The Importance of a Loan Policy "Tune-Up"

The fortunes of FDIC-insured institutions have been closely tied historically to how well they managed credit risk. A written loan policy, approved by a bank's board of directors and adhered to in practice, is of critical importance in ensuring that the bank operates within prescribed risk tolerances. In today's fiercely competitive and challenging lending environment, an up-to-date policy, appropriate to an institution's lending function and business plan, may be more important than ever. This article summarizes features and benefits of an effective policy, details warning signs and potential consequences of an outmoded policy, and offers practical advice about reviewing and updating a loan policy.

Elements of an Effective Loan Policy

Written loan policies vary considerably in content, length, and specificity, as well as style and quality. No two institutions share the same tolerance for risk, offer the same product mix, and face the same economic conditions. An effective loan policy should reflect the size and complexity of a bank and its lending operations and should be tailored to its particular needs and characteristics. Revisions should occur as circumstances change, and the policy should be flexible enough to accommodate a new lending activity without a major overhaul.

During risk management examinations, examiners make a determination about the adequacy of an institution's loan policy. Bank examiners are guided in their review by regulations, examination guidelines, and common sense: Is the policy up-to-date and are important areas adequately addressed? The *FDIC Manual of Examination Policies* lists broad areas that should be addressed in written loan policies, regardless of a bank's size or location (see box on p. 26).[1]

A loan policy should include more detailed guidelines for each lending department or function. For example, the real estate lending department should comply with specific guidelines appropriate to the size and scope of its operations. In fact, as part of the *Interagency Guidelines for Real Estate Lending Policies,* the federal banking agencies list 57 areas to be considered in written policies on real estate lending, ranging from zoning requirements to escrow administration.[2]

In addition, in 1995, the federal banking regulatory agencies established basic operational and managerial standards for loan documentation and credit underwriting.[3] These standards also should be incorporated into a bank's written loan policy. For example, loan documentation practices should take into account the size and complexity of a loan, the purpose and source of repayment, and the borrower's ability to repay the indebtedness in a timely manner. And among other things, underwriting practices should include a system of independent, ongoing credit review and appropriate communication to management and the board of directors.

[1] See *FDIC Manual of Examination Policies,* Section 3.2 – Loans (I. Loan Administration – Lending Policies).

[2] The *Interagency Guidelines for Real Estate Lending Policies* describes the criteria and factors that the bank regulatory agencies expect insured institutions to consider when establishing real estate lending policies. These guidelines, which took effect March 19, 1993, address loan-to-value limits for various categories of real estate loans.

[3] *The Interagency Guidelines Establishing Standards for Safety and Soundness,* which implements Section 39 of the Federal Deposit Insurance Act, was adopted on July 10, 1995.

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A Loan Policy Should Address…

- General fields of lending
- Normal trade area
- Lending authority of loan officers and committees
- Responsibility of the board of directors in approving loans
- Guidelines for portfolio mix, risk diversification, appraisals, unsecured loans, and rates of interest
- Limitations on loan-to-value, aggregate loans, and overdrafts
- Credit and collateral documentation standards
- Collection procedures
- Guidelines addressing loan review/grading systems and the allowance for loan and lease losses
- Safeguards to minimize potential environmental liability

Benefits of an Effective and Up-to-Date Loan Policy

A sound loan policy, established and overseen by the board of directors, reflects favorably on the board and management. When a board sets forth its expectations clearly in writing, management is better positioned to control lending risks, ensure the institution's stability and soundness, and fulfill oversight responsibilities. An effective and up-to-date loan policy increases the likelihood that actual loan documentation and underwriting practices will satisfy the board's expectations. Furthermore, a well-conceived policy clearly and comprehensively describes management's system of controls and helps examiners identify high-risk areas and prioritize and allocate examination time.

In 1997, the FDIC began implementing new, risk-focused examination processes.[4] During a risk-focused examination, examiners focus on areas that represent the greatest risk to the insured institution. A written policy is tangible evidence of the processes that have been established to identify, measure, monitor, and control risks in the lending area. An incomplete or inadequate policy makes it more difficult to identify potentially high-risk areas and may raise supervisory concerns about an institution's risk management practices.

Signs That a Loan Policy Needs a Tune-Up

A recent cover date does not provide adequate assurance that a policy is current. Only a careful review of the entire policy will reveal the extent of any shortcomings; however, even a cursory review can provide clues that a policy needs an overhaul. Common red flags include:

- The policy has not been revised or reapproved in more than a year.
- Multiple versions of the policy are in circulation.
- The table of contents is not accurate.
- The policy is disorganized or contains addendums from years past that have never been incorporated into the body of the policy.
- The policy contains misspellings, typos, and grammatical errors.
- Officers and directors who no longer serve are listed, or new ones are not listed.
- The designated trade territory includes areas no longer served, or new areas are omitted.

[4] On October 1, 1997, the FDIC, Federal Reserve, and state banking departments implemented a risk-focused examination process. To allocate examination resources effectively, on-site procedures are customized on the basis of a bank's overall risk profile. In April 2002, the FDIC implemented a streamlined examination program called MERIT (***M***aximum ***E***fficiency, ***R***isk-Focused, ***I***nstitution ***T***argeted Examinations). This program was applicable to banks that met basic eligibility criteria, such as total assets of $250 million or less and satisfactory regulatory ratings. In February 2004, the FDIC expanded the use of MERIT to eligible, well-rated banks with total assets of $1 billion or less; see FIL 13-2004 - https://www.fdic.gov/news/inactive-financial-institution-letters/2004/FIL1304.html.

- Discontinued products are included, or new products are not addressed.
- New regulations are not addressed.

In addition, a review of lending decisions may identify areas where management is departing from the specifics of the loan policy, such as:

- Actual lending practices vary significantly from those outlined in the policy.
- Numerous exceptions to policy requirements have been approved.
- Policy limits are being ignored.

Exceptions to policy should be few in number and properly justified, approved, and tracked. If actual practices vary materially from the written guidelines and procedures, the source of this discrepancy should be identified, and either actual practices or the written policy should be changed. Management may conclude that specific sections of the written policy are no longer relevant. A case is then made to the board of directors to amend the policy to reflect different, but still prudent, procedures and objectives.

Potential Consequences of an Inadequate Loan Policy

Outdated and ineffective loan policies can contribute to a range of problems. Introducing a loan product that is not adequately addressed in the written loan policy can create a variety of challenges for the lending staff and involve risks that management did not anticipate.

If lending authorities, loan-to-value limits, and other lending limitations are not revised when circumstances change, a bank could be operating within guidelines that are too restrictive, too lenient, or otherwise inappropriate in light of the bank's current situation and lending environment. If guidelines do not comply with current laws and regulations, lending decisions may not reflect best practices or regulatory requirements. Imprudent lending decisions can have a ripple effect. A loan policy that does not anticipate the risks inherent in an insured institution's lending practices can lead to asset quality problems and poor earnings. In turn, earnings that do not fully support operations increase an institution's vulnerability to adverse movements in interest rates, a downturn in the local economy, or other negative economic events.

The Loan Policy Updating Process

A bank's loan policy is not a static document, but rather should be revised as the institution, business conditions, or regulations change. A comprehensive annual review, in addition to more limited reviews as needed, will help ensure that a loan policy does not become outdated and ineffective. The frequency and depth of the reviews will depend on circumstances specific to each institution, such as growth expectations, competitive factors, economic conditions, staff expertise, and level of capital protection. Planned changes to an institution's lending function or business plan should prompt a modification to the policy. Pertinent criticisms and recommendations made during recent audits and regulatory examinations should be considered during the updating process.

In certain situations, a loan policy can be updated effectively through addendums or supplemental memorandums, but if carried too far, such "cobbling together" can result in a cumbersome and disorganized document. It is best to merge supplementary materials periodically into a logical place in the main document. The updating process also includes identifying obsolete or irrelevant sections of the policy. For example,

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a bank might have entered a new field of lending a few years ago and modified its loan policy at that time. However, when it became obvious the bank could not compete successfully in this field, management wound down the operations. The loan policy should reflect the decision to exit that lending niche.

Compliance testing, conducted as part of the updating and audit processes, will help management determine whether staff is aware of and adhering to the provisions of a loan policy. An institution's board of directors should demonstrate their commitment by emphasizing that noncompliance is unacceptable. Loan staff, executive officers, and directors should be able to demonstrate some level of familiarity with all provisions — more so with the provisions that affect their daily responsibilities. Awareness and knowledge of the policy's specific provisions can be promoted through periodic training that stresses the need for the policy to keep pace with current lending activities and clarifies any areas of ambiguity or uncertainty. Specific areas that may benefit from review are

- ranges for key numerical targets, such as loan-to-value ratios or loan portfolio segment allocations
- responsibility for monitoring and enforcing loan policy requirements
- documentation requirements for various classes of loans
- remedial measures or penalties for loan policy infractions
- preparation and content of loan officer memorandums
- individual and committee lending authorities

Conclusion

A current and effective loan policy is a tool to help management ensure that a bank's lending function is operating within established risk tolerances. Such a policy is more likely to be consulted and followed by staff and contributes to uniform and consistent board-approved practices. Therefore, insured institution staff, borrowers, and regulators will be well served by the implementation of a process that helps ensure that a bank's loan policy remains comprehensive, effective, and up to date.

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