BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
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DIVISION OF SUPERVISION AND REGULATION

SR 14-4

April 18, 2014

Revised December 6, 2021

On December 6, 2021 this letter was revised to modify its applicability. This letter applies to the supervision of state member bank and credit extending nonbank subsidiaries of bank holding companies with greater than or equal to $10 billion and less than $100 billion in total consolidated assets. The letter previously applied to state member bank and credit extending nonbank subsidiaries of bank holding companies with $10 to $50 billion in total consolidated assets. In addition, references to the allowance for credit losses (ACL) were added to the letter, as was a reference to SR 20-8, "Joint Statement on Adjustment to the Calculation for Credit Concentration Ratios Used in the Supervisory Approach." The officer approving the issuance of this letter was also revised to reflect the current Division Director.

TO THE OFFICER IN CHARGE OF SUPERVISION
AT EACH FEDERAL RESERVE BANK

SUBJECT: Examiner Loan Sampling Requirements for State Member Bank and Credit Extending Nonbank Subsidiaries of Bank Holding Companies in the Regional Banking Organization Supervisory Portfolio

Applicability: This letter applies to institutions supervised by the Federal Reserve with greater than or equal to $10 billion and less than $100 billion in total consolidated assets.

Introduction

This guidance sets forth loan sampling expectations for the Federal Reserve's examination of state member bank (SMB) and credit extending nonbank subsidiaries of bank holding companies with greater than or equal to $10 billion and less than $100 billion in total consolidated assets. Examiners will have the flexibility, depending upon the structure and size of subsidiary SMBs, to utilize the guidance applicable to smaller SMBs when the SMB subsidiary's total assets are below $10 billion. This guidance supersedes the examiner loan sampling expectations described in SR letter 94-13, "Loan Review Requirements for On-site

Examinations," and clarifies expectations for the assessment of material[1] retail credit portfolios for these institutions. This guidance should be implemented upon issuance for SMBs and credit extending nonbank subsidiaries of bank holding companies with greater than or equal to $10 billion and less than $100 billion in total consolidated assets.

A thorough review of a bank's loan and lease portfolio remains a fundamental element of the Federal Reserve's examination program for SMBs. Such credit reviews are a primary means for examiners to: (1) evaluate the effectiveness of a bank's internal loan review program and internal grading systems for determining the reliability of internal reporting of classified and Special Mention credits, (2) assess compliance with applicable regulations, and (3) determine the efficacy of credit risk management and credit administration processes. Further, examiners use the findings from their credit review to identify the overall thematic credit-risk management issues; to assess asset quality; to assist in the assessment of the adequacy of the allowance for loan and lease losses (ALLL) or allowance for credit losses (ACL), as appropriate; and to inform their analysis of capital adequacy.

Loan Sampling Methodology

Reserve Banks will establish the annual loan sampling objective during the supervisory planning process. The annual sampling objective should provide coverage of material exposures, including those in the retail segments.[2] Reserve Banks should plan on conducting at least two loan quality reviews during the annual supervisory cycle of SMBs with greater than or equal to $10 billion and less than $100 billion in total consolidated assets.

Each review should focus on one or more material commercial loan segment exposures by Call Report loan type and, in total over the annual cycle, should cover the four highest concentrations for commercial credits in terms of total risk-based capital for any Call Report loan type from Schedule RC-C. Loan segments that generate substantial revenues are generally likely to entail higher risk. To the extent that examiners can determine that a loan category contributes 25 percent or more to annual revenues,[3] examiners should sample these segments. Examiners should also sample other loan segments that they or the bank's internal loan review have identified as exhibiting high risk characteristics. Such risk characteristics include: liberal underwriting, high levels of policy exceptions, high delinquency trends, rapid growth, new lending products, concentrations and concentrations to industry, significant levels of classified credits, or significant levels of Special Mention credits. In addition to these risk-focused

[1] A loan portfolio or portfolio segment is considered material when the portfolio or segment exceeds 25 percent of total risk-based capital or contributes 25 percent or more to annual revenues. Total risk-based capital refers to tier 1 capital plus the allowance for loan and lease losses. See SR letter 20-8, "Joint Statement on Adjustment to the Calculation for Credit Concentration Ratios Used in the Supervisory Approach," for additional information.

[2] Commercial loan segments include commercial and industrial (C&I) loans, 1-4 family construction, other construction loans, multifamily loans, farm loans, non-farm non-residential owner occupied, and non-farm non-residential other loans. Retail loan segments include first lien mortgages, closed-end junior liens, home equity lines of credit (HELOCs), credit cards, automobile loans, and other consumer loans.

[3] The 25 percent threshold should be based on internal MIS and may not be applicable or available in all instances. For the purposes of this guidance, annual revenue equals net interest income plus non-interest income.

samples, a sample of loans to insiders must be reviewed.[4] Annual loan sampling coverage by examiners should take into consideration the severity of the asset quality component rating, the effectiveness of the internal loan review program, the results of internal loan portfolio stress testing, and current asset quality financial trends.

During the examination scoping phase, Reserve Bank staff should analyze the results of recent loan review reports or audits prepared for an institution's internal use and the Reserve Bank's most current assessment of credit risk management to help establish the size and composition of loans to be selected for review. An institution's internal loan review program should achieve substantial coverage beyond the examiners' annual judgmental sample of material loan portfolios. Examiners should review the findings and recommendations of the institution's internal loan review program to help identify areas of risk. In selecting loans from each segment of the loan portfolio to review, examiners should include a selection of the largest loans, problem loans (past due 90 days or more, nonaccrual, restructured, Special Mention, watch list, or internally classified loans), and newly originated loans. Examiners should ensure the sample selection includes robust coverage of classified, Special Mention, and watch credits. At a minimum, loans selected for review from commercial loan segments should represent 10 percent of the committed dollar amount of credit exposure within the loan segment.

Sample sizes should be increased beyond the 10 percent minimum, based on examiner judgment, for segments when the examination scoping process or the internal loan review program has identified:

1) deficiencies with credit risk management and administration practices,
2) loan growth has been unusually high,
3) credit quality or collateral values have been adversely affected since the prior review by volatile local or national economic conditions, or
4) unreliable internal credit risk grading.

Conversely, sample sizes should be based on the 10 percent minimum if:

1) previous examinations concluded that internal loan review and credit risk identification is effective,
2) internal loan review has reviewed a loan segment within the last 12 months and noted no material weaknesses, and
3) the examination scoping process reveals no significant credit risk management issues.

In general, the lower range of 10 percent sampling of each segment or the entire commercial portfolio would be acceptable when all aspects of credit risk, as discussed in this letter, indicate low and stable risk.

[4] Federal Reserve examiners must test and evaluate Regulation O compliance annually.

Examiners should determine classification amounts for retail credits using the Uniform Retail Classification Guidance (SR letter 00-8, "Revised Uniform Retail Credit Classification and Account Management Policy"). Annually, examiners should focus on one or more material retail loan segment exposures by Call Report loan type. Examiners should determine the appropriate sample of retail loans from material segments based on risk to be tested for compliance with internal credit administration policies and underwriting standards. While there is no minimum coverage expectation for retail portfolios or segments, the goal of sampling is to assist examiners in making an informed assessment of all aspects of retail credit risk management. If applicable, examiners should evaluate and test secondary market origination and servicing practices and quality assurance programs. Examiners should also sample other retail loan segments, as needed, from segments the examiners or internal loan review identify as exhibiting high risk characteristics such as liberal underwriting, high delinquency trends, rapid growth, new lending products, or significant levels of classified credits.

Documentation of Loan Sampling Analysis and Methodology

Examiners should discuss their analysis and objectives for achieving loan sampling coverage with Board staff during the annual supervisory planning process. Upon reaching a consensus with Board staff, the analysis and methodology should be retained in workpapers and documented in the supervisory plan. Further, examiners should document their loan sample selection methods in scoping memoranda and in the confidential section of the report of examination. The required workpaper documentation of the commercial loan coverage calculation should be based on total loan commitments and should generally exclude loans reviewed outside of the Reserve Bank's supervisory plan when a detailed analysis of the loans by an examiner and an assessment of credit risk management were not performed. Review of syndicated loans and participations, such as those from the Shared National Credits (SNCs) annual review, should only be included in the coverage ratio if Reserve Bank staff reviewed the credit-risk management aspects of the credit (for example, adherence to underwriting policies) and these findings are included in the examiner's assessment of overall credit-risk management practices. Examiners should continue to follow the SNC grading guidance.[5]

Follow-Up Expectations for Examinations with Adverse Findings

Examiners should generally consider a bank's internal risk rating system to be less reliable when examiner downgrades[6] or internal loan review downgrades equal 10 percent of the total number of loans reviewed, or 5 percent of the total dollar amount of loans and commitments reviewed. When a bank's risk rating system is determined to be unreliable, examiners may need to expand sampling to better evaluate the effect of rating differences on the bank's ALLL/ACL and capital. In such situations, examiners should direct the bank to take corrective action to validate its internal ratings and to evaluate whether the ALLL/ACL or capital should be

[5] Refer to SR letter 77-377, "Shared National Credit Program."

[6] A credit risk grading difference is considered a downgrade when: a) a risk rating is changed by the examiner from an internal Pass rating to Special Mention or classified category, b) a risk rating is changed by the examiner from Special Mention to a classified category, or c) a risk rating is changed by the examiner within the classified categories.

increased. The Reserve Bank will follow-up with the bank to assess progress on corrective action and verify satisfactory completion. The timeframe for follow-up should correspond with the timeframe during which actions are to be completed.[7] All follow-up actions on adverse findings should be discussed with Board staff.

Reserve Banks are asked to distribute this letter to state member bank and credit extending nonbank subsidiaries of regional banking organizations, appropriate safety-and-soundness examiners, and other supervisory staff. Questions regarding this letter may be sent via the Board's public website.[8]

Michael S. Gibson
Director
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Cross references:

- SR letter 20-8, "Joint Statement on Adjustment to the Calculation for Credit Concentration Ratios Used in the Supervisory Approach"
- SR letter 13-13/CA letter 13-10, "Supervisory Considerations for the Communications of Supervisory Findings"
- SR letter 00-8, "Revised Uniform Retail Credit Classification and Account Management Policy"
- SR letter 77-377, "Shared National Credit Program"

[7] Refer to SR letter 13-13/CA letter 13-10, "Supervisory Considerations for the Communications of Supervisory Findings."

[8] See http://www.federalreserve.gov/apps/contactus/feedback.aspx.