EM-21.1

Category: **Assets**
Topic: **Portfolio Quality & Composition**
Published: 3/21/2022

Overview

The *Portfolio Quality & Composition* topic provides guidance on evaluating the quality, composition, growth, and prospective risks in a Farm Credit System (System) institution's loans and loan-related assets (collectively, loans) at the portfolio level. Loan-related assets include leases, notes receivables, other property owned (OPO), and any other assets that are generated through lending activities. For banks, it includes the direct loan portfolio.

Evaluating the condition of loans is essential because these assets are a System bank or association's primary asset class and source of earnings, and largely determine the institution's overall financial condition and performance. They also expose the institution to credit risk, which can adversely affect earnings performance, capital adequacy, and liquidity. As such, Farm Credit Administration (FCA) examiners need to carefully analyze these assets to determine conditions, trends, and risk exposure. Examiners should also factor in results from testing risk identification and credit administration on individual loans. Examiners may need to adjust the institution's reported credit quality information if this examination work identifies material risk identification concerns.

The examination of loan portfolio management (LPM) is closely related to the portfolio quality and composition evaluation. LPM topics generally focus on identifying and managing risks, while this topic looks at the impact of those risks on portfolio quality and composition. The institution's portfolio quality and composition are also indicators of portfolio management effectiveness. As such, close coordination is needed when completing examination work in this topic and the various LPM topics.

Note: Investment portfolio quality and composition are addressed in the *Investments* topic of the Examination Manual.

Examination Procedures and Guidance

General

1. Quality & Composition:

Evaluate current portfolio quality, composition, and related trends, including the impact any significant concentrations have had on the portfolio.

Guidance:

Evaluating the institution's portfolio quality and composition is a critical part of assessing its safety and soundness. It primarily involves determining the aggregate level of credit risk in the loan portfolio. Credit risk is the current and prospective risks to earnings or capital arising from a borrower's failure to meet the terms of a loan or otherwise failing to perform as agreed. This risk can be realized through increased servicing and legal costs, reduced interest income, or provisions for loan losses and chargeoffs.

FCA assesses credit risk through the Uniform Classification System (UCS), FCA performance categories, the System risk rating guidance, and other measures. Although credit risk can be identified and measured many ways, portfolio quality statistics reported under the UCS and FCA performance categories are the primary sources of information used by examiners to evaluate portfolio quality.

Evaluating portfolio composition includes identifying and evaluating how the makeup of the portfolio, including any concentrations, is affecting or could affect portfolio quality. There are many possible ways to view portfolio composition and concentrations. In the broadest sense, all System institutions have an industry concentration in agriculture and varying degrees of geographic concentrations based on their mission and chartered territories. More specifically, examiners will focus on portfolio segments such as commodities, lending programs, loan products, large loans, affiliated and interdependent borrowers, and counterparty concentrations. The types of portfolio segments and their relevance can vary widely from institution to institution.

Note: This procedure focuses on the current quality and composition of the portfolio. Examiners should typically complete this procedure together with the *Prospective Risks* procedure that is included later in this topic. Also, these procedures address identifying portfolio composition and evaluating the impact of concentrations on portfolio quality. In addition to the inherent risks from portfolio concentrations, weaknesses in managing concentrations (e.g., lack of adequate risk parameters or hold limits) could result in concentrations that are not adequately identified or controlled by the board and management. This could result in excessive risk to capital and earnings. Because of the importance of examining concentrations, the *Concentration Risk Management* topic in the Examination Manual addresses this as part of FCA's LPM evaluation. Examiners should refer to the work completed in that topic and consider the results when completing these procedures.

Evaluative questions and items to consider when examining portfolio quality and composition include:

- ***Primary Portfolio Quality Indicators:*** **What are the current levels, trends, and primary drivers of portfolio quality? Do key portfolio quality measures compare favorably with FCA's Financial Institution Rating System (FIRS) benchmarks, board standards and goals, and peers?** This assessment typically begins by reviewing key loan portfolio statistics and any corresponding benchmarks. The levels of adverse, criticized, Special Mention, past due, and nonaccrual assets are the most common measures used to determine the amount of credit risk in the portfolio. However, examiners should be mindful of the inherent limitations associated with some of these measures and consider other information as appropriate. For example, UCS classifications are reported on a historical basis and can lag actual changes in credit risk, particularly on loans underwritten using scorecard or low documentation programs or otherwise lacking current financial information. It is also important to consider the level of risk relative to risk-bearing capacity. For example, institutions that have adverse assets-to-total regulatory capital ratios over 50 percent are generally considered to have excessive risk relative to risk-bearing capacity, and at a minimum, should be closely evaluated to determine the extent of that risk. The FIRS benchmarks provide general guidelines on portfolio risk, but the overall evaluation of portfolio quality should consider the institution's unique business model, financial condition, and risk profile. Additionally, comparisons of portfolio quality measures to peer groups can be useful but should also consider the institution's unique characteristics. The following are other considerations when completing a portfolio quality evaluation:

- It is important to complete a comparison of key asset measures to board standards and goals from business plans or other institution documents to evaluate portfolio quality relative to the institution's expectations.
- A thorough investigation of significant changes or adverse trends in key factors and statistics may be needed to determine the cause and effect on the portfolio. Conversely, stable or static portfolio conditions generally require less analysis and review.
- A review of changes and trends over 12-month periods can help to eliminate the effects of seasonality. Also, evaluating changes and trends over at least a 3-year period will provide important insight into portfolio quality. A longer time horizon may be appropriate if significant or unusual changes are identified. Examiners should also review any migration analyses completed by the institution to identify significant trends in risk ratings that may warrant further evaluation.
- The Consolidated Reporting System (CRS) is a useful tool to identify changes and trends in the portfolio. The CRS Uniform Performance Report and 6-Year Trend Report provide comprehensive summaries of portfolio quality statistics. There is also a wealth of information available in the other CRS schedules, which can provide additional insight into portfolio quality and composition.
- If examiners determine risk identification processes are unreliable based on work performed in the *Risk Identification* topic, FCA-adjusted credit quality statistics should be used when completing the portfolio quality analysis.
- At institutions experiencing material loan growth, the examination of portfolio quality measures may require evaluating how new volume has impacted those measures. For example, material amounts of new volume can mask deteriorating quality in the existing portfolio. Additionally, while new volume will generally be classified Acceptable at origination, a prevalence of credit factor weaknesses, exceptions to underwriting standards, or credit administration concerns may exist that could contribute to deterioration in portfolio quality going forward. Refer to the *Growth* procedure for conducting a more thorough evaluation of how material growth impacts portfolio quality and composition.
- If loan volume is declining, evaluate the reasons for the decline and the impact on portfolio quality and composition measures. Institutions that experience portfolio quality issues for an extended period may see loan volume decrease, as their efforts and resources are concentrated on portfolio servicing and the collection or correction of problem accounts. Also, institutions experiencing declining loan volume, regardless of the causes, are likely to see their earnings impacted negatively.

- ***Other Credit Risk and Portfolio Quality Indicators:* To what extent do other information, factors, or measures indicate significant or increasing levels of credit risk in the portfolio?**

Examples to consider include:

- Increased levels of refinanced principal and interest
- Increased levels of carryover debt and line of credit usage
- Amount of restructured loans
- Amount of loans in bankruptcy or foreclosure
- Amount of impaired loans, allowance for loan losses, chargeoffs, and recoveries
- Amount of OPO
- Amount of scorecard volume, change in scorecard performance, frequency of overrides, or changes in scorecard cutoff scores
- Volume to borrowers of minimally acceptable quality as measured by Probability of Default (PD) ratings
- Volume dependent on or covered by guarantees or other credit enhancements (e.g., Farm Service Agency guarantee volume or Federal Agricultural Mortgage Corporation Long Term Standby Purchase Commitments)
- Amount, types, and frequency of loan underwriting standard exceptions or credit factor weaknesses
- Amount and type of leveraged lending activities (e.g., highly leveraged transactions)
- Volume dependent on unproven or nonrecurring cash flow for repayment (e.g., project/construction/start-up financing, expanding operations, land-in-transition financing)
- Volume in new, untested, or politically sensitive industries (e.g., alternative fuels, hemp)
- Amount and nature of collateral risk (e.g., loans with specialized collateral, rapidly increasing or decreasing collateral values, or real estate collateral with very limited or no income producing capability)
- Exposure to loss as measured by the Loss Given Default (LGD) ratings

- ***External Operating Environment and Conditions:*** **To what extent have external factors and conditions impacted portfolio quality and composition?** Examiners should consider how external factors or conditions have contributed to the current portfolio's quality and composition. Common examples include:

    - Distressed industry or borrower conditions
    - Commodity prices
    - Input costs
    - Production issues (e.g., disease, weather)
    - Interest rates
    - Government policy issues (e.g., impact of changes to support programs, environmental regulations, trade policies)
    - General economic conditions

- ***Portfolio Composition:*** **What is the composition of the portfolio? Is it well diversified or are there material concentrations? To what extent has portfolio composition impacted credit risk and portfolio quality?** The composition of the portfolio can have both positive and negative effects on portfolio quality. A well-diversified portfolio is more likely to be less susceptible to changing economic conditions than a portfolio with material concentrations. Concentrations can come in many forms, but generally exist any time loans have similar characteristics or are affected by the same factors. Commodity (or industry) and geographical area are two of the most common concentrations in System institutions and are a typical focus when examining portfolio composition. Large loans, counterparty exposures, and interdependent or affiliated exposures are others that should be specifically evaluated. Further, there are many other ways to view portfolio composition and concentrations. For example, portfolio quality and performance can be influenced by the various lending programs and products used, as well as the proportion of real estate loans compared to operating and intermediate term loans. Also, scorecard, participation, similar entity, out of territory, and other credit needs loans are common examples of lending programs that can present additional or unique risk to the institution. Similarly, some loan products (e.g., unsecured loans, revolving lines of credit, asset-based loans, construction loans, interest-only term loans, and leases) can present risk that may warrant evaluation and consideration as a concentration. Examiners should review and analyze material concentrations to determine how they have impacted portfolio quality and composition, using portfolio quality indicators such as those listed above. In addition to identifying aggregate volume and percentages (e.g., of assets and capital) for these concentrations, consider the need to evaluate specific characteristics and commonalities of the assets within each material concentration segment.

- ***Participation Pool Programs:*** **How does involvement in participation pool programs impact portfolio quality and composition?** An institution's use of participation pool programs, such as an association selling a pool of loans to its funding bank, can impact portfolio quality and composition measures. For example, if the pool contains higher or lower than average quality loans or loans with similar characteristics, there can be an impact on the various portfolio quality indicators and portfolio composition at both institutions. Also, participation pool programs, including those designed to operate on an income neutral basis, could still contain credit risk for the selling institution. In some cases, the bank could penalize the originating institution if poor risk identification or credit administration practices are discovered in the loan pool. If there is evidence from LPM examination results or transaction testing to suggest the participation pool agreements may be unenforceable, examiners should complete an analysis of portfolio quality and composition that includes this sold or guaranteed volume.

2. Growth:

Evaluate the amount, quality, and sources of portfolio growth and how it impacts portfolio quality and composition.

Guidance:

A healthy institution that is successfully carrying out its mission will typically have a well-planned and effectively controlled approach to loan portfolio growth. Institutions can prudently grow their portfolios through a variety of strategies, including increased lending to existing customers, originating loans to new customers, or purchasing participations from other financial institutions. However, portfolio growth that is poorly planned, not mission-focused, or outside of managerial and financial capabilities can result in increased risk to the institution. In addition, periods of rapid growth without sound underwriting or credit administration practices can create potential credit risk. Such growth could improve portfolio quality ratios in the near term but adversely affect the institution in the future.

Note: While this procedure can be used to analyze new loan growth in any institution, it is especially focused on facilitating a more in-depth analysis at institutions experiencing material growth. Also, new loan growth is an important consideration when completing most loan portfolio management examination work and when evaluating capital adequacy. As such, examiners completing this procedure should consider examination results in those areas. In particular, the *Planning & Strategies* procedure in the *Portfolio Planning & Analysis* topic of the Examination Manual and the *Capitalization of Growth* procedure in the *Capital Adequacy* topic address several specific issues related to growth.

Evaluative questions and items to consider when examining portfolio growth and how it impacts portfolio quality and composition include:

- ***Growth Rate*: What is the portfolio growth rate and how does it compare with business plan projections, prior years, and capital growth?** Growth in loans and loan related assets is typically analyzed over 12-month periods to eliminate seasonal changes. As part of this analysis, it's important to evaluate growth compared with the institution's historical and planned growth and consider general market conditions to better understand the significance of the growth. It is also important to understand the level of growth relative to the institution's ability to capitalize that growth. If the actual growth rate temporarily exceeds the institution's sustainable growth rate (SGR), it is typically manageable depending on capital adequacy. However, if the actual growth rate exceeds SGR for longer time periods, the impact on capitalization could be significant. Refer to the *Capitalization of Growth* procedure in the *Capital Management* topic for information on SGR and guidance on examining growth relative to SGR.

- ***Sources of Growth*: What are the sources and primary drivers of portfolio growth?** The board and management should be identifying and monitoring the sources of growth and should understand the primary drivers of that growth. In addition to obtaining that information and discussing it with management, examiners should consider the following:

  - The planned sources of growth from the business plan. Projected growth should have adequately supported assumptions. Comparing projections and related assumptions to actual growth can provide valuable insight when evaluating the sources and primary drivers of portfolio growth. Also, there should be evidence that management and credit staff exhibit the expertise to facilitate that growth, especially if it involves new types of lending or comes from unplanned sources. In these situations, the institution may be unprepared to manage the risks that could arise from this growth. Rapid loan growth attributed to any one branch office or loan officer may also be cause for concern.

  - How changes to loan underwriting standards and exceptions to standards are impacting growth. Relaxing or tightening loan underwriting standards and the number and frequency of loan underwriting exceptions that are allowed can be key drivers of new loan volume.

  - How incentives to borrowers or lending staff facilitate growth. Examples of incentives to borrowers could include using teaser rates or waiving fees for refinancing or repricing. Incentives to lending staff would most commonly include bonuses or incentive pay linked to loan growth.

- ***Quality and Composition of Growth*: What is the quality and composition of new volume, and how does this compare with and impact overall portfolio quality and composition?** Evaluating new loan volume and how it impacts portfolio quality and composition should focus on the underlying risk characteristics of the new volume. In completing this evaluation, consider the same portfolio quality indicators and composition considerations that are discussed in the *Quality & Composition* procedure. Apply those indicators and considerations to the new loan volume and determine how adding new loan volume has impacted the overall portfolio. For example, evaluate the impact of growth on existing portfolio concentrations. Also consider the following:

- Institutions generally originate Acceptable quality loans and limit lending to borrowers with criticized loans. Acceptable loans typically do not present an undue or unwarranted credit risk, but the quality of individual Acceptable loans can vary widely. For example, the quality of Acceptable loans to borrowers with PD ratings of 9 under the System risk rating guidance are defined as "minimally acceptable" and described as, in part, "prone to deterioration in a difficult economy." Often, new PD 8 and 9 loans are weaker than overall portfolio quality and increase the institution's portfolio risk profile. While this additional risk can be manageable in the short term, the consequences of regularly pursuing lower quality new loans could significantly impact portfolio quality over time.

- Reviewing the specific underwriting exceptions and credit factor weaknesses on new loan volume provides insight on the quality of growth and how vulnerable this volume is to adversity. For example, new loan volume that does not comply with the institution's liquidity or repayment capacity standards may go past due or become criticized in a relatively short period even though other credit factors (e.g., collateral, character, or solvency) have complied with standards and supported an Acceptable classification.

Refer to the following for additional information and guidance:

- FCA Informational Memorandum on Asset Growth, Market Volatility, and Best Practices for Fast Growing Institutions dated May 9, 2008

- FCA Informational Memorandum on Significant Asset Growth & Its Implications dated February 9, 2007

3. Prospective Risks:

Evaluate emerging and prospective risks and their potential impact on the portfolio.

Guidance:

An evaluation of portfolio quality and composition should consider the potential impact of emerging and prospective risks. Conditions, especially in volatile economic times, may change quickly. Institutions should have robust and dynamic systems and tools to identify emerging and prospective risks and quantify their effect. By identifying these risks early, institutions can adjust their LPM practices, including loan servicing strategies and staff resources, to mitigate or control the potential impact.

Evaluative questions and items to consider when examining emerging and prospective risks and their potential impact on portfolio quality include:

- ***Sources of Emerging and Prospective Risk*: What are the ongoing and emerging risks that may impact the portfolio?** Emerging and prospective risks that could impact the portfolio may arise from various sources. The institution should be identifying these risks as part of the business planning process and through ongoing portfolio monitoring activities and analyses. Examiners should review the institution's business plans, portfolio monitoring reports, allowance for losses analyses, economic or industry studies, and any other documents that identify emerging and prospective risks. Because some risks can emerge or change quickly and may not be reflected in these documents, it is also important that examiners discuss with the institution's credit and risk management personnel any material risk factors they see (e.g., extreme weather or market events). The evaluation of prospective risk should also include identifying and evaluating any material portfolio concentrations that would magnify the adverse effects of the risk on the institution (refer to the *Concentration Risk Management* topic of the Examination Manual for examining concentration risk identification and management). There are many possible credit, operational, market, reputation, strategic, or compliance risks that could affect portfolio quality based on portfolio composition, the institution's business model, and a variety of internal and external factors. The following are common examples of areas where conditions or circumstances could impact portfolio quality:

  - Commodity prices
  - Input costs
  - Interest rates
  - Weather and production expectations
  - Collateral values
  - Off-farm income reliance and reliability
  - Government programs
  - General economic conditions
  - Competitive pressures in the marketplace
  - Regulatory, environmental, or technological factors affecting the institution or its customers
  - Off-balance sheet items (e.g., unfunded commitment exposure, letters of credit, commitments to extend credit, loans serviced for other entities)

- ***Impact to Portfolio Quality and Composition:*** **How do the emerging and prospective risks potentially impact the institution? Do the risks pose a significant threat to portfolio quality or financial condition and performance?** The board and management should have a good understanding of the sources, causes, and potential impacts of emerging and prospective risks and should analyze the likelihood of the risk occurring. The business plan should identify the risks and consider the potential impact on projected credit quality and financial results, with material risks addressed via strategies, actions, and contingency plans. The institution should use stress testing or other analyses to quantify the impact from potential risks (refer to the *Portfolio Planning & Analysis* topic in the Examination Manual for guidance on examining stress testing). The key ratios, statistics, and other portfolio quality indicators discussed in the *Quality & Composition* procedure above would typically be used when quantifying the potential impact on portfolio quality. Refer to the *Capital Adequacy*, *Earnings Adequacy*, and *Allowance for Losses* topics in the Examination Manual for guidance on examining the impact of prospective risks in each of these areas. Examiners involved in evaluating portfolio quality and these other topics should coordinate closely when examining the potential impact of prospective risks due to the interrelationships that exist between these examination topics.

Refer to the following FCA Informational Memorandums for additional information and guidance on addressing prospective risks:

- Servicing Loans to Borrowers in Distressed Industries dated January 21, 2016
- Portfolio Management in Volatile Times dated January 29, 2015
- Confronting the Increased Risk Environment dated July 2, 2009

4. Direct Loans (banks only):

Assess the quality and composition of the direct loan portfolio.

Guidance:

FCA Regulation 614.4000 authorizes System banks to extend credit to System direct lender associations and other financing institutions (OFIs) through a direct loan. Direct loans are wholesale lending relationships between the funding bank and its affiliated associations and OFIs. OFIs are banks, trust companies, agricultural credit corporations, incorporated livestock loan companies, savings institutions, or any association of agricultural producers engaged in making loans to farmers, ranchers, and aquatic harvesters or producers. In some cases, a direct loan relationship may exist between a bank and a non-affiliated association in another district and involves participation interests in direct loans between funding banks. Associations and OFIs use the proceeds from the direct loan to fund lending operations. Direct loans generally comprise a substantial portion of a bank's assets. The direct loan is primarily secured by the institution's loan portfolio and is controlled by a borrowing base. Historically, losses in direct loans are rare because of regulatory capital requirements, the underlying collateral supporting retail loans, and the ability of an institution to merge if its viability is threatened. Nonetheless, it is important to review the quality of the direct loan portfolio. Classification and credit administration for direct loans is evaluated in the *Uniform Classification System* procedure in the *Risk Identification* topic and the *Direct Loan & OFI Administration (banks only)* procedure in the *Credit Administration* topic, respectively.

Evaluative questions and items to consider when examining direct loan portfolio quality and composition include:

- ***Direct Loan Quality:* What are the current levels, trends, and primary drivers of credit quality in the direct loan portfolio? Is the credit risk appropriate for the bank's risk-bearing capacity?** Banks typically use the UCS and risk ratings (PD and LGD) to identify and report risk in direct loans. Examiners should evaluate direct loan portfolio quality in relation to risk-bearing capacity using Total Regulatory Capital and risk weighting the direct loans consistent with regulatory capital treatment. If a bank reports any criticized direct loans, consider comparing the risk-weighted criticized direct loan volume to the criticized retail volume in that institution to help assess the basis for the classification. Most often, inconsistencies in classifications occur when significant weaknesses in board or management practices impact the direct loan classification but have yet to materialize in the association's or OFI's loan portfolio or impact financial condition and performance. FCA Special Supervision or Enforcement Actions should also be considered when analyzing the quality of a bank's direct loan portfolio.

- ***Direct Loan Composition*: What is the composition of the direct loan portfolio? To what extent has portfolio composition impacted or could impact credit risk and portfolio quality?** A bank's direct loan portfolio may be comprised of loans having significant size variances or underlying retail portfolio concentrations. If the direct loan portfolio is heavily concentrated in one or two large associations, it creates increased risk to the bank. Single loan regulatory limits do not apply to direct loans. However, concern about credit risk in a single, large direct loan could affect the overall determination of direct loan portfolio quality. In addition, if the underlying retail portfolio is heavily concentrated in one commodity or in a few large loans, that concentration increases the risk to a bank's direct loan as well. If the bank has a material OFI portfolio, that portfolio may also create additional risk given a more limited lending relationship and less information in comparison to its association portfolio. Refer to the *Concentration Risk Management* Examination Manual topic for additional considerations.

- ***Prospective Risks*: What are the potential impacts of prospective risks on credit quality in the direct loan portfolio?** Many of the prospective risks that affect retail portfolios would also affect direct loan portfolios since direct loan collateral and repayment sources are primarily comprised of association loan portfolios. Refer to the *Prospective Risk* procedure for additional information. In addition to those risks, the bank must also consider changes to the association's control environment and potential risks (e.g., cybersecurity threats, fraud events) that could impact operations and the ability to perform on the direct loan.