1.5 Organization of the Study

This study will be presented under five Sections, viz, i) Introduction, ii) Loan Review, iii) Research Findings, iv) Recommendations, and v) Conclusion.

The Introduction Section will give a brief overview of the study. The loan review section will give an in-depth explanation of the bank loan review function. This will be followed by research findings. Based on the findings, recommendations will be made to further enhance the loan review system at RHB. This study will end with a conclusion.

2. LOAN REVEIW

Once a loan has passed the approval process, it cannot be ignored. During the life of the loan, a borrower's credit quality improves, deteriorates, or fluctuates between these two possibilities. Credit quality rarely remains the same. For this reason, as part of the loan approval process, bank loans are approved subject to certain monitoring procedures, also known as loan review.

2.1 Definition of Loan Review

McCuistion (1992) defined loan review as an independent, formal evaluation program for examining outstanding loans as to policy compliance, credit quality, documentation and signs of deterioration to prevent loan losses.

Morsman (1982) commented that Bankers use terms such as "loan or credit administration," "loan monitoring," and "loan review" in many ways and frequently are used interchangeably.

Loan monitoring or loan review refers to a tactical process of tracking key elements of a borrower's operation. These elements indicate the ability to repay the bank's loan. The degree of monitoring is commensurate with the perceived risk. Morsman (1982) added that loan review is a strategic process designed to give management an overview of the administration of the lending function, the quality of the loans portfolio, and adherence to loan policy.

2.2 Location of Loan Review in the Credit Organization Chart

Morsman (1982) indicated that the choice of where to locate loan review in the Credit Organization Chart is ideally outside the lending function. The obvious argument for this is the independence gained and presumably greater objectivity. As loan review is concerned about checking on compliance in respect of loan polices, laws and documentation and credit quality, hence the loan review function should not be incorporated with the lending function to avoid biasness and at the same time engender greater transparency. If a lending officer were to discover an error committed during approval of the loan in the subsequent review exercise, his or her tendency to conceal the error would be very great, to avoid embarrassment.

Behrens (1992) added that loan review is best placed in the organization chart as an autonomous department reporting directly to the board of directors. Loan review should be accomplished by independent and objective individuals charged with the responsibility of examining individual borrowers.

McCuistion (1992) agreed with the other two authors that loan review should be an independent department reporting directly to the board of directors. Since loan review is a type of audit function, independence is critical for loan review function to be carried out without any partiality.

According to Choo (1995), the loan review function is integrated within the ambit of the Credit Department but, it is located outside the lending function. In discussing loan review, he has outlined the following diagram called The Lending Process Tree to identify where best to locate the loan review function on the Credit Organization Chart.

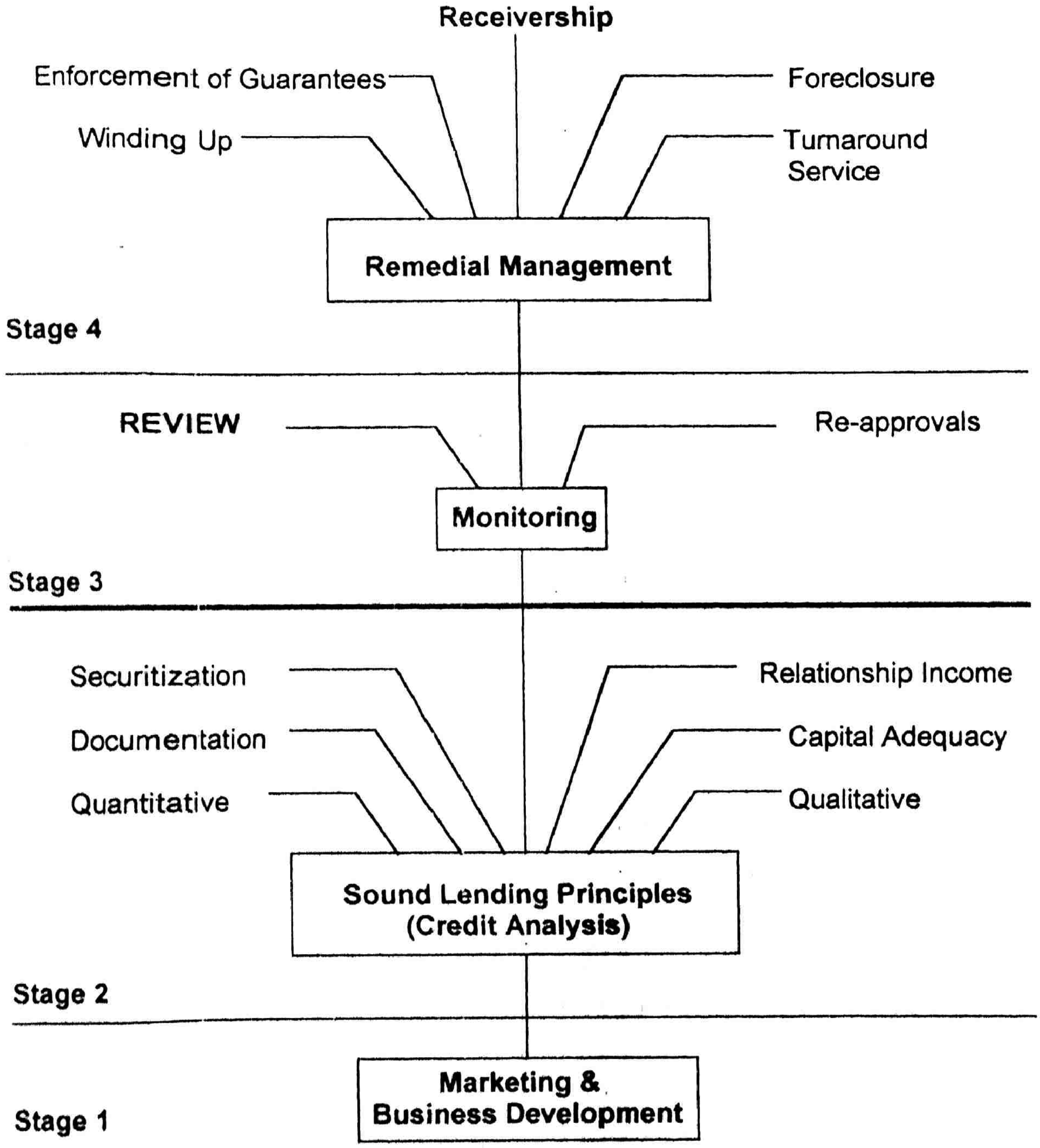

Figure 1: The Lending Process Tree (Source: Bank Lending: Assessment and Management, Howard Choo, 1995, page 4)

2.3 Bank Negara Malaysia Guidelines

In accomplishing its responsibilities as the governing body of all financial institutions in the country, Bank Negara Malaysia has implemented policies and guidelines covering all aspects of the financial industry including loan review and non-performing loans. To meet the objectivity of this study, it is important to understand the existing Bank Negara Guidelines in respect of loan review and non-performing loans.

2.3.1 Bank Negara Malaysia Guidelines on Loan Review

The requirement for banks to conduct loan review is explicitly stated in the Bank Negara Guidelines. It states that loan accounts should be reviewed prior to renewal, enhancement, reduction or restructure of existing credit exposures. Loan review includes analyzing the borrower's periodic financial statements, reassessing collateral values, making site visits to the borrower's business premises and keeping abreast with trends and developments in the economy. An effective loan review system could serve as an early warning system for detecting potential problematic loans. (BNM/GP10, 1997, Item 2.7.1)

2.3.2 Bank Negara Malaysia Guidelines on Non-performing Loans

As one of the aims of loan review function is to improve loan quality and minimize non-performing loans, it serves good purpose to cover the existing guidelines on the classification of non-performing loans.

A loan is classified as a non per-performing (NPL) when the principal or interest is due and is unpaid for six or more months from the first day of default. This is illustrated as follows:

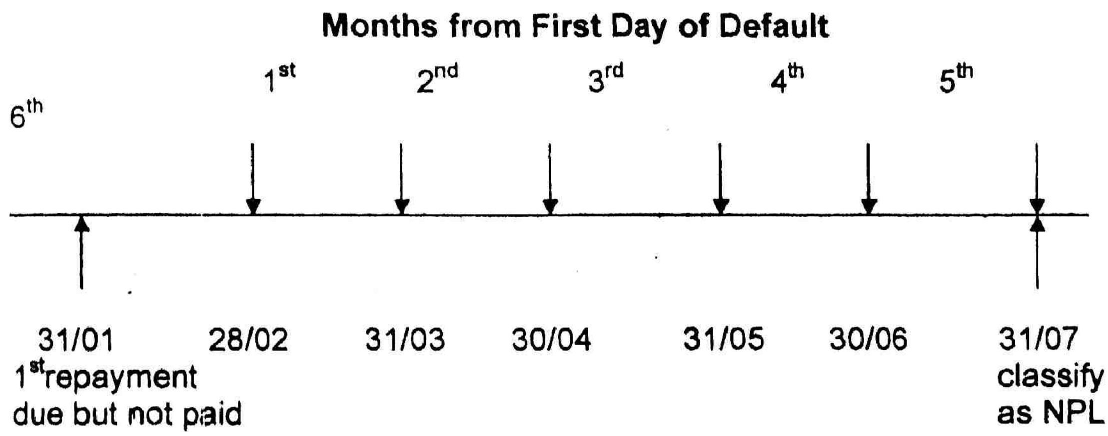

Figure 2: The Ageing Process of a Non-performing Loan
(Source: BNM/GP3, 1998, Item 5)

The various types of loan facilities shall be classified as non-performing in the following manner (BNM/GP3, 1998, Item 5):

- Overdraft : 1. When the account has been dormant for six months or more and the outstanding amount is in excess of the approved limit.
  2. When the overdraft facility has been recalled, the account shall be classified as non-performing immediately.

- Term Loan : When the principal or interest is due and unpaid for six months or more from the day of first default.

- Trade Bills : When the instrument is due and unpaid for one month after maturity date.

2.3.3 Provisions for Substandard, Bad and Doubtful Debts

The concern to prevent a loan from turning non-performing is based on two factors, that is the risk involved in collecting back the loan itself and the requirement by Bank Negara Malaysia to provide specific provisions for the non-performing loan. The provision exercise reduces the profit margin of the bank and restricts expansion and investment plans. Table 1 below shows Bank Negara Malaysia Classification of non-performing loans and the rate of specific provision.

Table 1: Provisions for Substandard, Bad and Doubtful Debts

Period of Default	Classification	Specific Provision on the shortfall in security value over the amount outstanding, net of unearned interest and interest suspended
6 months but less than 9 months	Substandard	20% provisioning unless overall loan loss provisions are adequate
9 months but less than 12 months	Doubtful	50%
12 months and above	Bad	100%

Source: BNM/GP3, 1998, Item 24

2.4 Scope of Loan Review

Based on Bank Negara Malaysia Classification, a loan turns non-performing when the principal or interest is due and unpaid for six months or more from the first day of default. This means that until the 180^{th} day (assuming 30 days in a month), the loan can be saved from turning non-performing. This is the scope of loan review, that is before the loan turns non-performing.

Once a loan turns non-performing, it is no longer within the parameter of the loan review function. The bank's concern will be in recalling the loan if the borrower is unable to make payments or fails to comply with the bank's proposals. The loans recovery department would then take over the management of the non-performing loan as the recovery process entails legal procedures such as foreclosure and enforcement of guarantees.

Morsman (1982) commented that in establishing the scope of reviewing requirements, the bank should focus on those aspects of repayment where vulnerability is the greatest. Scope of loan review is determined largely by the type and nature of the loan products. Heavy monitoring of small loans is unprofitable. Normally, loans subject to a fixed structured repayment arrangement are waived from loan review in view of the low perceived risk.

Scope of loan review is also determined by current happenings such as industry performance and natural disasters. The outbreak of the Foot and Mouth disease in Malaysia in 1995 called for all banks to conduct special reviews on all borrowers engaged in the cattle industry.

2.5 The Loan Review Process

Loan review function is the process of reassessing (reviewing) the credit worthiness of an existing borrower of the bank in respect of several key factors including conduct of the loans favoring the borrower, the borrower's business performance based on latest audited financial statements, collateral values and compliance to terms and conditions of the loans vis-à-vis the bank's overall credit policies.

During loan review, the processing officer's task would be to reassess and recommend the renewal and extension of the outstanding loan facilities of the borrower under review for management's approval. Thus, the review function allows the bank to exercise its rights of reviewing and taking corrective and preemptive measures if warranted which is stipulated in the Letter of Offer.

2.6 Bank Loan Products

Some of the most common bank loan products offered by a commercial bank are Term Loans, Overdraft, Trade Bills and Bridging Loans. Term Loans are subject to fixed repayment arrangement with a specific maturity date. Examples of Term Loans are Housing Loans and Fixed Loans. Overdraft and Trade Bills are offered repayable on demand and subject to review.

Commercial banks often package the loan products to meet the needs of the borrower. Some of the common packages are Bridging Loans, Revolving Credits and Contract Financing. A detailed definition of bank loan products is provided in Appendix 1.

2.7 Functions of Loan Review

McCuistion (1992) has defined the functions of the loan review unit as follows:

- To identify problem or potential problem loans.
- To identify and recommend corrective actions for improving loan and collateral documentation and credit documentation deficiencies.
- To make recommendations to the bank's senior management for inclusion of certain loans on the supervised loan list.
- To assign an internal credit rating to all loans reviewed.

2.8 Purposes of Loan Review

Behrens (1992) identified four primary purposes of loan review. They are:

- To determine compliance with loan policy.
- To assist in detecting any deterioration in loan quality.
- To indicate when collection activity is needed.
- To help in the prevention, or at least, reduction of loan losses.

McCuistion (1992) outlined the following reasons as to why the review function is critical to banks:

- Problem loan identification
- Economic uncertainties
- Collateral values are declining
- Unparalleled losses
- Required by the regulatory authorities
- To determine reserve adequacy for loan losses

2.9 Objectives of Loan Review

What McCuistion (1992) expressed as `functions' and what Behrens (1992) termed as `purposes' were identified as objectives by Morsman (1982) in his mission statement for loan review. Morsman (1982) highlighted the following six objectives:

- Credit quality
- Adequacy of the loan loss reserve
- Trends
- Problem identification
- Adherence to loan policy, laws, and regulation
- Profitability and funds management objectives

2.9.1 Credit Quality

By assessing the risk of individual borrowers, loan review offers an opinion on the ultimate collectibility of the loans extended to the borrowers of the bank. The risk assess exercise also provides an indication of the quality of loans in the portfolio.

2.9.2 Adequacy of the Loan Loss Reserve

The adequacy of the loan loss reserve is based on management's continuing evaluation of a number of factors including:

- Historical loan loss and recovery experience
- Projected loan losses and recoveries
- Review of problem loans
- Overall portfolio quality
- Current and anticipated economic conditions
- Ability of the bank to replenish reserves through earnings

Loan review should evaluate how the adequacy of the loan loss reserve is determined and ensure that it is a logical and comprehensive process.

2.9.3 Trends

Banking is a dynamic business with enormous potential for change. The loan review function should examine such factors as the quality of loan, concentration of credit and vulnerability to economic conditions. From these examinations, loan review should attempt to project trends and isolate potential problem areas or identify unique opportunities.

2.9.4 Problem Identification

Loan review is the first line of defense in problem loan identification. In the process of loan reviewing, some problem loans or loans with the potential of developing problems would be encountered. Potential problem areas would include concentrations of credit which are particularly vulnerable to economic cycles. Loan review should isolate these problematic loans and recommend corrective actions to protect the loans. Assuming the corrective actions have been approved, loan review should follow-up periodically to ensure that the recommendations are carried out. As a loan deteriorates, progressively more stringent monitoring is usually applied, and problem loan techniques are utilized at the appropriate time.

If problems that were undetected during loan processing are pointed out during loan review, there may be serious deficiencies in loan approval. An effective loan review function can go beyond identifying problem loans by examining why the problems occurred.

2.9.5 Adherence to Loan Policy, Laws, and Regulation

In the examination of individual borrowers, loan review may encounter violations of loan policy, laws, and regulations. Recommendations will be made for corrections and follow-up steps will be established. The continuous violation of a certain element of loan policy might indicate that the policy is unrealistic and should be amended. Excessive violations of compliance regulations might indicate a need for more specific training in the area identified.

Along with the assessment of compliance to policy, loan review should periodically examine the loan policy itself and determine whether it is adequate and realistic. Loan review can recommend policy changes where necessary.

2.9.6 Profitability and Funds Management

During loan review, it is important to address the achievement of profitability and funds management objectives. Appropriate measurement systems must be in place to gauge results and trigger corrective action when necessary. By evaluating results and offering effective recommendations, loan review contributes significantly to bank profitability.

2.10 The Content of Loan Review

The examination of individual loans is the sole purpose of loan review. In looking at individual borrowers, loan review focuses on different issues that are important to the appropriate supervision of a particular loan.
To achieve the objectives of loan review, Morsman (1982) commented that loan review should address the following five specific issues whenever it examines individual borrowers:

- Credit Rating
- Loans and Security Documentation
- Liquidation Value of Collateral
- Pricing
- Compliance Checking

2.10.1 Credit Risk Rating

The credit rating exercise to determine credit quality is one of the most vital functions of loan review. Credit quality is basically the expectation of the risk of loss or the expectation of the collectibility of a loan. In examining credit quality, loan review must determine the probability of repayment in accordance with approved terms and conditions. A portfolio can then be arrayed on a spectrum of low-risk easily supervised loans to high-risk loans requiring heavy supervisions.

2.10.2 Loans and Security Documentation

The bank as a lender resorts to the provisions of loan documentation only when enforcement is needed. At that point, it is the mission of the opposing party, either the borrower or other creditors, to attack the bank's position or security interests. The bank cannot correct documentation from the witness stand.

Loan review is in a good position to examine documentation. Errors can be pointed out and rectified. Additional protection may well be recommended for deteriorating loans.

2.10.3 Liquidation Value of Collateral

Collateral is only needed at one point in a borrowing relationship when it must be liquidated to settle an outstanding loan. Book values based on financial statements can be meaningless.

Loan review must consider in terms of what the collateral will bring as collected or on the auction block. Liquidations normally occur under adverse economic conditions which must also be reflected in the value of collateral. Loan review must provide an objective third-party opinion so that realistic loan-to-collateral relationships are maintained.

2.10.4 Pricing

Pricing and risk should bear a direct correlation for two reasons:

- The higher the risk of loss, the greater the provision for loan loss expense.
- The higher the risk, the more loan monitoring is required which results in a higher allocation of overhead.

Loan management should be certain that there is a reasonable relationship between pricing and risk and conduct and scrutinize any exceptions. Monitoring is an overhead factor which should be considered in the pricing of a loan.

The objective of a pricing strategy is to obtain a gross yield sufficient to meet profitability standards after covering the cost of funds, expenses related to risk, and allowed overhead.

The costs relating to each loan consists of:

- Cost of funds
- Cost of credits, interest, liquidity, and economic risks
- Cost of supervision

It is part of the review function to make sure that all loans on the spectrum are priced so that the Bank's profitability objective is achieved, on the whole. During loan review, review officers must evaluate if the pricing accorded commensurate with the credit risk. If it is perceived that the loan does not contribute adequately to profitability objectives, the review officers should recommend what combinations of increased rates or fees are necessary.

2.10.5 Compliance Checking

Through the examination of borrowers, loan review is in a good position to check and ensure adherence to policy and take corrective measures to put right what is wrong. To do this, loan review officers must have a complete understanding of the loan policies as well as of laws and regulations governing lending practices. Consequently, loan review should not only identify violations but recommend corrections as well.

2.11 Customer Credit Risk Rating

Customer credit risk rating is an attempt to quantify the perceived risk of loss on every loan or borrower in a portfolio of a Bank. The risk rating exercise permits comparison of loans and highlights exceptional areas of potential loss. A risk rating system should be designed to facilitate reporting and statistical and trend analysis. The risk rating process can be applied to reflect the strength and weakness of each borrower and the overall loans portfolio of the bank.

Perceived risk is reflected in the years in the business, years of good conduct (with other banks for new borrowers) collateral, and financial health reflecting turnover, profits (losses), liquidity, leverage and collection period.

The rating is based on an assignment of weights to different ratios. Risk assessment is boiled down to a single number often expressed as Class or Grades as shown below:

Grade I or A	: highest quality
Grade II or B	: good quality
Grade III or C	: satisfactory quality
Grade IV or D	: below-average quality
Grade V or E	: poor quality

2.11.1 Initial Rating

Since the intensity of loan review should be proportional to the perceived risk involved, the risk must be assessed at the time of loan approval. This assessment can be accomplished by the responsible loan processing officer at the time of loan approval. The assessing of credit risk at the origination of the loan is the key to monitoring it. Loan review could change the rating at a later date based on its own assessment of the risk.

2.12 Frequency of Review

Loan review establishes its frequency based on risk. Frequency of review commensurate with perceived risk. Should a loan quality deteriorate, more frequent review will be applied. If a loan falls under high risk grades, problem loan administration techniques are applied. Periodically, generally quarterly, half yearly or annually, depending on the perceived risk, loans must be reviewed. Normally, credits in risk grades `A' and `B' are reviewed annually. Loans graded `C', `D', and `E' are closely monitored via more frequent reviews usually on quarterly basis or semi-annual basis.

2.13 Degree of Monitoring

Although monitoring borrowing customers is expensive, lack of it can produce prohibitive costs. Because the value of the loan at risk vastly exceeds the cost of its supervision, the bank should err on the side of over-monitoring. However, banks should establish guidelines for the degree of monitoring they expect in relation to the risk of the loan. The degree of loan monitoring stringency must be responsive to changes in the perceived risk of the borrower and to changes in economic conditions.

If monitoring is properly accomplished, loan review officers can concentrate their efforts on their riskier loans. Management, in turn, is involved only in the exceptionally risky credits. By this process of exception management, the banks can focus their talents where they produce the best results.

2.14 Tickler Systems

Once the monitoring requirements have been established, they must be incorporated into a tickler system to track and ensure that the loan review is duly conducted. A computer generated listing indicating the names of the borrowers, account numbers, loan limits and respective branch due for review during each month should be made available either on monthly or quarterly basis, depending on the size of the bank. This listing is often called a Review Register.

2.15 Evaluation of the Portfolio as a Whole

Loan review may be charged with evaluating portfolios annually or accomplishing specific reviews such as that of a particular branch or sector or industry. Loan review can determine what dollar amount and percentage of the portfolio was reviewed, as well as the number and percentage of borrowers.

This type of analysis gives the reviewer some idea of the scope and integrity of the entire portfolio. Loan review should chart significant indicators and periodically share the results with loan management.

2.16 Obstacles of Loan Review

The need and worth of loan review is obvious but selling loan review is not easy. McCuistion (1992) has identified several obstacles, which are as follows:

- Senior management is not committed to loan review. Despite the losses that have been occurring, banks often turn a deaf ear to loan review simply because the function is not revenue generating. Without top management's support, an effective loan review system is almost impossible to be implemented.

- The bank is too small. Some smaller banks simply do not feel they can justify the additional expense of loan review.

- Shortage of qualified personnel. Loan review officers should have upper hand knowledge pertaining to loans lending and recovery policies.