

LOAN REVIEW: THE LENDER'S FUTURE PARTNER?

The first of a two-part look at Loan Review

Loan review seems to have come of age in the current credit cycle.

What will this mean to frontline lenders and loan review officers? And to examiners and the banks they regulate?

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In the current credit cycle, Loan Review seems to have come of age. In years past, it was a type of internal control, a third-party's look at individual credits that could be rolled up into a snapshot of the condition of the loan portfolio. Loan review staffs, whether they comprised bank employees or third-party consultants, were seen as "examiners" or "inspectors." As a result, the role was as often as not an adversarial one with the lending line.

To the examiners, a bank's loan policy is the first line of defense. The credit standards are set out there for what is an acceptable loan and how it will be structured, documented, funded, administered, and collected. The credit and collateral files are the ultimate repository of the information on a particular credit on which a quality judgment can be based. The loan review process consists of reviewing the "tracks" left in the files and looking at how the credit has and continues to perform in the light of current economic conditions.

The current round of bank examinations is demonstrating that examiners are pushing banks that haven't taken these issues seriously enough to beef up, in a hurry.

A banking paradox

We all know that credit files and financial statements don't often tell the whole story. How often do we as lenders shade our write-ups and craft our presentations to showcase a particular credit in the best possible way?

Ours is the only industry that puts its salesmen in charge of the credit function.

Think about that! We're trained to sell risk to others who don't know the particular customers as well as we do, no matter how skilled they are in credit matters and methods. We do our best to make the sale. For the moment of our presentation, we are the customer's advocate and we're selling his deal to our employer.

As sales people, we are optimists. We look for ways to do things, rather than turn them down.

I remember one credit culture where the motto was: "Don't say no, say how."

But we were always selling, internally and externally, and we viewed things like capacity to repay and the integrity and skill of the borrower through our own prisms. This continues today. We aren't always exactly right, but we're pretty consistent.

As banks are generally conservative environments, occasional errors in judgment were not dangerous to the health of the bank.

When caution evaporated

Then came the crazy period. Loan products became risky by their nature or underwriting practices shaved credit standards for competitive reasons. Bosses wanted production—loan volume, product sales, growth, and fee income.

Fortunately, the economy was good so what we were selling, credit, seemed to be of reasonable quality.

In our financial system banks facilitate the economic payment system and that runs on the confidence of the general public that banks can function as they are supposed to.

Enough people are questioning that premise today so we all know it's a problem. The public perception is that banks have lost their way as underwriters of sound credit and jeopardized their ability to function. Even worse, in their eyes, we seem to have lost the moral high ground.

Loan Review's importance

From a regulatory view, loan review is the second line of defense and a very close second to loan policy. Loan review gives us that independent assessment of whether credit quality is up to standard in the portfolio. The emphasis isn't on the individual loan, but on the quality of the types of loans taken as a class—auto loans, equipment loans, home loans, working capital loans, and the like. This requires an honest assessment of each individual credit building to a composite judgment on the overall level of quality of all the loans.

Loan review officers can't know what's in your head or mine. They are limited to what's in the file and what the objective evidence is of performance in the past. They pay attention to the local and regional economic conditions; but the intimate knowledge of the customer and his business is the frontline lender's stock in trade.

The integrity of the loan review process depends on our ability to honestly assess the creditworthiness of our customers and prospects and to accurately reflect that assessment in a real-time way.

Loan Review can't do it in a vacuum. It takes what we know about the customer to complete the picture and to make that honest assessment.

When examiners come in for a safety and soundness examination, the credibility of the credit function is on the line each

and every time. It starts with Loan Review's work product—the grading and assessments that roll up into the stratification of the portfolio by quality that in turn drives the adequacy of the loan loss reserve. That requires intellectual honesty and candor by the lenders.

Hard look at loan quality review

In a "soft" economy, it's reasonable to assume that all businesses are at more risk than in strong economic times. Our business environments are not static. Do our loan grades reflect this dynamism, favorable or unfavorable?

It's an imperfect process at best. Yet with a level of candor and mutual respect between lenders and loan reviewers, the process works quite well. It's where the examiners start their assessment: Does this bank's loan review function really know the quality of the credits?

Next instalment, we'll talk about the Four Cs of an effective loan review system. These are the responsibility of the line lenders to divulge about their customers: Information that is Correct, Clear, Comprehensive, and Candid.

Meanwhile, think about how central candor is to the credit grading process. Can candor take a back seat to maintaining an acceptable overall level of loan quality? Not for very long.

About Ed O'Leary:

Veteran lender and workout expert O'Leary spent more than 40 years in bank commercial credit and related functions, working with both major banks as well as community banking institutions. He earned his workout spurs in the dark days of the 1980s and early 1990s in both oil patch and commercial real estate lending.

O'Leary began his banking career at The Bank of New York in 1964, and worked at banks in Florida, Texas, Oklahoma, and New Mexico. He served as a faculty member and thesis advisor at ABA's Stonier Graduate School of Banking for more than two decades, and served as long as a faculty member for ABA's undergraduate and graduate commercial lending schools.

Today he works as a consultant and expert witness, and serves as instructor for ABA e-learning courses and a frequent speaker in ABA's Bank Director Telephone Briefing series. You can hear interviews with Ed about workouts here. You can e-mail him at etoleary@att.net. O'Leary's website can be found at www.etoleary.com.

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