EM-22.2

Category: **Loan Portfolio Management**
Topic: **Risk Identification**
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Overview

Accurate and reliable risk identification is essential to effectively managing a Farm Credit System (System) institution's loan portfolio and overall safety and soundness. Institutions identify, measure, and report credit risk through a number of different methods. These include the Uniform Classification System (UCS), risk ratings, performance categories, and high-risk asset accounting requirements. Each of these methods plays an important and unique part in the risk identification process and should be effectively implemented to ensure accurate and reliable reporting.

In evaluating risk identification, Farm Credit Administration (FCA) examiners should focus first on the adequacy of the institution's processes and internal controls. This includes evaluating risk identification guidance, board involvement in establishing direction, and training to implement the guidance. This also includes determining whether controls are sufficient to ensure board and management guidance is effectively implemented, and regulatory requirements are met. A key part of this evaluation is to determine if internal reviews of risk identification are effective. Finally, examiners will conduct transaction testing to validate the accuracy and reliability of the institution's risk identification processes and controls.

Examination Procedures and Guidance

General

1. Uniform Classification System:

Determine if the institution maintains an effective process for accurately identifying risk through the Uniform Classification System.

Guidance:

The Uniform Classification System (UCS) is a critical credit risk identification process used by federal banking regulators to provide a common method for understanding credit risk in financial institutions. The UCS consists of the following five classification categories: Acceptable, Special Mention, Substandard, Doubtful, and Loss. FCA has aligned our classification category definitions with those used by the other regulators and added a formal definition for Acceptable. The classifications are assigned based on risk as determined by a thorough analysis of the five credit factors, which consist of capacity, capital, collateral, character, and conditions. Assets may be assigned more than one classification when portions of the asset clearly meet different classification standards. Refer to Classifying Assets Using the UCS for FCA's UCS definitions and related guidance on analyzing the five credit factors, and FCA's FAQs About Risk Identification for additional information on using the UCS effectively. The Office of the Comptroller of the Currency's (OCC) Rating Credit Risk booklet also provides useful information on the UCS and evaluating credit risk.

FCA uses the UCS to evaluate the quality of retail loans and loan-related assets, the direct loan between banks and associations, and loans to Other Financing Institutions. However, it can also be used to assess risk in some mission related investments (MRIs) based on the risk characteristics of the obligor(s). FCA does not currently classify investments held for liquidity purposes using the UCS.

The UCS also provides FCA a means to evaluate portfolio quality in aggregate. For example, assets classified Substandard, Doubtful, and Loss are considered adversely classified assets. FCA also considers other property owned (OPO) to be an adverse asset, but does not assign it a specific credit classification. Assets classified less than fully Acceptable (i.e., Special Mention, Substandard, Doubtful, and Loss) are considered criticized assets. Adversely classified and criticized asset volumes and trends are key factors when analyzing an institution's asset quality and risk-bearing capacity.

Evaluative questions and items to consider when examining an institution's processes for identifying risk through the UCS include:

- ***Board Involvement:*** **Is the board sufficiently involved in reviewing and approving risk identification policy direction?** The board should be familiar with the UCS and how it relates to System risk rating guidance and internal risk identification processes. Policy direction should define the board's expectations regarding accurate and reliable risk identification practices and related reporting.

- ***Policies and Procedures:*** **Do policies and procedures provide adequate guidance on using the UCS?** Specifically, policies or procedures should define UCS classifications consistent with FCA's definitions. They should also define the processes for assigning, reviewing, changing, and reporting asset classifications, including validation processes to ensure accurate reporting of UCS classifications in shareholder disclosures and FCA Call Reports.

- ***Processes:*** **Does the institution maintain appropriate processes to accurately map from its two-dimensional risk rating system to the UCS?** The System uses a two-dimensional risk rating system that includes Probability of Default (PD) and Loss Given Default (LGD) ratings. Because PDs and UCS classifications are highly correlated, PDs can generally be mapped directly to a UCS classification that would correlate with FCA's UCS definitions. However, some loans, such as those with a guarantee against loss, could have a high PD that would not directly map to an Acceptable UCS classification. In these and other similar instances, the institution's mapping processes should ensure that UCS classifications are accurately reported. See the *Risk Ratings* procedure for additional details.

- ***Training:*** **Is training sufficient to ensure staff understand and accurately assign UCS classifications?** Credit staff should possess the knowledge and expertise to accurately assign UCS classifications to individual assets. As discussed above, there are differences between PDs and UCS classifications when used on certain guaranteed loans. In addition, other differences may arise if the evaluation of credit risk is too narrowly focused on the probability of default. For example, a loan could be structured in a way that makes the possibility of default remote; however, the loan structure itself could represent a potential weakness warranting a Special Mention classification under the UCS (e.g., loans with overly liberal repayment terms). As such, staff needs to understand these differences to ensure accurate reporting of UCS classifications. To accomplish this, institutions should periodically provide staff with appropriate training on the UCS. Examiners can use internal review results and FCA's transaction testing to evaluate the effectiveness of training and other control processes at ensuring staff members accurately classify loans and loan-related assets.

2. Risk Ratings:

Assess whether the institution maintains an effective process for establishing Probability of Default and Loss Given Default ratings.

Guidance:

The System maintains a two-dimensional risk rating process to facilitate risk identification in loans and loan-related assets. This process enables institutions to more precisely reflect the level of credit risk by using PD and LGD ratings. It is also intended that the probability of default and loss given default of all assets in a particular classification be consistent and comparable in the occurrence of defaults, and the actual losses after default, across all geographic areas and industries. While FCA has not adopted this risk rating process, it provides a sound basis for identifying and measuring credit risk if consistently and properly implemented. Importantly, it often supports numerous key institution processes (e.g., hold limits, underwriting, loan pricing, allowance for losses methodology, capital planning, and other risk management functions).

The System risk rating guidance is also intended to facilitate consistent System-wide reporting to investors and FCA. As a result, it is important that all institutions strive to align internal guidance on risk ratings with System-wide definitions and reflect comparable default and loss rates on assets with the same ratings. Institutions may adjust the criteria used to assign PDs to align actual default experience with the expected default percentages in the System guidance. However, PD definitions must be consistent with System guidance and the criteria used should be adequately supported. Given the System-wide use and reporting on risk ratings, examiners should evaluate the degree to which the System guidance has been adopted for establishing PD and LGD ratings. Examiners should also determine the degree to which risk ratings are used throughout the institution, and if significant, should generally complete more in-depth examination work in this area. If risk ratings are not extensively used, examiners should evaluate the rationale for not incorporating them into other management processes.

Evaluative questions and items to consider when examining an institution's processes for identifying risk through the risk rating process include:

- ***Board Involvement:*** **Is the board sufficiently involved in reviewing and approving policy direction for risk identification?** Policy direction should define the board's expectations regarding accurate and reliable risk ratings. While FCA does not require adoption of the System guidance, board policies should reflect an appropriate level of consistency with the System guidance. As such, the board should be familiar with the System guidance and how it is incorporated into the board policy.

- ***Policies and Procedures:*** **Are policies and procedures in place to support an effective risk rating process?** Policies and procedures should define the processes for assigning, reviewing, changing, and reporting risk ratings. They should also define validation processes to ensure accurate internal and external reporting of risk ratings. Examiners should review the consistency of the institution's policy and procedural direction with the System guidance. This includes reviewing the institution's PD definitions and default percentages, metrics used for assigning PD ratings, and LGD guidance. Institutions should document and support any material differences between their guidance and the System guidance.

- ***Judgment:*** **Do processes for assigning risk ratings allow for sufficient judgment when evaluating objective and subjective factors?** For example, the mechanical application of PD rating criteria and use of average PD scores can de-emphasize individual credit factor weaknesses and result in inaccurate PDs. As such, the institution's processes should ensure key factors like repayment capacity are appropriately weighted, and subjective factors such as risk management capabilities are appropriately considered when assigning ratings.

- ***Shared Assets:*** **Are effective processes in place to coordinate with other System institutions on risk ratings assigned to shared assets?** Institutions should have documented processes for ensuring coordination with other System institutions that are involved in the same shared asset. This would include coordination as either the designated System lead or a System participant, as outlined in the System's risk rating guidance. Nevertheless, institutions should still perform their own independent analysis since they are ultimately responsible for assigning their own risk ratings. While FCA expects participating institutions to report the risk in shared assets consistently, there may be instances where differences are warranted (e.g., the System lead's risk rating is inaccurate). These differences should be justified and documented.

- ***Guidance Updates:*** **Are processes in place to review and implement revisions to the institution's guidance on a timely basis?** The institution should have a documented process for periodic review, testing, and revision to its risk rating guidance. This should include reviewing revisions to the System guidance. If an institution does not address the process for reviewing the System guidance in its procedures, examiners should discuss this with management to determine how revisions are addressed.

- ***Training:*** **Is training sufficient to ensure staff understand and accurately assign risk ratings?** Institutions should provide staff with adequate training for assigning PDs and LGDs to individual assets and emphasize the importance these ratings have on other processes (e.g., the allowance for losses). This would typically include training on the definitions and assignment of PDs and LGDs, expectations for reviewing and changing ratings, and related delegated authorities. Examiners can use internal review results and FCA's transaction testing to evaluate the effectiveness of training and other control processes at ensuring staff members accurately risk rate loans and loan-related assets.

Refer to questions 8, 17, and 18 in FCA's FAQs About Risk Identification for guidance on assigning PD and LGD ratings in specific situations.

3. Performance Status:

Determine if guidance and processes for identifying the performance status of loans and loan-related assets are sufficient and result in accurate reporting.

Guidance:

Institutions must identify and report the performance status of loans and loan-related assets. FCA Regulation 621.6 defines specific performance categories focused on identifying high-risk assets. These categories include:

- Nonaccrual
- Formally restructured (troubled debt restructuring in accordance with Accounting Standards Codification 310-40)

- 90 days past due still accruing interest

Loans that do not fit the criteria for any of the above categories are considered performing. Furthermore, while it is not a specific performance category, other property owned (OPO) is also addressed in this regulation.

Performance category and OPO information is disclosed in the financial statements, shareholder reports, and FCA Call Reports. The disclosures provide interested parties (including FCA, shareholders, and investors) with essential information for understanding the institution's asset quality. Accurate performance category use is also essential for the board and management to effectively identify and manage risk. Understanding the risks associated with OPO and assets in these performance categories is important for determining the impact such assets have on the institution's financial condition. This impact typically occurs through non-earning assets, increased operating expenses (including servicing costs), provisions for loan losses, and chargeoffs.

Examiners should refer to the following FCA documents when examining performance category and OPO guidance and processes:

- High-Risk Asset Accounting and Reporting (for definitions and related guidance on the performance categories and OPO).
- FAQs About Risk Identification
- FCA Informational Memorandum on Accounting and Disclosure of Troubled Debt Restructurings, as required under GAAP dated March 14, 2011.

In addition, the following are evaluative questions and items to consider when examining an institution's guidance and processes for identifying the performance status of loans and loan-related assets:

- ***Policies and Procedures:* Do policies and procedures provide adequate guidance on performance categories and OPO?** FCA Regulation 621.10(a)(3) requires institutions to develop and implement policies and procedures governing performance categories and OPO. At a minimum, policies and procedures must conform to the definitions, rules, and standards set forth in Part 621 of the regulations. This includes items such as FCA Regulation 621.6 and 621.7, which provide criteria on each performance category, OPO, and the rule of aggregation. As a best practice, policies or procedures should also define responsibilities and expectations for assigning, reviewing, revising, and reporting performance status on loans and loan-related assets. This should include validation processes to ensure accurate reporting of performance status and OPOs to FCA and others.

- ***Review of Assets:* Does the institution have a reliable process for reviewing performance category designations and the collectibility of accrued income on all high-risk assets?** FCA Regulation 621.10(a)(4) and (5) requires at least a quarterly review to ensure all high-risk loans are assigned the appropriate performance category and are reviewed to determine the collectibility of accrued but uncollected income. The review of accrued but uncollected interest is important for determining whether a loan should be transferred to nonaccrual. Institutions should also be alert to increased amounts of accrued interest being capitalized into loans, which may indicate performance problems or improper identification and disclosure of high-risk assets. Similarly, the institution's review should also consider increased amounts of adversely classified or past due loans and whether these assets are properly categorized. Processes and expectations for this should be defined in policy, procedure, or related guidance.

- ***Reporting:*** **Does the institution comply with reporting and disclosure requirements related to performance categories and OPO?** FCA Regulation 621.10(a)(1) and (2) requires reporting and disclosure to shareholders, investors, boards of directors, and FCA on performance categories and OPO, as well as any material events that could impact near-term portfolio performance. Examiners should review routine board reports, shareholder reports, and FCA Call Reports and consider transaction testing results to determine compliance with the reporting and disclosure requirements.

- ***Training:*** **Is training sufficient to ensure staff understand and accurately assign performance categories to individual assets?** Credit staff should possess the knowledge and expertise necessary to accurately assign performance categories to individual assets. While institutions may have credit staff designated to handle high-risk assets, all credit staff should have a basic understanding of the performance categories to ensure accurate and timely identification. To accomplish this, institutions should periodically provide staff with appropriate training. Examiners can use internal review results and FCA's transaction testing to evaluate the effectiveness of training and other control processes at ensuring staff members accurately assign performance categories to loans and loan-related assets.

Refer to the following documents developed by other federal regulatory agencies for additional information on evaluating performance category designations and OPO:

- Interagency Policy Statement on Prudent Commercial Real Estate Loan Workouts
- FASB Accounting Standards Update No. 2011-02 (April 2011)

4. High-Risk Asset Accounting:

Determine if guidance and processes are effective for ensuring proper accounting and reporting of high-risk loans and loan-related assets.

Guidance:

FCA Regulations and generally accepted accounting principles (GAAP) prescribe the proper accounting treatment of high-risk loans and loan-related assets. FCA Regulation 621.6 requires institutions to use performance categories and other property owned (OPO) to categorize high-risk loans and loan-related assets, and GAAP provides related accounting guidance on these assets. Properly accounting for high-risk assets is an essential element of an institution's risk identification process and overall loan portfolio management. Institutions must properly account for high-risk assets to ensure the board, shareholders, investors, and FCA are apprised of credit risk that has, or could, adversely impact performance of the loan portfolio. Examiners should refer to the following FCA documents when examining high-risk asset accounting guidance and processes:

- High-Risk Asset Accounting and Reporting
- FAQs About Risk Identification
- FCA Informational Memorandum on Accounting and Disclosure of Troubled Debt Restructurings, as required under GAAP dated March 14, 2011

In addition, the following are evaluative questions and items to consider when examining an institution's guidance and processes for high-risk asset accounting:

- ***Policies and Procedures:*** **Do policies and procedures provide adequate guidance on high-risk asset accounting treatment?** Guidance should be kept current so it is consistent with GAAP, FCA guidance, and System accounting guidelines. Policies and procedures should specifically address issues such as:

- o The appropriate accounting treatment for nonaccrual loans (including cash basis nonaccrual loans), application of payments and income recognition, accounting for legal and other expenses, and requirements for return to accrual status (FCA Regulations 621.6, 621.8, and 621.9).

- o Loan loss accounting, specifically chargeoffs, recoveries, and specific allowances on impaired loans (FCA Regulation 621.5). Refer to the *Allowance for Losses* Examination Manual topic for guidance on specific allowances.

- o Recognition of losses, recoveries, income, and expenses on OPO and sales contracts.

- ***Training:*** **Is training sufficient to ensure staff understand and accurately apply the accounting rules and guidelines for high-risk assets?** The staff responsible for high-risk asset accounting varies. In some institutions, the chief financial officer is responsible for high-risk asset accounting, while other institutions may employ a large financial and accounting staff. Furthermore, credit staff servicing high-risk assets may be responsible for completing quarterly impairment analyses and identifying appropriate chargeoffs, recoveries, and specific allowances. Regardless of the organizational structure, any individual involved in accounting for high-risk assets should receive sufficient training to remain knowledgeable of the accounting rules and FCA guidance. Examiners can use internal review results and FCA's transaction testing to evaluate the effectiveness of training and other control processes at ensuring staff members accurately apply accounting rules and guidelines to high-risk loans and loan-related assets.

5. Audit/Review:

Determine if the institution conducts an effective audit/review (scope, reporting, and followup) of risk identification.

Guidance:

The internal audit or review function is a key component of an institution's credit control systems and is essential for detecting weaknesses in risk identification. FCA Regulation 618.8430(c) requires each institution to establish an internal control policy that provides adequate direction for a program to review and assess its assets. With respect to risk identification, such a program must include standards that address loan review, including scope of review selection, workpapers, and supporting documentation, as well as standards on asset quality classification and training to initiate the program. A major component of this is the independent internal credit review program (also commonly referred to as an internal review, audit, or asset review), which may be staffed with internal or externally-sourced resources.

An independent internal review program is critical to the board's ability to monitor asset quality and reliability of risk identification practices. As such, the internal review staff or vendors must have direct access to the board or audit committee. This is important to ensure all material findings or breakdowns in control processes can be communicated without undue management influence. Failure to maintain a reliable and effective internal review process is an unsafe and unsound practice that boards must correct immediately.

Evaluative questions and items to consider when examining an institution's internal review of risk identification include:

- ***Audit Coverage:*** **Is there periodic audit or review coverage of risk identification?** Audit or review coverage and frequency should be appropriate relative to risks, changes in the operating environment, regulatory requirements, and periodic testing needs. Coverage should also be consistent with the institution's risk assessment results and annual audit plan. The risk assessment process should consider any new lending programs or initiatives, high-risk industries, portfolio segments with a high growth rate, or any other areas where risk identification is critical or may be suspect. Without adequate consideration of these areas, the scope, depth, and frequency of reviews may be insufficient to detect weaknesses in risk identification.

- ***Scope and Depth:*** **Are audit or review scope and depth sufficient to conclude on the adequacy, completeness, and timeliness of risk identification processes?** The scope should cover key processes and controls within the area being audited or reviewed. The depth of work should be sufficient to determine if internal controls are functioning as intended and regulatory requirements are met. The scope and depth of coverage should be consistent with the approved audit or review plan and engagement contract (if applicable). If audit or review work deviated materially from the original planned scope, the board (or Audit Committee, if so delegated) should be notified of the reasons for the change. Specific items that should be considered in the audit or review scope include:

    - Overall accuracy of risk identification processes and reporting on loan portfolio quality.
    - Reliability of asset classifications, risk ratings, and performance category designations.
    - Compliance with accounting requirements (e.g., specific allowances, chargeoffs, application of payments and income recognition on nonaccrual loans, troubled debt restructurings, and OPO).
    - Risk identification policies, procedures, and other guidance.
    - Staff adherence to policies, procedures, and other guidance related to risk identification. Internal reviews should include sufficient testing of these lending controls to detect noncompliance with established policies, procedures, and regulatory guidance, and deviation from sound business practices.
    - Fraud-related threats and vulnerabilities, as well as anti-fraud controls.
    - Periodic, onsite branch or regional audits and reviews, including review of some loan transactions without advance notice.

- ***Loan Sampling:*** **Was an appropriate loan sampling process used?** It is important to understand how the loan sample was selected to determine if relevant subsets of information were considered. Database queries could identify trends and patterns that would detect anomalies that warrant investigation. For some programs, such as scorecard lending, random sampling may be the only way to test the program efficiently. Random sampling also should be used to draw inferences over the probability that systems are functioning as intended. In other cases, a targeted loan sample could be used to review risk identification in a distressed industry, test specific internal controls, or detect potential fraud. The following are examples of loan attributes internal reviewers should consider when selecting a sample for these purposes:

- The level of credit risk (e.g., UCS classification, risk rating, credit metrics, or commodity exposure)
- New loans or loans with recent servicing actions
- Past due or delinquencies
- Size
- Originator or underwriter (loan officer, credit analyst, etc.)
- Loan programs and types
- Branch
- Loan complex (including all related loans, especially operating loans)
- Revolving lines of credit evidencing no revolvement
- Insider loans
- Borrowers and employees with matching addresses
- Loans just below delegated lending authority limits that did not require loan committee approval

- ***Reliability of Results:*** **Did FCA identify any concerns with audit and review reliability?** Evaluate the reliability of internal audit or review work by comparing the results to FCA's examination results in this area. This comparison often includes FCA testing of transactions that were covered in the internal audit or review (transactions are often loans or loan applications, but may include other types of transactional activity, as well). In addition to the audit or review report, examiners should request and review the workpapers and hold discussions with the auditor to obtain a more thorough understanding of work completed. Often, auditors and reviewers will complete line sheets, flowcharts, control matrices, standard work programs, workpaper forms, or other relevant documents when conducting work. Workpapers should adequately document the work performed and support the final report. In addition, any proforma work programs, workpapers, or other tools should be accurate and sufficiently thorough. If there are material weaknesses identified by examiners that are not identified by internal audits or reviews, examiners should assess the underlying reasons. Even if the differences in results are attributed to differences in the loan samples for the reviews, the scope and overall effectiveness of the internal review process should be thoroughly investigated. Examiners should also consider the results of any reviews completed by the funding bank or others.

- ***Reports:*** **Do internal review reports sufficiently communicate risk identification review results and recommendations, if applicable?** Examiners should consider the following when evaluating the audit or review report:

  - Is the report prepared in accordance with the institution's guidelines?

  - Is an executive summary or overview included to provide the board with a general conclusion on audit or review results?

  - Is the report accurate, concise, supported, and timely in communicating the audit or review objectives, scope, results, conclusions, and recommendations?

  - Are conclusions and recommendations realistic and reasonable given the institution's size and complexity, with material and higher risk issues clearly identified and prioritized?

  - Are conclusions and recommendations supported by convincing evidence, persuasive arguments (condition, criteria, cause, and effect), and adequate workpaper documentation on individual assets reviewed?

  - Does the report conclude whether the institution adheres to policies, procedures, and applicable laws or regulations, and whether operating processes and internal controls are effective?

  - Does the report address potential vulnerabilities to fraud, if applicable?

- ***Corrective Action:*** **Are management responses to review findings in this area reasonable, complete, and timely? Have corrective actions been effective?** Audits and reviews are only effective if corrective action is taken to remedy the weaknesses identified. As such, there should be a reasonable, complete, and timely management response to the audit or review report. Management should also promptly update individual loan classifications, risk ratings, and performance categories as recommended by internal review. While it is typical for reviewers to discuss differences with management to validate facts, there should not be a significant delay between receipt of internal review conclusions and when the appropriate changes are recorded. In some cases, management commitments and agreements or any areas of disagreement are documented in the report or in a separate memo or tracking system. If corrective actions are not resolving the issues or concerns (based on repetitive audit findings, FCA findings, etc.), examiners should further investigate the reasons. For example, this could indicate the audit or review did not sufficiently identify the underlying causes or materiality of weaknesses, sufficient resources are not being directed toward corrective actions, or weaknesses exist in the institution's corrective action process, including board oversight of the process.

6. Transaction Testing:

Examine individual loans to assess compliance with FCA and the institution's risk identification guidance and applicable laws and regulations, and to evaluate effectiveness of internal controls, including the reliability of the internal credit review function.

<u>Guidance</u>:

Loans and loan-related assets are examined, in part, to determine if the institution is adequately identifying risk. As such, FCA's transaction testing is a critical part of the overall evaluation of an institution's risk identification processes. Some specific objectives of risk identification transaction testing are to validate and determine the following:

- Accuracy of UCS classifications.
- Accuracy of performance category designations.
- Whether high-risk assets are receiving appropriate accounting treatment (e.g., application of payments and income recognition on nonaccrual loans, troubled debt restructurings, OPO, chargeoffs, and recoveries). Guidance on specific allowance transaction testing is included in the *Allowance for Losses* Examination Manual topic.
- Whether staff members are appropriately applying policies and procedures.
- The cause of elevated risk levels (e.g., whether credit administration or loan portfolio management weaknesses contributed to elevated credit risk – see the *Transaction Testing* procedure in the *Credit Administration* Examination Manual topic for more information and to document related examination findings).
- Accuracy of internal review testing and related conclusions.
- Consistency in reporting loan classifications and chargeoffs on shared assets. FCA's

Informational Memorandum on Allowance for Loan Losses dated June 30, 2009, identifies the need for consistently reporting these assets. Any differences should be justified and documented.

FCA transaction testing may also include review of PD and LGD ratings to assess the effectiveness of the institution's risk rating process. To the extent the institution's risk rating guidance is adequate (see the *Risk Ratings* procedure), this testing should focus on adherence to the institution's guidance and the reliability of internal review in evaluating risk ratings.

Selecting the Loan Sample: The adequacy of key control processes is an important factor to consider when selecting loans for examination. As such, past examination results and any recent information from the funding bank on the institution's internal review program should be considered when selecting loans. In addition, if adequate policies and procedures for classifying assets are not in place, the reliability of risk identification processes may be in question and additional asset testing may be necessary. In contrast, the board and management may have adequate policies, procedures, and internal controls, and demonstrate the capacity and willingness to promptly identify and correct problems. To determine the appropriate sample size for testing the institution's risk identification processes, examiners should also consider factors such as:

- Previous examination findings.
- Changes in lending operations or programs.
- Risk, growth, and trends in the loan portfolio.
- Economic conditions and any distressed industries.
- The institution's financial condition and performance.

Based on a review of these factors, individual assets can be selected for examination to validate the reliability of the institution's risk identification processes. It is essential that loans selected for examination focus on areas of risk and achieving specific objectives. For example, a sample of loans to borrowers in a distressed industry may be selected to specifically evaluate the institution's timely recognition of increasing risk (see FCA's Informational Memorandum on Servicing Loans to Borrowers in Distressed Industries dated January 21, 2016, for guidance on how the servicing of these loans impacts risk). A sample of loans should also be selected to evaluate internal review program reliability, which is a key loan review objective.

Evaluating Testing Results: In developing conclusions from transaction testing, examiners should focus on the overall accuracy of the institution's asset classifications and other risk measures, rather than on individual assets that were misclassified. Generally, FCA considers risk identification processes *unreliable* or *unsatisfactory* when more than 10 percent of the loan volume examined is misclassified, and *needs improvement* when more than 5 percent of the loan volume is misclassified. Examiner judgment is critical in applying these guidelines and must be supported by an examination scope sufficient to substantiate the conclusion. For example, one or a few large misclassified loans may result in these guidelines being exceeded, but not reflect a pattern or practice to support calling risk identification processes less than satisfactory. In addition, classification differences between Acceptable and Special Mention are generally not considered material enough to conclude that risk identification is unreliable. An exception to this is when a pattern or practice has been identified where the institution is clearly not identifying or addressing emerging risk.

Examiners should also consider the underlying causes of classification differences and if those factors could apply to other loans in the portfolio. To the extent that those factors apply broadly across the loan portfolio, a more critical conclusion on risk identification may be warranted.

Conversely, when classification differences are limited to loans evidencing certain characteristics or commonalties, conclusions on risk identification may be more effectively targeted to that particular aspect of the process.