



## Standardized lending processes: The key to compliance, risk management, and efficiency

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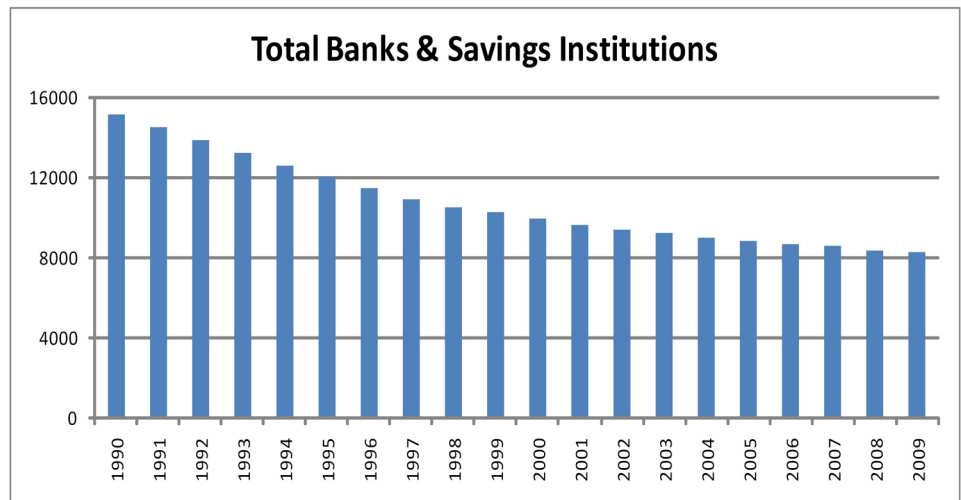
As the industry has consolidated, many banks have grown by acquisition but have not standardized key processes and systems. Critically, these include key lending processes which have come under fire during the current financial crisis. As a result, some banks find it difficult to respond to evolving regulatory requirements and to manage risk effectively in their loan portfolios. Banks that take steps to begin standardizing their lending processes will be better-positioned to manage through the current environment and beyond.

The banking industry has undergone substantial consolidation over the past 20 years. Just two decades ago, there were more than 15,150 banks and savings institutions in the United States. Today, there are just over 8,200; a decrease of nearly 50 percent over 20 years.

We can attribute much of this consolidation to strategic merger and acquisition activity initiated to increase market presence, decrease competition in high-growth areas, and create synergies in key lines of business. More recently, though, the consolidation has been accelerated by the financial crisis that has hit the banking industry particularly hard. From the beginning of the financial crisis in 2007 through August 2009, 103 banks have closed their doors—many of which have been or are being absorbed by healthier institutions. Economic indicators suggest this trend will continue for some time.

### Challenges of standardizing operations.

Whether during good times or bad, bank mergers face major challenges in integrating operational practices and technologies. The merging banks' differences in processes and systems may be large or small, but invariably they cause difficulties over time. One area that banks traditionally have struggled to integrate—lending



processes—has come under particular scrutiny since the onset of the financial crisis.

Fundamentally, lending processes are similar across most institutions; yet there may be differences in the details, even within a single institution, that lead to major discrepancies. This is often due to:

- ◆ Limited emphasis on standardization, especially during mergers and acquisitions
- ◆ The experience level of the staff
- ◆ The manual nature of certain aspects of the lending process
- ◆ Insufficient controls to ensure accuracy and consistency
- ◆ Limited real-time monitoring of loan data quality

In fact, many banks have failed or are experiencing difficulties today because of risky loans and/or overexposure in risk-prone areas such as commercial real estate. While banks continually try to manage the risks associated within their loan portfolios, it is much more difficult to do so when the organization continues to use disparate lending processes.

### **Increased management and regulatory reporting requirements.**

At the same time, the regulatory environment is casting much greater scrutiny on banks—and particularly on the information related to their loan portfolios. Banks with non-standard lending processes may have different rules for determining the values for key loan attributes and in some cases, the required attributes themselves may be different across the organization.

Historically these banks have struggled to respond to management and regulatory requests for information. Here are two examples:

**Primary collateral determination.** A bank that has grown through acquisition may find it has several different approaches for determining a loan's primary collateral, or its source(s) for repayment. For example, in instances where multiple collateral is taken on the loan, one area of the bank may consider any real estate taken in a security position as the primary collateral regardless of the percentage of the collateral base it represents, while another area of the bank will select the primary collateral based on the asset that makes up the majority of the collateral base. This difference in approach affects the collateral information entered by loan operations into the bank's loan system—information that is critical to management and regulatory reporting. Perhaps even more important, the lack of consistent information affects the bank's ability to accurately set its provision for loan loss given the risk factors tied to different collateral types.

**Commercial real estate portfolio information.** Bank executives as well as regulators want a better understanding of the quality of a bank's loans and its overall exposure to commercial real estate. For example, occupancy is an

important quality attribute for real estate loans. This risk measure helps the bank understand the exposure associated with a specific property—if a commercial property is occupied by the primary borrower's business or outside tenants, there is less risk of default than if it is unoccupied and produces no rental income to cover the monthly debt service. The ability to accurately report on occupancy, traditionally captured in credit presentations, may be impacted by:

- ◆ The use of different rules for determining occupancy: square footage vs. percentage of rental income
- ◆ Disparate processes for updating this information in a timely manner: quarterly vs. annually vs. not at all
- ◆ The ability of the loan system to capture sufficient information

As a result, many banks don't have a clear view of this important risk factor across their loan portfolio.

Some banks have tried to address discrepancies through manually intensive reporting processes that are relatively expensive to operate and still leave a large margin for error. Besides posing an ongoing expense and quality challenge, this solution is not scalable and or responsive to a dynamic regulatory environment.

### **The mandate to standardize.**

With the financial crisis continuing, it is difficult to predict the long-term implications for the banking industry. But, one needs to look only as far back as 2002 to the collapse of Enron and WorldCom, the introduction of Sarbanes-Oxley, and the effort and expense invested by public companies to meet the new requirements. If this history is any indication, it is safe to say that banks will face more regulatory control, risk management and reporting requirements in the future.

Although the regulators and lawmakers are still debating the new banking industry regulations, we can be sure these will revolve around lending processes and the quality of loan portfolios. Even in advance of formal regulations, the regulatory environment is beginning to evolve. Regulators are asking for more information about banks' loan portfolios than they have in the past, and they are asking many banks

to perform stress tests of their loan portfolios to determine whether they have sufficient capital to withstand adverse changes in the market such as rising unemployment or declining home values.

To satisfy these evolving regulatory requests and establish sound risk-management capabilities for uncertain times, financial institutions now need to begin standardizing loan processes, loan data elements, and loan reporting across their organizations—if they haven't already. Doing so not only addresses regulatory reporting needs; it will:

- ◆ Streamline loan processes and make operations more efficient
- ◆ Improve confidence in the quality and accuracy of loan portfolio data
- ◆ Improve consistency of loan data across the portfolio
- ◆ Accurately provision and reserve for potential future loan losses
- ◆ Improve concentration monitoring

### **A framework for change.**

While this effort will require change—for some, substantial process and cultural changes—this framework can help define the effort involved:

1. Perform an assessment of all lending processes and systems across the organization
2. Identify process optimization opportunities, as well as gaps and remediation plans
3. Develop standard loan processes and data attributes
4. Apply the newly developed standards and data attributes to the existing portfolio through automation or manual file review
5. Establish a mechanism for ongoing monitoring

Banks operate in a different environment today than they did even a decade ago, and there is no doubt this environment will continue to evolve as we work our way out of the financial crisis and learn from lessons of the past. As the market begins to turn around, we will begin to see an increase in loan originations as well as merger and acquisition activity within the banking industry. Banks that proactively work to standardize their disparate loan processes and systems will find themselves in a position for greater success than their competitors and better prepared to manage the risk in their loan portfolios and comply with the evolving regulatory environment.

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