Module: Assets
Section: Analytical Review of Assets
EM-315

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Introduction

The primary objective of asset examinations is to assess the adequacy of board and management in managing the institution's assets and the resulting condition and safety and soundness of the institution. For this assessment to be complete, examiners should consider the effectiveness of management decisions and actions, and the results achieved. These results are reflected in the condition of an institution's assets and can be evaluated by examining the composition, quality, and profitability of assets. An analytical review of assets is used to determine the adequacy of results and overall effectiveness of asset management.

Evaluating the condition of assets is important in assessing the safety and soundness of an institution. The interest generated from loans is the primary source of income for Farm Credit System (System) institutions. Furthermore, the inherent risk in such assets can expose institutions to substantial losses if not properly managed. As such, assets should be carefully analyzed to detect trends or weaknesses that may adversely affect the safety and soundness of the institution. This section discusses the primary factors examiners should consider in their analysis of assets and provides procedures for completing this analysis.

Examination Objectives

Determine the overall effectiveness of asset management.

Determine if the condition of assets is sufficient to ensure the safety and soundness of the institution.

Evaluative Criteria

The condition of assets can be evaluated by assessing the composition, quality, and profitability of assets. For the purpose of this section, composition refers to the type and amount of assets held, quality refers to the credit risk in those assets, and profitability is the ability of those assets to generate sufficient income to cover all expenses and build capital. The following discussion describes these factors and their interrelationships.

<u>Composition of Assets</u>

The composition of assets reflects management investment decisions and their use of funds. From a safety and soundness perspective, the composition of assets must be sufficient to ensure profitable operations, while at the same time not exposing capital to excessive risk.

Noting the levels, changes, and trends in interest earning and non-interest earning assets provides examiners the broadest perspective on the composition of assets. Reviewing the composition of assets in this manner helps provide insight into the current and prospective profitability of assets. Low levels or decreasing trends in interest earning assets compared to non-interest earning assets can also be an indicator of improper institution strategy and management. While a certain level of investment in non-interest earning assets is expected and is a normal cost of business, i.e., premises and equipment, such investments should be in line with the norm and based on the institution's needs.

Interest earning assets include accrual loans and leases, cash-basis nonaccrual loans, sales contracts, notes receivable, and marketable investments. Non-interest earning assets are primarily comprised of accrued interest receivable, nonaccrual loans, cash, accounts receivable, investments in other System institutions, and premises and equipment. In institutions where the interest charged on loans is compounded or a significant amount of interest is recognized on cash basis nonaccrual loans, examiners should consider these factors in their analysis.

The majority of institution assets are comprised of loans. Therefore, examiners should further evaluate the composition of assets by reviewing the loan portfolio and noting any concentrations of credit. A concentration of credit exists when loans to a group of similar borrowers or a single borrower are significant in relation to permanent capital.

Concentrations of credit can affect both the quality and profitability of assets. For example, if loans are concentrated to borrowers producing a particular commodity and a decline in that commodity price occurs, the quality of those loans may deteriorate. Furthermore, if quality deteriorates to the point where loans to these borrowers become nonaccrual or non-interest earning assets, profitability would be affected. Profitability can also be affected by maintaining certain concentrations of loans with high or low costs of servicing.

The investment portfolio in some System institutions, particularly banks, may also comprise a significant portion of assets. In these instances, examiners should review the composition of assets in the investment portfolio. The Investments section of this module provides additional direction for analyzing these assets.

Asset Quality

Assets can expose the institution to substantial risk. In addition, the quality of assets can significantly affect profitability. This makes quality an important factor in determining the overall adequacy of assets.

The inherent risks in lending makes the quality of loans and the loan portfolio significant factors in assessing overall asset quality. There are numerous quantitative measures which are useful in analyzing risk in the loan portfolio. Common measures include:

- Delinquent loans;
- Nonaccrual loans;
- Restructured loans;
- Impaired loans;
- Adverse assets;
- Criticized assets;
- Principal and/or interest federally guaranteed; and
- Allowances, chargeoffs, and recoveries.

Examiners should consider the trends in these amounts and their relationship to total loans. Significant adverse trends should be examined to identify why the situation exists.

It is also important to look at the loan portfolio from other perspectives besides just aggregate volumes and percentages. For instance, consider the following questions in analyzing the makeup of adverse loan volume:

- Is there a common basis of criticism?
- Are they mostly current or delinquent?
- Are many of the loans nonaccrual or impaired?
- Are they typically well secured or under-secured?
- To what extent are they guaranteed?
- Are many of the loans restructured?
- When do most of these loans mature?
- Are the adverse loans today the same loans that were adverse last year?
- Are the loans concentrated in certain commodities or dependent on similar sources of repayment?

Similar questions can be applied to other segments of the loan portfolio as well. Examiners should consider questions such as these to gain a better understanding of the institution's loan portfolio management practices and quality.

Another important factor in assessing the loan portfolio is the amount and trend of other property owned. Movement of loans to other property owned, length of time needed to dispose of the property, and amount received on disposition may provide insight into the degree of success management has in liquidating problem loans.

While there is no single measure for determining when risk in the loan portfolio is excessive, the measure of adverse assets to risk funds is usually a good indicator. Risk can also be determined excessive by considering the potential impact on the institution's profitability. For example, if a significant portion of interest income is generated on loans with well defined weaknesses in repayment capacity and the institution is dependent on that portion of interest income to cover interest and operating expenses, risk may be deemed excessive. In addition, institutions unable to cover operating expenses after making necessary provisions for loan losses may be considered to have excessive risk in their loan portfolio.

In institutions where marketable investments comprise a significant portion of total assets, examiners should also review the quality of assets in the investment portfolio. While FCA Regulations closely govern the type and quality of investments held, noncompliance may result in assets which expose the institution to substantial risk. The Investments section of this module discusses the regulatory eligibility and quality requirements for investments held.

<u>Profitability of Assets</u>

The safety and soundness of System institutions is dependent upon the profitable deployment of assets. Institutions must maintain sufficient interest earning assets to achieve economies of scale and to cover fixed costs of operations and provide capital necessary for sustaining operations and growth. Conversely, investments in non-interest earning assets should be limited to only those assets needed to support operations.

Management's pricing of loans, the primary interest earning assets of institutions, significantly affects profitability. Loans, loan portfolio sectors, and the entire loan portfolio should be priced commensurate with risk. In addition, the income generated on loans should be sufficient to cover the underlying costs of originating and servicing loans, and build necessary capital reserves.

While pricing decisions significantly influence profitability, management decisions regarding the composition and quality of the loan portfolio should also be considered. As previously discussed, these factors can affect the overall returns generated on the loan portfolio.

<u>Other Assets</u>

The analytical review of assets generally focuses on the condition of loans and loan-related assets (e.g., other property owned) and investments. However, additional review and analysis may be required to follow up on significant changes or trends identified in other assets. Other assets include cash; investments in other System institutions, premises, and equipment; and other miscellaneous assets. These assets normally comprise a small portion of total assets and, as a result, do not generally require substantial examination coverage. Procedures for analyzing these accounts are provided in the Other Assets section of this module.

Examination Procedures

Examiners should conduct an analytical review of assets in a systematic and thorough manner. Examining the level, trend, and change in total assets is typically the first step of the review. If total assets have changed significantly from a prior comparable period, the examiner should determine which asset components changed, by how much, and why. Generally, using a comparable date for analyzing changes in assets provides more meaningful information because of the seasonal fluctuation in assets in most System institutions.

Examiners should coordinate their efforts 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 asset analysis, ensuring sufficient work is completed to conclude on the adequacy of assets, and avoiding duplication of work. Other areas of examination that should be coordinated with the analytical review of assets include:

- Loan portfolio management;
- Allowance for loan losses;
- Finance;
- Asset/liability management; and
- Business planning.

Examiners should utilize discussions with institution management as needed to gather information and discuss trends, future operating environment expectations, and strategies.

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

1. From FCA's Consolidated Reporting System (CRS), generate the most recent quarterend reports to use in the evaluation of assets, such as the Call Report, Uniform Performance Report (UPR), Uniform Peer Performance Report, and Analysis of Loan Losses Report.

2. Obtain information from the institution regarding the quality, composition, and profitability of assets. Such information might include:

   a. Internal credit review reports;

   b. Allowance for loan losses studies;

   c. Periodic monitoring reports submitted to the board; and

   d. Annual and quarterly disclosures to shareholders.

3. Using comparable dates, evaluate the level, trend, and changes in total assets and the major components of assets, such as loans; accrued interest receivable; other property owned; marketable investments; investments in other System institutions, premises and equipment; and cash.

4. Through discussions with institution management or a review of available information, determine the cause of any significant changes or adverse trends in the level of total assets or its major components.

5. Evaluate the composition of assets by determining the percentage of total assets comprised of interest earning and non-interest earning assets, loans, marketable investments, and other significant assets.

6. Review the composition of assets in the loan portfolio and identify and describe all concentrations of credit which exceed 10 percent of the institution's assets.

7. Review the UPR "Loan Activity" report to determine the amount of new money extended, transfers to and from nonaccrual, capitalization of interest, and refinancing of principal during the reporting period.

8. Review the composition of assets in the investment portfolio and identify and describe all concentrations which exceed the regulatory limitations outlined in FCA Regulation 12 CFR §

615.5140.

9. Assess the quality of assets in the loan portfolio by considering the following factors:

    a. The volume and trend in delinquent, nonaccrual, restructured, criticized, and adverse assets;

    b. The underlying strengths and weaknesses in borrowers' credit factors, i.e., repayment margins, liquidity and solvency positions, collateral position;

    c. Concentrations of credit experiencing or likely to experience adverse economic, market, or weather conditions;

    d. Amount of principal and/or interest federally guaranteed;

    e. Allowances, chargeoffs, and recoveries;

    f. The existence of and adherence to sound underwriting criteria;

    g. Credit administration practices; and

    h. Loan terms and conditions, e.g., variable or fixed rate loans, loan maturities, etc.

10. Review the amount and trend in other property owned to determine loss exposure and management's effectiveness in liquidating problem loans. Consider the length of time needed to dispose of properties, and the amounts received on disposition.

11. Assess the quality of assets in the investment portfolio by considering the following factors:

    a. The portion of the portfolio held in obligations issued or fully guaranteed as to both principal and interest by the United States or any of its agencies or instrumentalities;

    b. The investment grade of investments not held in obligations issued or fully guaranteed by the United States or any of its agencies or instrumentalities; and

    c. The credit rating and existence of Federal deposit insurance on commercial banks where investments are made or held.

12. Based on the risks identified in loans, leases, sales contracts, other property owned, and investments, as well as the types of investments held (SFAS 115), determine if assets are appropriately valued and reported in accordance with generally accepted accounting principles (GAAP).

13. Compile asset quality statistics which identify the volume and percentage of total assets classified Acceptable, Other Assets Especially Mentioned, Substandard, Doubtful, and Loss.

14. Compile other asset quality statistics needed to quantify the level of risk in the institution's assets.

15. Determine if the quality of assets is adequate by comparing the level of risk in assets to the institution's risk-bearing capacity. Calculate and consider ratios such as:

    a. Adverse assets to risk funds, capital, or permanent capital;

    b. Criticized assets to risk funds, capital, or permanent capital;

    c. Unsecured assets to risk funds, capital, or permanent capital; and

    d. Collateral risk to risk funds, capital, or permanent capital.

16. Assess the profitability of the institution's assets by considering the following questions:

    a. Is interest income sufficient to cover interest expense, provisions for loan losses, and operating expenses, and to provide an adequate return to capital?

    b. Is the yield on assets commensurate with the risk and maturity of the loan and investment portfolios?

    c. What portion of interest income is from high risk, high yielding assets susceptible to deterioration and the suspension of accrued interest? What portion of income is generated from cash basis nonaccrual loans?

    d. What portion of interest income is from loans concentrated to one or a few individuals, industries, or geographic areas?

    e. Are low interest earning and non-interest earning assets maintained at minimum levels?

17. Compare the composition, quality, and profitability of assets reported at the date of examination to the business plan projections for the same date (if available), and at the end of the planning horizon.

18. Compare the composition, quality, and profitability of assets to peer institutions, note any significant differences, and evaluate the institution's strategy, if any, in maintaining a position significantly different from peer institutions.

19. Identify and summarize conditions disclosed during the examination of assets which impact the safety and soundness of the institution.

20. Discuss examination findings and conclusions with examiners responsible for evaluating management and loan portfolio management to determine the cause of conditions identified in assets.

21. Discuss examination findings and conclusions with examiners responsible for evaluating capital, earnings, and liquidity to determine the effect of conditions identified in assets on the institution's financial condition.

22. 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.

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

24. Organize asset statistics and information into appropriate graphs or appendices for inclusion in the Report of Examination.