



# Office of Inspector General

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**Audit Report No. 03-008**

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## **Examiner Assessment of Commercial Real Estate Loans**



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**DATE:** January 3, 2003

**TO:** Michael J. Zamorski, Director  
Division of Supervision and Consumer Protection

**FROM:** Russell A. Rau  
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**SUBJECT:** *Examiner Assessment of Commercial Real Estate Loans*  
(Audit Report No. 03-008)

The Federal Deposit Insurance Corporation's (FDIC) Office of Inspector General (OIG) has completed an audit of the Division of Supervision and Consumer Protection's (DSC) assessment of commercial real estate loans<sup>1</sup> in the course of safety and soundness examinations.

The objectives of this audit were to determine whether: (1) the examiners fully assessed appraised value, cash flow, and lending policies in their examination of commercial real estate (CRE) loans and (2) the examiners' strategies for assessing a significant level of CRE loan growth were sufficient for identifying increased risk. While our audit addressed both objectives, the subject matter and results were distinct enough that we have prepared separate reports to address each objective. This audit report addresses our work with regard to audit objective (1) above and covers our assessment of examiner analysis of appraisals, cash flow, and lending policies. A separate report addressing objective (2) has been issued.

To accomplish the audit objective, we reviewed Reports of Examination for 35 banks identified as having commercial real estate portfolios totaling 300 percent or more of Tier 1 Capital.<sup>2</sup> The

<sup>1</sup> For purpose of this review, the OIG defined commercial real estate loans as loans secured by real estate, including real estate loans secured by multifamily residential properties, non-farm nonresidential properties, and construction and land development loans. Loans secured by or for the construction and development of farmland and one-to-four family residential properties were excluded.

<sup>2</sup> The Division of Supervision and Consumer Protection *Manual of Examination Policies* provides a definition of Tier 1 Capital as the sum of:

- common stockholders' equity (common stock and related surplus, undivided profits, disclosed capital reserves, and foreign currency translation adjustments, less net unrealized losses on available-for-sale equity securities with readily determinable fair values); and
- noncumulative perpetual preferred stock and minority interests in consolidated subsidiaries,

minus:

- all intangible assets (other than limited amounts of mortgage servicing rights and purchased credit card relationships and certain grandfathered supervisory goodwill);
- identified losses (to the extent that Tier 1 capital would have been reduced if the appropriate accounting entries to reflect the identified losses had been recorded on the institution's books);
- investments in securities subsidiaries subject to section 337.4; and
- deferred tax assets in excess of the limit set forth in section 325.5(g).

banks selected for review were located in metropolitan areas that the FDIC had identified as potentially overbuilt in the commercial real estate sector. We also reviewed the DSC examination workpaper files associated with 248 loans made from these 35 banks. Appendix I contains additional details on our objectives, scope, and methodology.

## BACKGROUND

Between 1980 and 1994, more than 1,600 banks insured by the FDIC were closed or received FDIC financial assistance. Many of the banks that failed during that time were very active participants in the commercial real estate markets. Historical analysis of the banking crisis of the 1980s<sup>3</sup> has revealed that concentrations of real estate loans relative to total assets were higher for banks that failed than for banks that did not fail. During this period, large demand for real estate investments produced a boom in commercial real estate construction activity. In addition, overly optimistic appraisals, together with the relaxation of debt service coverage ratios<sup>4</sup> (DSCR), the reduction in the maximum loan-to-value (LTV) ratios,<sup>5</sup> and the loosening of underwriting standards,<sup>6</sup> often meant that borrowers frequently had little or no equity at stake, and in some cases lenders bore most or all of the risk.

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<sup>3</sup> *History of the Eighties—Lessons for the Future*, Volume 1, prepared by the FDIC Division of Research and Statistics (now part of the FDIC's Division of Insurance and Research).

<sup>4</sup> The Barron's Business Guide's, *Dictionary of Banking Terms* defines the term debt service coverage ratio as the financial ratio measuring a borrower's ability to meet payments on a loan after paying expenses. The ratio measures the number of times loan principal and interest payments are covered by net (after tax) income. It is generally applied to income property such as apartment buildings and multi-tenant office buildings.

<sup>5</sup> FDIC Rules and Regulations, 12 C.F.R. Part 365, Appendix A – Interagency Guidelines for Real Estate Lending Policies, defines the term loan-to-value as “the percentage or ratio that is derived at the time of loan origination by dividing an extension of credit by the total value of the property(ies) securing or being improved by the extension of credit plus the amount of any readily marketable collateral and other acceptable collateral that secures the extension of credit... Value means an opinion or estimate, set forth in an appraisal or evaluation... of the market value of real property... For loans to purchase an existing property, the term ‘value’ means the lesser of the actual acquisition cost or the estimate of value.”

<sup>6</sup> FDIC Rules and Regulations, 12 C.F.R. Part 365, Appendix A – Interagency Guidelines for Real Estate Lending Policies, indicates that “Prudently underwritten real estate loans should reflect all relevant credit factors, including:

- The capacity of the borrower, or income from the underlying property, to adequately service the debt.
- The value of the mortgaged property.
- The overall creditworthiness of the borrower.
- The level of equity invested in the property.
- Any secondary sources of repayment.
- Any additional collateral or credit enhancements (such as guarantees, mortgage insurance or takeout commitments).”

The Barron's Business Guide's *Dictionary of Banking Terms* defines bank underwriting as the detailed credit analysis preceding the granting of a loan, based on credit information furnished by the borrower, such as employment history, salary, and financial statements; publicly available information, such as the borrower's credit history, which is detailed in a credit report; and the lender's evaluation of the borrower's credit needs and ability to pay.

In each year from 1980 through 1994, the concentrations of commercial real estate loans relative to total assets were higher for banks that failed than for banks that remained open. In 1980, commercial real estate loans of banks that failed constituted approximately 6 percent of their total assets; in 1993, almost 30 percent.

In response to the problems experienced by banks in the 1980s, a number of requirements were put in place by statute and regulation. Section 304 of the Federal Deposit Insurance Corporation Improvement Act of 1991, amending 12 U.S.C. 1818, required each federal banking agency to adopt uniform regulations prescribing standards for real estate lending. In 1993, the FDIC issued standards that require institutions to adopt and maintain a written policy that establishes appropriate limits and standards for all extensions of credit that are secured by liens or interests in real estate made for the purpose of financing the construction of a building or other improvements. Further, the lending policies must establish:

- Portfolio diversification standards;
- Prudent underwriting standards, including LTV limits;
- Loan administration procedures;
- Documentation, approval, and reporting requirements; and
- Procedures for monitoring real estate markets within the institution's lending area.

FDIC Rules and Regulations, 12 C.F.R. Part 323, Appraisals, effective September 19, 1990, provided protection for federal financial and public policy interests in real estate-related transactions by requiring real estate appraisals used in connection with federally related transactions to be performed in writing, in accordance with uniform standards, by appraisers whose competency has been demonstrated and whose professional conduct will be subject to effective supervision. This part covers all transactions entered into by the FDIC or by institutions regulated by the FDIC. This regulation identifies which real estate-related transactions require the services of an appraiser; prescribes which categories of federally related transactions shall be appraised by a state-certified appraiser and which by a state-licensed appraiser; and prescribes minimum standards for the performance of the real estate appraisals in connection with federally related transactions under the jurisdiction of the FDIC.

Interagency guidelines<sup>7</sup> were also developed addressing maximum LTV limits. Institutions should establish their own internal LTV limits for real estate loans; however, their internal limits should not exceed established supervisory limits. Supervisory limits specify that institutions should not generally originate commercial, multifamily, and other non-residential loans that have an LTV ratio that exceeds 80 percent of the market value of the collateral securing the loan.

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<sup>7</sup> FDIC Rules and Regulations, 12 C.F.R. Part 365, Appendix A – Interagency Guidelines for Real Estate Lending Policies, states that these guidelines are intended to assist institutions in the formulation and maintenance of a real estate lending policy that is appropriate to the size of the institution and the nature and scope of its individual operations and that satisfies the requirements of the regulations.

## **FDIC Initiatives**

First issued in 1996, the FDIC's semiannual *Report on Underwriting Practices* is one of a number of FDIC initiatives aimed at providing early warnings of potential problems in the banking system. At the conclusion of each examination that the FDIC conducts, examiners complete a survey of underwriting practices. By systematically collecting these observations from examinations, the report is designed to provide an early warning mechanism for identifying potential problems. The information gathered during examinations at FDIC-supervised banks helps identify potential weaknesses in underwriting practices meriting additional attention during onsite examinations.

In addition, the FDIC developed an offsite model in 1999 for identifying institutions that may be susceptible to a downturn in the local commercial real estate market. This model, called the Real Estate Stress Test (REST), attempts to identify financial institutions that may be vulnerable to a real estate crisis similar to what occurred in New England in the late 1980s and early 1990s, when market values of CRE dropped precipitously. REST uses current Call Report data to forecast a financial institution's condition over a 3- to 5-year time horizon and assigns a rating based on the CAMELS<sup>8</sup> scale of 1 to 5. The primary risk factor in the REST score is the institution's level of construction and development loans.

The onsite safety and soundness examination is a critical aspect of the supervisory framework that helps to promote confidence and stability in the nation's banking industry. Through onsite safety and soundness examinations, risks to insured institutions are identified and communicated to the institution's management and board of directors. The *DSC Manual of Examination Policies* (DSC Manual) notes that examiners devote a large portion of their time and attention to the examination of bank loan portfolios.

## **RESULTS OF AUDIT**

Examiners could have better assessed appraised value and cash flow in the examinations we reviewed. Specifically,

- Examiners were not consistently: using the lesser of the acquisition cost or appraised value to compute the LTV ratios, using new financial information to update old appraisal assumptions, and documenting the results of their review of appraisals. As a result, we found cases where the LTV ratio appeared to comply with the recommended supervisory limits, but when recalculated using the lesser of the

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<sup>8</sup> The FDIC uses an examination rating system to uniformly reflect (1) the financial condition of an institution; (2) compliance with laws and regulations; and (3) overall operating soundness. The primary purpose of the rating is to identify any institution with weaknesses in these three areas that warrant special supervisory attention. The examination rating, known as CAMELS, represents the examiner's judgment of an institution's Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk. An institution is rated on a scale of 1 to 5, with "1" indicating strong performance and "5" indicating poor performance.

acquisition cost or appraised value, the LTV ratios were actually in excess of the recommended supervisory limits. Incorrect computation of the LTV ratio, and reliance on outdated financial information can cause potential losses to the institution to go undetected. Because the examiners' documentation of procedures performed varied significantly for each loan, it was often difficult to ascertain the supporting logic for conclusions as required by DSC procedures.

- For some of the loans we reviewed, there was no evidence on the examiners' loan line sheets<sup>9</sup> that a cash flow analysis had been performed. We also observed many cases where banks did not obtain current financial statements from borrowers. In a number of these instances, the examiners used this outdated financial information to perform the cash flow analysis or did not note the outdated information as a technical exception on the loan line sheets. Omission of the cash flow analysis or the use of outdated financial statements in the assessment of cash flow may leave the examiner with insufficient or misleading information for classifying the loan. Furthermore, if technical exceptions are not listed on the loan line sheets, the examiners may miss the opportunity to comment on the bank's credit administration weaknesses in the Report of Examination.

With regard to lending policies, examiners documented their work in varying degrees. In each case, the Reports of Examination or the examination workpapers contained indications that the examiners had reviewed the lending policies as part of the examination. However, we could not determine whether these reviews were adequate.

Our audit also identified DSC regional office best practices related to the lending area, which are presented in Appendix II.

## **EVALUATION OF APPRAISALS**

Examiners were not consistently using the lesser of the acquisition cost or appraised value to compute the LTV ratios, using new financial information to update old appraisal assumptions, and documenting the results of their review of appraisals. Lack of emphasis on the definition for the term "value" contributed to instances where examiners failed to ensure adherence to the regulatory guidelines for computing LTV ratios. Incorrect computation of the LTV ratio, reliance on outdated financial information, and lack of an in-depth review of appraisals can cause potential losses to the institution to go undetected.

### **Computation of LTV Ratios**

Our review of the computation of LTV ratios showed that examiners are not consistently recognizing the acquisition cost as a measure of collateral value when computing LTV ratios.

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<sup>9</sup> Examiners use loan line sheets to record pertinent information relating to a borrower and loan. Technical exceptions are also recorded if applicable.

FDIC Rules and Regulations, 12 C.F.R. Part 365, Appendix A, Interagency Guidelines for Real Estate Lending Policies, states that LTV ratios should be based on the lesser of the actual acquisition cost or the estimate of value (appraised value). However, we found instances where examiners did not follow interagency guidelines when computing the LTV ratio. In fact, we noted cases where the LTV ratios appeared to conform to the recommended supervisory values, but when recalculated using the lesser of the acquisition cost or appraised value, the LTV ratios were actually in excess of the recommended supervisory limits. As loans in excess of the supervisory limit have a higher level of risk to the institution, using an improper basis in the computation of the LTV ratio can cause potential losses to the institution to go undetected.

The interagency guidelines are intended to help institutions satisfy the regulatory requirements by outlining the general factors to consider when developing real estate lending standards. The guidelines suggest maximum supervisory LTV limits for various categories of real estate loans and explain how the agencies will monitor their use. Institutions are expected to establish LTV limits consistent with their needs. They should not exceed the recommended supervisory LTV limits as shown in Table 1:

**Table 1: Maximum Recommended LTV Limits**

<b>Loan Category</b>	<b>Loan-to-Value Limit</b>
Raw Land	65%
Land Development	75%
Construction:	
• Commercial, Multifamily <sup>a</sup>	80%
• 1- to 4-Family Residential	85%
Improved Property <sup>b</sup>	85%

Source: 12 C.F.R. Part 365, Appendix A, Interagency Guidelines for Real Estate Lending Policies.

<sup>a</sup> Multifamily construction includes condominiums and cooperatives.

<sup>b</sup> Improved property loan means an extension of credit secured by one of the following types of real property:

- (1) Farmland, ranchland or timberland committed to ongoing management and agricultural production;
- (2) 1–4 family residential property that is not owner-occupied;
- (3) Residential property containing five or more individual dwelling units;
- (4) Completed commercial property; or
- (5) Other income-producing property that has been completed and is available for occupancy and use, except income-producing property owner-occupied 1-4 family residential property.

The LTV relates to only one of several pertinent credit factors that need to be considered when underwriting a real estate loan. In particular, the “five C’s of credit” include a consideration of the borrower’s collateral, capacity, character, capital, and conditions. The first four factors apply to the borrower’s ability to pay, whereas the last one refers to general business conditions in the borrower’s industry. According to FDIC Rules and Regulations, 12 C.F.R. Part 365, Appendix A, it may be appropriate in some situations to originate loans that exceed the supervisory LTV limits if enough support is provided by other credit factors. However, loans exceeding the LTV



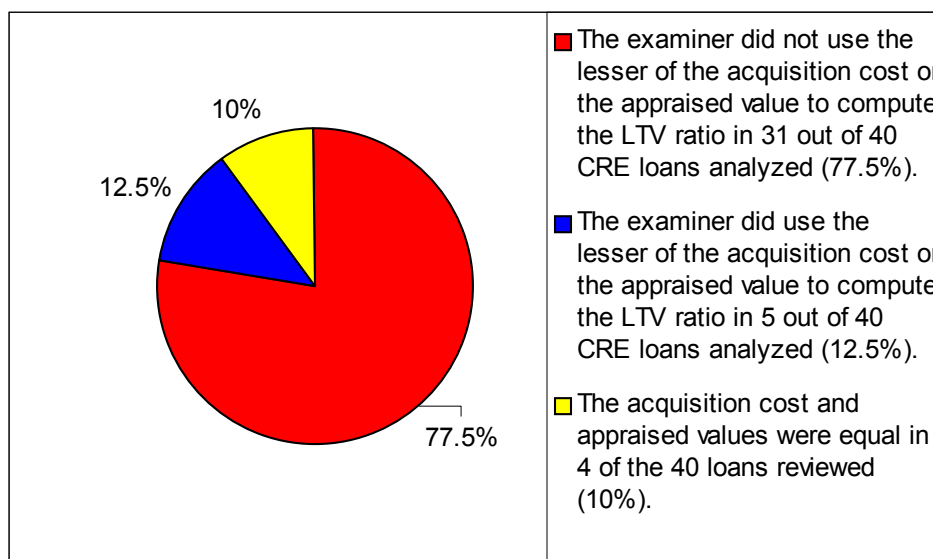
limits should be identified in the institution’s records, and their aggregate amount reported at least quarterly to the institution’s board of directors. The aggregate amount of all loans in excess of the supervisory maximum LTV limits should not exceed 100 percent of total capital.

Our sample contained loans that were made by the institutions for various purposes, including the purchase of CRE, the refinancing of CRE, and the rehabilitation of CRE properties. We identified 100 loans in our sample that were made for the purchase of CRE, and we concentrated our analysis of LTV calculations on these 100 CRE loans.

By reviewing the workpapers associated with the 100 loans, we determined that examiners did not document the loan’s acquisition cost in 60 of 100 (60 percent) cases. Interagency Guidelines for Real Estate Lending Policies require that in situations where the acquisition cost is lower than the appraised value, the acquisition cost should be used in the calculation of the LTV. Use of the appraised value in these circumstances can produce overstated LTV ratios and inconsistent examination results from one institution to the next. Therefore, it is important that in these situations, examiners record and use the acquisition cost so that they can more accurately assess the risk associated with the loan.

For the remaining 40 loans, the acquisition cost was recorded in the examiner’s workpapers, and we were able to perform further analysis on these 40 loans. We noted that in most cases (77.5 percent of the time) the examiners did not use the lesser of the acquisition cost or the appraised value when computing the LTV ratio. The details of our review of the 40 loans is shown in Figure 1 below:

**Figure 1: LTV Analysis**



Source: OIG Analysis of DSC’s examination workpapers that were obtained from field offices in the San Francisco and Dallas regions.

As part of our review, we re-calculated LTV ratios using loan value based on the lesser of the acquisition cost or appraised value. When calculated in this manner, we found that 8 of the 40 loans (20 percent) had LTV ratios in excess of the recommended supervisory limits as shown in the following table:

**Table 2: LTV Ratio Computations Using the Appraised Value vs. the Acquisition Cost**

<b>Loan No.</b>	<b>Bank No.</b>	<b>(1) LTV Ratio Based on Appraised Value</b>	<b>(2) LTV Ratio Based on Acquisition Cost</b>	<b>(3) LTV Limit</b>	<b>(4) Excess Over Statutory Limit (2) – (3)</b>
1	Bank 1	72%	87%	85%	2%
2	Bank 2	73%	83%	80%	3%
3	Bank 3	67%	85%	80%	5%
4	Bank 4	74%	96%	85%	11%
5	Bank 4	85%	90%	85%	5%
6	Bank 4	70%	93%	85%	8%
7	Bank 5	67%	91%	85%	6%
8	Bank 6	80%	87%	85%	2%

Source: Loan line sheets obtained from DSC examination workpapers in field offices in the San Francisco and Dallas regions.

We reviewed the eight loans shown in Table 2 and noted that two of the loans that exceeded the supervisory limits also had loan line sheets that listed the LTV ratio, either in part or as the sole reason for rating the loan as a “pass.”<sup>10</sup>

While the LTV ratio alone may not be a sufficient reason to drop a loan’s rating from pass to substandard, the ratio taken with other factors could cause an examiner to downgrade a loan. To make an accurate assessment of the loan’s collateral value, examiners should take the conservative approach and use the lowest asset value in their analysis.

DSC regional management commented that computation of the LTV ratio is a secondary issue in the examination of loans. They further indicated that loan performance is the primary issue of concern during an examination. If a loan is performing, then the examiner should ensure that the borrower has the ability to continue to meet payments. While we recognize that loan

<sup>10</sup> Pass – This term is generally used to indicate that based upon the examiner’s review, a particular credit (loan) met specific requirements and that the loan is performing as agreed. Adversely classified loans are allocated on the basis of risk to three categories: substandard, doubtful, and loss.

performance is an important factor in assessing the loan, computation of the LTV ratio using the lower of the acquisition cost or appraised value is necessary to assess bank compliance with the regulations and sufficiency of the collateral to protect against risk.

### **Use of Updated Financial Information in Assessment of Appraisals**

Many of the loans in our sample had appraisals that were not current. While banks had obtained updated financial information, in most cases the new financial information was not used to update prior appraisal assumptions. The DSC Manual, Section 3.1, Loans, identifies factors that could cause changes to originally reported appraisal values, including the passage of time, the volatility of the local market, and the availability of financing. While older appraisals are not always a problem, it is prudent to use the updated financial information in loan analysis computations. Use of outdated financial information can cause potential losses to the institution to go undetected.

Review of the Examination Documentation Module - Commercial/Industrial Real Estate Loan Review – Credit Analysis #12, 12A, and 12B, shows that examiners should consider the reasonableness of the facts and assumptions used in the most recent appraisal or evaluation. If material deviations from facts or assumptions are determined, examiners should adjust the estimated value of the property, if reasonably possible and supportable, for the purpose of the credit analysis. Factors that examiners should consider include the following:

- current and projected vacancy and absorption rates,
- lease renewals,
- trend in past due leases,
- feasibility study and market survey,
- rental rates or sales prices,
- operating expenses,
- deferred maintenance,
- net operating income of the property as compared with projections, and
- marketing period estimated to achieve appraised value.

Many of the loans in our sample had appraisals that were outdated. Approximately one-third of the appraisals associated with loans in our sample (91 of 248 loans) were at least 18 months old, and one was as old as 114 months. Of these 91 loans, we identified 67 instances where banks had obtained updated information from the borrowers. However, the examination workpapers showed that examiners only used this updated information in four cases. In the other 63 cases, there was no evidence in the workpaper files that examiners took advantage of the new financial information or used it to update old appraisal assumptions.

Using updated appraisal assumptions could be beneficial in instances where the financial institution is characterized by high concentrations of commercial real estate and also high loan growth. In these cases, there may be sufficient risk to the insurance fund so that examiners

should take the extra steps to ensure that they are using the most recent financial information available to reach conclusions about the creditworthiness of the institution's loan portfolio.

DSC guidance does not instruct examiners to use new financial information to update appraisals. DSC regional management commented that examiners generally do not reassess appraisal values, update financial data contained in the appraisals, or perform an analysis on a loan's collateral unless there is a problem with the loan, such as a case where the loan is non-performing. Further, regional management stated that time pressures restrict the review process, and FDIC regulations do not require a new appraisal on collateral. If the loan is performing, a new appraisal is not considered important.

DSC management has taken the position that the value of collateral would only be reassessed once weaknesses in the repayment capacity of the obligor have been identified. However, once these weaknesses are identified, the loan would probably be considered substandard and a review of the collateral at this stage would serve more for identifying loss rather than preventing loss.

### **Examiner Review of Appraisals**

Based on our review of CRE loans, we noted that examiners were not consistently documenting the results of their review of appraisals and, therefore, we could not determine the adequacy of examiner review of appraisals. Specifically, the loan line cards<sup>11</sup> and real estate line cards<sup>12</sup> did not always show whether examiners were following DSC guidance and performing an in-depth review of the appraised value of the loan's collateral. We also noted that some examiners may not have received the appropriate training in appraisal review, and DSC management expressed concern about the discontinuance of the FDIC's appraisal school and the resulting gaps in training for new examiners. The DSC Manual directs examiners to review appraisals to determine whether appraisal methods, assumptions, and findings are reasonable and in compliance with regulations, supervisory guidelines, and the bank's own policies. Also, internal DSC guidance directs examiners to demonstrate a clear trail of decisions and supporting logic, and provide written support for verification of procedures performed during the examination. If examiners do not perform an in-depth review of appraisals, they may accept appraisals with inflated values, and potential losses to the institution may go undetected.

FDIC Rules and Regulations, 12 C.F.R. Part 323, Appraisals, provides protection for federal financial and public policy interests in real estate-related transactions by requiring real estate appraisals used in connection with federally related transactions to be performed in writing, in accordance with uniform standards, by appraisers whose competency has been demonstrated and

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<sup>11</sup> Loan line cards, also known as line sheets, are prepared by examiners or generated from automated files to present general loan information for each line of credit reviewed. Line sheets should contain sufficient supporting data to substantiate the examiners' pass or adverse classification of a line of credit.

<sup>12</sup> Real estate line cards are prepared by examiners to document review of real estate loans. Real estate line cards are designed to capture data applicable to the review of appraisals, and provide examiners with the mechanism for recording the results of their review and documenting exceptions or compliance with appraisal regulations.

whose professional conduct will be subject to effective supervision. Further, Section 323.4 also establishes minimum appraisal standards for these transactions. The minimum standards include the following:

- (1) Be written and contain sufficient information and analysis to support the institution's decision to engage in the transaction;
- (2) Analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, non-market lease terms, and tract developments with unsold units;
- (3) Be based upon definition of market value;<sup>13</sup> and
- (4) Be performed by state licensed or certified appraisers in accordance with requirements set forth in this part.

The DSC *Manual of Examination Policies – Loans*, Section 3.1, Interagency Appraisal and Evaluation Guidelines, states “when an examiner analyzes individual transactions, examiners will review an appraisal or evaluation to determine whether the methods, assumptions, and findings are reasonable and in compliance with the agencies’ appraisal regulations, policies, supervisory guidelines, and the institution’s policies.”

The current DSC Regional Directors Memorandum entitled, *Guidelines for Examination Workpapers and Discretionary Use of Examination Documentation Modules*,<sup>14</sup> dated September 25, 2001, states that “...Examination documentation should demonstrate a clear trail of decisions and supporting logic within a given area. Documentation should provide written support for examination and verification procedures performed, conclusions reached, and support the assertions of fact or opinion in the financial schedules and narrative comments in the Report of Examination...Documents maintained in the final workpapers should...provide an audit trail of the examination findings.”

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<sup>13</sup> According to FDIC Rules and Regulations, 12 C.F.R. Part 323-Appraisals, *Market Value* means the most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:

- (1) Buyer and seller are typically motivated;
- (2) Both parties are well informed or well advised, and acting in what they consider their own best interests;
- (3) A reasonable time is allowed for exposure in the open market;
- (4) Payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and
- (5) The price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

<sup>14</sup> Examination Documentation Modules are an examination tool used by DSC examiners that focuses on risk management practices and guides examiners to establish the appropriate examination scope. Examination Documentation Modules incorporate questions and points of consideration that should be included in examination procedures. A module has been developed to specifically address a bank’s risk management strategies for each of the bank’s major business activities.

We observed that in 144 of the 248 sampled loans, all three approaches to value were not listed on the line cards. Therefore, we could not be certain that examiners had reviewed the appraiser's methodology or compliance with Uniform Standards of Professional Appraisal Practice (USPAP) in arriving at an estimated market value of the loan's collateral. An appraiser uses three market value approaches (cost, income, and comparable sales) to analyze the value of a property.<sup>15</sup> These estimates of value should be taken into consideration by the appraiser when assigning the market value of the loan's underlying collateral. Further, USPAP standards require that when an appraiser departs from this procedure and one or more methods are not used to arrive at market value, the appraiser is to document the reason for the omission in the appraisal report.

On most real estate line cards, the examiner did not provide a reason why a valuation method was missing. Specifically, in 132 out of 144 loans where one or more of the methods were missing from the line cards, there was no explanation on the real estate line cards as to why a method was missing. Because appraisers are required to consider all three methods when assigning market value to the collateral, omission of one of the methods from the appraisal would be an exception that examiners should note in the examination working papers.

We noted that in 51 out of the 248 loans in our sample, examiners did not use real estate line cards to record the results of their review of appraisals. Use of the real estate line cards in place of the standard line cards is not a DSC requirement, and their use is at the option of the examiner. However, the real estate line card contains sections to specifically capture data critical to an in-depth review of appraisals.

According to one regional director, documenting the three methods of valuation for the loan analysis is unnecessary. Furthermore, the regional director stated that examiners are under time pressure during examinations, and this time pressure prevents documentation and review at this level. Examiners are not trying to document their analysis of appraisals when no problem exists, but are documenting any exceptions from the bank's internal appraisal policies or from FDIC rules and regulations. However, our sample included CRE loans in markets where the demand for CRE loans was declining, and in these markets we would expect to see an increased effort by examiners to review the underlying value of the collateral associated with these high-risk loans. Because of the high-risk nature of commercial real estate loans and the inconsistencies in examiner documentation of their review of related appraisals, DSC should consider assessing the adequacy and documentation of appraisal review as part of its office review program.<sup>16</sup>

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<sup>15</sup> The DSC Manual states that an appraiser uses three market value approaches to analyze the value of a property – cost, income, and comparable sales – and reconciles the results of each to estimate market value. An appraisal will discuss the property's recent sales history and contain an opinion as to the highest and best use of the property.

<sup>16</sup> In a March 29, 1999 DSC memorandum, the DSC regional offices are charged with performing reviews of the operations of the field offices in a risk-focused approach.

DSC regional management and field office supervisors alike have expressed concern about the level of expertise examiners have in assessing real estate appraisals. Regional management noted that the Real Estate Appraisal School had been suspended for several years. They were particularly concerned about the new examiners who may not possess skills to adequately review appraisals. According to regional and field office management, many new examiners have not had the benefit of appraisal school training. Information contained in the Training Server System as of April 30, 2002 shows that 336 active commissioned DSC field examiners have not attended either the Real Estate Appraisal School that was run several years ago by DSC, or the Federal Financial Institutions Examination Council's (FFIEC's) Real Estate Appraisal program.<sup>17</sup> This represents approximately 23 percent of the commissioned examiners in the field. We spoke with one field office supervisor who told us that the field office had conducted its own real estate appraisal training because DSC was not offering the class.

## **Recommendations**

We recommend that the Director, DSC:

- (1) Remind examiners to verify institution compliance with Part 365 by using the lesser of the acquisition cost or the appraised value when computing the LTV ratio.
- (2) Clarify the division's expectations for examiners regarding the evaluation of appraisals of commercial real estate, including guidance on when it would be appropriate to update appraisals with new financial information.
- (3) Request DSC regional offices, as part of their current cycle of field office reviews, to specifically address whether the extent of examiners' review of appraisals is sufficient for high-risk CRE loans.
- (4) Provide additional training for examiners, as needed, on the adequate evaluation of appraisals.

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<sup>17</sup> The FFIEC's Real Estate Appraisal Review School provides examiners with the underlying knowledge and skills required to review a commercial real estate appraisal to determine compliance with appraisal regulations and standards as provided by the USPAP.

## **ANALYSIS OF CASH FLOW**

Examiners generally performed cash flow analysis during bank examinations. However, in a few instances there was no evidence of this analysis, and in most cases the debt service coverage ratio (DSCR) was not computed. The DSCR is a quick method for determining the number of times loan principal and interest payments are covered by the borrower's net after tax income, and clearly shows the borrower's ability to repay the loan. Additionally, the cash flow analysis was sometimes calculated using outdated financial information, and when this occurred, a technical exception was not usually noted in the examination workpapers.

The general guidance provided to examiners in the Examination Documentation (ED) Module entitled Loan Portfolio Management and Review: General, directs examiners to review appropriate financial ratios, trends, cash flow history, and projections to determine the repayment capacity of the borrower.<sup>18</sup> If examiners do not consistently compute the DSCR, use outdated financial information, or fail to document technical exceptions, they may underestimate the bank's risk of loss in the loan portfolio.

### **Examiners' Review of Cash Flow and DSCR**

In 230 out of 248 cases, the examiners performed the cash flow analysis during bank examinations, but for 18 of the loans we reviewed, there was no evidence on the loan line sheets that a cash flow analysis had been performed. We also noted that in 170 instances the DSCR was not computed. According to DSC management, cash flow is the single most important element in assessing the borrower's ability to repay debt. DSC training classes provide guidance to examiners on the importance of computing the cash flow analysis and DSCR, as well as detailed instructions on their computation.

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<sup>18</sup> Generally, the DSC Manual describes examination objectives but does not provide the examiners with specific steps to use in accomplishing the objectives, whereas Examination Documentation Modules list specific procedures to be performed to accomplish examination objectives.

To ensure consistent application of the risk-focused examination process nationwide, the Division of Supervision and Consumer Protection developed the Examination Documentation modules to provide examiners with a tool to focus on risk management and to establish an appropriate examination scope. The Examination Documentation modules incorporate questions and points of consideration into examination procedures to specifically address a bank's risk management strategies for each of its major business activities. In particular, the modules are segregated into three categories: Primary Modules, Supplemental Modules, and Loan and Other References. In addition, the format of the primary and supplemental modules is divided into three distinct sections of analysis: Core Analysis, Expanded Analysis, and Impact Analysis. The extent to which an examiner works through each of these three levels of analysis depends upon the conclusions reached regarding the presence of significant concerns or deficiencies.

As stipulated in the Regional Directors Memorandum entitled *Guidelines for Examination Workpapers and Discretionary Use of Examination Documentation Modules*, dated September 25, 2001, "The use of the ED modules is now discretionary... Although their use is now discretionary, the ED modules are excellent training and reference tools, which provide consistency and standardized procedures."



We reviewed the DSC *Manual of Examination Policies*, Section 3.1, Loans, for guidance on performing a cash flow analysis and calculating the DSCR. The DSC Manual provided guidance to examiners on the importance of calculating a cash flow analysis or debt service coverage ratio during the loan review process. DSC's Loan Analysis School, which is required for all examiners, also provides extensive training on cash flow analysis and calculation of the debt service coverage ratio. We also reviewed the DSC Regional Directors Memorandum System to determine whether any guidance had been provided to instruct examiners to perform a cash flow analysis or DSCR during the loan review process. We did not identify any memoranda to this effect.

The DSC ED Module entitled *Loan Portfolio Management and Review: General*, dated August 2000, states that examiners must determine whether the bank's financial analysis of borrowers is adequate in relation to the size and complexity of the debt. The Loan Module also states that the examiner must review appropriate financial ratios, trends, cash flow history, and projections sufficient to determine the financing needs and repayment capacity of the borrower.

According to DSC's Examination Documentation Module entitled *Commercial/Industrial Real Estate Loan Review Module*, dated November 1997, examiners should evaluate the cash flow potential of the underlying collateral to repay the loan within a reasonable amortization period. Examiners should also evaluate the borrower's willingness and ability to repay the loan from other resources when determining the credit quality of the loan.

We noted that some loan line sheets contained very detailed analysis of cash flow while others contained very scant information. We used very basic criteria in that we gave the examiner credit for performing a cash flow analysis if we saw any discussion at all on the loan line sheets indicating a cash flow analysis was performed. Our review was limited to the examiner's loan line sheets and supporting documentation.

According to one Regional Director (RD), in most cases the cash flow should be computed but in some situations it is not necessary and that would depend on the individual asset. For example, some tenants have long-term leases and nothing would change in 10 years regarding the income provided by the leases. The RD also stated that an examiner could encounter an asset that is rented to a "4 star" company and an updated cash flow may not be needed.

During our review we also noted that most of the line cards or other examination workpapers showed that examiners did not calculate the DSCR during their analysis of loans. Specifically, in 170 out of the 248 cases (69 percent) the examiner's line cards did not show the DSCR. We discussed our observations regarding the DSCR computations with a DSC Regional Director, who stated that computation of the DSCR is at the discretion of the examiner. While we agree that it may not be necessary to calculate the DSCR on every loan, prudent business practices dictate that in cases where repayment of the loan is dependent upon the income generated from the property, a DSCR should be calculated.

## **Age of Financial Statements**

Based on the data included in the examination loan line sheets and supporting documentation, we noted that in 63 instances out of the 248 loans reviewed (25 percent) banks did not obtain updated financial information on a timely basis. Examiners often performed the cash flow analysis using outdated financial information. We also noted there are no directives, procedures, regulations, or standards that require banks to obtain current financial information at specified intervals. While we recognize that the banks are solely responsible for obtaining updated financial statements from borrowers, examiners' use of outdated financial statements in their assessment of cash flow may produce conclusions that are misleading. It is important that examiners obtain current financial statements so that they can accurately assess the borrower's ability to repay the debt or inform management of the problem in their Report of Examination.

We reviewed the DSC Manual to determine if it included a discussion on how often banks should be expected to obtain current financial statements from borrowers, and to determine the age at which financial statements are generally considered outdated. We found that the DSC Manual did not address these issues. However, the FRB Manual states that banks should obtain at least annual financial statements from borrowers. In our opinion, financial statements should be updated at least annually, particularly on income producing properties.

In 63 loans (25 percent), we found that bankers had not obtained current financial statements from borrowers, and consequently examiners did not have updated financial information on which to base their analysis during the safety and soundness examinations. While financial institutions bear sole responsibility for obtaining current financial information on borrowers, examiners should take steps to encourage banks to obtain updated financial information on a timely basis by including these observations in the Report of Examination.

In 27 cases out of the 63 loans (43 percent) mentioned above, examiners used outdated financial information to perform the cash flow analysis. Further analysis of these 27 loans showed that in 15 cases, the examiner passed the loan based partly on the borrower's strong financial condition, but the examiner's decision was based on information derived from outdated financial information. Assessing loans using outdated financial statements does not provide assurance that the loan was adequately classified. In the remaining 36 of 63 cases, the examiners passed the loan based on reasons other than the borrower's financial condition, such as LTV ratio, strong guarantor, and large deposits at the bank.

Also, performing cash flow analysis using outdated financial information does not provide reasonable assurance of the borrower's current ability to repay the debt. The borrower's financial condition could have significantly deteriorated since the last financial reporting period, and the examiner would not necessarily be aware of changes that may have occurred in the borrower's financial position. Thus, financial risk to the institution may go undetected. As a result, the bank's exposure to loss could increase and its ability to implement timely corrective actions on individual loans to reduce risk could decrease.

## **Technical Exceptions**

Our analysis showed that examiners did not always note a technical exception on the loan line sheets when the borrower's financial statements were outdated. Although the DSC Manual instructs examiners to note outdated financial statements as an exception, the policy does not identify the age at which financial statements are considered outdated. By not specifying an age, some examiners may overlook the outdated financial statements and may not record the age of financial statements as a technical exception on the loan line sheets. If technical exceptions are not consistently listed on the loan line sheets, the examination team may not see the true extent of the problem and may miss the opportunity to comment on the bank's credit administration weaknesses in the Report of Examination.

The DSC Manual states that "Deficiencies in documentation of loans should be brought to the attention of management for remedial action. Failure of management to effect corrections may lead to the development of greater credit risk in the future. Moreover, the presence of an excessive number of technical exceptions is a reflection on management's quality and ability. Inclusion of the schedule 'Assets with Credit Data or Collateral Documentation Exceptions' and various comments in the Report of Examination is appropriate in certain circumstances." We discussed the issue of outdated financial statements with DSC regional management, and management confirmed that financial statements over 12 months are considered outdated.

As noted previously, 63 of the 248 loans in a sample did not have current financial statements. Further review of these 63 loans showed that in 28 out of the 63 cases (44 percent), the examiners noted technical exceptions on the loan lines sheets for financial statements that were over 12 months old. However, examiners did not note a technical exception on the loan line sheet for the remaining 35 loans (56 percent). We reviewed the Report of Examinations, Supplemental Sections, for these 35 loans and found that the examiners did not identify that the bank failed to obtain current financial statements from borrowers. To determine the age of the financial statements for the loans where a technical exception was not noted, we prepared an aging schedule. We found that the financial statements ranged in age from 13 to 40 months, with 11 exceeding 19 months in age.

## **Recommendations**

We recommend that the Director, DSC:

- (5) Provide guidance reminding examiners of the importance of performing cash flow analysis and computation of the DSCR for income-producing loans based on the risk level of the asset.
- (6) Reinforce to examiners the need to document technical exceptions (TEs) on the loan line sheets when financial statements are outdated or not available, and to retain a record of TEs provided to bank management.

## **REVIEW OF LOAN POLICIES**

In each of the 35 cases we reviewed, the Report of Examination or the examination workpapers contained indications that the examiners had reviewed the institutions' loan policies. However, the report statements and workpapers we reviewed were documented to varying degrees, and this inconsistency of documentation made it difficult for us to judge the quality and extent of examiner review of loan policies. Nevertheless, our own review showed that the banks' lending policies generally addressed the factors required by the DSC Manual.

FDIC Rules and Regulations implementing the Interagency Guidelines for Real Estate Lending Policies require institutions to adopt and maintain written lending policies that establish appropriate limits and standards for all extensions of credit that are secured by liens on or interests in real estate, or made for the purpose of financing the construction of a building or other improvements. Each institution's policies must be comprehensive, consistent with safe and sound lending practices, and must ensure that the institution operates within limits and according to standards that are reviewed and approved, at least annually, by the board of directors.

The DSC Manual, Section 3.1 – Loans, identifies broad areas that should be addressed in an examination of the institution's lending policies. These areas include real estate lending policies, LTV limits, loan review and credit grading systems, and appraisal policies.

We reviewed 35 Reports of Examination and their corresponding examination workpapers to determine the extent of the examiner's review and assessment of bank loan policies. We found that in each case the Report of Examination or the examination workpapers contained indications that the examiners had reviewed the institution's loan policies. In 27 of the 35 cases, examiners made comments in the Reports of Examination regarding the quality of the bank's loan policies.

In the remaining eight cases where the Reports of Examination did not contain examiner comments regarding the quality of loan policies, we found indications elsewhere in the working papers that showed that the examiners had reviewed loan policies. Evidence of examiner review in the workpapers included excerpts from bank loan policies, examiner notations on Examination Documentation Modules, and notations on other examination workpapers. However, the documentation was not always sufficient to evaluate the quality of the review. As a result, the inconsistency of documentation prevented us from reaching an overall conclusion on the quality of review.

Our own review showed that the banks' lending policies addressed specific factors that were prescribed within the DSC Manual. In particular, we reviewed DSC examination workpapers for the 35 banks in our sample and found that 28 contained copies of the loan policies. We compared these loan policies to the factors that the DSC Manual states should be included in bank lending policies. Specifically, we selected 18 factors from the DSC Manual that we deemed important to the evaluation of commercial real estate. These factors include standard lending policies; real estate lending limits, including LTV limits; credit grading systems; and appraisal policies. We found that the banks' policies generally addressed the 18 factors selected from DSC policies.

Absent any effect caused by the lack of documentation, we are not making recommendations related to this matter.

## **CORPORATION COMMENTS AND OIG EVALUATION**

On December 5, 2002, the DSC Director provided a written response to the draft report. The response and its attachment are presented in Appendix III to this report. Prior to the receipt of DSC's written response, DSC provided a draft of its written response on November 18, 2002. Based on the draft response, we provided written clarification to DSC on certain aspects of our audit report. We requested DSC to reconsider the draft report and its responses to our recommendations, especially in light of the principles of the risk-focused examination process. In the December 5<sup>th</sup> response, DSC management concurred with one of the six recommendations. DSC management did not concur with five recommendations, did not suggest acceptable alternative actions, and did not provide information that would convince us to revise any of the five recommendations.

Prior to responding to the report's six recommendations, DSC had some general comments about the report's findings and recommendations. These comments are bulleted below, followed by the OIG's response to those comments, in italics.

- DSC stated in its written response that "Although we share the Office of the Inspector General's (OIG) desire to identify and correct potentially harmful trends in commercial real estate lending at early stages, we believe that existing examination practices, guidance, and procedures adequately address these issues." DSC considers the concerns identified in the report as solely based on OIG-perceived documentation deficiencies. Further, the response states that the perceived documentation deficiencies are not linked to any error in judgement regarding the examiner's assessment of the loan portfolio.

*The DSC Manual of Examination Policies states that: "An appraisal of lending and collection policies...and the evaluation of individual loans are among the most important aspects of the examination process. To a great extent, it is the quality of a bank's loan portfolio that determines the risk to depositors and to the FDIC's insurance fund." Each bank in our sample had a significant volume of higher-risk commercial real estate loans. Our concerns stem from the fact that many loan line sheets lacked sufficient information to determine the capacity of the borrower to repay (for example, by calculating DSCRs) and/or lacked information to adequately value the underlying collateral for purposes of calculating loan-to-value ratios.*

*At issue is whether there is a correlation between the quality of the examination procedures supported by evidence in the working papers and the quality of the examinations themselves. While we did not rely solely on documentation to reach our conclusions, DSC policy (RD Memorandum 2001-039) states that: "Examination documentation should demonstrate a clear trail of decisions and supporting logic within a given area... Documents maintained in the final workpapers should... provide an audit*

*trail of the examination findings." This policy further provides that: "Documentation should provide written support for examination and verification procedures performed, conclusions reached, and support the assertions of fact or opinion in the... narrative comments in the Report of Examination." Our review of DSC workpapers included not only the line sheets, but also the Reports of Examination, pre-planning memoranda, ED modules, and other loan-related documentation. We did not always see sufficient evidence supporting examinations in accordance with these policy requirements. However, DSC's own policy is clear that sufficient documentation supporting the examination is required and does not endorse a presumption that an adequate examination took place in the absence of supporting evidence. In other words, documented evidence supporting the examination performed is a part of a quality examination. Without it, the adequacy of the examination cannot be determined.*

- DSC notes that although the institutions in the sample do indeed have concentrations in commercial real estate loans, and some of those institutions experienced significant loan growth, these factors alone do not result in their designation as high-risk institutions. Other mitigating factors may be in place such as strong underwriting processes and experienced management. Examiner judgement is used to assess risk within the institution. Examiners then make decisions guided by DSC policies and procedures as to the level of depth of their review and the level of documentation needed.

*We agree with DSC. Our concerns stem from the fact that some examination workpaper guidelines were not being followed by examiners and at other times it appeared examiners had not expanded their review when they should have done so.*

- The DSC response also notes that the FDIC employs a risk-focused examination program that is designed to focus examination resources on those areas that pose the greatest risk to an insured institution. DSC states that the audit report is considered to be very critical of the risk-focused examination process. According to DSC's response, the sample's composition and the OIG's findings indicate to DSC that the examiners employed appropriate risk-focused examination procedures to reach and support sound conclusions. Out of 35 institutions in the OIG's sample, 24 had total assets of less than \$250 million and only 3 of the institutions in the sample had an asset quality rating of "3."

*Contrary to DSC's assertion, our audit results are consistent with the underlying tenet of the risk-focused examination process. This process was designed to focus examination resources on bank activities that pose the greatest risk exposure to an institution. The program encourages less regulatory burden by focusing on testing, rather than duplicating, the work of audit and control functions. In particular, the risk-focused examination program encourages examiners to limit, or in some cases eliminate, traditional examination procedures in low-risk well-managed areas of the institution. Conversely, in our opinion, when implementing the risk-focused examination program for those institutions that exhibit one or more high-risk indicators, such as significant loan growth or high concentrations in commercial real estate loans, examiners should perform an assessment of management's ability to identify, measure, monitor, and*

*control these risks. In particular, when these high-risk indicators are present, more may need to be done than the traditional review process. In addition, these reviews should be documented and the analysis incorporated into the Reports of Examination as support for the examination ratings.*

*Also of note, the Division of Insurance and Research (DIR) April 2002 semiannual report on economic conditions and emerging risk in banking notes that one of the four main risks to the Corporation is commercial lending in formerly fast-growing metropolitan areas. The focus of the audit was on examinations performed at 35 institutions that generally had the following characteristics: (1) commercial real estate portfolios of 300 percent or more of Tier 1 Capital, (2) a “4” or “5” rating in the most recent Real Estate Stress Test, (3) located in metropolitan areas of the country that the FDIC had identified as potentially overbuilt in the CRE sector, and (4) experiencing rapid growth – in many cases over 40 percent in the prior year. We believe these are the types of institutions that would likely pose more risk than the average FDIC-regulated institution.*

*Between 1980 and 1993 almost 1,600 banks insured by the FDIC failed. Many of the banks that failed during that time were active participants in the commercial real estate markets. Historical analysis of the banking crisis of the 1980s has revealed that concentrations of real estate loans relative to total assets were higher for institutions that subsequently failed than for banks that did not fail. Also, our experience in reviewing banks that failed in the 1980s and early 1990s, particularly in the northeast, shows that it was not uncommon during that time for banks to have been rated “1” or “2” for several years prior to failure. It was not until the commercial real estate market declined and large numbers of loans went delinquent that the deterioration was typically reflected in lower component ratings.*

*Regarding the size of the institutions in the sample, we believe they are representative of the institutions that the FDIC regulates. As of September 30, 2002, 82 percent of FDIC-supervised institutions had total assets less than \$250 million.*

## **DSC Responses to OIG Recommendations**

The draft report contained eight recommendations, but after discussions with DSC management, we deleted two of our recommendations that were addressed by another recommendation. As a result, the final report contains six recommendations. DSC concurred with one of the six recommendations. That one recommendation is resolved; however it will remain undispositioned and open until we have determined that agreed-to corrective action has been completed and is effective. The five recommendations that DSC did not concur with are considered unresolved, undispositioned, and open. A summary of each recommendation and DSC’s comments follow, along with the OIG’s evaluation of the response.

**Recommendation 1: Remind examiners to verify institution compliance with Part 365 by using the lesser of the acquisition cost or the appraised value when computing the LTV ratio.**

DSC does not concur with this recommendation. Examiners are aware that to accurately calculate loan-to-value (LTV) ratios under Part 365, banks should use the lower of acquisition cost or appraised value and DSC does not believe that examiners need to be reminded to verify institutions' compliance with the Part 365 LTV guidelines. According to DSC, it is most common that acquisition cost and appraised value at the time of purchase are the same and additional instruction to examiners to document both values on the line sheet is not considered necessary. DSC stated that this fact most likely accounts for the finding in our report that in 60 of the 100 line sheets reviewed, the acquisition cost was not noted. If that is the case, DSC states the examiner would not be expected to document the property's acquisition cost on the line sheet, unless it had relevance to the evaluation of the credit, because the LTV at acquisition would have been reviewed at the prior examination. DSC further states that the Part 365 LTVs for commercial real estate are guidelines, and the bank's failure to follow the guidelines would only be commented on within the report of examination if excessive instances of noncompliance were identified.

DSC also commented on our report noting instances where the examiners used the appraised value, not the acquisition price, to determine the LTV. According to DSC, one reason for this occurrence is that in those instances that involved construction loans, it is possible that the acquisition cost did not reflect improvements subsequent to acquisition. Subsequent improvement costs may have impacted the current value of the property.

*DSC's response indicates that examiners understand the LTV ratios under Part 365 and do not need to be reminded that banks should be using the lower of acquisition cost or appraised value. We reviewed 100 line sheets where the purpose of the loan was for the acquisition of property. In 60 instances the purchase price was not documented on the line sheet even though many of these loans appeared to be new. For the 40 line sheets where examiners had documented the purchase price, we identified 31 instances (77%) where examiners did not use the lesser of the acquisition price or appraised value in the calculation of the LTV ratios. When the LTV ratios associated with these 40 loans were recalculated using the lesser of the appraised value or the acquisition price, 20 percent would have exceeded the LTV guidelines under Part 365.*

*While acquisition cost and appraised value at the time of purchase may be the same, this is not always the case and requires specific examiner attention particularly due to fluctuations in market value over time.*



**Recommendation 2: Clarify the division’s expectations for examiners regarding the evaluation of appraisals of commercial real estate, including guidance on when it would be appropriate to update appraisals with new financial information.**

DSC does not concur with this recommendation. DSC believes that adequate guidance regarding the evaluation of appraisals exists. DSC states that besides the Manual of Examination Policies, Part 323, and a Statement of Policy (Interagency Appraisal and Evaluation Guidelines), examiners attend an appraisal school and are given workbooks and reference guides on how to evaluate appraisals.

DSC agrees that some appraisals should be adjusted to reflect new information, but only when there is known deterioration of the primary repayment source. According to DSC, because of the close interrelationship between the primary repayment source and the secondary repayment source (assumed to be collateral), deterioration of the primary repayment source should serve as the trigger to adjust subject appraisals. Otherwise, in DSC’s view, it would not be beneficial from a cost or risk perspective to evaluate collateral for loss when no signs of increased risk have emerged.

*As discussed in our report, examiners rarely (4 of 67 cases) took advantage of updated appraisal information, even at the institutions in our sample that represent a higher concentration in commercial real estate loans. This information is important to assessing emerging risk to the institution and should be considered in the examination regardless of whether there is known deterioration of individual primary repayment sources. Our conclusion regarding the need for examiner guidance on how to evaluate appraisals is based on our (1) discussions with Regional Directors, Assistant Regional Directors, and Field Office Supervisors who told us that they were concerned about new examiners’ expertise in evaluating the adequacy of appraisals, (2) the discontinuance of the FDIC appraisal school, and (3) review of DSC working papers. History has shown us that inflated appraisals caused many problems in the 1980s. Further, we found that 23 percent of DSC’s commissioned examiners have not had specialized formal appraisal training, which could be a contributing factor to the problems noted separate from the lack of examination guidance.*

**Recommendation 3: Request DSC regional offices, as part of their current cycle of field office reviews, to specifically address whether the extent of examiners’ review of appraisals is sufficient for high-risk CRE loans.**

DSC does not concur with this recommendation. DSC management states that the field office review programs already address the sufficiency of examiners’ review of appraisals as part of the review process.

*Our review of the one field office review program provided to us by DSC did not show that our concerns regarding the extent of examiners’ review of appraisals for high-risk CRE loans are addressed. Specifically, our review of the field office review program and*

*several sample field office review reports found that the examiners' review of appraisals was not specifically included or mentioned.*

**Recommendation 4: Provide additional training for examiners, as needed, on the adequate evaluation of appraisals.**

DSC concurs with this recommendation. The real estate appraisal training was resumed in 2001. All commissioned examiners will be scheduled for this training. This recommendation is resolved. It will remain undispositioned and open until we have determined that agreed-to corrective action has been completed and is effective.

**Recommendation 5: Provide guidance reminding examiners of the importance of performing cash flow analysis and computation of the DSCR for income-producing loans based on the risk level of the asset.**

DSC does not concur with this recommendation. DSC states that the audit found that in almost all cases the examiners performed the cash flow analysis. However, in most cases the debt service coverage ratio (DSCR) was not indicated on the line sheet. According to DSC, the main concern is whether or not the borrower's cash flow covers the debt service, rather than manually calculating and transcribing the ratio on the line sheets. The emphasis is on identifying risk and supporting the classifications in those instances where loans are criticized or deteriorating. Further, DSC states that its Manual of Examination Policies does, in several areas, address the importance of cash flow analysis. Specifically, DSC cites section 3.1 of the Manual as addressing the importance of cash flow analysis under sections such as the various loan types, underwriting, loan analysis, debt repayment, credit file information and analysis, problem indicators, and internal loan portfolio review.

*Absent evidence to the contrary, we cannot presume that the DSCR was calculated in the 170 cases reviewed where the examination working papers did not contain the ratio. Further, we are concerned about trivializing the need for underlying support for the examiners' conclusions. As noted earlier, it is our position that the quality of the underlying support for the examination is inseparable from the overall quality of the examination.*

*Two main points made in the report are as follows:*

- (1) According to one Regional Director, analysis of cash flow is the most important element in assessing the borrower's ability to repay their debt. However, we found 18 instances in our review where there was no evidence in examination working papers that this most basic analysis was performed.*
- (2) Our report clearly states that it is not necessary to calculate the DSCR in every case, but prudent business practice dictates that where payment of the loan is dependent on the income generated by the CRE property, a DSCR should be calculated to ensure that there is sufficient income to repay the loan. In addition,*

*one Regional Director also stated that in cases where loan repayment is dependent on cash flow from the asset, the DSCR should be calculated.*

*Additionally, we agree that the DSC Manual addresses the importance of cash flow analysis and have revised the report to acknowledge this fact.*

**Recommendation 6: Reinforce to examiners the need to document technical exceptions (TEs) on the loan line sheets when financial statements are outdated or not available, and to retain a record of TEs provided to bank management.**

DSC does not concur with this recommendation. DSC states that our report did not find that many instances of stale financial statements during our review relative to the sample size. DSC does not want to document all TEs in the Report of Examination, as some TEs are not significant in nature. DSC believes that current practices and procedures are adequate to address the documentation of TEs.

*DSC management and staff informed us that there are a wide variety of approaches for recording the TEs, some of which result in TEs not recorded in the working papers, even when shared with management. In such cases, subsequent examination teams do not have this information for follow-up purposes or to document a continuing weakness. Therefore, it is our position that it is appropriate to standardize the recording of TEs identified during an examination. Standardization of the TE process will enhance the efficiency of DSC examinations and the effectiveness of examiners' follow-up to problems previously identified during DSC examinations.*

Because five recommendations in this report are unresolved, undispositioned, and open, we have requested DSC to reconsider its response to our report and provide us additional comments.

**OBJECTIVES, SCOPE, AND METHODOLOGY**

The objectives of this audit were to determine whether: (1) the examiners fully assessed appraised value, cash flow, and lending policies in their examination of commercial real estate (CRE) loans and (2) the examiners' strategies for assessing a significant level of CRE loan growth were sufficient for identifying increased risk. While our audit addressed both objectives, the subject matter and results were distinct enough that we have prepared separate reports to address each objective. This audit report addresses our observations with regard to objective (1) above and covers our assessment of examiner analysis of loan policy, cash flow, and appraisals. The audit focused on two DSC regional offices, San Francisco and Dallas, and four field offices within these regions.

To accomplish our objective we:

- reviewed a sample of the Safety and Soundness Reports of Examination (ROE) completed by DSC on banks identified by DSC as having commercial real estate portfolios of 300 percent or more of Tier 1 Capital;<sup>19</sup>
- reviewed and tested for compliance with applicable laws, regulations, and statements of policy;
- reviewed relevant sections of the *DSC Manual of Examination Policies*, Regional Directors Memoranda, and Examination Documentation Modules;
- reviewed relevant DSC examination workpapers;
- reviewed examiner analysis of loan files to include loan policies and loan line sheets;
- reviewed economic conditions and trends for commercial real estate;
- interviewed DSC Washington senior management; and
- interviewed DSC San Francisco and Dallas regional management, field office supervisors, and examiners.

We judgmentally selected and reviewed the examinations performed at 35 banks in the San Francisco and Dallas regions. The banks selected for review were located in Seattle, Phoenix, Dallas, Las Vegas, and Denver – all metropolitan areas that the FDIC had identified as

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<sup>19</sup> The DSC Manual provides a definition of Tier 1 Capital as “the sum of:

- common stockholders' equity (common stock and related surplus, undivided profits, disclosed capital reserves, foreign currency translation adjustments, less net unrealized losses on available-for-sale equity securities with readily determinable fair values);
  - noncumulative perpetual preferred stock;
  - minority interests in consolidated subsidiaries;
- minus
- all intangible assets (other than limited amounts of mortgage servicing rights and purchased credit card relationships and certain grandfathered supervisory goodwill);
  - identified losses (to the extent that Tier 1 capital would have been reduced if the appropriate accounting entries to reflect the identified losses had been recorded on the institution's books);
  - investments in securities subsidiaries subject to section 337.4; and
  - deferred tax assets in excess of the limit set forth in section 325.5(g).”

potentially overbuilt in the commercial real estate sector. Our fieldwork entailed reviewing pre-planning memoranda, examination reports, and examination workpapers. We also selected 248 commercial real estate loan line sheets as a basis to assess the examiners' review of appraisals, cash flow, and loan policies.

The limited nature of the audit objective did not require reviewing the Government Performance and Results Act, testing for fraud or illegal acts, or determining the reliability of computer-processed data obtained from the FDIC's computerized systems. Our assessment of internal management control was limited to a review of DSC's applicable policies and procedures as presented in the DSC Manual, Regional Directors Memoranda, and Examination Documentation Modules.

We performed fieldwork in Washington, D.C., the DSC San Francisco and Dallas regional offices, and four field offices (Seattle, Phoenix, Dallas, and Denver) located in the San Francisco and Dallas regions.

We focused our review on examinations that had been performed during the period of September 1999 through April 2001. The audit was conducted in accordance with generally accepted government auditing standards. The audit fieldwork was conducted from April 2001 through July 2002.

## **APPENDIX II**

### **BEST PRACTICES**

We noted several instances where the examiners-in-charge (EICs) prepared an in-depth summary of the institution's loan policies listing salient points of interest for the examination team to use in reviewing loans. Preparation of the loan policies in summary is a good method for distributing information to the examination team and a valuable practice for other EICs to follow.

Additionally, the Dallas Regional Office has established a Regional Banker Outreach Program with periodic meetings between DSC management and area bank management teams. This forum allows the FDIC to meet with the bankers in an informal setting that encourages bankers to freely express their opinions and concerns and to discuss current and emerging issues. The Regional Banker Outreach Program is a practice that encourages bankers within the region to stay informed regarding changes in the financial sector and local economy that may affect local area bankers and the FDIC.

## CORPORATION COMMENTS



**Federal Deposit Insurance Corporation**  
550 17th St. NW Washington DC, 20429

Division of Supervision and Consumer Protection

December 5, 2002

**TO:** Stephen M. Beard  
Deputy Assistant Inspector General  
Office of the Inspector General

**FROM:** Michael J. Zamorski *Michael J. Zamorski*  
Director  
Division of Supervision and Consumer Protection

**CONCUR:** John F. Bovenzi *John Bovenzi*  
Deputy to the Chairman and Chief Operating Officer

**SUBJECT:** Draft Report Entitled "Audit of Examiner Assessment of  
Commercial Real Estate Loans" (Assignment No. 2001-809)

The Division of Supervision and Consumer Protection (DSC) has reviewed the above-noted draft audit report. DSC is committed to ensuring that examiners carefully and accurately assess loan quality in FDIC-supervised financial institutions. Although we share the Office of the Inspector General's (OIG) desire to identify and correct potentially harmful trends in commercial real estate lending at early stages, we believe that existing examination practices, guidance, and procedures adequately address these issues.

The stated objective of this audit was to determine whether examiners fully assess appraised value, cash flow, and lending policies in their examination of commercial real estate loans. However, DSC believes that the report inappropriately contains conclusions relative to the adequacy of the examination loan review process solely based on perceived documentation deficiencies in examination workpapers, specifically loan line sheets. Further, the report does not link these perceived documentation deficiencies to any error in judgement regarding the examiners' assessment of the banks' loan portfolios. DSC firmly believes that its examination staff, using existing examination guidance and procedures, conducts appropriately risk-focused and accurate assessments of commercial real estate portfolios in FDIC-supervised institutions.

Under the heading of "Results of the Audit," the report states: "Examiners could have better **assessed** [emphasis added] appraised value and cash flow in the examinations we reviewed." This statement seems to imply that, if examiners *had* better assessed appraised value and cash flow, different examination findings may have been reached. However, neither the audit report

nor the current condition of the institutions sampled provides any indication that our examiners' conclusions were inaccurate. Again, the OIG's only basis for stating that examiners could have better assessed loan quality is that examiners did not consistently **document** within their workpapers certain details of their loan review. DSC feels it is inappropriate to draw the conclusions that examiners do not conduct an adequate assessment of cash flow or an appropriate review of appraisals simply because a particular cash flow ratio was not documented or all three appraisal methodologies were not noted on the loan line sheet.

Examiners have been provided appropriate guidance through memoranda and our examination documentation (ED) modules, among other resources, to clarify DSC's position that sufficient documentation should be maintained to provide a clear trail of decisions and supporting logic within the given area of review. In fact, the auditors were able to review preplanning memoranda, which documented the examiners' processes and conclusions prior to the start of the examination; completed ED modules; line sheets; reports of examination; copies of bank loan policies, asset appraisals, and internal audit reports; and various other documentation obtained by our examiners and maintained as a part of our examination workpapers. After reviewing all of this information, the auditors' criticisms focus on undocumented acquisition prices, debt service coverage ratios, and technical exceptions relating to stale financial statements. Accordingly, and while giving due consideration to the importance of the auditors' findings, DSC believes that the examiners' conclusions were adequately supported.

Prior to any examination, examiners analyze available offsite reports and take local economic information into consideration. In addition, pre-examination planning meetings are a critical element in approaching every examination. The examiners consult with bank management to gain their perspective on bank-specific conditions and concerns. Topics discussed during these meetings often include the bank's processes to monitor concentrations, its methodology for determining the allowance for loan and lease losses (ALLL), steps taken to address prior examination recommendations, and emerging issues or risks. During the examination, the examiners benefit greatly from loan discussions with the loan officers and senior management who generally have a strong understanding of their lending area and the financial condition of their loan customers. Although examiners may not always document all of the information gathered through such discussions on their line sheets, the onsite presence of examiners and the procedures they utilize during an examination provide an invaluable and accurate risk assessment of the quality of loans held by state nonmember institutions.

The FDIC, along with the other regulators, employs a risk-focused examination program. This program is designed to focus examination resources on those areas that pose the greatest risk to an insured institution. Examiners are encouraged to limit, or in some cases, eliminate traditional examination procedures in low-risk, well-managed areas of the institution. The risk-focused approach allows for better utilization of our examiners' time and serves to reduce the burden on our supervised institutions. In accordance with the risk-focused approach, DSC has instructed the examination workforce that documentation on a loan line sheet should fully support the conclusion to pass or classify the credit. Once sufficient information is obtained to make that determination, further documentation on the line sheet is not required.



conclusion to pass or classify the credit. Once sufficient information is obtained to make that determination, further documentation on the line sheet is not required.

Although the institutions in the sample do indeed have concentrations in commercial real estate loans, and some of those institutions experienced significant growth, these factors alone do not result in their designation as “high-risk” institutions. For example, an institution may have strong underwriting processes in place and a seasoned management team experienced in the local commercial real estate market. In addition, the significant growth that many of these institutions experienced was a planned part of their denovo operation or the result of mergers with other well-run state non-member institutions. Again, we must emphasize that examiner judgment is used to assess the risk within the whole institution as well as particular areas of operation. Examiners then make decisions, guided by DSC policies and procedures, as to the level of depth of their review, as well as to the level of documentation that is needed. DSC and its examination staff are well aware that commercial real estate loans can pose higher levels of risk to an institution, particularly when concentrations in these credits exist. Due to this higher risk, additional guidance is available and is followed during the review of commercial real estate loans. Although we believe that the auditors were already provided with this additional guidance, we have attached the DSC memo entitled, Loan Review, and three of the ED modules related to commercial loans to this memorandum and request that they be made a part of our official response to the audit report.

Although the auditors may not have intended for their findings and recommendations to be negative, the report’s narrative is considered to be very critical of our risk-focused examination process. In fact, the sample’s composition and the OIG’s findings indicate to DSC that the examiners employed appropriate risk-focused examination procedures to reach and support sound conclusions. The institutions sampled for this audit numbered 35. Twenty-four of the institutions had total assets of less than \$250 million. Only 2 of the 35 institutions had asset quality component ratings of “3,” and only 1 had an asset quality component and composite rating of “3.” Excluding those 3 institutions and the 8 denovo institutions in the sample, the remaining 24 institutions had asset quality, management, and composite ratings of “1” or “2,” on average, for the prior 9 years. In addition, of the 31 institutions in the sample that have had at least one examination subsequent to the examination reviewed by the auditors, 28 continue to be rated a composite “1” or “2.” While past performance is not a guarantee of future performance, it is certainly an important factor that, when combined with the size of the institution and the capabilities of the institutions’ management, will affect the risk-scoping process and, ultimately, the level of documentation required for examination workpapers.

As more fully discussed below in referencing each of the report’s recommendations, DSC believes that outstanding guidance and current examination practices for the review of real estate loans are appropriate for identifying risks within the commercial real estate portfolios of FDIC-supervised institutions. In addition, much of the guidance and examination practices have been developed on an interagency basis. For example, the Federal Reserve also uses the Examination Documentation Modules and the loan review system, Automated Loan Examination Review Tool (ALERT). Therefore, the audit’s recommendations have interagency implications.

We concur with only one of the six recommendations included within the report and note our planned action to address that recommendation. We do not concur with the remainder of the recommendations and do not intend to take any action with respect to them.

The following six recommendations have been proposed by the Office of the Inspector General (OIG) in the draft report:

- (1) *Remind examiners to verify institution compliance with Part 365 by using the lesser of the acquisition cost or the appraised value when computing the LTV ratio.*

#### **DSC's Response**

**DSC does not concur with this recommendation.** Examiners are aware that to accurately calculate loan-to-value (LTV) ratios under Part 365, banks should use the lower of acquisition cost or appraised value and we do not believe that examiners need to be reminded to verify institutions' compliance with the Part 365 LTV guidelines. The audit report notes that in the majority of the line sheets sampled, the examiners did not identify the acquisition cost but did calculate a LTV ratio. Since it is most common that acquisition cost and appraised value at the time of purchase are the same, additional instruction to examiners to document both values on the line sheet is not considered necessary. This fact most likely accounts for the findings in the OIG's report that in 60 of the 100 line sheets reviewed the acquisition cost was not noted. It is also possible that the loans sampled by the OIG had been reviewed at a prior examination. If that is the case, then the examiner would not be expected to document the property's acquisition cost on the line sheet, unless it had relevance to the evaluation of the credit, because the LTV at acquisition would have been reviewed at the prior examination. The auditors found only 8 instances out of 40 where using the acquisition cost instead of the appraised value would result in the loans exceeding the Part 365 LTV guidelines. It is important to note that the Part 365 LTVs for commercial real estate are, in fact, guidelines and a bank's failure to follow the guidelines would only be commented on within the report of examination if excessive instances of noncompliance were identified.

The OIG's report also notes 31 instances out of 40 where the examiners used the appraised value not the acquisition price to determine the LTV. However, if those instances involved construction loans, it is entirely possible that the acquisition cost did not reflect improvements that the appraisals may have considered. The age of the property and improvements subsequent to acquisition (e.g., zoning approvals obtained, building permits, site preparation, renovations, etc.) may have a material impact on the current value of the property. Therefore, the acquisition cost may not always be the appropriate value to use when calculating the LTV for a line sheet after the loan has been originated. Finally, it should not be assumed that the examiner did not review the bank's adherence to the Part 365 LTV guidelines at the loan's origination because the LTV calculated on a line sheet used the appraised value.

- (2) *Clarify the division's expectations for examiners regarding the evaluation of appraisals of commercial real estate, including guidance on when it would be appropriate to update appraisals with new financial information.*

### **DSC's Response**

**DSC does not concur with this recommendation.** The report notes that examiners are not consistently updating old appraisals with new financial information or documenting the results of an appraisal review. As support for the conclusion that examiners are not documenting the appraisal review, the OIG states that examiners did not list all three approaches to value on line cards in 155 of 260 instances. As a result of these observations, the OIG recommends that DSC clarify its expectations regarding the adequate evaluation of appraisals, including when to update appraisals with new financial information. DSC believes that further guidance regarding the evaluation of appraisals is not necessary. Besides the Manual of Examination Policies, Part 323, and a Statement of Policy (Interagency Appraisal and Evaluation Guidelines), examiners attend an appraisal school and are given workbooks and reference guides on how to evaluate appraisals. It seems inappropriate to conclude that examiners need additional guidance on how to evaluate appraisals because not all three approaches to value were listed on a line card, or old appraisals were not updated with new information.

First, all three approaches to value are normally evaluated, but not necessarily listed on the line card. Generally, only the final value is noted on the line card; however, examiners have to analyze each approach to value to determine the appropriateness of the final value. Typically, only one of the three values is most pertinent toward determining a final value, and examiners need to ensure that the appraiser uses the most pertinent approach to reconcile to a final value. For example, when reviewing a commercial real estate appraisal, examiners know that the income approach to value is the most pertinent indicator of value, and we would expect the appraiser to reconcile to the final value by most heavily considering the income approach. If the appraiser departs from that methodology, examiners would normally comment on the line sheet as to why another approach to value was more heavily weighted in the final reconciliation of value.

It is not appropriate to suggest that because the three approaches to value were not on a line card that examiners did not consider appraiser methodology. While not always documented in the interest of time, examiners have several tools with which to evaluate an appraiser's methodology. Besides the appraisal itself, examiners use bank-generated appraisal reviews, loan narratives, and previous appraisals on the same property to evaluate an appraiser's methodology. Additionally, examiners frequently rely on discussions with management or an in-house appraiser, and more rarely, with the appraiser or other bank-approved appraisers.

Second, the OIG's assertion that examiners should be provided guidance on when to update appraisals with new financial information is unrealistic and, if implemented, would burden the examination process, be cost inefficient, and result in a nominal benefit, if any. We concur that some appraisals should be adjusted to reflect new information, but only when there is known deterioration of the primary repayment source. Because of the close interrelationship between the primary repayment source and the secondary repayment source (assumed to be collateral), deterioration of the primary repayment source should serve as the trigger to adjust subject appraisals. Otherwise, it would not be beneficial from a cost or risk perspective to evaluate collateral for loss when no signs of increased risk have emerged. The ED module for Commercial/Industrial Real Estate Loan Review (attached) provides the following guidance: "If material deviations from facts and assumptions are determined, adjust the estimated value of the

property, if reasonably possible and supportable, for the purpose of the credit analysis. (Note: Adjustments to collateral value made for credit analysis purposes should not be based on worst case scenarios that are unlikely to occur.)”

When evaluating commercial real estate loans, those circumstances that pose increased risk to the primary repayment source (e.g., high vacancy rates, lowered rents or concessions, deferred maintenance, etc.) would also negatively and possibly materially affect the appraised value. However, updating an appraisal when little evidence of increased risk is evident would not be in keeping with the risk-focused examination process. For example, since commercial real estate appraisals are normally based on a “stabilized” occupancy, it would not be appropriate to adjust an appraised value simply due to a change in current occupancy rates. Examiners would typically not want to adjust these appraised values unless increased risk is present and it is probable that the property cannot reach the stabilized occupancy.

As an aside, and rather than individually adjusting appraisals as the primary means to identify loss, examiner discretion may dictate that a separate allocation to the ALLL be made due to general economic conditions. For example, increased repayment risk may not have surfaced in specific commercial real estate properties, yet the trend in general economic conditions is adverse relative to commercial real estate properties (i.e., cost of capital and interest rates increasing, early signs of rent reductions, vacancy rates creeping upward, etc.). To meet current risk-scoping requirements, this method is far less time-consuming and is available as a tool to analyze the appropriateness of the ALLL per current guidance.

(3) *Request DSC regional offices, as part of their current cycle of field office reviews, to specifically address whether the extent of examiners’ review of appraisals is sufficient for high-risk CRE loans.*

#### **DSC's Response**

**DSC does not concur with this recommendation.** Our field office review programs already address this as a part of the review process. In addition, and as discussed in our response to recommendation two, the documentation of an examiner’s review of an appraisal is expected to be commensurate with the level of concern the examiner has with the appraisal, the loan’s performance, its underwriting, the economy, etc.

(4) *Provide additional training for examiners, as needed, on the adequate evaluation of appraisals.*

#### **DSC's Response**

**DSC concurs with this recommendation.** While DSC does not believe that there is currently insufficient examiner expertise in the field to conduct adequate evaluations of appraisals in FDIC-supervised institutions, DSC concurs that formal appraisal training should be provided to all examiners. FDIC examiners attended real estate appraisal training through 1997; this training was provided to all examiners who were commissioned at that time. Beginning in 1998, this training was suspended, partially due to the training and additional workloads brought upon by

Year 2000 requirements. Real estate appraisal training was resumed when the Federal Financial Institutions Examination Council ("FFIEC") established a real estate appraisal training program in 2001. The FDIC sent 40 people in 2001, scheduled 101 in 2002, and 86 are currently scheduled for 2003. Going forward, all examiners who receive their commission will be scheduled for this training.

It should be noted that, while some newer examiners have not yet received formal real estate appraisal training, considerable on-the-job training occurs during the examination process. When an examiner is responsible for reviewing a loan that contains a complex appraisal with which they are unfamiliar, more seasoned examiners are available to provide guidance and answer questions.

(5) *Provide guidance reminding examiners of the importance of performing cash flow analysis and computation of the DSCR for income producing loans based on the risk level of the asset.*

#### **DSC's Response**

**DSC does not concur with this recommendation.** The audit found in 242 out of 260 cases (or 93%) that the examiners performed the cash flow analysis. Accordingly, we believe that examiners do not require additional guidance to remind them of the importance of analyzing cash flow in income producing properties.

However, in 181 out of the 260 cases the debt service coverage ratio (DSCR) was not indicated on the line sheet. It appears, therefore, that the auditors' conclusion that cash flow analysis should be improved is solely based on the lack of a documented DSCR and not on the absence of cash flow information. A requirement for examiners to manually calculate and transcribe the DSCR and cash flow analysis for every loan serves little purpose, other than to document the workpapers for audit purposes. The main concern is whether or not the borrower's cash flow covers the debt service, rather than manually calculating and transcribing the ratio on the line sheets. The emphasis is on identifying risk and supporting the classifications in those instances where loans are criticized or deteriorating. If the cash flow statement/analysis clearly shows that the property covers its debt service requirements and there appears to be no other reason for criticizing the credit's quality or its administration, then the documentation of a DSCR on the line sheet certainly becomes less critical.

Further, the DSC Manual of Examination Policies does, in several areas, address the importance of cash flow analysis. Specifically, Section 3.1 of the Manual addresses the importance of cash flow analysis under sections such as the various loan types, underwriting, loan analysis, debt repayment, credit file information and analysis, problem indicators, and internal loan portfolio review. Also, as the report notes, the ED modules specifically mention in several places the importance and requirement of cash flow analysis.

(6) *Reinforce to examiners the need to document technical exceptions (TEs) on the loan line sheets when financial statements are outdated or not available, and to retain a record of TEs provided to bank management.*

### **DSC's Response**

**DSC does not concur with this recommendation.** The OIG's report includes the statement "...performing cash flow analysis using outdated financial information does not provide reasonable assurance of the borrower's current ability to repay the debt." Although examiners would prefer to rely on current information, industry practice often dictates otherwise, mostly because of the cost versus benefit associated with obtaining current information. Generally, all bankers send notices to borrowers to update old financial information; however, to appropriately follow up on all these requests would require a level of administration that most banks can not bear. As a result, some financial statements arrive late, if at all, and bankers and examiners have to resort to alternative means to arrive at appropriate risk ratings. DSC consistently encourages bankers to obtain current financial information and to analyze the cash flow, performance, and trends provided by this financial information.

Technical exceptions (TEs) do not only cover financial information but also cover a wide range of information and documentation. Generally, TEs are documented in one of several places: line sheets, separate TE sheet given to management, combined TE sheet(s) in the examination workpapers, or, if TEs are excessive, a TE page is included with the examination report. When significant weaknesses are noted in this area, DSC also criticizes this in the examination report.

Because of the many variables involved in a particular lending relationship, each credit line must be reviewed separately. It is therefore difficult, if not impossible, to develop concise definitions for when a financial statement is outdated. As stated in the OIG's report, financial statements are generally considered stale after 12 months, but examiners have the discretion on when to cite these as TEs due to a variety of factors. Factors such as rent rolls, tenant stability and strength, actual age of financial statements, loan covenants, tax filing deadlines, time delays from CPA reviewed/prepared financial statements, etc., are all considered when an examiner determines whether or not to cite "stale financial statements" as a TE. The OIG's report notes that of 260 loans sampled, only 74 of the financial statements used by examiners to review the loans exceeded 12 months in age and only 16 of those exceeded 19 months in age. The report also notes that of those 74 cases, TEs for stale financial statements were noted in 28 instances. DSC believes that current practices and procedures are adequate to address the documentation of TEs.

As previously mentioned, bankers are aware of the need for updated financial information. However, bankers frequently have difficulty obtaining information after the loan is made and it is performing as agreed. Notwithstanding, bankers still pursue updated financial information and DSC strongly encourages the same at every examination. Appendix A of Part 365, under the subtitle Loan Administration, states that banks should "establish loan administration procedures for its real estate portfolio that address documentation, including 'type and frequency' of financial statements." In addition, examiners review the loan policies to ensure that credit file documentation standards are appropriate for the needs of the bank. Most banks now include such language in loan covenants (though non-submission is not generally considered a default), and banks maintain tickler systems for follow-up procedures to maintain current financial information and other current documentation.

<b>Division of Supervision</b>  <b>MEMORANDUM SYSTEM</b>	<b>CLASSIFICATION NUMBER: 6600</b>		
	<b>DATE: September 12, 2001</b>		
	<b>ISSUING OFFICE: DOS/PPD</b>		
	<b>CONTACT:</b> Robert Walsh P&PD 202-898-6911		
	<b>NOTICE</b>	<b>X</b>	<b>MEMORANDUM</b>

**MEMORANDUM TO:** Regional Directors

**FROM:** Michael J. Zamorski  
Acting Director

**SUBJECT:** Loan Review

**1. Purpose:** Recent indicators suggest the potential for an economic downturn. This, coupled with industry loan growth, indicates a need to re-emphasize to examiners the importance of the loan review function and the loan sampling process. This memorandum encompasses an initiative that originated from the DOS Process Redesign Project.

**2. Background:** The FDIC, in conjunction with the Federal Reserve and Conference of State Bank Supervisors, implemented a risk-focused examination process in 1997. This process was designed to focus resources on bank functions that pose the greatest risk exposure. Loans comprise a major portion of the asset structure of most banks and, as such, present the greatest potential loss exposure for banks and to the FDIC's insurance fund.

A thorough review of a bank's loan and lease portfolio and other related sources of credit risk is one of the most important elements of the Safety and Soundness examination process. Such credit reviews are a primary means for the examiner to evaluate the effectiveness of internal loan review and credit grading systems, to determine that credit is being extended in compliance with internal lending policies, and to assess the adequacy of capital and the allowance for loan and lease losses. Credit reviews also enable an examiner to ascertain a bank's compliance with applicable laws and regulations, make an overall judgment as to the safety and soundness of a bank's lending and credit administration functions, and directly evaluate the quality of a bank's loan and lease portfolio. The quality of the loan portfolio is not always apparent from financial institution performance indicators, and therefore an accurate assessment of loan quality necessitates an on-site examination analysis.

**3. Examiner Guidance:** Since examiners must make the most efficient use of limited resources, they are not required to review every loan within a bank's portfolio. Instead, examiners select for review a sample of loans that is of sufficient size and scope to enable them to reach reliable conclusions about the aforementioned aspects of a bank's overall lending function. Once an examiner has gathered essential credit information for selected loans to the point where a fair and accurate decision whether to pass the loan can be made, the decision should be documented on the line card and no further analysis is necessary. Further, examiners should assess credit administration and underwriting practices for selected loans.

In selecting a sample of loans for review, examiners should use their discretion to identify an appropriate loan sample for accurately assessing the overall condition of the loan portfolio. Examiners should be guided by the following guidance:

- **Commercial and Industrial and Commercial Real Estate Loans**

Commercial and industrial and commercial real estate loans<sup>1</sup> subject to examiner review during an examination should include all known problem loans and all insider loans of significant size. Problem loans comprise past-due loans, nonaccrual loans, loans otherwise impaired as defined in Statement of Financial Accounting Standards No. 114, renegotiated or restructured debt, loans internally criticized or classified by the bank, and loans that were adversely classified at the previous examination. Special Mention loans should also be reviewed. Insider loans are defined by Regulation O and include loans to a related interest of the insider.

In addition, "large" loans should also be reviewed as needed. Large loans are defined as loans, or aggregations of loans to the same or related borrowers, which exceed a dollar cut-off level established by the examiner-in-charge.<sup>2</sup>

This "target" group of loans (problem loans, Special Mention loans, insider loans, and large loans) would typically represent a sizable portion of the dollar volume of a bank's total commercial and industrial and commercial real estate loans. In some cases, additional loans may need to be selected from the remaining commercial portfolio so that the examiner can make an accurate and comprehensive assessment of the condition of the bank's primary lending activities and can further validate the internal watch list.

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<sup>1</sup> As defined in Call Report Guidance. These categories should be expanded to include agriculture loans, construction loans, or other high risk lending areas when such loans represent a significant lending activity. For the purpose of this guidance, the term "loans" includes all sources of credit exposure arising from loans and leases. Such exposure includes guarantees, letters of credit, and other loan commitments.

<sup>2</sup> Historically, examiners have used two to three percent of capital, or one percent of assets. A higher or lower percentage may be determined by the examiner-in-charge, depending on the circumstances of the bank being examined.



The loan penetration ratio of the target group of loans<sup>3</sup> should be based on a risk-assessment of the portfolio. Banking organizations with asset quality component and/or composite ratings of 3 or worse, or possessing other significant areas of supervisory concern, will generally have the highest target loan penetration ratios. Conversely, the lowest loan penetration coverage would be reserved for those banks that:

- Have a composite and asset quality ratings of 1 or 2;
- Are well-managed (Management rating of 1 or 2);
- Have effective internal risk controls and underwriting standards; and,
- Have no other matter of significant concern is present or has been identified during the examination.

Discretionary segmentation/stratification of commercial loans may be necessary. While the goal is to achieve an adequate penetration of the aggregate target group of loans, examiners have the flexibility to narrow their coverage of low-risk loan segments in order to achieve higher penetration rates in sub-categories that pose significant risk. For example, during the Asian financial crisis, certain banks' commercial loan categories contained loans to various Asian entities that posed significantly higher credit risk than that of their domestic counterparts. In these instances, it would be advisable to achieve higher coverage ratios with respect to these "riskier" portfolio segments.

- **Additional Loan Sampling (*If Necessary*)**

Under certain circumstances, subsequent to the start of an examination, it may be determined that additional loans should be added to the predetermined loan sample. Factors that could be considered regarding expanded samples include observations pertaining to internal loan grading systems, underwriting standards, loan file documentation, management information and internal control systems, and the adequacy of loan loss reserves. Existing and developing risk factors such as concentrations of credit, significant loan growth, and new credit products should also be considered. Other important factors to be taken into account include changes in management, economic conditions, the ability and experience of lending staff, and changes in asset quality or lending policies since the last examination.

Further, in determining the extent of additional loans to be reviewed, significant consideration should be given to the effectiveness of the internal credit review and

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<sup>3</sup> A loan penetration ratio should be calculated by dividing the dollar volume of commercial and industrial and commercial real estate loans reviewed during the examination by a bank's total dollar volume of such credits. For the purposes of this calculation, loans are defined as outlined in footnote 1. Credit exposures arising from trading and derivative activities are not generally included in this coverage ratio. However, such credit exposures should be reviewed and evaluated in a manner consistent with guidance included in this document. Homogeneous loan pools should be excluded from the coverage ratio calculation because limited loan sampling procedures, along with an assessment of management's practices and procedures, are often sufficient to assess these pools' overall credit quality. In addition, although Shared National Credits should be reviewed, to determine if there have been any material changes which would warrant a revision in an assigned rating, the dollar volume thereof should be excluded from the loan review coverage ratio calculation. Internally reviewed loans may be included in the coverage ratio only if their *accuracy* has been validated through statistical sampling.

grading system. If, for example, the review of the target group of loans verifies the integrity of the internal credit review and grading system, and there are no other significant risk factors that would necessitate additional sampling, then the volume of additional loans reviewed could be reduced accordingly.

The following factors can be useful in identifying additional loans for sampling. This list is neither mandatory nor all-inclusive; rather, it is a reference tool that, based upon examiner discretion, may be employed when there is a perceived benefit.

- Loans to new customers.
- Credits originated by a specific loan officer, particularly known weak lenders.
- Loans that, while not currently delinquent, have been past due a number of times subsequent to origination.
- Credits possessing interest rates that are unusually low (may represent renegotiated debt) or abnormally high (indicative of higher risk loans).
- Out-of-territory borrowers.
- Loans of various types and categories within the portfolio.
- Loans with unusual amortization periods or terms.
- Loans to apparently unrelated borrowers with the same address.
- Smaller loans that usually escape review based on their size.
- Random sampling.

Regardless of the total coverage afforded by reviewing the target loan group and additional loans, it is essential that loans selected for review are of sufficient number, volume, and variety to enable the examiner to form reasonable conclusions regarding the condition of the bank's entire loan and lease portfolio, and the effectiveness of credit administration policies and practices.

- **Retail Consumer Loans**

Retail consumer lending involves a large number of relatively homogeneous, small-balance loans such as instalment loans, credit card receivables, home equity lines of credit, and residential mortgages. The review and classification of retail consumer loans should be carried out in accordance with the procedures set forth in the DOS Manual of Examination Policies and Interagency Retail Credit Classification Policy and will generally be limited to past due and nonperforming assets. However, the classification of retail loans using these uniform classification methods may also be supplemented by the direct review of larger loans and/or sampling within various categories as considered necessary. In addition, examiners may shorten the periods for classification purposes, where warranted by credit risk. When applicable, examiners should follow the Interagency Policy Statement on Subprime Lending when such loans are encountered.

- **Trading and Derivatives Activities**

For banks active in such markets, the examination process should also include an assessment of credit exposures arising from foreign exchange and securities trading and derivatives activities. In particular, examiners should ensure that a sufficient number of these exposures are selected for review to allow an assessment of a bank's overall exposure to, as well as its ability to safely and soundly manage, trading and derivatives activities. Some commercial and industrial and commercial real estate loan relationships selected for review during an examination may include trading or derivatives exposures. However, examiners should also review a sample of credit relationships established solely for the purpose of facilitating trading or derivatives activities.

- **Documentation and Discussion of Loan Review Coverage**

The scope of loan coverage and loan sampling procedures used in the examination process should be fully discussed with the Case Manager during the preplanning process. Further, loan scope and sampling should be documented within examination work papers and Page A in the confidential section of the Report of Examination. Use of a table as noted in the current Report of Examination Instructions contained in the DOS Manual of Examination Policies is recommended. In particular, examiners should ensure that the reasoning used in determining the composition and volume of the loans reviewed is documented. The loan penetration ratio should also be reported on the Summary Analysis of Examination Report, Line 59F, in accordance with Transmittal 2001-010.

**4. Action:** This memorandum should be distributed to all examination staff and is effective immediately.

Transmittal Number 01-036

## Commercial/Industrial Real Estate Loan Review

Consider the following procedures at each examination. Examiners are encouraged to exclude items deemed unnecessary. This procedural analysis does not represent every possible action to be taken during an examination. The references are not intended to be all-inclusive and additional guidance may exist. Many of these procedures will address more than one of the Standards and Associated Risks. For the examination process to be successful, examiners must maintain open communication with bank management and discuss relevant concerns as they arise.

### IMPORTANT

**This module is intended for those extensions of credit secured by liens on or interests in income producing properties.**

### POLICY CONSIDERATIONS

1 Within the context of the bank's size and complexity, determine the adequacy of the commercial and industrial real estate lending policy. Determine if policies appropriately address the following areas:

1 A The bank's target market and circumstances under which the bank may extend commercial real estate credits on properties located outside this market.

1 B Maximum loan amount, loan maturity, amortization schedule, and pricing structure for each type of real estate loan.

1 C LTV limits in accordance with the Real Estate Lending Standards (FDIC's Rules and Regulation Part 365, FRB: Regulation H Subpart C.) (Note: It is important to distinguish between the regulation and the interagency guidelines. While the guidelines are included as an appendix to the regulation, they are not part of the regulation.)

1 D Guidelines for minimum debt service coverage ratios.

1 E Consideration of the overall creditworthiness of the borrower.

1 F The level of the borrower's equity invested in the property.

1 G Any secondary sources of repayment.

1 H Any additional collateral or credit enhancements, such as guarantees, mortgage insurance, or takeout commitments.

1 I Lending with partial or no recourse to the borrower.

1 J Guidelines for initiating foreclosure actions. (Refer to Other Assets and Liabilities module.)

1 K ALLL guidelines that address impaired real estate values and ALLL adequacy.

2 Determine if the appraisal and evaluation policy includes appropriate guidance for collateral valuation.

2 A Determine if all commercial real estate transactions of \$250,000 or more contain appraisals performed by a certified appraiser. (FDIC: Rules and Regulations - Appraisals. FRB: Regulation H - Appraisals.) (Note: Any transaction not requiring the service of a certified appraiser must still be supported by a collateral valuation that is consistent with safe and sound banking practices.)

## Core Analysis

2 B If an appraisal was not required or obtained, review management's procedures for valuing collateral. Determine if assumptions are reasonable.

2 C Review the adequacy of management's guidelines that describe when collateral reassessments are necessary (for example, prior to restructuring or refinancing the credit, or when problems with the primary source of repayment arise). Be sure to consider compliance with state law for collateral revaluation.

## ADMINISTRATION

3 Review the bank's underwriting practices. The following situations may indicate liberal underwriting practices:

3 A Inadequate credit or collateral documentation.

3 B Additional risk from real estate collateral located in unfamiliar or distant market areas.

3 C Loan terms, such as interest rates, limited recourse to the borrower, and LTV requirements that appear to be based on competitive factors and not underlying credit risk.

3 D No, or minimal, borrower equity.

3 E Real estate collateral values that have been driven up by rapid turnover of ownership without any corresponding improvements to the property or supportable income projections to justify the increased values (such as land flips). (Note: Uniform Standards of Professional Appraisal Practice (USPAP) require a discussion of the property's recent sales history.)

3 F Additional advances to service an existing loan without evidence that the entire loan will be repaid in full.

3 G Renewals, extensions, and refinancings that lack credible support for full repayment from reliable sources and do not have a reasonable repayment schedule.

3 H Speculative loans made with repayment dependent upon appreciation in the real estate collateral.

4 Determine if real estate taxes are current.

## DOCUMENTATION

5 Review the loan file to determine if all necessary documentation is included and accurately completed.

5 A The following loan documents should be in the file:

1. Recorded mortgage (or deed of trust).
2. Recorded note.
3. Attorney's title opinion or title insurance.
4. Appraisal or collateral evaluation.
5. Evidence of appropriate insurance (property, liability, flood).
6. Assignments of leases.
7. Copies of leases (if not included as part of the appraisal).

5 B The following documents should generally be considered as part the credit analysis.

1. Loan presentation or approval memorandum.

Core Analysis

2. Commitment letter (the final signed version).
3. Settlement sheet.
4. Current operating statements of the project.
5. Bank prepared "spreadsheets" or analysis.
6. Rent rolls.
7. Financial statements of other repayment sources.
8. Tax returns.
9. Loan officer's comment sheets.
10. Correspondence.
11. Guarantees (identify extent of guarantor liability).

**CREDIT ANALYSIS**

6 Review real estate market analyses for localities where the bank finances commercial real estate.

6 A Determine if management is aware of current market conditions and appropriately responding to changes. The following indicators or references are useful in evaluating the conditions of the real estate markets:

- 6 A1 1. Permits for new construction.
2. Estimated absorption periods.
3. Employment trends.
4. Vacancy rates.
5. Tenant lease incentives.
6. The level and trend in rental rates.
7. Internal resources (for example, Agency newsletters and publications).

7 Determine if repayment sources involve any intercompany borrower transactions.

8 Consider comparing rent rolls to rental income reflected in tax returns.

9 Determine if difficulties or weaknesses exist in individual commercial real estate projects.

9 A The following situations may indicate potential problems:

- 9 A1 1. Loan arrearages.
2. Tax arrearages.
3. Loans secured by junior liens.
4. Protracted amortization programs or maturity dates.
5. Excessive supply of similar projects in the same trade area.
6. Lack of a sound feasibility study or analysis.
7. Concept or plan changes (for example, a condominium project converted to an apartment project because of unfavorable market conditions).
8. Projects financed at the peak of the real estate cycle.
9. Projects refinanced for non-project related purposes.
10. Rent concessions resulting in cash flow below the level projected in the original feasibility study, appraisal, or evaluation.
11. Special purpose properties (for example, bowling alleys and full service car washes) that are not supporting debt service or providing a reasonable rate of return to the owner.
12. Concessions on finishing tenant space, moving expenses, and lease buyouts.
13. Slow leasing, lack of sustained sales activity, and increasing sales cancellations may reduce the project's income potential, resulting in protracted repayment or default.
14. Purchase money financing based on market values of collateral that are significantly higher than the actual purchase prices.

Core Analysis

15. Land values that assume future rezoning.
16. Borrowers inexperienced in managing the type of property financed.
17. Environmental hazards.

10 Determine the credit quality of sampled loans.

10 A Evaluate the cash flow potential of the underlying collateral to repay the loan within a reasonable amortization period.

10 B Evaluate the borrower's willingness and ability to repay the loan from other resources, if necessary, and according to existing loan terms.

10 C Consider present and past performance on the credit relative to contractual terms.

10 D Consider the prospects for support from any financially responsible guarantors, with emphasis on excess liquidity, cash flow, and demonstrated willingness to honor guaranty agreements. (Note: The primary basis for the review and classification of the loan should be the original source of repayment and the borrower's intent and ability to fulfill the obligation without relying on third-party guarantees; however, the examiner should also consider the support provided by any guarantees when determining the appropriate classification.)

11 Review the underlying real estate collateral. (Note: As the borrower's ability and willingness to repay a loan decreases, the importance of the collateral value increases. The depth of an appraisal review depends on many factors, such as loan performance, appraisal date, and market conditions. Therefore, depending on the circumstances, the following points may not be relevant.)

11 A When a formal appraisal is required, consider the following items:

- 11 A1 1. A thorough market analysis section generally indicates that the overall quality of the appraisal is acceptable.
2. The most reliable sales comparisons are those that require only modest adjustments.
3. When the direct capitalization approach to value is used, the operating statement in the appraisal should be comparable to the actual operating results.
4. The appraiser's reconciliation of the three approaches to value should be reasonable. Any significant variation among approaches should be adequately explained.

12 Assess the reasonableness of the facts and assumptions used in the most recent appraisal or evaluation. (Note: Assumptions should be given a reasonable amount of deference. Examiners should not challenge the underlying assumptions that differ only in a limited way from what would normally be associated with the type, condition, and location of the property under review.)

12 A If material deviations from facts or assumptions are determined, adjust the estimated value of the property, if reasonably possible and supportable, for the purpose of the credit analysis. (Note: Adjustments to collateral value made for credit analysis purposes should not be based on worst case scenarios that are unlikely to occur.)

12 B Consider the following items as part of the assessment.

- 12 B1 1. Current and projected vacancy and absorption rates.
2. Lease renewal trends and anticipated rates.
3. Volume and trend in past due leases.
4. Feasibility study and market survey (to determine support for the assumptions concerning future supply and demand factors).
5. Rental rates or sales prices (taking into account all concessions).

Core Analysis

6. Operating expenses (amounts and categories).
7. Deferred maintenance.
8. Net operating income of the property as compared with projections.
9. Discount and capitalization rates.
10. Marketing period estimated to achieve appraised value.
11. Conclusions.

13 Determine appropriate classification. (Notes: As a general principle, a performing real estate loan should not be automatically classified or charged off solely because the value of the underlying collateral has declined to an amount that is less than the loan amount. Conversely, the fact that the underlying collateral value equals or exceeds the current loan balance, or that the loan is performing as agreed, does not preclude the loan from classification if well-defined weaknesses jeopardize the repayment ability of the borrower. The evaluation of each credit should be based upon the fundamental characteristics affecting the collectibility of the particular credit.)

13 A When determining the appropriate classification of troubled commercial real estate loans when there are no other available and viable repayment sources other than the collateral, remember the definitions of Substandard, Doubtful, and Loss are different.

13 A1 1. **SUBSTANDARD:** Any such troubled real estate loan, or portion thereof, should be classified Substandard when well-defined weaknesses are present that jeopardize the orderly liquidation of the debt. Well-defined weaknesses include a project's lack of marketability, inadequate cash flow or collateral support, failure to complete construction on time, or the project's failure to fulfill economic expectations. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.

13 A2 2. **DOUBTFUL:** Doubtful classifications have all the weaknesses inherent in those classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable. A Doubtful classification may be appropriate in cases where significant risk exposures are perceived, but loss cannot be determined because of specific reasonable pending factors that may strengthen the credit in the near term. Examiners should attempt to identify loss in the credit where possible thereby limiting the excessive use of the Doubtful classification.

13 A3 3. **LOSS:** Advances in excess of calculated current fair value, which are considered uncollectible and do not warrant continuance as bankable assets. There is little or no prospect for near term improvement and no realistic strengthening action of significance pending.



## Commercial and Industrial Loans

Consider the following procedures at each examination. Examiners are encouraged to exclude items deemed unnecessary. This procedural analysis does not represent every possible action to be taken during an examination. The references are not intended to be all-inclusive and additional guidance may exist. Many of these procedures will address more than one of the Standards and Associated Risks. For the examination process to be successful, examiners must maintain open communication with bank management and discuss relevant concerns as they arise.

**Commercial and industrial lending covers a wide range of industries and requires varying analyses in order to ascertain credit quality. In general terms, these loans can be divided into three distinct types of financing: seasonal loans, term loans, and asset-based loans. This reference is intended to give examiners an overview of the basic policy and portfolio considerations necessary to evaluate a bank's commercial and industrial lending activities. Guidance regarding specific industries can be found in various banking publications such as those made available by Robert Morris Associates.**

Common types of commercial and industrial loans are presented below:

**Seasonal loans are short-term obligations that generally fund increases in accounts receivable and inventory. The accounts receivable and inventory are eventually liquidated, and the bank is repaid. Loan proceeds can also fund expenses of a service company until accounts receivable are created and collected.**

**Term loans are repaid over a period longer than one year, or longer than the normal operating cycle of the borrowing entity. Most often, term loan proceeds are used to purchase fixed assets. However, term loans may also be used to convert a permanent working capital loan with no repayment understanding to a structured repayment, to finance an acquisition or change in ownership, or to arrange orderly repayment of a seasonal line that was not paid out at the bottom of the operating cycle.**

**Asset-based loans (also referred to as accounts receivable and inventory financing, or revolving credit lines) are advances that are based upon a borrowing base (percent of eligible accounts receivable and inventory, and discounted value of machinery and equipment). This form of financing differs from seasonal financing, which may also attach receivables and inventory, in that lending controls are more aggressive. See 'Asset-Based Loans' starting with question 6 for a more detailed analysis of this unique form of financing.**

### SEASONAL AND TERM LOANS

#### *Policy Considerations*

1 Determine if the loan policy adequately addresses the following commercial and industrial lending considerations given the size and complexity of the portfolio.

1 A Commercial and industrial loan types that the bank is willing to extend.

1 B Minimum guidelines for underwriting and ongoing credit analysis.

#### **Administration**

2 Review the bank's loan approval process.

2 A Determine if loan presentations include an adequate analysis of the following items:  
(Note: Some of the following items may not be necessary for smaller, less-complex loans.)

## Core Analysis

- 2 A1 1. Loan purpose.
2. Repayment source(s).
3. Collateral.
4. Background of borrower.
5. Principals and management.
6. Financial information including balance sheet, income statement, etc.
7. Financial projections.
8. Industry and economic outlooks.
9. Cash flows.
10. Borrowing and deposit history.
11. Loan structure and terms.
12. Loan covenants.

2 B Determine whether the proper level of approval authority has been documented.

2 C Determine if loan commitment letters include the same terms and conditions that were approved.

3 Review and assess the bank's procedures for monitoring and evaluating collateral.

3 A Determine if the bank initially, and routinely thereafter, performs or obtains the following items as appropriate:

- 3 A1 1. Verifications and inspections.
2. Lien and litigation ("lis pendens") searches.
3. Collateral descriptions.
4. Accounts receivable agings, which are reviewed for trends, concentrations, ineligible accounts (intercompany transactions, receivables from foreign transactions, etc.), and compliance with formula borrowing base.
5. Inventory schedules that identify work in process, obsolete, and ineligible inventory.
6. Current equipment listings and evaluations.
7. Frequent repricing of liquid or readily-marketable collateral.
8. Valuation of intangible assets. Assessment methods include: discounted current value of cash flows; multiples of net income, commissions, and sales; comparability of recent sales or franchise values; and independent appraisals.

3 B Review the bank's lien perfection procedures.

- 3 B1 1. UCC filings.
2. Recorded mortgages.
3. Recorded lien on vehicle titles (where appropriate).
4. Possession.
5. Acknowledgment of assignments.
6. Ships/boats: file preferred ship mortgage with the US Coast Guard.
7. Airplanes: file with FAA in Oklahoma City (include description of motors and avionics).
8. Radio & TV license: file with FCC.

## Documentation

4 Review the loan files for the maintenance of appropriate documentation.

4 A Determine whether the following loan documents are on file as appropriate:

- 4 A1 1. Notes.

## Core Analysis

2. Borrowing authorization.
3. Verification of true legal entity (proprietorship, partnership, or corporation).
4. Collateral documents.
5. Perfection of lien inspection.
6. Guarantees.
7. Loan agreement.
8. Insurance (liability, fire, or key man).
9. Bond or stock powers.
10. Appraisals.
11. Landlord lien waiver.
12. Hypothecation agreement.
13. Subordination agreement.

## Credit Analysis

5 Determine if the bank's financial analysis is adequate in relation to the size and complexity of the debt.

5 A Determine whether the quality of the financial information submitted by borrowers is commensurate with the size and complexity of the loan.

5 B Review the financial analysis management prepared to determine the financing needs and repayment capacity of the borrower. The analysis should include appropriate financial ratios, trends, cash flow history, and projections. Some common analytical ratios are listed below:

- 5 B1 1. Current.
2. Quick.
3. Inventory turnover.
4. AR turnover.
5. AP turnover.
6. Debt service coverage ratios.
  - a. NP + Depreciation (Amortization)/CMLTD.
  - b. EBIT/Interest Expense.
  - c. EBITDA/(Interest expense plus Lease Expense).
7. Profitability ratios (including percentage change).
  - a. Gross profit margin.
  - b. Operating profit margin.
  - c. Net operating income to sales.
  - d. Net income to sales.
  - e. Net income to assets.
8. Debt/tangible net worth.
9. (Total liabilities less subordinated debt) / (subordinated debt plus tangible NW).
10. Sales/fixed assets.

5 C Assess whether the bank's review evaluates important items relating to insiders of the borrowing entity, such as salaries, fees, dividends, notes receivable, and notes payable.

5 D Determine if significant balance sheet and income statement changes are properly explained and financial statement footnotes are reviewed. Determine whether management properly identifies and reviews contingent liabilities.

5 E Determine whether borrowers' cash flow statements (source and use of funds) are evaluated.

Core Analysis

- 5 F Review borrower tax returns, if applicable.

**Policy Considerations**

**ASSET-BASED LOANS**

Since these credit arrangements are frequently a substitute for equity, the loans should always be secured by the liquidation value of accounts receivable, inventory, and any other collateral. Adequate administration and ultimate collectibility of these loans requires close monitoring and continuous evaluation of the value of the collateral.

- 6 Determine if the loan policy addresses the following asset-based loan considerations:

- 6 A Personal guarantees.
- 6 B Lender liability issues.
- 6 C Guidelines for qualified customers.
- 6 D Advance rates are justified by the value and marketability of underlying collateral.

**Administration**

- 7 Determine whether periodic on-site audits of borrowers are performed. If so, determine if the following items are included in the analysis as appropriate:

- 7 A Shipping documents.
- 7 B Inventory invoices.
- 7 C Turnover of AR & AP.
- 7 D Direct verification of AR & AP.
- 7 E Concentrations of customers' ARs. (Poor credit quality in a concentration may warrant lower advance rates.)
- 7 F Sales dilution resulting from merchandise returns, bad debt allowances, or uncollectible receivables.
- 7 G Borrower's credit and collection procedures.
- 7 H Ineligible affiliate and inter-company receivables.
- 7 I Other possibly ineligible AR.
  - 1. Restarts (new AR issued by borrower to replace an AR that is over 90 days effectively "restarts" the invoice).
  - 2. Service (lawyers, repair work, etc. are sometimes excluded).
  - 3. Foreign (sometimes excluded because of perfection difficulties outside the US).
  - 4. Chronic delinquents.
- 7 J Aging of AR & AP.
- 7 K Inventory make up.
  - 1. Shelf life.
  - 2. Obsolescence.

Core Analysis

3. High tech.
4. Work In Process (WIP) (exclude from borrowing base).

7 L Machinery and equipment listing. (Note: Specialty equipment, such as molds, are typically excluded as eligible collateral).

7 M Operational risk of the borrower. The following lists possible warning signs of increased operational risk:

- 7 M1 1. Poor bookkeeping.
2. Delinquent rent.
3. Unreasonable lease terms.
4. Delinquent payroll taxes.
5. Weak internal routine and controls, such as:
  - a. Reconciliation procedures.
  - b. Physical security.
  - c. Cash management and controls.

8 Determine if the bank establishes the following controls:

- 8 A Borrowing bases are tailored to each borrower.
- 8 B Borrowing bases are adequately monitored.
- 8 C The management information system is adequate for asset-based lending.
- 8 D Credit approval presentations contain adequate asset-based lending information.
- 8 E Controls over disbursements exist.
- 8 F Controls over borrower operating accounts (DDA) are in place.
- 8 G The bank takes adequate steps to ensure lien positions are not undermined by post-funding changes (for example, the filing of judgements against the borrower).

## Construction and Land Development

Consider the following procedures at each examination. Examiners are encouraged to exclude items deemed unnecessary. This procedural analysis does not represent every possible action to be taken during an examination. The references are not intended to be all-inclusive and additional guidance may exist. Many of these procedures will address more than one of the Standards and Associated Risks. For the examination process to be successful, examiners must maintain open communication with bank management and discuss relevant concerns as they arise.

### POLICY CONSIDERATIONS

1 Determine whether policies and procedures promote prudent lending practices. Consider the following items within the context of the bank's size and complexity:

- 1 A Feasibility studies, risk analyses, and sensitivity of income projections to economic variables.
- 1 B Minimum requirement for initial investment and equity maintained by the borrower.
- 1 C Standards for net worth, cash flow, and debt service coverage of the borrower or underlying property.
- 1 D Standards for the use of interest reserves or stipulation that interest reserves will not be used.
- 1 E Standards for the level of speculative loans relative to capital.
- 1 F Pre-sale and minimum unit release requirements for non-income producing property loans.
- 1 G Limits on lending with partial or no recourse to borrowers, if permitted.
- 1 H Take-out commitment requirements.
- 1 I Minimum covenants for loan agreements, such as financial statement requirements.
- 1 J Periodic inspections during the construction phase.
- 1 K Lien waivers from subcontractors.
- 1 L Disbursement controls.
- 1 M Inventory control records of unreleased units.
- 1 N Curtailments when original projections are not met.
- 1 O Certificates of occupancy.
- 1 P Joint ventures, such as profit sharing or equity arrangements.
- 1 Q Equity withdrawals from loan proceeds.
- 1 R Contractor's performance bonds for loans over a specified dollar amount.
- 1 S A survey before construction and after the foundation is in place to insure proper setbacks are maintained.

## Core Analysis

- 1 T Procedures to insure that the project complies with local codes and meets certificate of occupancy requirements. (Wetlands determination, zoning appraisals, and percolation results.)
- 1 U Maximum loan amount, pricing, and maturity by type of property.
- 1 V Value and marketability of the mortgaged property.
- 1 W Secondary sources of repayment.
- 1 X Additional collateral or credit enhancements.

## ADMINISTRATION

2 Determine if management monitors real estate markets and local economic conditions within the bank's trade area. Consider the following items:

- 2 A Demographic indicators, including population and employment trends.
- 2 B Zoning requirements.
- 2 C Current and projected vacancy, construction, and absorption rates.
- 2 D Current and projected lease terms, rental rates, and sales prices, including concessions.
- 2 E Current and projected operating expenses for different types of projects.
- 2 F Trends in loan applications and originations.
- 2 G Valuation trends, including discount and direct capitalization rates.
- 2 H Political considerations:
  - 2 H1 1. Zoning and mapping approval process within subject area compared to surrounding counties or political units.
  - 2. Fees and other taxes as compared to other political units.
  - 3. Wetland, environmental, density, water sharing, and miscellaneous issues.

3 Determine if the bank is providing permanent financing. (Note: If the bank provides permanent financing, determine if credit terms are consistent with the bank's normal underwriting standards.)

4 Review loan histories as needed for the following items:

- 4 A Disbursements conforming to loan agreements. For example, funds earmarked for hard costs should not be used for soft costs such as interest, marketing, administrative, architectural, engineering, or legal expenses.
- 4 B Lot releases corresponding to principal payments.

## DOCUMENTATION

5 Determine if the following loan documents are on file:

- 5 A Mortgage (or deed of trust).

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Bill's Test Bank

Lead Regulator: WO

Examination Start Date: 03/11/1999

Core Analysis

- 5 B Note.
- 5 C Attorney's opinion or title insurance.
- 5 D Appraisal or collateral evaluation.
- 5 E Evidence of appropriate insurance (property, liability, flood).
- 5 F Feasibility study.
- 5 G Business plan for the development.
- 5 H Take-out commitment(s).
- 5 I Commitment letter (the final signed version).

**CREDIT ANALYSIS**

6 Determine if acquisition, development, and construction credit decisions and loan administration include the following credit evaluation factors:

6 A Feasibility study that includes, if applicable to the project, the following items:

- 6 A1 1. Economic and environmental issues.
- 2. Engineering surveys and tests.
- 3. Soil borings.
- 4. Character of adjacent properties.
- 5. Flood plain and water table concerns.
- 6. Intrusions.
- 7. Seepage.
- 8. Zoning.
- 9. Political impact.
- 10. Jurisdiction of state and Federal agencies.
- 11. Water availability.

6 B Reasonable steps to determine borrower, developer, and contractor qualifications and reputation. Items to consider include the following:

- 6 B1 1. Construction experience of the borrower, developer, and contractor.
- 2. Payment history from suppliers, trade creditors, and major subcontractors.
- 3. Credit reports.

6 C Take-out commitments.

6 D Financial capacity of the take-out lender.

6 E Marketability of properties without take-out commitments.

6 F Borrower's outside repayment sources.

6 G Control of funds when the loan agreement contains hold back, retention, or interest reserve provisions.



Core Analysis

6 H Adequate hazard, builder's risk, and workman's compensation insurance with the bank named as loss payee where appropriate. (Note: The bank may have provided for additional coverage in the event the borrower's insurance lapses.)

6 I Lien searches prior to disbursement of loan funds.

6 J Lien priority as additional funds are advanced.

6 K Timely payment of subcontractors and suppliers.

7 Determine if the undisbursed loan balance is sufficient to complete the project. Consider the following items:

7 A Reports used to monitor construction progress, advances, sales, and pertinent factors.

7 B Inspection reports:

1. Compare budget to actual costs.
2. Compare draws to degree of completion.

8 Determine if the construction loan amount and the project's estimated completion date correspond to the amounts and expiration dates of the take-out commitment and completion bonds, if any.

9 Determine if loans are based on inflated collateral values caused by rapid turnover of ownership but without any corresponding property improvements (for example, land flips). (Note: Uniform Standards of Professional Appraisal Practice (USPAP) require a discussion of the property's recent sales history.)