EM-22.2

Category: **Loan Portfolio Management**
Topic: **Risk Identification**
Published: 6/14/2023

Overview

The *Risk Identification* topic provides guidance on evaluating a Farm Credit System (System) institution's guidance and controls for identifying credit risk. Accurate and reliable risk identification is essential to effectively managing an 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 should 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 its 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 investments 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) and OPO are considered criticized assets. Adversely classified and criticized asset amounts 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 higher-risk loans with a guarantee against loss, could have a less favorable 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, the institution 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.

- ***Direct Loan (banks only):*** **Do bank processes support proper identification of risk in direct loans?** Banks typically use the UCS and risk ratings (PD and LGD) to identify and report risk in direct loans. It is important for banks to assess risk in direct loans through ongoing discussions with association management, General Financing Agreement (GFA) monitoring, audit and review activities, and lending guideline comparison. This assessment should include consideration of objective financial performance indicators and ratios as well as subjective factors such as material events, board governance, management depth and experience, and volatility in risk profile. This assessment may include bank scoring metrics (e.g., Contractual Interbank Performance Agreement). Guidelines used by the banks in assessing direct loan risks may be similar to those typically used by examiners to evaluate the credit factors of institutions using the Financial Institution Rating System (FIRS) benchmarks. As outlined in EM-1.3 FIRS, the FIRS benchmarks provide general guidelines on the adequacy of key areas for an institution, as well as the overall risk profile of an institution through its composite and component ratings.

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 Systemwide reporting to investors and FCA. As a result, it is important that all institutions strive to align internal guidance on risk ratings with Systemwide 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 Systemwide 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. The institution should document and support any material differences between its guidance and the System guidance.

- ***Models*: Are the models used for assigning risk ratings managed in accordance with the institution's model risk management (MRM) framework and the guidance outlined in FCA's *Model Risk Management* procedure in the *Direction & Control of Operations* Examination Manual topic?** These models should be included in the institution's model inventory, which should accurately represent each model's risk, materiality, and validation status. Model validation, change controls, staffing, separation of duties, and new model development should be consistent with the guidance in the institution's MRM framework and FCA's *Model Risk Management* procedure, recognizing that application of this guidance varies based on model risk and materiality. *Note: Examiners completing this procedure should focus on the specific model(s) being used; the overall MRM framework is examined using the Model Risk Management procedure referenced above.*

- ***Judgment:* Do processes for assigning risk ratings allow for sufficient judgment when evaluating objective and subjective factors?** For example, 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?** The institution should have documented processes for ensuring coordination with other System institutions that are involved in the same assets. This would include coordination as either the designated System customer 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 customer 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?** The institution 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 lending staff 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 loans and loans 90-days past due and 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 and performance. 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

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 Regulations 621.6 and 621.7, which provide criteria on each performance category, OPO, and the rule of aggregation. Effective 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 Regulations 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. The institution 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 Regulations 621.10(a)(1) and (2) require 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 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 the institution may have 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, the institution 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 Interagency Policy Statement on Prudent Commercial Real Estate Loan Workouts developed by other federal regulatory agencies for additional information on evaluating performance category designations and OPO.

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 and loan portfolio management processes. 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

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?** Updated guidance should be maintained so it is consistent with GAAP, FCA guidance, and System accounting guidelines. Policies and procedures should specifically address issues such as:
    - 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).
    - Loan loss accounting, specifically chargeoffs, recoveries, and allowances on assets evaluated individually for expected credit losses (FCA Regulation 621.5). Refer to the *Allowance for Losses* Examination Manual topic for further guidance on assets evaluated individually for expected credit losses.
    - Recognition of losses, recoveries, income, and expenses on OPO and sales contracts.
    - Appropriate management and disposal of OPO. This may include expectations for acquiring title, maintaining the property, marketing the property, and complying with state and local laws. All sales and leases of OPO must comply with right of first refusal requirements, as addressed in the *Borrower Rights* Examination Manual topic.
- ***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 analyses identifying appropriate chargeoffs, recoveries, and allowances on assets evaluated individually for expected credit losses. 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 and 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 an 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.

Note: This procedure focuses on evaluating the reliability and effectiveness of internal audits and reviews in this topical area. Refer to the *Audit & Review Programs* topic in the Examination Manual for guidance on examining the overall internal audit and review program.

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 and depth of work, including transaction testing, should cover the primary processes and controls within the area being audited or reviewed and be sufficient to determine if internal controls are functioning as intended and regulatory requirements are met. The scope and depth of coverage should be documented and consistent with the approved audit or review plan and engagement contract (if applicable). Audit or review workpapers should be examined to verify the actual scope and depth of work performed. The workpapers may indicate the scope and depth deviated from what was identified (or implied) in the audit plan. For example, workpapers may indicate the work performed was limited to evaluating the existence of policies and procedures and didn't include reviewing other controls, such as training or reporting, or testing compliance with regulations or institution guidance. If the work deviated materially from the original planned scope, internal audit should notify the board (or Audit Committee, if so delegated) of the reasons for the change. Specific items that should be considered in the audit or review scope include:

- Risk identification policies and procedures.
- Compliance with risk identification policies, procedures, System risk rating guidance, FCA Regulations, and other FCA guidance.
- Monitoring and control processes (e.g., reporting, management oversight, delegated authorities, separation of duties, management information systems and data).
- Sufficient transaction testing to ensure accurate asset classifications, risk ratings, performance category designations, and high-risk asset accounting.
- Management of all significant risk identification models, including consistency with the institution's overall model risk management framework.
- Fraud-related threats and vulnerabilities, as well as anti-fraud controls.

- ***Loan Sampling:*** **Was an appropriate loan sampling process used?** It is important to understand how the loan sample was selected to determine if relevant information was considered. The loan sampling methodology should evidence appropriate use of data tools to be consistent with population size and target specific risk factors. For example, a loan sample may be based on specific loan attributes (e.g., size, risk rating, commodity, region) or other factors such as commodity specific adversity, changes in lending staff, or previous risk identification weaknesses. The loan sample methodology should be clearly documented and reported. In addition, loan sampling processes should consider periodic, branch or regional audits and reviews, including review of some loan transactions without advance notice.

- ***Reliability of Results:*** **Did FCA identify any concerns with audit or review reliability?** It is important to understand the scope and depth of the audit or review being examined, as discussed above, when evaluating audit or review reliability. With this understanding, the following are key considerations when evaluating the reliability of audit or review results:

  - *FCA Testing* – 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 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. This can be especially important if the audit or review report is not sufficiently detailed or FCA's examination work and testing identifies potential concerns. Auditors and reviewers complete line sheets, flowcharts, control matrices, standard work programs, workpaper forms, or other relevant audit evidence when conducting and supporting their work. (IIA Standards 2240, 2300, 2310, and 2320) Workpapers should adequately document the work performed and support the final report. If FCA identifies weaknesses that were not identified in the audit or review, the cause for any discrepancy should be determined.

  - *Audit/Review Staffing* – Whether internal or outsourced, auditors and reviewers conducting the work need to be qualified, independent, and objective to ensure reliable results. They should have the right mix of knowledge, skills, and other competencies needed to perform the work. (IIA Standard 2230) Additionally, auditors and reviewers need to be independent of the activities they audit so they can carry out their work freely and objectively. (IIA Standards 1100, 1112, 1120, and 1130) For example, audit and review staff should not be involved in developing and installing procedures, preparing records, operating a system of internal controls, or engaging in any other activity that they would normally review. Examiners should evaluate the staffing on the individual audit or review being examined as part of determining the reliability of results.

  - *Institution Review of Work Performed* – The institution should complete an independent review of the workpapers to ensure audit or review objectives and scope were met and the results and conclusions were reliable and supported. (IIA Standard 2340) Examples could include a supervisory review of in-house audit work by the Chief Audit Executive (CAE) or other audit staff, or a review of outsourced work by the CAE or audit coordinator. Examiners should consider whether the institution completed these reviews, and if any concerns were identified, when concluding on audit or review reliability.

- ***Reports:* Does the internal audit or review report 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 and communicated 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? (IIA Standards 2330, 2400, 2410, 2420, 2440, and 2450)

  - Are conclusions and recommendations realistic and reasonable, 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?

  - Do results in the workpapers align with report conclusions?

  - 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 audit or 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 commitments and agreements or any areas of disagreement should be documented in the report or in a separate memo or tracking system. (IIA Standards 2500 and 2600) If corrective actions are not resolving the issues or concerns in a timely manner, 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 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.

Guidance:

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 and risk ratings.

- 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, OPO, chargeoffs, and recoveries). Guidance on transaction testing of loans evaluated individually for credit losses is included in the *Allowance for Losses* Examination Manual topic.

- Whether credit staff 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 risk ratings, loan classifications and chargeoffs on shared assets. Any differences should be justified and documented.

FCA transaction testing will typically 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 extent of testing risk identification on individual loans should depend in part on the conclusions reached when completing the various *Risk Identification* examination procedures. If examination results indicate the institution has adequate guidance and effective internal controls (including independent internal credit review coverage and reliability) in place to ensure accurate risk identification practices, limited testing of individual loans to verify these conclusions may be all that is necessary. The loan sample may need to be expanded if examiners identify weaknesses in risk identification or transaction testing results indicate that policies, procedures, and controls are not being followed, functioning as intended, or achieving the desired results. Alternatively, if conditions warrant, we may ask the institution to complete an independent review to fully test whether controls are working as intended. To determine the appropriate sample size for testing the institution's risk identification processes, examiners should also consider the following factors:

- Previous examination, internal review, or other third-party testing and results.
- Changes to credit guidance and the internal control environment.
- Changes in lending operations or programs.
- Changes in management or lending staff.
- 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, with an emphasis on evaluating internal audit and review program reliability. In addition to focusing on the accuracy of risk identification, it is important to evaluate the timeliness of classification and risk rating changes, especially as credit risk is increasing. It is also important to test the accuracy of risk identification on marginally Acceptable and higher risk loans, because higher risk loans can have a greater impact on the allowance for credit losses and the institution’s financial condition. FCA’s Informational Memorandum on Servicing Loans to Borrowers in Distressed Industries dated January 21, 2016 provides guidance for properly identifying risk in a stressed environment.

Direct Loan Considerations (banks only): A sample of direct loans classified Acceptable, Special Mention, and Adverse should be considered in the examination scope. Depending on the number of other financing institutions (OFIs) in the district, a sample of or all OFI direct loans should be included. Additionally, participation interests purchased in direct loans should be included, if applicable.

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.

Direct Loan Considerations (banks only): Loan narratives should be commensurate with the risk in the direct loan or OFI. While FCA does not directly use FIRS ratings to classify direct loans under the UCS, there is an important link between the two systems. For example, associations with FIRS composite and component profiles of “1” and “2” are usually classified Acceptable under the UCS due to fundamentally safe and sound conditions. Conversely, associations with FIRS composite ratings of “3” (or worse) generally have risk profiles and performance weaknesses that translate to potential (Special Mention) or well-defined (Substandard) credit factor weaknesses under the UCS. Examiners should carefully consider conditions that cause the composite rating or a component rating to be a “3” or worse to evaluate if these conditions represent a potential or well-defined weakness, which would result in a less-than-Acceptable UCS classification. Examiners should also examine the bank’s due diligence in any participation interests purchased in direct loans, including the bank’s communication and coordination with the originating funding bank.