Module: Assets
Section: Loan Portfolio Management
EM-310

Date Published: 07/98

Introduction

Farm Credit System (System, FCS) institutions exist to provide loans and typically have few other earning assets. As a result, the safety and soundness of System institutions is ultimately dependent upon effective loan portfolio management. Effective loan portfolio management is more than generating favorable results, such as low levels of criticized loans or strong net interest rate margins. Effective loan portfolio management considers how those results were achieved, the likelihood those results will continue, and whether the institution is maximizing opportunities and providing the greatest benefit practicable to borrowers/members. A principal objective of the asset examination process is to thoroughly understand and evaluate the loan portfolio management system that controls, and the factors that influence, an FCI's loan portfolio.

Given the inherent risk of lending, including the statutory limitations on FCS lending authority which result in additional risk from credit concentrations, it is essential that System institutions effectively manage their loan portfolio in a safe and sound manner. Furthermore, a rapidly changing and competitive lending environment dictates that System institutions manage their loan portfolios proactively.

The board of directors and management must have systems and processes in place that result in adequate planning, directing, and controlling of lending operations. These systems and processes comprise loan portfolio management and are discussed in this section. Effective loan portfolio management includes strategic planning, lending policies and procedures, underwriting standards, risk identification, an internal credit review (ICR) program or process, and other internal control systems, such as board reporting, delegated authorities, performance plans/assessments, and loan committees. A thorough understanding and evaluation of these factors is necessary to assess management and to develop a prospective view of the condition of assets. In addition, an evaluation of loan portfolio management is the initial step in determining the scope and depth of testing needed to validate the implementation and effectiveness of loan portfolio management systems, processes, and internal controls.

Examination Objectives

Determine the reliability and effectiveness of the institution's internal controls relating to loan portfolio management.

Determine the effectiveness and adequacy of the institution's loan portfolio management.

Determine the effect or potential effect of the institution's loan portfolio management on the quality, composition, and profitability of the portfolio.

Compare the institution's loan portfolio management practices to its risk-bearing ability.

Determine the scope and depth of testing needed to validate implementation and effectiveness of loan portfolio management systems, processes, and internal controls.

Loan Portfolio Management Systems, Processes, and Internal Controls

The various systems and processes that comprise effective loan portfolio management are discussed below. These include strategic planning, policies and procedures, risk identification, ICR process, and other internal controls systems. In evaluating these systems and processes, consideration should be given to the size and organizational structure of the institution being examined. As the size, diversity, and decentralization of operations increase and authority is spread throughout the organization, more comprehensive and effective systems and processes are required. Also, the strengths and weaknesses of each system or process should be considered in the evaluation of other systems and processes based on both current and future operating environments.

Strategic Planning

Sound strategic planning is a critical component of loan portfolio management and provides the framework from which the board and management direct and control lending operations. Strategic planning is important because it defines the goals and objectives of the loan portfolio and provides the board of directors an opportunity to anticipate conditions in the institution's operating environment and react accordingly. From a loan portfolio management perspective, an institution's business and capital plans should numerically quantify the expansion and contraction of interest earning assets. Assets such as operating loans, installment financing, "low-doc" programs, participations, other financial institution loans, etc., are assigned target penetration levels with the intent of generating the best return to equity possible. Within targeted asset categories, the plans should provide a breakdown of components by commodity sector, loan type, geographic region, credit risk class, etc. This approach quantifies the targeted loan volume within each class or loan category to be achieved through marketing or, from a defensive posture, should be decreased to insulate institution capital from exposure. Further, the institution's board is expected to establish the limits of risk (risk parameters) it is willing to permit relative to the institution's risk bearing capacity.

Planning, in general, is discussed in the Business Planning section of the Management module. With respect to loan portfolio management, the mission statement; analysis of internal and external factors; and goals, objectives, and strategies are the primary components evaluated to determine if management has properly planned the performance of the loan portfolio.

Mission Statement--Since the primary function of System institutions is to provide credit to agriculture, mission statements should provide some insight as to the type of credit "provider" the institution intends to be. Mission statements should also provide some insight into the board's philosophy on generating profits from lending operations. Due to the broad and fundamental nature of mission statements, examiners need to review lending goals and objectives in the business plan and board lending policies to gain further perspective into the board's credit philosophy and approach to conducting lending operations.

Analysis of Internal and External Factors--This analysis should specifically consider factors that may impact the institution's loan portfolio. An analysis is completed to identify risks in the loan portfolio, threats to the loan portfolio, and opportunities that the institution may want to consider for enhanced profitability or growth. Once identified, the analysis should also determine the impact of those factors on the loan portfolio so that appropriate goals, objectives, and strategies can be established.

The adequacy of the institution's review and analysis of internal and external factors is largely dependent on the quality of the management information system (MIS). Extensive information from various sources is required to properly assess the institution's internal and external operating environment. While the board of directors may have access to reliable information on factors internal to the organization, the institution must also have access to complete and accurate information on external factors. The capability to predict the impact of external factors through stress testing (or similar means) further strengthens the institution's ability to operate in a safe and sound manner and to make timely adjustments to underwriting standards. The impact of such external factors as volatile commodity prices, global economic conditions, the agricultural credit market, pricing practices and services of competitors, interest rates, farm programs, existing and proposed regulations, technology, climatic conditions, and commodity markets should be analyzed. The institution's ability to adequately use this information in conducting sensitivity analyses will be dependent on the capabilities of the MIS. The key to evaluating an institution's analysis of internal and external factors is determining whether all relevant factors are considered and analyzed, and underlying assumptions are reasonable. Major assumptions made by the institution regarding commodity prices, credit quality, market share, competition, and loan growth should be well supported.

Goals, Objectives, and Strategies--Once the institution's analysis of its operating environment is complete, goals and objectives for the loan portfolio should be established. The board of directors should also establish strategies that are designed to accomplish their loan portfolio goals and objectives and to proactively position the loan portfolio to manage threats and maximize opportunities.

Typically, goals, objectives, and strategies should be established for the loan portfolio to address the following areas:

Quality--Goals and objectives should be directed at the desired level of credit risk in the portfolio. This level of risk should be determined through the institution's review of internal and external factors, with particular emphasis on the institution's capital adequacy, profitability, and overall risk-bearing capacity. Strategies that can be employed to achieve goals and objectives in this area include:

- Modifying loan underwriting standards to allow more or less risk or to require compensating strengths when certain credit factor weaknesses exist;
- Establishing credit administration standards, i.e., use of loan servicing plans and loan covenants;
- Modifying terms of credit extended, such as loan amortization requirements;
- Adjusting interest rates based on loan characteristics; and
- Modifying capital and risk funds positions.

Composition--Goals and objectives should focus on the desired portfolio mix and level of diversification to limit concentrations of credit relative to the institution's permanent capital or risk funds. Commodity or product concentrations within a loan portfolio exist when a group of similar borrowers have the same sources of repayment, collateral, economic, or geographic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions. Generally, this includes groups of similar loans that exceed 10 percent of the institution's assets. All System direct lenders have concentrations of credit within the general agricultural sector. Institutions with pronounced concentrations of credit in a particular commodity or to one or a few affiliated borrowers or geographic areas should consider strategies that:

- Monitor and reduce, when necessary, specific credit concentrations to a percentage of capital or risk funds (Note: regulatory limits already exist for loans to individual or affiliated borrowers, but additional in-house limits may be necessary given the institution's risk-bearing capacity and need to ensure compliance with FCA Regulations);

- Identify and monitor actual and potential concentrations of credit;

- Establish underwriting standards that require compensating strengths from borrowers, such as crop insurance, participation in farm programs, or hedging;

- Determine if there are opportunities for borrowers to diversify;

- Seek Farmers Home Administration or other similar guarantees;

- Purchase or sell loans;

- Utilize loan participations;

- Evaluate merger opportunities with other System institutions; and

- Increase capital.

Profitability--The board of directors should establish goals and objectives that address the desired profitability of the loan portfolio. These goals and objectives should be based on the level of risk in the loan portfolio, costs of operations, capital needs, and competitive position of the institution. Strategies that can be employed to achieve goals and objectives in this area include modifying loan pricing policies and procedures, identifying and monitoring profitability on a loan-by-loan and portfolio sector basis, or adjusting the interest rate spread or method of interest collection on loans.

Growth and Market Share--Goals and objectives that address growth and market share are necessary for System institutions to survive in the constantly changing and competitive financial services industry. The opportunities for growth or increased market share should be identified through the institution's review of external and internal factors. The external review should include an analysis of key demographic data and trends to determine the existing and potential markets. Also, changes in legislation, regulations, technology, interest rates, and competition should be closely monitored as they often create opportunities for growth or market share. In addition, strengths within the institution, such as experience and tenure of staff, lending expertise, cooperative organizational structure, and capital position, may provide opportunities for taking on additional growth or solidifying market share.

The various lending environments in which System institutions operate result in different goals and objectives for each institution. For instance, goals may call for slow, moderate, or rapid growth, merger with another institution, or other corporate restructuring activities. Strategies institutions may employ to achieve these goals and objectives include:

- Maintain current research data on the institution's market;
- Develop specialized products and services;
- Emphasize and specialize staff skills for customer service;
- Assign responsibility for business development to staff and board members;
- Establish performance and compensation programs that emphasize new business development;
- Implement a sales training program; and
- Develop a marketing plan and budget.

Lending Policies and Procedures

Lending policies and procedures are key elements of loan portfolio management. Lending policies and procedures provide valuable direction and control over lending operations and should exist for each lending program authorized by the institution's board of directors. Also, policies and procedures should specifically address the institution's analysis and documentation of loans, loan servicing requirements, and the collateral evaluation process as prescribed by FCA Regulations.

Depending on the philosophy of the board of directors, lending policies may provide general guidance or very specific direction to management. However, at a minimum, the direction provided by lending policies should be commensurate with the program's impact on lending operations and espouse the principles of sound lending. In addition, lending policies should be consistent with the goals and objectives outlined in the institution's business plan and, therefore, should be reviewed and updated, as needed, at least annually. Furthermore, management should maintain sufficient procedures to ensure lending staff adequately and consistently implements board policies.

Lending policies should be flexible to enable management to react to changing competitive situations. However, at the same time, the board's policies should define the levels and types of risk and lending practices that are acceptable and affordable by the institution. This is accomplished through well-defined operating parameters that address risk parameters, loan underwriting standards, and credit administration standards.

Risk Parameters--Risk parameters communicate to management what the board considers an acceptable range of risk exposure. Risk parameters are most effectively expressed in terms of a specific risk or volume of loans in a particular risk category to capital and/or risk funds. The establishment of risk parameters should be a dynamic process that flows out of the business planning effort and the review of internal and external factors affecting the institution. Therefore, the establishment of risk parameters should be tailored to the unique lending environment of each institution.

For instance, institutions primarily engaged in long-term real estate lending or institutions relying on real property collateral as a means of reducing credit risk may want to limit collateral risk (i.e., the potential that the value of the loan collateral will decline after loan inception and be insufficient to liquidate the loan, if necessary) to a certain percentage of capital and/or risk funds. For other institutions, parameters might include limiting loans to specific portfolio sectors or individuals, or limiting adverse loans to a certain percentage of capital and/or risk funds. Conversely, the institution may decide to conservatively increase exposure to potentially weak credits based on the institution's strong capital, overall performance, or projected opportunities in commodity or other industry sectors.

Loan Underwriting Standards--An institution's credit policy establishes a framework for lending and reflects an institution's credit culture and ethical business standards. The credit policy establishes a clear set of underwriting (lending) standards for the varied loan products under which funds are advanced. Credit policy should delineate the difference between underwriting standards and guidelines. Underwriting standards represent criteria, which require approval from supervisory authorities within the institution as delegated by the board or management. Exceptions to standards must be supported by compensating strengths in credit factors and/or approval controls above delegated levels.

Board-approved underwriting standards are indispensable to the safe and sound capital planning and portfolio administration in all FCIs. Loan underwriting standards delineate the desired or minimum level of creditworthiness for individual loans and the risk margin acceptable to the board of directors. They similarly ensure that loans originated comply with laws and FCA regulations. By specifying credit worthiness through standards, capital is insulated from unsafe and unsound lending practices or conditions. Therefore, in relation to loan underwriting standards, FCA defines unsafe and unsound conditions as any action(s) or lack of action that is contrary to generally accepted standards of prudent operations, the possible consequences of which, when continued, would expose an FCI or its shareholders to excessive risk or loss.

Underwriting standards clearly define, in measurable terms, the desired credit criteria for granting loans of acceptable risk. Acceptable loans should be categorized under three key evaluative areas (1) creditworthiness, (2) documentation and file completeness, and (3) legal and policy compliance. The appropriate evaluation of these three areas before loans are booked will reduce more loan losses than the best loan workout skills after cash is advanced. Therefore, underwriting standards should include:

- The assessment of the loan's purpose and associated repayment program (primary and secondary);
- The evaluation of the five Cs of credit--character, capacity, capital, conditions, and collateral;
- The evaluation of loan legality;
- The determination of the economic benefits to the institution;
- Assurance that speculation is prohibited; and
- Assurance that loans originated are within the institutions area of expertise.

Once these components are assessed, individual institutions may weight the scoring of the components in accordance with their perceptions of importance, such as evidenced in the Contractual Interbank Performance Agreement (CIPA). However, the desired outcome of whatever process is chosen would be to report clear and quantified delineations of which individual loans do not meet or comply with acceptable loan standards as defined by the board of directors. The board (or its designated committee) should be provided periodic reports detailing which loans are not in compliance with acceptable standards. Additional queries by commodity, risk class, price, size branch location, etc. could be extracted to further delineate a pattern or practice, and corrective actions could be implemented, if necessary.

Underwriting standards communicate and implement the capital, credit, and operating culture of the board as it pertains to the origination and monitoring of individual loans. When appropriately implemented and monitored, they represent a key preventive control over the inherent risk in agricultural lending.

Credit Administration Standards--Lending policies should identify the credit administration standards that lending staff and management are expected to follow. Adequate credit administration standards are necessary to ensure that loans are extended, serviced, and collected in a safe and sound manner. At a minimum, standards should address the need for complete and accurate financial information, credit analysis, and sound credit decisions. Furthermore, FCA Regulations require each System institution to develop policies and procedures that address:

- Lending practices and the analysis and documentation of credit factors (FCA Regulation 12 CFR § 614.4160);
- Collateral evaluations (FCA Regulation 12 CFR § 614.4245); and
- Loan servicing requirements (FCA Regulation 12 CFR § 614.4510).

Given the various types of lending and loan characteristics, the board of directors may want to differentiate credit administration standards based on loan size or type, or the enterprise(s) financed. This could include a minimum documentation loan program for certain types of credit.

Once lending policies are determined to include adequate credit administration standards, a sample of loans may be examined to validate and test compliance with board policy as deemed necessary. The Credit Administration section of this module provides additional guidance on evaluating the credit administration standards established and conducting the examination of individual loans for compliance.

<u>Risk Identification</u>

Properly identifying risk in the loan portfolio is critical to the overall effectiveness of loan portfolio management. Because an institution's plans, direction, and controls are based upon a perceived level of risk in the loan portfolio, the ability to identify risk affects the adequacy of these areas. For instance, the board of directors may establish profitability objectives for the loan portfolio, which provide inadequate returns to shareholders or fail to offset future loan losses due to inaccurate assessment of risk in the loan portfolio. Also, adequate controls may not be implemented to prevent loans from deteriorating and resulting in loan losses.

A breakdown in the risk identification process could seriously threaten the safety and soundness of an institution. Weaknesses in risk identification not only hinder sound loan portfolio management, but also affect the institution's ability to determine allowance for loan losses requirements and capital, earnings, and liquidity needs. Risk must also be adequately identified to fairly and accurately disclose the financial condition of System institutions to shareholders and investors.

The primary risks emanating from the loan portfolio are credit risk and interest rate risk. Credit risk is the potential for losses resulting from the failure of borrowers to repay their loans, and interest rate risk is the potential for losses resulting from the impact of market interest rate fluctuations. The identification of credit risk is the focus of this discussion, while interest rate risk is further discussed in the Asset/Liability Management section of the Finance module. However, interest rate risk is mentioned here to highlight the need to consider it in evaluating loan portfolio management. Also, interest rate risk can result in significant credit risk in situations where interest rate risk has been passed on to borrowers through variable rate loans.

The examination of an institution's risk identification process should primarily focus on management's ability to identify aggregate risks in the loan portfolio. Aggregate risks that should be identified include:

- Criticized and adversely classified assets;
- Past due loans;
- Nonaccrual loans;
- Restructured loans;
- Other property owned;
- Concentrations of credit;
- Dependence upon a single or a few customers;
- Loans that do not comply with underwriting criteria;
- Lack of borrowers' current and complete financial data;
- Other credit administration deficiencies; and
- Loans with common credit factor weaknesses.

Sufficient examination work should be completed to test and verify the accuracy of risk identified. Since the institution's risk identification process starts with the evaluation of individual loans, a sample of loans may be reviewed to determine if adequate credit evaluations were made and relevant information accurately recorded. The institution's credit evaluations should include an analysis of each credit factor, an assessment of credit administration, an assignment of a credit classification and performance category, and a determination of whether the loan should be combined with other loans for the purpose of calculating lending limits. Additional guidance on examining these aspects of the credit evaluation is provided in their respective sections of the Assets module.

The information generated from the credit evaluations, together with other useful data on loans, such as outstanding debt and commitment, loan type, terms, enterprise/commodity financed, and geographic location, should be accurately recorded and summarized by the institution. Summaries should provide the prevalent aggregate risk categories present or other information needed by the board and management to understand the risk characteristics of the loan portfolio. This may include common credit factor weaknesses on a group of loans, a breakdown of loan sizes, or the enterprises/commodities financed on certain classifications of loans. The capability to retrieve data and generate such information based on the institution's needs is largely dependent on the effectiveness of the institution's MIS.

Internal Credit Review (ICR) Process

The ICR process is one of the most crucial components of an institution's control system. FCA Regulation 12 CFR § 618.8430 requires each System institution to establish a policy that includes direction for the operation of a program to review and assess assets. Two dynamic components constitute this process: (1) the ongoing assignment of risk ratings on individual credits; and (2) the supervisory review and management of credit administration and loan servicing within the entire portfolio. The ICR process has the responsibility of ensuring that risk has been properly identified, serviced, and reported to management and the board.

An effective ICR process is critical to the board's ability to monitor the quality of the institution's assets, management's compliance with lending policies and procedures, and the adequacy of lending policies and procedures. The process should provide for a periodic review of the portfolio by qualified people who are independent from the credit decision processes of the institution and who, for ICR purposes, report directly to the board. While smaller institutions may not have the resources necessary to support a comprehensive program and/or a full-time reviewer, a process that utilizes employees on a part-time or rotational basis, or outside reviewers on a contract basis, should be considered by these institutions. The Internal Controls section of the Management module provides additional criteria for evaluating an institution's ICR process.

The ICR must include sufficient testing of lending and loan servicing practices to detect noncompliance with established policies and procedures, violations of law and regulations, and adherence to sound business practices. The reviews should be sufficient in frequency and scope to determine the adequacy of credit administration, and the reliability of asset classifications, performance categories, and the allowance for loan losses. The ICR should include an assessment of the system of internal controls over the credit function, the status of corrective action on previously identified weaknesses, and the cause of any deficiencies or adverse trends.

Examiners will use the following guidelines when evaluating the institution's ICR:

- An institution's ICR process should be an ongoing, dynamic process that identifies, categorizes, and reports risk in the entire portfolio.

- The ICR should analyze all credit characteristics of the portfolio. For example, it should identify the characteristics of risk in portfolio concentrations and discuss credit factor strengths and weaknesses in portfolio segments in comparison to the entire portfolio.

- Management should update classification changes as they occur. There should not be a lengthy lag-time between receipt/analysis of new loan information and the date on which the risk assessment is recorded in the management information system (MIS).

- While the ongoing risk identification process is dynamic, a formal ICR report to the board should be issued by all institutions. The typical ICR report should summarize evaluations of the institution's risk rating assessments, credit administration, and results of prior corrective actions. This formal report should be completed at least quarterly in large institutions, although it may be completed less frequently in smaller institutions. However, as conditions in the institution change or its lending environment deteriorates, more frequent, formal ICR reporting to the board should be required.

Examiners will employ an accuracy standard to determine the reliability of an institution's ICR. An ICR will be considered "unreliable" when incorrect classifications are found in excess of <u>10 percent</u> of the volume examined, provided this standard is applied with judicious caution. The following guidance should be used in applying these accuracy standards:

- ❖ Examiner judgment is critical in applying the 10 percent threshold for reliability. For example, a single large loan may distort this threshold. Therefore, a pattern or practice that causes the institution's assessment of risk to be flawed must be identified.

- ❖ ICR classification reliability is generally measured by differences between adverse and non-adverse classifications. Loans classified OAEM by FCA generally will not significantly influence the determination of reliability unless a pattern or practice has been identified where the institution is clearly not identifying emerging risk in acceptable loans.

- ❖ A conclusion that the ICR is unreliable must be supported by the scope of examination sufficient to support the conclusion. Generally, if loans are discovered that are in fact classified incorrectly, the EIC should select other loans in the portfolio with the same or similar characteristics to determine if a "pattern or practice" exists. Examiners must be mindful that one exception does not establish a pattern or practice.

- ❖ Examiners should clearly identify the pattern or practice and the extent the problem has had, or may have, on other aspects of the institution's operations and financial condition. This will also help develop the examination finding and conclusions as to *conditions, criteria, cause, and effect*.

- ❖ If examiners are able to quantify the problem with the institution's risk assessment, the institution's asset quality statistics should be adjusted accordingly in the examination report and ratings analysis. In addition, examiners should assess the impact those changes might have on the adequacy of the allowance. The problem with the ICR process may be correctable in the normal course of business. However, if the institution's incorrect risk assessment cannot be quantified by FCA examiners, the ICR process should be deemed unreliable and examiners should consider the need to require the board to obtain an independent review of risk until reliability of the ICR process can be established. The independent review will be important for the board to effectively manage through this period of uncertainty.

- ❖ When it is discovered that incorrect classifications range from 5 to 10 percent of the volume examined, examiners should include in the letter to the board chairman a requirement or recommendation to strengthen controls in order to correct the weakness that caused the inaccuracies in the ICR process. The pattern or practice that led to the incorrect risk assessments should be disclosed so the board and management can focus on correcting the problem. Usually this can be accomplished in the normal course of business within a reasonable timeframe (90 to 180 days).

- ❖ For institutions with classification errors of less than 5 percent, examiners may address the weaknesses in the Report of Examination but conclude the ICR remains reliable. Prudent examiner judgment, based on the commitment of the institution to correct the identified weaknesses, will be needed to address this in an appropriate manner.

<u>Other Internal Control Systems</u>

FCA Regulation 12 CFR § 618.8430 requires each System institution's board of directors to adopt an internal control policy that provides adequate direction to the institution in establishing effective control over and accountability for operations, programs, and resources. While the Internal Controls section of the Management module discusses internal controls in general, several key elements to an effective system of internal controls in lending operations are discussed below.

Board Reporting--The information reported to the board of directors should be sufficient to determine the condition of the loan portfolio, the progress made toward achieving planning and policy objectives, and the cause of performance that is below expected levels. Reporting should also inform the board on management's compliance with specific standards on loan underwriting and credit administration, and laws and regulations. It should also address the results achieved through management's actions to address previously identified weaknesses.

Discretionary Delegations of Authority--Delegation of authority based on the experience, tenure, and competence of lending staff can effectively limit risk resulting from unsound credit decisions. Because the ultimate responsibility for the affairs of the institution rests with the board of directors, the board must exercise due care in establishing lending authorities. While the board of directors should consider the potential risks resulting from the credit function, the board should also consider the potential cost of overly restrictive authorities. For instance, the board might want to balance the cost of internal controls with staff development, efficiency of operations, and service to borrowers.

Performance Plan Development and Assessment--The establishment of performance standards that hold management and lending staff accountable greatly enhances the probability that plans and policies will be implemented and desired results achieved. The performance standards established should be consistent with the authorities granted and the lending policies and plans of the institution.

Loan Committees--Loan committees provide an additional control over lending operations through group decision-making. Depending on the institution, the loan committee's participation in the lending function can vary from acting on every credit decision, to only acting on credit decisions with significant risk and high visibility. In this respect, the loan committee can exert tremendous influence in molding the institution's credit philosophy and ensuring adherence to the board's plans and policies and management's procedures. Regardless of the committee's level of participation, loan committees should be structured to bring additional expertise and management perspective into the credit decision-making process.

Examination Procedures

The examination of loan portfolio management begins with the assessment of the systems, processes, and internal controls discussed above. In many instances, this assessment is made on an ongoing basis through monitoring activities. Such activities typically include the review and evaluation of the business plan, changes in policies and procedures, internal audit and credit review reports, allowance for loan losses studies, and loan committee and board of directors meeting minutes and reports.

Although preliminary conclusions regarding the adequacy of loan portfolio management can be reached through this review, testing and verification are needed to determine that systems, processes, and controls are adequately implemented, working as designed, and effective. Testing and verification are particularly important when changes in the institution's performance, lending personnel, or lending philosophy occur; after a merger or new lending authorities are granted; or when there is a significant change in the economic environment affecting the institution.

The examination of loans is the primary method used to test and verify the implementation and effectiveness of the various systems and processes that comprise loan portfolio management. Additional guidance on selecting and examining individual loans for this purpose is provided in the Asset Classifications, Accounting for Problem Assets, and Credit Administration sections of this module.

The following list of procedures is provided to assist examiners in the evaluation of loan portfolio management. Consistent with risk-based examination principles, examiners should add, delete, or modify procedures as needed based on the particular circumstances of the institution.

Examiners should also coordinate their examination activities with other members of the examination team and the examiner-in-charge (EIC). Emphasis should be on identifying how examination findings in other areas impact the review, ensuring sufficient work is completed to support conclusions and avoiding duplication of examination effort.

Strategic Planning

1. Review the institution's mission statement and determine if it adequately defines the board's credit philosophy (i.e., type of credit provider and profitability of lending operations).

2. Determine if the institution's planning process adequately addresses the internal factors affecting the loan portfolio by determining whether the following areas were considered:

   a. Mission statement and credit philosophy;

   b. Underwriting standards and lending practices;

   c. Capital and risk funds constraints;

   d. Amount of portfolio risk;

   e. Loan portfolio characteristics (credit factor weaknesses, enterprise/commodity, loan size/ type, and geographic locations);

   f. Capability of directorate, management, and staff;

   g. Internal controls, systems, and processes; and

   h. Asset/liability management.

3. Determine if the institution's planning process adequately addresses the external factors affecting the loan portfolio by determining whether the following areas were considered (as applicable):

   a. Types of commodities, enterprises, potential borrowers, and agricultural activities in the trade area;

   b. Economic profitability of existing and potential markets;

   c. Current and anticipated market interest rates;

   d. World market conditions;

   e. Farm program changes and subsidies;

   g. Public policy influences;

   h. Sources and cost of capital for the institution;

   i. Pricing practices and services of competitors;

   j. Urban and society influences;

   k. Environmental concerns;

   l. Weather conditions;

m. Real estate and other collateral values;

n. Off-farm income and unemployment impact; and

o. Government regulations.

4. Review the assumptions made regarding the institution's internal and external operating environment for reasonableness by determining if assumptions are well supported with accurate, reliable, and complete information.

5. Determine if the institution subjects its assumptions to sensitivity analysis or modeling to determine the impact of such assumptions on the loan portfolio.

6. Determine if goals, objectives, and strategies were established in the plan and determine if they are:

   a. Quantifiable;

   b. Consistent with assumptions and analyses; and

   c. Reasonable and achievable.

7. Determine if the plan establishes goals, objectives, and strategies to address all key areas of lending operations, including:

   a. Quality of the loan portfolio;

   b. Composition of the loan portfolio;

   c. Profitability of the loan portfolio; and

   d. Growth and market share.

<u>Lending Policies and Procedures</u>

8. Determine if lending policies and procedures have been established for each lending program authorized by the board of directors.

9. Review the lending policies adopted by the board for adequacy. (Refer to the Policies and Procedures section of the Management module).

10. Evaluate the adequacy of lending policies in conveying risk parameters to management by noting if the following (or other) parameters exist:

    a. Adverse assets to capital/risk funds and/or net income;

    b. Criticized assets to capital/risk funds and/or net income;

    c. Unsecured loans to capital/risk funds and/or net income;

    d. Collateral risk to capital/risk funds and/or net income;

    e. Concentrations of industry or commodity risk to capital/risk funds and/or net income; and

    f. Lending limits to individual borrowers as a percent of capital/risk funds, i.e., in-house lending limits.

11. Review lending policies and procedures and identify all lending standards to determine:

a. If the loan underwriting standards have been approved by the board;

b. If standards exist for all authorized loan programs and major commodities financed, and whether they are industry specific or just generic standards; and

c. The board's objective(s) for each standard and whether it is consistent with the strategic objectives and risk parameters for the portfolio or portfolio segment; and

d. How each standard was derived and if it is adequately supported by studies, analyses, or reports on the financial performance or credit profiles for successful producers in that industry or commodity.

12. Determine whether, at a minimum, the loan underwriting standards address each credit factor, such as:

- Repayment capacity margins;
- Solvency and liquidity positions;
- Loan maturities and other terms;
- Loan-to-collateral-value ratios;
- Borrower delinquency or bankruptcy status;
- Compliance with legal requirements and FCI lending policies; and

13. Evaluate the adequacy of underwriting standards by determining if the following criteria are met:

- Commensurate with the risk-bearing capacity of the institution;
- Considers the types, terms, and conditions under which loans will be made;
- Establishes the desirable characteristics of credit factors under which the board expects lending officials to administer;
- Establishes standards to measure and manage concentrations of risk by commodity/industry, loan size, and risk categories; and
- Ensures compliance with applicable laws, regulations, and policies.

14. Determine if the board of directors is effectively using loan underwriting standards to achieve loan portfolio objectives and manage risk exposure within the FCI's risk-bearing capacity. How effectively do the standards:

- Control overall loan portfolio quality and credit risk exposure in accordance with strategic business, capital, and loan portfolio plans?

- Maintain or control loan volume and quality to ensure acceptable concentrations of risk within the portfolio?

- Expand or restrict portfolio growth in accordance with business needs or changing conditions, such as threats or opportunities in financed industries or commodities?

- Maximize loan portfolio profitability through close correlation of loan pricing and fees to loan quality and servicing needs as measured by loan underwriting standards?

- Strengthen the quality of criticized or deteriorating loans? Are loan underwriting standards incorporated in loan servicing plans, agreements and/or closing letters to establish goals or objectives for borrower performance?

15. Determine if the board has implemented a process for effectively reviewing and revising underwriting standards on a periodic bases and whether this process ensures they are timely adjusted in response

to changes in industry or market conditions.

16. Examine a sample of loans to determine if loan underwriting standards are enforced to control the institution's exposure to risk in the loan portfolio.

17. Review board meeting minutes and changes in lending policies to determine if the board adjusts loan underwriting standards as needed to control the institution's exposure to risk in the loan portfolio.

18. Review lending policies to determine if the board establishes adequate credit administration standards that address:

    a. Credit and financial information;

    b. Credit analysis and decisions;

    c. Monitoring and control; and

    d. Collection actions.

19. Examine a sample of loans to determine if credit administration standards are adhered to (For additional procedures, refer to the Credit Administration section of this module).

20. Review lending policies to determine if the board established adequate direction to ensure sound lending practices and compliance with FCA Regulations. Consider areas such as:

    a. Conducting collateral evaluations;

    b. Lending limits to individual borrowers;

    c. Loan purchases and sales;

    d. Loan terms and conditions; and

    e. Lending authorities.

21. Examine appropriate samples of loans to test adherence to the policy direction referenced in procedure 17 and compliance with FCA Regulations. (Use FCA 3010 and 3011 to test compliance with lending limit regulations.)

22. Review board meeting minutes and lending policies and procedures to determine if they have been reviewed at least annually and updated as needed.

<u>Risk Identification</u>

23. Determine if the institution adequately identifies the aggregate risks in the loan portfolio by noting if the following, and other areas of risk, are identified and reported to the board of directors:

    a. Criticized and adversely classified assets and the basis of criticism;

    b. Past due loans;

    c. Nonaccrual loans;

    d. Restructured loans;

    e. Other property owned;

f. Concentrations of credit;

g. Collateral risk;

h. Dependence upon a single or a few borrowers;

i. Exceptions to underwriting standards;

j. Lack of borrowers' current and complete financial data;

k. Other credit administration deficiencies; and

l. Loans that do not comply with policies, procedures, and regulations.

24. Review management's analyses of the loan portfolio to determine if they include an evaluation of how external factors may affect the level of risk in the portfolio (e.g., projecting the change in asset quality given a certain percentage decline in commodity prices or collateral values, or an increase in interest rates).

25. Review board meeting minutes and reports to determine if information regarding risk in the loan portfolio is complete, timely, and meaningful.

26. Based on procedures 20 through 22, conclude on the adequacy of the MIS in identifying and reporting risk in the loan portfolio.

27. Review the board's policies regarding the use of the Uniform Classification System or other risk rating system to determine if sufficient direction is provided to ensure reliable, accurate, and consistent reporting of risk in the loan portfolio.

28. Review the board's policies regarding accounting for problem assets for consistency and compliance with generally accepted accounting principles and FCA Regulations.

29. Examine a sample of loans to determine if risk is accurately identified and reported (Refer to the Asset Classifications and Accounting for Problem Assets sections of this module for additional procedures).

Internal Credit Review Process

30. Determine if the board established policies to direct the operation of a program to review and assess its assets [FCA Regulation 12 CFR § 618.8430(c)].

31. Review the policy established to direct the operation of a program to review and assess assets to determine if it includes standards that address the following areas:

    a. Loan, loan-related assets, and appraisal reviews;

    b. Scope of review selection;

    c. Workpapers and supporting documentation;

    d. Asset quality classifications;

    e. Assessing credit administration; and

    f. Training required to initiate the program.

32. Through discussions with the board or its audit committee and a review of pertinent personnel files, evaluate the competency of the ICR personnel by considering:

a. Level of education;

b. Significant experience;

c. Availability and participation in continuing education programs;

d. Membership in professional organizations;

e. Training methods; and

f. Level and quality of supervision.

33. Through discussion with appropriate personnel and the use of flowcharts, observation, and/or investigation, analyze the operation of the overall ICR process by considering:

a. Method of loan selection;

b. Frequency and scope of reviews;

c. Manner in which loans are analyzed;

d. Criteria for upgrading criticized assets;

e. Reports generated and provided to the board;

f. Use of results by appropriate personnel, (i.e., follow-up and corrective actions);

g. Any possible restrictions placed on the review function personnel;

h. Whether the review function reports directly to the board;

i. Independence and objectivity of the review function;

j. Assessments of the institution's adherence to regulations, credit policies, procedures, and underwriting standards;

k. Identification of credit administration weaknesses;

l. Accurate and timely asset and performance category classifications;

m. Identification of causes of any deficiencies and adverse trends;

n. Assessment and status of corrective action plans; and

o. Input for credit reports and the quarterly allowance for loan losses study.

34. Examine a sample of loans reviewed by the ICR process and compare examination findings to those identified by the review function.

35. Conclude on the adequacy of the ICR process using the criteria discussed under the ICR heading of this section.

<u>Other Internal Control Systems</u>

36. Identify all standard and customized reports the institution develops that utilize or present data related to loan underwriting standards. Determine whether the system provides periodic reports that:

a. Show each loan's compliance with the approved underwriting standards;

b. Summarize loans that do not comply with standards through either approved exceptions or loan deterioration;

c. Summarize loan pricing in correlation to compliance with loan underwriting standards; and

d. Provide sufficient information to monitor the performance of the loan portfolio and determine compliance with lending policies, including underwriting standards and credit administration criteria.

e. Provide sufficient summary information on loan underwriting standards compliance, the portfolio's historical performance, and existing risk exposure to effectively integrate credit standards with the allowance for loan loss analysis and planning for capital needs.

37. Determine if the IS effectively links borrower financial and credit information to the loan accounting system to provide a comprehensive database for loan portfolio management. Determine if sufficient IS controls are in place to ensure that borrower financial and credit data is accurate and current. Determine controls ensure that loan underwriting ratios are calculated in accordance with policy and procedure and are they consistent over reporting periods.

38. Review lending authorities delegated to management, lending staff, and the loan committee for appropriateness and reasonableness.

39. Review a sample of loan actions to determine if management, lending staff, and the loan committee acted within the lending authorities established.

40. Review management and lending staff performance plans and standards to determine if they are consistent with the authorities granted and the lending objectives of the institution.

41. Review performance evaluations to determine if management and lending staff are held accountable for complying with the standards established.

42. Determine if the loan committee is used to effectively control risk by examining a sample of loan actions approved by the committee and noting whether lending policies, procedures, and underwriting standards are adhered to and enforced.

43. Based on the procedures completed above and the examination of loans to test and verify the implementation and effectiveness of the systems, processes, and controls listed, conclude on the adequacy of loan portfolio management.

44. Discuss tentative conclusions and examination findings with examiners assigned areas that may be affected by the findings.

45. Discuss items of concern, scope of work performed, and conclusions with the EIC and with the appropriate institution manager. Obtain a response regarding the cause(s) of deficiencies or weaknesses and anticipated corrective actions.

46. Prepare a leadsheet or other summary document to provide workpaper support for the work performed and the conclusions reached.