CMS ADVISOR

CREDIT MANAGEMENT SERVICES

LOAN GRADING

The cornerstone to building your ALLL methodology.

Allowance for Loan and Lease Losses (ALLL) has become one of the most commonly used regulatory acronyms in today's banking world. Banks are continually monitoring, managing, and quite honestly, massaging, the methodology used for calculating this increasingly important number.

I have heard many thoughts on perfecting the methodology over the past year. Everything from "We changed our historical calculation from 5 years to 2 years" and "We are increasing our Q-factors due to changes in lending staff" to "We now perform a FASB 114 analysis on all of our Substandard or worse credits" are the type of discussion items we are hearing from bankers today. These things, and many others, are instrumental in refining the ideal ALLL process within your bank. However, it seems that many bankers that we visit with are overlooking the fundamental cornerstone of building a strong ALLL methodology: loan grading.

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Loan grading seems like such a simple task, especially for someone who is involved with the loan on a regular basis. You assess the risk and grade appropriately, right? Unfortunately, for many banks today, this seemingly simple task is not being performed properly. Due to this fact, banks across the country are understating the amount of their ALLL and therefore, overstating capital.

Inherently, most bankers realize the importance of accurate loan grading. Practically, proper grading can be difficult to implement.

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LOAN REVIEW: IS IT NECESSARY?

This question often arises with bankers, especially when times are good. The answer in all economic environments is a resounding "YES!!".

An independent loan review performed by a quality firm will identify weaknesses in internal loan grading, provide insight to potential impairment issues, and give management a better understanding of the bank's loan portfolio compared to peer banks.

If you are not currently using an independent firm or you would like a 'fresh set of eyes' to review your portfolio, call CMS today.

You, and your Board, will be glad you did.

be prudent for the bank to ask the responsible loan officer to grade his/her own credits. Sometimes, people get emotionally attached to deals. Regarding quality customer service, that may be a good thing. With regard to loan grading, emotional attachment is a disadvantage. For this reason, loan grading generally should be the responsibility of the Chief Credit Officer or Senior Lender. In many cases, the Chief Credit Officer or Senior Lender engages a third-party independent loan review firm to help apply grades and identify risks. A fresh set of eyes yields a rational grade in most instances. Although grading can be subjective, the facts are always the facts. An unbiased review of facts validates risk. Generally this is true, but not always.

Unfortunately, I could give you multiple examples of grade discrepancies that seem obvious from various banks. For the sake of time, I will address only one example. Consider the following scenario. XYZ Bank made a loan several years ago to a customer for the purchase of commercial real estate that the borrower now occupies. The loan is secured by the commercial real estate. The Bank recently obtained a new appraisal of the property reflecting a 62% Loan-to-Value ratio. Pretty good, considering the drop in property values since purchase. The borrower has had multiple delinquencies since the loan origination, in fact, the loan is several payments past due at this time. A red flag? The Bank requires the borrower to provide annual financial statements and tax returns. A review of the borrower's most recent tax return shows that his debt-to-income ratio is now 89%. His Adjusted Gross Income was $250,000. The remaining 11% does not easily support basic living expenses, taxes, entertainment, etc. A red flag? The most recent financial statement reveals that the borrower has almost no liquidity. Not surprising considering an 89% D/I ratio. Another red flag? Next, the borrower's property is located within a flood zone. The borrower's flood *and* hazard insurance has expired. Although the Bank has requested proof of insurance from the borrower multiple times, no evidence has been provided that it exists. Therefore, the Bank has force-placed flood and hazard insurance on the subject property. Another red flag? Next, the Bank has documented in the loan file that the borrower is at least two years delinquent on the property taxes associate with this real estate. Another red flag? Finally, due to all of the above factors, the Bank has initiated the foreclosure process by filing a Notice of Default. A HUGE red flag!?!?

These are the facts relating to this loan. The Bank has the loan graded as Watch. Most would believe that this was a simple oversight on the part of the responsible loan officer or maybe even the Chief Credit Officer. However, when asked, Bank personnel strongly defended the grading position based on the collateral value from the recent appraisal. Granted, the bank's dollar loss risk in this credit may be mitigated by the collateral value. However, due to the overwhelming negative factors, this loan clearly warrants a harsher risk grade than Watch. In fact, I believe it fair to say that virtually every credit that requires the initiation of foreclosure carries a risk weighting heavier than Watch. Loan grading should not be achieved purely on potential dollar loss to the Bank.

The above loan should have been graded harsher. However, the amount of dollar reserve associated with that particular loan may not change from Watch to Special Mention to Substandard due to the strength of the collateral. The bank should have a methodology in place to support the calculation of the reserve for individual loans based on the facts associated with each credit.

The point is that loan grading should not be derived solely based on the risk of loss to the bank. The loan portfolio should be graded based on the facts associated with each credit to determine the risk of each

individual credit failing to meet the contractual obligations of the Promissory Note. If there is a higher-than-normal risk of the credit failing to meet the contractual obligations, then the loan should be graded appropriately. Only after each loan is graded accurately, should the reserve calculation be considered.

If you are not accurately grading your loan portfolio, it is impossible to believe that your ALLL methodology can be valid. In today's banking world, if your ALLL methodology is not valid, you will likely not enjoy a positive relationship with your regulatory agencies. To go a step further, if your regulatory agencies are downgrading significant amounts of loans based on their reviews, you face a substantial risk of loss of credibility with your regulator, or even worse, a potential downgrade in the Management component of your CAMELS rating.

Loan grading is therefore a very serious issue for every bank to deal with in our current regulatory environment. Grading should not be a difficult process, however, it does have to be accurate.

Credit Management Services provides loan review services to banks throughout the western U.S. If you have a need for credit review or due diligence projects, call us first.

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