

## LOAN PORTFOLIO REVIEW

### Core Analysis Decision Factors

Examiners should evaluate the Core Analysis in this section to determine whether an Expanded Analysis is necessary. Click on the hyperlinks found within each of the Core Analysis Decision Factors to reference the applicable Core Analysis Procedures.

**Note:** This module should be used to review the asset quality of the loan portfolio. Refer to the Loan Operations Review module to evaluate loan operations and credit administration.

**Do Core Analysis and Decision Factors indicate that risks are appropriately identified, measured, monitored, and controlled?**

**C.1. Is the audit or independent review function adequate? Refer to Core Analysis [Procedures #2-3](#); [Procedures #11-12](#); & [Procedure #62](#).**

**C.2. Are information and communication systems adequate and accurate? Refer to Core Analysis [Procedure #6](#) & [Procedures #13-19](#).**

**C.3. Does management accurately identify, monitor, and reserve for credit risk? Refer to Core Analysis [Procedures #20-22](#); [Procedures #23-34](#) (ACL only); [Procedures #23a-34a](#) (ALLL only); & [Procedure #35](#).**

**C.4. Is portfolio quality satisfactory, considering trends in past dues, nonaccruals, charge-offs, adverse classifications, and the overall risk profile? Refer to Core Analysis [Procedures #7-8](#) & [Procedures #36-43](#).**

**C.5. Is the volume of other real estate (ORE) and repossessed assets manageable and the ORE portfolio adequately administered and controlled? Refer to Core Analysis [Procedures #9-10](#) & [Procedures #57-60](#).**

**C.6. Do the board and senior management effectively supervise this area? Refer to Core Analysis [Procedure #1](#); [Procedures #3-6](#); [Procedures #44-56](#); [Procedure #61](#); & [Procedure #63](#).**

<b>LOAN PORTFOLIO REVIEW</b>
<b>Core Analysis Procedures</b>

*Examiners are to consider the following procedures but are not expected to perform every procedure at every bank. Examiners should complete only the procedures relevant for the bank's activities, business model, risk profile, and complexity. If needed, based on other identified risks, examiners can complete additional procedures. References to laws, regulations, supervisory guidance, and other resources are not all-inclusive.*

<b>Preliminary Review</b>
<p><b>1. Review prior examination reports, prior examination work papers, the examination planning memorandum, audit reports, and file correspondence for an overview of any previously identified lending concerns. In addition, determine whether there were any prior concerns related to the allowance for loan and lease losses (ALLL) or allowance for credit losses (ACL) for loans and leases, repossessed assets, or ORE.</b></p>
<p><b>2. Review internal and external audit reports, and assess the audit scope.</b></p>
<p><b>3. Review internal and external loan review reports, as well as other reports provided by third parties.</b></p>
<p><b>4. Discuss with management any planned changes, such as changes in lending philosophy, portfolio composition, new products, pricing strategies. Determine whether current and planned lending strategies are consistent with the strategic plan.</b></p>
<p><b>5. Review and assess presentations to the loan committee and the board and information in the loan committee and board meeting minutes.</b></p>
<p><b>6. Obtain and analyze information used by management to supervise the loan portfolio. This information may include:</b></p> <ul style="list-style-type: none"> <li>• <b>Organizational charts;</b></li> <li>• <b>Written policies and procedures;</b></li> <li>• <b>Problem loan and watch list reports;</b></li> <li>• <b>Delinquency and nonperforming asset reports;</b></li> <li>• <b>Concentration reports;</b></li> <li>• <b>ALLL analysis or ACL analysis for loans and leases;</b></li> <li>• <b>Modified or restructured loan reports;</b></li> </ul>

<ul style="list-style-type: none"> <li>• Significant charge-offs or concentrations of charge-offs (by industry or types of borrowers) since the prior examination; and</li> <li>• Portfolio stress test reports and documentation, if applicable.</li> </ul>
<p>7. Review the composition of the loan portfolio by type, dollar volume, and percentage of capital. Determine whether specialty-lending areas exist, including any new loan types, and assign responsibility for completing appropriate reviews. Refer to individual Loan Reference modules for additional procedures.</p>
<p>8. Based on the findings and risk identified in the preliminary assessment of the loan review program, select an appropriate loan sample.</p>
<p>9. Determine the volume of other real estate and the change in volume since the prior examination.</p>
<p>10. Determine the volume of repossessed assets and the change in volume since the prior examination.</p>
<p><b>Audit or Independent Review<sup>1</sup></b></p>
<p>11. Determine whether the audit program is sufficient to obtain reasonable assurance that:</p> <ul style="list-style-type: none"> <li>• The ALLL or ACL for loans and leases is appropriate and is determined in accordance with generally accepted accounting principles (GAAP);</li> <li>• Loan review practices reasonably identify portfolio risk;</li> <li>• Loan portfolio quality is properly monitored and reported;</li> <li>• Nonperforming loans are appropriately placed on nonaccrual status;</li> <li>• Loan modifications are properly identified as troubled debt restructurings, when applicable; and</li> <li>• Management complies with applicable laws and regulations such as state legal lending limits and Federal Reserve Regulation O.</li> </ul>
<p>12. Determine whether the audit or independent review program provides sufficient coverage relative to the institution's size, scope of lending activities, and risk profile. Appropriate programs generally:</p> <ul style="list-style-type: none"> <li>• Recommend corrective action when warranted;</li> </ul>

<sup>1</sup> Coordinate with the examiners reviewing the internal audit function.

- **Verify that corrective action commitments are implemented;**
- **Assess separation of duties, internal controls, and supervision of lending activities;**
- **Determine compliance with policies, procedures, and regulatory requirements; and**
- **Assess the adequacy, accuracy, and timeliness of reports to senior management and the board.**

**Information and Communication Systems**

**13. Determine whether managerial reports provide sufficient information relative to the size and risk profile of the organization, and evaluate the accuracy and timeliness of reports produced for the board and senior management. Reports may include the following types of information:**

- **Analysis of the appropriateness of the ALLL or ACL for loans and leases;**
- **Level and trends of classified loans;**
- **Level and trends of past due and nonaccrual loans;**
- **Watch List;**
- **Foreclosures and repossessions;**
- **Insider borrowings;**
- **Kiting suspects;**
- **Overdrafts;**
- **Participations;**
- **Internal and external audit results;**
- **Loan review results;**
- **Portfolio composition; and**
- **Unfunded commitments.**

**14. Review the effectiveness and accuracy of the system for aggregating related credit exposures.**

**15. Analyze growth trends by volume and loan type, and determine whether actual data mirrors budgeted growth or strategic plans.**

**16. Review the accuracy of accounting for loan transfers and participations. Consider partial sales and recourse arrangements.**

**17. Determine whether procedures and practices for placing loans on nonaccrual status agree with Call Report Instructions.**

<p><b>18. Determine whether procedures and practices regarding troubled debt restructurings (TDR) agree with Call Report Instructions.</b></p>
<p><b>19. Validate the accuracy of the Call Report where necessary.</b></p>
<p><b>Identifying, Monitoring, and Reserving for Credit Risk</b></p>
<p><b>LOAN REVIEW</b></p>
<p><b>20. Consider whether loan review practices are appropriate for the size and complexity of the bank and whether loan reviews are conducted by individuals independent from loan origination, approval, and servicing. An effective loan review system generally accomplishes the following objectives:</b></p> <ul style="list-style-type: none"> <li>• Promptly identifies loans with actual and potential credit weaknesses so that timely action can be taken to strengthen credit quality and minimize losses;</li> <li>• Appropriately validates and, if necessary, adjusts risk ratings, especially for those loans with potential or well-defined credit weaknesses that may jeopardize repayment;</li> <li>• Identifies relevant trends that affect the quality of the loan portfolio and highlights segments of the loan portfolio that are potential problem areas;</li> <li>• Assesses the adequacy of and adherence to internal credit policies and loan administration procedures and monitors compliance with applicable laws and regulations;</li> <li>• Evaluates the activities of lending personnel and management, including their compliance with lending policies and the quality of their loan approval, monitoring, and risk assessment;</li> <li>• Provides management and the board with an objective, independent, and timely assessment of the quality of the loan portfolio; and</li> <li>• Provides management with accurate and timely credit quality information for financial and regulatory reporting purposes, including the determination of appropriate ACL for loans and leases or ALLL, as applicable.</li> </ul>
<p><b>21. Determine whether the watch list is regularly updated by management and reviewed by the board.</b></p>
<p><b>22. Assess the accuracy of the loan review system and internal risk ratings. Also, review any documentation exception reports and written classification summaries, and evaluate the scope, frequency, and timeliness of reviews and updates to the board.</b></p>
<p><b>Allowance for Credit Losses on Loans and Leases</b></p>

Use procedures 23-34 to assess the ACL for loans and leases methodology for institutions that have adopted ASU 2016-013, and use procedures 23a-34a to assess the ALLL methodology for institutions that have not adopted ASU 2016-013.

**METHODOLOGY** *(When appropriate, refer to the Subprime Lending, Credit Card Activities, and TDR Reference Modules for additional information on assessing whether the ACL level for loans and leases is appropriate.)*

**23. Determine the methodology or methodologies used to measure the expected collectability of loans, and consider whether management maintains supporting documentation for the assumptions and estimates used. Methodologies include:**

- Loss-rate;
- Weighted-average-remaining-maturity (WARM);
- Probability of default/loss given default (PD/LGD);
- Roll-rate;
- Discounted cash flow;
- A method that uses aging schedules;
- Fair value of the collateral (required for all collateral-dependent loans); and
- Another reasonable method to estimate expected credit losses.

**24. Assess the methodology or methodologies used in determining an appropriate ACL for loans and leases. Determine whether the complexity and scope of the ACL evaluation process for loans and leases and the loan review system are appropriate given the institution’s risk profile and complexity of lending activities. Consider whether management provides for the following:**

- An effective loan review system and controls;
- Data-capture and loan-reporting systems that provide meaningful information regarding portfolio risks to support and document the estimates of an appropriate ACL for loans and leases for regulatory reporting requirements and, if applicable, financial statement and disclosure requirements;
- Resources to appropriately evaluate loss-estimation models before they are implemented (when applicable) and to modify model assumptions as needed;
- Processes that support the determination and maintenance of an appropriate level for the ACL for loans and leases that are based on a comprehensive, well-documented, and consistently applied analysis of the loan and lease portfolio and off-balance-sheet credit exposures;
- Procedures for an independent third party to review and validate the ACL methodology for loans and leases;
- Processes for determining the appropriate historical period(s) to use as the basis for estimating expected credit losses and approaches for adjusting historical credit loss information to reflect differences in loan specific characteristics, as well as current conditions and reasonable and supportable forecasts that are different from conditions existing in the historical period(s);
- Procedures to incorporate relevant internal and external factors that significantly affect collectability over reasonable and supportable forecast periods, as well as to apply appropriate reversion techniques to periods beyond reasonable and supportable forecast periods;
- Processes for determining and revising the appropriate techniques and periods to revert to historical credit loss information when the contractual term of loans and leases or off-balance-sheet credit exposures extends beyond the reasonable and supportable forecast period(s);

- **Processes for segmenting the loan and lease portfolio for estimating expected credit losses and periodically evaluating the segments to determine whether the loans and leases continue to share similar risk characteristics; and**
- **Policies and procedures for the prompt write-off of loans and leases, or portions of loans and leases, when available information confirms the loans and leases to be uncollectible, consistent with regulatory reporting requirements.**

**25. Evaluate the criteria management uses to segment loans by similar risk characteristics. GAAP requires expected losses to be evaluated collectively when loans share similar risk characteristics. If a loan does not share similar risk characteristics with other loans, expected credit losses for that loan should be evaluated individually. Examples of risk characteristics include but are not limited to:**

- **Internal or external credit scores or credit ratings;**
- **Risk ratings or classifications;**
- **Loan type;**
- **Collateral type;**
- **Size;**
- **Effective interest rate;**
- **Term;**
- **Geographical location;**
- **Borrower industry; and**
- **Vintage.**

**26. Evaluate the policies and procedures for the ACL for loans and leases, and assess the loss estimation method(s) used to arrive at estimates of the ACL for loans and leases, including the documentation supporting management’s assumptions, valuations, and judgments. Determine whether management appropriately considers historical loss information, current conditions, and reasonable and supportable forecasts that are relevant to assessing the collectability of cash flows, including significant qualitative factors that affect the collectability of the loan and lease portfolio.**

**27. Determine the basis for evaluating groups of loans under ASC Subtopic 326-20 (CECL).<sup>2</sup>**

- **Evaluate the calculation of historical loss rates for each segment.<sup>3</sup>**
- **Review the time period and the method of calculation (e.g., simple average, weighted average) for reasonableness and consistency.<sup>4</sup>**

<sup>2</sup> Adjustments to historical loss information may be positive or negative, quantitative or qualitative, and are supported by relevant data (e.g., changes in unemployment rates, delinquency, or other factors associated with the loans).

<sup>3</sup> The granularity of segmentation and the method used to calculate loss rates affects the amount of adjustment, if any, necessary to appropriately estimate credit losses in a segment as of the evaluation date. For example, a loss rate calculated using a simple five-year average may require a larger adjustment in response to changes in the credit cycle than would a loss rate calculated using a recently weighted quarterly average.

<sup>4</sup> Historical loss information may be based on internal information, external information, or a combination of both.

- Consider whether the historical loss information may need to be adjusted for differences in current loan specific characteristics, such as differences in underwriting standards, portfolio mix, or when historical credit terms do not reflect the contractual terms of the loans being evaluated as of the reporting date.
- Consider the effect of new loan products or newly expanded markets.<sup>5</sup>
- Consider how segmentation methods and historical loss-rate calculations reflect the extent to which current conditions and reasonable and supportable forecasts differ from the conditions that existed during the historical loss period.
- Consider management's process for evaluating contractual terms of loans, considering expected prepayments.<sup>6</sup>

**28. Determine whether management considered all significant factors relevant to the expected collectability of the loan and lease portfolio as of the reporting date and maintains documentation sufficient to support all material adjustments. Appropriate documentation generally addresses all material factors that are relevant to the institution at the reporting date.<sup>7</sup> Qualitative or environmental factors may include:**

- The nature and volume of the loans and leases;
- The existence, growth, and effect of concentrations of credit;
- The volume and severity of past due loans, the volume of nonaccrual loans, and the volume and severity of adversely classified or graded loans;
- The value of the underlying collateral for loans that are not collateral-dependent;
- The institution's lending policies and procedures, including changes in underwriting standards and collections, charge-off, and recovery practices;
- The quality of the institution's credit review system;
- The experience, ability, and depth of the lending, collection, and other relevant management and staff;
- The effect of other external factors, such as the regulatory, legal and technological environments; competition; and events such as natural disasters; and
- Actual and expected changes in international, national, regional, and local economic and business conditions and developments in which the institution operates that affect the collectability of the loan and lease portfolio.

<sup>5</sup> Historical loss rates for new products or loans in a new market may not be reliable given lack of seasoning or market awareness.

<sup>6</sup> Renewals, extensions, and modifications are excluded from the contractual term of a loan for purposes of estimating the ACL for loans and leases unless there is a reasonable expectation of executing a troubled debt restructuring or the renewal and extension options are part of the original or modified contract and are not unconditionally cancellable by the institution.

<sup>7</sup> Historical credit losses (or even recent trends in losses) generally do not, by themselves, form a sufficient basis to determine the appropriate level of the ACL for loans and leases. Management should consider the need to qualitatively adjust expected credit loss estimates for information not already captured in the loss estimation process. These qualitative factor adjustments may increase or decrease management's estimate of expected credit losses. Adjustments should not be made for information that has already been considered and included in the loss estimation process.



<p><b>29. Determine how management estimates credit losses on a group of loans with similar risk characteristics when the institution does not have loss experience of its own for such a loan group.<sup>8</sup></b></p>
<p><b>30. Confirm that loans evaluated individually are not included in a collective assessment of expected credit losses.</b></p>
<p><b>31. When the contractual term of a loan or lease extends beyond the reasonable and supportable period, determine whether management reverts to historical loss information, or an appropriate proxy, for those periods beyond the reasonable and supportable forecast period (often referred to as the reversion period).</b></p>
<p><b>32. If the ACL for loans and leases includes an <i>unallocated</i> amount, determine whether it conforms to GAAP and is properly documented and supported.</b></p>
<p><b>33. Where appropriate, determine whether the assessment of an appropriate level for the ACL for loans and leases includes an estimate of losses from transfer risk associated with cross-border lending activities.</b></p>
<p><b>34. Determine whether the ACL evaluation process for loans and leases is completed at least quarterly, and evaluate the documentation maintained to support management’s assumptions, valuations, and judgments.</b></p>
<p><b>METHODOLOGY</b> <i>(When appropriate, refer to the Subprime Lending, Credit Card Activities, and TDR Reference Modules for additional information on assessing whether the ALLL level is appropriate.)</i></p>
<p><b>23.a. Assess the methodology used in determining the appropriate ALLL and consider whether it includes portfolio segmentation and impairment analysis for individually evaluated loans. (Refer to ASC Subtopic 450-20 and ASC Topic 310.) Determine whether the complexity and scope of the ALLL evaluation process and loan review system are appropriate given the institution’s risk profile and complexity of lending activities. Consider the following:</b></p> <ul style="list-style-type: none"> <li>• The effectiveness of the loan review system and controls;</li> <li>• The ability of internal data-capture and loan-reporting systems to provide robust and meaningful information regarding portfolio risks;</li> </ul>

<sup>8</sup> An institution may not have a loss history if the product is new or the institution is a de novo organization.

<ul style="list-style-type: none"> <li>• Management’s ability to evaluate loss-estimation models before they are implemented (when applicable) and to modify model assumptions as needed;</li> <li>• The methodology is based on a comprehensive, adequately documented, and consistently applied analysis of the loan and lease portfolio;</li> <li>• Management promptly charges off loans, or portions of loans, that are uncollectible; and</li> <li>• An independent third party periodically reviews and validates the ALLL methodology.</li> </ul>
<p><b>24.a. Evaluate the criteria management uses to select loans for individual evaluation under ASC Topic 310, such as:</b></p> <ul style="list-style-type: none"> <li>• Loans or relationships above a dollar threshold. If management uses a dollar threshold, assess the threshold in relation to average loan balances, concentrations, or other factors that would cause the loans to be more significant to the institution;</li> <li>• Loans or relationships on the Watch List or adversely classified Substandard or Doubtful. If selection criteria do not include loans rated Substandard or Doubtful, assess the rationale for the decision; and</li> <li>• Loans or relationships past due or on nonaccrual status.</li> </ul>
<p><b>25.a. Determine the methodology used by management to measure impairment on loans (within the scope of ASC Topic 310) that are individually evaluated and determined to be impaired, and consider whether management maintains supporting documentation for the assumptions and estimates used. Consider whether the methodology used is based on:</b></p> <ul style="list-style-type: none"> <li>• The present value of expected future cash flows for individually evaluated impaired loans that are not collateral dependent;</li> <li>• Observable market price for individually evaluated impaired loans that are not collateral dependent; or</li> <li>• The fair value of collateral method.<sup>9</sup></li> </ul>
<p><b>26.a. Evaluate the reasonableness of and support for management’s assumptions, valuations, and judgments used in the analysis of those loans individually evaluated for impairment under ASC Topic 310 and determined to be impaired.</b></p>
<p><b>27.a. Determine how management treats:<sup>10</sup></b></p>

<sup>9</sup> For Call Report purposes, the impairment of an impaired collateral-dependent loan must be measured using the fair value of collateral method.

<sup>10</sup> Examiners should determine that management is appropriately defining impaired loans (i.e. where collection of the full principal and interest is not expected per original contractual terms). If a loan is evaluated under ASC Topic 310 but is not impaired by definition, it should be included in the ASC Subtopic 450-20 evaluation. Once a loan is determined to be impaired and is measured for impairment under ASC Topic 310, it cannot be included in a group of

- **Loans individually evaluated for impairment under ASC Topic 310 that are determined not to be impaired; and**
- **Individually evaluated loans determined to be impaired that are measured with zero impairment (i.e., no allowance is established when measured for impairment under ASC Topic 310).**

**28.a. Determine the basis for evaluating groups of loans under ASC Subtopic 450-20.<sup>11</sup>**

- **Ensure that assets are adequately stratified into groups based on one or more risk characteristics.**
- **Evaluate the historical loss-rate calculation for each segment.**
- **Review the time period and the calculation method (e.g., simple average, weighted average) for reasonableness and consistency.**
- **Consider the effect of new loan products or newly expanded markets.<sup>12</sup>**
- **Consider how segmentation methods and historical loss-rate calculations reflect qualitative or environmental factors necessary to reflect current conditions and expectations.**

**29.a. Determine whether management considers relevant qualitative and environmental factors and maintains documentation sufficient to support material adjustments. Appropriate documentation generally addresses material factors that are likely to cause estimated losses to differ from historical losses. Qualitative or environmental factors may include, but are not limited to:**

- **Changes in lending policies and procedures, such as underwriting standards and collection, charge-off, and recovery practices;**
- **Changes in national and local economic business conditions and developments, including the condition of various market segments;<sup>13</sup>**
- **Changes in the nature and volume of the portfolio and in the terms of loans;**
- **Changes in the experience, ability, and depth of lending management and staff;**
- **Changes in the volume and severity of past due and adversely classified loans and in the volume of nonaccrual loans;**
- **Changes in the quality of the loan review system;**
- **Changes in the value of underlying collateral for collateral-dependent loans;**
- **The existence, level, and effect of concentrations of credit; and**
- **The effect of external factors, such as competition or legal and regulatory requirements.**

loans collectively assessed for impairment under ASC Subtopic 450-20, even if no ASC Topic 310 allowance is established.

<sup>11</sup> Adjustments for qualitative or environmental factors, which may be positive or negative, are typically made to reflect current conditions and expectations as of the balance sheet date if not otherwise captured in historical loss analysis. The granularity of segmentation and the method used to calculate loss rates would affect the amount of adjustment, if any, necessary to appropriately estimate credit losses in a segment as of the evaluation date. For example, a loss rate calculated using a simple five-year average may require a larger adjustment in response to changes in the credit cycle than would a loss rate calculated using a recently weighted quarterly average.

<sup>12</sup> Historical loss rates for a general segment may not be accurate for new products or loans in a new market that are included in the general segment.

<sup>13</sup> Credit loss and recovery experience may vary significantly depending on the business cycle.

<p><b>30.a. Determine how management estimates credit losses on a group of loans with similar risk characteristics when the institution does not have any loss experience of its own for such a loan group.<sup>14</sup></b></p>
<p><b>31.a. Confirm that management does not include loans measured for impairment under ASC 310 in the estimated credit losses under ASC Subtopic 450-20, even if the ASC Topic 310 impairment measurement was zero.</b></p>
<p><b>32.a. If the ALLL includes an <i>unallocated</i> amount, determine whether it conforms to GAAP and is properly documented and supported.</b></p>
<p><b>33.a. Where appropriate, determine whether the assessment of an appropriate level for the ALLL includes an estimate of losses from transfer risk associated with cross-border lending activities.</b></p>
<p><b>34.a. Determine whether the ALLL evaluation process is completed at least quarterly and evaluate the documentation maintained to support management’s assumptions, valuations, and judgments.<sup>15</sup></b></p>
<p><b>LEVEL OF THE ALLL OR ACL FOR LOANS AND LEASES</b></p>
<p><b>35. Evaluate the level of the ALLL or ACL for loans and leases.</b></p> <ul style="list-style-type: none"> <li>• <b>Determine whether the ALLL or ACL for loans and leases is appropriate based on a review of the institution’s methodology coupled with examination findings as they relate to:</b> <ul style="list-style-type: none"> <li>○ <b>Loan classifications and internal watch list ratings;</b></li> <li>○ <b>Effectiveness and reliability of the loan review system;</b></li> <li>○ <b>Level and trend of past due and nonaccrual loans;</b></li> <li>○ <b>Historical recovery of loan charge-offs;</b></li> <li>○ <b>Lending policies and procedures, such as underwriting, collection, and charge-off and recovery practices; and</b></li> <li>○ <b>Changes in the business cycle that necessitate qualitative or environmental factor adjustments to historical loss rates.</b></li> </ul> </li> </ul>

<sup>14</sup> An institution may not have a loss history if the product is new or the institution is a de novo organization.

<sup>15</sup> Refer to the 2001 Final Interagency Policy Statement on ALLL Methodologies and Documentation for Banks and Savings Institutions; and the 2006 Interagency Policy Statement on ALLL.

- Consider reviewing applicable ratios as a preliminary check on the reasonableness of the ALLL or ACL for loans and leases.<sup>16</sup>
  - Evaluate trends compared to historical experience (e.g., the relationship of the ALLL or ACL for loans and leases to adversely classified or graded loans, past due and nonaccrual loans, total loans, and historical gross and net charge-offs.
  - Analyze changes in key ratios from prior periods, assess the directional consistency of the ALLL or ACL for loans and leases in relation to these changes, and assess the appropriateness and reasonableness of the ALLL or ACL for loans and leases based on the collectability of the institution’s loan portfolio in the current environment.
- If the institution’s loan review system is effective and the methodology for determining an appropriate ALLL or ACL for loans and leases is acceptable, compare the result of the institution’s methodology to the actual ALLL or ACL for loans and leases balance. Ensure that the ALLL or ACL amount for loans and leases reported in the institution’s regulatory reports and financial statements reconciles to the ALLL or ACL analysis for loans and leases. Assess the reasons for material differences.
- Assess management’s estimated credit losses, and if necessary, consider the need for additional provision expenses based on examination findings. Consider whether:
  - The loan review system is substantially inaccurate;
  - The bank is lending in stressed market conditions;
  - Credit administration and underwriting weaknesses have not been timely identified or addressed; or
  - Examination results reflect significant loan quality deterioration.

**Portfolio Quality**

**36. Evaluate loan commitments, letters of credit, and other contingent liabilities for creditworthiness.**

**37. Review overdraft protection, large items, uncollected funds, and check kiting reports for irregular activity. Pay particular attention to overdrafts of bank insiders and insiders of other banks.**

**38. Evaluate the level and trend of past due ratios for each type of credit, and determine which loan categories pose elevated risk.**

**39. Review and analyze purchased loan participations for appropriate accounting<sup>17</sup> treatment, due diligence, creditworthiness, underwriting quality, and recourse provisions. Consider:**

<sup>16</sup> Ratio analysis can be a supplemental check on the reasonableness of management’s assumptions and analysis. However, sole use of ratio analysis is insufficient for determining an appropriate level for the ALLL or ACL for loans and leases.

<sup>17</sup> Refer to the definition of Transfers of Financial Assets in the Call Report Glossary for additional information.

<ul style="list-style-type: none"> <li>• Whether these credits are <u>internally</u> classified at the originating institution or other participation holders (when the information is available); and</li> <li>• Whether these credits are adversely classified in regulatory examination reports at the originating institution and other participation holders (<i>this information <u>cannot</u> be shared with management</i>).</li> </ul>
<p>40. If the institution has acquired other institutions or loan portfolios, analyze the effect these purchases have had on the bank’s portfolio composition and risk profile.</p>
<p>41. Determine whether it appears any loans were sold prior to the examination to another institution or to the holding company to avoid criticism by examiners.</p>
<p>42. Determine whether the institution has any borrowing relationships that qualify as Shared National Credits and assign classifications accordingly.</p>
<p>43. Evaluate the level and trend of classified loans and the effect on the institution’s credit risk profile.</p>
<p><b>Managerial Effectiveness</b></p>
<p><b>PROCEDURES AND PRACTICES</b></p>
<p>44. Determine whether loan and executive officers consistently follow the institution’s lending policies and practices.</p>
<p>45. Review the loan approval process and determine whether loan presentations include adequate analysis of the following items:</p> <ul style="list-style-type: none"> <li>• Loan purpose;</li> <li>• Repayment sources (primary and secondary) and cash flows;</li> <li>• Collateral;</li> <li>• Background of borrower;</li> <li>• Principals and management;</li> <li>• Financial information, including balance sheet and income statement;</li> <li>• Financial projections;</li> <li>• Industry and economic outlooks, including real estate trends;</li> <li>• Borrowing and deposit histories;</li> </ul>

- **Loan structure, terms, and covenants; and**
- **Justification for policy exceptions.**

**46. Determine whether the financial analysis of borrowers is adequate in relation to the size and complexity of the debt.**

- **Review financial analysis for appropriate financial ratios, trends, cash flow history, and projections sufficient to determine the financing needs and repayment capacity of the borrower.**
- **Assess whether the credit assessment includes a review of credit reports to identify other outstanding debts or contingent liabilities.**
- **Assess whether the review evaluates important items such as salaries, fees, dividends, notes and accounts receivable, and notes and accounts payable, including those to insiders.**
- **Determine whether significant balance sheet and income statement changes are properly explained and whether management identifies and reviews contingent liabilities.**
- **Evaluate the comparison of actual results to projected performance.**
- **Consider the prospects for support from any financially responsible guarantors, with emphasis on excess liquidity, cash flow, and demonstrated willingness to honor guaranty agreements.**
- **Determine whether the global cash flow analysis considers all relevant parties to the transaction.**

**47. Determine whether management uses financial and reporting covenants. If so, evaluate how covenants are tracked and monitored, and whether management enforces them or regularly waives them.**

**APPLICABLE LAWS AND REGULATIONS**

**48. Determine the institution's regulatory and internal lending limits, and assess management's compliance with the limits.**

**49. Review transactions with affiliates for compliance with Section 23A of the Federal Reserve Act.<sup>18</sup>**

**50. Review extensions of credit to insiders for compliance with FRB Regulation O.**

<sup>18</sup> 12 U.S.C. 371 (c) defines covered transactions; sets quality, terms, and collateral requirements; and places aggregate limits on such activities.

<p><b>51. Review management’s compliance with the anti-tying provisions of Section 106(b) of the Bank Holding Company Act Amendments of 1970 (12 U.S.C.1972), which prohibits extensions of credit conditioned on the borrower obtaining or providing any additional credit, property, or service to or from the institution or its holding company.</b></p>
<p><b>52. Determine whether management complies with applicable laws and regulations for loans secured by stock. Items to consider include:</b></p> <ul style="list-style-type: none"> <li>• Loans secured by the bank's own stock;<sup>19</sup></li> <li>• Loans to purchase or carry margin stock;<sup>20</sup> and</li> <li>• Management’s familiarity with the Lost and Stolen Securities program (SEC Rule 240.17f1) and measures it has taken to minimize exposure on loans secured by stock. Refer to the <a href="#">securities information center webpage</a> for further guidance.</li> </ul>
<p><b>53. Review and assess the management’s compliance with applicable real estate lending and appraisal regulations.</b></p>
<p><b>CREDIT ADMINISTRATION</b></p>
<p><b>54. Assess management’s actions to correct criticisms noted in prior examination reports, recent loan review reports, and recent internal and external audits.</b></p>
<p><b>55. Evaluate management’s effectiveness at reacting to changing economic, industry, and regulatory environments.</b></p>
<p><b>56. Evaluate the composition of the loan committee. Determine whether members are independent and qualified.</b></p>
<p><b>Other Loan Related Items</b></p>
<p><b>OTHER REAL ESTATE</b></p>

<sup>19</sup> 12 U.S.C.83, Section 5201 of the Revised Statutes and Section 9 of the Federal Reserve Act prohibit an institution from making a loan secured by its own stock.

<sup>20</sup> If secured directly or indirectly by margin stock, Federal Reserve Board’s Regulation U is applicable.



**57. Determine whether ORE files are adequately documented. Consider the following:**

- Evidence of ownership;
- Book value (current and at the time of acquisition);
- Appropriateness of capitalized costs, if any;
- Current outside appraisal or internal valuation;
- Analysis of cost to carry (break-even analysis);
- Formal purchase offers (if applicable);
- Sales efforts or listing agreements;
- Current hazard and liability insurance;
- Receipt evidencing payment of real estate taxes; and
- Disposal of the parcel (who, when, how), if applicable.

**58. Determine the appropriateness of ORE accounting procedures, carrying values, and dispositions. Consider the following:**

- Appropriateness of initial recording of ORE at fair value less cost to sell, which becomes the cost basis of the ORE;
- Prior liens, including recording such liens as liabilities;
- Appropriateness of accounting for ORE after acquisition at lower of cost or fair value less cost to sell, including the use of a property-specific valuation allowance for any decline in fair value less cost to sell below cost;
- Appropriateness of rental income and expense entries;
- Appropriate review of expenses;
- Adequacy of appraisal or evaluation;
- Environmental concerns; and
- Holding period in compliance with state laws.

**59. Evaluate the quality of the portfolio and classify parcels accordingly.**

**REPOSSESSED ASSETS**

**60. Determine the appropriateness of repossessed asset accounting policies, carrying values, holding periods, and dispositions. Classify as necessary.**

**NON-LEDGER ASSETS**

**61. Determine whether appropriate approval authorities and levels of review are in place given the volume and magnitude of charge-offs.**

**62. Ascertain whether audit practices are sufficient given the volume and magnitude of charge-offs.<sup>21</sup>**

- **Auditors typically determine the validity of charged-off assets by physical inspection of items held at the bank or by direct confirmation with persons who have possession of them outside of the bank (e.g., attorneys or collection agents).**
- **The validity of charged-off items is typically tested, with particular attention given to possibly fictitious loans that were charged-off. Methods of authenticating the validity of charged-off items include:**
  - **Direct confirmation with borrowers;**
  - **Evidence of personal contact with the borrower by persons other than the loan officer responsible for the borrowing relationship;**
  - **Verification through bank records that the borrower received the loan proceeds; and**
  - **Verification through non-bank records, such as telephone and city directories that the borrower may exist.**
- **The auditor may choose to confirm all charge-offs of more than a certain size or may prefer to confirm a statistical sample of all charge-offs over a certain amount.**

**63. Determine that appropriate efforts are made to collect charged-off assets.**

**End of Core Analysis. If needed, Continue to the Expanded and Impact Analyses.**

<sup>21</sup> **Coordinate with the examiners reviewing the internal audit function.**