

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

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The following sections are extracts from the Office of Examination's program for examining an institution's loan underwriting. It is designed to assist examiners in reviewing this area and is structured to provide:

- An overview and description of the program area (pg 1)
- A summary of subcomponents of "Loan Underwriting," including:
  - i. Underwriting Direction (pg 1-2)
  - ii. Credit Analysis, Due Diligence, and Loan Structuring (pg 2-4)
  - iii. Underwriting and Growth Analysis (pg 4)
- A summary of examination criteria (pg 5)
- The objectives for examining this area (pg 5)
- The examination procedures and guidance (pg 5-22)

### **Overview**

Loan underwriting is one of the most critical aspects of the LPM process. 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.

To facilitate examination of this topic, the Loan Underwriting module is broken down into the following three subcomponents:

- Underwriting Direction
- Credit Analysis, Due Diligence, and Loan Structuring
- Underwriting and Growth Analysis

### ***Underwriting Direction***

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. Underwriting standards define the board's desired level of creditworthiness for individual loans and provide uniform criteria for evaluating loans with similar characteristics. Additionally, underwriting standards provide a mechanism for reinforcing the institution's risk appetite and credit culture with staff. Ultimately, the use of solid underwriting standards helps insulate an institution's capital from unsafe and unsound lending conditions.

An institution's underwriting expectations and its desired changes in underwriting can be communicated to staff in many shapes and forms. The board has a key role in communicating underwriting expectations through mechanisms such as board policies, planning documents, approved underwriting standards, incentive compensation programs, targeted exception rates, and portfolio parameters. Management provides more direct communication to staff of underwriting expectations through items

such as credit procedures, credit letters, staff meetings, and loan committee feedback.

An institution's underwriting standards must reflect the composition of the portfolio by addressing each of the major commodities or industries financed by the institution. Adopted standards should consider the risks inherent in specific industries and be developed via studies that identify the financial condition and operating and performance levels achieved by successful operators in that industry. Also, lending activities for new loan programs and other growth areas should be directed by appropriate underwriting standards.

Objectives of this examination subcomponent are two-fold. Examiners should determine if institutions have adequate mechanisms in place to communicate underwriting expectations to staff and if appropriate changes have been made to underwriting practices in response to or anticipation of changing conditions. Since an institution has multiple options for communicating desired underwriting changes, examiners should be cognizant that a lack of action in one area can be offset by actions in another. For example, some institutions may choose not to make changes to underwriting standards. However, a more conservative underwriting philosophy can still be communicated through direction to staff to underwrite fewer credits with lower risk ratings (e.g., loans with PD ratings of 8 and 9) and to reduce the rate of underwriting exceptions. When assessing whether appropriate changes have been made to underwriting practices, it is important for examiners to evaluate the collective actions to adjust underwriting that were taken by the institution.

When examining institutions with significant credit quality challenges, examiners should be cognizant that changes in underwriting practices are only part of the solution. Time is required before revised underwriting practices can improve portfolio quality. Efforts to contain credit risk and service/work out of troubled credits also require careful evaluation at these institutions.

### ***Credit Analysis, Due Diligence, and Loan Structuring***

Effective loan underwriting cannot be accomplished without adequate credit analysis, due diligence, and appropriate structuring on individual loans. During periods of growth and strong economic conditions, an institution may become lax in its credit practices. When the economic cycle changes, weaknesses in credit analysis and due diligence become evident in the form of deteriorating credit quality and increased loan losses.

Efforts by an institution to strengthen underwriting should include an assessment of credit analysis, due diligence, and loan structuring practices. Possible enhancements could include greater efforts to establish constructive loan covenants, increased emphasis on balance sheet verifications, requiring better quality information on customers, more in-depth analysis of borrowers' risk management practices, and more limited use of interest only/short maturity loan structures.

***Credit and Financial Information:*** Credit direction (policies, procedures, and other management guidance) should identify minimum information requirements for various types of loans and should include a differential approach for requiring additional information as risk, size, or other factors warrant. Direction should ensure complete and accurate information is obtained to support lending decisions. This direction should address requirements for gathering financial information, such as how much historical information is required and what constitutes a "current" financial statement. Additional items to address in guidance include identifying when GAAP statements are necessary versus market value information, when earnings projections are required, and expectations for verifying assets and liabilities, pulling credit bureau information, and performing lien searches.

***Credit Analysis and Due Diligence Practices:*** An institution's credit analysis and due diligence practices must keep pace with the ever growing complexity of the operations financed. This requires both analysis and credit skills and an understanding of the business being financed. Proper credit analysis involves correctly analyzing all credit factors to determine if the credit risk is acceptable and consistent with sound business and credit practices. A disciplined approach in evaluating the five credit factors helps ensure that each loan is made on a sound basis.

Sound credit analysis and due diligence begins with appropriate guidance to staff. Credit guidance should direct staff to get “behind the balance sheet” and “inside the income statement” and to evaluate financial performance with a questioning eye. Guidance should address factors such as reconciling balance sheet changes to the income statement, analyzing changes in working capital, and adjusting financial statements to reflect realistic valuations in consideration of asset marketability and accessibility. Direction to staff should also address factors such as use of accrual versus cash earnings statements, evaluating extraordinary earnings items, and accurately identifying a borrower’s living expenses. While appropriate direction to staff is important, even more critical is having adequate controls in place, such as the internal credit review (ICR) function, to ensure direction is effectively implemented.

Lenders must remain ever mindful of the need to exercise an independent credit judgment as required by FCA Regulation 616.6100 when buying portions of loans from other lenders. Accordingly, institutions cannot rely on the analysis performed by the lead lender as support for the decision to purchase a loan participation interest. The complexities of loan participation transactions require an increasingly sophisticated due diligence process. The institution must not only accurately assess the risk in a complex operation and loan transaction, but the capability and reliability of the loan servicer must also be evaluated. Additionally, the institution must assess the risk inherent in having limited or no control in the servicing and structuring of the credit and oftentimes no access to the customer.

**Assessing the Management Factor:** Each credit factor carries its own significance in a lending transaction, but a proper assessment of the borrower’s management skills is perhaps the most critical component of any due diligence process. A complete analysis will involve an assessment of the borrower’s marketing, production, risk management, and financial management abilities. An assessment of this nature requires staff to have a complete understanding and thorough knowledge of the borrower’s operation.

**Loan Structure, Terms and Conditions:** A basic lending principle is that loans are meant to be repaid with cash from operations. With the exception of self-liquidating loans involving the current assets of a business, loans are not meant to be repaid from 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. At times, borrower quality and history with the lender justify favorable terms and conditions. However, some institutions will be challenged for years to come by loans written during the “covenant lite” era as loan terms, conditions, and structure were not always commensurate with the borrower’s financial capacity and risk in the credit facility.

Loan structure is critical to managing and controlling risk and lenders must take considerable care to ensure loans are properly structured. 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 non-typical loan structures. These loan structures may be warranted in some instances based on the borrower’s quality and individual needs, but the use of such structures should be well justified as part of the underwriting process. Loan payments should be matched to the timing of the borrower’s cash flow. Transactions where the borrower’s cash flow is unstable or unpredictable because the cash flow is reliant on asset sales or capital gains income should be approached with great caution.

Balloon structures on mortgage loans are being used by some institutions 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. As a result, quality expectations at the time of loan origination must not be compromised due to the presence of a balloon structure.

Loan covenants and approval conditions provide lenders excellent mechanisms for controlling risk in the underwriting process. Covenants that limit capital purchases, specify minimum working capital, equity, and cash flow levels, or require submission of borrowing base, financial, and production information provide lenders valuable tools for managing risk in individual loan transactions. Furthermore, loan approval conditions such as requirements for insurance, assignments of proceeds, cosigners, equity

investors, and cross collateralization/cross default agreements can also facilitate controlling risk in the underwriting process.

### ***Underwriting and Growth Analysis***

Underwriting portfolio analysis involves analyzing portfolio quality and performance to identify areas of concern needing to be addressed through revised underwriting practices. This analysis should support whether underwriting practices are achieving desired credit objectives and are consistent with the institution's risk tolerance.

A reporting process to identify and track compliance with underwriting standards is a key component in the underwriting process. When viewed collectively, underwriting exception levels and related trends provide valuable insight into an institution's underwriting practices. Exception levels and trends 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 can alert management that adjustments to underwriting practices are necessary, before weak underwriting becomes evident in credit quality deterioration.

The Board should be provided periodic reports that identify loan volume that is not in compliance with standards. The reports should summarize exceptions for each underwriting standard and by type of loan (mortgage, short-term, consumer, capital markets, etc.), show the volume of loans with more than one exception, and the trend of exceptions. Additional reporting could address exceptions by commodity, renewals versus new money, in-territory volume compared to outside the territory, loans to existing versus new customers, loan size, branch location, loan officer, etc., to further delineate a pattern or practice.

Analyzing underwriting performance may also include tracking the loan portfolio for loan quality, risk rating, and performance characteristics (delinquencies, nonaccruals, charge offs, etc.) by underwriting segment and year of origination. The System's 14 point risk rating system provides enhanced capabilities for management to analyze and better understand an institution's underwriting performance. Accordingly, factors such as risk ratings at loan origination and risk rating migrations since origination will typically be significant components in efforts to analyze underwriting performance. Supporting analysis and reporting may involve trending the migration of credit quality, risk ratings, and performance characteristics by year of loan origination and/or evaluating the difference in performance over time between loans meeting standards and those that do not. This analysis can also include looking at which type of exceptions lead to breakdowns in loan performance and conducting environmental/industry assessments to identify factors which may warrant changes in underwriting standards and practices.

Loan underwriting encompasses a broad spectrum of loan actions including renewals, refinancing loans a customer already has with the institution, and approving new volume to existing or new customers. An institution's actions to analyze underwriting performance should address all loan actions, but an in-depth review of new volume activity is particularly important. Underwriting actions that involve new volume warrant particular scrutiny because an institution has 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 because significant new volume is necessary to offset regular loan pay downs and payoffs. Corresponding underwriting analysis should include analyzing the sources, quality, and characteristics of loan growth/new money. New volume activity should be scrutinized to determine not only the amount of new volume but also its sources and quality. For example, new volume originated by the institution to existing customers within the chartered territory exhibits a much different risk profile than out-of-territory loan participation volume to new borrowers with no track record at the institution.

## **General Examination Criteria**

In addition to the Agency's [LPM publication](#) and this examination guide, the following additional criteria and resources exist:

- [FCA Regulations 614.4150, 616.6300, 614.4120, 614.4325, and 616.6100](#)
- FCA [Bookletter BL-037](#) - Lending Policies and Loan Underwriting Standards
- FCA [Informational Memorandums](#):
  - February 2007 – Significant Asset Growth and Its Implications
  - May 2008 – Asset Growth, Market Volatility, and Best Practices for Fast Growing Institutions
  - December 2009 – National Oversight Plan for 2010
- FCA Examination Manual Sections [EM-310](#) and [EM-330](#) and workpaper FCA 3100
- FCA Asset Growth Survey Phases 1 and 2

## **Examination Objectives**

- Determine if loan underwriting standards, practices, and supporting control processes are sufficient and result in a loan portfolio with quality that is commensurate with the institution's risk-bearing ability.

## **Examination Procedures and Guidance**

### **Underwriting Direction**

**Key Question:** Does the institution have sufficient processes in place to communicate underwriting expectations, including appropriate standards, and has the board and management made appropriate changes to underwriting practices and underlying controls in response to changing economic conditions, portfolio quality, and loan loss levels?

#### ***1. Developing/Maintaining Standards:***

Determine if the institution's process for developing/maintaining underwriting standards is adequate.

#### **Guidance:**

The following are possible considerations in making this determination:

- Does the institution complete studies of significant industries, lending programs, or other categories of loans (such as those listed in Step 3 below) to develop underwriting standards?
- Do industry studies and resulting standards identify/consider the financial condition and performance of successful operators in the industry?
- Does the institution have topical specialists that are assigned to specific industries, lending programs, or other categories of loans who participate in developing the standards?
- Do the topical specialists and/or management review all underwriting standards at least annually to determine if the standards remain appropriate?

#### ***2. Adequacy of Standards:***

Evaluate the adequacy of the institution's various underwriting standards. Identify changes to underwriting standards made in response to changing credit conditions, update the OE Loan

Underwriting Standards database and utilize the database as appropriate to assist in analyzing the institution's underwriting standards. Also, discuss with management if they have concerns with the standards currently in place and expect to make any changes. Conclude on the reasonableness of actions to change standards or the adequacy of support for not making changes to underwriting standards.

Guidance:

In evaluating the adequacy of the institution's various underwriting standards, consider if:

- Standards are appropriate for the risk-bearing ability of the institution.
- Standards contain objective and measurable criteria and address all appropriate credit factors.
- The institution has "standards" that provide ranges in financial/production ratios for "low", "medium", and "high" risk. These situations are most likely concerns 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 consider and aid in managing concentration risks faced by the institution, such as commodity/industry and loan size (e.g., are standards more stringent if the association has a heavy concentration in a particular industry or the market segment is dominated by larger loans?).

In assessing whether changes are needed to underwriting standards, be mindful of areas where changes may be warranted in light of past events, such as:

- Lower loan-to-value standards on real estate and home loans.
- Higher credit score requirements on scorecard and/or consumer loans.
- Increased working capital and/or repayment capacity requirements on livestock loans (in recognition of increased volatility).
- Shorter loan amortizations/loan terms on loans secured by specialized collateral, highly improved collateral, facilities, etc.
- More conservative standards on loans in specialized industries/with specialty collateral, purchased participations, or loans from outside an institution's chartered territory.

Examiners should also be cognizant of "enterprise guidelines" used by some institutions. Oftentimes, the guidelines constitute underwriting standards as they represent the primary drivers/analysis benchmarks for the underwriting decision. In discussions with management, determine if any guidelines exist that in effect represent underwriting standards and analyze accordingly.

In some institutions, underwriting standards may be highly correlated/integrated with risk rating systems and guidance. In order for these systems to be effective, the institution must clearly identify what constitutes minimum underwriting expectations, identify what constitutes an exception to a standard, and provide differential risk rating guidance by industry. For example, in market segments that would typically warrant specific underwriting standards, the institution should have risk rating guidance tailored to that market segment. This risk rating guidance should identify financial performance levels in each credit factor that are needed to justify specific risk ratings. Examiners must be comfortable with the integrity, accuracy, and granularity, of the institution's risk rating process for this type of system to be effective.

Situations where institutions have not adopted formal underwriting standards warrant intense scrutiny and appropriate criticism.

### **3. Standard for Major Loan Types/Programs:**

Determine if there are significant portfolio segments or loan programs where specific/customized

underwriting standards are not in place but should be.

Guidance:

The need for underwriting standards in a particular portfolio segment is primarily driven by concentration/volume levels of that portfolio segment and 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 significantly grow within a specific 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, or borrower/loan characteristics (e.g., segment dominated by large loans, specialized collateral, etc.) that differ significantly from the institution's core portfolio. The following are some portfolio segments to consider when evaluating whether an institution has sufficient standards in place:

- Large loans
- Part-time farmer vs. full-time
- YBS borrowers
- Individual commodities/industries
- Scorecard lending
- Unsecured lending
- Integrator loans/grower loans
- Consumer loans
- Loans constituting project/construction financing or expansion financing
- Highly leveraged transactions
- Mission Related Investments
- Loan participation volume
- Capital markets volume
- Out-of-territory loans
- Other credit needs loans
- Loans with specialized collateral
- Loans in non-core industries
- New lending programs
- Loans dependent on capital gain/asset sale income for repayment
- Loans secured by land with very limited or no income producing capability (recreation land, etc.)

**4. Board Involvement/Direction:**

Assess the level/adequacy of board involvement in establishing underwriting standards and in setting the institution's underwriting direction.

Guidance:

Given the critical nature of underwriting standards, a best practice would consist of the board conducting an annual review/affirmation of underwriting standards and/or the board reviewing/approving underwriting standards when changes occur. However, for some institutions such involvement by the board may not be practical given the number of underwriting standards that are in place, frequency of changes, and the detailed/technical nature of the standards utilized. However, at a minimum, management should keep the board informed of changes made to underwriting standards. If the board is not involved in reviewing/approving underwriting standards, there should be evidence the board has established and communicated its risk appetite through other means such as setting the institution's strategic underwriting direction/goals and approval of incentive plans, exception targets, risk-rating based underwriting direction, etc.

The need for board involvement in setting underwriting standards will also be driven by the nature of the standards undergoing changes. Board review/approval of underwriting standards may be reasonable to expect if the institution has a relatively limited number of underwriting standards and changes to standards are relatively rare. For example, if an institution changes its long-standing core underwriting standards, which are utilized on a large percentage of the portfolio, it may be reasonable to expect board involvement in this change. In contrast, the need for board involvement is lower on less substantive/technical changes such as adjusting credit score requirements on housing loans or modifying financial/performance ratios in industry/risk rating specific standards.

### **5. Policy Direction:**

Evaluate the adequacy of any loan underwriting-related board policies, including any recent underwriting-related board policy changes.

#### Guidance:

At a minimum, the institution should have underwriting-related policies that meet the requirements of FCA Regulations [614.4150](#), [616.6300](#), [614.4120](#), [614.4325](#), and [616.6100](#). The need for additional underwriting-related board policies will be dictated by the scope and complexity of the institution's portfolio and lending operations.

### **6. Credit Culture:**

Determine if the institution has assessed the need for changes to its credit culture in response to credit challenges or changing credit conditions. If changes were deemed necessary, evaluate the institution's plans/strategies for changing its credit culture.

#### Guidance:

Changing an institution's credit culture is a long-term endeavor. For background information see [RMA Credit Culture Article](#).

### **7. Planning Direction:**

Assess the adequacy of underwriting direction contained within the institution's planning documents, specifically the business plan and credit plan (if such a document is prepared by the institution).

#### Guidance:

Coordinate with exam activities to complete the business planning leadsheet. Evaluative questions/steps include:

- Do planning documents provide an adequate discussion of past, current, and anticipated credit challenges?
- Do planning documents identify changes that will occur in underwriting in response to credit challenges?
- Do planning documents provide a reasonable assessment of portfolio conditions and realistic outlook for performance of the portfolio moving forward?
- Does the current year business plan/credit plan contain material differences from the prior year plan/plans in the discussion of, approach to, and strategies to address credit/underwriting issues?



- Are year to year differences in the planning documents reasonable when considering the changes in credit conditions and changes in the institution's overall risk profile?

### **8. Delegated Authorities:**

Determine if the association has utilized delegated lending authorities to aid in communicating underwriting expectations, and review the adequacy and reasonableness of lending delegations.

#### Guidance:

Evaluative questions/steps include:

- Have any significant changes been made recently in lending delegations? Were changes, or lack of changes, reasonable in consideration of credit conditions and the institution's overall risk profile?
- Have more restrictive delegations been established for new volume on loans with lower risk ratings?
- Have reduced lending authorities been established on loans that involve exceptions to underwriting standards?
- Are staff experience and skill levels appropriately considered when establishing delegation levels?
- Are delegation levels for specific staff, including senior management, set at reasonable levels relative to the institution's risk-bearing capacity, with use of a loan committee for decisions of significant size?
- When loans are approved under individual delegations at the senior management level, are credit requests screened and recommended for approval by junior credit staff? (For example, if a CEO has individual delegated authority, does the CEO act on all applications falling above certain size thresholds or only on credit requests that are first reviewed and recommended for approval by credit staff with lower delegations?)
- Do delegated authority procedures/guidance address requirements for district bank approvals?

### **9. Incentive Compensation:**

Determine if the institution utilizes its incentive compensation programs to communicate underwriting expectations and assess the adequacy of any underwriting-related direction/controls in compensation plans.

#### Guidance:

Coordinate with exam activities to review overall compensation practices. Evaluative questions/steps include:

- With respect to credit-related areas, what are the key differences in the current year incentive plan versus the prior year?
- Are changes, or lack of changes, in the incentive compensation plan adequately supported and reasonable when considering changes in the economic environment and the institution's risk profile from the prior year?
- Do compensation plans demonstrate a reasonable balance between portfolio quality/profitability and volume growth?
- Is credit-related criteria in compensation plans consistent with and supportive of credit and underwriting-related business plan goals and objectives?
- Do incentive plans contain appropriate controls, such as credit quality, credit administration, and earnings qualifiers to ensure payments are not made or are reduced when portfolio

conditions are weak or deteriorating?

#### **10. Changes in Underwriting Practices:**

Determine if the institution has adequately adjusted its underwriting practices based on actual or anticipated changes in the lending environment. Consider any substantive underwriting guidance and direction to staff (besides changes to underwriting standards) that the board and management have used to influence underwriting practices. In the event an institution has made limited changes to underwriting practices, determine if the institution's limited actions were appropriate.

##### Guidance:

Institutions may use various means to change or redirect underwriting practices that do not involve actually changing the institution's underwriting standards. Underwriting direction may come in form of targeted exception rates, direction based on risk ratings, changes in target markets, and revised practices in response to loan losses. Guidance may also come in a more general form of staff meeting information, procedure changes, credit letters to staff, general management communications to staff (e.g., intranet postings and e-mails), etc.

Provided below are examples of key mechanisms that the board and management could utilize to communicate underwriting direction, in particular changes to underwriting direction. While there is no requirement that an institution do these particular things, they represent common methods for directing underwriting activities. Also, note that changes in underwriting practices should be considered based on both positive and negative changes in the lending environment. Refer to **Loan Underwriting Subcomponent 3 - Underwriting and Growth Analysis**, as information from analyses and reports covered in that subcomponent would provide valuable information that the institution should be considering when determining the need to modify underwriting direction or practices.

**Exception Levels:** If the institution utilizes exception levels/targets to communicate underwriting expectations to staff, consider the following information, evaluative steps, and questions:

- The institution could direct a more conservative underwriting approach by establishing exception targets that are lower than past exception targets/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, etc.
- Guidance should include tangible and measureable criteria rather than simply consist of the message "reduce (increase) the amount of exceptions."
- Has the institution launched efforts to lower exceptions in response to credit challenges (or raise exception rates when warranted by positive conditions)?
- Is the institution's guidance based on underwriting exceptions reasonable considering the institution's overall risk profile and credit quality trends?

**Risk Ratings:** If the institution utilizes risk ratings to communicate underwriting expectations, consider the following information, evaluative steps, and questions.

- The institution could direct a more conservative underwriting approach by directing staff to limit underwriting/new volume activity on accounts with less favorable risk ratings (e.g., PD ratings of 8 and 9).
- The institution could direct staff to pursue correction, collection, or encourage refinancing on accounts with lower risk ratings (e.g., PD ratings of 10 and worse, and PD ratings of 8 and 9 in certain situations/industries).
- Guidance for underwriting based on risk 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, etc.

- Guidance should include tangible and measureable criteria rather than simply consist of the message “reduce the amount of new volume on accounts with less favorable risk ratings.”
- Examiners must be comfortable with the integrity of the institution’s risk rating process in order for this type of underwriting direction to be effective. Also, institution’s with risk rating systems that lack sufficient granularity (e.g., PD ratings for Acceptable loans are concentrated in favorable ratings such as 4 and 5) would not be well suited for this type of underwriting direction.
- Is underwriting direction based on risk ratings reasonable considering the institution’s overall risk profile and credit quality trends?

**Loan Losses:** If the institution experienced notable loan losses in recent time periods, consider the following information, evaluative steps, and questions:

- Does the institution have procedures or a process in place to conduct “post mortem” analyses on loans where notable losses occur or on loan programs where there are notable losses or is widespread quality deterioration?
- Are “lessons learned” via the analyses used to adjust underwriting and due diligence practices?
- Review analyses for specific loans/programs as applicable. Do these analyses contain the appropriate depth and address the underlying cause of the losses?
- Are resulting changes to underwriting and due diligence practices reasonable?

**Changes in Target Markets:** If the institution is utilizing target markets/changes in targeted markets to communicate underwriting direction, consider the following information, evaluative steps, and questions:

- Has the institution adjusted the markets, customers, or industries it is targeting to redirect loan originations away from segments that are under stress, or toward a higher quality market segment?
- Efforts to change target markets should be supported by controls such as volume goals/projections and other objective criteria, and revised portfolio parameters (e.g., industry and lending programs).
- Examples of changes in target markets may include:
  - Reducing the amount of out-of-territory lending.
  - Decreasing the emphasis on capital markets activity/purchasing loan participations.
  - Reducing marketing emphasis and/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 and/or outside credit staff’s core competencies.
  - Decreasing lending activity in specialized lending programs such as “other credit needs” and processing and marketing financing.
- Are changes in target markets reasonable considering the institution’s overall risk profile and credit quality trends?

**Other Guidance to Staff:** In the event the institution utilizes other mechanisms to communicate underwriting expectations to staff, consider the following information, evaluative steps, and questions:

- Request from management other substantive underwriting guidance and direction issued to staff in an effort to determine other ways the institution has adjusted underwriting practices. (Suggest obtaining substantive guidance for at least the last 12 months.)
- Guidance may consist of staff meeting information, procedure changes, credit letters to staff, and general management communications to staff (e.g., intranet postings and e-mails, etc.)
- Is other underwriting guidance reasonable considering the institution’s overall risk profile and

credit quality trends?

***Institutions with no changes/limited changes:*** In situations where the institution has not made any (or made 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. In addition, where applicable, consider whether similar factors were present to support decisions by the institution to implement less restrictive underwriting practices to facilitate growth and better serve the institution's marketplace.

## **Credit Analysis, Due Diligence, and Loan Structuring**

***Key Question:*** Are credit analysis, due diligence, and loan structuring procedures and practices supportive of constructive loan underwriting and consistent with the board and management's overall underwriting objectives, and have appropriate revisions been made in these areas in response to changing credit conditions?

### ***1. Compliance with Standards:***

Determine whether credit analysis documents/credit narratives on individual loans are required to denote a loan's compliance or lack of compliance with the institution's loan underwriting standards.

#### **Guidance:**

The following are items to consider when evaluating the adequacy of an institution's credit direction on supporting compliance with underwriting standards:

- Do credit narrative templates include a section on compliance with underwriting standards?
- Are 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 lower delegated lending authority levels on loans with underwriting exceptions compared to loans without underwriting exceptions?

Note: The primary means to answer the above questions will be a review of credit procedures and other credit guidance and management discussions. However, loan review should be utilized as needed to support conclusions.

### ***2. Quality of Borrower Financials:***

Determine if underwriting decisions and loan analysis efforts are required to be supported by borrower financial information that is of sufficient quality.

#### **Guidance:**

The following are items to consider when evaluating the adequacy of direction on quality of borrower financial information:

- Have any significant changes been made recently concerning expectations on the quality of borrower financial information? Were these changes, or lack of changes, reasonable?
- Does the institution have reasonable criteria/direction for when audited or review quality

financial information is required versus borrower-supplied financial information and when quarterly or monthly information is required versus annual? Focus in particular, on evaluating the adequacy of an institution's direction and practices on when audited financial statements are required. Loan size is but one of many factors in making this determination. For example, audited financial statements may be warranted on loans of \$5 million if the borrower's operations are extremely complex and the loan package/borrower's operation contains significant inherent risk. In contrast, an institution's decision to not require audited financials on an account with a \$50 million exposure may be reasonable if certain mitigating factors exist. Utilize the loan specific questions in the sub-bullets below to aid in evaluating the adequacy of an association's approach in this area. An institution's guidance, direction, and criteria should consider items of the nature discussed in the sub-bullets.

- Is the institution able to identify which borrower relationships fall outside established criteria for information requirements?
- What is the quality of information present on borrowers that comprise the institution's top ten loan commitments or other large loans as determined by the institution? (Determine in conjunction with completing the **"Managing Risk Concentrations"** large loan concentration subcomponent.) Follow-up on concerns as necessary. Situations where top ten borrowers do not have audited financial statements warrant additional scrutiny. Questions to consider when evaluating whether audited statements (or at least review quality statements) are warranted on a specific account include:
  - Does the borrower have a complex ownership structure? Sole proprietors or basic partnerships would represent straightforward ownership structures while items such as multiple entities or partial ownership by the borrower in numerous companies, which trigger consolidation requirements per GAAP, would represent more complex structures.
  - Are the borrower's operations/activities complex? A borrower engaged in a single line of business (crop production, hog production, milk production, etc.) would represent non-complex operations while borrowers with multiple business lines such as dairy production, milk processing, trucking, and livestock sales would represent more complex business activities.
  - Does the borrower/business have meaningful off balance sheet exposure such as guarantees, contracting activity (e.g., grower contracts), use of futures/options/swaps, liabilities stemming from ownership interests in other entities (but full consolidation is not required per GAAP)?
  - Do intangibles/goodwill comprise a significant portion of the borrower's asset base?
  - Does the borrower operate in an industry outside the institution's core areas of expertise?
  - Does loan collateral consist of specialty property, property with limited income potential, or rapidly depreciating assets?
  - Is the borrower's business growing rapidly?
  - Is the borrower's business located and conducted outside the institution's chartered territory?
  - Is the borrower's income stream/cash flow erratic and subject to significant volatility?
  - Is the loan relationship originated and serviced by another lender?
  - Is the borrower a new customer or a customer that has a limited history with the institution?
  - Does the loan exposure represent a significant portion of the institution's risk funds and earnings stream?
  - Does the nature of the borrower's business carry a higher than normal risk of fraud? Characteristics that signal a higher possibility of fraud include complex ownership structures, extensive off balance sheet activity, very liquid/easily transported assets, significant inter-company transfers, extensive owner withdrawals, and lending/funds transfers between the borrower and principal owners.

*As the number of the above questions with "Yes" answers increases, the expectations for audited statements on smaller loan exposures increases. In contrast, as the*

*number of the above questions with “No” answers increases, relatively larger loan exposures without audited statements can be justified. Note also that concerns are mitigated to some degree if the institution is obtaining review quality statements on the customer.*

- In the absence of requiring audited statements for customers with large accounts and/or those with significant inherent risk, does the institution have a robust asset and collateral verification process? Does the process not only verify the presence, existence, ownership, and value of “hard” assets (inventories, machinery, and equipment) but also of other assets and liabilities such as receivables, payables, accruals, and hedging account equity?
- Do loan review findings (ICR and FCA) support sound and appropriate execution on financial information direction?

### **3. Other Financial Information Requirements:**

Evaluate the adequacy of direction to staff (policies, procedures, and other management guidance) on other borrower financial information requirements.

#### Guidance:

The following are items to consider when evaluating the adequacy of direction on gathering/verifying financial information:

- Have any significant changes been made recently concerning expectations on borrower financial information requirements? For example, were expectations for balance sheet verifications increased in response to issues such as increasing open accounts on livestock producers? Were changes, or lack of changes, reasonable?
- Does direction to staff support a differential approach to information requirements based on loan size, complexity, risk, and type of enterprise financed?
- Are minimum information requirements identified by type or size of loan?
- Does credit direction adequately address the following areas:
  - Need for historical financial statements (when and how many years).
  - Acceptable age of a “current” financial statement.
  - Number of years of earnings data and type of information required (tax returns, farm records, etc) and expectations on most current year available.
  - When earnings projections are expected and when other supporting documents are expected such as cash flows, pro-forma balance sheets, etc.
  - When assets and liabilities are required to be verified and what is to be verified (dollar amount, percentage, when material to the balance sheet, type, etc.).
  - When a credit bureau report is required and the acceptable age of it.
  - When a lien search is required and the acceptable age of it.
  - When open accounts require verification.
  - When livestock and crop production/scale records are required.
- Does direction to staff identify if exceptions to information requirements can be made and if so by whom?
- Do loan review findings (ICR and FCA) support sound and appropriate execution on financial information direction?

### **4. Credit Analysis Practices:**

Evaluate the adequacy of direction to staff (policies, procedures, and other management guidance) on credit analysis expectations.

Guidance:

The following are items to consider when evaluating the adequacy of credit analysis direction:

- Have any significant changes been made recently concerning credit analysis expectations? Were these changes, or lack of changes, reasonable?
- Does direction adequately address the growing complexity of the operations/types of businesses the institution finances?
- Does direction adequately address analyzing all credit factors to support if a credit risk is acceptable and consistent with sound business and credit practices?
- Does direction adequately address the following areas in the preparation/analysis associated with the balance sheet:
  - Reconciling balance sheet changes to earnings results through loan comments, earned gain analysis, and/or sources and use analysis.
  - Reconciling balance sheet to credit bureau and lien search information.
  - Proper treatment of leases (operating versus capital).
  - Proper consolidation of ownership in other entities and risk recognition (e.g., impact on leverage if only equity interest is shown, amount the partially owned entity represents of total net worth, ability to collect from asset, and ability to control the liquidation of the entity to access the equity).
  - Proper treatment of assets and liabilities when a spouse is not signed on a loan and recognition of risk associated with remaining assets (i.e., what assets are available in a collection scenario).
  - Proper treatment of intangible assets/goodwill and recognition of whether there is any value in these assets to a lender.
  - Adjusting asset values and addressing marketability of material unusual, non-typical, or high value assets.
  - Conclusion on the customer's true financial risk-bearing ability and what amount of net worth is truly available to the lender for purposes of collecting a shortfall in the loan.
- Does direction adequately address what the earnings analysis is to be based on (i.e., historical versus projected performance or a combination thereof)?
- Does direction adequately address when the analysis should focus more on historical performance versus projections and vice versa?
- Does direction provide a reasonable basis for when projections will serve as the primary mechanism for analyzing earnings, for example when the operation has significant changes in size and scope or the expense structure has materially changed? (Generally, the earnings analysis should consider both actual and projected performance but factors may exist to justify deviations.)
- When projections are to be utilized, does direction address using realistic yields, prices, and expenses based on past performance and does the institution have a process to provide staff with prices to be used for various commodities when preparing earnings projections? Is the price guidance to staff realistic based on current commodity prices or long-term average prices? Are price levels differentiated based on the length of the loan term? (On operating loans using current prices is a reasonable practice. However, on long-term loans, especially when price levels are unusually high, a long-term average price is more appropriate to utilize, given the volatility in commodity markets.)
- Does direction adequately address how to analyze earnings when material changes have occurred in the operation in terms of size, enterprises, or debt levels?
- Does direction adequately address the preference of accrual or cash statements and the need to look at the cash flow of the operation and whether it is providing adequate coverage of repayment needs?
- Does direction adequately address the proper handling and evaluation of hedging gains and losses, inventory valuation adjustments (current assets and noncurrent assets), and capital and extraordinary gains and losses?

- Does direction adequately address calculating and analyzing capital debt repayment capacity (CDRC) addressing factors such as:
  - Including capital asset replacement costs as a debt servicing expense, calculating an operation's capital asset replacement needs, and identifying situations where it is appropriate not to include capital asset replacement costs as a debt servicing expense.
  - Including amounts to replenish working capital deficiencies as a debt servicing expense, calculation of working capital shortfalls, and appropriate times frames for restoring working capital levels.
  - Including amounts to pay off carryover operating debt as a debt servicing expense and appropriate time frames for paying off operating carryover debt
- Does direction adequately address the need to accurately identify a borrower's living expenses and provide appropriate direction on how to determine this amount? A reasonable approach for guidance is to establish a fixed family living expense amount that is adjusted higher based on the type of factors listed below:
  - Amount of non-farm income (many people tend to live on what they earn).
  - Family size.
  - Age of family members (college, child care, etc.).
  - Itemized tax deductions (contributions, medical expenses, and other items not expensed in the farm income statement).
  - Credit card debt.
  - Cost of health care, life, and disability insurance.
  - Age and type of personal vehicles.
  - Size and quality of home and personal furnishings.
  - Ownership of second homes and recreational property.
  - General knowledge about a customer's lifestyle.
  - Family living costs buried in Schedule F (i.e., do the farm expenses seem reasonable given the size /revenue stream of the farming operation?).
- Do loan review findings (ICR and FCA) support sound and appropriate execution on credit analysis direction?

### **5. Assessing the Management Factor:**

Evaluate the adequacy of direction to staff (policies, procedures, and other management direction) on assessing the borrower's management skills.

#### Guidance:

The following are items to consider when evaluating the adequacy of an institution's credit direction on assessing the "management" factor:

- Have any significant changes been made recently concerning expectations for assessing a borrower's management capabilities? Were these changes, or lack of changes, reasonable?

**Marketing Management:** Does guidance direct staff to evaluate if the borrower:

- Displays a command of acceptable marketing techniques, demonstrates sound execution on marketing plans, and follows an established marketing program.
- Establishes realistic price goals and has sound plans for achieving them.
- Effectively uses available means for price protection including crop insurance, forward contracting, futures and options.
- Uses forward contracts and other price protection mechanisms to reduce input price variability.



**Production Management:** Does guidance direct staff to evaluate if the borrower:

- Demonstrates knowledge and control of operating costs.
- Has acceptable production practices and applies modern techniques.
- Has the ability to properly organize land, labor and capital to produce adequate economic returns.
- Seeks and applies professional advice.
- Ranks favorably among peers in the industry in terms of production performance.
- Uses diversified production practices through types and mixes of enterprises.
- Maintains the physical condition of machinery and the farmstead.

**Financial Management:** Does guidance direct staff to evaluate if the borrower:

- Keeps adequate financial records for review, analysis, and demonstration of earnings ability.
  - Makes purchasing decisions based on capital position and repayment capacity.
  - Maintains adequate levels of crop and casualty insurance.
  - Shows a willingness and ability to take and manage risk versus a desire to avoid risk or take excessive risks.
  - Adjusts living expenses to net income (i.e., when the farm operation is less profitable the borrower reduces living expenses).
  - Prioritizes purchases for needs, versus desires and has as a long-range plan for capital purchases.
  - Demonstrates dedication and thrift to accumulate equity and working capital during favorable conditions to use during periods of low income or other adversity.
  - Has succession plans in place to ensure continued operations.
- Do loan review findings (ICR and FCA) support sound and appropriate execution on direction for assessing management abilities?

## **6. Analyzing Borrower Risk Management Practices:**

Determine if the institution performs adequate analysis of a borrower's risk management practices in support of the credit analysis/due diligence process.

### Guidance:

Borrower risk management practices should vary based on the size, complexity, and sophistication of the operation. Risk management practices encompass areas such as the use of crop insurance and utilizing futures, options, and forward contracts to manage revenue streams and control input cost. The following are items to consider when evaluating the adequacy of an institution's efforts to assess borrower risk management practices:

- Have any significant changes been made recently concerning analysis expectations of a borrower's risk management practices? Were these changes, or lack of changes, reasonable?
- Do credit analysis efforts performed in support of loan underwriting evidence that the institution has a sufficient understanding of the borrower's risk management practices?
- Is an assessment of the borrower's risk management practices a required component of the credit analysis process/included on credit narrative templates for large customers?
- Does the credit analysis process include an assessment of the borrower's insurance coverage (crop insurance as well as casualty and life insurance)?
- Are appropriate systems and controls in place to monitor the borrower's risk management efforts?

- Do loan review findings (ICR and FCA) evidence sufficient analysis of borrower risk management practices?

**Note:** Expectations for analyzing risk management practices will vary based on loan size and borrower complexity. For larger accounts, an institution should understand the borrower's overall risk management process and determine if the borrower's use of futures, options, and forward contracts represent appropriate actions to control input costs and lock in revenue streams. Appropriate monitoring systems (i.e., periodic borrower reporting) should be in place to monitor the borrower's risk management efforts, especially when institution funds are being used to fund risk management activities (e.g., hedging loans, using operating lines of credit to pay margin calls, option premiums, etc.).

### **7. Due Diligence on Participations:**

Determine if the institution has adequate guidance and controls in place to ensure satisfactory due diligence is performed on loan participation purchases.

#### Guidance:

The following are items to consider when evaluating the institution's due diligence practices:

- Have any significant changes been made recently concerning due diligence expectations on loan participation transactions? Were these changes, or lack of changes, reasonable?
- Does credit guidance (including the loan participation policy) adequately address the need to exercise independent credit judgment and to assess the risk inherent in having limited or no control in the servicing and structuring of the credit and oftentimes no access to the customer?
- Does credit guidance adequately address the need to assess the risk inherent in financing industries where the institution's expertise may be limited?
- Do credit narratives on loan participations evidence that a bona fide credit analysis was completed by institution staff versus a "cut and paste" from the analysis documents provided by the lead lender or the lender selling the loan?
- Are loans purchased from an institution's funding bank subject to the same due diligence requirements as other loan participations?
- Do loan review findings (ICR and FCA) evidence adequate due diligence analysis?

### **8. Loan Structure, Terms, & Conditions:**

Evaluate the adequacy of direction to staff (policies, procedures, and other management direction) on expectations for loan structure, terms, and conditions. Determine if any significant changes have occurred recently concerning expectations on loan structure, terms, and conditions.

#### Guidance:

The following are items to consider when evaluating the institution's practices related to loan structure, terms, and conditions:

- Have any significant changes been made recently concerning expectations on loan structure, terms, and conditions? Were these changes, or lack of changes, reasonable?
- Does credit direction support that a decision on conditions of loan approval should be based on analyzing the other four credit factors to identify borrower creditworthiness and risk areas (tailored for that loan and that borrower)?
- Does credit direction support that terms and conditions should be based on the borrower's cash flow, management skills, financial condition, and the economic life of the project or asset?

being financed, and that these terms and conditions must:

- Balance credit risks with effective loan controls.
- Cover the loan risk, cost of extending the credit, and competitive market factors, and leave adequate profit for the institution.
- Does credit direction support that loans are to be repaid with cash from operations and not from the sale of collateral, and if exceptions are granted are they based on borrower quality and individual need and justified as part of the underwriting process?
- Does credit direction support that transactions where the borrower's cash flow is unstable or unpredictable (e.g., because the cash flow is reliant on asset sales or capital gains income) should be approached with great caution?
- Does credit direction support the importance of proper loan structure and provide sound guidance for this? In particular, does credit direction provide reasonable guidance on when interest only loan structures (see separate exam step on this topic) and balloon features are appropriate, taking into consideration the life and nature of the asset financed, adequacy and stability of collateral, and financial position of the borrower?
- Does credit direction provide guidance on establishing loan covenants and direction on what might be considered? The direction could address items such as when quarterly or monthly financial/inventory reporting is required, when to use financial covenants, how to set financial covenants, and when to utilize loan conditions such as requiring insurance, cross-collateralization agreements, cosigners, etc.
- Does credit direction address "covenant lite" transactions including the institution's appetite for such assets and mitigating factors that need to present to justify underwriting such transactions?
- Do loan review findings (internal credit review and FCA) support sound and appropriate execution on credit direction on loan structure, terms, and conditions?

### **9. Interest Only Loans:**

Evaluate the adequacy of direction to staff (policies, procedures, and other management direction) on the use of interest only loan structures.

#### Guidance:

The following are items to consider when evaluating the use of interest only loan structures:

- Have any significant changes been made recently concerning expectations on interest only loans? Were these changes adequately supported and reasonable in consideration of the institution's overall risk profile?
- To what extent does the institution utilize interest only loan structures? Use queries of the loan database and management discussions to identify this, with particular scrutiny of interest only real estate transactions. (Short-term revolving lines of credit adequately controlled by properly-structured borrowing base arrangements would typically not be concerns.)
- Are risk levels reasonable on these types of loans? Segment interest only loan exposure by borrower risk rating as necessary to gauge risk levels (i.e., identify those credits where the ability to pay may be in question).
- Are interest only structures being reserved for only high quality customers?
- Is adequate guidance/direction in place for loan programs that feature interest only payment terms?

### **Underwriting and Growth Analysis**

**Key Question:** Does the institution have adequate reporting and analysis systems to assess if underwriting direction is being effectively implemented and to analyze underwriting performance?

## **1. Process to Identify Exceptions:**

Determine if the institution has an adequate process in place to identify underwriting exceptions. Evaluate the accuracy and integrity of that process.

### Guidance:

When evaluating the loan underwriting exception process, be mindful of some common concerns such as:

- Assuming all loans were written under core standards and as a result, loans written under “enterprise guidelines” or other categories with unique standards are compared against core standards.
- Identifying exceptions by the number of customers/number of loans, but not by volume.
- Covering only a portion of the portfolio, such as loans written under core standards, but capital markets loans/loans written under specialized standards are not addressed in exception reporting.
- 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. (Examiners may wish to identify a group of loans from loan review efforts where credit narratives indicate underwriting exceptions occurred and review exception reports to determine if those loans were identified as exceptions).

## **2. Exception Reporting:**

Evaluate the content and overall adequacy of underwriting exception reports. Determine if exception reports are provided to the board and assess the reasonableness of any differences in the content and depth of exception information provided to the board versus reports used by management.

### Guidance:

The suggested frequency of exception reports is quarterly, with summary information from past quarters to allow comparisons/trending of information. A best practice is to include a narrative summary with each quarterly exception report that addresses items such as whether the amount, type, and trends of exceptions pose acceptable risk, whether the level of exceptions are within expectations/targets, and whether changes or corrective actions to underwriting practices are necessary based on exception trends.

In determining whether the content of exception reports is adequate, the following are possible ways that exception reports could be stratified to ensure effective reporting:

- Type of loan or customer (ag mortgage, consumer, short-term [operating/intermediate term], capital markets, participations, etc.).
- Commodity/industry.
- Loan renewals/refinancing of existing debt with the institution versus new loans/new volume.
- Loan size.
- Branch location.
- Loan officer.
- In territory versus out-of-territory volume.
- New customers versus existing customers.
- Volume of loans with more than one exception.
- Risk ratings.
- Loans with exceptions where quantifiable offsetting strengths are present (e.g., the working capital standard was not met but the borrower had owner equity that exceeded standards by a

large margin).

Considerable examiner judgment is necessary to determine if further stratification of underwriting exceptions is necessary. Factors unique to individual institutions such as overall level of underwriting activity, amount of out-of-territory lending, level of loan activity with new customers, etc., will drive the need for further stratification.

### **3. Analyzing New Volume:**

Determine if the institution has adequate processes in place to identify and report the sources, quality, and risk profile of new volume. Follow up on concerns regarding the quality or profile of new volume underwritten by the institution, as applicable.

#### Guidance:

In completing this examination step, consider whether the institution has reasonably defined what constitutes new volume and whether reporting and analysis:

- Identifies underwriting actions that involve bona fide new volume (i.e., lending decision is more discretionary compared to underwriting actions that involve renewals to existing customers or protective advances/additional operating funds to stressed customers).
- Addresses new volume quality/risk rating trends and if new loan quality is consistent with institution underwriting direction/objectives.
- Segments new volume by factors such as loan type (commercial versus mortgage), industry, and origination process (traditional underwriting by institution, scorecard, loan participation purchases, etc.).
- Identifies if new volume sources are consistent with institution direction/objectives concerning target markets.
- Identifies other key characteristics such as the amount of new volume to:
  - Existing borrowers
  - New borrowers
  - Borrowers within the territory
  - Borrowers outside the territory

**Note:** Information gathered when completing Phase 1 of the Asset Growth Survey may be useful in completing this examination step.

### **4. Other Analysis/Reports:**

Evaluate the adequacy of any other loan underwriting-related analyses and reports, (beyond those covered in the prior two exam steps), and identify how they are used in the overall underwriting process.

#### Guidance:

In completing this examination step, consider whether reporting and analyses include topics such as:

- Loan quality/risk rating and performance characteristics (past dues, nonaccruals, and charge-offs) stratified by underwriting segment and trended over time.
- Loan quality/risk rating, risk rating migrations, and performance characteristics stratified by year of origination.
- Performance differences over time between loans that meet standards and those that do not

(analysis may include evaluating what type 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 warrant changes to underwriting practices.
- Definitive conclusions on whether underwriting practices are achieving desired objectives and results.

Note: The extent that an institution needs to “drill down” on its underwriting performance will depend on risk and volume levels of specific portfolio segments. This type of analysis can be quite revealing. 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 year of origination, it may become evident that loans written during certain time frames are performing less favorably than the portfolio as a whole.