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Agencies update guidance on credit risk review systems

What is noteworthy is the timing of the release and the signaling by the regulators for institutions to remain laser-focused on credit quality.

Introduction

On May 8, 2020, the Federal Reserve Board (FRB), Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC), and National Credit Union Administration (NCUA) (collectively, the US bank regulatory agencies) provided the banking industry (for example, banks, savings associations, and credit unions, regardless of asset size) updated interagency guidance on *credit risk review systems*.[1,2] This guidance is principle-based and outlines a set of practices to be used within a dedicated unit or credit review function or by multiple units across an institution to form a credit risk review system, consistent with safe and sound lending practices. What is noteworthy is the timing of the release and the signaling by the regulators for institutions to remain laser-focused on credit quality.

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Credit risk review systems will vary based on an institution's size, complexity, loan types, risk profile, and risk management practices, and in larger or more complex institutions, a dedicated credit review function will be in place. The interagency guidance elevates the status of the credit review function through the following principles:[3]

- **Should be separate from internal audit.** The credit review function is an independent function primarily responsible for validating and, if necessary, adjusting credit risk ratings and is not intended to be performed by an institution's internal audit function. An effective internal audit function maintains the ability to independently audit the credit review function and end-to-end credit processes. Consistent with broad US bank regulatory safety and soundness standards, the credit review function should report directly to an institution's board of directors (BoD) or a designated board committee.
- **Mandate is different from monitoring, managing, and reporting by other credit risk functions.** The purpose of the credit review function is to identify in a timely and accurate manner credit weaknesses, which then informs management of how to best risk-manage their portfolio of credit exposure.
- **Prevails where a risk rating discrepancy exists.** Due to its independence, risk-rating decisions made by the credit risk function should prevail over the business, unless material information can be produced by the business to support their position, which then still must be reviewed and challenged by the credit risk review function.
- **Should be empowered to evaluate workout plans specific to the assessment of the reasonableness of strategies.** The credit review function should determine the appropriateness or reasonableness of assumptions regarding loss estimation for credits with significant weaknesses.

Overview of the finalized guidance[4]

Risk rating framework

An effective credit risk review system should be based on accurate and timely risk ratings that assess credit quality and identify or confirm problem loans. This risk rating framework should include the following:

- A risk rating scale that reflects the risk of default and credit losses, supported by written descriptions and alignment to the regulatory classification framework used by the federal banking agencies.
- Identifying individual or groups of loans that require closer monitoring and/or special attention by management (for example, as regulatory definitions note watch list, special mention, substandard, doubtful, or loss). Rationale for these loans should also be documented.
- Ability to evaluate the effectiveness of approved workout plans and the institution's historical loss experience for each of its risk ratings on the scale.
- Reporting directly, periodically, and timely information to senior management and the BoD.

Written credit risk review policy

Institutions should have a written credit risk review policy that is reviewed and approved at least annually by the BoD or a designated board committee. This policy should describe the overall risk rating framework, establish responsibilities for credit review, and drive the following activities:

- **Frequency of review:** Review and evaluate internal or external factors indicating a potential for deteriorating credit quality on a regular basis.
- **Scope of review:** Make risk-based decisions on all segments of the loan portfolio that pose significant credit risk or concentrations or have similar risk characteristics, such as those related to borrower risk or transaction risk.
- **Depth of review:** Evaluate loans for credit quality, appropriateness of automated underwriting when applied, use of overrides, reasonableness of assumptions, sufficiency of credit and collateral documentation, compliance with internal policies and procedures, and appropriateness of credit loss estimation.
- **Review of findings and follow-up:** Discuss review findings and the resolution of risk rating differences through an established governance and process, including escalating to senior management and the BoD when necessary.
- **Communications of results:** Report results to the BoD with comparative trends that identify significant changes in the overall quality of the loan portfolio; the adequacy of, and adherence to, internal policies and procedures; the quality of underwriting and risk identification; compliance with laws and regulations; and management's response to substantive criticisms or recommendations.

Qualifications and independence of credit risk review personnel

Credit risk review personnel should have the appropriate knowledge, experience, and credit training, commensurate with the nature of the risk and complexity of the institution's portfolio. Credit risk review personnel should serve as a credible challenge to the loan approval process and loan performance with their independent assessment of credit risk.

Effective credit risk review system

As described in the above, an effective credit risk review system needs to have the right foundation, with a robust risk rating framework, written policy, and qualified and independent personnel, in order to achieve the following:

- Promptly identify loans with actual and potential credit weaknesses so that timely action can be taken to mitigate losses and strengthen credit quality prospectively.
- Appropriately validate and, if necessary, mandate adjustments to the respective risk ratings.

- Identify relevant trends affecting loan portfolio, and highlight potential problem areas.
- Assess the adequacy of, and adherence to, internal credit policies, loan administration procedures, and compliance with applicable laws and regulations.
- Evaluate the activities and qualifications of lending personnel, including their compliance with lending policies and the quality of their loan approval, monitoring, and risk assessment.
- Comprehensively and effectively cover all segments of the loan portfolio that pose significant credit risk or concentrations, and consider the current market conditions or other external factors that may affect a borrower's current or future ability to repay the loan.
- Provide management and BoD with accurate and timely credit quality information that is also used for financial and regulatory reporting purposes, including the determination of appropriate allowance for credit losses (ACL) or allowance for loan and lease losses (ALLL), as applicable.

The criticality of the risk rating review by the credit review function becomes especially important during the shared national credit (SNC) process for credits of the respective institution which are reviewed.[5] The outcome of the SNC review, whether it is a confirmation as a pass or noted as a classified credit (substandard, doubtful, or loss), as noted by the US bank regulatory definitions, can be an implicit validation of the integral workings of the credit risk review system.[6]

Key considerations

When evaluating the guidance against their current credit risk review system, institutions should consider what the guidance does not address, the impact of forbearance and deferment, and any overlaps in their current governance model, as well as the regulators' intent.

Maintaining a robust risk assessment process and credit review plan: The guidance does not address the elements of a robust portfolio risk review process, which is usually owned and executed by the first line of defense to manage their respective portfolios. Such reviews are performed on a regular basis (for example, quarterly or as required). These reviews not only consider the performance of the portfolio and its individual borrowers, but also monitor and evaluate the impact of external factors at the loan and portfolio level, such as the economic impact of the COVID-19 pandemic. This type of review can serve as a data input for the planning of credit risk review's annual plan for the following year or as an adjustment to the current plan. The annual plan should be sufficiently flexible to perform targeted reviews that evaluate the impact of an emerging issue on an institution's loan portfolio on a timely basis.

Evaluating portfolios, especially industries and sectors, as a result of the economic impact of the COVID-19 pandemic: Given the current economic crisis and uncertainty of its duration, the impact on credit portfolios is likely to continue over the next year. Institutions have loans on forbearance and/or deferment that will need to be monitored closely for potential deterioration, especially should borrowers request extensions or exhibit hardship or the inability to pay. Institutions may also have large exposures to industries and sectors that are severely affected. Specialized portfolio reviews; regrading of entire portfolios or individual loans; and establishing additional monitoring, escalation, and reporting processes may also be warranted. These additional risk practices can be performed by the business, the risk function, and the credit review function.

Reassessing the credit review function's current plan and resources: Institutions evaluating their loans in response to COVID-19 will need to evaluate and potentially modify the current plan, scope, and approach to proactively identify potential deteriorating trends, loans requiring downgrades and/or management's attention, and additional loss reserves. To that end, institutions should also focus on the number, level, and experience of current credit review risk personnel—many may be unfamiliar with how to assess borrower creditworthiness in this environment or long-term workout strategies. Institutions are turning to third parties, which have the requisite skills to supplement their teams.

Understanding the regulators' expectations, both explicit and implicit: As mentioned earlier, the four regulatory agencies have collectively agreed to issue this guidance now. The guidance is not focused on stimulating the economy or giving relief to borrowers, as is the aim of other recent issuances. Instead, it is emphasizing safety and soundness standards—the need for an independent, ongoing credit risk review system, including a risk rating framework, credit risk review policy, and qualified and independent personnel, as well as timely reporting to senior management and the BoD. Institutions will still be held accountable for accurately risk-rating their portfolios, monitoring credit quality and potential deterioration, and determining the possible impact on credit reserves. Ultimate responsibility will remain with senior management, with the BoD as oversight.

Conclusion

In conclusion, the credit review function is a key component of an effective credit risk review system and integral to the success of an institution's credit risk management. It is the independent credit function tasked with the timely and accurate identification and reporting of credit weakness and validation of credit risk ratings within the institution's portfolios. It implicitly supports the institution's use of its capital and can serve as an early or timely warning to management and BoD of a changing risk profile. With the 2020 interagency issuance, the credit risk function is recognized to be an independent oversight function, having full access to the BoD as required.

Deloitte continues to monitor the financial, regulatory, and supervisory impact of a potentially deteriorating credit market. Continue reading about this topic in our other blog, "Addressing the credit impact of the current environment."[7]

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Endnotes

1. Board of Governors of the Federal Reserve System (FRB), Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), and National Credit Union Administration (NCUA), "Interagency Guidance on Credit Risk Review Systems," accessed June 14, 2020.
2. The interagency guidance partially supersedes the attachment to SR letter 06-17, "Interagency Policy Statement on the Allowance for Loan and Lease Losses," entitled "Loan Review Systems."
3. FRB, FDIC, OCC, NCUA, "Interagency Guidance on Credit Risk Review Systems," accessed June 14, 2020.
4. Ibid.
5. FRB, "Shared National Credit Program," accessed June 14, 2020.
6. FRB, "Shared National Credit Program, 1st and 3rd Quarter 2019 Reviews."
7. Deloitte, "Addressing the credit impact of the current environment," accessed June 14, 2020.