to in support of safe and sound risk management practices.

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