EM-22.5

Category: **Loan Portfolio Management**
Topic: **Loan Underwriting**
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Overview

Loan underwriting is one of the most critical aspects of the overall loan portfolio management (LPM) function. Sound underwriting on individual loan transactions, administered under a framework of well-conceived underwriting standards and supporting control processes, is an indispensable component of an effective portfolio management system. Loan underwriting exemplifies an institution's credit culture in action and, if done successfully, results in loan portfolios with risk and return characteristics commensurate with the board's risk appetite and strategic objectives, as well as safety and soundness constraints.

Loan underwriting standards and practices will vary based on the nature of an institution's territory, portfolio, risk profile, and other factors. As such, institutions can use a variety of practices to satisfactorily carry out, document, and report on the loan underwriting function. Examiners should consider this as they apply the concepts, strategies, and questions outlined below.

Examination Procedures and Guidance

General

1. Process for Establishing Standards:

Evaluate the sufficiency of the institution's process for establishing underwriting standards, including the level of board involvement.

Guidance:

Underwriting standards represent the single most important piece of underwriting direction that an institution provides to staff. Underwriting standards provide the foundation for an effective loan underwriting process as they define the desired level of creditworthiness for individual borrowers and provide uniform criteria for evaluating loans with similar characteristics. Additionally, underwriting standards provide a mechanism for reinforcing the institution's risk appetite with staff. Given the critical nature of underwriting standards, the board should have an appropriate level of involvement in identifying the institution's risk appetite and establishing or changing underwriting standards. The extent of board involvement can vary, as discussed below.

Evaluative questions and items to consider when examining processes for establishing underwriting standards include:

- ***Developing Standards:*** **Does the institution have adequate processes for developing underwriting standards?** Institutions should have a logical process or approach to developing underwriting standards. The following are some typical ways to accomplish this:

- Have experienced staff complete studies of significant industries, lending programs, or other categories of loans based on historical, current, and projected information. These studies and the resulting standards would typically address the financial condition, performance, and other desired characteristics of successful operators in the industries being financed.

- Have topical specialists participate in developing standards by providing their expertise in specific industries or lending programs.

- Benchmark the standards of other lenders that conduct similar types of lending.

- Consider other techniques and information as discussed elsewhere in this module, such as Combined System Risk Rating Guidance (CSRRG) probability of default (PD) rating criteria, portfolio performance, loss experience, and desired changes in target markets.

- ***Maintaining Standards:*** **Does the institution have an adequate process for maintaining underwriting standards?** Institutions should have a defined and structured process for periodically reevaluating underwriting standards. Considerations include:

  - The agricultural lending environment is subject to ever-changing conditions and variables. Do not automatically assume that underwriting standards that facilitated past lending success will ensure future success. New or changing conditions and variables warrant proactive consideration of corresponding adjustments in underwriting standards.

  - All underwriting standards should be reviewed periodically. An annual review cycle is common. Some institutions review all standards at the same time while others review a portion of the standards at different times throughout the year (particularly institutions that have a large number of standards across many different portfolio segments).

  - Periodic reviews of underwriting standards should address a wide range of considerations – for example, changing economic and market conditions, portfolio and portfolio segment performance, business plan goals and objectives, new or planned lending programs, etc.

  - The various techniques applicable to initial development of underwriting standards are also applicable to periodic reevaluations, such as industry or portfolio segment studies, use of topical specialists, benchmarking to other lenders, CSRRG criteria, etc.

- ***Board Involvement and Direction:*** **Does the board conduct an annual review and affirmation of underwriting standards? Is the board sufficiently involved when making changes to standards?** A key role of the board is to determine the appropriate risk appetite for the institution as part of establishing strategic underwriting direction and standards. As a best practice, the board should also conduct an annual review and affirmation of underwriting standards. The need for board involvement in approving new or revised underwriting standards, however, can vary based on the nature of the standards. Board review and approval is more critical if the institution has a relatively limited number of underwriting standards and changes to standards are rare. For example, if an institution changes its long-standing core underwriting standards, which are utilized on a large percentage of the portfolio, the need for board understanding and approval is high. In contrast, significant board involvement may not be practical if there are many underwriting standards, unusual or highly technical standards for unique or specialized portfolio segments, or a high frequency of changes. For example, the need for board involvement is lower on less substantive technical changes, such as adjusting credit score requirements or modifying financial ratios for more specialized industry standards. In such cases, management should at least keep the board informed of changes to standards.

2. Adequacy of Standards:

Evaluate the adequacy of underwriting standards, including any related guidelines.

Guidance:

An institution's underwriting standards must reflect the composition of the portfolio by reasonably addressing each of the major commodities or industries financed. Standards should address risks inherent in specific industries and reflect the financial condition and operating performance levels consistent with successful operators in that industry who can withstand a reasonable level of adversity. It is particularly important that new loan programs and other growth areas be guided by appropriate underwriting standards. Ultimately, the use of solid underwriting standards helps protect an institution's capital from unsafe and unsound lending practices. FCA Regulation 614.4150(g) provides specific requirements for establishing measurable loan underwriting standards. Situations where institutions have not adopted measurable standards warrant close scrutiny and appropriate criticism.

Evaluative questions and items to consider when examining the adequacy of underwriting standards include:

- *Appropriateness of Standards:* **Do the institution's various underwriting standards set the bar high enough to ensure risk from loan underwriting activities is commensurate with the institution's financial condition and performance and risk management capabilities?** In evaluating the adequacy of underwriting standards, consider the following:
    - Standards should be appropriate for the institution's risk-bearing capacity.
    - Standards should contain objective and measurable criteria and address all appropriate credit factors.
    - Standards should not simply provide ranges in financial or production ratios for low, medium, and high risk. These situations are most likely a concern unless the institution clearly delineates which ratios serve as the benchmarks to justify underwriting the credit, to identify exceptions, and to trigger the need to identify offsetting strengths.
    - Standards should consider concentration risks faced by the institution, such as commodity or industry and loan size. For example, standards could be more stringent if the institution has a heavy concentration in a particular industry or the market segment is dominated by large loans. Alternatively, institutions may adjust other risk management practices to address the concentration risk instead of changing the underwriting standards.
    - Some institutions may use enterprise guidelines (or similar terminology) as part of their loan underwriting guidance. These guidelines likely equate to underwriting standards if they represent the primary drivers and analysis benchmarks for

underwriting decisions. If such guidelines exist that in effect represent underwriting standards, examiners should evaluate them accordingly.

  - Examiners are encouraged to determine how the subject institution's underwriting standards compare with the standards used by other Farm Credit System (System) institutions with similar types of lending.

- ***Mapping to Risk Rating Criteria:*** **How do underwriting standards map to both the institution's internal PD risk rating criteria and System-wide rating criteria?** One of the most effective methods to evaluate the adequacy of underwriting standards is to determine how the standards map to PD risk rating criteria. Consider the following:

  - The CSRRG developed by the System contains detailed financial metrics for measuring borrower financial strength and performance across a wide range of industries they finance. Refer to the applicable CSRRG appendices, but recognize the guidance calls on institutions to establish their own objective criteria for applicable industries, giving consideration to regional, economic, and other differences.

  - Underwriting standards define the quality of new volume that an institution desires to add to its portfolio. The CSRRG defines a PD 6 borrower as good quality, a PD 7 as average, a PD 8 as adequate, a PD 9 as minimally acceptable, and a PD 10 as Special Mention. With this in mind, standards that map to a PD 6 could be viewed as conservative and standards that map to a PD 7 or 8 would typically be considered reasonable. Standards that correlate to a PD 9 or 10 are concerning and warrant particular scrutiny.

  - If underwriting standards do not map to the institution's internal or System-wide PD rating criteria in an intuitive or expected manner, further follow-up and scrutiny are warranted. Through management discussion and analysis, determine the reasons and whether the underwriting standards create unwarranted vulnerability to originating weak credits. Significant differences between internal and the System-wide PD rating criteria should be evaluated as part of the ***Risk Identification*** examination workprogram.

  - Some institutions might highly integrate underwriting standards with PD risk rating systems and guidance. If this approach is taken, the institution should clearly identify what constitutes minimum underwriting expectations, identify what constitutes an underwriting exception, and provide differential PD rating guidance by industry. For market segments that would typically warrant specific underwriting standards, the institution should have PD rating criteria tailored to that market segment. This guidance should identify financial performance levels in each credit factor that are needed to justify specific ratings. The integrity, accuracy, and granularity of the institution's PD rating guidance and process must be robust before it could also effectively guide the underwriting function.

- ***Standards for Major Loan Types/Programs:*** **Are there significant portfolio segments or loan programs where specific, customized underwriting standards are not in place but should be?** The need for underwriting standards for a particular portfolio segment is primarily driven by concentration and volume levels of that segment or the presence of unique risk factors. Note that while a concentration or significant volume in a particular segment may not exist today, an institution's plans to grow appreciably within a segment could warrant setting customized standards on the front end of that planned growth. Unique risk factors to consider may include lack of staff experience with a particular program or industry, and borrower or loan characteristics that differ significantly from the institution's core portfolio, such as a segment dominated by large loans or specialized collateral. The following are some portfolio segments to consider when evaluating whether an institution has sufficient standards in place:

- Individual commodities or industries
- Part-time versus full-time farmer
- Large loans
- Young, beginning, or small borrowers
- Scorecard lending
- Housing and other consumer loans
- Unsecured lending
- New lending programs
- Livestock integrator and grower loans
- Project, construction, or expansion financing
- Leveraged lending (i.e., more than industry-normal leverage)
- Mission-related investments
- Loan participations and syndications, including capital markets
- Out-of-territory lending
- Other credit needs lending
- Loans with specialized collateral
- Loans in non-core industries
- Loans for, or secured by, land in transition (see FCA Examination Bulletin 2009-2)
- Loans secured by land with limited or no income-producing capability (e.g., recreational property)
- Loans dependent on capital gains or asset sale income for repayment

- ***Changes to Standards:* Were changes, or lack of changes, to underwriting standards reasonable and appropriate?** Evaluate any changes made since this workprogram was last completed, drawing on examination guidance provided throughout this workprogram. If no changes were made, institutions should be able to support the reasons for not making changes. Consider any management concerns with current standards and corresponding plans for change. In assessing whether changes are needed to underwriting standards, be mindful of areas where changes may be warranted in light of past, recent, changing, or emerging conditions. For example, considerations may include:

  - Likely need for increased working capital or repayment capacity requirements on livestock and crop loans in response to an ongoing environment of heightened volatility in agriculture. Note that liquidity metrics that measure the amount of working capital relative to the size of operations (e.g., working capital as a percent of adjusted gross income) may be more effective than a traditional current ratio measurement.

  - Potential need for lower loan-to-value standards or other underwriting adjustments on real estate and home loans, especially in an environment where land values are changing significantly. Collateral underwriting standards at or near the 85 percent regulatory maximum warrant extensive scrutiny. Refer to the ***Collateral Risk Management*** examination workprogram for related discussion and guidance.

  - Potential need for higher credit score requirements on scorecard and consumer loans, depending on portfolio performance, vulnerability to changing or more volatile economic conditions, etc.

- ***Compliance with Standards:*** **Has the institution provided staff with adequate direction for analyzing and documenting compliance with underwriting standards?** At a minimum, credit direction should meet the requirements of FCA Regulation 614.4150(i). In addition, consider the following when evaluating the adequacy of direction for supporting compliance with underwriting standards:

    - Do credit narrative templates include a section on compliance with underwriting standards?

    - Is staff supposed to justify exceptions to underwriting standards in credit narratives by identifying offsetting strengths in other credit factors? Has management identified what constitutes an offsetting strength? Is the definition of an offsetting strength reasonable?

    - Are loans with exceptions to underwriting standards subject to more restrictive lending approvals? For example, do lending staff have more limited delegated lending authority levels on loans with underwriting exceptions than on loans without exceptions?

3. Other Direction & Practices:

Evaluate other underwriting-related direction as well as techniques for adjusting underwriting practices based on organizational performance, actual and anticipated changes in the lending environment, and portfolio planning.

Guidance:

Institutions should effectively communicate underwriting expectations to staff, and assess if changes are needed to underwriting practices in response to, or in anticipation of, changing conditions. In addition to underwriting standards, institutions can communicate expectations and any desired changes in underwriting practices to staff in many forms. The board has a key role in communicating underwriting expectations through mechanisms such as policies, incentive compensation programs, targeted exception rates, new loan quality goals, and changes in target markets. Management provides more direct communication to staff on underwriting expectations through items such as credit procedures, credit letters, staff meetings, delegated authorities, and loan committee feedback.

Examiners should be cognizant that a lack of action in one area can be offset by actions in another. For example, some institutions may decide to leave underwriting standards unchanged. However, the board and management can still communicate a more conservative underwriting philosophy by giving direction to staff to underwrite fewer credits with less favorable ratings (e.g., loans rated PD 8 and 9) or reduce the rate of underwriting exceptions. When assessing whether appropriate changes were made to underwriting practices, it is important to evaluate the collective actions taken to adjust underwriting.

Evaluative questions and items to consider when examining the adequacy of other underwriting-related guidance and practices include:

- ***Policy Direction:*** **Does underwriting-related board policy direction effectively define the institution's risk appetite and comply with FCA Regulations?** Underwriting-related board policies should set the *tone at the top* for the institution's underwriting activities. The scope and complexity of the portfolio and lending operations should drive the depth of coverage of underwriting-related topics in board policies. Any changes to underwriting policies should be reasonable based on the institution's financial condition and performance, portfolio risk levels, the risk environment, and portfolio risk management capabilities. At a minimum, underwriting-related policies must meet the applicable requirements of FCA Regulations 614.4120, 614.4150, 614.4325, 616.6100, and 616.6300.

- ***Incentive Compensation:* Do incentive compensation plans promote sound loan underwriting and the institution's credit goals and objectives?** Considerations include:

    - Incentive plans should reflect a reasonable and healthy balance between portfolio quality, portfolio profitability, and volume growth.

    - Changes (or lack of changes) in incentive plans should be consistent with the economic environment and the institution's risk profile.

    - Credit-related incentives should be consistent with and supportive of credit and underwriting-related business plan goals and objectives.

    - Incentive plans should contain appropriate controls (e.g., credit quality, credit administration, and earnings qualifiers) to ensure payments are not made or are reduced when portfolio conditions are weak or deteriorating.

- ***Delegated Authorities:* Do delegated authorities reflect appropriate controls that facilitate sound loan underwriting?** Considerations include:

    - Delegated authority levels should reflect both staff experience and skill levels. Authority levels should also consider the institution's risk-bearing capacity, with a loan committee typically used for transactions of substantial size. Authority thresholds also need to conform to prior approval requirements from the district bank.

    - More restrictive delegations are common for higher-risk credit actions, such as loans with less favorable risk ratings (PD or Loss Given Default), newer lending programs, loans with underwriting exceptions, unsecured loans, project or construction financing, loans to specialized industries or with specialized collateral, out-of-territory loans, etc.

    - Loan actions approved under individual delegations at the senior management level are typically screened and recommended for approval by junior credit staff. This promotes training and collaboration, and allows personnel at multiple levels to contribute their expertise and perspective.

    - Changes (or lack of changes) in delegated authorities should consider internal and external audit and review results, the economic environment, and current and projected credit risk levels.

- ***Changes in Underwriting Practices:* Has the institution adequately adjusted its underwriting practices based on portfolio quality and performance and actual or anticipated changes in the lending environment?** Institutions may use various means to change or redirect underwriting practices that do not involve changing underwriting standards. Underwriting direction may come in the form of targeted exception rates, direction based on PD ratings, changes in target markets, or revised practices in response to loan losses. Guidance may also come in a more general form such as staff meeting information, procedure changes, credit letters to staff, or general management communications to staff (for example, intranet postings and e-mails). In situations where the institution has not made any (or very limited) substantive changes to underwriting practices, consider whether factors such as minimal loan losses, modest portfolio deterioration, adequate risk-bearing capacity, previously sound underwriting practices, and a solid credit culture were present to negate the need for tightening underwriting practices. Where applicable, consider whether similar factors were present to support decisions to implement less restrictive underwriting practices to facilitate growth and better serve the marketplace.

As previously discussed, the board and management have various means to communicate underwriting direction and related changes. Provided below are additional insights into some of the most common methods. No requirements exist for an institution to use any particular method. Also, changes in underwriting practices should be considered based on both positive and negative changes in the lending environment. Refer to the ***Analysis & Reporting*** procedure, as information from that procedure would provide valuable information the institution should be considering when determining the need to modify underwriting direction or practices.

Exception Levels: If the institution utilizes exception levels or targets to communicate underwriting expectations to staff, consider the following:

- The institution could direct a more conservative (lenient) underwriting approach by establishing exception targets that are lower (higher) than past exception levels.
- Guidance for underwriting based on exceptions can be further segmented by areas of risk, such as certain industries, new versus existing customers, renewals versus loan actions where new volume is approved, out-of-territory volume versus loans within the territory, loan participations/syndications, etc.
- Guidance should include tangible and measureable criteria rather than simply a general message to reduce (or increase) the number of exceptions.
- Guidance on underwriting exceptions should be reasonable considering the institution's overall risk profile and credit quality trends. For example, has the institution launched efforts to lower exceptions in response to credit challenges (or raise exception rates if warranted by positive conditions)?

PD Ratings: If the institution communicates underwriting expectations based on PD ratings, consider the following:

- The institution could direct a more conservative underwriting approach by directing staff to limit underwriting and new volume activity on accounts with less favorable ratings, such as PD 8 or 9.
- The institution could direct staff to pursue correction or collection, or encourage refinancing, on accounts with less favorable ratings, such as PD 10 and worse, and PD 8 or 9 in certain situations or industries.
- Guidance for underwriting based on PD ratings can be further segmented by areas of risk, such as specific industries, new versus existing customers, renewals versus loan actions where new volume is approved, out-of-territory volume versus loans within the territory, loan participations/syndications, etc.
- Guidance should include tangible and measureable criteria rather than simply a general message to reduce or limit volume with less favorable PD ratings.
- The PD rating process must be robust and sound for this type of underwriting direction to be effective. Institutions with limited granularity in risk rated volume (e.g., most Acceptable volume concentrated in only a few PD rating categories) would not be well suited for this type of underwriting direction.

Changes in Target Markets: If the institution utilizes target markets (or changes in target markets) to communicate underwriting direction, consider the following:

- Has the institution adjusted the markets, customers, or industries it is focusing on to proactively manage its exposure to high risk market segments? Efforts to change target markets should be supported by volume goals or projections, revised portfolio parameters (e.g., industry and lending program risk parameters), and other objective criteria such as efforts to reach all segments of potential borrowers.
- Examples of changes in target markets may include:
    - Reducing out-of-territory lending.
    - Decreasing the emphasis on capital markets activity, such as purchasing loan participations/syndications.
    - Reducing marketing emphasis or increasing the quality emphasis on industries where the institution is highly concentrated.
    - Reducing lending activity in industries that are not common to the institution's territory or are outside credit staff's core competencies.
    - Decreasing lending activity in specialized lending programs (for example, project or construction financing, other credit needs, etc.).
    - Increasing outreach efforts and lending activities to market segments that may have been underserved.
- Are changes in target markets reasonable considering the institution's overall risk profile and credit quality trends?

Loan Losses: If the institution experienced notable loan losses recently, consider the following:

- Does the institution have procedures or a process in place to conduct post-mortem analyses on loans or loan programs where significant losses or widespread quality deterioration have occurred? Lessons learned from these analyses should be used to adjust underwriting and due diligence practices.
- Is the depth of these analyses sufficient and do they address the underlying cause of the losses or deterioration?

4. Loan Structure, Terms, & Conditions:

Evaluate the sufficiency of credit direction, guidance, and practices for loan structure, terms, and conditions.

Guidance:

Effective loan underwriting cannot be accomplished without adequate loan structuring and appropriate loan terms and conditions. Periods of growth and strong economic conditions can inherently cause an institution to become more lax in its credit practices. When the economic cycle changes, weaknesses in loan structure, terms, and conditions become evident in the form of deteriorating credit quality and increased loan losses. Institutions should continually reassess guidance and practices related to loan structures, terms, and conditions.

Proper loan structures, terms, and conditions are critical to managing and controlling risk. Revolving term facilities, interest only loans, and term loans that require little or no principal amortization during the life of the loan are a few of the many examples of loan structures that can impact risk. The use of such structures should be well justified as part of the underwriting process. At times, borrower quality and history with the lender justify favorable structures, terms, and conditions. However, institutions can get drawn into excessive *covenant lite* lending with loan terms, conditions, or structures that are not commensurate with the borrower's financial capacity and cause elevated risk in the credit facility. Market conditions often contribute to less restrictive underwriting terms, conditions, and structures, especially during favorable business cycles. While institutions may adjust their practices to be competitive in such environments, they must also remain prudent to ensure the resulting risks are appropriately managed.

Evaluative questions and items to consider when examining the appropriateness of loan structures, terms, and conditions include:

- ***Guidance:*** **Is there adequate direction to staff (policies, procedures, and other management direction) regarding expectations for loan structures, terms, and conditions?** In particular, guidance should address the types of items discussed below and be consistent with actual institution practices. Any significant recent changes should be closely evaluated. Also, consider if loan review findings (internal credit review and FCA) confirm sound and appropriate execution of credit direction regarding loan structure, terms, and conditions.

- ***Loan Covenants:*** **Does credit direction provide sufficient guidance on establishing and modifying loan covenants?** Loan covenants provide lenders an excellent mechanism for controlling risk in the underwriting process. Covenants that limit capital purchases, specify minimum working capital, equity, or cash flow levels, or require submission of borrowing base, financial, or production information provide lenders valuable tools for managing risk in individual loan transactions. Related guidance could address items such as when quarterly or monthly financial and inventory reporting is required, when to use and how to set financial covenants, and when it's acceptable to modify covenants. Where applicable, credit direction should also address *covenant lite* transactions, including the institution's appetite for such assets and mitigating factors that need to be present to justify underwriting them.

- ***Loan Approval Conditions:*** **Do guidance and practices sufficiently address loan approval conditions?** Loan approval conditions (e.g., requirements for insurance, assignments of proceeds, cosigners, equity investors, and cross collateralization or cross default agreements) can materially help control risk in the underwriting process.

- ***General Loan Structuring Considerations:*** **Do guidance and practices result in loan payments being matched to the timing of the borrower's cash flow, rather than being reliant on asset sales?** Situations exist where asset sales can be a planned or typical part of ongoing business operations, such as self-liquidating loans involving the current assets of a business or the orderly sale of assets as part of retirement planning. However, transactions where the borrower's cash flow is unstable or unpredictable because it's reliant on asset sales or capital gains income should be rare and approached with caution. A core lending principle is that loans are meant to be repaid with cash from operations. Repayment should not be dependent on one-time, unusual items such as the sale of collateral or production assets. A competitive landscape combined with pressures to grow the portfolio can cause some lenders to deviate from this core principle.

- ***Balloon Structures:*** **Is the use of balloon payment structures appropriately controlled and managed?** Some institutions use balloon structures, particularly on mortgage loans, to help manage loan pricing and credit risk. Institutions need to be careful not to view the balloon structure as a basis to support accepting greater risk in a loan or utilizing weaker credit standards. The shorter maturity may create additional servicing options, but does not ensure an institution will be able to exit the loan at maturity if desired. The presence of a balloon structure should not compromise quality expectations at the time of loan origination.

- ***Interest-Only Loans:*** **Is adequate guidance in place for loan programs that feature interest-only payment terms? Is the use of interest-only terms appropriate?** Institutions should provide direction to staff on the appropriate use of interest-only loan structures. This should include addressing risk mitigation expectations, such as mandatory asset sales, excess cash flow sweeps, and evaluating loans using a normal amortization. Any significant changes to guidance or practices regarding the use of interest-only loans should be adequately supported and reasonable relative to the institution's overall risk profile. Additional considerations include:

- o To what extent does the institution use interest-only loan structures? Use loan database queries and management discussions to identify this, with particular scrutiny of interest-only real estate transactions. Short-term revolving lines of credit controlled by properly-structured borrowing base arrangements for appropriate asset-based lending would typically not be a concern.

- o Are risk levels reasonable on these types of loans? Segment interest-only loan exposure by borrower risk rating as necessary to gauge risk levels. Institutions should typically reserve interest-only structures for high quality customers.

5. Analysis & Reporting:

Evaluate the sufficiency of institution processes for analyzing the sources, nature, and quality of new loan volume; identifying, analyzing, and reporting loan underwriting exceptions; and conducting any other underwriting-related analyses.

<u>Guidance</u>:

Processes to identify, analyze, and report loan underwriting results and compliance with standards are a critical component of the underwriting function. Institutions should analyze portfolio quality and performance to identify areas of concern needing to be addressed through revised underwriting practices. This analysis should determine if underwriting practices are achieving desired credit objectives consistent with the institution's risk tolerance, or if underwriting adjustments are needed.

An analysis of underwriting exception levels, trends, and related information can provide valuable insight into an institution's underwriting practices. Exception levels and trends, in particular, can serve as a predictive indicator of future credit quality as loans not meeting all standards are typically more vulnerable to adversity. Monitoring trends in underwriting exceptions and other related information can alert management and the board that adjustments to underwriting practices are necessary, before weak underwriting becomes evident via credit quality deterioration.

Evaluative questions and items to consider when examining an institution's analysis and reporting on loan underwriting activity include:

- ***Analyzing New Volume:*** **Does the institution adequately identify and report the sources, quality, and risk profile of new loan volume?** Loan underwriting encompasses a broad spectrum of loan actions, including renewals, refinancings, and new loan volume to existing or new customers. An institution's efforts to analyze underwriting performance should address all loan actions, but an in-depth review of new volume activity is particularly important. Institutions have greater options and flexibility on these loan actions compared to those involving volume a customer already has with the institution. Even institutions with static loan volume trends underwrite a sizable amount of new volume every year to offset regular loan pay-downs and pay-offs. New volume activity should be analyzed to determine not only the amount, but also the sources and quality. Management should report to the board a summary of results from these analyses. When examining an analysis of new volume, consider whether the institution has reasonably defined what constitutes new volume and whether the analysis and related reporting:

- Identifies underwriting activity that involves bona fide new volume (since the lending decision is more discretionary compared to underwriting actions that involve renewals to existing customers or protective advances to stressed customers).

- Addresses new volume quality trends (e.g., risk ratings) and if new loan quality is consistent with institution underwriting direction and objectives.

- Segments new volume by factors such as loan type, industry, and origination process (traditional underwriting by institution, scorecard, loan participation purchases, etc.).

- Identifies if new volume sources are consistent with institution direction and objectives concerning target markets.

- Identifies other key characteristics, such as the amount of new volume to existing borrowers versus new borrowers or borrowers within the territory versus outside the territory. For example, new volume originated to existing customers within the chartered territory should likely exhibit a different risk profile than out-of-territory loan participation volume to new borrowers with no track record with the institution.

- ***Underwriting Exception Processes:*** **Are sufficient processes in place to identify and analyze loan underwriting exceptions?** When evaluating the loan underwriting exception process, be mindful of common concerns such as:

  - Assuming all loans were written under core underwriting standards. As a result, loans written under enterprise guidelines or other categories with unique standards are only compared against core standards.

  - Identifying exceptions by number of customers or loans, but not by volume.

  - Covering only a portion of the portfolio, such as loans written under core standards, while loans written under specialized standards are not addressed in exception reporting. Similarly, adjustments may be needed in exception reports to ensure unique or specialized loans are not measured against underwriting standards that were not fully applicable to them.

  - Having data integrity concerns in borrower loan information or shortcomings in the methodologies used to extract information for identifying exceptions, resulting in inaccurate exception information. (During loan review activities, examiners may want to watch for loans where credit narratives indicate underwriting exceptions occurred and review exception reports to confirm they were included.)

- ***Content of Exception Analyses:*** **Is the content of underwriting exception analyses adequate?** Basic underwriting exception analyses would typically identify loans with exceptions to standards and provide a summary on the percent of loan activity with exceptions. An effective summary would also provide information on total exceptions to each standard. Considerable judgment is necessary to determine what further stratifications are warranted in loan underwriting exception analyses. Factors to consider include makeup of the portfolio, lending to new versus existing customers, engagement in out-of-territory lending, etc. The following are possible ways that exception analyses and reports could be stratified to ensure effective analysis of underwriting activity:

- Type of loan or customer (agricultural mortgage, consumer, operating, intermediate term, participations, capital markets, etc.)
    - Commodity or industry
    - New customers versus existing customers
    - Loan renewals or refinancings versus new loans or new volume
    - In-territory versus out-of-territory volume
    - Volume of loans with more than one exception
    - Loans with exceptions, but also material quantifiable offsetting strengths
    - Risk ratings
    - Loan size
    - Branch location
    - Loan officer

- ***Board Reporting on Exceptions:*** **Does the board receive sufficient, periodic reports that identify loan volume with underwriting exceptions?** Reports should summarize information such as aggregate exception rates, the rate of exceptions to each standard, the volume of loans with more than one exception, and the trend in exception levels. Additional reporting could address exceptions based on stratifications such as those listed above to further delineate a pattern or practice. A best practice is to include a narrative summary with each exception report. This summary could address items such as whether the amount, type, and trends of exceptions pose acceptable risk, whether the level of exceptions are within expectations or targets, and if changes or corrective actions to underwriting practices are necessary based on exception levels and trends. A common frequency of exception reports is quarterly, with summary information from past quarters to allow trending of information.

- ***Other Analysis/Reports**:* **Does the institution effectively use other types of analyses and reports to evaluate underwriting performance?** The extent that an institution needs to drill down into its underwriting performance will depend on risk and volume levels of specific portfolio segments. Using tools such as the System PD risk rating system can help management analyze and better understand the institution's underwriting performance. PD risk ratings at loan origination and risk rating migrations since origination provide valuable data that can be quite revealing. While there are many types of analyses that can be completed, the following are examples of best practices that can help an institution draw definitive conclusions on whether underwriting practices are achieving desired objectives and results:

    - Loan quality (risk rating) and performance characteristics (past dues, nonaccruals, and chargeoffs) stratified by underwriting segment and trended over time.

    - Loan quality, risk rating migrations, and performance characteristics stratified by year of origination. For example, performance concerns may not be evident when looking at a broad portfolio segment such as loans to a specific industry. However, when loan performance is segmented by origination year, it may become evident that loans written during certain time frames are performing less favorably than the portfolio as a whole.

    - Performance differences over time between loans that meet standards and those that do not. This analysis may include evaluating what types of exceptions tend to cause loan performance to break down and the impact of more than one underwriting exception.

- Assessment of economic and other market factors that might impact borrower performance and thus warrant changes to underwriting practices.

6. Transaction Testing:

Examine individual loans to assess compliance with FCA and the institution's loan underwriting guidance and applicable laws and regulations, and to evaluate effectiveness of underwriting-related internal controls.

Guidance:

The examination of underwriting practices should be supplemented as necessary with transaction testing conducted as part of FCA's loan review. The primary objectives of underwriting-related transaction testing are to:

- Determine if the institution is following its established underwriting direction.
- Verify the accuracy of underwriting reporting and analysis.
- Validate findings developed when completing other parts of this workprogram.

The following types of loans should be considered for underwriting-related transaction testing:

- Loans with exceptions to underwriting standards.
- Loans to new customers and loans representing new money to existing customers, with special emphasis on loans to customers with less favorable PD ratings.
- Loan exposures in portfolio segments that may be outside the institution's primary areas of expertise, such as loans in non-core industries, loan participations/syndications, out-of-territory volume, start-up project or construction financing, and loans to fund expansion activities.
- New loans or new money to existing customers in industries or portfolio segments where management has issued specific guidance to adopt more conservative underwriting.