Independent Loan Review Guide

Independent Loan Review has an important role in a CDC’s internal control of the loan portfolio. Periodic objective, independent reviews of credit risk levels and risk management processes are essential to effective portfolio management. SBA regulations require that all Certified Development Companies (CDCs) have a board-approved internal controls policy (see 13 CFR § 120.823 and 13 CFR § 120.826(b)). This guide provides clarification to CDCs on the role of Independent Loan Reviews in a CDC’s internal controls process.

Independent Loan Review Sample Size and Methodology

Each CDC’s internal controls policy should establish Independent Loan Review guidelines specifying:

- frequency of the review (no less than annually);
- independence of the loan reviewers and credentials of the reviewers;
- review sample size;
- sampling methodology for loans and appraisals originated in the last 12 months for underwriting/closing requirements;
- sampling methodology for reviewing loan in servicing based on loans that are current, delinquent, in intensive servicing or liquidation;
- appraisal review standards; and
- requirements for work papers and documentation

Frequency of Reviews

An independent loan review should be conducted at least annually, by someone qualified to conduct such a review and independent of the function being reviewed.

Loan Reviewers

The CDC is not required to hire an outside contractor to conduct this independent review, if it can be done in-house by a group which is considered independent of the function being reviewed. For example, someone involved in loan underwriting should not be reviewing the loan underwriting area. In this example, perhaps the CDC would utilize someone involved in loan servicing to conduct the loan underwriting review. However, to ensure independence in the review process, the review team should report to the Board of Directors (or to an audit committee at the Board level) and, the Board or committee should approve the performance evaluation for the review and review the unit’s strategic and operating plans, and act on the unit’s findings.

Loan Review

The review of loans should include both new and legacy loans (loans originated over 12 months ago) for adherence to SBA Loan Program Requirements. The review of
new loans (originated in the past 12 months) should focus on underwriting and closing, and the review of legacy loans should focus on servicing and liquidation, if applicable. The review also needs to include an assessment of the loan classification (aka loan risk rating) to ensure loans are risk-classified appropriately and that risk classifications are updated in a timely manner (when new information is obtained, but at least annually).

Each 504 loan file in the sample should be reviewed for:

- Eligibility;
- Credit Analysis;
- Credit documentation;
- Collateral documentation;
- Proper lien perfection;
- Adherence to loan covenants;
- Loan Authorization, Closing and Disbursement;
- Appraisals;
- Environmental reports;
- Servicing and Liquidation;
- Compliance with internal policies and procedures, and applicable laws and regulations; and
- The accuracy and timeliness of risk rating/loan classification assigned by loan officers.

**Core Analysis Phase**

Core analysis phases during the Independent Loan Review must include:

1.) Determining whether deficiencies noted in last examination and most recent internal/external audit have been addressed and/or corrected by management; and

2.) Determining if any member of senior management of Board of Directors/Chairman have ability to override credit grades or decisions.

**Outcome of an Independent Loan Review**

The following objectives generally should be addressed in an effective CDC Independent Loan Review process and should serve as potential points for improvement:

- To provide the Board of Directors and senior management with an objective assessment of the overall portfolio quality;
- To assess the adequacy of, and adherence to, SBA’s Loan Program Requirements, and to monitor compliance with relevant laws and regulations;
- To promptly identify loans with credit weaknesses so that timely action can be taken to minimize credit loss, including review of the CDC’s loan classifications;
- To identify relevant trends affecting the collectability of the loan portfolio and isolate potential problem areas;
To provide essential information for determining the adequacy of the PCLP reserve (if loans are PCLP);
To evaluate the activities of lending personnel; and
To provide management with information related to credit quality that can be used for financial and regulatory reporting purposes.

**Loan Quality Classifications Consistent with Federal Financial Institution Regulators**

The Independent Loan Reviewer should opine on the risk-rating of each loan reviewed as to whether he/she agrees with the risk rating or feels it should be up-graded or down-graded and provide an explanation for the change. Timely and accurate classification of loans allows the CDC to better manage its 504 loan portfolio.

An example of a loan classification system used by a Federal Financial Institution Regulator would be the Uniform Classification System (UCS) referenced by the Farm Credit Administration on their website at:


**Control Requirements for the CDC’s oversight of Professional Services Contracts**

CDCs are expected to monitor their Professional Services Contracts to ensure that the services provided and the fees paid are prudent and customary. There must be no actual or appearance of a conflict of interest. The CDC should establish a way to monitor performance of loans where Professional Service Contracts were used.

**Standards for Training to Implement the Loan Review Program.**

Training procedures are essential to maximize the benefit of the loan review program. This training procedure should include, at a minimum: who is being trained; what information is provided in the training; how often the training will occur; and the manner in which ongoing training will take place based on the findings of the loan review program.

**CDC Follow up on Results of Independent Loan Reviews**

The Board and senior management should use the results of the Independent Loan Reviews to improve the current and future loan-making and monitoring functions.
Recommended Checklist

Summary of 504 Independent Loan Review Reports

The following items should be addressed in the Independent Loan Review Report.

1. Date of Independent Loan Review.

2. Name and title (and company name if review is conducted by an external entity) of individual(s) who carried out the review. If the reviewer is an employee of the CDC and the review is done “in-house”, specify how the reviewer is independent of the process being reviewed.

3. Portfolio details at the time of review:
   □ Number of total outstanding loans.
   □ Gross Principal Balance of outstanding loans.
   □ Number of total “new loans” (less than 12 months on books).
   □ Gross Principal Balance of new loans.
   □ Number of total “legacy loans” (greater than 12 months on books).
   □ Gross Principal Balance of seasoned loans.
   □ Number of total “active default” loans (where debenture has been purchased but not charged off by SBA).
   □ Gross Principal Balance of “active default” loans.

4. Loan Review details:
   □ List all loans included in the review sample with SBA loan number and SBA Loan Name.
   □ Number of total loans reviewed.
   □ Gross Principal Balance of total loans reviewed.
   □ Number of “new loans” reviewed.
   □ Gross Principal Balance of new loans reviewed.
   □ Number of “legacy loans” reviewed.
   □ Gross Principal Balance of seasoned loans reviewed.
   □ Number of “active default” loans reviewed.
   □ Gross Principal Balance of “active default” loans.
   □ Describe how the sample is sufficient in size to represent the condition of the portfolio.

5. Provide details on the specific selection criteria used for the review:
   □ Name, title, and company (if applicable) of the individual who selected the loans.
   □ Details on the methodology used to decide which loans were to be selected.
6. Provide details on the specific review criteria used in the review:
☐ Materials used in the review such as work papers, checklists, etc. (Include completed checklists and work papers)

7. Synopsis of the Deficiencies identified by the reviewer during the Independent Loan Review with list of loans by deficiency and recommended Corrective Actions within the following categories:
☐ Eligibility
☐ Credit Analysis
☐ Credit documentation
☐ Collateral documentation
☐ Proper lien perfection
☐ Adherence to loan covenants
☐ Loan Authorization, Closing and Disbursement
☐ Appraisals
☐ Environmental reports
☐ Servicing and Liquidation
☐ Compliance with internal policies and procedures, and applicable laws and regulations; and
☐ The accuracy and timeliness of credit grades assigned by loan officers.

8. Evidence that the report was presented to the Board of Directors.

9. Summary of the Board of Director’s position on findings and their plan for operational improvement

(4/27/15)