LOAN REVIEW: FATHOMING DEPTH

BY DEV STRISCHEK – PRINCIPAL, DEVON RISK ADVISORY GROUP, LLC

SPONSORED BY DICOM SOFTWARE

INTRODUCTION: AFTER SCOPING IT OUT, HOW DEEP DO I DIG?

If scope is breadth, then what is depth? The German philosopher Friedrich Nietzsche observed, “They muddy the water to make it seem deep,” but he also said, “There are no beautiful surfaces without terrible depth.” Is scope about picking out something on the beach horizon that attracts your attention and then digging into its depths to see what is under the surface?

Here is another way to think about the difference between scope and depth. Scope is the number of different operations you do on the job and the frequency with which you do them. The lower your task level, the lower the scope. For example, when putting doors on cars in an assembly line, you are doing one specialized task over and over again, so, the scope of your task is quite low. On the other hand, if you rotate among putting doors on cars, putting seats in cars, and checking the steering mechanism, your scope is relatively high because your job has less frequent repetition and more variation. On the other hand, depth is the amount of control you have over the tasks that you do. If your job has low depth, that means there are strict guidelines you must follow, and you have very few decisions to make. Usually, jobs that involve mass production by means of assembly lines have low depth. High depth jobs, on the other hand, normally include decision making and allow employees to set their own pace. Most actors’ jobs have high depth. For example, they are given parts and told to interpret the characters and lines in their own way. You would also have high depth if you were given a project within your company and told to develop it at your own pace. (1)

The relationship of scope and depth can change with a specific task, so that the amounts of scope and depth vary at different times. An example of how a manager’s scope and depth can change during one day. For example, a manager’s first task of the day is to choose an advertising design and layout scheme for an upcoming promotion (high scope, high depth). His next task is to make out the weekly work schedule for employees (low scope, high depth). Then the manager signs employee timecards (low scope, low depth). Finally, he evaluates employee performance according to HR standards (high scope, low depth). (2)

The scope and depth of one employee’s job may also change more than that of another employee within the same organization. Servers taking food orders, bringing drinks, and talking with their customers, have a broader scope than dishwashers in the kitchen. You want to know the range of scope and depth of a specific job to fill it with the right human resources to carry out the required tasks. Due to the varying scope and depth of each position within an organization, some employees will be more capable and better suited to complete certain responsibilities than others. (3) How does this apply to loan reviewers?

In the previous piece in this loan review series, we explored scope. How far must a loan reviewer walk to look around an organization's portfolio? How broad a field does loan review need to plow in order to unearth potential credit risks and to assess overall credit quality.

SCOPE: HOPE WE GET THERE SOON

The Interagency guidance on credit review systems (4) says that comprehensive and effective loan reviews cover all segments of the loan portfolio (high scope) that pose significant credit risk or concentrations, and other loans that meet certain institution-specific criteria. Without defining what a properly designed scope (lots of high scope now) should look like, the guidance expects the properly designed scope to take into account current market conditions, say, soaring lumber and construction materials prices, or other external factors—the pandemic or cyber criminals shutting down oil pipelines--that may impact a borrower's current or future ability to repay the loan. Without offering any examples of and appropriate review scope, the guidance calls for the establishment of an appropriate review scope to ensure that the sample of loans selected for review, or portfolio segments selected for review, is representative of the portfolio as a whole and provides reasonable assurance that any credit quality deterioration or unfavorable trends are identified.

If that isn't enough, the guidance also expects the credit risk review function to consider industry standards for credit risk review coverage consistent with the institution's size, complexity, loan types, risk profile, and risk management practices (really high scope). The institution's board of directors or appropriate board committee typically approves the scope of the credit risk review on an annual basis or whenever significant interim changes are made in order to adequately assess the quality of the current portfolio. What does the regulatory guidance expect on depth?

DEPTH OF TRANSACTION OR PORTFOLIO REVIEWS: SHOVELS READY?

The guidance notes that loans and portfolio segments scoped for review are then typically evaluated for: Credit quality, soundness of underwriting and risk identification, borrower performance, and adequacy of the sources of repayment;

- When applicable, this evaluation includes the appropriateness of automated underwriting and credit scoring, including prudent use of overrides, as well as the effectiveness of account management strategies, collections, and portfolio management activities in managing credit risk;
    - Reasonableness of assumptions;
    - Creditworthiness of guarantors or sponsors;
    - Sufficiency of credit and collateral documentation;
    - Proper lien perfection;
    - Proper approvals consistent with internal policies;
    - Adherence to loan agreement covenants;
    - Adequacy of, and compliance with, internal policies and procedures, such as those related to nonaccrual and classification or risk rating policies, laws, and regulations;

- o The appropriateness of credit loss estimation for those credits with significant weaknesses including the reasonableness of assumptions used, and the timeliness of charge-offs;
- o The accuracy of risk ratings and the appropriateness and timeliness of the identification of problem loans by loan officers.

This list of stuff to be evaluated sure sounds like high depth, or maybe deep depth to me. To perform the items on this list requires more than familiarization, overview, or introduction to each topic. It calls for detailed knowledge, considerable practice, extensive experience to develop the skills needed to perform loan reviews of this depth. One of the quandaries of loan review management is finding, training, and retaining this level of talent, and as pointed out in earlier pieces in this loan review series as well as DiCOM's annual loan review survey (5), loan review units have a severe manpower shortage at the junior and senior levels. To make the manpower shortage all the more critical, there is no real certification or formal training program for loan reviewers, yet.

For those loan reviewers who would like to compare their guidance on depth with the guidance, here's a handy checklist to diagnose yourself:

Depth Diagnostic Checklist	Yes, we do this	No, we don't	Assigned to?	Completion deadline
1- Evaluation of credit quality, soundness of underwriting and risk identification, borrower performance, and adequacy of the sources of repayment				
2- Evaluation to include appropriateness of automated underwriting and credit scoring, prudent use of overrides, and effectiveness of account management strategies, collections, and portfolio management activities in managing credit risk				
3- Reasonableness of assumptions				
4- Creditworthiness of guarantors or sponsors				
5- Sufficiency of credit and collateral documentation				
6- Proper lien perfection				
7- Proper approvals consistent with internal policies				
8- Adherence to loan agreement covenants				
9- Adequacy of, and compliance with, internal policies and procedures, such as those related to nonaccrual and				

classification or risk rating policies, laws, and regulations				
10- Appropriateness of credit loss estimation for credits with significant weaknesses including reasonableness of assumptions used, and timeliness of charge-offs				
11- Accuracy of risk ratings and appropriateness and timeliness of problem loan identification by loan officers				

Loan review managers have developed numerous ways to expedite the excavation, e.g., differentiation between performing loans with no delinquencies, defaults, and overdrafts vs. borrowers with excessive past-dues, covenant defaults, and overdrafts. If you have some methods on how to reduce depth or scope, please consider sharing them with DiCOM and me.

SUMMARY AND CLOSING: FATHOMING DEPTH

Ralph Waldo Emerson wrote, "It is not the length of life but the depth of life." Unless loan reviewers manage both the scope and depth of their reviews, they may not live long enough to enjoy their lives, so look at what you are doing in both dimensions, scope and depth, and consider how to set them to a scale that balances what your resources can support and simultaneously meet regulatory expectations. Remember what Will Rogers cautioned, "Don't let yesterday take up too much of today."

(1) "Scope and Depth of Jobs," https://fcschools.instructure.com/courses/20908/pages/scope-and-depth-of-jobs (July 16, 2021)
(2) Ibid.
(3) Ibid.
(4) *Interagency Guidance on Credit Risk Review Systems*, FIL-55-2020, May 8, 2020
(5) Contact DiCOM's Jim Xander at jxander@dicomsoftware.com for more information regarding the annual loan review survey

ABOUT DICOM

Established in 1999, DiCOM Software is the leading provider of automated loan review management systems in the marketplace today. Specifically, DiCOM's Credit Quality Solution (CQS) is designed to provide financial institutions with powerful, automated credit risk tools that replace tedious, outdated methods and deliver measurable results. Visit the DiCOM Website for more information.