



KANSAS

JOHN P. SMITH, ADMINISTRATOR

KATHLEEN SEBELIUS, GOVERNOR

DEPARTMENT OF CREDIT UNIONS

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TO: Board of Directors and Managers of Kansas Chartered Credit Unions
SUBJECT: Elements of Effective Loan Policies

The success of a credit union is closely related to how well it manages credit risk. A written loan policy, approved by the credit union's board of directors, reviewed at least annually and adhered to in practice is of critical importance in ensuring that the credit union operates in a safe and a sound manner. In today's competitive and challenging lending environment, an up-to-date policy, appropriate to a credit union's lending function and business plan, is more important than ever. This Bulletin summarizes features and benefits of an effective policy, details warning signs and potential consequences of an outdated policy, and offers practical advice about reviewing and updating a loan policy.

ELEMENTS OF AN EFFECTIVE LOAN POLICY

Written loan policies vary considerably in content, length, and specificity, as well as in style and quality. No two credit unions share the same tolerance for risk, offer the same loan products, or face the same economic conditions. An effective loan policy should reflect the size and complexity of a credit union and its lending operations and should be tailored to its particular needs and characteristics. Revisions should occur as circumstances change, and the policy should be flexible enough to accommodate new lending activity without a major revision.

During examinations, examiners will make a determination concerning the adequacy of a credit union's loan policy. Examiners are guided in their review by K.S.A. 17-2206, share (deposit) insurance rules, and common sense: Is the policy up-to-date and are important areas adequately addressed. Regardless of a credit union's size or location, a loan policy should address:

- Lending authority of loan officers or credit committee
- Credit evaluation and collateral documentation standards
- Limitations on loan-to-value, and loan segment totals
- Guidelines for the loan portfolio mix, risk diversification and rates of interest
- Internal controls to ensure compliance with policy
- Collection procedures for delinquent loans
- Methodology used to determine the amount of an appropriate Allowance for Loan and Lease Losses

BENEFITS OF AN EFFECTIVE AND UP-TO-DATE LOAN POLICY

A sound loan policy, established and overseen by the board of directors, reflects favorably on the board and management. When a board sets forth its expectations clearly in writing, management is better positioned to control lending risks, ensure the credit union's stability and soundness, and fulfill oversight responsibilities. An

effective and up-to-date loan policy increases the likelihood that actual loan documentation and underwriting practices will satisfy the board's expectations. Additionally, a well-conceived policy clearly and comprehensively describes management's system of controls and helps examiners identify high-risk areas and prioritize and allocate examination time.

As part of the Department's risk-focused examination process, examiners focus on areas that represent the greatest risk to the credit union. A written loan policy is tangible evidence of the processes that have been established to identify, measure, monitor, and control risks in the lending area. An incomplete or inadequate policy makes it more difficult to identify potential high-risk areas and may raise supervisory concerns about a credit union's risk management practices.

INDICATORS THAT A LOAN POLICY NEEDS ATTENTION

A recent adoption or cursory review of the policy does not provide adequate assurance that a policy is adequate. Only a careful review of the entire policy will reveal the extent of any shortcomings; however, even a cursory review can provide clues that a policy needs attention. Common concerns include:

- The policy has not been revised or re-approved in more than a year.
- Multiple versions of the policy are in circulation within the credit union.
- The table of contents is not accurate.
- The policy is disorganized.
- The policy contains misspellings, typos, and grammatical errors.
- Discontinued products are included, or new products are not addressed.
- Front line employees cannot find a copy of the policy.

In addition, a review of actual lending decisions often identifies areas where management is departing from the specifics of the loan policy, such as:

- Actual lending practices vary significantly from those outlined in the policy.
- Numerous exceptions to policy requirements have been approved.
- Policy limits are being ignored.

Exceptions to policy should be few in number and properly justified, approved, and tracked. If actual practices vary materially from written guidelines and procedures, the source of this discrepancy should be identified, and either actual practices or written policy should be changed. Management may conclude that specific sections of the written policy are no longer relevant. A case is then made to the board of directors to amend the policy to reflect different, but still prudent, procedures and objectives.

POTENTIAL CONSEQUENCES OF AN INADEQUATE LOAN POLICY

Outdated and ineffective loan policies can contribute to a range of problems. Introducing a loan product that is not adequately addressed in the written loan policy can create a variety of challenges for the lending staff and involve risks that management did not anticipate.

If individual loan officer lending authorities, loan-to-value, and other lending limitations are not revised when circumstances change, a credit union could be operating within guidelines that are too restrictive, too lenient, or otherwise inappropriate in light of the credit union's current situation and lending environment. If the loan policy does not comply with current statutes and regulations, lending decisions may not reflect best practices or regulatory requirements. Imprudent lending decisions can have a ripple effect. A loan policy that does not anticipate the risks inherent in a credit union's lending practices can lead to asset quality problems and poor earnings, which increases a credit union's vulnerability to adverse movements in interest rates, a downturn in the local economy, or other negative economic events.

THE LOAN POLICY REVIEW AND UPDATING PROCESS

A credit union's loan policy is not a static document, but rather should be revised as the credit union itself, general business conditions, rules, or regulations change. A comprehensive annual review, in addition to frequent interim reviews, will help ensure that a loan policy does not become outdated and ineffective. The frequency and depth of the reviews will depend on circumstances specific to each credit union, such as growth expectations, competitive factors, economic conditions, staff expertise, and level of capital protection. Planned changes to a credit union's lending function or business plan should prompt a modification to the policy to incorporate the new programs as well as to identify obsolete or irrelevant sections of the policy. Pertinent criticisms and recommendations made during recent audits or examinations should be considered during the updating process. Compliance testing conducted as part of the review and updating processes, will help management determine whether staff is aware of and adhering to the provisions of its loan policy. A credit union's board of directors should demonstrate their commitment by emphasizing that noncompliance is unacceptable. Lending staff, executive officers, and directors should be able to demonstrate some level of familiarity with all provisions—more so with the provisions that affect their daily responsibilities. Awareness and knowledge of the policy's specific provisions can be promoted through periodic training that stresses the need for the policy to keep pace with current lending activities and clarifies any areas of ambiguity or uncertainty. Specific areas that may benefit from review are:

- **ranges** for key numerical targets, such as loan-to-value ratios or loan portfolio segment allocations
- **responsibilities** for monitoring and enforcing loan policy requirements
- **documentation** requirements for various classes of loans
- remedial **measures** for loan policy infractions
- individual loan officer and credit committee lending **authorities**

CONCLUSION

A regularly reviewed and updated loan policy is an important tool to help management ensure that a credit union's lending function is operating within established risk tolerances. Such a policy is more likely to be consulted and followed by staff and contributes to uniform and consistent board-approved practices. Therefore, credit union staff, members, and regulators will be well served by the implementation of a process that helps ensure that a credit union's loan policy is, and remains, comprehensive, effective, and up to date.



John P. Smith, Administrator

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