CREDIT QUALITY BULLETIN

Continuous Monitoring: Improving Risk Management Effectiveness

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Limitations of the Transaction Review Process

Despite today's ultra-heightened focus on managing credit risk—primarily a result of increased pressure from regulator—one of the main concerns of senior management still continues to be the lack of sound methods for monitoring and managing credit risk.

While most lending policies require the relationship manager to regularly monitor the condition of their customers, most managers also rely on additional oversight by a loan review or credit quality function to systematically sample a small portion of the portfolio to test the process.

The most common transaction review method, used as the sole means to monitor risk has limitations. The transaction review method, if performed in a vacuum, can leave significant gaps in the credit management oversight process. Left unchecked, these gaps may expose even the most diligent financial institutions to potential risk.

For example, sampling random transactions only provides a miniscule snapshot of an organization's overall credit condition at a given moment in time. Additionally, the credit reviews are done infrequently. While the individual reviews are typically very detailed and thorough, they usually are only performed every 12 to 18 months. This makes the assumptions under which the bank is basing its credit decisions flawed since the data can quickly become obsolete.

Another challenge is that since the method is random, the reviews are often performed on non-problematic credits instead of on those that carry a higher degree of risk. This issue is usually accompanied by the reality that staffing levels rarely increase proportionally with loan portfolio growth, creating coverage (penetration) and efficiency limitations that further compound the problem. As lending practices change, the processes that identify, measure, monitor and control risk likewise need to evolve to keep pace with industry best practices.

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While the transaction review process is mandated by regulators and serves an important role in the overall risk management strategy, a supplemental method that can enhance the overall quality of your credit is "continuous monitoring."

Shifting the Focus to CPIs

Continuous monitoring is precisely as the name implies: reviewing credits on an ongoing basis—but with two key differences. First, instead of the main focus on random reviews of loans in the portfolio, the emphasis shifts to "credits of primary interest" or CPIs.

What constitutes a CPI is defined by each financial institution and must be determined based on various criteria such as the size of the loan, volatility of the borrower's industry, collateralization factors, etc. Second, the financial institution establishes a much more frequent schedule for reviewing CPIs, typically each month.

When used in conjunction with the transaction review process, continuous monitoring of credits of primary interest offers significant benefits to more effectively identify, measure, monitor and control risk:

- It enables the bank to become more proactive in anticipating problems and ultimately, working out viable solutions before issues become critical

- It empowers the reviewer by providing more current information about the loan, enabling them to make decisive, fact-based recommendations

- Monitors the loan throughout its lifecycle, rather than just once every 12 or 18 months

- Provides more accurate regulatory reporting about loan activity since review officers have deep insight and knowledge about ongoing loan activity

- Maximizes/leverages staff resources as the loan portfolio grows since time spent on transaction reviews decrease, due to a shift in focus to high risk credits

- Provides a more accurate history of a particular credit, enabling the financial institution to either encourage or avoid a particular type of loan

Implementing a Continuous Monitoring System

Every financial institution's credit risk monitoring methodology can and should be customized to meet the unique requirements of the institution. The size of the bank, its loan policies, its lending philosophy, the profile of the customer base, underwriting standards, administration and approval processes, due diligence procedures, documentation standards and board member mandates are just some of the factors that can come into play developing a viable monitoring process.

There are, however, some basic tenets that should be considered when implementing such a program:

- Research industry best practices to establish what is and is not an "acceptable" level of risk for your type of financial institution

- Define the monitoring criteria for the CPIs so it is clear throughout the organization

- Define the workflow before implementing the process

- The importance of data integrity cannot be over emphasized as it is vital in ensuring decision-making accuracy

- Determine the individual reviewer assignments (i.e.by geography, loan size, type of loan, industry, etc.)

- Determine how borrower information (financial statements and current status) will be made available and who will have access to review the credits. Up-to-date monitoring results must be immediately accessible by all key authorized personnel so that managing risk becomes a bank-wide process embedded into overall policies and procedures

- Begin by implementing a small pilot program

With so much at stake—including a bank's very survival—financial institutions must continue to seek processes, methods, best practices and automation technology that will improve their ability to manage and control risk. This should be done both at the individual loan level, as well as across the entire portfolio.

Continuous monitoring is one pillar in the overall credit risk management strategy that financial institutions should use to supplement existing processes to increase its effectiveness and, ultimately, improve bottom line profitability.

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