FARM CREDIT ADMINISTRATION
■ Examination Manual

EM-41.1

Category:	**Earnings**
Topic:	**Earnings Adequacy**
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Overview

The *Earnings Adequacy* topic provides guidance on evaluating the quantity and quality of earnings and any significant risks to earnings. Strong earnings demonstrate to members, investors, and rating agencies that the institution has both the commitment and ability to maintain its financial strength. In addition, strong earnings provide the resources and financial strength to implement strategic initiatives.

Earnings adequacy is primarily a function of the quantity and quality of earnings, and the risks and threats that could cause a decline in earnings. The quantity of earnings focuses on past and projected trends in earnings amounts and earnings-related ratios and statistics. The quality of earnings addresses the composition, stability, and sustainability of each source of earnings. Risks to earnings focus on the adequacy of earnings in relation to the institution's various risk exposures. These factors are interrelated and should all be considered in the evaluation of earnings strength.

Examination Procedures and Guidance

General

1. Quantity & Quality:

Evaluate past and projected trends in earnings amounts and earnings-related ratios and statistics. Also, evaluate the composition of earnings and the quality and stability of significant earnings sources.

Guidance:

The quantity and quality of earnings are critical factors in evaluating the adequacy of earnings. An examination of earnings quantity is an evaluation of the amount of and trends in net income in relation to the institution's unique needs. The examination of earnings quality evaluates composition of net income and its impact on the institution's earnings capacity.

Evaluative questions and items to consider when examining the quantity and quality of earnings include:

- *Earnings Quantity:* **What are the current levels, trends, and causes of trends in earnings and earnings ratios? Do key earnings measures and ratios compare favorably with Financial Institution Rating System (FIRS) benchmarks, capital needs, and the board's earnings goals and business plan projections?** The quantity of earnings focuses on the level

and trends in net income and in key earnings measures. Earnings should be sufficient to cover expenses, provide for expected losses, build capital and achieve capitalization goals, generate an adequate rate of return, and ensure the institution's ongoing viability. While the FIRS benchmarks provide general guidelines on earnings adequacy, the amount of earnings needed depends on the institution's unique business model, risk profile, capital needs (including capitalization of growth), and operating environment. For example, high loan growth requires relatively higher earnings to capitalize the growth. In addition, all institutions should operate with a sound cushion of earnings to protect against emerging risks and downturns in business cycles that inevitably occur. The level of earnings should demonstrate (to institution members, FCA, investors, and rating agencies) the institution is committed to maintaining its financial strength and viability, and has sufficient earnings to capitalize and support future strategic initiatives. Comparisons of earnings measures to peer groups are useful but should consider differences in business models and asset characteristics, along with unique earnings needs.

- *Earnings Quality:* **What are the primary sources of earnings and are each of these sources stable, recurring and sustainable over the long-term, controllable, and central to the institution's principal business and mission? Is normalized net income (and return on assets) adequate after adjusting for all low quality sources of earnings?** The quality of earnings addresses the composition and sources of net income. The primary objectives when evaluating the quality of earnings are to determine if reported earnings represent the true economic performance of the institution, and if each key source of earnings is stable, sustainable, controllable, and generated by the institution's principal operating activities. For example, revenue recognized from an accounting adjustment would be considered a low-quality source of earnings because it doesn't represent the true economic performance of the institution and is nonrecurring. Likewise, a widening of spreads due to a temporary market anomaly would be considered low quality because it's driven by factors and markets outside the institution's control. By identifying and adjusting for items like these, the normalized net income and true earnings power of the institution can be determined. The following are examples that could indicate weaknesses in the quality of earnings:

  o Declining return on assets, net interest margin, or other key earnings measures.

  o Reversals of or unusually low provisions for losses.

  o Increasing or heavy reliance on earnings from high-risk or unstable business lines.

  o Increasing or heavy reliance on sources of income that are unusual, nonrecurring, noncore, or non-operating (e.g., tax credits or refunds, Farm Credit System Insurance Corporation refunds).

  o Fluctuations in key sources of earnings.

  o Changes in balance sheet composition, such as shifts to assets with lower spreads.

  o Changes in loan pricing that may result in lower spreads and fee income, such as increasing competitive pressures on spreads.

  o Declining net income from operations as a percentage of total revenues or total net income.

- Operating expense growth rate exceeding growth rates for net interest income and earning assets.

- Declining loanable funds as a percentage of interest earning assets.

- Large gains or losses on derivatives due to ineffective hedge positions or positions that do not use hedge accounting.

- Extraordinary accounting adjustments or increasing reliance on aggressive accounting practices, such as:

  - Early revenue recognition.
  - Capitalization or deferral of expenses.
  - Capital gains.
  - Inadequate asset impairment charges or allowance for loan losses.
  - Excessive impairment charges that are subsequently recovered and increase future profits.
  - Management of earnings through manipulation of accruals (evidenced in part by increasing divergence of net income compared to net cash flows from operations).

- *Local Earnings:* **Are locally generated earnings sufficient to meet the institution's earnings needs? If not, what are the primary causes?** Local earnings are defined simply as net income before patronage refunds received. Farm Credit System (System) institutions frequently receive patronage refunds as a source of earnings. Associations, for example, may receive patronage refunds from their funding bank or from other associations with whom they have business relationships. Such patronage refunds are typical under the federated cooperative business model (a federated cooperative is owned by local cooperatives). They are also consistent with an originating institution philosophy of maximizing earnings and subsequently distributing excess earnings after capital needs have been assessed. This *earn it first* philosophy contributes to the originator's (and System's) financial strength and risk-bearing capacity. Nonetheless, for the recipient, this source of earnings is at risk, out of the recipient's direct control, and can quickly change. This is especially true with patronage refunds designated as special or one-time. Therefore, institutions should not rely on this source of earnings to meet minimum earnings needs. The institution should have adequate local earnings to sustain sound financial performance if patronage income declines or disappears. If local earnings are inadequate, this condition should not be attributed to over-reliance on patronage refunds, but to the fundamental operational and strategic issues that are causing the inadequate local earnings (e.g., pricing, expenses, credit quality, provisions for losses, earnings philosophy, competitiveness, etc.).

- *Projected Earnings:* **Are projected earnings reliable and adequate in relation to earnings and capital?** The primary considerations when evaluating projected earnings are the reliability of projections, adequacy of earnings in relation to the institution's needs, and causes of significant changes in the composition of earnings. The assumptions underlying the projections are particularly important when making these determinations. For example, assumptions should be questioned if the institution has a large volume of nonaccrual loans and is assuming a 50 percent decline in only 1 or 2 years, or if unusually large recent provisions for losses due to increasing credit risk are assumed to return immediately to normal levels. The quality of earnings should also be a key consideration when evaluating

reliability of projected earnings. Low quality sources of earnings that are unsustainable should typically be excluded from projected earnings, depending on the unique circumstances. The following are additional considerations when reviewing the reliability of projected earnings:

- o Consistency of projections with previous earnings performance.
- o Past success in achieving projections.
- o Reasonableness and support for assumptions underlying projections.
- o Stability and sustainability of each key source of projected income.
- o Risks that may affect earnings.
- o Changes in business strategies or the operating environment that may impact projections.

2. Risks to Earnings:

Evaluate threats and risks to earnings.

Guidance:

Earnings are the return on the stockholders' capital investment and represent the first line of defense against capital depletion. A key financial concept is that the return should be commensurate with the risks taken. As risks increase, expected returns should also increase. The level of earnings, therefore, should be commensurate with the level and nature of all risks to which the institution is exposed. However, there is a limit on the extent to which earnings can compensate for higher risks. For example, even the strongest earnings can disappear quickly if widespread credit deterioration occurs. In addition, inadequate risk management can result in significant earnings volatility.

Institutions with unusually low risk exposures and strong capitalization may be able to operate in a safe and sound manner with relatively lower earnings. However, regardless of how low identified risks are, an earnings buffer is still needed to cover unidentified risks and continue prospering during adverse business cycles. No institution should operate with marginal earnings levels. Such institutions would be prone to financial failure because it's impossible to predict all risks that will emerge or to withstand the effects of business decisions or assumptions that prove incorrect.

Evaluative questions and items to consider when examining risks to earnings include:

- *Credit Risks:* **Does the quality or composition of assets present a significant threat to earnings? Is the allowance for credit losses adequate?** In System institutions, credit risk in the loan and investment portfolios is typically the most significant threat to earnings. Deterioration in the quality of individual assets can result in nonearning assets that reduce net interest income and increase provisions for losses or impairment charges. Credit concentrations can result in more widespread deterioration in the portfolio and increased servicing costs to manage higher risk assets. Such widespread credit deterioration can cause even the strongest earnings to quickly disappear. A highly diversified portfolio, such as a portfolio of small loans with low risk correlations, can help insulate the institution against business cycles. Sound loan and investment portfolio management processes (particularly underwriting practices, credit administration, and risk identification) are critical to managing credit risks and ensuring stable and reliable earnings.

- *Other Risks:* **Does the institution's exposure to other risks pose a significant threat to earnings?** While credit risk is typically the primary threat to earnings, other risks can also

pose a significant threat. Other risks to earnings may include the following:

- o *Interest Rate Risk* – Changes in market interest rates can adversely affect earnings depending on the structure of assets, liabilities, and off-balance sheet exposures.

- o *Liquidity Risk* – Penalties, fees, and higher interest rates on funding might be assessed as liquidity risk increases.

- o *Strategic Risk* – Incorrect business decisions and strategies, improper implementation of strategies, or lack of responsiveness to changes in business conditions can adversely affect earnings.

- o *Operations Risk* – Fraud or inadequate internal controls, processes, and management systems can result in losses.

- o *Reputational Risk* – Negative public and investor opinion or perception can result in a decline in the customer base, increased exposure to litigation, increased cost of funding, or other effects that impact earnings.

- o *Compliance Risk* – Nonconformance with Federal laws and regulations can result in fines, penalties, or voiding of contracts.

- *Off-Balance Sheet Risks:* **Do off-balance sheet risks and contingent liabilities pose a significant threat to earnings?** Many of the risks discussed above can emanate from off-balance sheet liabilities and contingencies. Common examples include litigation, unfunded commitments on adverse or nonaccrual loans, letters of credit, guarantees by the institution, and requirements to repurchase loans previously sold (triggered by violations of representations and warranties). Each of these off-balance sheet exposures will likely result in losses if the institution is required to fund and bring it onto the balance sheet.

- *Stress Test Results:* **Do results of the institution's stress tests indicate earnings are reasonably insulated against potential risks?** Results of stress tests can provide valuable information on risks to earnings. Stress tests can be performed on credit risk, off-balance sheet risk, interest rate risk, and other significant sources of risk. The usefulness and interpretation of stress test results should consider the reliability, plausibility, severity, and conceptual soundness of the stress test scenarios along with whether the scenarios appropriately focus on the institution's primary risk exposures.