DCU BULLETIN

Division of Credit Unions

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Implementing a Commercial Loan Risk Rating System

Credit ratings are the primary indicator of a financial institution's commercial credit exposure based on assessments of the borrower creditworthiness and the severity of the estimated loss. These ratings shape and reflect the nature of commercial lending decisions made from loan inception until loan pay-off. A strong credit rating process will make clear the risks being taken while holding the commercial loan and help lending officials better identify, monitor, and mitigate the risks. Commercial credit rating systems are used for a variety of purposes, such as determining loan approval requirements, identifying problem loans, performing portfolio management and loan monitoring, pricing loans, and supporting the loan loss reserve calculations. In short, risk rating systems are generally an important element of a safe and sound member business lending program.

The information detailed in this bulletin is not intended to prescribe the precise framework for a credit rating system. However, this guidance is intended to highlight regulatory principles, standards, and expectations that will enable credit unions to implement a rating system in a flexible and useful manner. This is one of the FDIC topics in the safety and soundness standards contained in Bulletin B-06-01, Appendix A.

Applicability to Selected Credit Unions

The Division of Credit Unions' (Division) expects Washington State chartered credit unions, that have a material amount of member business loans (MBLs), to adopt and implement a commercial loan rating system. Materiality for this purpose is defined as those credit unions that have over five percent in aggregate MBLs to

total assets or over $25 million in MBLs. As of December 31, 2006, fifteen state chartered credit unions in Washington meet the materiality criteria. Senior management and the Board of Directors should determine what type of risk rating system should be implemented. In addition, credit unions that do not meet the above materiality threshold may also benefit from such a system. A credit rating system is a fundamental function within an effective commercial lending program.

Structure of a Commercial Credit Rating System

MBLs should be rated on a basis that is consistent with systems used by state and federal financial institutions regulators. Although there isn't one correct commercial credit rating system, most effective rating systems have between seven to ten risk grades. This system must include, at a minimum, the following four categories:

1. Pass
2. Substandard
3. Doubtful
4. Loss

The categories of substandard, doubtful and loss are defined in WAC 208-460-110 and credit unions must adversely classify MBLs when commercial loans meet one of these definitions.

Although the four above categories provide the basis for rating commercial credits, the pass category could be expanded to include more levels. At a minimum, we recommend that the following three categories be included in the passing rating:

- Exceptional
- Good Quality
- Acceptable

In addition, credit unions should consider using at least one of the following two categories of risk rating:

a. <u>Watch List</u> – Watch list loans have potential weaknesses that deserve management's attention, but these loans do not go on the special mention list. Watch list loans are not adversely classified and do not expose an institution to significant risk.
b. <u>Special Mention</u> – Special mention loans are commercial loans needing close operating attention or action to mitigate possible weakness. These commercial loans have emerging identifiable problems.

Making the Credit Rating System Effective at Your Organization
Credit unions must be able to make meaningful and consistent differentiations among credit exposures along two dimensions – borrower default risk and loss severity in the event of default. When loans are rated, credit grade pools become obvious. Experience and judgment, as well as objective rating elements, are vital in assigning risk ratings. Objective rating elements can be financial ratios or other measurable credit quality elements.

Implementing a Commercial Credit Rating System
Risk ratings are typically assigned (or reaffirmed) at the time of each underwriting or credit approval action. The assigned rating will influence the approval process because underwriting limits and approval requirements depend on the ratings. The system should have segregation between the individual who assigns the risk rating and the individual who confirms that the rating is appropriate to the risk.

While logically separate, the analysis supporting the rating and underwriting processes are inseparable and intertwined. For example, an individual staff member typically proposes a risk rating as part of the pre-approval process for a new credit. The proposed rating is then approved or modified at the same time that the transaction itself receives approval and must meet the requirements embedded in the credit union's policies. After approval, a loan administration team is generally responsible for monitoring the loan and for changing the rating promptly as the condition of the borrower or collateral changes. Loans with adverse risk ratings often become the responsibility of a separate unit, such as a workout or loan review unit.

Commercial credits that are above a certain dollar amount or that receive a poor initial credit rating should be reviewed annually or more often as determined by management and as conditions change. The parameters for performing and updating commercial credit ratings should be stated in your credit union's loan policy. Updating a credit rating should be done for each MBL in conjunction with receiving current financial information on the borrowing entity and the guarantors.

Although there is no specific guide as to who must perform the commercial credit ratings, this responsibility should be firmly established in your credit union's policy. The policy should also establish who reviews the credit rating for appropriateness. It should also provide for an adequate separation of duties between the person who recommends the credit rating and the person who reviews the commercial credit rating.

Credit unions must have an ongoing validation process for the rating system that includes; process verification, benchmarking, and a comparison of the predicted parameter values to actual outcomes (back testing). An example of back testing would be comparing an MBL's initial credit rating against the credit rating established after a set period of time (say one to three years) to determine whether there are concerns and/or inconsistencies on how the ratings were determined. It is particularly valuable to analyze those credit ratings that changed over time. Back testing of the commercial credit rating system should be performed periodically as well as independent third party testing of the appropriateness of the commercial credit ratings.

Examination

Examiners will evaluate the overall adequacy of the internal risk rating system, as well as a credit union's ability to satisfactorily implement the credit rating system. The credit union should be able to demonstrate to the examiner how the commercial credit rating system was designed, and how it is being implemented in order to assess how well your credit union is performing its commercial lending operation. Examiners will take into consideration the nature, size and complexity of your credit union and its commercial lending activities when reviewing its credit rating system. Examiners will review internal management reports to determine if lower quality commercial loan totals have grown over time and whether reserves are adequate for the substandard, doubtful and loss credits.

Division Bulletin B 06-01, Appendix A, Item G requires FDIC regulated financial institutions to implement a commercial loan asset quality program. In addition to the commercial credit risk rating system discussed above, the following safety and soundness standards should be considered:

1. Estimate the inherent losses in those assets and establish reserves that are sufficient to absorb estimated losses;
2. Compare problem asset totals to capital;
3. Take appropriate corrective action to resolve problem assets;
4. Consider the size and potential risks of material asset concentrations; and
5. Provide periodic asset reports with adequate information for management and the board of directors to assess the level of asset risk.

Summary

This Bulletin was written to emphasize the importance of successfully implementing a commercial credit rating system. This Bulletin does not constitute

a regulation or a requirement for all credit unions, but offers guidance for safe and sound business lending practices for those with material commercial loan portfolios. The proper implementation of a credit risk rating system is consistent with the examination standards as set forth by the FDIC in 12 CFR Part 364, Appendix A. The following is the link to 12 CFR Part 364, Appendix A: http://www.fdic.gov/regulations/laws/rules/2000-8630.html#2000appendixatopart364. We would expect that as the complexity and size of a credit union's commercial lending practice grows, the credit union would expand its policy and practice of a commercial credit rating system. As with most other types of financial risk management tools, one size does not fit all. However, there are basic tenets that should be incorporated into each commercial credit rating system. Many of those fundamental elements are identified in this Bulletin.

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