From Policy to Practice

Volunteer Oversight in Commercial Lending

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Learning Objectives

- Learn how to effectively evaluate your existing policies and reporting.
- Explore ways to mitigate credit risk.
- Discover how to spot problem loans and workout strategies.
- Explore tips for effectively monitoring your lending portfolio.

Topics

- Policies and reporting
  - Regulatory requirements
- Credit and collateral risk
  - How to mitigate credit risk
  - Collateral monitoring and limits
- Spotting problem loans and workout strategies
- Regulatory ‘hot buttons’, loan participations and tips for lending portfolio management

Regulation Part 723 Requirements Board of Directors

- Approve a commercial loan policy that complies with Part 723.4 on an annual basis
- Ensure appropriate staffing
- Understand and remain informed about the nature and level of risk in the commercial loan portfolio

Regulation Part 723 Requirements Required Expertise & Experience

- Senior executive officers overseeing the portfolio must have an understanding of the role of commercial lending in the overall business model and establish risk management processes and controls necessary to safely conduct commercial lending
- Qualified lending personnel in underwriting and processing, overseeing and evaluating the performance of the portfolio, and collection and loss mitigation
- Several options to meet the experience requirements are available

Commercial Lending Policies (Section 723.4)

- Types of commercial loans permitted
- Trade area
- Maximum amount of assets in relation to net worth allowed in any given category or type of commercial loan and to any one borrower or group of associated borrowers
- Qualifications and experience requirements for personnel
- Loan approval process including approval authority
- Underwriting requirements
- Risk management processes

Underwriting Standards

- Level and depth of financial analysis
- Due diligence of the principal(s)
- Borrower-prepared projections when historic performance does not require debt payments
- Financial statement quality and the degree of verification
- Methods to be used in collateral evaluation, including LTV limits
- Appropriate risk assessment including analysis of the current market conditions

Risk Management Processes

- Loan covenants
- Periodic loan review
- Credit risk rating system
- Process to identify report and monitor loans exceptions
- Compliance with government guaranteed programs
- Independent loan review (internal audit or outsourced)
  - Frequency based on risk profile
  - Scope:
    - Risk rating accuracy/timeliness
    - Underwriting adherence/documentation completeness
    - Covenant compliance

Committee & Internal Audit Responsibilities

- **Independent assurance role** over commercial lending program
- Evaluate
  - Policy compliance vs. actual practices
  - Adequacy of internal controls
  - Accuracy and reliability of reporting to the Board
- Ensure **segregation of duties** between
  - Origination
  - Credit approval
  - Risk rating
  - Loan review

Committee & Internal Audit Responsibilities Data Integrity

- Validation of:
  - Spreads and financial statement inputs
  - Debt service calculations (DSCR)
  - Global cash flow analysis
- Controls over:
  - Spreading software
  - Risk rating models
  - Stress testing assumptions

Board Reporting

- Does the Board get regular reporting? Is it being reviewed and validated?
  - Commercial loan delinquency reporting
  - Watch list and criticized assets reporting
  - Migration reporting
  - Exception monitoring
  - Internal loan review statistics
    - Past due reviews and other categories
  - Pipeline reporting
  - Monitoring of deposit accounts held at the credit union

Credit Risk Review & Analysis Key Points

- Three primary sources of repayment
  1. Cash flow
  2. Collateral liquidation
  3. Guarantor Support
- Property/Borrower debt service vs. global debt service
  - Which is more important?
- Pro-forma vs. historical
  - Are you accounting for risk of projections-based lending?

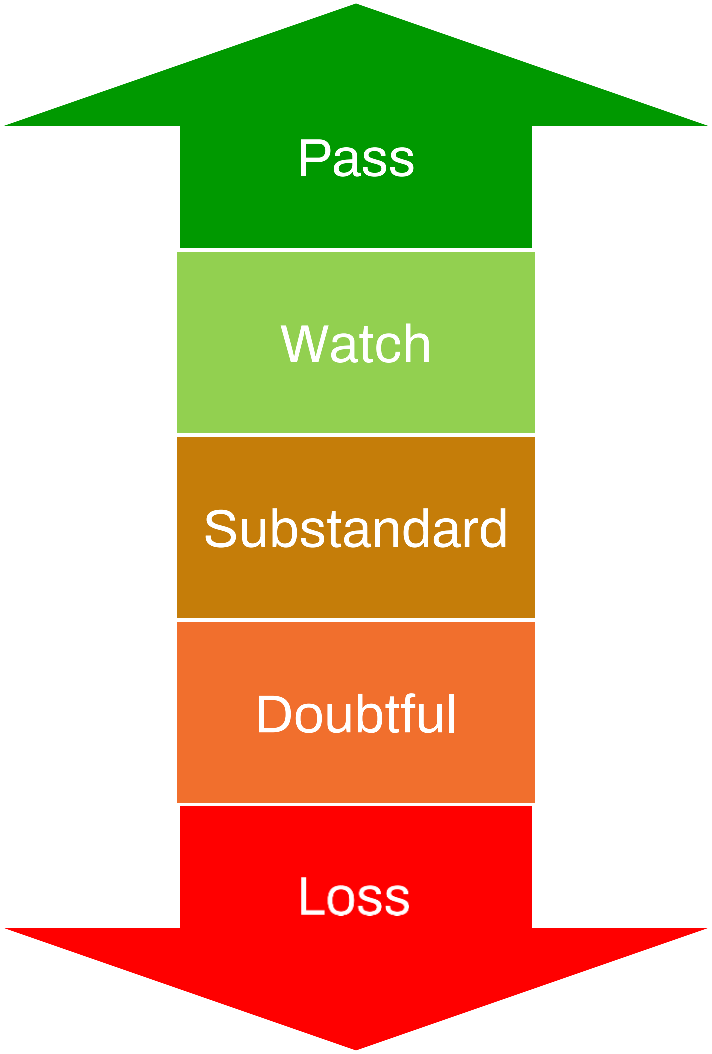
Credit Risk Review & Analysis Key Points

- Stress testing loans
  - Consider stress testing for shorter amortizations, such as 20-year when using a 25-year amortization
  - Are you stress testing loans for increase in interest rates?
  - Vacancies and breakeven analysis
  - Are deferred maintenance considered when looking at future cash flow and needs?
- Other items
  - Verification of debt on balance sheet
  - Working capital for C&I loans
  - C&D loans

Credit Risk Review & Analysis Key Points

- Independent challenge of assumptions
  - Vacancy rates
  - Interest rate increases
  - Cap rate changes
- Scenario severity
  - Are “downside” cases realistic?
- Documentation
  - Are results used in decision-making?

Credit Risk Ratings/Definition



- Definition clarity and objectivity
- Consistent application

Credit Risk Ratings

						Watch	Substandard	Doubtful	Loss
Category	**Weight**	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**
CF	40.0%	2.00+	1.50-2.00	1.20-1.50	1.20	1.00-1.20	0.80-1.00	<0.80	
LTV	20.0%	50%	60%	70%	75%-80%	85%-90%	90%-100%	>100%	
Liquidity (months of coverage)	15.0%	24	18	12	9	6	0-6	<1	0
Trends (Mgmt./Operations/FICO)	7.0%		Significant increase	Slight increase	Stable	Some decline	Significant decline	Noted failures	
Local Market Risk	7.5%		Significant increase	Slight increase	Stable	Some decline	Significant decline	Noted failures	
Industry Risk	5.0%		Significant increase	Slight increase	Stable	Some decline	Significant decline	Noted failures	
Leverage	5.0%								

Collateral Risk Overview

- Does the credit union have well defined thresholds for % limits on types of loans?
  - Are these being monitored and reassessed on an annual basis?
- Collateral monitoring
  - Does the credit team have an accurate way to reassess collateral and is it being instituted properly?
  - How are changes in collateral being addressed?
  - What is the process for monitoring collateral outside of your geographic footprint?
  - Are collateral migration and loan to values in the portfolio being tracked and reported?

Collateral Risk Overview

- Concentration monitoring
  - By industry (e.g., CRE, office, hospitality)
  - By geography
  - By borrower relationship
- Limits testing
  - Compare actual vs. policy thresholds
- Internal audit validation
  - Are concentrations accurately reported?
  - Are limits exceeded and properly approved?

Collateral Risk Overview

- Rent roll analysis
  - Are loan terms being matched to rent rolls (excluding multi-family)?
  - Review of lease turnover
    - When do leases expire and how does this affect capacity?
    - If an anchor tenant is in place, does the lease run through the term of the loan? If not, how will they be replaced?
- Equipment
  - Is useful life being considered?
  - Matching amortizations
  - How is it being valued?
- Borrowing-based lending

Spotting Problem Loans

- Delinquency issues
- Missing financial statements
- Lack of cooperation with requests
- Loan officer and analysts have little knowledge of current situation
- Troubling industry data (office, hotel, etc.)
- Declines in market values
- Increases in vacancy rates
- Deferred maintenance issues
- Overdraft on accounts

Use common sense!

Spotting Problem Loans

- Add structured **audit testing of early warning indicators**:
  - Covenant violations
  - Declining DSCR trends
  - Delays in receiving financial statements
  - Frequent overdrafts (already mentioned)
- Internal audit should test whether exceptions are
  - Logged
  - Escalated
  - Resolved timely

Workout Strategies Overview

- Steps when a troubled loan is identified
  - Primary focus is to maximize repayment of loan
  - Collect current information
  - Review current loan documentation for missing signatures, covenant measurements, etc.
  - Verify UCC filings and tax payments
  - Consider updating appraisal
  - Visit borrower and discuss issues and potential strategies

Workout Strategies

- Hire legal counsel
- Take control of collateral
- Update collateral information
- Identify what debt levels can be supported
- Ensure all agreements are executed, collateral is perfected
  - Insurance gaps, guarantee enforceability
- Loan modifications
  - Identify what options may work
- Refinances
  - SBA or conventional
- Adjust due dates
- A and B note options
- Negotiate liquidation of collateral

Regulatory Findings

- Collateral reevaluation
  - Is collateral reevaluated when an annual review is completed?
- Board reporting
  - Is the board well informed through monthly and quarterly reporting?
- Projection based lending
  - Are the projections realistic and are they being reviewed?
  - How are you accounting for projections in your risk rating?

Loan Participations & CUSOs

- Proper and thorough due diligence is critical
- Due diligence defined in policy
- Credit review should be independent of the originating institution
- Ongoing monitoring should also be independently performed
  - Ensure to use recent financial statements
  - Order new appraisals if out of date
- Ultimately, your institution assumes the risk associated with these loans

Loan Participations & CUSOs

- Internal audit should assess
  - Due diligence documentation
  - Monitoring of lead lender performance
  - Timeliness of financial information
- Vendor risk if using
  - Loan review firms
  - Appraisal firms

Allowance for Credit Losses (ACL/CECL) Oversight

- Review methodology and assumptions
- Validate qualitative factors
- Test data inputs
  - Alignment between:
    - Risk ratings
    - Historical loss data
    - Forecast adjustments

Credit Culture & Incentives

- Are lending incentives tied to volume vs. credit quality?
- Signs of poor culture
  - Weak documentation
  - Aggressive risk ratings

Tips for Lending in an Uncertain Economy

- Consider increasing equity requirements
- Increase financial reporting requirements.
- Improved balance sheet analysis
- Consider covenants to manage distributions and preserve equity
- Enhanced rent roll analysis
- Shorter term loans
- Variable vs. fixed rate lending

Improved risk mitigation leads to stronger credit culture

Commercial Loan Audit Scope Outline

- Policy compliance testing
- Loan file reviews (sample-based)
- Risk rating validation
- Covenant testing
- Collateral verification
- Board report reconciliation
- ACL methodology review
- Concentration risk testing

Example Only
Always tailor your specific situation for sample coverage and depth

Questions?

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Thank you