MUCH ADO ABOUT SOMETHING: SOME COMMENTARY ON THE 2020 GUIDANCE ON CREDIT REVIEW SYSTEMS

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INTRODUCTION[i]

Irish author Oscar Wilde once admitted, "I am so clever that sometimes I don't understand a single word of what I am saying." Likewise, sometimes cleverness creeps into rule writing only to render the results hard to understand and follow. Fortunately for us in banking, proposed new rules must undergo a public comment period and by perusing the comments and the responses to them, we can get some idea of intent and purpose as well as learning of unintended consequences and their resolution. The commenters often point out ambiguities, discrepancies, errors, contradictions to be resolved and even offer their own suggestions. To that end, after several pieces on various topics in the interagency guidance on credit risk review systems, the comments gathered on the proposed guidance offer useful insights into major issues for loan reviewers as well as the agencies' resolution of some of those issues.

In case you had forgotten, on May 8, 2020, The Federal Reserve Board, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Office of the Comptroller of the Currency issued interagency guidance on credit risk review systems for their supervised institutions. The guidance replaced the "Loan Review Systems" guidance contained in Attachment 1 of the 2006 Interagency Policy Statement on the Allowance for Loan and Lease Losses.[ii]

The 2020 credit risk review guidance discusses sound management of an institution's credit risk; a system of independent, ongoing credit review; and appropriate communication about the performance of the institution's loan portfolio to its management and board of directors. Further, guidance terminology was adjusted to be consistent with the current expected credit losses (CECL) methodology, the 2016 principle added to the Financial Accounting Standards Board's generally accepted accounting principles (GAAP).

PUBLIC COMMENT: VOX POPULI, VOX DEI?

Whether the agencies believe "the voice of the people is the voice of God," the agencies are required to seek public comment before proposed guidance becomes final guidance. In this case, the agencies collectively received 19 comments on the proposed guidance. That may not seem like very many comments, but the commenters included trade associations, banks, credit unions, and members of the public. Most commenters expressed general support for the guidance and noted that the proposed guidance reflected sound practices and principles, incorporated the core elements of credit risk review, and did not represent a fundamental shift from 2006's Attachment 1. However, some commenters were concerned that the guidance was too prescriptive and, in some instances, commenters requested clarifications such as:

- the role of credit risk review including its relation to other functions, such as internal audit[iii];
- the appropriate scope, depth and frequency of credit risk review activities; internal responsibility for an institution's risk rating framework;
- the process for adjudicating risk rating disputes;
- the communication of credit risk review results and qualifications of credit risk review personnel;

- credit risk review in the context of retail portfolios;
- and the use of technology and data in credit risk review.

Other commenters worried about a one-size-fits-all approach in the proposed guidance and the potential burden to smaller institutions, so they suggested that the agencies specifically tailor the guidance to emphasize flexibility based on an institution's risk profile or even exempt small institutions from the guidance. Some commenters advocated independence of the credit risk review function and argued that credit risk review provides a critical and independent assurance role while noting that role has expanded in scope and may overlap with duties performed by other functions resulting in a duplication of efforts. Finally, commenters expressed concern generally with the implementation of the CECL methodology; the relationship of the proposed guidance to Allowances for Credit Losses (ACL); and whether CECL would make credit risk review more burdensome, particularly for smaller institutions.

Review of the commentary also reflects several issues loan reviewers raised in DiCOM's 2021 survey, especially widening scope and increasing depth in the face of manpower limitations and shortages.[iv] So, let's look at the issues raised by commenters and how the regulators resolved them.

COMMENTER COMMENTARY AND AGENCY RESPONSES

In this summary individual commenter remarks and the agencies' collective responses, you will find that the agencies already had answered commenter concerns or revised the final guidance to accommodate the suggestions. The order of the topics follows the summary of comments preceding the final guidance, and, in turn, the final guidance generally follows the order of the comments, so perusal of these summaries will give you an overall understanding of what the final guidance does and does not do for CRR:

1. Too Much or Too Little Guidance?
2. Role of CRR—Roll over or Roll Up?
3. Spotting Problem Loans Is Job 1 for Credit Administration, Not CRR
4. Audit vs CRR—Not the Same
5. Loan Operations, Compliance, and Workout vs CRR
6. CRR--System or Function?
7. Scope—Less Risk, Less Look?
8. Non-lending Activities if Credit Risk Exists
9. Concentrate on Concentrations
10. Policy Exceptions as a Rule?
11. High-Risk Indicators—Take Your Pick?
12. Depth—Dig for Answers as Needed
13. Credit Loss Estimation—Go Figure?
14. Validation of Underwriting Assumptions—Be Reasonable
15. Back-end or Front-end Loan Evaluation—No End to Debate?
16. Frequency—More or Less?
17. Risk Rating Responsibility and Adjudication—Who Has the Final Call?
18. Communication of Results—No Quarter, Please?
19. Forward-Looking Indicators—After You
20. Reporting Deficiencies and Weaknesses—Spill It All
21. Personnel Qualifications—Generally, Yes

22. Retail and Consumer Portfolios—Yes, They Are Different
23. Technology and Models—Use What Works for You
24. Scalability of the Guidance—Whatever Fits You
25. CRR Independence—Preferred, Ideally?
26. CRR Reporting Structure—Ideally to the Board?
27. Current Expected Credit Losses—CRR's Role?
28. Allowance for Credit Losses (ACL's)—Maybe?

1-TOO MUCH RULE OR TOO LITTLE GUIDANCE?

Some commenters complained the guidance was too prescriptive and might be enforced as regulation, but others pointed out that the proposed guidance reflected foundational principles and outlined elements of a sound credit risk program without mandating how credit risk review should operate. Too much rule, or too little guidance?

An effective credit risk review function is integral to the safe and sound operation of every insured depository institution, so to assist institutions in the creation and operation of the credit risk review functions, the agencies decided to describe a broad set of practices and principles for developing and maintaining a credit risk review function consistent with safe and sound credit risk management practices and the Interagency Guidelines Establishing Standards for Safety and Soundness. However, the final guidance does not establish any requirements or rules, nor does it mandate implementation of a specific system or prescribe specific actions with which institutions must comply.

2-ROLE OF CRR—ROLL OVER OR ROLL UP?

Some commenters called for the guidance to better delineate between the responsibilities of credit risk review and other functions, e.g., the role of credit risk review vs. the roles of other organizational entities such as audit also responsible for monitoring, managing, and reporting credit risk. The agencies responded by encouraging institutional flexibility to determine the specific roles, responsibilities, and duties of these different groups. The core responsibilities of a credit risk review system are discussed in the final guidance under the objectives of an effective credit risk review system, and include the prompt identification of loans with credit weaknesses and the validation and adjustment of risk ratings.

3-SPOTTING PROBLEM LOANS IS JOB 1 FOR CREDIT ADMINISTRATION, NOT CRR.

One commenter disagreed that a primary objective of credit risk review was to promptly identify all loans with actual and potential credit weaknesses because the commenter felt that this responsibility belongs to the credit administration function with credit risk review identifying and confirming such loans using a sample-based approach. The final guidance does not specifically assign the process of risk identification to credit risk review; effective ongoing credit administration practices allow other credit risk functions to have a role in the prompt detection of changes in loan quality and appropriate adjustments to the risk rating. As part of its independent risk rating validation process, credit risk review may identify loans with significant weaknesses and identifiable losses and adjust the risk rating accordingly. The emphasis for credit risk review or any party identifying credit risk is on timely and accurate identification of credit weaknesses so that action can be taken to strengthen credit quality and minimize loss.

4-AUDIT VS CRR—NOT THE SAME.

Several commenters asked for clarification of credit risk review's role in relation to internal audit. The final guidance states internal audit is not expected to perform the credit risk review function. In fact. the March 2003 Interagency

Statement on the Internal Audit Function and Its Outsourcing discusses the coordination of the internal audit function with risk monitoring functions, such as the credit risk review function. The 2003 policy statement acknowledges that coordination of credit risk review with the internal audit function can facilitate the reporting of material risk and control issues to the audit committee, increase the overall effectiveness of these monitoring functions, better utilize available resources, and enhance the institution's ability to comprehensively manage risk. Nevertheless, CRR is not an audit function, and audit is not a CRR function.

5-LOAN OPERATIONS, COMPLIANCE, AND WORKOUT VS CRR.

Commenters asked if it were appropriate for CRR or for other internal functions within a CRR system to perform activities that are compliance or operational in nature, such as confirming proper lien perfection and collateral documentation. CRR provides support to financial and regulatory reporting functions but does not directly deliver outputs to these functions, so commenters requested that the proposed guidance be clarified on this point. The final guidance acknowledges that duties such as assuring lien perfection and collateral confirmation might not be directly undertaken by the CRR function, but evaluation and confirmation of such actions is within the scope of the CRR function and a key aspect of an assessment of the overall quality of the credit. The CRR function may use information generated by other functions when developing an independent assessment of credit risk

Some commenters insisted that CRR should not have a role in evaluating workout plans and wanted any related language eliminated from the guidance. However, given that an effective workout plan is typically designed to rehabilitate a troubled credit or to maximize the amount of repayment ultimately collected, it is therefore a loss mitigation strategy. For this reason, 2006's Attachment 1 included similar language to the proposed guidance on workout plans because effective workout plans are critical to managing risk in a loan portfolio. Since assessment of such strategies is within the scope of the CRR's role, the final guidance retains the reference to evaluating workout plans.

6-CRR--SYSTEM OR FUNCTION?

One commenter stated that one part of the proposed guidance allows institutions to have a system concept for structuring CRR, but later on the proposed guidance defined specific roles for a credit review function. So which is right—system or function? Well, the agencies have seen institutions use both terms when referring to CRR, with the term used generally depending on the size of the institution and composition of its risk review framework. While the agencies incorporated both terms to provide flexibility to institutions, the terms can be used interchangeably depending on the institution's existing framework.

7-SCOPE—LESS RISK, LESS LOOK?

Commenters requested that the proposed guidance permit reduced credit review scrutiny for seasoned loans with a history of performance and enhanced collateral positions and instead, focus on higher risk or newer loans. The agencies reaffirm that, as stated in the proposal, institutions may tailor their CRR practices based on a number of factors, including the nature of the institution's loan portfolio and overall risk profile.

8-NON-LENDING ACTIVITIES IN SCOPE IF CREDIT RISK EXISTS.

Was the proposed guidance intended to cover non-lending activities? Some argued that these activities should not be within the scope of CRR, while other commenters suggested that all references to “loans” in the proposed guidance be changed to a broader term that incorporates assets other than loans, such as securities. In response, the agencies recognize that credit risk may arise from activities that are not specific to lending and encourage institutions to consider

whether such activities should be included in the scope of the CRR function, e.g., institutions that hold investment securities or engage in capital markets, treasury, or automated clearinghouse activities, so the final guidance allows organizations to include the credit risk related to these activities in the scope of a review.

9-CONCENTRATE ON CONCENTRATIONS.

Some commenters argued that smaller banks and credit unions may have difficulty in identifying concentrations of credit risk and other loans affected by common repayment factors and that the phrase “common repayment factors” could lead to a much larger scope of review. In response, the agencies note that, under the Interagency Guidelines Establishing Standards for Safety and Soundness, insured depository institutions are expected to establish and maintain a system commensurate with the institution's size and the nature and scope of its operations to identify problem assets and prevent deterioration in those assets, which includes considering the size and potential risks of material asset concentrations. The reference to “common repayment factors” is simply meant to provide flexibility to institutions to consider a variety of factors that are applicable to the institution's circumstances but which may still lead to a concentration of credit risk.

10-POLICY EXCEPTIONS AS A RULE?

Commenters suggested that CRR focus on loans that contain major, significant, or critical exceptions to policy rather than “approved” exceptions or loans with minor or administrative policy exceptions or on loans “major” exceptions to policy strongly mitigated. The final guidance is not prescriptive and allows for institutions to set their own parameters for determining the materiality of policy exceptions that should fall into the scope of a credit review.

11-HIGH-RISK INDICATORS—TAKE YOUR PICK?

Further, commenters suggested that CRR focus on loans with high-risk indicators and so asked the agencies to let institutions define and target “segments of the loan portfolio experiencing “rapid growth” and have independent loan review verify those targets. In fact, the final guidance emphasizes that an effective scope is risk-based and includes loans or portfolios that have high-risk indicators, exceptions to policy, are experiencing rapid growth, or have other risk attributes. The final guidance provides examples of high-risk indicators and other characteristics of loans that may warrant additional review, but it does not prescribe specific targets or thresholds. Institutions can select their own high-risk indicators but keep in mind how the indicators fit the characteristics of the overall portfolio and how the indicators help to reinforce safe and sound practices.

12-DEPTH—DIG FOR ANSWERS AS NEEDED.

Commenters complained that the language in the proposed guidance stating that loans selected for CRR are evaluated for “sufficiency of credit and collateral documentation” was too broad. The final guidance does not recommend that CRR perform or oversee the loan documentation process. However, inadequate loan documentation and lien perfection may adversely impact the risk rating and could result in losses for a financial institution, so effective CRR often includes the evaluation of loan documentation as part of the overall assessment of the credit risk of a particular transaction. Effective CRR assesses and evaluates information from departments responsible for loan documentation and highlights identified concerns in the reports to management, including recommendations for their resolution.

13-CREDIT LOSS ESTIMATION—GO FIGURE?

One commenter suggested that credit review should not validate the translation of loss numbers; rather, internal audit and external auditors should review accuracy, timeliness, and consistency of charge-offs. The bullet in the proposed guidance mentioning quality of the information used in the credit loss estimation process was not intended to expand the review of such information beyond that of 2006's original Attachment 1. Its focus was on assessing the adequacy of the identification and related impairment calculation of individually impaired loans under the ALLL methodology, a process which will no longer be applicable to loans evaluated under CECL. The agencies acknowledge that the calculation of estimated ACL or ALLL is not the role of CRR. However, effective CRR results help ensure that the ACL or ALLL adequately reflects risk in the credit portfolio. In performing its assessment of reasonableness, CRR can leverage work performed in this area by other functions, such as internal audit.

14-VALIDATION OF UNDERWRITING ASSUMPTIONS—BE REASONABLE.

Several commenters suggested that evaluating the validity of underwriting assumptions was too broad of an activity for CRR and could imply that CRR is responsible for back testing assumptions, so the agencies should instead refer to evaluating the "reasonableness" of assumptions, such as borrower cash flow forecasts. In response, the final guidance has been revised to provide that such loans, and segments of portfolios, selected for review are generally reviewed for the reasonableness of assumptions, but back testing the validity of assumptions is often a part of the underwriting and monitoring processes. CRR can use this information, if available, when making their assessments.

15-BACK-END OR FRONT-END LOAN EVALUATION—NO END TO DEBATE?

Commenters recommended that institutions should receive credit during a review if back testing of initial loan risk ratings shows a high level of accuracy. Further, it was suggested that the agencies' guidance should focus less on risk evaluation and more on the front-end loan evaluation by bank staff. The agencies responded that the focus of the CRR system is on assessing credit quality in the credit portfolios, and that is an important input into determining the ACL and ALLL. Therefore, an effective CRR system considers any information available that can impact or provide insight into the quality of the portfolio. To the extent that back testing results are available, they can be considered by CRR staff in their assessment of credit quality.

16-FREQUENCY, MORE OR LESS?

Several commenters questioned the frequency of CRRs and asked when reviews could be conducted less frequently than annually, especially for well-managed institutions with lower risk portfolios. Commenters also requested that the proposed guidance respect the authority of a board of directors to approve when audits and loan reviews are completed, and how frequently reports are reviewed. One commenter suggested that frequency of review should be determined by a firm's board of directors. In response, the agencies noted that each institution has the flexibility to set the scope of coverage and frequency of reviews based on the institution's specific circumstances while continuing to operate in a safe and sound manner. Accordingly, the agencies have clarified in the final guidance that effective CRRs are typically performed annually but in certain circumstances more frequent reviews may be necessary. Reviews that are less frequent are typically well supported and reflective of low risk portfolios, are conducted consistent with safe and sound practices, and are approved by the institution's board of directors or board committee . Finally ,the final guidance states that an effective CRR system starts with a written CRR policy typically reviewed and approved at least annually.

17-RISK RATING RESPONSIBILITY AND ADJUDICATION—WHO HAS THE FINAL CALL?

Commenters asked if CRR should always be the final arbiter of a risk rating or whether institutions ought to employ an arbitration process. The agencies believe that the guidance describes a clear disposition process for adjudicating risk ratings flexible for institutions of all sizes. In particular, the final guidance addresses risk rating differences between the CRR and areas responsible for loan approval. Typically, the lower credit quality classification or risk rating assigned by CRR prevails unless there is additional information that would support a higher credit quality classification or risk rating. The final guidance also discusses a risk rating framework that is consistent with safe and sound practices and the agencies' guidelines for supervisory classifications. Unfortunately, it does not answer the underlying question about the CRR finality and so somewhat detracts from the independence of CRR.

18-COMMUNICATION OF RESULTS—NO QUARTER, PLEASE?

In general, commenters expressed support for CRR reporting directly to the board of directors, but others objected the proposed guidance quarterly board reporting was too prescriptive. Commenters recommended that the proposed guidance permit boards of directors to tailor their policies based on the size, scope, and complexity of the loan portfolio, as well as to the complexity of a loan itself. The agencies believe that it is consistent with safe and sound lending practices to have the CRR function report findings regularly and directly to the institution's board of directors or a committee. Institutions have discretion to determine the frequency and extent of such reporting, taking into account the nature of their loan portfolios and the importance of informing the board of directors on credit risk. To clarify this flexibility, the proposed guidance was revised to state that effective communication typically involves providing results of the CRRs to the board of directors or appropriate board committee quarterly. This change emphasizes that quarterly reporting of results is a typical practice, but institutions have room to adjust the frequency given their risk profile and consistent with safety and soundness.

19-FORWARD-LOOKING INDICATORS—AFTER YOU.

One commenter noted that the guidance should specifically recommend tracking forward-looking indicators to help identify risk trends to support informed decisions and proactive risk mitigation. The agencies acknowledge that forward-looking indicators such as portfolio concentration trends, shifting underwriting standards, and risk rating migrations are consistent with proactive risk management activities. The agencies recognize that institutions may develop internal parameters for establishing, tracking, and reporting forward-looking indicators of credit exposure that are specific to the institution's business model and lending activities. The agencies believe that language in the proposed guidance is sufficient to address this issue.

20-REPORTING DEFICIENCIES AND WEAKNESSES—SPILL IT ALL.

Commenters also requested that the agencies only require “material” deficiencies and weaknesses still unresolved beyond the scheduled time frames for correction be reported to senior management and the board of directors or appropriate board committee. Nice try, but to protect CRR independence, the agencies believe that an effective credit review system should report all noted deficiencies and weaknesses to the board of directors. Of course, CRR may prioritize findings of weaknesses or deficiencies and let management decide the materiality of findings.

21-PERSONNEL QUALIFICATIONS—GENERALLY, YES.

One commenter suggested the proposed guidance be revised to emphasize the importance of the qualifications, independence, and expertise of personnel conducting the internal audit of a CRR system or function. The agencies believe that the qualifications of audit personnel are sufficiently addressed in the 2003 policy statement referenced in the final guidance. One commenter noted that CRR staff knowledge of an institution's membership and experience with

underwriting are key factors in determining CRR qualifications, and the final guidance broadly addresses personnel experience including knowledge of the institution's portfolio and experience with underwriting. Specific personnel qualifications are the purview of management and the board and are typically reflective of the institution's business model.

22-RETAIL AND CONSUMER PORTFOLIOS—YES, THEY ARE DIFFERENT.

The agencies received a number of comments regarding the differences in characteristics between retail/consumer and commercial loan portfolios, as well as the processes, techniques, tools, data and technology used to conduct CRR of retail loan portfolios. One commenter stated that the proposed guidance inadequately differentiated between product types and exposures of commercial and retail loans and stated that the use of manual review of individual loans to assign and validate risk ratings would be impractical for a large portfolio of smaller retail loans. The agencies recognize that differences between retail and most commercial loans and portfolios may justify differences in approaches, techniques, and tools for conducting CRR.

The proposed guidance was designed so that institutions may apply its principles to the review of all loans and portfolios, including retail loan portfolios. In response to comments received, the agencies have made revisions to the final guidance in order to provide flexibility to institutions in determining the scope and depth of the loan review for all loan portfolios. The revisions for the final guidance discussed below reflect existing industry practices. They are applicable to all types of loan portfolios, but especially for retail portfolios. Specifically, the final guidance includes language in a new bullet under the “Scope of Reviews” section, which acknowledges that institutions may determine the scope of the CRR by segmenting or grouping loans based on similar risk characteristics, such as those related to borrower risk, transaction risk, and other risk factors. The new bullet is intended to provide clarity and reflect existing industry practices for retail portfolios. Similar references to portfolio segments have been made in the “Depth of Transaction or Portfolio Reviews” and “Communication and Distribution of Results” sections.

Additionally, the final guidance includes language in a new sub-bullet under “Depth of Transaction Reviews.” The sub-bullet indicates that in evaluating 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.” The agencies added the new sub-bullet in response to commenter requests for more guidance on the applicability of the guidance to retail loan portfolios. The new sub-bullet acknowledges that some institutions, especially those with large retail portfolios, may use models or other automated decision tools in their credit decision or risk rating processes, so effective CRR can consider the appropriateness of the business line's application of these tools in these processes. Further, an effective CRR can consider the effectiveness of account management strategies, such as credit line management, re-aging, and extension/renewal in managing credit risk. An effective CRR can also consider whether portfolio management activities, such as risk identification and performance monitoring, and collection policies and practices are commensurate with the institution's risk profile and complexity of the products and loan structures offered.

23-TECHNOLOGY AND MODELS—USE WHAT WORKS FOR YOU.

Commenters also asked about the use and governance of technology in CRR. Commenters discussed the use of analytical and management information system tools, particularly for consumer loans, and suggested that the guidance recommend automation of risk data aggregation. The agencies believe institutions have significant flexibility to use

various types of technology to assist in the CRR process; as such, the agencies decline to recommend the use of any specific types of technology. One commenter worried about the potential risks associated with the use of models in various credit processes and suggested that the proposed guidance emphasize the appropriateness and effectiveness of reviewing credit model design, performance, and governance. A commenter indicated that the guidance should include robust governance of artificial intelligence algorithms. The agencies recognize the importance of model risk management, which is discussed in other existing guidance.

24-SCALABILITY OF THE GUIDANCE—WHATEVER FITS YOU.

The agencies received numerous comments about whether the proposed guidance's apparent one-size-fits-all approach is appropriate for institutions of all sizes and called for the proposed guidance to be tailored based on the size and activities of the institution, as well as the complexity of the loan portfolio. The agencies believe that the final guidance provides both small and large institutions flexibility to tailor the credit review function to the activities of the institution. For example, the final guidance states that the nature of CRR varies based on an institution's size, complexity, loan types, risk profile, and risk management framework. In addition, as described under "Independence of CRR Personnel," smaller or less complex institutions have flexibility to use an independent committee of outside directors or qualified members of the staff to perform the CRR function, and small or rural institutions possessing few resources or employees may adopt modified CRR procedures and methods to achieve a proper degree of independence. As the final guidance notes, doing so is appropriate when more robust procedures and methods are impractical. The final guidance also notes that CRR systems in larger institutions may include a dedicated CRR function. Institutions of all sizes have the flexibility to tailor the various principles and practices in the final guidance to systems appropriate for their circumstances.

25-CRR INDEPENDENCE—PREFERRED, IDEALLY?

Some commenters suggested that creating the independence structure described in the proposed guidance would be a problem for small banks and credit unions by leading to duplicative functions and compliance burden for small banks and credit unions with limited staffing. The agencies recognize that small institutions with few resources may need to adopt modified CRR procedures in order to achieve a proper degree of independence. The guidance allows small or rural institutions with few resources to employ qualified members of the staff, including loan officers, other officers, or directors, who are not involved with originating or approving the specific credits being assessed and whose compensation is not influenced by the assigned risk ratings in the CRR process. However, that institution management and the board, or board committee, should have reasonable confidence that the personnel chosen will be able to conduct reviews with the needed independence despite their position within the loan function.

26-CRR REPORTING STRUCTURE—IDEALLY TO THE BOARD?

The agencies note that the Interagency Guidelines Establishing Standards for Safety and Soundness state that an institution should have internal controls and information systems appropriate to the size of the institution, as well as nature, scope and risk of its activities, including clear lines of authority and responsibility for monitoring adherence to established policies. This statement applies to policies for a system of independent, ongoing credit review and appropriate communication to management and to the board of directors. Whether or not the institution has a dedicated CRR department, it is prudent for the CRR function to report directly to the institution's board of directors or one of its committees. This reporting structure allows the CRR function to provide the board of directors with an independent assessment of the overall quality of loan portfolios and other areas of credit exposure as mandated. Senior management may be responsible for appropriate administrative functions, provided such an arrangement does not compromise the independence of the CRR function.

27-CURRENT EXPECTED CREDIT LOSSES—CRR'S ROLE?

Some commenters cautioned the agencies against incorporating FASB ASC Topic 326 into the credit review final guidance because this would create a complex methodology that many institutions would be unable to implement. For example, one commenter expressed concern with maintaining historical loss experience on a segment level because loan segmentation under FASB ASC 326 may be more granular than what is currently maintained and may change over time, and others observed that while institutions with large and complex loan portfolios typically maintain records of their historical loss experience for credits in each of the categories in their risk rating framework, this may not be the case in smaller institutions. The final guidance does not incorporate FASB Topic 326, but the agencies have observed that maintenance of historical loss information has traditionally been part of an effective credit risk grading framework for institutions of all sizes as it provides a basis for credit loss estimation for various credit types. Institutions have flexibility in how historical loss data information is maintained as long as it provides sufficient information to inform and help confirm the accuracy of risk rating similar credits. To provide further clarity and to emphasize the flexibility available to institutions, the agencies have modified the final guidance to read "evaluation of the institution's historical loss experience for each of the groups of loans with similar risk characteristics into which it has segmented its loan portfolio."

28-ACL'S—MAYBE?

Should CRR functions conduct risk-specific assessments on the valuations of financial assets measured at an amortized cost basis, such as held-to-maturity securities and for institutions that produce economic forecast estimations as a component of their ACL estimate, should CRR functions integrate and align economic forecast estimations into qualitative assessments of individual loans and portfolios? As discussed previously, the agencies are issuing this final guidance as a standalone document separate from any guidance on estimation of expected credit losses because CRR is an important component of safety and soundness on its own. Refer to the Interagency Policy Statement on Allowances for Credit Losses for how CRR can facilitate the loss estimation process.

SUMMARY AND CLOSING

Oscar Wilde argued, "Consistency is the last refuge of the unimaginative," but guidance is not intended to be imaginative; it is designed to provide clear instruction and identical results. In that spirit, most commenters expressed general support for the guidance and noted that the proposed guidance reflected sound practices and principles, incorporated the core elements of CRR, and did not represent a fundamental shift from 2006's Attachment 1. The agencies generally responded that the guidance gives organizations the flexibility to run CRR the way they want as long as CRR keeps tabs on an organization's credit risks. The guidance generally stays away from specific, firm rules, but there are some basic principles that the guidance could have embraced more firmly:

1-If CRR is to be independent, its decisions must be respected and protected the same as internal audit from appeal; only bank examiners should be able to trump a loan review call

2-CRR ought to be embedded in the third line of defense and report to a risk committee of the board of directors just as internal audit reports to the audit committee

3-To meet its scope and depth expectations, CRR must be adequately staffed with experienced and trained loan reviewers

4-CRR must be able to check, review, and report the organization's credit risks anywhere and anytime to the Board or its risk committee

If any of you have a principle or two you would like to add to the list, please send your suggestions to me in care of DiCOM's Jim Xander. Don't be shy; all ideas are welcome. As Oscar Wilde observed, "An idea that is not dangerous is unworthy of being called an idea at all."

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.

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[i] SR 20-13: Interagency Guidance on Credit Risk Review Systems, Division of Supervision and Regulation, Federal Reserve System, May 8, 2020 (https://www.federalreserve.gov/supervisionreg/srletters/SR2013.htm)

[ii] In 2006, the OCC, the Board, the FDIC, and the NCUA (collectively referred to as the agencies) issued the Interagency Policy Statement on the Allowance for Loan and Lease Losses. Attachment 1 of that statement, entitled "Loan Review Systems," served as the agencies' guidance on credit risk review (Attachment 1). Attachment 1 supplemented and aligned with other relevant agency issuances on credit review, including the Interagency Guidelines Establishing Standards for Safety and Soundness.

[iii] The credit risk review function is not intended to be performed by an institution's internal audit function. However, as discussed in the agencies' March 2003 Interagency Policy Statement on the Internal Audit Function and its Outsourcing (2003 policy statement),some institutions coordinate the internal audit function with several risk monitoring functions, such as the credit risk review function. The 2003 policy statement states that coordination of credit risk review with the internal audit function can facilitate the reporting of material risk and control issues to the audit committee, increase the overall effectiveness of these monitoring functions, better utilize available resources, and enhance the institution's ability to comprehensively manage risk. However, an effective internal audit function maintains the ability to independently audit the credit risk review function.

[iv] Contact DiCOM's Jim Xander for a copy of the 2021 Loan Review Survey and related White Paper at jxander@DiCOMsoftware.com