reTHINK your approach to loan management

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Preparing for a Financial Institution Safety and Soundness Exam

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March 2010

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In today's recessionary economy, decreasing real estate values, and an increasing number of loan defaults, regulatory enforcement actions are on the rise. This environment has been a source of increasing anxiety on the part of bank management since a number of the economic and political factors are out of their control. However, taking a proactive approach to preparing for a bank examination will allow the best possible exam result.

The following are the key areas your financial institution's management should give some attention before an upcoming bank examination focused on asset quality or safety and soundness in your institutions loan portfolio.

1. **Loan Policy** – Is your institution's loan policy up to date and reflective of the current regulatory guidance for loan portfolio and credit risk management practices? The loan policy is the primary means by which your institution's board and senior management guide and monitor lending activities. The loan policy should provide a framework for your institution's asset quality and earnings objectives, setting of limits on risk tolerance levels, and guides the institution's lending activities consistent with the institution's overall strategic direction. In addition, the loan policy sets standards for portfolio composition, individual credit decisions, fair lending and compliance management. There is no ideal format for a loan policy as they can vary in length and degree of detail depending on the size and complexity of your institution's lending activities. At a minimum, your loan policy should contain the following topics with supporting detail:

   - Loan authorities
   - Limits on aggregate loans and commitments
   - Portfolio distribution and concentration limits by loan category and product
   - Geographical limits
   - Desirable types of loans
   - Underwriting criteria
   - Financial information and analysis requirements
   - Stress testing of CRE loans and loan portfolio
   - Collateral and structure requirements
   - Margin requirements
   - Pricing guidelines
   - Documentation standards
   - Collections and charge-offs

Additional topics should be considered if your institution is engaged in more complex or specialized industry types of loans.

Many financial institution enforcement actions and the supplemental communications that accompany these actions will typically indicate that the 'root cause' of the various areas criticized is due to a lax 'credit culture'. A strong, up to date loan policy that is being followed will set the tone for an examiners view of your credit culture.

2. **Risk Identification** – Does your financial institution have your commercial loans properly risk rated and graded consistent with your institutions risk grading policy? A primary component contributing to a financial institution enforcement action is for the examiners to downgrade risk ratings below what your institution has identified in the portfolio, particularly if there is a number of instances of downgrades they have identified. Risk ratings should be properly set each time a customer loan relationship is reviewed for a new or renewal loan request to ensure the risk grade is set properly. For term amortizing credits, an annual review process is recommended once annual financial information is received to in order to accurately review the customer against your institutions risk grade

policy. An addition means of ensuring accurate risk ratings prior to an exam is to have an active internal or external loan review process that is periodically reviewing and testing the accuracy of the risk grade for a loan customer. A culture of actively upgrading or downgrading a risk grade for changing credit or environmental conditions is encouraged. Risk grades should be fluid and be based on current conditions and not future expected outcomes.

3. **Document and Policy Exceptions** – A major weakness found in a number of financial institutions engaged in lending is the lack of proper identification of documentation or policy exceptions that exist in the loan portfolio. Your institution should have strong controls in place from a loan administration process and procedures to accurately identify and track outstanding document and policy exception until they are cured. In addition, your institution's internal or external loan review process should serve as a check against the loan administration procedures for proper identification of these exceptions. Finally, the number of outstanding documentation exceptions should be actively managed and at a minimum number of only the most recent active exceptions in the process of being cured.

4. **Concentration of Risk** – Your financial institution should have identified prior to any examination a solid understanding of where you have various concentrations in your loan portfolio. The concentrations segmentation should include concentrations to any one borrower or group of borrowers, industry concentrations and concentrations by loan types such as commercial and industry, real estate, and consumer loans. Within these broad segments, additional segmentation should be documented. Where there are deemed to be concentrations by either regulatory or your institutions policy limits, additional documentation is recommended for how the bank is strategically managing the concentration and its potential impact on the bank's overall loan portfolio risk profile. For instance, an institution with a concentration in commercial real estate loans should have strong policies and procedures in place for stress testing loans and the portfolio to determine impact on risk grades or the bank's capital levels, based on changing conditions for interest rates, cap rates, absorption or vacancy.

5. **Allowance for Loan and Lease Losses (ALLL)** – Your institution should review its ALLL policy and procedures to ensure the process by which you determine the adequacy of your loan loss reserves is accurate and is fully funded based on the results of the ALLL analysis. Your ALLL policy and procedures should be adequately documented and reviewed by your institutions board of directors. The ALLL documentation should also document your institution's compliance with FAS 5 and FAS 114 regarding regulatory accounting guidance on establishing portfolio reserves based on historical loss in various categories of loans combined with evaluating reserves for impaired loans. Additional environmental factors at the local or national level should be evaluated and factored into any final reserve allocations.

6. **Collections and Work-out –** Prior to an exam, review your procedures and process for handling past due and problem loans. Early identification of credit weaknesses or adverse trends are critical to the ongoing minimization of future credit losses that might be incurred if a loan is not properly managed either before it comes past due or after its risk grade has been downgraded to a criticized or classified loan.

7. **Credit Management Systems –** While strong loan polices and procedures are critical to ensuring a good exam for safety and soundness, examiners will also be reviewing the systems your institution is utilizing to determine how well they support and supplement your overall loan portfolio management and the controls you have at the loan officer, credit analyst and at the credit and loan administrative functions. A strong credit management system(s) as provided by your core and various software applications will need to be documented in term of policy and procedures and how they support your

lending function in terms of controls and information reporting to management and the board

Your institution's attention to these seven key areas throughout the year and prior to a bank exam will be a positive contributing factor in the final assessment of your bank Safety and Soundness exam, particularly if the actual results and conclusions of the examines are consistent with what your institution has already identified and are in the process of proactively managing, particularly if asset quality is declining.

About Suntell

Suntell, Inc. (www.suntell.com) is a leading provider of software for loan portfolio and risk management for banks and credit unions of all sizes in the United States. Suntell is the developer of the SquareOne Credit Suite, which includes products for loan approval and underwriting, risk identification and management, documentation and exception tracking, collections and problem loan workout planning, management information reporting, loan document imaging, agricultural underwriting and analysis, loan pipeline and workflow solutions, as well as interfaces to core accounting systems and loan origination systems. The company is owned by Financial Institution Technologies.