



Federal Reserve Bank of Atlanta

# Components of a Sound Credit Risk Management Program



## **LOAN POLICY**

The loan policy is the foundation for maintaining sound asset quality because it outlines the organization's default risk tolerances, states terms to mitigate exposure at default, and provides key controls to help the lending institution identify, manage, and report risk mitigation. Generally, the loan policy outlines risk tolerances at the transactional and portfolio level. At a minimum, every loan policy should accomplish the following:

### **Sound underwriting standards**

- Describe both desirable and undesirable loans.
- Provide underwriting standards and monitoring requirements for all loans the bank offers and extends. It is important to delineate primary risk mitigation strategies by transaction and by portfolio.
- Establish concentration limits and sublimits. The policy should also describe enhanced monitoring and underwriting practices such as management information systems granularity, stress testing, market and industry analyses, systemic dependency, and credit reviews.
- Describe the credit approval process, identifying lending authorities and outlining the responsibility of the board in reviewing, ratifying, and approving loans.
- Define transactions requiring credit memorandums.
- Define transactions requiring audited, reviewed, or compiled financial statements.
- Define transactions requiring environmental audits.
- Establish credit and collateral file maintenance standards.
- Provide specific documentation requirements for all loan types offered or extended.
- Establish guidelines for insider transactions, including overdrafts, to ensure compliance with Regulation O.
- Establish appraisal guidelines to ensure compliance with Regulation Y and the Uniform Standards of Professional Appraisal Practices.

### **Sound credit risk management and monitoring**

- Establish an effective loan review system and address key elements of an effective loan review program (such as qualifications and independence of loan review personnel; frequency, scope, and depth of reviews; the review of findings and follow-up; and work paper and report distribution).
- Establish a comprehensive and effective credit-grading system.
- Create portfolio mix and risk diversification guidelines and limits.

- Establish collection and problem loan resolution procedures.
- Establish charge-off and nonaccrual policies.
- Establish the methodology for determining the adequacy of the allowance for loan and lease losses (ALLL). It should also ensure compliance with Accounting Standards Codification and regulatory guidance.
- Establish a threshold for annual credit reviews to assess the financial strength of borrowers.
- Establish procedures to identify, approve, monitor, and report all loan policy exceptions with acceptable risk mitigants. Additionally, the loan policy should set risk tolerances for total policy exceptions.

The loan policy should be tailored to the organization and reflect the local/regional economic conditions and credit needs. At least annually, the board should review and revise the policy and communicate the policy to all appropriate personnel. Deviations from the loan policy should not be recurring or excessive and should be reported (by policy exception and in the aggregate) to the board of directors.

## **CREDIT UNDERWRITING**

### **Commercial and commercial real estate loans**

Traditionally, community banks have based many credit decisions on management's previous experience with borrowers and on proposed collateral values rather than on information in financial statements. However, good-quality financial statements play a critical role in helping the organization identify objective risk characteristics and implement proactive risk mitigation strategies. The lending institution should measure objective and subjective risk characteristics in the underwriting process to understand the borrower's probability of default and reliability of alternative repayment sources to estimate potential loss. A credit memorandum that provides details on the credit applicant, credit request, and underwriting conclusions should accompany all commercial loans as defined in the institution's loan policy. Typically, credit memorandums include:

- The purpose of the loan. It is crucial that the lender understand the root cause of a customer's borrowing need. Otherwise, an inappropriate structure could result and negatively affect cash flow and repayment capacity.
- The sources and reliability of repayment (primary, secondary, and tertiary).
- A description and valuation of any collateral and the source of the valuation.

- A summary of the borrower's direct and indirect debt with the bank and a brief reference to payment performance.
- A summary of the borrower's line of business and an analysis of current financial information. Typically, an assessment explains changes in revenue levels, operating expenses, and net profit, as well as changes to key balance sheet components such as receivables, inventory, cash accounts, short- and long-term debt, and trade accounts. Changes in balance sheet components often prompt a company's need to borrow but can also affect its ability to meet debt service requirements.
- An analysis of the borrower's repayment ability. Typically, the analysis measures cash flow available for debt service for the borrower (debt service coverage) and for any related entities (global debt service coverage). If debts to other creditors are not considered, the applicant's repayment capacity is overstated. Common methods employed include Uniform Credit Analysis (UCA) and earnings before interest, tax, depreciation, and amortization (EBITDA). Generally, use UCA for borrowers whose balance sheets reflect moderate changes during business cycles, and EBITDA for borrowers whose balance sheets remain relatively stable.
- An analysis of the guarantor's financial condition. The analysis considers the personal debt-to income ratio, credit bureau report highlights, and personal financial statement factors with an emphasis on liquidity, leverage, income, net worth, and contingent liabilities. Again, understanding the borrower's **global debt service coverage requirements** is critical.
- The credit risk rating.
- Loan policy exceptions and the rationale for deviating, if applicable.

The institution should enhance underwriting considerations for higher-risk lending activities such as concentrations, participations, asset-based lending, leveraged buyouts, and specialty lending. Specifically, it should identify key risk drivers, hurdles for repayment, and controls to identify and manage problems. It should also enhance its monitoring of industry, market, and economic conditions; stress test repayment streams; and estimate potential exposures.

## **CONSUMER LOANS**

Lending to consumers includes direct and indirect lending relationships. Institutions should employ underwriting standards to measure default risk and qualify borrowers for specific loan terms and pricing policies. At a minimum, underwriting guidelines should include:

- A complete and signed loan application that references the purpose of the request.
- Debt-to-income calculations on all loan decisions.
- A current credit bureau report.
- Recent income and employment verifications on all loan decisions.
- Tax returns for self-employed borrowers.

## **LOAN REVIEW SYSTEM**

Community banks are expected to have a loan review function. To conserve costs, many small community banks outsource the loan review function. Management may outsource the activity, but the directors retain responsibility for ensuring an effective and comprehensive program. At a minimum, an effective loan review system should:

- Promptly identify loans with potential credit weaknesses that could jeopardize repayment and appropriately grade or adversely classify them.
- Promptly identify relevant trends affecting the collectability of the portfolio and isolate segments of the portfolio that could present problems.
- Assess the adequacy of and adherence to internal credit policies and loan administration procedures and monitor compliance with relevant laws and regulations.
- Evaluate the activities of lending personnel including their compliance with lending policies and the quality of their loan approval, monitoring, and risk assessment.
- Give senior management and the directors an objective 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, including the determination of an appropriate ALLL.

## **LOAN GRADING SYSTEM**

The foundation for any loan review system is an accurate and timely loan classification or credit grading system. Community banks are expected to have a formal credit grading system based on quantitative data. The system should have sufficient granularity to allow the directors and senior management to monitor risk migration of loan portfolios over time and provide for accurate and timely identification of criticized or adversely classified risk grades for special-mention, substandard, doubtful, and loss categories. Risk ratings should be developed for various credit types based on their unique features and risk characteristics—that is, credit scores, debt-to-income ratios, collateral types, and loan-to-value ratios for consumer loans, and debt service coverage, financial

strength of management/major tenant, and loan-to-value ratios for commercial real estate credits.

Ideally, grading systems should have several pass categories based on the borrower's earnings/operating cash flow, liquidity, leverage, and net worth. Collateral (quality and control), the company's management, and the strength provided by any guarantors should also be considered. Because grades reflect varying degrees of risk, they are expected to be major components for determining the adequacy of the ALLL and loan pricing. An inaccurately graded loan may lead to unprofitable lending and inaccurate risk identification and reporting.

An effective loan classification and credit grading system generally relies primarily on the institution's lending staff to identify emerging loan problems. Given the importance of timely and accurate loan grading systems, the judgment of an institution's lending staff should be subject to review by 1) peers, superiors, or loan committee(s); 2) an independent, qualified employee; 3) an internal department staffed with a credit review specialist; or 4) qualified outside credit review consultants. An independent review of the lending function is preferred because it provides an objective assessment of credit quality.

## **TOP 5 COMMON LENDING MISTAKES**

- Absent, incomplete, or incorrect cash flow analyses (debt service coverage and global debt service coverage calculations) that overestimate a borrower's ability to repay debt.
- Speculative commercial and residential real estate loans that are often extended to developers or builders without adequate cash flow and liquidity analyses to validate their capacity to carry unsold or unleased inventory for extended periods.
- Subjective risk definitions that allow broad interpretations of risk appetites and, therefore, do not accurately reflect the financial condition of, or the risks posed by, borrowers.
- A failure to use loan covenants to protect future cash flow streams and liquid assets from being diverted to underperforming projects.
- Loan pricing that is not commensurate with risk.



FEDERAL  
RESERVE  
BANK  
*of* ATLANTA

This Guide was created by the Supervision and Regulation Division  
of the Federal Reserve Bank of Atlanta

1000 Peachtree Street, N.E., Atlanta, Georgia 30309