The Board's Role in Overseeing Credit Risk

by: David Ruffin, Principal, IntelliCredit

As a director, do you know the right questions to ask about the quality of your bank's loan portfolio and the loan underwriting process that supports it? The board plays a vital role in maintaining the institution's credit standards. It does not have (nor should it have) direct day-to-day responsibility for credit risk management, but instead needs to set the tone for senior management and the lending team, first by establishing clear credit standards, and second by applying sound risk governance oversight to the lending process. Here are six questions that the board should consider in terms of how it approaches credit oversight.

1. Should we be engaged in transactional credit approvals?

This is a pattern that once-and-for-all needs breaking. Admittedly, the boards at smaller banks are more likely to perform the last screening rites for large deals than bigger, more complex banks. In an era where credit risk talent in general is at a premium in our industry, it is presumptuous to think that wisdom resides exclusively in the directorate. As most bank executives acknowledge the often "rubber stamp" nature of board level approval forums, there's the efficiency issues for loan turnaround. Besides, direct approval of loans brings personal liability to directors. It's not a matter of divesting from credit generally, but of the primary focus being macro—not transactional. As a director you need to see the forest, not the trees.

2. What key mileposts are there in embracing more macro portfolio oversight?

Macro portfolio oversight is where the action needs to be for directors. Key questions:

- Are we employing periodic credit stress tests, and are they aligned with strategic planning?
- Do we understand that as we move through the credit lifecycle, statistical measures such as probabilities of default (PDs) and loss given defaults (LGDs) are more informative than debt service coverages (DSCs) and loan-to-values (LTVs)?
- In keeping our credit risk appetites dynamic, can we tie default rates to underwriting factors being used?
- Do we employ enough risk grading granularity and awareness of credit migration patterns?
- Do we have embedded risk in the portfolio that we're not getting paid for? What are estimated losses by loan categories compared to their respective yields?
- Is loan review independent—and effective?
- Do we hold management accountable for credit performance?
- Are we too conservative? Are we operating with PDs lower than budget?

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3. How do we manage through concentrations? In-house limits? Related exposures? Purchased loan growth?

As an industry we're back to and exceeding pre-crisis concentration levels on commercial real estate (CRE), but it's not enough this time to be under the 300% (CRE)/100% (Acquisition/Construction/Development) of real estate lending-to-capital concentrations. Get beyond the blunt numbers; peel the onion down to layers of performance at all subsets of loan products—focusing on growth, vintage, risk grade migration, yield, baseline and stressed impact on capital, and tolerances within board-deter- mined goals. Make sure you understand the heightened risk of eating in big chunks. Know also that when you buy loan growth through whatever variance of participations, you're buying someone else's deal, underwriting, servicing and risk appetite.

4. How do we get comfortable with and oversee niche lending?

In a strategy designed to break away from the more tepid loan growth of traditional generalist commercial lending products, some high performance banks are out-pacing the industry by finding niche lending opportunities. In spite of its counter-diverse nature, if done correctly, it can be successful. Non-negotiable items include knowledge of the industry and its cycles, redundancy of internal talent to offset loss of key personnel, templated offerings and discipline, and a deep, almost real-time, assessment of the specialized lending pool's performance.

5. How do we describe our credit culture?

This is more than an esoteric exercise. It speaks directly to your bank's lending values and performance protocols. Too many community and smaller regional banks are confederations of lenders, mechanically credit trained elsewhere. Little has been done to invest in a culture unique to your institution or even to ensure that credit roles and accountabilities are clearly defined to enforce that culture.

6. What's the clearest sign of problems in managing the credit portfolio?

Beyond the usual suspects of delinquencies and charge-offs, my advice to directors is a very subjective, non-quantitative one: Are we hit with too many surprises? In the post financial crisis era when risk management has to be more forward-looking and anticipatory, too many credit surprises are all you need to know that the credit process is not working well.

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