LOAN PORTFOLIO REVIEW

Expanded Analysis Decision Factors

This section evaluates the significance of deficiencies or other specific concerns identified in the Core and Expanded Analyses. Click on the hyperlinks found within each of the Expanded Analysis Decision Factors to reference the applicable Expanded Analysis Procedures. If needed, proceed to the accompanying Impact Analysis.

E.1.	**Are deficiencies immaterial to the supervision of the lending function? Refer to Expanded Analysis *Procedures #1-21*.**
E.2.	**Are deficiencies immaterial to the bank's condition? Refer to Expanded Analysis *Procedures #1-21*.**

LOAN PORTFOLIO REVIEW
Expanded Analysis Procedures

Generally, procedures used in the Expanded Analysis should target concerns identified in the Core Analysis and Decision Factors. The flexible procedures specified for the Core Analysis also apply to the Expanded Analysis.

Identifying, Monitoring, and Reserving for Credit Risk

LOAN REVIEW

1. Evaluate the inadequacies in the loan review process to determine the underlying cause(s).

2. Expand loan sampling to gain a better understanding of the credit risk in the loan portfolio.

ALLOWANCE FOR LOAN AND LEASE LOSSES (ALLL) OR ALLOWANCE FOR CREDIT LOSSES (ACL) FOR LOANS AND LEASES

When the ALLL or ACL for loans and leases appears deficient, examiners should direct management to address the appropriateness of its ALLL or ACL for loans and leases estimate and to provide additional allowances as necessary for estimated credit losses identified in the examination process that have not been included, or have not been fully included, in management's original ALLL or ACL for loans and leases estimate.

Examiners should determine whether the bank's methodology can be used with adjustments to arrive at a reasonable and reliable estimate for additional needed provisions. If the bank's methodology can be used, examiners should direct bank management to make appropriate adjustments and use the most relevant information sources available to develop a reasonable estimate of the deficiency in the ALLL or ACL for loans and leases. The information sources used should include examination loan review findings and publicly available data on real estate or other collateral values in the bank's lending area.

In the rare event that the bank's methodology cannot be used, even with adjustments (e.g., due to substantially inadequate loan review or material weakness in credit administration) examiners should estimate the ALLL or ACL for loans and leases deficiency in the absence of more relevant data. The selection and use of financial ratios or statistical models (using bank-specific historical loss data) should be supported by sufficient analysis to demonstrate objective support for a short-term range of proxy estimates. However, such estimates based on industry or peer group information should only be used as a short-term proxy and cannot be accepted as a substitute for an effective ALLL or ACL for loans and leases methodology. Examiners should direct management to correct deficiencies in its methodology as soon as possible.

Consider the following items in this section to determine an appropriate ALLL or ACL for loans and leases level.

3. Determine whether the ALLL or ACL for loans and leases is sufficient to cover estimated credit losses on:

- **Loans classified Loss (in whole or in part) that have not yet been charged-off;**
- **Loans classified Doubtful (without partial Loss classification);**
- **All remaining adversely classified loans (without partial Loss or Doubtful classifications);**
- **Other problem loans; and**

- **Remaining loans with similar risk characteristics evaluated collectively, as well as unique loans reviewed individually.**

4. Consider the bank's loan loss history in aggregate and by loan type.

- **Calculate the average loan loss history, generally for the past five years, using net loan charge-offs to average total loans when estimating lifetime loss rate for banks using the ACL for loans and leases framework or when estimating annual loss rate for banks using the ALLL framework. Such data is available in year-end UBPRs.**
- **Evaluate any aberrations in a specific year, and make adjustments as needed to arrive at a realistic average that reflects loss expectations.**
- **Consider migration analysis.**

5. Consider the most recent, average loan loss reserve coverage of nonperforming loans by state, rating, and charter.[1]

6. Consider the historical average of loan loss reserves to nonperforming loans for all banks in the region and the nation. (Reminder: Reserve coverage of nonperforming loans is typically higher at banks with sound loan portfolios. FDIC: Refer to the FDIC Quarterly Banking Profile.)

7. Compare management's credit loss estimates to actual write-offs, at the portfolio level and in aggregate, to confirm whether amounts recorded in the ALLL or ACL for loans and leases were sufficient to cover actual credit losses. Such data should be available in year-end UBPRs.[2]

8. Consider the following factors to determine appropriate adjustments to the bank's average loss experience by loan type for nonclassified loans:[3]

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[1] Care should be exercised when considering reserve coverage because these ratios compare banks' ALLLs or ACLs for loans and leases to the amount of these loans. The ALLL should cover the estimated credit losses on the nonperforming loans, which is an estimate of the net charge-offs likely to be realized on the loans; particularly for nonperforming loans that are collateralized, net charge-offs are not likely to equal the entire amount of these loans. The ACL for loans and leases should cover the estimated credit losses over the life the loans.

[2] This analysis supports whether appropriate ALLLs or ACLs for loans and leases were recorded and provides insight into the loss estimation process's ability to estimate expected credit losses. This analysis is not intended to reflect the accuracy of management's economic forecasts.

[3] If management uses a formula approach that includes historical loss experience, a reasonable and supportable forecast, and adjustments for qualitative or environmental factors to determine an appropriate level for the ACL for loans and leases, it may be feasible to use the internal formula in arriving at the estimated credit losses for these loans even though the overall system may be considered inadequate.

- **Degree of board or committee involvement, oversight, and control;**
- **Expertise, training, and adequacy of loan staff;**
- **Adequacy of and adherence to the bank's loan policy;**
- **Effectiveness of collection procedures;**
- **Adequacy of renewal and extension policies;**
- **Adequacy of charge-off policies;**
- **Effectiveness of internal loan review function;**
- **Adequacy of appraisal procedures;**
- **Maintenance and analysis of financial information;**
- **Adequacy of documentation (other than financial information);**
- **Capitalization of interest;**
- **Over reliance on collateral values;**
- **Composition of the loan portfolio;** ***(Note: It may be appropriate to use different percentages for consumer, residential and commercial real estate, and commercial loans.)***
- **Existence of self-dealing and insider transactions;**
- **Level of classified loans and trend over past few examinations;**
- **Level and trend of internally identified loan problems;**
- **Level and trend of overdue and nonaccrual loans;**
- **General economic considerations (local, state, regional, national);**
- **Growth trends;**
- **Entry into new areas of lending;**
- **Extent of out-of-territory lending; and**
- **Adequacy of follow-up systems.**

Portfolio Quality

9. Determine the reasons for the current level of problem assets.

- **Evaluate the impact of local economic conditions on the loan portfolio.**
- **Determine whether there are sectors of risk in the portfolio by type of or concentrations of risk.**
- **Evaluate the impact of ineffective underwriting in new product areas on the level and severity of classifications or delinquencies.**
- **Determine whether appropriate loan approval authorities have been established and implemented either on an individual or committee basis.**
- **Evaluate modification volumes and delinquency levels of loans serviced by individual account officers.**
- **Evaluate individual loan officers' experience levels and expertise.**

10. Based on the results of the above analysis, consider expanding the sample of loans (including off-balance sheet activities).

Managerial Effectiveness

APPLICABLE LAWS AND REGULATIONS

11. Determine the cause(s) of any violations and identify responsible parties. Consider the following items:

- **Lack of familiarity with laws or regulations;**
- **Negligence;**
- **Misinterpretation; and**
- **Willful disregard or noncompliance.**

CREDIT ADMINISTRATION

12. Determine why collateral appraisals are not sufficient to support current loan advances.

13. Determine why management did not correct identified deficiencies. Consider whether:

- **Management overlooked issues;**
- **Management is unfamiliar with prudent loan portfolio practices and procedures; or**
- **Management is unwilling or unable to react to changing conditions.**

14. Determine why loan losses are not recognized in a timely manner. Reasons may include the following:

- **Inadequate identification or reporting of problem loans;**
- **Loss deferral motivated by earnings performance and bonus compensation; and**
- **Loss deferral motivated by poor financial condition.**

Other Loan Related Topics

OTHER REAL ESTATE (ORE)

15. Determine whether management's non-compliance with regulations or accounting pronouncements are due to oversight, lack of requisite knowledge or experience, or a general disregard.

16. Compare expenses and income information contained in appraisals with the actual income and expenses of related income producing properties. Recalculate appraisal results using realistic assumptions, if necessary.

17. Investigate the deficiencies identified in managing foreclosed real estate.
18. Expand file sampling as necessary to accurately determine the quality of ORE. Where appropriate, consider conducting on-site inspections to assist in valuation and classification.
REPOSSESSION
19. Investigate the deficiencies identified in managing repossessed assets.
20. Expand file sampling as necessary to accurately determine the quality of repossessed assets. Where appropriate, consider physical inspections of the repossessed assets to assist in valuation and classification.
NON-LEDGER ASSETS
21. Determine the underlying reasons for asset write-offs.
End of Expanded Analysis. If needed, Continue to Impact Analysis.

LOAN PORTFOLIO MANAGEMENT AND REVIEW: GENERAL

Impact Analysis Procedures

Impact Analysis reviews the impact that deficiencies identified in the Core and Expanded Analysis and Decision Factors have on the bank's overall condition, and directs the examiner to consider possible supervisory options.

Impact Analysis Procedures
1. Determine the impact of noted deficiencies on capital, earnings, and liquidity, and assess the future impact on the bank if these deficiencies continue.
2. Assess the effectiveness of risk management practices in light of the identified deficiencies.
3. Determine the impact of an inadequate ALLL or ACL for loans and leases on earnings and capital.
4. Determine the need for direct confirmation of loan accounts.
5. If administrative or enforcement actions appear necessary, form specific recommendations and discuss concerns with appropriate supervisors.
6. If approved by appropriate supervisors, discuss the possibility of administrative and enforcement actions with executive management and the board.
7. Investigate the circumstances and facts surrounding apparent violations. Prepare recommendations for appropriate actions
End of Impact Analysis.