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Office of Thrift Supervision
Department of the Treasury

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May 17, 2001

MEMORANDUM FOR: CHIEF EXECUTIVE OFFICERS

FROM: Richard M. Riccobono Richard M. Riccobono

SUBJECT: Effective Internal Asset Review Systems

A few recent examinations at thrift institutions or their subsidiaries have revealed internal asset reviews (IAR) that were not commensurate with the institution's size, risk, and the complexity of its lending and investment activities. Very often, we have traced an institution's inadequate response to problem loans or lending to an inadequate loan review function or one that is poorly structured or that is not sufficiently independent. Too often, such weaknesses in the IAR system become evident when the institution is experiencing credit problems that may have been prevented with an effective IAR system.

Thrift Bulletin 3, originally issued in October 1988, set forth guidelines for establishing an internal loan review program. This guidance was revised and incorporated as Attachment 1, "Loan Review Systems," to the Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL), issued December 21, 1993.

The interagency guidance states that institutions should establish an internal loan review system that:

- Promptly identifies loans having potential credit weaknesses so that timely corrective action can be taken to minimize losses;
- Assesses relevant trends that may affect collectability;
- Provides information to assess the adequacy of the ALLL;
- Assesses the adequacy of and adherence to internal loan policies;
- Evaluates the activities of lending personnel; and
- Provides management and the board of directors with objective, accurate, and timely information of the quality of the portfolio.

The structure, scope, complexity and size of the loan review system should be commensurate with the depth, complexity, and size of the institution's lending programs and should include all loans, whether originated or purchased.

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Management should make every effort to identify weaknesses in the portfolio, and take appropriate corrective actions when necessary. The guidelines also list several important elements to an effective loan review system.

These are:

- Qualifications and independence of loan review personnel;
- Frequency, scope, and depth of reviews;
- Management review of findings and follow-up corrective action; and
- Report distribution to appropriate staff, management, and the board of directors.

While each of these elements is important to an effective loan review function, one of the most critical elements is independence. Often, the initial loan review function is given to loan officers because they are the most familiar with their loans and can spot weaknesses early. This is acceptable, as a first line of review. However, institutions should avoid over-reliance on loan officers and their line supervisors for identification of problem loans. **Senior management and the board of directors should ensure that loans are also reviewed by individuals who do not have control over the loans they review and are not part of, or influenced by, anyone in the approval process.**

Please review your internal loan or asset review function to determine if it is adequate, effective, and follows the interagency guidelines.

Attachment

Attachment 1 : Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL) - December 21, 1993

Loan Review Systems

The nature of loan review systems may vary based on an institution's size, complexity, and management practices. For example, a loan review system may include components of a traditional loan review function that is independent of the lending function, or it may place some reliance on loan officers. In addition, the use of the term "loan review system" can refer to various responsibilities assigned to credit administration, loan administration, problem loan workout, or other areas of an institution. These responsibilities may range from administering the internal problem loan reporting process, to maintaining the integrity of the credit grading process (e.g., ensuring that changes are made in credit grades as needed) and coordinating the information necessary to assess the adequacy of the allowance for loan and lease losses (ALLL). Regardless of the structure of the loan review system in an institution, at a minimum, an effective loan review system should have the following objectives:

- To promptly identify loans having potential credit weaknesses and appropriately classify loans with well-defined credit weaknesses that jeopardize repayment so that timely action can be taken and credit losses can be minimized;
- To project relevant trends that affect the collectibility of the portfolio and isolate potential problem areas;
- To provide essential information to determine the adequacy of the ALLL;
- To assess the adequacy of and adherence to internal credit policies and loan administration procedures and to monitor compliance with relevant laws and regulations;
- To evaluate the activities of lending personnel;
- To provide senior management and the board of directors with an objective and timely assessment of the overall quality of the loan portfolio; and
- To provide management with accurate and timely information related to credit quality that can be used for financial and regulatory reporting purposes.

Credit Grading Systems

The foundation for any loan review system is accurate and timely credit grading, which involves an assessment of credit quality and leads to the identification of problem loans. An effective credit grading system provides important information on the collectibility of the portfolio for use in the determination of an adequate level for the ALLL.

Regardless of the particular type of loan review system employed, an effective credit grading framework generally places primary reliance on loan officers to identify emerging loan problems. However, given the importance and subjective nature of credit grading, a loan officer's judgment regarding the assignment of a particular credit grade to a loan may be subject to review by: (a) peers, superiors, or loan committee(s); (b) an independent, qualified part-time or full-time person(s); (c) an internal department staffed with credit review specialists; or (d) outside credit review consultants. A credit grading review that is independent of the lending function is the preferred approach because it typically provides a more conservative and realistic assessment of credit quality. Because accurate and timely credit grading is a critical component of an effective loan review system, each institution should ensure that its loan review system includes the following attributes:

- A formal credit grading system that can be reconciled with the framework used by the federal regulatory agencies;[1]
- An identification or grouping of loans that warrant the special attention of management;
- Documentation supporting the reason(s) why a particular loan merits special attention;
- A mechanism for direct, periodic and timely reporting to senior management and the board of directors on the status of loans identified as meriting special attention and the action(s) taken by management; and
- Appropriate documentation of the institution's credit loss experience for various components of its loan and lease portfolio.[2]

An institution should maintain a written description of its credit grading system, including a discussion of the factors used to assign appropriate credit grades to loans. Loan credit grades should reflect the risk of credit losses. In addition, the loan review program should be in writing and reviewed and approved at least annually by the board of directors to evidence their support of and commitment to the system.

Loan Review System Elements

The following discussion refers to the primary activities comprising a loan review system that were previously addressed, ranging from the credit administration function to the independent internal loan

[1] *An institution may have a credit grading system that differs from the credit grading framework used by the federal banking agencies. However, each institution that maintains a credit grading system that differs from the agencies' framework should maintain documentation that translates its credit grading system into the pass-special mention-substandard-doubtful-loss credit grading framework used by the federal regulatory agencies. This documentation should be sufficient to enable examiners to reconcile the totals for the various credit grades under the institution's system to the agencies' categories listed above.*

[2] *Institutions are encouraged to maintain records of net credit loss experience for credits in each of the following categories: items not classified or designated as special mention, special mention, substandard, doubtful and loss.*

review function. An institution's written policy and documentation for its loan review system should address the following elements:

- Qualifications of loan review personnel;
- Independence of loan review personnel;
- Frequency of reviews;
- Scope of reviews;
- Depth of reviews;
- Review of findings and follow-up; and
- Workpaper and report distribution, including distribution of reports to senior management and the Board of Directors.

Qualifications of Loan Review Personnel

Persons involved in the loan review function should be qualified based on level of education, experience, and extent of formal credit training; and should be knowledgeable in both sound lending practices and the institution's lending guidelines for the types of loans offered by the institution. In addition, these persons should be knowledgeable of relevant laws and regulations affecting lending activities.

Independence of Loan Review Personnel

An effective loan review system utilizes both the initial identification of emerging problem loans by loan officers, and the credit review of loans by individuals independent of the credit approval decisions. An important element of an effective system is to place responsibility on loan officers for continuous portfolio analysis and prompt identification and reporting of problem loans. Because of their frequent contact with borrowers, loan officers can usually identify potential problems before they become apparent to others.

However, institutions should be careful to avoid over-reliance upon loan officers for identification of problem loans. Institutions should ensure that loans are also reviewed by individuals that do not have control over the loans they review and are not part of, or influenced by anyone associated with, the loan approval process.

While larger institutions typically establish a separate department staffed with credit review specialists, cost and volume considerations may not justify such a system in smaller institutions. In many smaller institutions, an independent committee of outside directors may fill this role. Whether or not the institution has an independent loan review department, the loan review function should report directly to the board of directors or a committee thereof (though senior management may be responsible for appropriate administrative functions so long as they do not compromise the independence of the loan review function).

Frequency of Reviews

Optimally, the loan review function can be used to provide useful continual feedback on the effectiveness of the lending process in order to identify any emerging problems. For example, the frequency of review of significant credits could be at least annually, upon renewal, or more frequently when internal or external factors indicate a potential for deteriorating credit quality in a particular type of loan or pool of loans. A system of ongoing or periodic portfolio reviews is particularly important to the ALLL determination process, which is dependent on the accurate and timely identification of problem loans.

Scope of Reviews

The review should cover all loans that are significant. Also, the review typically includes, in addition to all loans over a predetermined size, a sample of smaller loans; past due, nonaccrual, renewed and restructured loans; loans previously classifed or designated as special mention by the institution or by its examiners; insider loans; and concentrations and other loans affected by common repayment factors. The percentage of the portfolio selected for review should provide reasonable assurance that the results of the review have identified the major problems in the portfolio and reflect its quality as a whole. Management should document that the scope of its reviews continues to identify major problems in the portfolio and reflect the portfolio's quality as a whole. The scope of loan reviews should be approved by the institution's board of directors on an annual basis or when any significant changes to the scope of reviews are made.

Depth of Reviews

These reviews should analyze a number of important aspects of selected loans, including:

- Credit quality;
- Sufficiency of credit and collateral documentation;
- Proper lien perfection;
- Proper approval by the loan officer and loan committee(s);
- Adherence to any loan agreement covenants; and
- Compliance with internal policies and procedures and laws and regulations.

Furthermore, these reviews should consider the appropriateness and timeliness of the identification of problem loans by loan officers.

Review of Findings and Follow-up

Findings should be reviewed with appropriate loan officers, department managers, and members of senior management, and any existing or planned corrective action should be elicited for all noted deficiencies and identified weaknesses, including the time frames for correction. All noted deficiencies and identified weaknesses that remain unresolved beyond the assigned time frames for correction should be promptly reported to senior management and the board of directors.

Workpaper and Report Distribution

A list of loans reviewed, the date of the review, and documentation (including summary analyses) to substantiate assigned classifications or designations of loans as special mention should be prepared on all loans reviewed. A report that summarizes the results of the loan review should be submitted to the board of directors on at least a quarterly basis.[3] In addition to reporting current credit quality findings, comparative trends can be presented to the board of directors that identify significant changes in the overall quality of the portfolio. Findings should also address the adequacy of and adherence to internal policies, practices and procedures, and compliance with laws and regulations so that any noted deficiencies can be remedied in a timely manner.

[3] *The board of directors should be informed more frequently than quarterly when material adverse trends are noted.*