Best Practices for Dealing with Heightened Levels of Asset Quality Concerns

The loan portfolio is typically the largest asset and the most predominant source of income for a financial institution and is also one of the greatest sources of risk. Effective loan portfolio management is fundamental to a financial institution's safety and soundness. When a financial institution is experiencing heightened credit losses, increased nonperforming assets, or negative loan portfolio trends, management should implement proactive strategies to identify problems timely and protect the viability of the financial institution.

Board and Committee Involvement

One of the hallmarks of an effective management team is frequent communication and involvement with the Board of Directors (Board) particularly when asset quality concerns are escalating. At a minimum, the status of identified problem assets should be discussed with the Board at monthly meetings. Enhanced monitoring of the loan portfolio is vital in understanding the scope and extent of asset quality challenges. Emphasis on controlling the quality of ongoing individual loan approvals and managing the overall performance of loans continues to be essential; however, forward-looking risk indicators of the comprehensive loan portfolio are also necessary. Management should monitor and report the loan portfolio in its segments and wholistically to consider risks posed by each credit as well as interrelationships that can multiply risks. Historical indicators of credit quality such as delinquency, nonaccrual status, and risk rating trends are beneficial; however, forward-looking metrics such as loan-to-values, debt service coverage ratios, loan policy exceptions, and concentration segments can be valuable in understanding the depth of the asset quality weaknesses.

Another action to consider is to curtail loan approval limits, so that credit approvals over a certain dollar amount are approved by the Board or Loan Committee before funding. Additional layers of review of new and renewing credits can be effective, particularly when Boards have knowledge of the marketplace and industry, which is often the case. Prudent risk selection in times of asset quality challenges is vital to future loan quality.

Board and Loan Committee direction throughout the loan process from commitment to repayment should be followed. Financial institution staff should comply with Board-established loan policies and procedures on a consistent basis and consequences for non-compliance should be established. Loan policy compliance can be imbedded in the loan operations area and a secondary review process can be established to verify policy compliance.

Identification of Problem Loans

Management should review loan portfolios closely and objectively to proactively identify problem credits. This process should include evaluating not only non-performing loans but also borrowers that have structural or operational issues, especially where payments may have been kept current through interest reserves or payments from other sources. By identifying such loans, management can establish appropriate strategies to strengthen these credits and initiate an effective collection strategy to minimize potential loss exposure.

Management Oversight of Identified Problem Loans

Increased oversight of identified problem assets is essential. A management loan committee could be used to review watch list loans weekly to determine the condition of the loan, identify action items that need to be accomplished, and establish timelines for these action items. In instances of loan portfolio concentrations, a financial institution should review loans within the concentration with appropriate considerations. For example, a financial institution with an acquisition, development, and construction concentration would review items such as current condition of the borrower, building permits issued, housing or lot sales, speculative and pre-sold units, total builder inventory, and the construction inspections. In all cases, it is important that management be aware of the condition of the collateral. If a borrower is not maintaining the physical upkeep and security of the collateral, the financial institution may need to take possession of the property to safeguard the value of the collateral.

Management should evaluate staff responsibility in handling identified problem credits. Management might choose to establish a special assets structure for problem loans where collection responsibility is transferred away from the originating loan officer once the credit has been moved to a Special Mention or Adversely Classified status. This change permits a more objective, and often, a more seasoned loan officer to supervise the collection of impaired or non-performing assets. It is particularly important that senior management assess the adequacy of loan staffing during this period of increased asset quality weaknesses. It is vitally important that staffing be both adequate in number and experience to meet the challenges of properly managing asset quality issues.

Management should analyze the entire loan portfolio in a timely manner to determine if credit concerns are isolated or systemic. The analysis should include, at minimum, a review of collateral type, loan product, geographic location, and loan policy exceptions to determine if similar risk characteristics of problem credits exists. By performing this analysis, the Board and management can project the potential financial impact to the institution to proactively determine appropriateness of lending curtailments, bulk sale opportunities, or needed external capital enhancements. Previous economic challenging environments have shown proactive leadership allows the institution to pursue greater internal and external opportunities to provide long term viability to shareholders or members.

Appraisals

One likely impact of a weakened economic environment is a decline in appraised market values. Management may choose, or be required, to obtain new appraisals to accurately quantify potential loss exposure on real estate loans. Close evaluations of appraiser qualifications and, in some cases, decreasing the number of qualified appraisers can be used by the financial institution to maintain quality control. Management may also consider using a third-party appraisal review company to ensure that the appraisals meet Interagency Guidelines on Real Estate Appraisals and Evaluations and Uniform Standards of Professional Appraisal Practice requirements and appear appropriate based on the reviewer’s knowledge of the market.

External Loan Review

A strong, independent, and qualified external loan review is one of the most necessary strategies that management can use to identify asset quality concerns in a timely and effective manner. The Board should make certain that the firm hired to perform this function is experienced and independent in their judgment and reporting procedures. Management should consider an increase in the frequency and scope of these reviews during a period of asset quality stress.

Loan Operational Concerns

Experience has shown that when large loan losses are examined in detail, their common characteristics often include:

- Loan documentation problems, including the lack of perfected collateral liens or other structural concerns;
- A misunderstanding or misanalysis of the financial institution's collateral position;
- Loan funding prior to the receipt of complete collateral and/or credit documentation;
- Weak or poorly analyzed financial information;
- An undocumented or poorly understood plan of repayment;
- Assuming more risk in the transaction by delaying principal reductions when the borrower is generating cash flows; and/or
- Not requiring the borrower to have sufficient project equity.

To avoid these challenges, management should establish and provide for adequate loan operational staffing as well as policies and procedures to address these challenges when the credit is extended or renewed. In times of asset quality challenges, management should perform operational reviews on the existing loan portfolio to identify and correct documentary and operational deficiencies where possible.

Allowances for Credit Losses (ACL)

During a period of weakened asset quality, it is important that management increase focus on maintaining a proper and adequate ACL. Management is required to establish a sound and well-documented methodology that reflects the condition of the financial institution, and which is affirmed as satisfactory during the examination process and independent audit.

Strategies for the Recordation and Disposition of Problem Assets

Financial institutions must properly reflect the valuation of assets on their books and records. The Board must provide for establishment of a well-documented, regulatory-conforming process that results in an appropriate balance in the ACL account. In addition, other real estate and repossessed assets should be reflected at a proper valuation when collateral is taken by the financial institution and periodically until resolution.

Management needs to develop adequate strategies for disposition of problem assets that consider the individual circumstances of each financial institution and may vary depending on the status and condition of the borrower, the location of the property or collateral, and assessment of the real estate or other collateral market. Management should develop a structured workout strategy and timeline for each problem credit. Department staff will consider the following items in the assessment of workout strategies for problem assets:

- Are the strategies outlined realistic and do they appear to maximize the collectability of the loan or other real estate?
- Are the strategies realistic when viewed wholistically with the condition of the financial institution, including the level of the ACL, capital, and liquidity?
- Is there a proper assignment of management responsibility for the workout strategies and oversight?
- Is there an established timeline for the strategies and are the timelines being met?
- Are the strategies regarding the disposition of collateral (ownership by the borrower or taking possession of the collateral by the financial institution) appropriate based on the circumstances, conditions, and valuation of the collateral?

Operational Impact

Financial institutions experiencing asset quality weaknesses may also experience significant earnings pressures due to a combination of declining net interest margins, increasing ACL provisions, and increasing collections expenses. While it is important during this period to carefully monitor expenses and perhaps even reduce expenses, it is imperative that financial institutions obtain and retain competent and seasoned loan officers and loan personnel with experience in collections.

Liquidity and funds management is another area of operational focus. Financial institutions experiencing higher levels of non-performing assets must focus on balance sheet funding and make necessary decisions on obtaining and accessing funding sources. Management must closely analyze the market and competition; offer or obtain needed or projected funding sources; and realistically evaluate available funding sources in consideration of the current or projected capital position or other regulatory limitations. Liquidity and funds management also involves seeking and obtaining various secondary liquidity sources and actively monitoring and managing liquidity daily.

Impacts from declines in investment portfolio marketability and valuations should be closely monitored. Material levels of unrealized loss embedded in the securities portfolio may impact using securities as a pledging resource for public funds or secondary lines of funding; liquidating investments to fund loans; and compounding income declines. The impact to liquidity and overall balance sheet management should be closely forecasted.