Loan Sample Selection Methodology for Examinations

February 2019 PAE Memorandum 19-001

Memorandum

Program Audits and Evaluations

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Date: February 4, 2019

Memorandum To: Doreen R. Eberley
Director, Division of Risk Management Supervision

/Signed/
From: Terry L. Settle
Assistant Inspector General for Program Audits and Evaluations

Subject: **Loan Sample Selection Methodology for Examinations |**
Report No. PAE Memorandum 19-001

In June 2016, we initiated an evaluation of the Federal Deposit Insurance Corporation (FDIC) loan sample selection methodology, including examiner compliance with relevant guidance. The evaluation scope covered risk management examinations completed from January 2013 through December 2015. We reviewed loan information for a judgmental sample of examinations performed at 16 FDIC-supervised institutions during this timeframe. We also analyzed loan sample information for all FDIC examinations completed during 2015 through 2017.

We completed certain aspects of our fieldwork, and subsequently the personnel working on this review departed from the Office. We then determined that it did not warrant further resources to complete the evaluation, and we did not reach conclusions regarding the FDIC's implementation of the loan sample methodology. However, we are providing you with our observations as we believe they provide management with useful insight into how examiners are implementing loan sampling during the examination process.[1]

BACKGROUND

The FDIC Strategic Plan states that the FDIC's Division of Risk Management Supervision (RMS) is responsible for performing risk management (safety and soundness) examinations to assess an institution's overall financial condition; management practices and policies; compliance with applicable laws and regulations; and the adequacy of management and internal control systems to identify, measure, and control risks.

According to Regional Director (RD) Memorandum 2001-036, *Loan Review*, dated September 12, 2001, examiners should evaluate a bank's lending policies, credit administration, and quality of the loan portfolio. RD Memorandum 2001-036 states that this loan evaluation is among the most important aspects of the examination process.

The quality of the loan portfolio reflects the likelihood that a bank will be repaid the money it disburses on loans, and this quality may not always be readily apparent from financial institution

[1] The work we performed does not constitute an evaluation in accordance with the Quality Standards for Inspection and Evaluation.

performance indicators.[2] For example, weaknesses in risk management practices intended to ensure that loans are made to borrowers who have the ability to repay do not immediately result in loan losses. Therefore, examiners are required to conduct an assessment of loan quality onsite, where examiners can review institution policies and procedures and whether bank managers and personnel are following them. In that regard, FDIC guidance instructs examiners to select for review a sample of loans that addresses a sufficient number and variety of loans to enable examiners to reach reliable conclusions about the bank's overall lending function.

RD Memorandum 2001-036 also provides examiners with guidance for pre-examination planning and sets expectations for selecting loan samples. FDIC examiners are to perform a pre-examination risk assessment of the financial institution's loan portfolio. According to FDIC guidance, examiners should document examination planning, proposed loan scope, and loan penetration strategies in a pre-examination planning memorandum (known as the PEP Memo).[3]

According to RD Memorandum 2008-008, *Revised Pre-Examination Planning Memorandum*, dated April 3, 2008, the PEP Memo should include a section on the examiner's proposed loan scope, emphasizing high risk lending activities, poor underwriting standards, and notable concentrations. The guidance also notes that examiners should include a post-examination comment in the report of examination addressing any significant difference between projected and actual examination hours, scope, and procedures.

The FDIC Risk Management Manual of Examination Policies (Examination Manual) provides guidance for examiners in sampling and reviewing institution loans. According to this examination guidance, examiners should use a risk-focused and forward-looking approach to sample an appropriate variety and volume of loans. This approach helps to identify and mitigate risks before those risks impact the financial condition of an institution. The Examination Manual further indicates that examiners should aim to reach reasonable conclusions regarding the quality of the institution's portfolio and the effectiveness of management's underwriting standards and credit administration policies and practices.

RMS uses an electronic system, the Examination Tools Suite-Automated Loan and Examination Review Tool (ETS-ALERT), to facilitate such loan reviews by examiners. ETS-ALERT enables examiners to acquire, review, manipulate, process, and print loan examination data from the bank's electronic loan trial balance. In addition, ETS-ALERT provides examiners an analytical tool for identifying and assessing loans posing the greatest risk in the bank's overall loan portfolio.

OIG OBSERVATIONS

Examiner Review of Loans

Based on our limited work, we observed that examiners prepared PEP Memos for the 16 examinations. We saw no material deviations between projected and actual loans reviewed. For the few instances with immaterial deviations, examiners explained those differences in the reports of examination.

[2] The primary performance indicator of loan quality is whether the loan is current, meaning the borrower is making loan payments on time.

[3] The loan scope for an examination is the composition and volume of loans selected for review. Examiners calculate the Loan Penetration Ratio at each examination during pre-examination planning and at the conclusion of the examination loan review. The Loan Penetration Ratio is calculated by dividing the total dollar volume of non-homogenous loans reviewed by the total dollar volume of non-homogenous loans. Non-homogenous loans are loans that are commercial or agricultural in nature, and include commercial and industrial loans, construction and land development loans, loans secured by farmland, commercial real estate loans, and loans secured by multifamily residential properties (such as apartment buildings). In simple terms, loan penetration represents the percentage of a certain type of loans that will be subject to detailed review by the examiner.

We also performed analyses to determine whether examiners complied with RD Memorandum 2001-036 in selecting and reviewing loans; however, we did not complete our work in this area.[4]

RD Memorandum 2001-036 describes a target group of loans, including large loans, problem loans and insider loans, and loans based on risk (as described below) that would enable an examiner to make an accurate and comprehensive assessment of the condition of the bank's primary lending activities.

With respect to **Large Loans**, the Examiner-in-Charge may establish a dollar cut-off amount, which is historically 2 to 3 percent of capital, or 1 percent of assets. For the 16 institutions reviewed, examiners established cut-off amounts for 12 of the institutions and the extent to which they reviewed loans above the cut-off amount follows:

- 100 percent at 5 institutions,
- over 60 percent at 4 institutions, and
- between 30 and 60 percent at 3 institutions.

For the other four institutions, the examiners reported they reviewed between 21 and 41 percent of large loans but did not report a loan cut-off amount. For these examinations, the loan scope also included a focus on specific loan types such as new loans, unsecured credits, leases, small business loans, municipalities, and energy loans.

With respect to **Problem and Insider Loans**, we observed the following:

Loans Past Due (loans past due over 60 days): Examiners performed a full- or limited-scope review of 100 percent of these loans, with the exception of one bank (6 percent of our sample) for which the examiner reviewed 17 percent of the past due loans.

Watch List Loans (loans that an institution identifies as potentially problem loans that require closer monitoring): Examiners collectively performed a full-scope review of 89 percent of Watch List loans. In the case of two banks, (13 percent of our sample), each with over 500 Watch List loans, the examiners reviewed 75 and 76 percent of those Watch List loans, respectively. For one bank, the Report of Examination showed a cut-off amount was assigned to Watch List loans which could explain the lower percentage reviewed. For the other bank, the Report of Examination did not include a cut-off amount for the percentage of Watch List loans reviewed.

Examiners may conduct either a "full" or "limited-scope" review of individual loans. A full-scope review involves accessing and reviewing the loan file for the sampled loan to assess the risk involved in the project being financed; the nature and degree of collateral security; the character, capacity, financial responsibility, and record of borrower; and the feasibility and probability of the loan being repaid according to its terms. Among other things, examiners review the loan's payment history and ensure that banks have current appraisals for collateral and financial statements for borrowers. A limited-scope review involves the examiner discussing individual loan risks and characteristics with bank personnel without accessing or reviewing the loan file.

Troubled Debt Restructure (TDR) Loans (problem loans for which the bank has renegotiated or restructured loan or payment terms): Examiners collectively performed a full-scope review of 93 percent of TDR loans. In the case of one bank (6 percent of our sample) examiners reviewed 75 percent of TDR loans without providing an explanation for why a lower percentage was reviewed. The TDR loans not reviewed were mostly residential or consumer loans with relatively small outstanding loan balances.

[4] For example, we did not interview examiners to understand their rationale for the loans they selected for review. We did not perform procedures to assess either examiners' review of loans or the significance of loans not reviewed at the 16 examinations in our sample.

Non-Accrual Loans (loans that are past due longer than 90 days): Examiners collectively performed a full-scope review of 73 percent and limited-scope review of 27 percent of Non-Accrual loans.

Loans to Insiders (loans by a bank to an executive officer, director, or principal shareholder of the bank[5]): Examiners collectively performed a full-scope review of 49 percent of the loans to insiders. Loans that were not reviewed were mostly lower-risk retail consumer loans or small dollar loans.

Adversely Classified Loans (ACLs): The Examination Manual indicates examiners should review loans or lines of credit adversely classified at the previous examination or listed for Special Mention.[6] In 14 of the examinations, examiners reviewed all but 1 or 2 of the previously Adversely Classified Loans we could identify.[7] For two of the examinations (13 percent of our sample), examiners reviewed all but 4 to 8 such loans. We did not determine why the examiners did not review more ACLs at these two institutions.

With respect to **Loans Based on Risk**, the Loan Review guidance states that loans selected for examination review should be based on a risk assessment of the bank's loan portfolio. Financial institutions with the asset quality component and/or composite ratings of 3, 4, or 5,[8] or possessing other significant areas of supervisory concern, will generally have the highest ratios of loans reviewed. A bank's asset quality rating reflects the existing and potential credit risk associated with the loan and investment portfolios, other real estate owned, and other assets, as well as off-balance sheet transactions. Examiners also consider the ability of management to identify, measure, monitor, and control credit risk.

Loans used to acquire, develop, construct, improve, or refinance real estate—referred to as Commercial Real Estate (CRE); Acquisition, Development, and Construction (ADC); and Commercial and Industrial (C&I) loans present greater risk of credit loss to financial institutions, because they are generally larger and more complex than retail consumer loans such as home mortgages and credit card receivables. Accordingly, the Loan Review guidance instructs examiners to focus on CRE, ADC, and C&I loans.[9]

We analyzed statistical data for these loans in 4,764 examinations of FDIC-supervised banks completed during 2015, 2016, and 2017 and found that:

- As asset quality ratings declined, examiners reviewed a higher percentage of these loans relative to previous examination cycles; and

- Examiners reviewed a larger percentage of these loan types than other risky loan categories (as discussed above in the previous section of this Memorandum).

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[5] Insider loans are defined by Regulation O (12 CFR 215), Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks.

[6] Institutions are required to employ a loan classification system for risk ranking loans. Loan classifications are expressions of different degrees of the risk of loan nonpayment. Adversely classified loans are allocated on the basis of risk to three categories—Substandard, Doubtful, and Loss. Other loans of questionable quality, but involving insufficient risk to warrant classification, are designated as Special Mention loans.

[7] Based on the records maintained by the bank, we could not be certain that we had identified all previously classified loans in ETS-ALERT, because the bank may have no longer held the loan or because of differences in how the loans were identified in the bank's records.

[8] Financial institution regulators and examiners use the Uniform Financial Institutions Rating System (UFIRS) to evaluate a bank's performance in six components represented by the CAMELS acronym: Capital adequacy, Asset quality, Management practices, Earnings performance, Liquidity position, and Sensitivity to market risk. Examiners assign a rating of 1 through 5 to each component, and an overall composite score, with 1 having the least regulatory concern and 5 having the greatest concern.

[9] Subsequent to the period covered by our review, RMS issued an amended RD Memorandum on Commercial Real Estate Work Program (Transmittal 2017-005, August 3, 2018). According to the Memorandum, to ensure a comprehensive assessment of CRE lending risk management practices, the examiner should ensure the loan sample includes an appropriate assortment of CRE loans. For example, the review could sample new CRE originations, out-of-territory CRE loans, and smaller CRE loans as a complement to loans normally reviewed, such as large loans and problem loans.

As noted above, we do not intend to conduct additional work in this area at this time.

We provided a draft of this Memorandum to RMS and incorporated their comments as appropriate.