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5 best practices for minimizing your commercial loan portfolio risk

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Fueled by record low interest rates and enhanced consumer confidence, U.S. lenders have dramatically boosted their lending activity over the past several years, with their commercial and industrial loan portfolios combined tallying a record $1.9 trillion, a 50 percent increase since 2010.

While such activity understandably elicits a chorus of public optimism, the prudent financial institution executive, less than a decade removed from the 2008 downturn, remains stoically reserved.

If the collapse of some of the country's most distinguished financial institutions taught us anything, it's that an enhanced loan review process is a necessary safeguard for minimizing financial risk. Indeed, for the typical organization with less than $10 billion in assets, its loan portfolio exceeds 60 percent of its total consolidated assets. And such disproportionate weighting underscores the importance of a strategic, disciplined loan review process, one that can alert lenders to portfolio risks and prompt them to take corrective action — proactive or reactive — when necessary to minimize the economic impact.

As the lending portfolios of financial institutions rebound and even swell, failure is not an option. This might explain the financial executive's muted response to an economy that by many metrics has surpassed activity preceding the recession. There has been a heightened focus on the loan review process, with restraint and vigilance overtaking complacency.

What about your commercial loan portfolio? Have you adopted best practices in the loan review process, minimizing your exposure and risk? Below are five key best practices to adopt:

Declaration of independence

Objectivity should be a primary focus of the loan review process. While many financial institutions intermingle those duties — loan review personnel may report to a senior lender — this creates a conflict of interest while compromising independence. Loan review personnel independent of the lending function must be able to communicate their findings directly to the board of directors to ensure the objective assessment of a portfolio's quality. This should be formalized in the organizational structure, incorporating straight-line reporting from loan review personnel to the board or a board committee.

Top-down support

For organizational change to be meaningful, it must receive a shared commitment from top executives. As you consider revising your loan review process, there must be consensus from senior management to ensure its successful deployment. Do not leave this to informal enforcement and compliance; incorporate the process into your institution's written policy, allocating the necessary resources (formal change comes at a cost) for proper deployment and oversight.

PPO (policies, procedures, and objectives) plan

Once executive support is secured, communicate and observe unambiguous policies (P), procedures (P), and objectives (O). The loan policies should address both inherent and residual risk, identifying the types of loans that the institution will underwrite as well as the preferred loan portfolio mix.
Procedures should provide a precise scope of the review process while prescribing ongoing monitoring and maintenance to ensure everything conforms to the expected risk profile.
The policy objectives are distinct from loan procedures and should establish over-arching principles and a decision-making framework.

Depth of view

Risk varies among financial institutions; as such, the breadth of an institution's loan review process should address its risk profile. For those whose portfolio remains rather static, this may entail a routine review of its largest loans; while for others, where the composition of the portfolio changes over time, the scope must change and probably expand. Perform regular reviews to assess whether your process reflects your current portfolio.

Outside help

As loans comprise an increasing proportion of a financial institution's portfolio, modifying existing processes is both a critical and sensitive endeavor. To ensure the process addresses your unique concerns, consult third-party experts who will provide an unbiased assessment of your situation. Don’t leave this to chance. Remember: Failure is not an option.

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