Module: Assets
Section: Credit Administration
EM-330

Date Published: 07/98

Introduction

Credit administration is the standards and practices followed in extending, servicing, and collecting loans. Such factors as loan purpose, size, type, and complexity; the borrower's financial condition, earnings history, integrity, and ability; and the impact of macro- and micro-economic conditions on the institution's territory influence credit administration.

As discussed in the Loan Portfolio Management section of this module, the institution's lending policies should include adequate credit administration standards. Credit administration can have a significant impact on the quality of the loan portfolio. Effective credit administration can mitigate certain credit risks, while deficient credit administration can increase credit risk and is often a forerunner of deterioration in the loan portfolio. As such, credit administration standards should ensure all loans are administered in a safe and sound manner and in compliance with FCA Regulations. This section provides guidance in evaluating these standards, as well as the actual practices followed in the administration of credit.

Examination Objectives

Determine if loans are extended, serviced, and collected in accordance with institution policies and procedures, loan underwriting standards, sound lending practices, regulations, and laws.

Evaluate credit administration standards and practices to determine if the institution adequately identifies and controls risk in the loan portfolio.

Determine the effect, or potential effect, of credit administration practices on the quality of the loan portfolio.

Credit Administration Standards and Practices

The adequacy of credit administration standards and practices, and the extent to which they are followed, largely determines the institution's ability to extend, service, and collect loans in a safe and sound manner. In general, standards and practices should ensure risk is properly identified and controlled in the loan portfolio. To accomplish this, standards and practices should address the information and analysis needed to identify risk, and the credit decision-making process needed to control risk. Standards and practices should also be differentiated based on the size, type, and risk in loans, with more information, analysis, and controls required on large and complex loans.

Complete and accurate financial information is necessary to adequately identify risk in loans. Financial information is necessary not only at the inception of the credit, but also throughout the term of the loan as the institution considers various servicing and collection activities. Lending policies and credit administration standards should define the financial statement requirements for entities and individuals at various borrowing levels and should include requirements for audited, non-audited, fiscal, interim, operating, cash flow, and other statements. Credit administration standards should also identify other information requirements necessary to evaluate the borrower's credit standing and the steps needed to ensure the reliability of information submitted.

An objective, thorough, and ongoing analysis of information received is needed to determine the inherent risk in loans and loan requests. The institution's underwriting criteria should provide a framework for conducting such an analysis with various standards, ranges, and/or criteria established to evaluate the five credit factors. Credit administration practices should also include an analysis of planned sources of repayment, actual repayment, and disposition of loan proceeds. The performance of an institution in this area is predicated directly on the quality of loan information assembled and the technical ability of the lender's credit staff.

Once credit risk is identified and evaluated, appropriate decisions must be made to ensure risk to the institution is adequately controlled. Credit decisions entail more than approving or denying a request for funds; they include establishing adequate terms and conditions at origination and pursuing appropriate servicing and collection actions throughout the term of the loan. Credit administration standards and practices should ensure credit decisions are preceded by sufficient analysis to determine risk exposure. And, as discussed in the Loan Portfolio Management section of this module, credit decisions should result in sound loans and lending actions and a level of risk in the loan portfolio commensurate with the institution's risk-bearing capacity.

Examination Procedures

The extent of credit administration evaluation should be preliminarily determined during examination planning based on past monitoring and examination results as well as the survey work performed. Survey work should include a thorough review and understanding of the institution's lending policies, credit administration standards and practices, and the internal controls used to prevent and detect noncompliance. This planning activity allows the examiner to: (1) target specific areas in the credit administration process requiring review; (2) achieve greater depth in the examination coverage of a particular area; and (3) ensure more consistency among examiners conducting the examination of credit administration.

Credit administration is most effectively examined using a systems analysis approach that determines how the process is supposed to be done, how it is actually being done, and what the weaknesses are in the process. This approach also includes identifying the cause of deficiencies and the corrective action needed.

Survey work should provide the examiner a general understanding of how the credit administration process is supposed to be done (review of policies and procedures), and how it is actually being done (internal credit review). However, depending on the adequacy of internal controls, it may be necessary to examine individual loans to further evaluate credit administration practices, to follow up on specific concerns, or to verify preliminary conclusions.

When a credit administration evaluation includes examination of individual loans, examiners should identify specific credit administration deficiencies, the degree to which they contribute to risk in loans, and any underlying weaknesses in related policies, procedures, and internal controls. The results of such review should be continually reassessed to determine if sufficient work has been done to reach a conclusion. If a conclusion cannot be reached or unforeseen weaknesses are disclosed, then the evaluation should be expanded or refocused on the particular pattern of weaknesses. Conclusions reached from the examination of individual loans should focus on credit administration practices prevalent throughout the loan portfolio that have or may increase risk in the loan portfolio.

Consistent with risk-based examination principles and the particular circumstances of the institution, examiners should add to, delete, or modify the following procedures in conducting the examination of credit administration:

1. In coordination with the examiner assigned to loan portfolio management, review the institution's lending policies and procedures to determine if they include adequate credit administration standards and requirements that address the following areas:

    a. Financial statements for entities and individuals based on size and type of borrowings;

    b. Audited, non-audited, fiscal, interim, operating, cash flow, and other financial statements;

c. Other information necessary to evaluate the borrower's credit standing (corporate and partnership documents, financial statements on guarantors, etc.);

d. The steps needed to ensure the accuracy of information submitted, such as:

- Courthouse searches
- Obtaining credit reports
- Verifying debts with other lenders
- Reviewing tax returns
- Field inspections
- Conducting collateral evaluations

e. Analyzing risk in loans and credit requests by considering the following factors:

- The purpose, terms, and conditions of credit;
- Adequacy and reliability of sources of repayment;
- Past, present, and projected repayment capacity;
- Liquidity and solvency positions;
- The accuracy and adequacy of collateral coverage, including the degree of collateral risk;
- Management capability and performance;
- Type, eligibility, and complexity of the borrowing entity;
- Compliance with established underwriting criteria;
- Past loan activity, i.e., disposition and repayment of loan proceeds, and compliance with loan conditions; and
- External factors that contribute to risk in the loan, e.g., weather conditions, commodity prices, and interest rates.

f. Documenting the basis for credit decisions and actions;

g. The establishment of adequate terms and conditions that address:

- Loan purpose;
- Loan structure and maturity;
- Disbursement of loan proceeds;
- Repayment plan/schedule;
- Minimum liquidity and solvency ratios; and
- Collateral requirements.

h. Use of loan agreements, cosigner/guaranty agreements, and borrower contacts and counseling to control risk;

i. Criteria for determining restructure, workout, or collection activities/actions;

j. The analysis needed on participations purchased from other lenders; and

k. Development and implementation of loan servicing plans on adversely classified loans.

2. Determine if the loan committee is used to effectively control risk by examining a sample of loan actions approved by the committee to determine whether:

- Loans with exceptions to the FCI's underwriting standards receive closer monitoring, servicing, or controls;
- Exceptions to the underwriting standards are justified and appropriately documented in the loan file;

- There is a pattern or practice of granting exceptions to underwriting standards; and
- Loans with underwriting exceptions have deteriorated in asset quality since origination.

3. Review the institution's internal controls to determine if sufficient procedures are in place to ensure the following:

   a. Adequate loan file organization and documentation;

   b. Notes are adequately completed, signed, and safeguarded;

   c. Mortgages and financing statements are adequately completed, signed, and filed;

   d. Preliminary and final title opinions and/or title insurance are obtained;

   e. Signed loan applications are obtained for all loans and extensions of credit;

   f. Loan disbursements are within the commitment designated on the note; and

   g. Evidence of insurance with loss payee clause is obtained, when required.

4. Identify and summarize areas of credit administration not adequately addressed by policies, procedures, and internal controls to determine potential weaknesses in the institution's identification and control of risk.

5. Review the results of the institution's internal credit review process to determine lending staff's compliance with credit administration policies and procedures and the effectiveness of internal controls.

6. In coordination with the examiner(s) assigned to loan portfolio management and analytical review of assets, identify additional areas of credit administration requiring follow-up and review.

7. Select and examine individual loans to follow up on potential credit administration problems; to test lending staff's compliance with policies, procedures, sound lending practices, and FCA Regulations; and to determine the effectiveness of internal controls.

8. Document the examination of credit administration on individual loans by identifying exceptions, the extent to which they contribute to risk in the loan, and the underlying cause.

9. Summarize the credit administration exceptions noted on loans and identify the weaknesses and practices that increase risk in loans and the loan portfolio.

10. Conclude on the adequacy of credit administration by determining the effect, or potential effect, on the quality of the loan portfolio.

11. Discuss tentative conclusions and examination findings with examiners assigned to areas that may be affected by the findings.

12. Discuss items of concern, scope of work performed, and conclusions with the examiner-in-charge and with the appropriate institution manager. Obtain a response regarding the cause(s) of deficiencies or weaknesses and anticipated corrective actions.

13. Prepare a leadsheet or other summary document to provide workpaper support for the work performed and the conclusions reached.