DEPARTMENT OF TREASURY
Office of the Comptroller of the Currency
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FEDERAL RESERVE SYSTEM
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FEDERAL DEPOSIT INSURANCE CORPORATION
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NATIONAL CREDIT UNION ADMINISTRATION
RIN 3133-AF05

Interagency Guidance on Credit Risk Review Systems

AGENCY: Office of the Comptroller of the Currency (OCC), Treasury; Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); and National Credit Union Administration (NCUA).

ACTION: Final guidance.

SUMMARY: The OCC, the Board, the FDIC, and the NCUA (collectively, the agencies) are issuing final guidance for credit risk review (final guidance). This guidance is relevant to all institutions supervised by the agencies and replaces Attachment 1 of the 2006 Interagency Policy Statement on the Allowance for Loan and Lease Losses. The final guidance discusses sound management of credit risk, a system of independent, ongoing credit review, and appropriate communication regarding the performance of the institution's loan portfolio to its management and board of directors.

DATES: The final guidance is available on [INSERT DATE OF PUBLICATION IN THE **FEDERAL REGISTER**].

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SUPPLEMENTARY INFORMATION:

I. Background

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*.[1] 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.*[2]

In October 2019, the agencies invited public comment on proposed guidance on credit risk review (proposed guidance or proposal).[3] The proposed guidance would update and clarify Attachment 1. It also would adjust terminology to be consistent with the current expected credit losses (CECL) methodology, a recent accounting standards change.[4] The agencies are adopting the proposed guidance in final form (final guidance), with certain revisions as discussed below. The final guidance replaces Attachment 1 as the agencies' guidance on credit risk review systems for all supervised institutions and is being issued as a standalone document. Attachment 1 is rescinded as of [INSERT DATE OF PUBLICATION IN THE **FEDERAL REGISTER**].

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[1] *See* OCC Bulletin 2006-47; FDIC Financial Institution Letter FIL-105-2006; Federal Reserve Supervision and Regulation (SR) letter 06-17; NCUA Accounting Bulletin No. 06-01.

[2] 12 CFR part 30, Appendix A (OCC); 12 CFR part 208, Appendix D-1 (Board); 12 CFR part 364 Appendix A (FDIC). *Also see* 12 CFR part 723 (NCUA).

[3] Interagency Guidance on Credit Risk Review Systems, 84 FR 55679 (Oct. 17, 2019).

[4] *See* Financial Accounting Standards Board's, Accounting Standards Codification Topic 326, which revises the accounting for the allowances for credit losses (ACLs) and introduces the CECL methodology. [The agencies' final guidance on CECL is contained in a separate notice published in the **Federal Register**.]

II. Overview of Comments

The agencies collectively received 19 comments on the proposed guidance. Commenters included trade associations, banks, credit unions, and members of the public.

Most commenters expressed general support for the guidance. Commenters 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 Attachment 1. Some commenters raised concerns including that the guidance was too prescriptive.

The comments addressed a wide range of topics, and in some instances, commenters requested clarifications to certain aspects of the proposed guidance. For example, commenters discussed the role of credit risk review including its relation to other functions, such as internal audit; 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.

A number of commenters expressed concern with what they viewed as the one-size-fits-all approach of the proposed guidance and the potential burden to smaller institutions. Commenters requested 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 discussed independence of the credit risk review function and acknowledged that credit risk review provides a critical and independent assurance role but noted that role has expanded in scope and may overlap with duties performed by other functions resulting in a duplication of efforts.

Commenters also 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.

III. Discussion of Comments on the Proposed Guidance

The agencies are finalizing the guidance with targeted changes and clarifications to address the concerns raised by commenters. The comments, and any revisions to the final guidance, are discussed below and grouped based on the three questions posed in the proposal and other related topics raised by commenters. The agencies' three questions asked whether the proposed guidance reflected sound practices, whether the proposed guidance was appropriate for institutions of differing sizes, and whether the agencies should include additional factors in the proposed guidance to help credit risk review achieve a sufficient degree of independence.[5]

The agencies emphasize that credit risk review is a significant risk management function separate from the determination of the appropriate reserve for credit losses. While the results of the credit risk review can help ensure that the ACLs or Allowance for Loan and Lease Losses (ALLL) adequately reflects risk in the institution's loan portfolio, the agencies are addressing the implementation of CECL separately from the final guidance.

[5] Question 1: To what extent does the proposed credit review guidance reflect current sound practices for an institution's credit risk review activities? What elements should be added or removed, and why?
Question 2: To what extent is the proposed credit review guidance appropriate for institutions of all asset sizes? What elements should be added or removed for institutions of differing in sizes, and why?
Question 3: What, if any, additional factors should the agencies consider incorporating into the guidance to help achieve a sufficient degree of independence and why? To what extent does the approach described for small or rural institutions with fewer resources or employees provide for an appropriate degree of independence in the credit review function? What if any modifications should the agencies consider and why?

A. General Application of Guidance

Some commenters indicated the guidance was too prescriptive; in one case, a commenter considered the guidance excessively detailed and not aligned with current practices for credit unions in particular. Others indicated that the proposed guidance reflected foundational principles and outlined elements of a sound credit risk program without mandating how credit risk review should operate. Commenters also raised concerns that the proposed guidance would be enforced as a regulation.

An effective credit risk review function is integral to the safe and sound operation of every insured depository institution. To assist institutions in the creation and operation of such functions, the agencies have developed the final guidance 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.*[6] 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.

One commenter expressed general concern about guidance being applicable to all institutions, including credit unions, because the commenter considered credit union operational practices as distinct from those of other institutions. Another commenter called for the guidance to address how it intersects with the NCUA Examiner's Guide. The NCUA notes that credit risk is related to the characteristics of the loan, and not the type of institution providing the financing. This guidance is an appropriate reference to assist in establishing a credit risk review function for both credit union and other institutions' loan portfolios. Furthermore, the final guidance aligns

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[6] *Supra* note 2.

with the NCUA Examiner's Guide for commercial loans[7] and 12 CFR part 723 of the NCUA's regulations, and the NCUA supports the recommendations in this final guidance as it pertains to retail and consumer loan portfolios. The NCUA Examiner's Guide will be updated to reflect this new guidance.

B. Elements of the Guidance

Commenters addressed the role of credit risk review; scope, depth, and frequency of reviews; responsibility for and determination of risk ratings; timely communication of results; qualifications of credit risk review personnel; tailoring of the guidance to retail portfolios; and use of technology in the credit risk review process.

1.   Role of Credit Risk Review

Some commenters called for the guidance to better delineate between the responsibilities of credit risk review and other functions. As provided in footnote 5[8] of the final guidance, the role of credit risk review is distinct from the roles of other groups within an institution that are also responsible for monitoring, managing, and reporting credit risk. The agencies reiterate that institutions have 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

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[7] *See* the Commercial and Member Business Loans section of the NCUA Examiner's Guide (Commercial and Member Business Loans > Commercial Loan Administration>Independent Loan Review).

[8] Footnote 5 states that credit risk review may be referred to as loan review, credit review, asset quality review, or another name as chosen by an institution. The role of, expectations for, and scope of credit risk review as discussed in this document are distinct from the roles, expectations, and scope of work performed by other groups within an institution that are also responsible for monitoring, managing and reporting credit risk. Examples may be those involved with lending functions, independent risk management, loan work outs, and accounting. Each institution indicates in its own policies and procedures the specific roles and responsibilities of these different groups, including separation of duties. A credit risk review unit, or individuals serving in that role, can rely on information provided by other units in developing its own independent assessment of credit risk in loan portfolios, but the credit risk review unit critically evaluates such information to maintain its own view, as opposed to relying exclusively on such information.

prompt identification of loans with credit weaknesses and the validation and adjustment of risk ratings.

One commenter disagreed that a primary objective of credit risk review was to promptly identify all loans with actual and potential credit weaknesses. The commenter believed that this responsibility primarily lies with the credit administration function while credit risk review would identify such loans using a sample-based approach. The guidance does not singularly 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.

Several commenters asked for clarification of credit risk review's role in relation to internal audit. As discussed in footnote 4[9] of the final guidance, the credit risk review function is not intended to be performed by an institution's internal audit function. The March 2003 *Interagency Statement on the Internal Audit Function and Its Outsourcing* (2003 policy

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[9] Footnote 4 states that 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. (The NCUA was not an issuing agency of the 2003 policy statement.)

statement)[10] discusses the coordination of the internal audit function with risk monitoring functions, such as the credit risk review function. The 2003 policy statement provides 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.

Commenters noted that credit risk review and other banking units should coordinate their activities and requested clarification of whether it would be appropriate for credit risk review or for other internal functions within a credit risk review system to perform activities that are compliance or operational in nature, such as confirming proper lien perfection and collateral documentation. Commenters also stated that credit risk review provides support to financial and regulatory reporting functions but does not directly deliver outputs to these functions, and requested that the proposed guidance be clarified in this regard.

While duties such as assuring lien perfection and collateral confirmation might not be directly undertaken by the credit risk review function, evaluation and confirmation of such actions is within the scope of the credit risk review function and a key aspect of an assessment of the overall quality of the credit. The credit risk review function may use information generated by other functions when developing an independent assessment of credit risk, but footnote 5 of the final guidance provides that such information is typically subject to critical challenge and evaluation and a credit risk review function typically does not rely exclusively on such information.

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[10] The 2003 policy statement was issued by the Board, OCC, and FDIC on March 17, 2003. *See* SR Letter 03-5, OCC Bulletin 2003-12, FDIC Financial Institution Letter FIL-21-2003. NCUA was not a party to the issuance.

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

One commenter stated that one part of the proposed guidance allows institutions to have a system concept for structuring credit risk review whereas the latter part of the proposed guidance defined specific roles for a credit review function. The commenter requested clarification on the words "system" and "function" as used in the guidance. The agencies have seen institutions use both terms when referring to credit risk review, 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.

2. Scope

Commenters suggested that the agencies consider the nature of a loan portfolio and the history and experience of an institution's management team when determining the scope of credit risk review. Commenters requested that the proposed guidance indicate that credit review practices can be tailored when loans are seasoned and have a history of performance and enhanced collateral positions. Some commenters recommended that credit risk review focus on higher risk or newer loans. The agencies reaffirm that, as stated in the proposal, institutions may tailor their credit risk review practices based on a number of factors, including the nature of the institution's loan portfolio and overall risk profile.

Commenters requested clarification about whether the proposed guidance covered non-lending activities. One commenter indicated that these activities should not be within the scope of credit risk review, while other commenters disagreed. Some 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 credit risk review function. For example, institutions that hold investment securities or engage in capital markets, treasury, or automated clearinghouse activities may elect to include the credit risk related to these activities in the scope of a review. While the examples of non-lending credit activities cited here are not exhaustive, and may not apply to all institutions, they illustrate other areas that management and the board of directors may consider in the development of a review plan that reflects the risk profile of the institution.

Further, some commenters expressed the view that smaller banks and credit unions may have difficulty in identifying concentrations of credit risk and other loans affected by common repayment factors. Commenters stated that the phrase "common repayment factors" could lead to a much larger scope of review. The OCC, Board, and FDIC note that, under the *Interagency Guidelines Establishing Standards for Safety and Soundness*,[11] insured depository institutions should establish and maintain a system that is commensurate with the institution's size and the nature and scope of its operations to identify problem assets and prevent deterioration in those

[11] *Supra* note 2.

assets, which includes considering the size and potential risks of material asset concentrations. The reference to “common repayment factors” is meant to provide flexibility to institutions to consider a variety of factors that are applicable to the institution’s circumstances and which may lead to a concentration of credit risk.

Commenters suggested that credit risk review focus on loans that contain major, significant, or critical exceptions to policy, rather than “approved” exceptions or loans with minor or administrative policy exceptions. Commenters also suggested that there may be “major” exceptions to policy with strong mitigating factors that suggest these exceptions may not warrant a focus in the review process. 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.

Further, commenters suggested that credit risk review focus on loans with high-risk indicators and asked the agencies to clarify that institutions can define “segments of the loan portfolio experiencing rapid growth.” Commenters suggested that it is appropriate for banks and credit unions to define their own “rapid growth” targets for credit review and to have independent loan review verify those targets. This 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 does not prescribe specific targets or thresholds. Institutions can select their own high-risk indicators, keeping in mind how the indicators fit the characteristics of the overall portfolio and how the indicators help to reinforce safe and sound practices.

3. Depth

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

One commenter recommended removing language in the proposed guidance stating that loans selected for credit risk review are evaluated for "quality of the information used in the credit loss estimation process, including the reasonableness of assumptions used and the timeliness of charge-offs." The 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 the original Attachment 1. The focus of Attachment 1 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. In order to direct the focus and applicability of the review under both allowance methodologies, the agencies have revised the language in the final guidance to read as follows: “the appropriateness of credit loss estimation for those credits with significant weaknesses including the reasonableness of assumptions used, and the timeliness of charge-offs.” Additionally, the agencies acknowledge that the calculation of estimated ACL or ALLL is not the role of credit risk review. However, effective credit risk review results help ensure that the ACL or ALLL adequately reflects risk in the credit portfolio. In performing its assessment of reasonableness, credit risk review can leverage work performed in this area by other functions, such as internal audit.

Several commenters suggested that evaluating the validity of underwriting assumptions was too broad of an activity for credit risk review, and could imply that credit risk review is responsible for back testing assumptions. Commenters suggested that 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. Back testing the validity of assumptions is often a part of the underwriting and monitoring processes. Credit risk review can use this information, if available, when making their assessments.

Commenters indicated that institutions should receive credit during a review if back testing of initial loan risk ratings shows a high level of accuracy. Similarly, commenters suggested that the agencies’ guidance should focus less on risk evaluation, but instead focus on the front-end loan evaluation by bank staff. The focus of the credit risk review system is on the assessment of credit quality in the credit portfolios, which is an important input into the determination of the ACL and ALLL. An effective credit risk review 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 credit risk review staff in their assessment of credit quality.

4. Frequency

Several commenters raised questions about the frequency of credit risk reviews and requested clarification as to when it is appropriate for reviews to be conducted less frequently than annually. Commenters suggested there are instances in which less frequent reviews are appropriate, such as 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. With respect to the credit risk review policy, one commenter suggested that frequency of review should be determined by a firm's board of directors.

Consistent with the principles in the final guidance, 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 credit risk reviews are typically performed annually. However, 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 thereof. The agencies have clarified in the final guidance that an effective credit risk review system starts with a written credit risk review policy that is typically reviewed and approved at least annually.

5. Risk rating responsibility and adjudication

Several commenters observed that the proposed guidance provided an opportunity to establish which area or department at the institution will have responsibility over risk rating dispositions within the credit review function. Commenters asked if credit risk review should always be the final arbiter of a risk rating, even if credit risk review's rating is less conservative than that determined by the business line. Commenters requested that the proposed guidance clarify that an institution's board of directors retains the responsibility for maintaining a bank's credit risk rating and establishing relevant policies. Some commenters questioned whether the proposed guidance would require institutions to employ an arbitration process.

The agencies believe that the language as proposed describes a clear disposition process for adjudicating risk ratings that is flexible for institutions of all sizes. In particular, the final guidance addresses risk rating differences between the credit risk review and areas responsible for loan approval. Typically, the lower credit quality classification or risk rating assigned by credit risk review 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.[12]

6. Communication of Results

In general, commenters expressed support for credit risk review reporting directly to the board of directors. Other commenters indicated that the language in the proposed guidance was

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[12] Two commenters requested clarification from the NCUA regarding whether credit unions are required to adopt the loan classification system described in footnote 7 of the guidance. The NCUA does not require credit unions to adopt the regulatory classifications of substandard, doubtful or loss. However, NCUA does support the use of these classifications, as defined by the other banking agencies, as an effective method for rating adversely classified loan risk. *See* the Commercial and Member Business Loans section of the NCUA Examiner's Guide (Commercial and Member Business Loans > Credit Risk Rating Systems> Credit Risk Rating Categories).

too prescriptive, particularly regarding communication to the board at least quarterly. 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 credit risk review function report findings regularly and directly to the institution's board of directors or a committee thereof. 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 credit risk reviews 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.

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.

Commenters also requested that the agencies clarify that only "material" deficiencies and weaknesses that remain unresolved beyond the scheduled time frames for correction should be promptly reported to senior management and the board of directors or appropriate board committee. The agencies believe that an effective credit review system should report all noted deficiencies and weaknesses to the board of directors. Credit review may prioritize findings of weaknesses or deficiencies; however, allowing management to determine the materiality of findings can compromise the independence of the credit review process.

7. Qualifications of Personnel

One commenter suggested that footnote 4 of the proposed guidance be revised to emphasize the importance of the qualifications, independence, and expertise of personnel conducting the internal audit of a credit risk review system or function. The OCC, Board, and FDIC believe that the qualifications of audit personnel are sufficiently addressed in the 2003 policy statement, which is referenced in the final guidance.

One commenter noted that with respect to credit risk review staff, knowledge of an institution's membership and experience with underwriting are key factors in determining the qualifications of credit risk review personnel. This final guidance broadly addresses the experience of personnel, which would include 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.

8. Retail and Consumer Portfolios

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 credit risk review of retail loan portfolios. One commenter stated that the proposed guidance inadequately differentiated between product types and exposures of commercial and retail loans. The commenter 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 credit risk review. 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 credit risk review 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, with regard to evaluating credit quality, soundness of underwriting and risk identification, borrower performance, and adequacy of the sources of repayment, "[w]hen 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 have 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 takes into account the fact 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, and thus clarifies that effective credit risk review can consider the appropriateness of the business line's application of these tools in these processes. Further, an effective credit risk review can consider the effectiveness of account management strategies, such as credit line management, re-aging, and extension/renewal in managing credit risk. An effective credit risk review 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.

9. Technology

Commenters posed a number of questions and comments related to the use and governance of technology in credit risk review. 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 credit risk review process; as such, the agencies decline to recommend the use of any specific types of technology.

One commenter expressed concern 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.[13]

C. Scalability of the Guidance

The agencies received numerous comments about whether the proposed guidance is appropriate for institutions of all sizes. Several commenters expressed concern with what they viewed as a one-size-fits-all nature, 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. Commenters also requested accommodations for smaller institutions, including credit unions. One commenter stated the proposed guidance could impose higher costs on smaller institutions because such costs cannot be spread across a large asset base and requested the guidance provide more flexibility for review activities. One commenter suggested that the proposed guidance would benefit from additional discussion and analysis of how modest-sized institutions with limited personnel would implement the guidance. This commenter expressed concern that the proposed guidance would be burdensome for such institutions and potentially require outsourcing of credit risk review. Another commenter requested that the proposed guidance specifically exempt small, non-complex rural institutions, thereby allowing them to utilize their existing review functions. Another commenter requested that the agencies clarify the proposed guidance's applicability to large banks, including defining a large institution based on asset size

[13] See the interagency statement titled, Supervisory Guidance on Model Risk Management, published by the Board in SR Letter 11–7 and OCC Bulletin 2011–12 on April 4, 2011. The FDIC adopted the interagency statement on June 7, 2017. Institutions supervised by the FDIC should refer to FIL 22–2017, Adoption of Supervisory Guidance on Model Risk Management, including the statement of applicability in the FIL.

and examples of complex institutions and explaining how supervisors make these determinations.

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 credit risk review varies based on an institution's size, complexity, loan types, risk profile, and risk management framework. In addition, as described under "Independence of Credit Risk Review 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 credit risk review function. Footnote 6[14] of the final guidance emphasizes that small or rural institutions that have few resources or employees may adopt modified credit risk review 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 credit risk review systems in larger institutions may include a dedicated credit risk review 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.

D. Independence Considerations

Some commenters suggested that creating the independence structure described in the proposed guidance would be a problem for small banks and credit unions. Commenters stated

[14] Footnote 6 states that small or rural institutions that have few resources or employees may adopt modified credit risk review procedures and methods to achieve a proper degree of independence. For example, in the review process, such an institution may use 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. It is appropriate to employ such modified procedures when more robust procedures and methods are impractical. Institution management and the board, or a 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.

that doing so could lead to duplicative functions and compliance burden for small banks and credit unions, which have limited staffing. Commenters also stressed that small credit unions may find it costly to hire third parties to ensure the independence of the credit review function. One commenter called for an exemption for small institutions and requested that the agencies adopt alternative independence standards, such as those articulated in the agencies' appraisal guidance, which would allow third-party staff members or an independent lender to confirm the risk rating of another lender. This commenter also suggested a rotation of duties as a way to achieve independence in the credit risk review function. Another commenter noted that the boards of directors of small, closely held institutions may be involved in the credit process from the beginning, and the board's input and participation in loan origination can be more important than the subsequent credit review that happens post origination.

As stated above, the agencies recognize that small institutions with few resources may need to adopt modified credit risk review procedures in order to achieve a proper degree of independence, as previously referenced in footnote 6 of the proposed guidance. That footnote states that small or rural institutions with few resources may use 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 credit risk review process. The footnote also states 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.

Commenters asked for clarification on the reporting structure of credit risk review. The OCC, Board, and FDIC note that the *Interagency Guidelines Establishing Standards for Safety* *and Soundness*[15] state that an institution should have internal controls and information systems that are 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 credit risk review department, it is prudent for the credit risk review function to report directly to the institution's board of directors or a committee thereof. This reporting structure allows the credit risk review 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 credit risk review function.

E. Current Expected Credit Losses

The agencies received a number of comments related to the CECL methodology as described in FASB ASC Topic 326.[16] 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. Commenters on the proposed credit review guidance noted that while institutions with large and complex loan portfolios typically maintain

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[15] *Supra* note 2.
[16] Refer to the final Interagency Policy Statement on Allowances for Credit Losses published elsewhere in today's Federal Register for more details on CECL methodology.

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 is intended to be flexible and consistent with CECL, but it does not incorporate FASB Topic 326. 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 to the extent that 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."

Some commenters recommended that the agencies clarify credit risk review's role in determining ACLs. One commenter asked for clarification on whether credit risk review functions must conduct risk-specific assessments on the valuations of financial assets measured at an amortized cost basis, such as held-to-maturity securities. With regard to institutions that produce economic forecast estimations as a component of their ACL estimate, the commenter also asked whether credit risk review functions should integrate and align the 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, as credit risk review is an important component of safety and soundness on its own. Commenters should refer to the Interagency Policy Statement on Allowances for Credit Losses[17] regarding how credit risk review can facilitate the loss estimation process.

IV. Paperwork Reduction Act

In accordance with the requirements of the Paperwork Reduction Act of 1995 (PRA),[18] the agencies may not conduct or sponsor, and the respondent is not required to respond to, an information collection unless it displays a currently valid Office of Management and Budget (OMB) control number.

The final guidance will not create any new or revise any existing collections of information under the PRA. Therefore, no information collection request will be submitted to the OMB for review.

V. Final Guidance

The text of the final guidance is as follows:

INTERAGENCY GUIDANCE ON CREDIT RISK REVIEW SYSTEMS

Introduction

The *Interagency Guidelines Establishing Standards for Safety and Soundness* (Guidelines)[1] underscore the critical importance of credit risk review and set safety and soundness standards for insured depository institutions to establish a system for independent, ongoing credit risk review, and for appropriate communication to their management and boards

[17] This guidance is contained in a separate notice published in the Federal Register.
[18] 44 U.S.C. 3501-3521.
[1] 12 CFR part 30, Appendix A (OCC); 12 CFR part 208, Appendix D-1 (Board); and 12 CFR part 364, Appendix A (FDIC). Part 723 of NCUA Rules and Regulations.

of directors.[2] This guidance, which aligns with the Guidelines, is appropriate for all institutions[3] and describes a broad set of practices that can be used either within a dedicated unit or across multiple units throughout an institution to form a credit risk review system that is consistent with safe and sound lending practices. This guidance outlines principles that an institution should consider in developing and maintaining an effective credit risk review system.

Overview of Credit Risk Review Systems

The nature of credit risk review systems[4] varies based on an institution's size, complexity, loan types, risk profile, and risk management practices. For example, in smaller or less complex institutions, a credit risk review system may include qualified members of the staff, including loan officers, other officers, or directors, who are independent of the credits being assessed. In larger or more complex institutions, a credit risk review system may include components of a dedicated credit risk review function that are independent of the institution's lending function.[5] A credit risk review system may also include various responsibilities assigned

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[2] For foreign banking organization branches, agencies, or subsidiaries not operating under single governance in the United States, the U.S. risk committee would serve in the role of the board of directors for purposes of this guidance.

[3] For purposes of this guidance, regulated institutions are those supervised by the following agencies: The Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), and the Office of the Comptroller of the Currency (OCC), hereafter referred to as the "agencies."

[4] 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. (The NCUA was not an issuing agency of the 2003 policy statement.)

[5] Credit risk review may be referred to as loan review, credit review, asset quality review, or another name as chosen by an institution. The role of, expectations for, and scope of credit risk review as discussed in this document are distinct from the roles, expectations, and scope of work performed by other groups within an institution that are also responsible for monitoring, managing and reporting credit risk. Examples may be those involved with lending functions, independent risk management, loan work outs, and accounting. Each institution indicates in its own policies and procedures the specific roles and responsibilities of these different groups, including separation of

to credit underwriting, loan administration, a problem loan workout group, or other organizational units of an institution. Among other responsibilities, these groups may administer the internal problem loan reporting process, maintain the integrity of the credit risk rating process, confirm that timely and appropriate changes are made to risk ratings, and support the quality of information used to estimate the Allowance for Credit Losses (ACL) or the Allowance for Loan and Lease Losses (ALLL), as applicable. Additionally, some or all of the credit risk review function may be performed by a qualified third party.

Regardless of the structure, an effective credit risk review system accomplishes the following objectives:

- Promptly identifies loans with actual and potential credit weaknesses so that timely action can be taken to strengthen credit quality and minimize losses.
- Appropriately validates and, if necessary, adjusts risk ratings, especially for those loans with potential or well-defined credit weaknesses that may jeopardize repayment.
- Identifies relevant trends that affect the quality of the loan portfolio and highlights segments of those portfolios that are potential problem areas.
- Assesses the adequacy of and adherence to internal credit policies and loan administration procedures and monitors compliance with applicable laws and regulations.

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duties. A credit risk review unit, or individuals serving in that role, can rely on information provided by other units in developing its own independent assessment of credit risk in loan portfolios, but the credit risk review unit critically evaluates such information to maintain its own view, as opposed to relying exclusively on such information.

- Evaluates the activities of lending personnel and management, including compliance with lending policies and the quality of their loan approval, monitoring, and risk assessment.
- Provides management and the board of directors with an objective, independent, and timely assessment of the overall quality of the loan portfolio.
- Provides management with accurate and timely credit quality information for financial and regulatory reporting purposes, including the determination of an appropriate ACL or ALLL, as applicable.

Credit Risk Rating (or Grading) Framework

The foundation for any effective credit risk review system is accurate and timely risk ratings to assess credit quality and identify or confirm problem loans. An effective credit risk rating framework includes the monitoring of individual loans and retail credit portfolios, or segments thereof, with similar risk characteristics. An effective framework also provides important information on the collectibility of each portfolio for use in the determination of an appropriate ACL or ALLL, as applicable. Further, an effective framework generally places primary reliance on the lending staff to assign accurate and timely risk ratings and identify emerging loan problems. However, given the importance of the credit risk rating framework, the lending personnel's assignment of risk ratings is typically subject to review by qualified and independent: (i) peers, managers, or loan committee(s); (ii) part-time or full-time employee(s); (iii) internal departments staffed with credit review specialists; or (iv) external credit review consultants. A risk rating review that is independent of the lending function and approval process can provide a more objective assessment of credit quality.[6]

An effective credit risk rating framework includes the following attributes:

- A formal credit risk rating system in which the ratings reflect the risk of default and credit losses, and for which a written description of the credit risk framework is maintained, including a discussion of the factors used to assign appropriate risk ratings to individual loans and retail credit portfolios, or segments thereof, with similar risk characteristics.[7]
- Identification or grouping of loans that warrant the special attention of management or other designated "watch lists" of loans that management is more closely monitoring.[8]
- Clear explanation of why particular loans warrant the special attention of

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[6] Small or rural institutions that have few resources or employees may adopt modified credit risk review procedures and methods to achieve a proper degree of independence. For example, in the review process, such an institution may use 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. It is appropriate to employ such modified procedures when more robust procedures and methods are impractical. Institution management and the board, or a 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.

[7] A bank or savings association may have a credit risk rating framework that differs from the framework for loan classifications used by the federal banking agencies. Such banks and savings associations should maintain documentation that translates their risk ratings into the regulatory classification framework used by the federal banking agencies. This documentation will enable examiners to reconcile the totals for the various loan classifications or risk ratings under the institution's system to the federal banking agencies' categories contained in the Uniform Agreement on the Classification and Appraisal of Securities Held by Depository Institutions Attachment 1 – Classification Definitions (OCC: OCC Bulletin 2013-28; Board: SR Letter 13-18; and FDIC: FIL-51-2013). The NCUA does not require credit unions to adopt a uniform regulatory classification system. Risk rating guidance for credit unions is set forth in NCUA letters to credit unions 10-CU-02, "Current Risks in Business Lending and Sound Risk Management Practices," issued January 2010 and 10-CU-03, "Concentration Risk," issued March 2010. *See also* the Commercial and Member Business Loans section of the NCUA Examiner's Guide (Commercial and Member Business Loans > Credit Risk Rating Systems) and the preamble to 1 CFR Parts 701, 723 and 741 Member Business Loans; Commercial Lending: Proposed Rule July 2015.

[8] In addition to loans designated as "watch list," this identification typically includes loans rated special mention, substandard, doubtful, or loss.

management or have received an adverse risk rating.

- Evaluation of the effectiveness of approved workout plans.
- A method for communicating direct, periodic, and timely information to the institution's senior management and the board of directors or appropriate board committee on the status of loans identified as warranting special attention or adverse classification, and the actions taken by management to strengthen the credit quality of those loans.
- 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**.**[9]

Elements of an Effective Credit Risk Review System

An effective credit risk review system starts with a written credit risk review policy[10] that is reviewed and typically approved at least annually by the institution's board of directors or appropriate board committee to evidence its support of, and commitment to, maintaining an effective system. Effective policies include a description of the overall risk rating framework and establish responsibilities for loan review based on the portfolio being assessed. An effective credit risk review policy addresses the following elements, described in more detail below: the qualifications and independence of credit risk review personnel; the frequency, scope, and depth

[9] In particular, 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. For banks and savings associations, these categories are either those used by, or those that can be translated into those used by, the federal banking agencies.

[10] *See* 12 CFR part 30, Appendix A (OCC); 12 CFR part 208, Appendix D-1 (Board); and 12 CFR part 364 Appendix A (FDIC). *See also* 12 CFR part 723 (NCUA).

of reviews; the review of findings and follow-up; and communication and distribution of results.

Qualifications of Credit Risk Review Personnel

An effective credit risk review function is staffed with personnel who are qualified based on their level of education, experience, and extent of formal credit training. Qualified personnel are knowledgeable in both sound lending practices and the institution's lending guidelines for the types of loans offered by the institution. The level of experience and expertise for all personnel involved in the credit risk review process is expected to be commensurate with the nature of the risk and complexity of the portfolios. In addition, qualified credit risk review personnel possess knowledge of relevant laws, regulations, and supervisory guidance.

Independence of Credit Risk Review Personnel

An effective credit risk review system incorporates both the initial identification of emerging problem loans by loan officers and other line staff, and an assessment of loans by personnel independent of the credit approval process. Placing primary responsibility on loan officers, risk officers, and line staff is important for continuous portfolio analysis and prompt identification and reporting of problem loans. Because of frequent contact with borrowers, loan officers and line staff can usually identify potential problems before they become apparent to others. However, institutions should be careful to avoid over-reliance on loan officers and line staff for identification of problem loans. An independent assessment of risk is achieved when personnel who perform the loan review do not have control over the loan and are not part of or influenced by individuals associated with the loan approval process.

While a larger institution may establish a separate department staffed with credit review specialists, cost and volume considerations may not justify such a system in a smaller institution. For example, in the review process, smaller institutions may use an independent committee of outside directors or 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. Whether or not the institution has a dedicated credit risk review department, it is prudent for the credit risk review function to report directly to the institution's board of directors or a committee thereof, consistent with safety and soundness standards. Senior management may be responsible for appropriate administrative functions provided such an arrangement does not compromise the independence of the credit risk review function.

The institution's board of directors, or a committee thereof, may outsource the credit risk review function to an independent third party.[11] However, the responsibility for maintaining a sound credit risk review system remains with the institution's board of directors. In any case, institution personnel who are independent from the lending function typically assess risks, develop the credit risk review plan, and verify appropriate follow-up of findings. Outsourcing of the credit risk review function to the institution's external auditor may raise additional independence considerations.[12]

<u>Frequency of Reviews</u>

An effective credit risk review system provides for review and evaluation of an institution's significant loans, loan products, or groups of loans typically annually, on renewal, or more frequently when internal or external factors indicate a potential for deteriorating credit

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[11] For supervisory guidance related to outside service providers, refer to SR letter 13-19/CA letter 13-21, "Guidance on Managing Outsourcing Risk," issued by the Board on December 5, 2013; FIL-44-2008, "Guidance for Managing Third-Party Risk," issued by the FDIC on June 6, 2008; and OCC Bulletin 2013-29, "Third-Party Relationships: Risk Management Guidance," issued by the OCC on October 30, 2013. For credit unions, refer to NCUA letters to credit unions 01-CU-20 "Due Diligence over Third Party Service Providers," issued November 2001 and 07-CU-13 "Evaluating Third Party Relationships," issued December 2007.

[12] *See* footnote 4.

quality or the existence of one or more other risk factors. The credit risk review function can also provide useful continual feedback on the effectiveness of the lending process in order to identify any emerging problems. Ongoing or periodic review of an institution's loan portfolio is particularly important to the estimation of ACLs or the ALLL because loss expectations may change as the credit quality of a loan changes. Use of key risk indicators or performance metrics by credit risk review management can support adjustments to the frequency and scope of reviews.

Scope of Reviews

Comprehensive and effective reviews cover all segments of the loan portfolio that pose significant credit risk or concentrations, and other loans that meet certain institution-specific criteria. A properly designed scope considers the current market conditions or other external factors that may affect a borrower's current or future ability to repay the loan. Establishment of an appropriate review scope also helps 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. An effective credit risk review function also considers industry standards for credit risk review coverage consistent with the institution's size, complexity, loan types, risk profile, and risk management practices and helps to verify whether the review scope is appropriate. 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. An effective scope of credit risk review is risk-based and typically includes:

- Loans over a predetermined size;

- A sufficient sample of smaller loans, new loans, and new loan products;
- Loans with higher risk indicators, such as low credit scores, high credit lines, or those credits approved as exceptions to policy;
- Segments of loan portfolios, including retail, with similar risk characteristics such as those related to borrower risk (e.g. credit history), transaction risk (e.g. product and/or collateral type), or other risk factors as appropriate;
- Segments of the loan portfolio experiencing rapid growth;
- Exposures from non-lending activities that also pose credit risk;
- Past due, nonaccrual, renewed, and restructured loans;
- Loans previously adversely classified and loans designated as warranting the special attention of the institution's management;[13]
- Loans to insiders or related parties;
- Loans to affiliates;
- Loans constituting concentrations of credit risk and other loans affected by common repayment factors.

Depth of Transaction or Portfolio Reviews

Loans and portfolio segments selected for review are 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

[13] *See* footnote 8.

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

Review of Findings and Follow-Up

An important activity of an effective credit risk review system is the discussion of the review findings, including all noted deficiencies, identified weaknesses, and any existing or planned corrective actions (including time frames for correction) with appropriate loan officers, department managers, and senior management. An effective system includes processes for all noted deficiencies and weaknesses that remain unresolved beyond the scheduled time frames for correction to be promptly reported to senior management and the board of directors or appropriate board committee.

It is important to resolve risk rating differences between loan officers and loan review personnel according to a pre-arranged process. That process may include formal appeals procedures and arbitration by an independent party or may require default to the assigned classification or risk rating that indicates lower credit quality. If credit risk review personnel conclude that a loan or loan portfolio is of a lower credit quality than is perceived by the portfolio management staff, the lower classification or risk rating typically prevails unless internal parties identify additional information sufficient to obtain the concurrence of the independent reviewer or arbiter on the higher credit quality classification or risk rating.

Communication and Distribution of Results

Personnel involved in the credit risk review process typically prepare a list of all loans (and portfolio segments) reviewed, the date of review, and a summary analysis that substantiates the risk ratings assigned to the loans reviewed. Effective communication also typically involves providing results of the credit risk reviews to the board of directors or appropriate board committee quarterly.[14] Comprehensive reporting includes comparative trends that identify significant changes in the overall quality of the loan portfolio, the adequacy of, and adherence to, internal policies and procedures, the quality of underwriting and risk identification, compliance with laws and regulations, and management's response to substantive criticisms or recommendations. Such comprehensive reporting provides the board of directors or appropriate board committee with insight into the portfolio and the responsiveness of management and facilitates timely corrective action of deficiencies.

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[14] An effective credit risk review system provides for informing the board of directors or appropriate board committee more frequently than quarterly when material adverse trends are noted. When an institution conducts loan file reviews less frequently than quarterly, the board or appropriate board committee will typically receive results on other credit risk review activities quarterly.

Joseph M. Otting,
Comptroller of the Currency.

By order of the Board of Governors of the Federal Reserve System.

Ann Misback,
Secretary of the Board.

Federal Deposit Insurance Corporation.
Dated at Washington, DC, on or about May 7, 2020.
Robert E. Feldman,
Executive Secretary.

By the National Credit Union Administration Board.

Gerard Poliquin,
Secretary of the Board.