

Category: Loan Portfolio Management
Topic: Managing Risk Concentrations

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

- An overview and description of the program area (pg 1)
- A summary of subcomponents of "Managing Risk Concentrations," including :
 - i. Risk Parameters (pg 1-2)
 - ii. Large Loan Concentrations (pg 2-3)
 - iii. Interdependence/Affiliated Exposures (pg 3-4)
 - iv. Counterparty Risk (pg 4-6)
- A summary of examination criteria (pg 6)
- The objectives for examining this area (pg 6)
- The examination procedures and guidance (pg 6-19)

Overview

Managing risk concentrations allows institutions to control risk exposure to different types of portfolio concentrations. These concentrations may be by industry, geographical area, large loan exposures, individual borrowers/groups of borrowers, reliance on third parties, etc. Effective management of risk concentrations allows institutions to minimize risk exposure due to changing economic cycles, issues affecting individual customers, or other situations that might pose risk to a portfolio.

The importance of managing risk concentrations has greatly increased in recent years due to factors such as:

- Larger loans being made or purchased by institutions.
- Greater volatility in commodity prices and operating costs.
- Increased capital markets and participation lending activity.
- Growing dependency on other parties for operational, cash flow, or management needs.
- Actions to move accounts and risk off the institution's balance sheet.

The board and management need to establish clear direction for managing risk concentrations and ensure sound processes and controls are in place. Risk concentration exposures must be commensurate with the risk-bearing and earnings capacity of the institution and the risk management skills and abilities of the board and management. Appropriate concentration levels are not static and need to be continually evaluated and adjusted to ensure prudent and manageable risk exposures.

Risk Parameters/Concentrations

Risk concentrations come in many shapes and forms. Concentration risk can emanate from items such as the financing of certain commodities, utilization of unique lending programs/credit delivery systems, new loan products, new target markets, and risk factors/characteristics shared by a group of customers. This subcomponent focuses on the identification of risk concentrations by institutions and the utilization of risk parameters as a key first step in managing pertinent risk concentrations. Key risk concentrations

including large loans, interdependence/affiliation, and counterparty are addressed in greater depth in separate examination subcomponents within this module.

Risk parameters are controls that communicate the board and management's risk appetite and tolerance. Risk parameters are commonly used to set limits on an institution's exposure to certain commodities/industries and in specialized or new lending programs. The limits established by risk parameters should not be viewed as extremely rigid and inflexible. Rather, when the institution's actual exposure approaches a risk parameter, the institution should perform a thorough review of the risk posed by the concentration and the adequacy of underlying risk management mechanisms. The results of this review can be used as the basis to reaffirm or adjust the parameter, approve a temporary exception to a parameter, or to revise supporting risk management practices.

Risk parameters should be uniquely tailored to the risk faced by an institution and that institution's risk-bearing and earnings ability. As such, risk parameters may vary significantly between institutions. Risk parameters are most effective when expressed in terms relative to risk-bearing capacity (e.g., as a percent of risk funds) and/or the impact on the institution's earnings stream (e.g., as a percent of 3-year average net income). This provides for a dynamic control that considers changes over time in risk-bearing and earnings capacity. Recognizing that earnings can be particularly volatile, it is reasonable to express/analyze risk parameters in terms of average earnings for a period of time (e.g., past 3 years).

While it is preferable and a best practice to have parameters expressed in dynamic terms (as a percent of risk funds and/or net income), many institutions may choose to express parameters as a dollar amount or as a percentage of the portfolio. This practice in and of itself does not warrant criticism. However, in order to evaluate the reasonableness of the parameter, the examiner should compare it against risk funds and the institution's earnings stream. Furthermore, risk parameters and supporting systems to measure compliance with the parameters should address loan commitments rather than just outstanding balances. Because undisbursed commitments can be significant and are typically readily available to the customer, loan commitments provide a more complete and appropriate view of total risk exposure.

The effect of certain loan participation and credit enhancement activities needs to be considered when measuring an institution's risk exposure to a particular concentration. For example, several banks have set up participation pool programs. These programs have been utilized by institutions as a means to improve certain regulatory ratios, but the programs are intended to operate on an "income neutral" basis for associations selling participations to their funding banks. The net returns (positive or negative) from the loans in these programs are anticipated to be transferred back to each respective participating association via patronage payments or adjustments in related association capitalization/stock levels in the bank. As such, under reasonably normal conditions, if the programs function as designed, the concentration risk effectively reverts back to the participating associations. Under periods of extreme stress, however, the funding banks would be increasingly exposed to the credit risk in these loans.

As a result of the complexities of these programs, it is reasonable to measure and analyze risk concentration exposures in a dual fashion, (i.e., both with and without program volume included in concentration statistics). An association that opts to measure its risk exposures by including all such program volume in its concentration statistics is not a concern. However, if an association's sole method of analyzing its concentration exposures is to exclude this volume, the institution is understating its concentration risk exposure. Similar expectations (viewed from the opposite side of the transaction) apply when analyzing risk concentrations at the bank level.

Risk parameters should be routinely monitored and reviewed for ongoing relevance in light of changing portfolio conditions. As risk levels and portfolio concentrations change, and institutions devise new loan products and programs, the continued adequacy of established parameters also requires review.

Large Loan Concentrations

Large loan concentration risk represents the collective risk/exposure a group of large loans presents. This is normally measured based on an institution's top ten loan commitments. The higher the level of

exposure the top ten loan commitments present to risk funds or earnings the more in-depth the examiner's analysis must be.

A careful review is needed to evaluate the risk posed by large loans based on items such as:

- Are the loans originated and serviced by the institution or are they purchased assets?
- What is the risk rating profile and trend?
- Do the loans meet all respective underwriting standards/how many loans involve exceptions?
- Do the loans involve customers from within or outside the territory?
- Do the loans involve specialized collateral?
- How much of the volume is tied to the same industry?

The institution's reporting and analysis process must identify the individual risk as well as the collective risk of these loans. Circumstances where loans will act in a similar manner, (e.g., customers in a common industry or customers impacted by changes in grain prices, etc.) should be identified in reporting and monitoring processes.

Individual borrower hold positions are an integral part of managing large loan concentrations. Borrower hold positions limit the amount of an institution's loan volume to a single obligor (including attributed borrowers). In determining borrower hold positions, the board and management must decide how much of the institution's capital and earnings stream they are comfortable placing at risk with one customer. Factors such as portfolio conditions, borrower quality, the board and management's risk appetite, and portfolio management capabilities need to be evaluated when establishing hold positions. Borrower hold limits should generally be differentiated based on a varying risk scale (e.g., risk ratings) to sufficiently reflect and manage the wide range of risk among different credit assets. Hold limits may also be differentiated based on industry, with more conservative hold positions established for borrowers in industries that are specialized in nature or where staff has less expertise. Finally, in assessing the reasonableness of borrower hold positions, the board and management should closely evaluate the credit exposure relative to the institution's risk-bearing capacity (e.g., risk funds). Additionally, an emerging best practice is to analyze hold positions relative to an institution's earnings. Stable earnings performance is critical to maintaining the confidence of borrowers and investors. As such, care should be taken to ensure that losses from one loan or a limited number of accounts cannot unduly disrupt an institution's earnings stream.

Interdependence/Affiliated Exposures

Interdependence/affiliation risk occurs when otherwise unrelated loans are linked together by a common relationship/dependency. While attribution is not required for regulatory lending limit purposes, in these loans a common link creates interdependence and additional risk.

To fully understand interdependence/affiliation risk you must evaluate the borrower from the perspective of an "Interdependence Continuum." For example, begin with the grain farmer who operates independently and has numerous options for selling production ranging from commercial grain terminals to local livestock producers. In contrast, a hog farmer, while independent, may only have limited choices on where to sell pigs and a sugar beet grower must own shares in one of a limited number of cooperatives in order to market their production. Other examples include an ethanol plant that is structured as an independent limited liability company (LLC), but operates under the corporate umbrella of a parent company. While perhaps not attributed to the parent company for lending limit/attribution purposes, actions of the parent company can affect the financial condition and performance of the LLC. Even further up the "Interdependence Continuum" is the borrower who is quite dependent on the financial health and stability of others. Examples include contract growers for integrated poultry and swine operators, where the borrower/grower has limited financial ability to stand on their own. Also, note that at the end of the "Interdependence Continuum" are borrowers who are so interdependent that attribution is required for lending limit purposes. However, as noted earlier, the focus of this subcomponent is recognizing and managing risks where loan attribution is not required per regulatory criteria.

Interdependency/affiliation exposures must first be identified before corresponding risk management actions can be taken. Accordingly, institutions must have a management information system that aggregates loan exposures based on these relationships. Examples of interdependence/affiliation exposures that should be identified and tracked include:

- Integrator/downline barns.
- Unrelated borrowers that join forces for a common project, (e.g., a packing plant or value added cooperative (the project may or not be financed by the institution)).
- Borrowers that operate as independent LLCs but are under the same corporate parent.
- Borrowers with different ownership where management services are provided by a common entity.
- Unrelated borrowers selling production to the same entity and the number of buyers for the borrower's production is very limited (e.g., eggs, sugar beets, cranberries, certain fruits, etc.).
- Borrowers structured as LLCs/partnerships where the same individuals or groups of individuals have ownership shares, although individual ownership levels are not enough to trigger legal attribution. For example, one individual owns a 25 percent interest in ten separate companies that borrow from an institution (present at times on land-in-transition lending for example).

Interdependence/affiliation risk needs to be considered on an individual loan basis and for the portfolio. This type of evaluation may deem individual loans to pose too much risk after evaluating the interdependency risk combined with items such as credit factors, loan size, terms, and quality of collateral. On a portfolio basis, the board and management must determine what specific credit controls need to be established to adequately manage resulting risk exposure. Controls could consist of items such as tailored underwriting standards, maximum hold limits tied to an affiliation, and use of government guarantees.

The risk caused by interdependence/affiliation varies greatly in part because of oftentimes unique underlying circumstances. When assessing the risk posed by interdependency and the need for corresponding risk parameters, examiners and institutions may find it useful to segment interdependence/affiliation risk by tiers. For example:

- Tier 1: Borrowers exhibit a high degree of interdependence on affiliate and rely heavily on affiliate for financial stability. Most prominent examples include integrator (affiliate)/downline barn arrangements in the poultry and swine industries.
- Tier 2: Borrowers are somewhat less dependent on affiliate, but the performance and decisions of the affiliate can significantly affect the performance of related borrowers. Examples include borrowers contracting with the same company for management services and LLCs with the same corporate parent or common members. These types of loans in a portfolio might be limited in number, but loan size may be fairly large.
- Tier 3: Borrowers operate fairly independently by raising their own production but the number of buyers for the production is limited and the ability to sell production may be dependent on membership in a select cooperative or organization (affiliate). Examples include sugar beet growers, cranberry and egg producers, and certain fruits. The number of loans in a portfolio may be fairly high in number, but loan sizes are typically more moderate.

Counterparty Risk

Counterparty risk occurs when System institutions engage in financial and credit transactions and operational services with both System and non-System counterparties. Counterparty risk comes from many sources including loan participations (selling and buying), investments and financial derivatives, and credit enhancements, such as standby commitments, credit guarantees, etc. Financial counterparty risk is the risk that one of the parties to a financial transaction cannot, or will not, meet contractual obligations, while operational services counterparty risk could relate to a service provider's willingness

or ability to perform as expected.

While all significant business relationships pose counterparty risk, for purposes of examining loan portfolio management (LPM), the focus is on counterparty risk that emanates from execution of the lending function. As such, this document does not address examining counterparty risk in investments and financial derivatives or in the operations area (e.g., contracts for technology, audit, human resource services, etc.).

Counterparties add complexity to the risk management process. An institution's counterparty may have counterparties who also have counterparties. There are also differences between credit risk and financial counterparty risk, such as:

- Counterparty risk is more open-ended and uncertain.
- Counterparty risk is often bi-lateral.
- Counterparty positions can sometimes offset one another.
- Counterparty risk mitigation techniques are more complex.
- Counterparty risk monitoring and reporting is more challenging.

Appropriate selection of counterparties combined with properly structured transactions represent a sound business practice that can help manage and diversify risks, improve earnings, add to capital, and allow an institution to better serve its market. However, over reliance on a single counterparty is risky and can impair an institution's safety and soundness.

When selecting counterparties, institutions should seek those with financial strength and stability. Also, if the action involves buying an interest in a loan, an assessment of the business practices of the counterparty should be completed. For example, the institution should assess how the counterparty monitors, services, structures, and prices loans, the adequacy of underwriting standards, and its risk appetite. Management must also assess and monitor the financial stability of counterparties and take appropriate action to manage and control potential risk. This should include obtaining financial reports on an ongoing basis, monitoring debt ratings, etc.

Loan sale transactions involve different counterparty risks. When the counterparty is a loan participation buyer, up-front due diligence and analysis expectations are lessened. The original purchase of the loan, (and related remittance of funds), represent the counterparty's ability to perform. However, an institution must not become over-reliant on a single counterparty for buying its volume. The possible inability of that counterparty to purchase additional volume could disrupt ongoing lending operations. When selling volume, institutions should strive to select counterparties that understand and have the capacity to withstand the cyclical nature of agricultural lending. A common concern among many System institutions that sell volume is that upon credit deterioration some buyers would rather exit the credit versus working with the customer. **Furthermore, institutions active in selling loan participations must ensure underwriting, servicing, and loan/loan participation documentation practices are sufficient to withstand allegations of negligence that could result in the buyer being able to "put-back" the previously sold loan.**

Boards must establish appropriate internal controls for counterparty risk. As such, each institution board must carefully consider the amount of risk funds and/or earnings that will be exposed to individual counterparties. Additionally, boards should also adopt policy direction consistent with FCA's October 2003 Counterparty Risk Informational Memorandum.

A sound counterparty analysis should include stress testing or worst case scenarios that are completed for the board to help them establish appropriate limits and strategies. The analysis should consider the impact of these scenarios on the institution's balance sheet, income statement, and continuity of operations.

Each institution must be able to accurately measure and effectively control exposure to counterparties. In addition, System institutions should jointly develop policies and practices that limit exposure to

material single counterparties within a District and throughout the System.

Institutions should also evaluate credit risk that results from counterparty risks faced by borrowers. For example, ethanol plants (possibly borrowers) that forward contract grain with local farmers/borrowers represent counterparty risk within the loan portfolio. Another example includes borrowers that prepay for fertilizer and seed in the fall, but do not receive the product until the following spring. These borrowers are subject to counterparty risk relative to the supplier's ability to perform.

General Examination Criteria

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

- [FCA Regulations](#) Part 614, Subpart J- Lending and Leasing Limits- 614.4350 to 614.4361
- FCA Examination Manual Section [EM-310](#)
- FCA Informational Memorandum October 2003- [Counterparty Risk](#)
- FCA Uniform [Call Report Instructions](#) for Schedule RC.1 4(g)

Examination Objectives

- Determine if adequate processes and controls are in place for the institution to manage its risk concentrations.
- Determine if risk concentration exposures are reasonable based on the institution's loan portfolio management (LPM) capabilities and the institution's risk-bearing capacity and income-generating ability.

Examination Procedures and Guidance

Risk Parameters/Concentrations

Key Question: Has the institution identified key risk concentrations, effectively utilized appropriate risk parameters as part of its process for managing risk, and adopted appropriate risk mitigation practices for significant concentrations?

1. Adequacy of Risk Parameters:

Determine if the institution has adequate risk parameters in the following identified categories, as applicable, and for any other areas where significant activity is expected or a concentration exists. Document and describe the applicable parameters and any concerns with the level of risk exposure allowed by the parameter. If the institution does not have a parameter in a specified area, conclude on whether the exposure is significant enough to warrant a parameter. If the institution has any risk parameters in areas not listed below, document and describe the parameters in terms of risk funds and earnings levels and note any concerns. As part of this examination step, verify that all established parameters are setting exposure limits based on loan commitments rather than just outstanding balances.

Guidance:

The following are common categories that may warrant establishment of risk parameters. Examiners

should identify and evaluate the amount of exposure the institution has in each of these areas.

- Individual commodities
- Scorecard lending
- Unsecured lending
- Loans constituting project financing (i.e., loans funding construction of large facilities)
- Loans to borrowers that are significantly expanding operations
- Highly leveraged transactions (see definition at: HLT Definition)
- Borrowers with significant goodwill and/or negative tangible net worth
- Mission Related Investments
- Loan participation volume/capital markets volume
- Out of territory loans
- Other credit needs loans
- Loans with specialized collateral
- Loans in non-core industries (i.e., industries not common to institution's territory)
- New lending programs
- Loans dependent on capital gain income for repayment (land in transition)
- Loans secured by land with very limited or no income producing capability (recreation ground, etc)
- Adverse loans
- Special Mention loans
- Nonaccrual loans

Note: Interdependence/affiliations, individual and large loan concentrations, and counterparty risks are addressed in separate areas of this examination guide.

Establishing appropriate risk parameters is an art. Risk parameters should be tailored to the unique characteristics and concentrations of an institution. FIRS rating benchmarks may be useful in evaluating some asset quality-related parameters. However, in most cases one size does not fit all, so it is difficult to establish firm guidance on when parameters are necessary or are overly lenient.

Consider the following points for evaluating the adequacy of and/or need for risk parameters:

- Does the risk concentration/portfolio segment make up a large number of borrowers by number with moderate to smaller sized loans?
- Does the risk concentration/portfolio segment involve commodities and industries that are common to the chartered territory?
- Does the risk concentration/portfolio segment involve customers from within the chartered territory?
- Does the risk concentration/portfolio segment involve a mature industry?
- Does the risk concentration/portfolio segment involve an industry with low volatility?
- Does the risk concentration/portfolio segment involve borrowers that operate independently (not a high degree of contracting/integration)? For example, grain producers are typically independent producers while poultry operations are usually highly integrated.
- Does the risk concentration/portfolio segment involve traditional loan programs and structures?
- Does the risk concentration/portfolio segment consist of collateralized loans where the collateral is typical and common to the territory?
- Do the underwriting standards of the concentration/portfolio segment support sound lending and acceptable risk?
- Does the exposure in relationship to the potential risk soundly match up to the risk-bearing ability of the institution as a percent of risk funds and/or 3-year average net income?
- Is the weighted PD rating of loans in this risk concentration/portfolio segment favorable (PD rating of 7 or better) and are there any significant risk exposures based on LGD designations? (Examiners must be comfortable with the granularity and integrity of the

institution's risk rating process to meaningfully answer this question.)

The more questions above with a “no” answer, the more conservative the risk parameter should be.

2. Monitoring/Reporting Risk Parameters:

Determine if risk parameters are properly monitored and accurately reported on an ongoing basis. Document the monitoring process, controls to ensure accuracy of reporting, and any concerns with accuracy. Also, describe the reporting process, including frequency and practices/controls for updating risk parameters, and note any concerns.

3. Risk Parameter Exceptions:

As applicable, evaluate instances where the institution has exceeded or increased an established parameter. Determine if the institution's actions were appropriate, adequately supported, and commensurate with the risk-bearing and earnings capacity of the institution. Evaluate whether board involvement was required (or should have been required) to approve parameter increases or exceptions.

4. Managing Concentration Exposures:

If the work performed in prior examination steps resulted in identifying a significant concentration risk exposure, evaluate the adequacy of management's efforts to mitigate and control that risk exposure.

Guidance:

EIC and Senior Examiner judgment will drive the amount of work performed in this examination step. When determining whether to perform examination work relative to specific risk concentrations, consider factors such as:

- Exposure levels relative to earnings and capital.
- Quality (PD and LGD ratings) of the assets that comprise the risk concentration.
- Inherent risk in the concentration (e.g., concentrations with a large number of “no” answers to the questions in **Exam Step 1** exhibit greater inherent risk).
- Whether the concentration has received adequate coverage in past examination work.

Because risk concentrations represent such a wide range of potential topics and are unique to specific institutions, detailed guidance has not been prepared relative to examining all pertinent risk concentrations. However, various resources, including guidance for examining scorecard lending practices and lending in key industries, are available in the Credit Exam Guidance Library, and in the FCA Examination Manual (in particular in the Examination Bulletins and General Examination Guidance sections). (Note: The Credit Exam Guidance Library and the General Examination Guidance section of the FCA Examination Manual are available to internal users only.)

Absent tailored examination guidance, when evaluating risk management efforts for a specific concentration, consider evaluating the adequacy of items such as the following:

- Established underwriting standards
- Policy, procedure, and other credit-related direction
- Recent changes in direction provided to staff

- Risk analysis efforts
- Staff expertise levels
- Supporting controls
- Lending delegations
- Coverage by the ICR and Internal Audit
- Reporting to management and the board

Large Loan Concentrations

Key Question: Has the institution effectively managed its large loan concentrations to ensure large loan exposures do not subject the institution to undue risk?

1. Large Loan Concentrations:

Identify the top ten loan commitments as a percent of risk funds and 3-year average net income, and determine the overall depth of examination needed to evaluate large loan concentrations.

Guidance:

The Agency has not established formal benchmark criteria on the top ten loan commitments as part of its FIRS process. However, FCA's Credit Specialist Group endorses the following informal criteria to assist examiners in gauging the reasonableness of an institution's risk exposure from large loan concentrations.

Top ten commitments as a percent of risk funds:

- Low concern < 45 percent,
- Moderate concern < 75 percent, and
- High concern > 75 percent.

Top ten commitments as a percent of 3-year average net income:

- Low concern < 400 percent,
- Moderate concern < 650 percent, and
- High concern > 650 percent

The respective level of an institution's exposure to large loan concentrations should dictate how deep an examiner goes in completing the following examination steps. For example, the top ten loan commitments comprising 75 percent or more of risk funds should trigger an intense review of large loan concentrations and could likely result in recommendations to reduce and better manage large loan concentration risk. Forty-five to 75 percent would support a moderate level of review, and if under 45 percent the review can be more limited.

The criteria for the top ten commitments as a percent of average net income is viewed as more stringent in comparison to the risk funds criteria. The criteria was developed with the view that earnings are an institution's first line of defense against losses. With this in mind, consider the following when determining the depth of review to perform:

- Institutions where the top ten commitments fall into the high concern range for both the risk funds and net income criteria are the most significant concerns.
- An institution in the high concern range for the net income criteria only is not as much of a concern as an institution that is in the high concern range based on the risk funds criteria.

When determining the risk posed by large loan concentrations, examiners must also recognize situations where earnings are unusually volatile. If earnings are significantly affected by one-time

events such as fluctuating patronage payments from the funding bank and allowance provisions, examiners should factor in this earnings volatility when formulating conclusions. Furthermore, the appropriateness of the criteria for measuring large loan concentrations as a percent of net income will be reviewed over time after examiners have the opportunity to apply the criteria during ongoing examination work.

2. Large Loan - Reporting/Analysis:

Obtain and analyze reporting/analysis done on large loan concentrations (internal and board reporting) and/or the top ten loan commitments. Conclude on the adequacy of large loan reporting/analysis and note any concerns.

3. Large Loans - Risk Profile:

Analyze the risk profile of the top ten loans (or other large loan concentration as determined by the institution).

Guidance:

Evaluative questions to consider when analyzing the risk profile of the institution's large loans include:

- Are the loans primarily originated and serviced by the institution or are these purchased assets?
- What is the risk rating profile and trend? Consider both the probability of default (PD) and the loss given default ratings (LGD). (Examiners must be comfortable with the granularity and integrity of the institution's risk rating process to meaningfully answer this question.)
- Do the loans meet all respective underwriting standards/how many loans involve exceptions?
- Do the loans involve customers from within the territory or outside the territory?
- Do the loans involve specialized collateral?
- How much of the volume is associated with customers in the same industry?
- Are any of the customers interdependent on or affiliated with one another? (See Interdependence/Affiliated Exposures subcomponent for additional details).
- Are multiple customers sensitive to the same stressors, such as high grain prices?
- Is risk mitigated on the loans by the presence of substantive and reliable/stable off-farm income?
- Does the institution have high quality and current financial/borrower performance information on customers with large loans, such as annual audited or reviewed financial statements, monthly or quarterly interim financial information, and monthly/quarterly borrowing base reports?

4. Large Loans - Risk Exposure:

Conclude on whether large loan concentrations present undue risk exposure to the institution.

Guidance:

Consider results from the three preceding procedure steps. Also, examiners may wish to analyze how dependent the institution's overall revenue stream is on income from large loans. For example, determine what percent of the institution's interest income is generated by the institution's top ten loans. Fully explain and support conclusions, especially in cases where the top ten commitments are greater than 75 percent of risk funds and/or greater than 650 percent of 3-year average net income.

5. Borrower Hold Limits:

Describe and evaluate the institution's hold limit process for individual borrowers.

Guidance:

Institutions need to establish reasonable and appropriate hold limits as a fundamental risk management control. Hold limits should generally be differentiated by loan quality (and other applicable factors) for maximum effectiveness. Evaluative questions/analysis steps to consider for examining hold limits and supporting controls include:

- Identify if and how borrower hold limits are stratified by risk rating/loan quality or other differentiating factors such as industry. Document how much the maximum allowable loan exposure to a single customer represents as a percentage of risk funds and 3-year average net income, and note any related quality requirements. For purposes of determining maximum hold limits, factor out loan amounts that are federally guaranteed or supported by viable credit enhancements that effectively transfer credit risk.
- Compare the maximum internal hold position with single borrower limits prescribed by the institution's General Financing Agreement/promissory note with its funding bank.
- Verify that hold limits are expressed in terms of loan commitments rather than outstanding principal.
- Analyze how the institution supported its internal lending limits/hold positions and what factors it based its position on (e.g., institution capital and earnings, stress testing, portfolio conditions, borrower quality, borrower industry, board and management risk appetite, portfolio management capabilities, etc.). Also, note controls or triggers for revisiting hold limits.
- Analyze the approval process for handling exceptions to a hold position and how authorities are structured (management vs. board, prior or post approval by board). Be cognizant of differences in handling exceptions that are caused due to deterioration in borrower quality versus decisions to exceed hold positions that are more under the institution's control. Carefully evaluate processes that allow "temporary" exceptions (e.g., after the loan is booked/funded the institution seeks additional buyers for the volume).
- Note any unique characteristics of the hold limit process. Possible examples include scoring the borrower/loan based on subjective factors and the resulting score permits upward or downward adjustments to established hold limits, and internal attribution criteria used for hold limits that differs from requirements of FCA Regulation 614.4359. For example, some institutions for internal hold limit purposes may not necessarily require attribution when the conditions of 614.4359(a)(3) exist.

6. Loan Attribution Process/Controls:

Review the adequacy of guidance and controls for ensuring proper loan attribution and for tracking and monitoring hold limits. Ensure criteria utilized by the institution is consistent with regulatory requirements in FCA Regulation 614.4359. As part of this examination step, evaluate the accuracy of information reported on FCA Call Report Schedule RC.1 4(g). Note any concerns.

7. Appropriateness of Hold Limits:

Conclude on the reasonableness of the institution's hold limits as related to the institution's risk management abilities, risk funds, earnings capacity, and large loan risk profile.

Guidance:

Maximum borrower hold positions in excess of 7.5 percent of risk funds and 65 percent of 3-year

average net income should receive additional scrutiny. Note, however, that quality stratifications should also be considered in evaluating the reasonableness of hold positions. Large hold positions are not as concerning when limited to extremely high quality customers. When concluding on the adequacy of hold limits, consider the hold limit levels for loans the institution is most likely to make (i.e., loans with a PD rating of 6 or worse). In instances where the institution is judged to be more lenient in assigning risk ratings to loans, (e.g., the portfolio has a high percentage of loans with PD ratings of 4 and 5, but in reality the loans should be assigned risk ratings of 5 or 6), examiners may choose to designate loans with a PD rating of 5 as the type of loan the institution is most likely to make. Also, be cognizant that hold limits represent potential exposure while the top ten commitments represent actual exposure. As a result, institutions with actual top ten commitment exposure exceeding 75 percent of risk funds and 650 percent of net income are much higher concern than institutions where hold limits would potentially allow that level of exposure.

Interdependence/Affiliated Exposures

Key Question: Has the institution effectively managed its interdependence/affiliation risk through staff guidance and controls to ensure that these relationships are appropriately recognized and do not expose the institution to undue risk?

1. Credit Guidance & Controls:

Conclude on the adequacy of guidance and controls the institution has in place to identify, analyze, and report on interdependence/affiliation risk. Note any concerns or suggestions for improvement, and conclude on how the institution is executing its guidance/controls based on examination findings.

Guidance:

Evaluative questions to consider when reviewing an institution's guidance and controls related to interdependence/affiliation risk include:

- Does credit guidance address identification and management of affiliation risk?
- Does credit guidance address expectations for use of government guarantees on affiliated accounts?
- Is a process in place to perform periodic credit analysis/approval of an affiliate (such as a swine or poultry integrator) and ongoing financial review and analysis?
- Are underwriting standards tailored to affiliates, including collateral considerations (age, condition, size, location, etc., if specialized collateral)?
- Are risk parameters/portfolio limits in place to address affiliated risks and are the parameters reasonable based on risk funds and/or 3-year average net income?
- Do risk parameters include reasonable limits on grower volume for specific integrators?
- Is there board and management reporting on interdependence/affiliation risk?
- Is stress testing of interdependent loans/affiliated loans performed to evaluate potential portfolio risk?

2. Interdependency/Affiliation Risk Profile:

Evaluate the risk profile of the top five interdependence/affiliation relationships (reduce or add to this number based on the materiality of the total commitment involved) to determine whether these relationships pose acceptable risk. Utilize the results of this risk profile evaluation to assess the adequacy of established parameters, the need for new or revised parameters, and whether risk exposure to the institution is at reasonable levels.

Guidance:

Consider the following questions when evaluating the risk profile of an institution's largest interdependence/affiliation relationships(interdependence/affiliation risk exposures with a large number of "no" answers to these questions exhibit greater inherent risk):

- Does the risk segment involve commodities and industries that are common to the chartered territory?
- Is the risk segment involved with loans originated and serviced by the association?
- Does the risk segment involve a mature industry?
- Does the risk segment involve an industry with low volatility?
- Does the risk segment consist of non-specialized collateral?
- Does the institution have a current and sound understanding of the financial condition and risk bearing ability of the affiliate?
- Are underwriting standards appropriately matched to the financial soundness and risk bearing ability of the affiliate?
- Are there several options for continued operations if the relationship with the affiliate is lost?
- Are government guarantees appropriately used to manage risk?
- Does the exposure in relationship to the potential risk soundly match up to the risk bearing ability of the institution as a percent of risk funds and/or 3-year average net income?
- Is the risk exposure concentrated in a fairly large number of customers with moderate or smaller sized loan exposures?
- Do loans to the interdependent/affiliated borrowers carry a favorable risk profile (PD rating of 7 or better along with favorable LGD ratings)? (Examiners must be comfortable with the granularity and integrity of the institution's risk rating process to meaningfully answer this question.)

3. Information Systems:

Determine if the institution's information system supports accurate identification and reporting of interdependence/affiliation risk. Note any concerns.

4. Managing Interdependence/Affiliation Risk:

If the work performed in prior examination steps resulted in identifying a significant interdependence/affiliation risk exposure, evaluate the adequacy of management's efforts to mitigate and control that risk exposure.

Guidance:

EIC and Senior Examiner judgment will drive the amount of work performed in this examination step. When determining whether to perform additional examination work relative to specific interdependence/affiliation risk exposures, consider factors such as:

- Exposure levels relative to earnings and capital.
- Quality ratings (PD and LGD) of the assets that comprise the risk concentration.
- Current financial condition of affiliates (e.g., integrators, parent companies in a LLC relationship, etc.).
- Inherent risk in the concentration (e.g., interdependence/affiliation risk exposures with a large number of "no" answers to the questions in **Exam Step 2** exhibit greater inherent risk).
- Whether the area has received adequate coverage in recent examination work.

In addition to work completed as part of previous examination steps, consider evaluating:

- The adequacy of policy, procedure, and other credit-related direction on lending programs for the specific interdependence/affiliated exposures (e.g., integrator/contract grower lending programs).
- The adequacy/frequency of financial analysis performed on specific affiliates (e.g., integrators or parent companies in LLC arrangements).
- Staff expertise in specific programs.
- Coverage by the ICR and Internal Audit.

Counterparty Risk

Key Question: Is the institution effectively managing its counterparty risk based on sound analysis, monitoring, and reporting on counterparties and does the institution have controls to ensure that counterparties do not expose the institution to undue risk?

1. Types/Dollar Amounts:

Identify and document the specific types and dollar amount of LPM-related counterparty risk the institution is exposed to (e.g., System and non-system participation loan sellers and buyers, guarantors, etc.). Note any concerns with current exposure (in total or relative to a specific counterparty).

Guidance:

Examiners should generally evaluate at least the top five counterparty exposures, and more if justified by the extent of exposure. A table is provided in the Results section as an option for documenting the review of individual counterparty exposures. **Note: Interdependent/affiliated loans are addressed in a separate subcomponent of the Managing Risk Concentrations module.**

2. Board Policy Direction:

Determine whether the institution has adequate counterparty risk policy direction in place.

Guidance:

In assessing the adequacy of policy direction, determine if key items from FCA's Counterparty Risk Informational Memorandum are addressed, including:

- Criteria for appropriate due diligence analysis including processes for measuring and managing counterparty risk.
- Criteria for selecting and maintaining relationships with counterparties, which may include credit ratings.
- Controls that limit the exposure to single counterparties expressed as a percent of the institutions capital base (i.e., risk funds) and/or earnings.
- Periodic reporting and monitoring of counterparty exposures to the board.
- Periodic reporting to the board on each counterparty's financial condition, including an assessment of its ability to perform on agreements and contracts executed with the institution.
- Actions to mitigate exposure in the event the financial condition of the counterparty deteriorates and doubts arise about its ability to perform in accordance with the agreements and contracts executed.

Also, determine if the policy allows exceptions to guidelines, limits, etc. If so, is the approval process for exceptions reasonable (e.g., who can approve exceptions, are exceptions prior approved or approved after the fact, are exceptions reported to the board, etc.)?

3. Selecting Counterparties/Due Diligence:

Determine if the institution performs adequate due diligence on counterparties and assess the adequacy of processes to select counterparties.

Guidance:

Consider the following when evaluating the adequacy of actions to select and perform due diligence on counterparties.

As part of due diligence does the institution obtain the following, if applicable:

- Adequate financial information on the counterparty (3 to 5 years of audited financial statements/annual reports).
- Written documentation of the institution's underwriting procedures, practices and standards.
- Written documentation of loan servicing procedures (e.g., delinquencies, gathering financial information, amendments, partial releases, etc.).

In the due diligence process does the institution consider the following with respect to the counterparty (obtain from management discussions and by reviewing a sample due diligence analyses):

- Resources/personnel at the counterparty that will be/are devoted to the relationship with the institution and where the resources are located.
- Adequacy and stability of management at the counterparty.
- The pricing methodology and customary loan structures (e.g., variable versus fixed rates, fully amortizing versus balloons, product terms, etc.).
- The credit philosophy and those items deemed most important in the credit analysis process.
- The approach to financial covenants and non-compliance actions.
- The counterparty's existing portfolio (e.g., industry concentrations, geographic locations, total volume, credit quality, delinquency rates, reserves/charge offs, trends, etc.).
- Industries of focus and whether industry specialists exist in support of lending to these industries.
- How credit quality is measured (e.g., risk rating system, internal classifications, etc.).
- What is considered a distressed account and how is this determined (i.e., are there criteria other than payment default and/or non-compliance with covenants).
- How the institution services distressed accounts (e.g., specialized staff, centralized unit, is focus on collection or restructuring, etc.).
- In the event the counterparty materially fails to perform according to agreements, (i.e., is negligent in servicing) does the counterparty have the financial capacity to honor "put-back" provisions in participation agreements to buy back sold volume?

In the due diligence and counterparty selection process did the institution:

- Complete an analysis on each lead lender and approve the lead lender.
- Establish minimum acceptable credit ratings (if available) and set a maximum amount of exposure for each lead lender.

In individual loan purchase transactions from each counterparty does:

- The credit analysis for individual loan credit actions include a brief description of the lead lender, status of the relationship, current exposure, and date of the last due diligence analysis.

Note: The above is directed primarily at counterparties that are selling loan volume to the institution being examined. Counterparties in loan sale transactions are addressed in examination step number 4. Counterparties that act as guarantors/execute standby commitments are addressed in examination step number 6.

4. Loan Sales:

Determine if the institution has adequate risk management mechanisms in place to manage risk exposure stemming from selling loans.

Guidance:

Complete this examination step only if the institution being examined is an active seller of loan participations/is the lead lender on numerous participated credits. Consider the following when evaluating counterparties and counterparty risk on loan sales:

- Is the institution dependent on a limited number of institutions for buying its originated loan volume? If so, has the institution analyzed the risks faced in the event a specific counterparty significantly reduces volume purchased or discontinues purchasing loans?
- How dependent is the institution on loan sales channels in order to serve its existing customers? For example, what is the amount of volume that the institution originates and sells to others compared to the overall portfolio? Also, on participated loans originated by the institution, how much volume is sold to others compared to the amount retained by the institution?
- Has the institution reviewed its agreements/legal documents to determine if the institution is adequately protected against loan buyers forcing the institution/seller to repurchase previously sold volume (i.e., “put back” risk)?
- Does the institution have sufficient underwriting, credit administration, and loan servicing practices and controls in place to defend against possible representation and warranty claims by buyers or buyer allegations of negligence?
- Has the institution analyzed the financial impact of having to buy back one or more of its previously sold loans, or portions of loans, due to a buyer enforcing a loan “put back” or “make whole” provision?

5. Servicing Non-Originated Accounts:

Determine if the institution has assessed and mitigated, where necessary, its risk exposure stemming from performing loan servicing on assets where the institution does not originate the credit or act as the lead lender.

Guidance:

Consider the following when evaluating other loan servicing-related risks:

- Beyond servicing volume associated with loan participation transactions where the institution originates the credit and serves as the lead lender, does the institution perform servicing on assets owned by others? If so, how much volume is involved? (Examples could include loan portfolios where the institution purchased the servicing rights or where the institution is servicing the loans under a contract with entities such as commercial banks, insurance

- companies, Farmer Mac or other System institutions.)
- Has the institution reviewed underlying legal agreements to ensure the documents contain reasonable expectations of the servicer and do not result in conditions where the counterparty can easily assert representation and warranty claims or negligence by the loan servicer?
- Through the ICR or other review processes has the institution examined whether its servicing practices are consistent with actions prescribed by the underlying legal agreements? (These reviews are especially beneficial if servicing practices employed on these loans are materially different than loans of the same type that are owned by the institution.)

6. Guarantors:

Determine if the institution has performed adequate due diligence on counterparties that act as guarantors.

Guidance:

Guarantors can include institutions/parties that execute standby commitments or insure against credit defaults. Consider the following when evaluating due diligence and selection practices on counterparties that act as guarantors. As part of the due diligence process, did the institution:

- Obtain adequate financial information on the counterparty (3 to 5 years of audited financial statements/annual reports).
- Complete an analysis on the guarantor that addressed factors such as:
 - whether the guarantor has the financial ability to honor its guarantees.
 - earnings performance.
 - charge-off/guarantee payment trends.
 - risk levels/credit trends in the guarantor's on and off-balance sheet portfolios.
 - trends in the guarantor's credit rating (if applicable).
 - portfolio concentrations (industry, borrower, geographic, etc.).
 - adequacy/stability of management.
 - risk management practices employed by the guarantor (including its use of counterparties to lay off credit risk).
 - events/situations defined in underlying legal agreements that would allow the guarantor to not honor a guarantee.
 - responsibilities of the guarantor/institution on an ongoing basis and upon loan default.
 - collateral requirements of the guarantor and guarantor requirements when guaranteed loans are cross-collateralized or share collateral with unguaranteed loans.
 - the cost of obtaining the credit guarantee.
 - the guarantor's past history/performance for honoring or not honoring guarantees.
- Has the institution reviewed underlying legal agreements for concerns such as overly broad conditions that would allow the guarantor to not honor a guarantee or conditions that are unduly favorable to the guarantor?

7. Controls to Limit Exposure:

Determine if the institution has established appropriate limits on counterparty exposures.

Guidance:

Consider counterparties that are lead lenders/loan sellers/loan originators, owners of loans contracting for servicing, loan buyers, and guarantors. When evaluating the adequacy of an institution's actions to set counterparty risk exposure limits, consider the following:

- Maximum allowable exposure to a single counterparty must be identified and in many cases it

will vary based on whether it is a System or non-system institution and whether the counterparty is acting as a loan seller, buyer, or guarantor. System institutions will normally have higher exposure limits. Sometimes institutions will also establish a maximum exposure to all counterparties (again stratified by System versus non-System).

- Single counterparty exposures (System or non-System) exceeding 50 percent of risk funds or 350 percent of 3-year average net income should be carefully reviewed for excessive risk.
- Counterparty limits should be increasingly conservative as the financial condition and or/credit ratings become less favorable and when the counterparty has limited financial resources such as brokers, finance companies, and smaller commercial banks.
- How often are counterparty limits reviewed for continued adequacy and appropriateness (suggested at least annually, more frequently if amount of activity with a particular counterparty is growing rapidly or the counterparty is under stress)?
- What are the financial implications to the institution if a counterparty is unable to perform its ongoing duties and responsibilities?

8. Reporting:

Evaluate the adequacy of counterparty risk reporting.

Guidance:

Consider the following when evaluating counterparty risk reporting practices.

- A suggested minimum reporting period to the board is 6 months with ongoing monitoring by management.
- Reporting should include summary financials/ratios, credit rating if available, and conclusions on the counterparty's ability to perform on agreements and contracts.
- Are policy exceptions/exceptions to guidelines/limits addressed in the reporting process?
- Due diligence analysis should be updated annually on all approved counterparties and more frequently when concerns exist or when significant growth is evident.
- Does the institution have systems and controls in place to accurately measure exposure to counterparties on an ongoing basis?

9. Counterparty Distress:

Determine if the institution is able to take actions to mitigate exposure in the event the financial condition of a counterparty deteriorates and doubts arise about the counterparty's ability to perform in accordance with executed agreements and contracts.

Guidance:

Consider the following when evaluating counterparty distress:

- Determine if agreements identify rights and necessary actions for the institution to assume the lead lender position and control servicing of the loan.
- Determine if agreements contain "put back" provisions that would force the lead lender to repurchase the loan when the lead lender/counterparty does not fulfill obligations under agreements.

10. Stress Testing:

Determine if the institution completes a stress test or worst case scenario as part of their counterparty analysis to assist the board in establishing appropriate limits and strategies.

Guidance:

The analysis should consider the impact of these scenarios on the institution's balance sheet, income statement, and continuity of operations.

11. Portfolio Risk Assessment:

Determine if management assesses counterparty risk faced by borrowers in portfolio analysis efforts. If the institution's analysis identified notable concerns, ensure appropriate risk mitigation strategies were employed.

Guidance:

Counterparty risk faced by an institution's borrowers would generally involve situations where multiple borrowers have relationships with the same entity. For example, ethanol plants (possibly borrowers) that forward contract grain with local farmers/borrowers represent counterparty risk within the loan portfolio, since those borrowers would all be dependent on that ethanol plant's ability to purchase their grain under the agreed upon terms. Another example includes borrowers that prepay for fertilizer and seed in the fall, but do not receive the product until the following spring. These borrowers are subject to counterparty risk relative to that supplier's ability to deliver.

12. Counterparty Risk - Funding Bank:

Determine if the association has an awareness and understanding of credit counterparty risk posed by its funding bank. Where applicable, assess whether the institution has analyzed credit counterparty risk posed by its funding bank.

Guidance:

The funding bank would typically not be subject to the same counterparty limits and due diligence processes as a traditional counterparty. However, if the bank is selling a significant amount of volume to the association or if the bank is buying a significant amount of volume from the association (e.g., large loan pools), some of the concepts discussed in the above examination steps may apply. The main objective of this examination step is to build awareness that the bank should be viewed as a counterparty, where appropriate, and that the resulting counterparty risk should be analyzed accordingly.