



ALLL Methodology: The Loan Review System is ALLL-Important

| by Randy Olson

These days, financial institutions' allowances for loan and lease losses (ALLL) adequacy and their ALLL methodologies are the focus of significant attention from bank boards, management, external accountants and, of course, regulators.

Some of this attention has been in the form of criticism from regulators. Those criticisms typically include: the need to increase the level of ALLL and enhance the ALLL process and methodology; the need for improved supporting documentation and rationale; and a lack of adequate ALLL policies and procedures, including internal loan review practices. In fact, regulators are equally interested in the methodology for calculating the allowance as they are in the adequacy of the allowance.

This focus on the ALLL isn't likely to change soon, as many banks continue to experience increasing delinquencies, higher nonaccruals, and rising classifieds in some or many portfolios. Also, the ALLL is a significant estimate in an institution's financial statements and regulatory reports.

If an institution's ALLL adequacy or methodology has come under fire recently or the effectiveness of its loan review system is in question, there are steps it can take to help resolve those issues. To avoid criticisms of the ALLL adequacy or methodology, a natural first step is to look to the latest regulatory guidance on the topic. The Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and the Office of Thrift Supervision and National Credit Union Administration jointly issued guidance dated December 13, 2006, titled *Interagency Policy Statement on the Allowance for Loan and Lease Losses*. This policy statement outlines the key concepts and requirements banks need to follow to achieve an adequate and compliant ALLL.

Providing guidance on the ALLL is not new. What is new is the current economic environment and its affect on bank loan portfolios.

Ultimately, regulators hold the bank's board of directors responsible for overseeing management's judgments and estimates regarding an appropriate ALLL. While some trade publication articles, training and roundtable events on the ALLL have highlighted the nature and purpose of ALLL, historical loss rates and factors affecting them, the importance of an effective loan review system has been largely ignored.

In reality, an effective loan review system is a key control or tool the board can use to oversee the ALLL process, along with comprehensive policies and sound loan administration and collection procedures.

THE GRADING SYSTEM IS KEY

A prerequisite for a strong loan review system is the loan classification or grading system. It must be accurate, consistent and responsive to ongoing changes. The loan classification system provides information regarding the collectability of the portfolio, credit quality and problem loan identification. Although most organizations place the primary responsibility for loan classification accuracy and timeliness on the lending staff, because of the importance and subjective nature of the loan grades, it's critical for ratings to be subject to a separate and independent review.

The overall structure of a loan review system can look very different depending on the size and complexity of the bank, its loan portfolio and management practices. In a smaller bank, a loan review system may use staff from credit administration, loan administration, senior management and even the board to fulfill responsibilities. More common is a traditional independent loan review function or even outsourcing some or all of the function to a qualified external loan reviewer or third party.

The loan review system structure isn't as important as its effectiveness. An effective loan review system promptly: identifies credit weaknesses; verifies the appropriateness of the loan classification or credit grade; identifies portfolio trends; evaluates credit policy effectiveness, regulatory compliance and lender compliance with the credit policies; provides senior management and the board with objective and timely portfolio information; and provides management with accurate and timely information for regulatory reporting and determination of the ALLL. An effective loan review system is also alert to changes in internal and external factors affecting the portfolio's level of credit risk and should work to ensure the accuracy of internal credit classification or grading systems and, thus, the quality of information used to assess the appropriateness of the ALLL.

The bank should have a written policy defining its loan review system, which should be reviewed and approved annually by the board of directors. The policy should address the qualifications and

independence of loan review personnel; the frequency, scope and depth of reviews; the review of findings and follow-up; and work paper and report distribution.

The scope and coverage of a loan review and the loan file testing can provide management and the board with critical information to be considered in the ALLL process. This information can provide assurance of the accuracy of loan classifications. Loan reviewers are in a unique position to spot potential trends in the portfolio that management may not see — such as evaluations related to collateral adequacy affecting individual impaired loans (FAS 114) and timely charge-off. Loan reviewers also evaluate compliance with policies and procedures, including nonaccrual and charge-off timing. They may also see systemic issues that may be important to consider in management's assessment of qualitative or environmental factors in determining adjustments to historic loss rates (FAS 5) and overall trends in the portfolio.

WHAT THE FUTURE MAY HOLD

A portion of the regulator's scope in reviewing the ALLL is to consider the effectiveness of board oversight and the quality of the institution's loan review system and management in identifying, monitoring and addressing asset quality problems. This includes a review of the institution's loan review function and credit grading system, and regardless of whether all regulators have focused on this in the past, they are likely to in the future.

The institution's loan review system is all-important. If regulators find differences in loan classifications or credit grades and the bank is more liberal or has an unreliable loan review system, expect regulators to recommend improvements to the existing loan review system. If, on the other hand, management has established an effective loan review system, along with other components of the ALLL process, examiners will be more likely to accept management's estimates of credit losses. ■



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