Module: Assets
Section: Introduction
EM-305

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Introduction

The Assets module provides information, objectives, and procedures for examining the management and condition of Farm Credit System (System) institutions' assets. The purpose of this section is to introduce the Assets module and the asset examination, in general. The Assets module includes the following sections:

- Loan Portfolio Management--provides criteria and procedures for examining the key management systems and processes that comprise loan portfolio management.
- Analytical Review of Assets--provides criteria and procedures for evaluating the condition of assets and determining the adequacy of results and overall effectiveness of asset management.
- Asset Classifications--provides criteria and procedures on classifying assets for the purpose of verifying management's risk identification process.
- Accounting for Problem Assets--provides a description and application of each performance category and related accounting issues.
- Credit Administration--provides criteria and procedures for evaluating the adequacy of credit administration standards and practices.
- Allowance for Loan Losses--discusses the allowance for loan losses account and provides procedures for determining the adequacy of management's process and the reasonableness of allowances established.
- Investments--provides criteria and procedures for examining the management and condition of marketable investments.
- Other Assets--provides criteria and procedures for examining cash, premises, equipment, and investments in other System institutions.
- Other Financing Institutions (OFIs)--provides information and procedures unique to OFI lending.

A substantial portion of the Assets module is devoted to loan portfolio management and the examination procedures completed to validate its adequacy. Loan portfolio management is emphasized to highlight its importance to the overall safety and soundness of System institutions. Loans are an institution's primary earning assets, the profitability of which affects the overall financial condition of the institution. As such, the management and quality of loan assets is a major determinant in the success or failure of institutions and the degree of risk to stockholders and investors.

While the majority of an institution's assets are comprised of loans, effective management of all assets is important. For example, investments held by some institutions may comprise a significant portion of total assets and contribute favorably to earnings performance. However, the underlying investment practices may expose the institution to excessive risk.

Management decisions and actions are ultimately reflected in the composition, quality, and profitability of an institution's assets. In turn, these factors impact the institution's earnings, liquidity, and capital.

Therefore, it is imperative that examinations focus on the adequacy of management systems and processes that provide a basis for the decisions and actions taken to mitigate threats and to pursue opportunities in the institution's operating environment.

Examination Objectives

Determine the quality of board and management performance in managing the institution's assets.

Assess the composition, quality, and profitability of the institution's assets and determine how such factors impact the soundness of the institution.

Assess the threats and opportunities in the institution's operating environment and determine the potential effect on the institution's assets.

General Examination Approach

Examination planning is necessary to identify which specific asset areas require evaluation and/or verification. Sufficient examination work should be planned to validate the preliminary conclusions reached on management and the condition of the institution's assets. Reliability of the institution's internal controls is an important factor in determining the extent of evaluation necessary. For example, if the internal credit review was found to be reliable during prior examination work and/or monitoring, and the institution's risk identification practices and remedial effort have not changed, the amount of verification necessary could be reduced or even eliminated. However, an unreliable internal credit review program may necessitate substantial examination of loan classifications.

Examiners should also consider any unique or unusual circumstances existing at the institution being examined, such as extraordinary loan growth or dissipation, substantial increases in investments, or plans to expand or build additional office space. Unique or unusual circumstances warrant careful consideration when planning the scope of an asset examination.

When examining assets, examiners should focus on the reasonableness and adequacy of management's systems and processes. Generally, the more effective the system or process, the more assurance that the credit, investment, or other function is operating as directed and achieving desired results.

One of the most important management processes is planning. The examination of an institution's business plan is a logical starting point in assessing the adequacy of management's plans for loans, investments, and other assets. Once the planning process is assessed, examiners should determine the adequacy of policies, procedures, and internal controls. The Loan Portfolio Management section provides procedures on examining these aspects of management and other systems and processes that pertain to the loan portfolio.

One aspect of evaluating the adequacy of management's systems and processes is completed through an analytical review of the institution's assets. An analytical review provides insight into the effectiveness of management's systems and processes by showing the end results of management's decisions and actions. These "end results," or conditions, are the composition, quality, and profitability of assets. The analytical review of these conditions is further discussed in the Analytical Review of Assets section of this module.

Examiners should compile and analyze results from all asset examination areas to determine if the board and management adequately direct and control the composition, quality, and profitability of the institution's assets. This should include identifying interrelationships between examination conclusions in each specific area. Generally, weaknesses disclosed in asset classifications, credit administration, or the allowance can be attributed to ineffective management systems and processes.

Determination should be made of how the management and condition of assets -impact the overall soundness of the institution. For instance, weaknesses in planning could result in loan growth that seriously reduces capital adequacy or results in excessive concentrations of credit. Another institution might have existing or potential loan losses that could reduce earnings and, ultimately, capital to the point that permanent capital is insufficient to protect the institution from additional risks.

Examiners should incorporate all results into an overall asset assessment and CAMEL component rating. Any conditions which could significantly impact the institution's financial condition should be discussed with the examiner(s) responsible for that portion of the examination.