Introduction – Asset Quality

Most bankers and examiners will agree that the single greatest risk in banking is the risk of loan losses. This is because loans typically comprise a majority of the assets in most banks. It's not hard to imagine an entire year's worth of earnings being completely eliminated because of one or two large loans being charged off. Because the exposure is so vast, examiners spend a significant amount of time assessing asset quality, primarily loan quality, at almost every examination. Of course, given the size of the exposure, we think the directorate should spend a significant amount of time assessing this risk as well, in formulating loan policies, attending loan committee meetings, reading credit reviews, and reviewing various management reports on the condition of the loan portfolio. This lesson will explain how examiners assess loan quality and how directors can keep a more watchful eye on their bank's loan portfolio. We will review the examiner's comments about asset quality for our sample bank and let you recommend some corrective measures and assign a rating to the component. Go to the "Next" button below to begin the instructional content for asset quality.

Instructional Content – Asset Quality

Overview

In evaluating asset quality, examiners will look at the existing and **potential** loss exposure, primarily in your loan portfolio, but also in the investment portfolio and other assets as well. As with every CAMELS component, we put a lot of weight on management's ability to recognize and control portfolio risk. Even if your bank has very few adversely classified assets, asset quality could still be rated less than satisfactory because management is not adequately controlling the **potential** credit risks. Keep in mind, our conclusions about asset quality will directly impact the other component areas, such as capital, earnings, and especially management.

Evaluation Factors

The assessment of asset quality involves much more than simply calculating past due and adverse classification ratios. In addition to assessing trends in classified assets, delinquent loans, and credit concentrations, the asset quality component rating takes into account management's ability to underwrite and administer credits in a prudent and sound manner.

What Should a Director Do?

As directors, you have four primary responsibilities in the asset quality area:

1. Adopt effective policies before loans are made
2. Enforce those policies as the loans are made
3. Monitor the portfolio after the loans are made
4. Maintain an adequate Allowance for Loan and Lease Losses (ALLL)

1. Adopt Effective Loan Policies

In today's environment, the need for effective policies is more critical than ever before. New products, new regulations, merger activity, etc. require that the board effectively convey their risk tolerance to the loan officers. Make sure it is your credit culture that the loan officers are adhering to, not their previous employer. Listed below are other items to keep in mind as you annually revise your loan policy.

- **Send a clear message -** Don't confuse your loan officers with a loan policy that sounds conservative when management stresses growth. Whatever your plan is, use your policies as a guide to achieve that plan.

- **Customize your policies to suit your institution** - There is no "one size fits all" loan policy just like there is no "one size fits all" for an audit program or business resumption plan. While examiners don't expect boards to reinvent the wheel, you will still need to take a generic policy and tailor it to your own size, products, risk tolerance, etc.

2. Enforce Adherence to the Loan Policies

The two largest aspects of enforcing policy adherence are (1) requiring loan officers to provide comprehensive credit memos/write-ups to the loan committee during the approval process that identify exceptions to the loan policy, and (2) ensuring that an effective loan review function is in place to review the loans after they are approved (discussed below). Loan officers should be required to address exceptions to the loan policy in their credit approval memos/write-ups. The loan officers should explain why the exceptions are necessary and how the exposure is mitigated. This gives you and/or other approving officials the ability to track exceptions in monthly reports and ensures that the loan officers are familiar with the policy. Keep in mind that loan officers have been known to deliberately structure loans to avoid bringing them to loan committee. This exposure can be mitigated by requiring your bank's loan review process to review smaller loans, under the loan committee threshold, for exceptions to the loan policy.

3. Monitor the Loan Portfolio

After loans are made, directors should be monitoring the portfolio to determine if the credits are being administered properly and what the overall condition of the portfolio is. At a minimum, directors should provide for an effective credit review program and review a variety of management reports on the loan portfolio during the board meetings.

- **Management Reports** - The monthly board packages should include a variety of loan reports, including a watch list detailing all problem or potentially problem credits. The package should also contain a delinquency report, a listing of new and renewed credits, the results of the internal or external loan reviews, and asset concentration reports. The board should require management to explain changes or trends and should require accuracy and objectivity in the reports. For example, an examiner should rarely be the one to convey bad news regarding a credit. If your loan officers and management teams are truly monitoring their portfolios, then they should be the first to downgrade credits. Having a lot of downgrades at an examination indicates an internal control weakness that will impact not just the asset quality rating but also the management component rating.

- **Loan Review Systems** – Every bank should have a loan review system that, among other things, accurately assigns risk ratings and promptly identifies loans or industries that are developing credit weaknesses. This allows senior management and the board to take appropriate action to mitigate risks and provides them with the information needed to assess the adequacy of the ALLL.

The complexity of the loan review process will vary based upon a bank's size and type of operations and could be performed internally or externally.

Directors should ensure that the scope of the loan review covers all significant credits or pools of credits. Besides large loans and known problem credits, you might want your credit review to target loans from a specific branch, department, or officer - especially if they have generated an unusually large amount of business. The review could also focus on concentrations to a particular industry or collateral type, or areas that the board has deemed to be a higher risk. Expect management to address all of the concerns identified in the loan review reports and expect status reports and timelines for correction in an audit tracking report.

4. Maintain an Adequate ALLL

The board and management are responsible for maintaining an allowance for loan and lease losses that is adequate relative to the estimated credit losses in the loan portfolio. The adequacy of the ALLL should be evaluated at least quarterly based on a comprehensive analysis of the portfolio, including the loan review process that we discussed above. The ALLL analysis should include all significant, classified, and past due credits, with the remaining portfolio segmented into separate components based on similar characteristics, such as grade, loan type, etc. While historical loss experience provides a reasonable starting point for the analysis, this is not a sufficient basis for determining an appropriate ALLL. The ALLL analysis should also consider factors such as:

- Changes in lending procedures and/or staff
- Changes in the nature and volume of loans
- Trends in past due and adversely classified credits
- The existence of credit concentrations
- Changes in local and national economic conditions

If you would like more guidance on the allowance, please review the Interagency Policy Statement on the ALLL at http://www.fdic.gov/regulations/laws/rules/5000-4700.html

Concentrations

We've mentioned concentrations several times throughout this exercise. This is certainly an area that regulators are concerned with and is an area that is starting to receive more attention. A concentration is a large volume of economically related assets by borrower, industry, or collateral type. Concentrations are not necessarily a reflection of inadequate management; they are oftentimes created by factors such as location, economic environment, or a given bank's market niche. However, the additional risk requires higher levels of capital and oversight. The board should consider these concentrations when formulating growth plans and policies, including establishing prudent limitations as a percentage of capital. All concentrations should be monitored closely by management

and receive a more in-depth review than the more diversified portions of the institution's assets - the greater the concentration, the greater the need for monitoring. The board needs to monitor the exposure via management reports detailing the dollar volume of the exposure, industry status, supply and demand trends for that type of property, or changes in underwriting standards. You should be getting enough information so that you can feel comfortable that management is controlling the risk. This is one of the more critical responsibilities of a director, since credit concentrations have been a factor in a very high percentage of bank failures.

UBPR Analysis of Asset Quality

Now that you are armed with some information on how regulators evaluate and rate asset quality, as well as some suggestions on where you should focus your attention, let's apply this knowledge to First State Bank.

The UBPR is a good starting point to begin extracting asset quality information. It is a very useful tool for identifying trends or outlying performance issues relative to a group of similar banks. Examiners use the UBPR to plan for examinations by identifying areas with potential credit exposure. Nonetheless, the UPBR will only take you so far in painting a picture of asset quality. The onsite portion of the examination will build upon the UBPR analysis and so should your board reviews.

Several financial ratios relating to asset quality are available in the UBPR. These ratios provide detail on balance sheet composition, off-balance sheet commitments, delinquencies, charge-offs, and portfolio mix. We are only going to focus on four ratios in our brief exercise, but we invite you to go to www.ffiec.gov and review the significant amount of information that we have compiled on your bank. Four ratios to focus on when assessing asset quality include:

1. **Asset Growth Rate** - This ratio details the change in total assets over the past 12 months.

2. **Non-current Loans and Leases to Gross Loans and Leases** - This ratio reflects the percentage of loans that are 90 days or more past due, or are no longer accruing interest.

3. **Net Losses to Average Total Loans and Leases** - This ratio presents the level of net losses, on an annualized basis, as a percentage of the total portfolio. It takes into consideration any recoveries on prior period losses.

4. **Loan and Lease Allowance to Total Loans -** This ratio measures the allowance available to absorb loan losses relative to total loans outstanding.

Let's review the UBPR for First State Bank and analyze these four ratios. They are detailed on the Summary Ratios page (page 1) and, as always, we will assess level and trend.

CERT# 12345 FIRST STATE BANK
CHARTER# 311 COUNTY: MADISON SUMMARY RATIOS

	12/31/2004			12/31/2003			12/31/2002		
AVERAGE ASSETS ($000)		182,836			145,180			143,139	
NET INCOME ($000)		2,084			2,018			1,961	
	BANK	PEER	PCT	BANK	PEER	PCT	BANK	PEER	PCT
EARNINGS AND PROFITABILITY:				*EARNINGS*					
PERCENT OF AVERAGE ASSETS:									
INTEREST INCOME (TE)	8.28	7.79	65	7.74	7.56	62	7.67	7.49	66
- INTEREST EXPENSE	3.63	3.55	69	3.36	3.33	51	3.34	3.31	51
NET INTEREST INCOME (TE)	4.65	4.24	66	4.38	4.24	58	4.33	4.18	61
+ NONINTEREST INCOME	0.52	0.75	38	0.58	0.74	35	0.50	0.72	38
- NON-INTEREST EXPENSE	2.89	2.92	46	2.64	2.95	34	2.53	2.87	33
- PROVISION: LOAN&LEASE LOSSES	0.37	0.16	61	0.16	0.17	49	0.16	0.14	51
= PRETAX OPERATING INCOME (TE)	2.01	1.90	63	2.16	1.85	75	2.14	1.87	81
NET INCOME	1.14	1.26	49	1.39	1.23	63	1.37	1.24	59
MARGIN ANALYSIS:									
NET INT INC-TE TO AV EARN ASSET	4.89	4.53	67	4.51	4.55	53	4.44	4.48	45
LOAN & LEASE ANALYSIS:				*ASSET QUALITY*					
NET LOSS / AVERAGE TOTAL LN&LS	0.22	0.12	84	0.14	0.12	56	0.16	0.14	56
LN&LS ALLOWANCE/TOTAL LN&LS	1.13	1.28	43	1.30	1.29	55	1.26	1.3	48
NON-CURRENT LN&LS/ GROSS LN&LS	3.11	0.81	89	1.01	0.83	62	1.02	0.79	63
LIQUIDITY:				*LIQUIDITY*					
NET NONCORE FUND. DEPENDENCE	21.76	15.22	68	15.25	15.09	53	15.05	14.72	54
NET LOANS & LEASES TO ASSETS	76.94	65.74	76	65.01	64.04	55	63.23	66.18	47
CAPITALIZATION:				*CAPITAL*					
TIER ONE LEVERAGE CAPITAL	8.08	9.11	41	9.61	9.09	56	9.18	9.14	54
CASH DIVIDENDS TO NET INCOME	60.55	40.04	88	59.61	40.54	89	55.69	40.35	89
GROWTH RATES:									
ASSETS	33.60	8.58	78	2.77	7.23	14	1.63	8.68	15
TIER ONE CAPITAL	5.89	12.81	42	6.21	12.78	38	7.51	12.45	37
NET LOANS & LEASES	62.56	12.92	89	6.59	11.71	32	1.13	9.72	20
SHORT TERM INVESTMENTS	-50.88	11.28	15	2.37	13.61	35	5.58	11.03	41
SHORT TERM NON CORE FUNDING	35.43	8.16	78	1.91	8.14	37	2.33	12.14	36

OK, now let's talk about what you discovered. Consider the following:

1. Asset Growth Rate – What is the rate of asset growth and how would you characterize this growth?

[Answer] The asset growth rate for the past year is 33.60%. This is a significant increase from the two prior years of 1.63% and 2.77%, and significantly higher than peer. This is clearly something the directors should be aware of and monitoring.

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2. What category dominated asset growth?

[Answer] Growth was centered in loans at 62.56% at the expense of short term investments, which declined by more than 50%.

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3. Non-current Loans to Gross Loans – The ratio of non-current loans to gross loans is 3.11%.
How would characterize the level of delinquencies?

[Answer] The ratio has risen dramatically and is high relative to peer.

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4. Net Losses to Average Total Loans – This ratio is 0.22%. What has the trend been?

[Answer] The ratio has not increased dramatically but it is higher than peer and trending upwards. Potential problems are not yet impacting the portfolio.

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SHORT TERM NON CORE FUNDING	35.43	8.16	78	1.91	8.14	37	2.33	12.14	36

5. Loan and Lease Allowance to Total Loans and Leases – This ratio is 1.13%. What conclusions can you draw about the adequacy of the allowance?

[Answer] Nothing definite, this is almost a trick question! There is NO benchmark or acceptable range for the ALLL. An assessment of ALLL adequacy will consider past loss history, changes in underwriting standards, economics, etc. We can see, however, that the provision expenses have not kept pace with portfolio growth resulting in a deteriorating allowance as a percent of total loans. Additionally, examination findings will suggest that the risk profile is rising, which will necessitate a higher rather than lower ALLL. (Requirements for ALLL calculation methodologies are fully detailed in the July 2001 Interagency Policy Statement on the ALLL)

CERT# 12345

CHARTER# 311 COUNTY: MADISON

FIRST STATE BANK

SUMMARY RATIOS

	12/31/2004			12/31/2003			12/31/2002		
AVERAGE ASSETS ($000)		182,836			145,180			143,139	
NET INCOME ($000)		2,084			2,018			1,961	
	BANK	PEER	PCT	BANK	PEER	PCT	BANK	PEER	PCT
EARNINGS AND PROFITABILITY:				*EARNINGS*					
PERCENT OF AVERAGE ASSETS:									
INTEREST INCOME (TE)	8.28	7.79	65	7.74	7.56	62	7.67	7.49	66
- INTEREST EXPENSE	3.63	3.55	69	3.36	3.33	51	3.34	3.31	51
NET INTEREST INCOME (TE)	4.65	4.24	66	4.38	4.24	58	4.33	4.18	61
+ NONINTEREST INCOME	0.52	0.75	38	0.58	0.74	35	0.50	0.72	38
- NON-INTEREST EXPENSE	2.89	2.92	46	2.64	2.95	34	2.53	2.87	33
- PROVISION: LOAN&LEASE LOSSES	0.37	0.16	61	0.16	0.17	49	0.16	0.14	51
= PRETAX OPERATING INCOME (TE)	2.01	1.90	63	2.16	1.85	75	2.14	1.87	81
NET INCOME	1.14	1.26	49	1.39	1.23	63	1.37	1.24	59
MARGIN ANALYSIS:									
NET INT INC-TE TO AV EARN ASSET	4.89	4.53	67	4.51	4.55	53	4.44	4.48	45
LOAN & LEASE ANALYSIS:				*ASSET QUALITY*					
NET LOSS / AVERAGE TOTAL LN&LS	0.22	0.12	84	0.14	0.12	56	0.16	0.14	56
LN&LS ALLOWANCE/TOTAL LN&LS	1.13	1.28	43	1.30	1.29	55	1.26	1.3	48
NON-CURRENT LN&LS/ GROSS LN&LS	3.11	0.81	89	1.01	0.83	62	1.02	0.79	63
LIQUIDITY:				*LIQUIDITY*					
NET NONCORE FUND. DEPENDENCE	21.76	15.22	68	15.25	15.09	53	15.05	14.72	54
NET LOANS & LEASES TO ASSETS	76.94	65.74	76	65.01	64.04	55	63.23	66.18	47
CAPITALIZATION:				*CAPITAL*					
TIER ONE LEVERAGE CAPITAL	8.08	9.11	41	9.61	9.09	56	9.18	9.14	54
CASH DIVIDENDS TO NET INCOME	60.55	40.04	88	59.61	40.54	89	55.69	40.35	89
GROWTH RATES:									
ASSETS	33.60	8.58	78	2.77	7.23	14	1.63	8.68	15
TIER ONE CAPITAL	5.89	12.81	42	6.21	12.78	38	7.51	12.45	37
NET LOANS & LEASES	62.56	12.92	69	6.59	11.71	32	1.13	9.72	20
SHORT TERM INVESTMENTS	-50.88	11.28	15	2.37	13.61	35	5.58	11.03	41
SHORT TERM NON CORE FUNDING	35.43	8.16	78	1.91	8.14	37	2.33	12.14	36

Of course, UBPR analysis is a starting point. Let's move on in our examination exercise and see what else we can learn about asset quality at First State Bank.

Examination Exercise – Report of Examination

The Report of Examination provides several useful pages for assessing asset quality. As with all of the other CAMELS components, the Examination Conclusions and Comments page provides a summary of the examination findings, along with support for the examiner's rating. The Examination Data and Ratios page will present the volume and severity of adversely classified assets and the Items Subject to Adverse Classification page will have detailed write-ups for the larger classified loans and those that examiners are grading more harshly than management. These write-ups are worth reading because they may contain information that your management team may not have given you previously. Finally, the Concentrations page will detail concentrations identified by examiners. Hopefully, your management team has been providing you with this information for as long as the concentrations have existed; however, this is a good secondary check for directors.

See what the examiners said about asset quality at First State Bank.

Examination Conclusions and Comments

ASSET QUALITY

Asset quality has deteriorated. Adversely classified items to Tier 1 Leverage Capital and the Allowance for Loan and Lease Losses (ALLL) now total 37%, up from 23% at the prior examination. The severity of adversely classified items has also increased as assets classified Doubtful and Loss total $1.2 million, or 26% of total adverse classifications - up from $177,000 at the prior examination.

The increase in classifications is a direct result of more liberal credit practices and lax loan documentation, particularly within the commercial real estate and construction loan portfolios. Management has aggressively pursued these loans despite the economic downturn in its trade area. The bank now has significant concentrations of credit in commercial real estate and construction loans, aggregating 480% and 530% of Tier 1 Capital, respectively. These figures exceed policy maximums, and rather than control these risks, the board opted to increase policy risk limits. Furthermore, management has exceeded the loan-to-value guidelines contained in Part 365 of the FDIC's Rules and Regulations on many loans, and an excessive 62% of loans reviewed contained documentation exceptions.

Management's monitoring of loan concentrations is deficient. Concentration reports show only the bank's aggregate exposure to commercial real estate and construction loans rather than segmenting the portfolios by loan type/collateral, etc. These reports do not allow management to adequately identify, manage, and monitor concentration risk. Refer to the Concentrations page for further details.

Loan Policy

The Loan Policy does not establish prudent guidelines for loan concentrations and provides inadequate guidance for commercial real estate and construction lending. As a result, loan concentrations are excessive and are not being properly monitored or controlled. Additionally, asset quality has deteriorated due to weak loan underwriting and credit administration practices. The Loan Policy is again criticized for its lack of sufficient guidance for underwriting commercial real estate and construction loans. The policy does not:

- Establish prudent credit concentration guidelines
- Establish effective concentration monitoring and reporting procedures
- Require comprehensive analysis of cash flow and repayment ability
- Specify the type of financial information and other documentation necessary for each loan type
- Require property inspections on commercial real estate and construction loans

Loan Underwriting Weaknesses

- Credit memos do not provide a clear assessment of repayment capacity - many real estate credits are approved based solely on collateral values with no cash flow analysis performed
- Loan documentation weaknesses are again noted at this examination – an excessive 62% of the credits reviewed contained documentation exceptions
- Property inspections are not being prepared for all commercial properties

Credit Administration Weaknesses

- Ongoing loan documentation is poor as updated financial statements are not being acquired
- Management's internal credit review is based solely on delinquency
- The watch list is inadequate - many of the credits classified in this examination were not classified internally

Allowance for Loan and Lease Losses (ALLL)

The ALLL methodology is inadequate and a provision of at least $500M is needed to replenish the ALLL following the credit losses identified during the examination. The methodology needs to be revised to include the following items from the Interagency Policy Statement on ALLL Methodologies and Documentation:

- The performing portion of the loan portfolio should be stratified into groups with similar characteristics
- Reserves should be assigned based on the risk present in each group
- Factors such as changes in economic trends, underwriting standards, and portfolio growth should be considered in determining an adequate reserve level.

Discussion Points – Asset Quality

The examination identified a number of significant weaknesses with regard to the bank's rapid expansion. Some of the more significant concerns related to asset quality include the following:

- The volume and severity of adversely classified items rose substantially to 37% of Tier 1 Capital and the ALLL
- Deterioration in asset quality is a result of more liberal credit practices and lax loan documentation
- Credit approval memos do not provide a clear assessment of the borrowers' repayment ability
- Loan documentation exceptions were noted in 62% of the loans reviewed
- The internal loan review and watch list process are inadequate
- The methodology for determining an appropriate Allowance for Loan and Lease Losses is insufficient
- Management and the board are not adequately monitoring significant concentrations of credit
- The loan policy is inadequate with regard to concentrations, commercial real estate lending, and construction lending

The problems cited above signify failures with regard to management and board oversight. As a board member, what are some of the actions that you would take to address these concerns? We have detailed potential solutions below, and in a normal Report of Examination, you would see these recommendations detailed in the Examination Conclusions and Comments pages. Click on the items below for recommendations to improve management and board oversight.

- (Potential Answer number 1) Revise the Loan Policy to require more stringent credit practices and loan documentation standards
- (Potential Answer number 2) Revise the Loan Policy to provide more guidance over commercial real estate and construction lending
- (Potential Answer number 3) Revise the Loan Policy to establish more prudent limits for concentrations and require more rigid monitoring and reporting processes for concentrations
- (Potential Answer number 4) Enforce the Loan Policy and require exceptions to be reported to, and approved by, the board
- (Potential Answer number 5) Require more detailed credit approval memos from the loan officers
- (Potential Answer number 6) Stop/slow loan growth until management has properly addressed underwriting and administration weaknesses
- (Potential Answer number 7) Determine if the experience and abilities of the lending staff are sufficient relative to the portfolio and portfolio growth
- (Potential Answer number 8) Improve the internal loan review and grading function

Rating Asset Quality

The findings are substantial and will clearly have a negative impact on the asset quality rating. Click on the link below to review the regulatory rating guidelines and determine which rating best fits this bank. Keep in mind that the asset quality rating incorporates both the quantity of adverse classifications and quality of underwriting/administration practices.

Rating Asset Quality - Continued

The following is an excerpt from the Uniform Financial Institutions Ratings System. Read the ratings guide and rate the asset quality component for First State Bank.

Uniform Financial Institution Ratings System

The asset quality rating reflects the quantity of existing and potential credit risk associated with the loan and investment portfolios, other real estate owned, other assets, and off-balance sheet items. The ability of management to identify, measure, monitor, and control credit risk is also reflected here. The evaluation of asset quality should consider the adequacy of the allowance for loan and lease losses. The asset quality of a financial institution is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The adequacy of underwriting standards, credit administration, and risk identification practices
- The level, distribution, severity, and trend of problem assets
- The adequacy of the Allowance for Loan and Lease Losses
- The credit risk arising from off-balance sheet transactions such as unfunded commitments and commercial or standby letters of credit
- The existence of asset concentrations
- The adequacy of loan and investment policies, procedures, and practices
- The ability of management to properly administer its assets, including the timely identification and collection of problem assets
- The adequacy of internal controls and management information systems
- The volume and nature of credit documentation exceptions

Ratings

1 A rating of “1” indicates strong asset quality and credit administration practices. Identified weaknesses are minor in nature and risk exposure is modest in relation to capital protection and management's abilities. Asset quality in such institutions is of minimal supervisory concern.

2 A rating of “2” indicates satisfactory asset quality and credit administration practices. The level and severity of classifications and other weaknesses warrant a limited level of supervisory attention. Risk exposure is commensurate with capital protection and management's abilities.

3 A rating of “3” is assigned when asset quality or credit administration practices are less than satisfactory. Trends may be stable or indicate deterioration in asset quality or an increase in risk exposure. The level and severity of classified assets, other weaknesses, and risks require an elevated level of supervisory

concern. There is generally a need to improve credit administration and risk management practices.

4 A rating of “4” is assigned to financial institutions with deficient asset quality or credit administration practices. The levels of risk and problem assets are significant, inadequately controlled, and subject the financial institution to potential losses that, if left unchecked, may threaten its viability.

5 A rating of “5” represents critically deficient asset quality or credit administration practices that present an imminent threat to the institution's viability.

What should the Asset Quality component be rated?

Consider the ratings definitions above and compare them to the circumstances described in the Report of Examination for First State Bank. What should the Asset Quality component be rated?

1. Strong (link to asset quality answer)
2. Satisfactory (link to asset quality answer)
3. Less than satisfactory (link to asset quality answer)
4. Unsatisfactory (link to asset quality answer)
5. Critically deficient (link to asset quality answer)

(Answer) - Examiners rated asset quality a “3”. While the level of classifications may not be high enough to justify a “3” rating on its own, poor underwriting and credit administration practices suggest future losses may be significant. Additionally, the risk profile is heightened by a weak loan policy, increasing and unmonitored loan concentrations, and generally weak risk management practices. If you assigned a “4” rating, then you weren’t very far off; however, what you haven’t been able to read are management’s responses. It is possible that the rising classifications in a very new portfolio were enough to make management agree to curtail future expansion until these weaknesses are corrected. Additionally, the bank has historically been rated a “2” overall, leading us to believe that they may have the ability to correct these deficiencies before the level of adversely classified items threatens the bank’s viability.

Now let’s move on to the capital module.