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Handbook: Thrift Activities
Subjects: Lending Risk Assessment

Section: 210
TB 3

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Internal Loan Review

RESCINDED

Summary: This Bulletin discusses the common objectives and major elements which comprise effective internal loan review systems.

For Further Information Contact:
The appropriate FHLBank or the Thrift Activities Division of the Office of Regulatory Activities, Washington, DC.

Supplementary Information:
This Bulletin provides guidance to assist individual institutions in evaluating or establishing their respective internal loan review program which is an essential part of their asset classification system.

Thrift Bulletin 3

The Competitive Equality Banking Act of 1987 resulted in revised regulations being promulgated by the Federal Home Loan Bank Board. The revised "Classification of Certain Assets" regulation (12 CFR 561.16c) requires each insured institution to classify its own assets on a regular basis.

Unlike the regulation which applies to *all* assets held by an insured institution, this Bulletin addresses only the systems implemented by institutions to monitor lending portfolio risk.

While an internal loan review system may take many forms (reliance on loan officers to identify problem loans; review of junior officers' loans by a senior lending officer; use of a qualified, part-time person; or an independent department staffed with credit analysts), effective systems have the following common objectives:

- To help minimize loss to the institution by the early identification and classification of loans possessing potential and well defined credit weaknesses so that timely action can be taken.
- To provide essential information for determining the adequacy of valuation allowances.
- To assess the adequacy and adherence to internal policies and procedures and to monitor compliance with laws and regulations.
- To provide senior management and the board of directors with an objective assessment of the overall quality of the loan portfolio, and
- To ensure the integrity of financial reports.

As a visible sign of the directorate's full support of and commitment to the program, the internal loan review program should be in writing and be approved initially and annually by the board of directors.

An internal loan review program should address the following elements:

- Independence of loan review personnel,
- Description of classification rating system.
- Qualifications, and reporting lines of loan review personnel.
- Frequency of reviews.
- Scope of the review.
- Depth of the review.
- Review and follow-up.
- Workpaper and report distribution.

Independence of Loan Review Personnel

An effective system of internal loan review incorporates both a high degree of independence (by the credit review staff) and also uses loan officers (who may be more knowledgeable but less independent) to serve as the first line of defense in identifying emerging problem loans. An important element of an effective system is to place responsibility on loan officers for continuous portfolio analysis and identification of problem loans. Because of their frequent contact with borrowers, loan officers can usually identify potential problems before they become apparent to others.

While larger institutions typically establish an independent department staffed with credit analysts, cost and volume considerations may not justify such a system in smaller institutions. Nevertheless, independence can be maintained provided loan evaluators do not have control over the loans they review, and are not a part of, or influenced or controlled by anyone associated with the loan approval process. In many smaller institutions an independent committee of outside directors may fill this role.

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Description of Classification Rating System

Classifications should *accurately reflect the risk of nonpayment.* If an institution's classification rating system differs from those categories (substandard, doubtful, loss and special mention) outlined in the "Classification of certain assets" regulation (12 CFR 561.16c and 571.1a), the definitional criteria of the ratings or categories used should closely parallel those contained in the regulation to both facilitate accuracy in filing quarterly reports and to enable examiners to test the accuracy of the ratings.

Qualification and Reporting Lines of Inernal Loan Review Personnel

Loan review personnel should be qualified based on level of education, experience, and extent of formal credit training, should be knowledgeable in sound lending practices for the types of loans offered by the institution, and should report directly to the board of directors or a committee thereof.

Frequency of Reviews

Optimally, the internal loan review function would impact the loan process during three stages - before the loan is made, shortly after the loan is committed or disbursed, and periodically thereafter until the loan is paid in full. While each institution should consider adopting a program that encompasses all three stages, stage three or periodic reviews should be conducted, at a minimum, on a regular basis for all lending areas. Classified loans should be reviewed on at least a quarterly basis to ensure that aggregate totals of each classification category and that valuation allowances are accurately reported on the Thrift Financial Report.

Scope of Reviews

The review typically includes, in addition to all loans over a predetermined size, a sample of small loans; past due, non-accrual, renewed and restructured loans; loans previously classified; insider loans; and inter-related or common interest loans. 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.

Depth of Reviews

Reviews should usually analyze selected loans for:

- credit quality,
- concentrations,
- sufficiency of credit and collateral documentation,
- proper lien perfection,
- proper approval by the loan officer and/or loan committee(s),
- adherence to any loan agreement covenants,
- compliance with internal policies and procedures and laws and regulations.

Review and Follow-up

Findings are usually reviewed with appropriate loan officers and department managers and present or planned corrective action is elicited for all noted deficiencies and identified weaknesses, including the time frames for correction.

Workpaper and Report Distribution

A list of loans reviewed, the date of the review, and credit rating summations to substantiate assigned classifications, including "pass" loans, should be prepared on all loans reviewed. The results of the loan review would then be submitted to the board of directors on at least a quarterly basis. In addition to reporting current credit quality findings, comparative trends can be presented to enable the directorate to spot significant changes in the overall quality of the portfolio. Findings should also address the adequacy 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.

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