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Sampling Program

This document and any attachments are replaced by version 1.0 of the “Sampling Methodologies” booklet published May 2020.

EXAMINATION OBJECTIVES

To select a sample of homogeneous assets that will enable the examiner to evaluate the institution’s underwriting and draw conclusions about asset quality.

To assess the Internal Asset Review (IAR) program to draw a conclusion about the reliability of the institution’s IAR program and, for nonhomogeneous assets, to determine if the assets reviewed under the IAR program can be included in the examination asset review sample.

To select a sample of nonhomogeneous assets that, together with the review of the adequacy of the IAR program, will enable the examiner to draw conclusions about the institution’s underwriting and asset quality.

EXAMINATION PROCEDURES

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Reviewing the Institution’s Underwriting Policies

1. Review the general ledger to ascertain the overall characteristics of the loan portfolio. Determine the number of loans held in portfolio for each of the different loan types, i.e., one- to four-family residential loans, consumer loans, business loans, and commercial real estate (CRE) loans, etc. Also determine the type and amount of investment securities. Ensure that adequate records are readily available to facilitate the loan sampling review.

2. Review the adequacy of the institution’s policies for underwriting and acquiring assets pursuant to the other sections of Chapter 200 of this Handbook.

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Testing the Internal Asset Review (IAR) Program

3. Review the preceding report of examination and all IAR-related comments, exceptions, and recommendations noted and determine if management has taken appropriate corrective action.

4. Review the Matters Requiring Board Attention and Corrective Actions from the three or four previous ROEs to ensure that the board and management have taken appropriate corrective action where necessary and persistent problems have not recurred.

5. Review the institution's IAR program pursuant to CEO Memo 140, Effective Internal Asset Review Systems. Review IAR program sampling methodology and obtain schedules of internally reviewed nonhomogeneous assets.

   For homogeneous assets reviewed under the institution's IAR program, determine whether the institution's classifications are based primarily on delinquency status pursuant to CEO Memo 128, Revised Uniform Retail Credit Classification and Account Management Policy (July 2000). Proceed with step 8 for reviewing homogeneous assets.

   If the policies and procedures of the IAR program are deemed sufficient, select a representative sample of nonhomogeneous assets reviewed in the IAR program and proceed with step 6.

   Note: If the IAR program is simply incomplete, e.g., it does not include reviews of a particular category of assets, and the rest of the IAR program is considered acceptable, then the examiner may still proceed with step 6 to determine if the internal classifications of the acceptable portion of the IAR program may be included in the minimum examination sampling coverage standards. You should conduct an independent sampling and review of those categories of assets for which the IAR program is not acceptable.

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6. Review the selected assets for classification. If you find internally reviewed classifications are acceptable, then all assets reviewed in the IAR program and their internal classifications should be included in the minimum examination sampling coverage standards. If an unacceptable number of exceptions in classifications are found, then only assets actually reviewed by examiners should be included in calculating the examination sampling coverage.

7. Document your conclusions regarding the reliability of the IAR program for reporting and monitoring purposes between examinations and comment in the Report of Examination (ROE), if necessary. Discuss IAR program deficiencies noted with management and initiate appropriate corrective action.

Examination Asset Review

Homogeneous Assets (Refer to Exhibits 1 and 2 of this Section)

8. Begin with a top-down approach to review overall portfolio performance, including all significant subcategories of assets. Use electronic loan data, if available, to facilitate your portfolio evaluation and sample selection.

   Select a risk-based judgemental sample of the various types of homogeneous assets. The extent that sampling of homogeneous assets is necessary is based on your assessment of the risk profile of the various loan portfolios, adequacy of an association's underwriting policies and standards, asset acquisition policies and practices, internal controls, portfolio performance, and the structure, administration, scope, and risk profile. You should sample higher risk, new loan types (or new sources), and marginal or poor performing loan segments.

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9. With respect to loans made since the previous examination, determine if the association is using prudent underwriting standards and is exercising proper lending controls.

With respect to loans made in prior periods, evaluate asset quality by reviewing overall portfolio performance. If seasoned loans display performance problems, determine the cause of the problems, such as poor underwriting, high-risk loan products (such as high LTV, option ARM, and low documentation), or local economic factors, and evaluate the effect that such factors have on the association's asset quality. Be alert to permissive or poorly supervised re-aging, restructuring, deferral, or rewriting policies that may mask delinquency problems. Also, be alert to poor loan administration and collection efforts, which may give rise to higher delinquency in seasoned portfolios.

Sampling should be robust for higher risk assets and for associations with subprime lending programs, or when the institution originates and sells subprime assets but does not retain them. (See CEO Memo 137, Expanded Guidance for Subprime Lending Programs.) If you determine that the IAR program is inadequate or fails to cover some loan types, if you have performance or underwriting concerns, or if the association has a subprime lending program, you should select a sufficient sample of homogeneous assets for review to enable you to assess the association's asset quality.

10. Review the selected sample of homogeneous loans to ascertain whether those made during the review period were underwritten in a prudent manner and in compliance with the association's policies, and are classified appropriately. For determining whether an asset is underwritten in a prudent fashion, focus on the overall quality of the asset, the documentation of the borrower's willingness and ability to repay the loan, and documentation for collateral support.

Begin by reviewing a small sample of each risk type. Document your work and your conclusions, as needed, if you plan to cite problems or deficiencies in the ROE, or based on a regional office determination that documentation of individual loan data is appropriate and necessary in a particular instance.

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11. If the review of homogeneous assets reveals a level of credit risk higher than you had assessed during the sample selection phase (such as poorly underwritten loans, loans made as exceptions to stated underwriting standards, or groups of loans with documentation or performance issues), then consider expanding your sample to include additional loans within those groups.

    When you note problems in the review sample, determine if the problems are systemic or not. Determine whether there is a trend and whether material noncompliance with regulation and policy has, in fact, occurred. If there is a general pattern of noncompliance with OTS and interagency policies, guidelines, and regulations, determine the frequency and extent of such noncompliance. Rather than continuing to enlarge the sample to find every exception, focus on why the exceptions are occurring and how they affect asset quality. Then you should conduct any additional examination procedures needed and recommend corrective action.

12. Scan records of homogeneous assets to identify unusually large assets and verify that any unusually large assets are properly designated by purpose. Include any improperly designated homogeneous assets with nonhomogeneous assets for sampling and review.

13. Review a sample of exceptions to the institution's general lending policies. For loans that differ from internal standards, focus on whether the loan was prudently underwritten, whether departures from the association's policies are justified and uniformly applied, and whether exceptions were authorized and appropriately reported to management or the board of directors.

14. Determine if additional sampling or other examination procedures are needed to determine the cause for the exceptions and the corrective action needed. If appropriate, undertake additional sampling. A large volume of exception loans subjects the institution to greater credit risk and should generally be subject to criticism in the ROE.

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15. Confirm that the association's classifications of homogeneous assets is based primarily on delinquency status. Institutions should classify homogeneous loans in accordance with instructions in Examination Handbook Section 260, Classification of Assets, and CEO Memo 128, Uniform Retail Credit Classification and Account Management Policy.

If necessary, expand samples of any groups of assets suspected to contain material amounts of assets that may warrant classification. Review expanded samples to determine if any assets from the expanded samples should be adversely classified. Discuss classification concerns with management.

16. If the sample review indicates possible material risk of loss in a subcategory of homogeneous assets, include that subcategory with nonhomogeneous assets for additional sampling and review.

17. Document your conclusions regarding the underwriting and asset quality of homogeneous assets and comment in the ROE. Discuss any underwriting deficiencies noted with management and initiate appropriate corrective action.

Perform Independent Sampling of Nonhomogeneous Assets

18. Estimate of the extent of adverse classification based on internal classifications, examiner classifications from the preceding examination, loan performance, the adequacy of lending policies and procedures and how effectively they are followed. Include both seasoned loans and loans made during the review period (because you are assessing overall asset quality and the association's ongoing internal asset review procedures).

Based on the expected condition of the assets, set an initial coverage range for the review of the entire nonhomogeneous portfolio. Where available, use electronic loan data to facilitate your portfolio evaluation and sample selection.

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Sample two different populations of nonhomogeneous assets:

- First, sample loans reviewed by the association under its IAR program to determine whether the association properly reviews its assets, whether its classifications are consistent with regulatory and policy standards, and whether the IAR program is reliable for the purpose of including IAR program results in meeting minimum examination sampling coverage standards.
- The second sampling requirement is referred to as a judgmental sampling. The judgmental sample should focus on higher risk loans, new loan products, and loan types that may not be covered by the association's IAR program.

The combined samples should generally total from 20 percent to 40 percent of the aggregate portfolio value of nonhomogeneous assets, depending on the risk profile of the portfolio. This includes nonhomogeneous assets reviewed by the institution's IAR function if it is deemed reliable.

When severe asset quality problems are known or suspected, it may be necessary to increase the sample size even further to greater than 40 percent of total nonhomogeneous assets to adequately determine the extent of asset quality problems, the need for valuation allowances, and the effect on capital.

Review 10 percent of nonhomogeneous assets regardless of the IAR coverage. Loans you review to assess IAR adequacy may be included in this total.

When sampling risk is minimal, you may select a combined sample size of 20 percent of nonhomogeneous loans. This applies to examinations of associations that:

— Are highly rated and well capitalized.

— Have high asset quality.

— Have excellent lending standards, underwriting policies, and internal controls.

— Exhibit no material areas of concern.

— Have a history of good portfolio performance and no significant asset quality problems.

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— Have not experienced rapid growth in their nonhomogeneous portfolio, introduced new products, materially changed underwriting standards, or experienced material turnover in lending personnel.

In such circumstances, the Examiner-in-Charge, in consultation with the Field Manager, will determine what sampling coverage is appropriate for the institution, depending on the risk profile of the association, the time between examinations, and the scoping objectives.

Evaluate the Internal Asset Review Program

19. Assess the structure, administration, scope, and results of the association's IAR program. The association's IAR program should be independent, staffed with experienced and well-trained personnel, and include periodic sampling of all asset types. The IAR should identify all major portfolio problems and provide an accurate assessment of the association's overall asset quality. The IAR program should also assess risk of loss so management may determine appropriate levels of specific and general allowances.

    Review the association's documentation of its IAR programs sampling process to ensure that all asset types are adequately sampled.

    Use the results of your review in conjunction with other assessment factors to evaluate the effectiveness of the association's IAR process.

    If you determine that the IAR program is unacceptable due to its structure, coverage, or unreliability of findings, then proceed with the minimum examination sampling coverage. In such cases, only include the assets you review in the minimum coverage standards.

    In order to initiate corrective action, discuss IAR program deficiencies with management, in the ROE, and in the meeting with the board of directors.

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If you conclude that the IAR program is effective and its classifications are reliable, assets reviewed under the IAR program may be included in meeting the sampling coverage objective determined appropriate for the association during the scoping process.

Determine Sampling Methodology

20. Use a *statistical* sampling technique for review of internally reviewed nonhomogeneous assets in cases where you expect to count all assets covered by the IAR as part of the exam loan review coverage. In most cases you will use the *dollar-proportional methodology*, which works best for portfolios with a wide range of loan sizes. The dollar-proportional methodology is explained more fully under Sampling Overview.

    If you do not plan to count IAR reviewed assets as part of the loan review coverage *non-statistical* methods may be used. *Dollar cut-off* is one non-statistical selection criteria that is effective at selecting the highest dollar exposure.

Sampling of Nonhomogeneous loans not covered by the IAR

21. If the IAR program of loan reviews and monitoring does not provide adequate coverage either through individual loan reviews or some monitoring process, consider performing additional loan review or increasing your coverage to assess the level of risk in these portfolios. Use whatever selection process is most efficient in determining the level of risk inherent in the assets not covered by the IAR. The selection criteria may be judgmental and rely on certain screening criteria such as: internal risk ratings, LTV, debt service coverage, year of origination, payment record, etc.

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Judgmental Sampling of Nonhomogeneous Assets

22. In addition to sampling assets reviewed under the association's IAR program, an independent or judgmental sample is often appropriate. If you determine that the IAR program is unacceptable due to its structure, coverage, or unreliability of findings, then conduct a judgmental sample of the association's loans.

Review a judgmental sample to:

— Evaluate loans with a high potential for unrecognized loss, e.g., nonaccrual loans, and troubled, collateral dependent assets.

— Assess the adequacy of underwriting for new or high growth lending programs.

— Review loan portfolios not adequately covered by the IAR.

— Assess credit administration practices for obtaining current financial statements, financial statement analysis and monitoring, loan modification, and updating collateral values.

Review Judgmental Sample

Review the selected sample to ascertain whether the assets were underwritten in a prudent manner, in compliance with the association's policies, and whether the association has properly classified them.

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Reviewing Previously Examined Assets

23. Limit your analysis of performing, nonclassified assets reviewed in prior examinations to a quick review of the previous examination line sheets, the asset's current performance, and new file information for indications of a material change in the condition or cash flow of the obligor or the collateral.

Update the previous examination line sheets with the current balance, performance information, and current financial data.

24. Document your conclusions regarding the underwriting and asset quality of nonhomogeneous assets and comment in the ROE. Discuss any underwriting deficiencies noted with management and initiate appropriate corrective action.

CONCLUSION

25. Ensure that the Objectives of this Handbook Section have been met. State your findings and conclusions, as well as recommendations for any necessary corrective measures, on the appropriate work papers and ROE pages.

EXAMINER'S SUMMARY, RECOMMENDATIONS, AND COMMENTS

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