Credit Portfolio Management

Reference Materials

The Federal Reserve System
Commercial Bank Examination
Manual (Excerpts)

2nd Year Class
2020 Virginia Bankers School of
Bank Management

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Federal Reserve – Commercial Bank Exam Manual

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Review the bank's internal controls, policies, practices, and procedures for managing the bank's loan portfolio. The bank's system should be documented completely and concisely and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information.

LENDING POLICIES AND PROCEDURES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written loan portfolio management policies and objectives that—
   a. establish suggested guidelines for the distribution of loans in the commercial, real estate, and installment categories?
   b. establish geographic limits for loans?
   c. establish suggested guidelines for aggregate outstanding loans in relation to other balance-sheet categories?
   d. establish the loan authority of committees and individual lending officers?
   e. define acceptable types of loans?
   f. establish maximum maturities for various types of loans?
   g. establish loan pricing?
   h. establish an appraisal policy?
   i. establish the minimum financial information required at the inception of credit?
   j. establish limits and guidelines for purchasing paper?
   k. establish guidelines for loans to bank directors, officers, principal shareholders, and their related interests?
   l. establish collection procedures?
   m. define the duties and responsibilities of loan officers and loan committees?
   n. outline loan portfolio management objectives that acknowledge—
      - concentrations of credit within specific industries?
      - the need to employ personnel with specialized knowledge and experience?
      - community service obligations?
      - possible conflicts of interests?
   o. ensure that all of the bank's loan portfolios are monitored and reviewed to ensure continued compliance with sections 23A and 23B of the Federal Reserve Act and Regulation W.
2. Are loan portfolio management policies and objectives reviewed at least annually to determine if they are compatible with changing market conditions?
3. Are the following reported to the board of directors or its committees (indicate which) at their regular meetings (at least monthly):
   a. past-due single-payment notes? (If so, indicate the minimum days past due for them to be included ________.)
   b. notes on which interest only is past due? (If so, indicate the minimum days past due for them to be included ________.)
   c. term loans on which one installment is past due? (If so, indicate the minimum days due for them to be included ________.)
   d. total outstanding loan commitments?
   e. loans requiring special attention?
   f. new loans and loan renewals or restructured loans?
4. Are reports to be submitted to the board or its committees rechecked by a designated individual for possible omissions before the reports are submitted?
5. Are written applications required for all loans?
6. Does the bank maintain credit files for all borrowers?
7. Does the credit file contain information on—
   a. the purpose of the loan?
   b. the planned repayment schedule?
   c. the disposition of loan proceeds?
8. Does the bank require periodic submission of financial statements by all borrowers whose loans are not fully secured by readily marketable collateral?
9. Is a tickler file maintained to ensure that current financial information is requested and received?
10. Does the bank require submission of audited financial statements based on the dollar amount of the commitment? (If so, state the dollar minimum for requiring $________.)
11. Does the bank perform a credit investigation on proposed and existing borrowers for new loan applications?

12. Is it required that all loan commitments be in writing?
13. Are lines of credit reviewed and updated at least annually?
14. Are borrowers' outstanding liabilities checked to appropriate lines of credit before granting the borrowers additional advances?
15. Does the bank employ a procedure for disclosure of a loan or combination of loans that are or will be secured by 25 percent of another insured financial institution's stock?
16. Does the bank employ procedures to ensure compliance with the requirements of the Lost and Stolen Securities Program (17 CFR 240.17f-l)? (See Internal Control Questionnaire questions 6–15 of section 4150.4 "Review of Regulatory Reports.")
17. Is there an internal review system (it may be a function of the internal audit department) that covers each department, and does it—
    a. recheck interest, discount, and maturity-date computations?
    b. reexamine notes for proper execution, receipt of all required supporting papers, and proper disclosure forms?
    c. determine that loan approvals are within the limits of the bank's lending authorities?
    d. determine that notes bear the initial of the loan officer?
    e. ascertain that new loans are within the limitations set for the borrower by corporate resolution?
    f. recheck the liability ledger to determine that new loans have been accurately posted?
18. Does the bank have a loan-review section or the equivalent?
19. Is the loan-review section independent of the lending function?
20. Are the initial results of the loan-review process submitted to a person or committee that is also independent of the lending function?
21. Are all loans exceeding a certain dollar amount selected for review?
22. Do lending officers recommend loans for review?
23. Is a method, other than those detailed in steps 21 or 22, used to select loans for review? (If so, provide details.)
24. Are internal reviews conducted at least annually for all lending areas?
25. In an officer-identification system, are guidelines in effect that define the consequences of an officer's withholding a loan from the review process?
26. Is the bank's problem-loan list periodically updated by the lending officers?
27. Does the bank maintain a list of loans reviewed, indicating the date of the review and the credit rating?
28. Does the loan-review section prepare summations to substantiate credit ratings, including pass loans?
29. Are loan-review summations maintained in a central location or in appropriate credit files?
30. Are follow-up procedures in effect for internally classified loans, including an update memorandum to the appropriate credit file?
31. Are officers and employees prohibited from holding blank signed notes in anticipation of future borrowings?
32. Are paid and renewed notes cancelled and promptly returned to customers?
33. Are loan records retained in accordance with the record-retention policy and legal requirements?
34. Are new notes microfilmed daily?
35. Is a systematic and progressively stronger follow-up-notice procedure used for delinquent loans?
36. Does the bank maintain loan interest-rate schedules for various types of loans?
37. Does the bank periodically update interest-rate schedules? If so, state the normal frequency of updates ________.
38. Does the bank maintain records in sufficient detail to generate the following information by type of advance:
    a. the cost of funds loaned?
    b. the cost of servicing loans, including overhead?
    c. the cost factor of probable losses?
    d. the programmed profit margin?
39. Has the bank conducted industry studies for those industries in which it is a substantial lender?
40. Are loan proceeds either credited to customers' accounts or released through issuance of official bank checks payable to the borrower?
41. Is a record of charged-off loans maintained by a person other than the one who has custody of the notes or receives payment? Is this record checked against the notes at least annually?

42. Are adequate procedures in effect with respect to recoveries?

MORTGAGE BANKING ACTIVITIES

1. Are the assumptions used in the bank's valuation models supported when these assumptions are not benchmarked to market participants' assumptions and to the bank's actual portfolio performance across each product type?
2. Are there questionable, inappropriate, or unsupported items in the valuation models (for example, retention benefits, deferred tax benefits, captive reinsurance premiums, or income from cross-selling activities). The inclusion of such items in the bank's mortgage-servicing asset (MSA) valuation must be appropriate under generally accepted accounting principles (GAAP) and must also be consistent with what a willing buyer would pay for the mortgage-servicing contract.
3. Does bank management use comparable market data as a means of supporting model assumptions and the fair value of MSAs?
4. Does bank management frequently change the assumptions it uses in its MSA valuation models from period to period for no compelling reason?
5. Are there inconsistencies in the MSA valuation assumptions used in valuation, bidding, pricing, and hedging activities as well as, where relevant, in mortgage-related activities in other aspects of the bank's business?
6. Is there satisfactory segregation of duties from an organizational perspective between the valuation, hedging, and accounting functions for the bank's mortgage banking activities?
7. Does bank management use appropriate amortization practices for its MSAs?
8. Does the bank properly stratify MSAs for impairment-testing purposes?
9. Do the bank's MSA impairment analyses use reasonable and supportable assumptions?
10. Does bank management use a valuation allowance for the impairment of a stratum of MSAs when repayment of the underlying loans at a rate faster than originally projected indicates the existence of an impairment for which a direct write-down should be recorded?
11. Does bank management evaluate MSAs for impairment at least quarterly to ensure that amounts reported in the call report are accurately stated?
12. Does bank management measure the actual performance of MSAs by analyzing gross monthly cash flows of servicing assets relative to the assumptions and projections used in each quarterly valuation?
13. Does bank management validate or update models for new information?
14. Does bank management periodically inventory and revalidate its MSA valuation models, including an independent assessment of all key assumptions?
15. Does the bank obtain periodic third-party valuations by qualified market professionals to support the fair values of its MSAs and to update its internal models?
16. Does the bank have comprehensive documentation standards for all aspects of mortgage banking, including mortgage-servicing assets?
17. Does bank management and, where appropriate, the board of directors, review and approve results and assumptions of the bank's MSA valuation models?
18. Does bank management compare models used throughout the company, including valuation, hedging, pricing, and bulk acquisition, to identify inconsistencies? Are identified inconsistencies satisfactorily supported?
19. Does the bank have systems to measure and control interest-rate risk?
20. Does bank management ensure that appropriate systems and internal controls are in place to oversee hedging activities, including monitoring the effectiveness of hedging strategies and reviewing concentrations of hedge instruments and counterparties?
21. Does bank management ensure that the bank's hedge accounting methods are adequately documented and consistent with GAAP?
22. Does the bank's board receive information on hedged and unhedged positions, mark-to-market analyses, warehouse aging, the valuation of MSAs, various rate shock scenarios and risk exposures, the creation of economic value, and policy exceptions

whenever material exposure to MSAs exists?

23. Does the bank have written and consistently applied accounting policies for its commitments to originate mortgage loans that are held for resale and its commitments to sell mortgage loans under mandatory-delivery and best-efforts contracts?
24. Has the bank developed, and does it use, approved valuation methodologies and procedures to obtain formal approval for the changes to those methodologies?
    a. Are the valuation methodologies reasonable, objectively supported, and fully documented?
    b. Does the bank have internal controls, including an effective independent review or audit, in place that give integrity to the valuation process?
25. If the bank issues fixed-, adjustable-, and floating-rate derivative loan commitments or forward loan-sales commitments, does it review an adequate sample that evidences the full coverage of these types of transactions?
    a. Are these types of transactions properly reported on the balance sheet as an ''other asset'' or an ''other liability'' according to whether the individual commitment has a positive (asset) or negative (liability) fair value, in accordance with the bank Call Report instructions?
    b. Are floating-rate derivative loan commitments and other derivative loan commitments reported at their entire gross notional amount in the bank Call Report?
    c. Is the bank's balance-sheet presentation of all such transactions (including the netting of contracts, the application of hedge accounting to mortgage banking activities, the valuation of derivatives, and any material or other accounting changes for derivative loan commitments and loan-sales agreements) accounted for and reported in accordance with the May 3, 2005, Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans and in accordance with generally accepted accounting principles (GAAP)?
    d. Are periodic changes in the fair value of derivative loan commitments and forward loan-sales commitments reported in current-period earnings in either ''other noninterest income'' or ''noninterest expense,'' as appropriate?
26. Has the bank's management failed to follow the bank's accounting and valuation policies for its commitments to originate mortgage loans that are held for sale and its commitments to sell mortgage loans, according to the instructions in the bank Call Report, the May 3, 2005, interagency advisory, or GAAP?
27. Does the bank have satisfactory systems that track quality-control exceptions?
28. Does bank management analyze the bank's quality-control reports to determine credit quality, loan characteristics and demographics, trends, and sources of problems?
29. Does the bank have satisfactory systems that track and collect required mortgage loan documents?
30. Does bank management ensure that adequate control processes are in place for both front-end-closing and post-closing loan documents?
31. Does the bank have satisfactory systems that monitor and manage the risks associated with third-party-originated loans?
32. Does bank management ensure prudent risk-management systems are in place for broker and correspondent approvals and for ongoing monitoring, including controls on the appraisal and credit-underwriting process of third-party-originated loans?
33. Is the bank's internal audit coverage of its mortgage banking activities adequate?

CONCLUSION

1. Is the foregoing information considered an adequate basis for evaluating internal control; that is, there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly and indicate any additional examination procedures deemed necessary.
2. Based on a composite evaluation as evidenced by answers to the foregoing questions, is internal control considered adequate?

Concentrations of Credit
Internal Control Questionnaire
Effective date March 1984

Section 2050.4

Review the bank's internal controls, policies, practices, and procedures relating to concentrations of credit. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information.

POLICIES

1. Has a policy been adopted that specifically addresses concentrations of credits?
2. Does the policy include deposits and other financial transactions with financial institutions?
3. Have controls been instituted to monitor the following types of concentrations:
   a. loans and other obligations of one borrower
   b. loans predicated on the collateral support afforded by a debt or equity issue of a corporation
   c. loans to a company dominant in the local economy, its employees, and major suppliers
   d. loans dependent upon one crop or herd
   e. loans dependent upon one industry group
   f. loans considered out of normal territory
4. Are periodic reports of concentrations required to be submitted to the board or its committee for review (if so, state frequency ________)?
5. Are the periodic reports checked for accuracy by someone other than the preparer before being submitted to the board or its committee?
6. When concentrations exist predicated upon a particular crop or herd of livestock, does the bank attempt to diversify the inherent potential risk by means of—
   a. participations or
   b. arrangements with governmental agencies such as—
      - guarantees or
      - lending arrangements?
7. When concentrations exist predicated upon a particular industry, does the bank make a periodic review of industry trends?

CONCLUSION

8. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficiencies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly and indicate any additional examination procedures deemed necessary.
9. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

The criteria used to assign quality ratings to extensions of credit that exhibit potential problems or well-defined weaknesses are primarily based upon the degree of risk and the likelihood of orderly repayment, and their effect on a bank's safety and soundness. Extensions of credit that exhibit potential weaknesses are categorized as "special mention," while those that exhibit well-defined weaknesses and a distinct possibility of loss are assigned to the more general category of "classified." The term "classified" is subdivided into more specific subcategories ranging from least to most severe: "substandard," "doubtful," and "loss." The amount of classified extensions of credit as a percent of capital represents the standard measure of expressing the overall quality of a bank's loan portfolio.

These classification guidelines are only applied to individual credits, even if entire portions or segments of the industry to which the borrower belongs are experiencing financial difficulties. The evaluation of each extension of credit should be based upon the fundamental characteristics affecting the collectibility of that particular credit. The problems broadly associated with some sectors or segments of an industry, such as certain commercial real estate markets, should not lead to overly pessimistic assessments of particular credits in the same industry that are not affected by the problems of the troubled sector(s).

ASSESSMENT OF CREDIT QUALITY

The evaluation of each credit should be based upon the fundamentals of the particular credit, including, at a minimum—

- the overall financial condition and resources of the borrower, including the current and stabilized cash flow (capacity);
- the credit history of the borrower;
- the borrower's or principal's character;
- the purpose of the credit relative to the source of repayment; and
- the types of secondary sources of repayment available, such as guarantor support and the collateral's value and cash flow, when they are not a primary source of repayment. (Undue reliance on secondary sources of repayment should be questioned, and the bank's policy about permitting such a practice should be reviewed.)

The longer the tenure of the borrower's extension of credit or contractual right to obtain funds, the greater the risk of some adverse development in the borrower's ability to repay the funds. This is because confidence in the borrower's repayment ability is based upon the borrower's past financial performance as well as projections of future performance. Failure of the borrower to meet its financial projections is a credit weakness, but does not necessarily mean the extension of credit should be considered as special mention or be classified. On the other hand, the inability to generate sufficient cash flow to service the debt is a well-defined weakness that jeopardizes the repayment of the debt and, in most cases, merits classification. When determining which credit-quality rating category is appropriate, the examiner should consider the extent of the shortfall in the operating figures, the support provided by any pledged collateral, and/or the support provided by cosigners, endorsers, or guarantors.

Delinquent Extensions of Credit

One of the key indicators of a problem credit is a borrower's inability to meet the contractual repayment terms of an extension of credit. When this occurs, the extension of credit is identified as past due or delinquent. An extension of credit that is *not* delinquent may be identified as special mention or classified. Nondelinquent extensions of credit (also referred to as "performing" or "current") should be classified when well-defined weaknesses exist that jeopardize repayment. Examples of well-defined weaknesses include the lack of credible support for full repayment from reliable sources, or a significant departure from the intended source of repayment. This latter weakness warrants concern because a delinquent credit may have been brought current through loan or credit modifications, refinancing, or additional advances.

SPECIAL MENTION CATEGORY

A special mention extension of credit is defined as having potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may, *at some future date*, result in the deterioration of the repayment prospects for the credit or the institution's credit position. Special mention credits are not considered as part of the classified extensions of credit category and do not expose an institution to sufficient risk to warrant classification.

Extensions of credit that might be detailed in this category include those in which—

- the lending officer may be unable to properly supervise the credit because of an inadequate loan or credit agreement;
- questions exist regarding the condition of and/or control over collateral;
- economic or market conditions may unfavorably affect the obligor in the future;
- a declining trend in the obligor's operations or an imbalanced position in the balance sheet exists, but not to the point that repayment is jeopardized; and
- other deviations from prudent lending practices are present.

The special mention category should not be used to identify an extension of credit that has as its sole weakness credit-data or documentation exceptions not material to the repayment of the credit. It should also not be used to list extensions of credit that contain risks usually associated with that particular type of lending. Any extension of credit involves certain risks, regardless of the collateral or the borrower's capacity and willingness to repay the debt.

For example, an extension of credit secured by accounts receivable has a certain degree of risk, but the risk must have increased beyond that which existed at origination to categorize the credit as special mention. Other characteristics of accounts receivable warranting identification as special mention include a rapid increase in receivables without bank knowledge of the causative factors, concentrations in receivables lacking proper credit support, or lack of on-site audits of the bank's borrower.

CLASSIFICATION CATEGORIES

Split Classifications

When classifying a particular credit, it may not be appropriate to list the entire balance under one credit-quality category. This situation is commonly referred to as a "split classification" and may be appropriate in certain instances, especially when there is more certainty regarding the collectibility of one portion of an extension of credit than another. Split classifications may also involve special mention as well as "pass" credits, those that are neither special mention nor classified. Extensions of credit that exhibit well-defined credit weaknesses may warrant classification based on the description of the following three classification categories.[1]

Substandard Extensions of Credit

A "substandard" extension of credit is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Extensions of credit so classified must have a well-defined weakness or

1. Guidelines for the uniform classification of consumer-installment extensions of credit and credit card plans, as well as classification guidelines for troubled commercial real estate credits, are discussed in detail in sections 2130.1 and 2090.1, respectively.

weaknesses that jeopardize the liquidation[2] of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of substandard credits, does not have to exist in individual extensions of credit classified substandard.

Doubtful Extensions of Credit

An extension of credit classified ''doubtful'' has all the weaknesses inherent in one classified substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors that may work to the advantage of and strengthen the credit, its classification as an estimated loss is deferred until its more exact status may be determined. Pending factors may include a proposed merger or acquisition, liquidation proceedings, capital injection, perfecting liens on additional collateral, or refinancing plans.

Examiners should avoid classifying an entire credit as doubtful when collection of a specific portion appears highly probable. An example of proper use of the doubtful category is the case of a company being liquidated, with the trustee-in-bankruptcy indicating a minimum disbursement of 40 percent and a maximum of 65 percent to unsecured creditors, including the bank. In this situation, estimates are based on liquidation-value appraisals with actual values yet to be realized. By definition, the only portion of the credit that is doubtful is the 25 percent difference between 40 and 65 percent. A proper classification of such a credit would show 40 percent substandard, 25 percent doubtful, and 35 percent loss.

Examiners should generally avoid repeating a doubtful classification at subsequent examinations, as the time between examinations should be sufficient to resolve pending factors. This is not to say that situations do not occur when continuation of the doubtful classification is warranted. However, the examiner should avoid undue continuation if repeatedly, over the course of time, pending events do not occur and repayment is again deferred awaiting new developments.

Loss Extensions of Credit

Extensions of credit classified ''loss'' are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the credit has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future. Amounts classified loss should be promptly charged off. (See SR-04-9 and its attachment.)

Banks should not be allowed to attempt long-term recoveries while the credit remains on the bank's books. Losses should be taken in the period in which they surface as uncollectible.

In some cases, examiners should determine a reasonable carrying value for a distressed extension of credit and require a write-down through a charge to the allowance for loan and lease losses, or to other operating expenses in the case of an ''other asset.'' Such a determination should be based on tangible facts recorded in the bank's credit file and contained in reports on problem credits submitted to the board of directors or its committee, and not solely on verbal assurances from a bank officer.

SITUATIONS NOT REQUIRING CLASSIFICATION

It is generally not necessary to classify extensions of credit and contingent liabilities that are adequately protected by the current sound worth and debt-service capacity of the borrower, guarantor, or the underlying collateral. Further, a performing extension of credit should not automatically be identified as special mention, classified, or charged off solely because the value of the underlying collateral has declined to an amount that is less than the balance outstanding. Extensions of credit to sound borrowers that are refinanced or renewed in accordance with prudent underwriting standards should not be cat-

2. This terminology is used in the original classification definitions as set forth in the 1938 accord and its amendments. The term ''liquidation'' refers to the orderly repayment of the debt and not to a forced sale of the loan or its underlying collateral.

egorized as special mention unless a potential weakness exists, or classified unless a well-defined weakness exists that jeopardizes repayment. The existence of special mention or classified extensions of credit should not be identified as an imprudent banking practice, as long as the institution has a well-conceived and effective workout plan for such borrowers, and effective internal controls to manage the level of these extensions of credit.

Partially Charged-Off Extensions of Credit

When an institution has charged off a portion of a credit and the remaining recorded balance of the credit (1) is being serviced (based upon reliable sources) and (2) is reasonably assured of collection, categorization of the remaining recorded balance as special mention or classified may not be appropriate.[3] For example, when the remaining recorded balance of an extension of credit is secured by readily marketable collateral, the portion that is secured by this collateral would generally not be identified as special mention or classified. This would be appropriate, however, if potential or well-defined weaknesses, respectively, continue to be present in the remaining recorded balance. In such cases, the remaining recorded balance would generally receive a credit rating no more severe than substandard.

A more severe credit rating than substandard for the remaining recorded balance would be appropriate if the loss exposure cannot be reasonably determined, for example, when significant risk exposures are perceived, such as might be the case in bankruptcy or for credits collateralized by properties subject to environmental hazards. In addition, classification of the remaining recorded balance would be appropriate when sources of repayment are considered unreliable.

3. The accrual/nonaccrual status of the credit must continue to be determined in accordance with the glossary section of the Instructions for the Consolidated Reports of Condition and Income (Call Report). Thus, while these partially charged-off credits may qualify for nonaccrual treatment, cash-basis recognition of income will be appropriate when the criteria specified in the Call Report guidance are met.

Formally Restructured Extensions of Credit

Restructured troubled debt should be identified in the institution's internal credit-review system and closely monitored by management. When analyzing a formally restructured extension of credit, the examiner should focus on the ability of the borrower to repay the credit in accordance with its *modified terms*.[4] With formally restructured credits, it is frequently necessary to charge off a portion of the principal, due to the borrower's difficulties in meeting the contractual payments. In these circumstances, the same credit-risk assessment given to nonrestructured credits with partial charge-offs (see the previous subsection) would also generally be appropriate for a formally restructured credit. This includes *not* identifying the remaining recorded balance as special mention or classified if unwarranted. The assignment of special mention status to a formally restructured credit would be appropriate, if, after the restructuring, potential weaknesses remained. It would also be appropriate to classify a formally restructured extension of credit when well-defined weaknesses exist that jeopardize the orderly repayment of the credit, based upon its reasonable modified terms. For a further discussion of troubled debt restructurings, see the glossary section of the Instructions for the Consolidated Reports of Condition and Income and "Loan Portfolio Management," section 2040.1.

ROLE OF GUARANTEES

The primary focus of a review of an extension of credit's quality is the original source of repayment and the borrower's ability and intent to fulfill the obligation without reliance on guarantors.[5] In situations involving troubled credits, however, the assessment of credit quality should also be based upon the support provided by guarantees. As a result, the lending institution

4. An example of a restructured commercial real estate credit that does *not* have reasonable modified terms would be a mortgage that requires interest payments *only*, but no principal payments, despite the fact that the underlying collateral generates sufficient cash flow to pay both.

5. Some credits are originated based primarily upon the financial strength of the guarantor, who is, in substance, the primary source of repayment. In such circumstances, examiners generally assess the collectibility of the credit based upon the guarantor's ability to repay the credit.

must have sufficient information concerning the guarantor's financial condition, income, liquidity, cash flow, contingent liabilities, and other relevant factors (including credit ratings, when available) to demonstrate the guarantor's financial capacity to fulfill the obligation.

Examiner Treatment of Guarantees

A guarantee should provide support for repayment of indebtedness, in whole or in part, and be legally enforceable. It is predicated upon both the guarantor's financial capacity and willingness to provide support for a credit.

To assess the financial capacity of a guarantor and determine whether the guarantor can honor its contingent liabilities in the event required, examiners normally rely on their own analysis of a guarantor's financial strength. This includes an evaluation of the financial statements and the number and amount of guarantees currently committed to.

A guarantor's willingness to perform is assumed, unless there is evidence to the contrary. Since a guarantee is obtained with the intent of improving the repayment prospects of a credit, a guarantor may add sufficient strength to preclude or reduce the severity of the risk assessment.

Examiners should consider and analyze the following guarantee-related factors during the course of their review of extensions of credit:

- The degree to which the guarantors have demonstrated their ability and willingness to fulfill previous guarantees.
- Whether previously required performance under guarantees was voluntary or was the result of legal or other actions by the lender. Examiners should give limited credence, if any, to guarantees from obligors who have reneged on obligations in the past, unless there is clear evidence that the guarantor has the ability and intent to honor the specific guarantee under review.
- The economic incentives for performance by guarantors. This includes—
  - — guarantors who have already partially performed under the guarantee;
  - — guarantors who have other significant investments in the project;
  - — guarantors whose other sound projects are cross-collateralized or otherwise intertwined with the credit; or
  - — guarantees collateralized by readily marketable assets that are under the control of a third party.
- The extent to which guarantees are legally enforceable, although in general this is the only type of guarantee that should be relied upon.
  - — Collection of funds under a guarantee should not be subject to significant delays or undue complexities or uncertainties that might render legal enforceability questionable.
  - — Although the bank may have a legally enforceable guarantee, it may decide not to enforce it. The examiner's judgment should be favorably affected by previous extensions of credit evidencing the timely enforcement and successful collection of guarantees.
- The type of the guarantee. Some guarantees for real estate projects are limited in that they only pertain to the development and construction phases of a project. As such, these limited guarantees cannot be relied upon to support a troubled credit after the completion of these phases.

OFF-BALANCE-SHEET ITEMS

The principal off-balance-sheet credit-related transactions likely to be encountered during loan reviews are loan commitments, commercial letters of credit, and standby letters of credit. When evaluating off-balance-sheet credit transactions for the purpose of assigning a credit-quality rating, the examiner should carefully consider whether the bank is irrevocably committed to advance additional funds under the credit agreement. If the bank must continue to fund the commitment and a potential weakness exists that, if left uncorrected, may at some future date result in the deterioration of repayment prospects or the bank's credit position, the amount of the commitment may be categorized as special mention. If there is a well-defined weakness that jeopardizes repayment of a commitment, classification may be warranted. If an amount is classified, it should be separated into two components: the direct amount (the amount that has already been advanced) and the indirect amount

(the amount that must be advanced in the future).

Loan Commitments

Loan commitments are defined as legally binding obligations to extend credit (other than in the form of retail credit cards, check credit, and related plans) for which a fee or other compensation is typically received. Different types of loan commitments vary based upon the nature of the credit granted. Loan-commitment credit risk stems from the possibility that the creditworthiness of the customer will deteriorate between the time the commitment is made and the funds are advanced. (See ''Contingent Claims from Off-Balance-Sheet Activities,'' section 4110.1.)

Commercial Letters of Credit

Commercial letters of credit involve a buyer of goods and a seller of goods and are instruments issued by a bank serving as an intermediary between the two for the resultant payment for the goods. Commercial letters of credit are customarily used to facilitate international trade due to the distances involved, as well as differences in legal, political, and business practices. Additionally, there may be a lack of familiarity between the buyer and seller. As a result, the bank substitutes its credit in place of the buyer's credit and promises on behalf of its customer to pay predetermined amounts of money to the seller against the delivery of documents indicating shipment of goods and representing title to those goods. If the shipping documents are in order, the bank is obligated to pay the seller through the issuance of a sight or time draft. The bank is then reimbursed by its customer for the amount of the shipment plus a fee for conducting the transaction.

Given the nature of the bank's commitment to pay for the goods on behalf of its customer, a commercial letter of credit is typically irrevocable. This means that it cannot be cancelled or revoked without the consent of all parties concerned. As a result, there is added credit risk for the issuing bank since it cannot cancel its commitment in the event the credit standing of its customer deteriorates, even if the deterioration occurs before the shipment of the goods.

Standby Letters of Credit

Most standby letters of credit (SLCs) are unsecured and involve substituting the bank's credit standing for that of the bank's customer on behalf of a beneficiary. This occurs when the beneficiary needs to ensure that the bank's customer is able to honor its commitment to deliver the goods or services by the agreed-upon time and with the agreed-upon quality. For credit-analysis purposes, SLCs are to be treated like loans and represent just one type of extension of credit relative to the overall exposure extended by the bank to the borrower. SLCs can be divided into two main groups: ''financial SLCs'' and ''nonfinancial SLCs.'' Financial SLCs essentially guarantee repayment of financial instruments and are commonly used to ''guarantee'' payment on behalf of customers, issuers of commercial paper, or municipalities (relative to tax-exempt securities). Nonfinancial SLCs are essentially used as bid and performance bonds to ''guarantee'' completion of projects, such as building or road construction, or to guarantee penalty payment in case a supplier is unable to deliver goods or services under a contract.

REQUIRED LOAN WRITE-UPS

A full loan write-up (see criteria below) is required for all significant or material classified or specially mentioned assets if (1) management disagrees with the disposition accorded by the examiner, or (2) the institution will be rated composite 3, 4, or 5. The write-ups will be used to support the classifications to management and, in the case of problem banks, to support any necessary follow-up supervisory actions.

An abbreviated write-up may be appropriate for other loans to illustrate a credit-administration weakness or to formalize certain decisions, document agreements, and clarify action plans for management. For example, bank management may have agreed to either collect or charge off a loan classified doubtful by the next call report date or to reverse interest accruals and place the loan on nonaccrual status. These agreements may be expressed in the report through a brief comment under the classification write-up.

The examiner may find it beneficial to list extensions of credit alphabetically by depart-

ment and/or branch. When more than one borrower is relevant to a single write-up, the alphabetization of the prime borrower or the parent corporation should determine the credit's position in the list. All other parties to the credit, including cosigners, endorsers, and guarantors, should be indicated directly under the maker of the notes or embodied within the write-up.

Although classifications and items listed for special mention may be listed alphabetically on the report page, examiners may elect to format the listing or write-ups in other ways to illustrate examination findings or conclusions. For example, examiners may wish to group classifications into categories of weakness and to use these listings to support loan-administration comments without providing a write-up for each classified item.

Notwithstanding this guidance, examiners have the flexibility of writing up more than the criticized assets, including any special mention credits, if deemed necessary. The decision to increase the number of write-ups should be based on factors such as the overall financial condition of the bank, quality of the loan portfolio, or adequacy of loan portfolio administration.

It is important that a sufficient number of write-ups with appropriate content be provided to support the examiner's assessment of the bank's problem loans, leases, and other extensions of credit. The write-ups should also support any comments pertaining to credit-administration policies and practices as they relate to this component of the bank's loan portfolio.

General Guidelines for Write-Ups of Special Mention and Classified Extensions of Credit

Extension of credit write-ups may be in a narrative or bullet format, similar to the write-ups of shared national credits, where appropriate. When the special mention or classified credit consists of numerous extensions of credit to one borrower, or when multiple borrowers are discussed in one write-up, the write-up should be structured to clearly identify the credit facilities being discussed. For example, each extension of credit could be numbered when multiple credits are involved.

Before a write-up is prepared, the examiner should recheck central information files or other sources in the bank to determine that all of the obligor's debt, including related debt,[6] has been noted and included. The examiner should consider identifying accrued interest receivable as special mention or classified, especially when the cumulative effect on classified percentages is significant or the accrued interest is appropriately classified loss.

Even though the length of a write-up may be limited, the information and observations contained in the write-up must substantiate the credit's treatment as a special mention or classified credit. To prepare a write-up that brings out pertinent and fundamental facts, an examiner needs to have a thorough understanding of all the factors relative to the extension of credit. An ineffective presentation of the facts weakens a write-up and frequently casts doubt on the accuracy of the risk assessment. The examiner might consider emphasizing deviations from prudent banking practices as well as loan policy and procedure deficiencies that are pertinent to the credit's problems. When portions of a borrower's indebtedness are assigned to different risk categories, including portions identified as "pass," the examiner's comments should clearly set forth the reason for the split-rating treatment. A full write-up on items adversely classified or listed as special mention must provide sufficient detail to support the examiner's judgment concerning the rating assigned. To ensure that the write-ups provide a clear, concise, and logical discussion of material credit weaknesses, the following minimum categories of information should be presented, preferably in the order listed (see SR-99-24):

1. *A general description of the obligation.*
   - *Amount of exposure (both outstanding and contingent or undrawn) as follows:*
     - Summarize total related and contingent borrowings, including amounts previously charged off and recovered.
     - List the borrower's total related liabilities outstanding. Amounts making up this total refer to credits in which the borrower may have a related interest and is directly or indirectly obligated to repay, such as partnerships and joint ventures. The rule for determining what

6. The term "related" refers to direct and indirect obligations.

is included in related debt (aggregating debt), which ultimately has to do with ascertaining compliance with legal lending limits, is governed by state law.

— List and identify the obligor's contingent liabilities to the bank under examination. Contingent liabilities include items such as unadvanced portions of a line of credit or extension of credit (commitments), guarantees or endorsements, and commercial and standby letters of credit. Although contingent liabilities to other lenders represent an important component of the financial analysis of the obligor, they should not be listed in the write-up unless they are particularly relevant to the situation, or are portions of both related and contingent liabilities that represent participations purchased from and sold to other lenders. The latter example should be listed even though the entire relationship may not have been identified as special mention or classified. Additionally, only the classified portion of extensions of credit or contingent liabilities of the bank under examination should be listed in the appropriate column(s) of the classified asset page.

- *The obligor and the obligor's location and type of business or occupation.* For the type of business or occupation of the obligor, indicate whether the business is a proprietorship, partnership, joint venture, or corporation. This information can be used to compare the purpose of the credit with the source(s) of repayment, and to compare the credit's structure with the obligor's repayment ability. The general identification of occupation, such as professional or wage earner, may not be definitive enough, so it may be necessary to indicate that, for example, the extension of credit is to a medical doctor.

  Types of businesses may be clearly indicated in the borrower's business name and may not require additional comment. For example, Apex Supermarket and Ajax Sporting Goods Store imply a retail supermarket and a retail sporting goods store. However, examiners should not be misled in their analysis of the credit; likewise, the write-up reviewer should not be misled by assuming that a borrower is necessarily in the same line of business indicated by the borrower's business name. In the preceding example, if the borrower is primarily a wholesale grocery or sporting goods supplier, or if it radically deviates from the type of business indicated in its business name, the situation should be clarified. It is important to state the borrower's position in the marketing process—manufacturer, wholesaler, or retailer—and to indicate the types of goods or services.

- *Description and value of collateral.* The type of lien, collateral description and its condition and marketability, as well as the collateral's current value, date of valuation, and basis for the valuation, should be included. If values are estimated, the write-up should indicate the source of the valuation, such as the obligor's recent financial statement, an independent appraisal, or an internal management report. If valuations are not available, a statement to that effect should be included. A bank's failure to obtain collateral valuations, when available, is cause for criticism. Also include any other pertinent information that might impede or facilitate the possible sale of the collateral to repay the extension of credit.

  When problem borrowers are involved, the sale of the collateral often becomes the sole or primary source of repayment. As a result, the valuation of the collateral becomes especially important when describing the credit, as described in the specific examples below.

  If real estate is pledged to secure the credit, the write-up should provide a description of the property, the lien status, the amount of any prior lien, and the appraised value. If multiple parcels are securing the credit, appraised values should be listed for each parcel, including the date of the appraisal and the basis for the value. When bank staff or examiners' challenges to appraisal assumptions are supported, the resulting adjustment in value for credit-analysis purposes should be indicated. If the property held as collateral has tenants, its cash flow should be noted and the financial strength of the major lessees commented upon, if appropriate.

  If the collateral represents shares of or an interest in a closely held company, the

shares or ownership interest held should be indicated in relation to the total shares outstanding, and the financial condition of the closely held company should be summarized in the write-up. Additionally, the approximate value of the closely held company, as indicated by its financial statements, should be compared for consistency with the value of the company as indicated on the principal's or partner's personal financial statement. The values often do not correlate to the extent they should, which typically indicates overvaluation of the asset on the balance sheet of the entity owning the shares or ownership interest.

If a blanket lien on assets, such as receivables, inventory, or equipment, is pledged as collateral, the current estimated value of each asset type should be shown separately. The basis for these values can come from various sources, which should be indicated:

— If receivables are pledged as collateral for an asset-based extension of credit, a current aging report and an assessment of the appropriateness of the advance ratio is usually necessary to determine their collectibility and value.
— If inventory is pledged as collateral for an asset-based extension of credit, an assessment of the appropriateness of the advance ratio is necessary. Additionally, the value varies with the condition and marketability of the inventory.
— If listed securities or commodities are pledged as collateral, the market value and date of valuation should be noted.

- *Notation if borrower is an insider or a related interest of an insider.*
- *Guarantors and a brief description of their ability to act as a source of repayment.* If the financial strength of guarantors has changed significantly since the initial guarantee of the credit facility, this should be noted. The relationship of the guarantors to the borrower should be identified, including a brief description of the guarantors' ability (financial strength) to serve as a source of repayment independent of the borrower. Any collateral supporting the guarantees should also be stated. See the previous subsection, "Role of Guarantees," for further guidance on considering guarantees for credit-analysis purposes.
- *Amounts previously classified.*
- *Repayment terms and historical performance, including prior charge-offs, and current delinquency status (with notation if the credit is currently on nonaccrual status).* Any changes to the original repayment terms, whether initiated by bank management or the obligor, should be detailed with an appropriate analysis of the changes included in the write-up. Renewals, extensions, and rewritten notes that deviate from the stated purpose and repayment expectations, as approved by management, should be discussed in light of their effect on the quality of the credit. Restructurings should be discussed in terms of their reasonable objectives, focusing on the prospects for full repayment in accordance with the modified terms.

  It may be prudent to state the purpose of the credit. The purpose can be compared with the intended source of repayment for appropriateness. For example, a working capital extension of credit generally should not depend on the sale of real estate for repayment. Additionally, the obligor's prior business experience should correlate to the credit's purpose.

2. *A summary listing of weaknesses resulting in classification or special mention treatment.*
3. *A reference to any identified deficiencies in the item that will support loan-administration or violation comments elsewhere in the report.* This information may consist of deficiencies in credit and collateral documentation or violations of law that have a material impact on credit quality. Loan-portfolio-administration performance includes, but is not limited to—
   - changes in asset quality since the last examination;
   - the appropriateness of loan-underwriting standards;
   - the adequacy of—
     — loan documentation;
     — management information systems;
     — internal control systems; and
     — loan-loss reserves;
   - the accuracy of internal loan-rating systems;
   - the ability and experience of lending officers, as well as other personnel managing the lending function; and
   - changes in lending policies or procedures since the last examination.

4. *If management disagrees with the classification, a statement to that effect along with management's rationale.* Information could include selected data from the most recent fiscal and interim financial statements (discussion of items such as leverage, liquidity, and cash flow) when the primary reason for the write-up relates to the borrower's financial condition or operating performance. Cost of goods sold, nonrecurring expenses, dividends, or other items indicating deterioration in the credit quality may also be highlighted. Any stated value of the borrower's encumbered assets should be set off against specific debt to arrive at the unprotected balance, if applicable. In addition, the examiner should identify encumbered assets that are pledged elsewhere.
5. *A concise description of any management action taken or planned to address the weakness in the asset.* The action plan should focus on a concise description of management's workout or action plan to improve the credit's collectibility or to liquidate the debt. Review of the bank's documented workout plan should give an examiner a clear idea of past efforts to improve the prospect of collectibility and management's current efforts and future strategy. The plan should clearly state the bank's goals and corresponding timetable as they appear at that point, including items such as the degree of repayment envisioned and the proceeds anticipated from the sale of the collateral. Based on this information, the examiner should succinctly summarize in the write-up the bank's collection efforts to date and its ongoing plans to address the situation.

Optional Information for Write-ups

At the examiner's discretion, other information may be included in loan write-ups. For example the examiner may want to include current financial information on the borrower, cosigners, and guarantors. The additional information may consist of discussions regarding current balance sheets and operating statements. If discussed, the examiner should indicate whether the financial statements have been audited, reviewed, compiled, or prepared by the borrower, and whether they are fiscal or interim statements. If the statements are audited, the examiner should indicate the type of opinion expressed—unqualified, qualified, disclaimer, or adverse—and whether the auditor is a certified public accountant. If the opinion is qualified, note the reason(s) given by the auditor.

When the examiner includes comments regarding the borrower's financial condition, the comments should always highlight credit weaknesses in a manner that supports the risk assessment. It is important that sufficient detail is provided to identify unfavorable factors. A trend analysis or details of balance-sheet, income-statement, or cash-flow items can be included. The examiner may also include comments when special mention or classified credits may exhibit favorable as well as unfavorable financial characteristics. Both types of pertinent factors may be included in the write-up as long as they are placed in the proper perspective to demonstrate the credit's inherent weaknesses.

Review the bank's internal controls, policies, practices, and procedures for making and servicing real estate loans. The bank's system should be documented completely and concisely and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. Negative responses to the questions in this section should be explained, and additional procedures deemed necessary should be discussed with the examiner-in-charge. Items marked with an asterisk require substantiation by observation or testing.

LOAN POLICIES

1. Has the board of directors and management, consistent with their duties and responsibilities, adopted and, at least annually, reviewed and approved written real estate loan policies that define—
   a. the institution's target market?
   b. loan portfolio diversification standards?
   c. acceptable collateral types?
   d. prudent, clear, and measurable underwriting standards, including relevant credit factors such as—
      - maximum loan amount by type of property?
      - maximum loan maturity by type of property?
      - repayment terms?
      - pricing structure for each type of real estate loan?
      - loan-to-value (LTV) limits by type of property?
   e. procedures for reviewing real estate loan applications?
   f. loan-origination and -approval procedures (including loan-authority limits) by size and type of loan?
   g. review and approval procedures for exception loans?
   h. loan-administration procedures that include documentation, disbursement, collateral inspection, collection, and loan review?
   i. minimum loan-documentation standards, such as minimum frequency and type of financial information required for each category of real estate loan?
   j. LTV limits that are consistent with regulatory supervisory limits?
   k. real estate appraisal and evaluation programs consistent with the Federal Reserve's appraisal regulation (12 CFR 208.50–51), the Interagency Appraisal and Evaluation Guidelines (see section 4140.1), and the October 27, 2003, interagency statement on Independent Appraisal and Evaluation Functions (see SR-03-18)?
   l. reporting requirements to the board of directors relative to loan portfolio monitoring, including items such as compliance with lending policies and procedures, delinquency trends, and problem loans?
2. Are real estate policies and objectives appropriate to the size and sophistication of the bank, and are they compatible with changing market conditions?

LOAN RECORDS

*1. Are the preparation and posting of subsidiary real estate loan records performed or adequately reviewed by persons who do not also—
   a. issue official checks and drafts?
   b. handle cash receipts?
   c. reconcile subsidiary records to general ledger controls?

*2. Are the subsidiary real estate loan records reconciled at least monthly to the appropriate general ledger accounts? Are reconciling items adequately investigated by persons who do not also handle cash or prepare/post subsidiary controls?

3. Are loans in excess of supervisory LTV limits identified in the bank's records, and are the aggregate amounts of such loans reported at least quarterly to the board of directors, along with the experience of the high-LTV loan portfolio?
4. Are loan statements, delinquent-account-collection requests, and past-due notices reconciled to the real estate loan subsidiary records? Are the notices and reconcili-

ations handled by persons who do not also handle cash?

5. Are inquiries about loan balances received and investigated by persons who do not also handle cash?

*6. Are documents supporting recorded credit adjustments subsequently checked or tested by persons who do not also handle cash?

7. Does the bank maintain a daily record summarizing note-transaction details (loans made, payments received, and interest collected) to support applicable general ledger account entries?

8. Are note and liability trial balances frequently reconciled to the general ledger by employees who do not process or record loan transactions?

9. Are subsidiary payment records and files pertaining to serviced loans segregated and identifiable?

10. Are past-due-loan reports generated daily?

LOAN INTEREST AND COMMITMENT FEES

*1. Are the preparation and posting of loan interest and fee records performed or adequately reviewed by persons who do not also—
   a. issue official checks or drafts?
   b. handle cash?

2. Are any independent interest and fee computations made and compared with or adequately tested to loan interest records by persons who do not also—
   a. issue official checks or drafts?
   b. handle cash?

PROCESSING AND DOCUMENT CONTROL

*1. Are all real estate loan commitments issued in written form?

2. Are loan officers prohibited from processing loan payments?

*3. Are loan payments received by mail recorded upon receipt independently before being sent to and processed by a note teller?

*4. Regarding mortgage documents—
   a. Has the responsibility for the document files been established?
   b. Does the bank use a check sheet to ensure that required documents are received and on file?
   c. Are safeguards in effect to protect notes and other documents?
   d. Does the bank obtain a signed application form for all real estate mortgage loan requests?
   e. Are separate credit files maintained?
   f. Is there a program of systematic follow-up to determine that all required documents are received after the loan closing and from public recording offices?
   g. Does a designated employee conduct a review after loan closing to determine if all documents are properly drawn, executed, recorded, and filed within the loan files?
   h. Are all notes and other instruments pertaining to paid-off loans returned promptly to the borrower, canceled, and marked paid, where appropriate?
   i. Are charged-off notes and related files segregated and adequately controlled?

LOAN ORIGINATION

1. Does the bank have a written schedule of fees, rates, terms, and types of collateral for all new loans?

2. Does the bank have a mortgage errors and omission policy?

3. Are procedures in effect to ensure compliance with the requirements of governmental agencies that insure or guarantee loans or with the requirements of private mortgage insurance companies?

ESCROW PROCESSING

1. Regarding insurance and property taxes coverage—
   a. Is there a procedure for determining that private mortgage insurance premiums are current on insured loans?
   b. Is there a procedure for determining that property and hazard insurance premiums are current on properties securing loans?

c. Does the bank require that the hazard insurance policies include a loss-payable clause to the bank?
d. Are escrow accounts reviewed at least annually to determine if monthly deposits will cover anticipated disbursements?
e. Are disbursements for taxes and insurance supported by records showing the nature and purpose of the disbursement?
f. If advance deposits for taxes and insurance are not required, does the bank have a system to determine that taxes and insurance are being paid?

LOAN ADMINISTRATION

*1. Are approvals of real estate advances reviewed, before disbursement, to determine that such advances do not increase the borrower's total liability to an amount in excess of the bank's legal lending limit?
2. Are detailed statements of account balances and activity mailed to mortgagors at least annually?

COLLECTIONS AND FORECLOSURES

1. Does the bank have adequate collection procedures to monitor delinquencies and, as necessary, have procedures to pursue foreclosure?
2. Are properties under foreclosure proceedings segregated?
   a. Has the bank decided not to complete any foreclosures after the foreclosure process was initiated? If yes,
      1) Are there policies and procedures for regularly monitoring the property values to support the analysis—to continue or abandon the foreclosure? Is the collateral valuation information sufficient to support a decision to initiate, continue, or abandon a foreclosure proceeding?
      2) After discussing the examination findings with the organization's management, were the necessary commitments obtained for corrective action? Will these actions address the noted deficiencies and weaknesses? If not, is supervisory action is necessary?
3. Are properties to which the bank has obtained title appropriately transferred to other real estate owned (OREO)? See "Other Real Estate Owned," section 2200.1, for requirements.
4. Does the bank have an adequate management and sales disposition program for timely liquidation of OREO? Does the program take into account the maximum retention period for OREO allowed under state law?
5. Does the bank have adequate procedures for filing and monitoring its mortgage insurance claims for government-insured or -secured programs and for private mortgage insurance?

HOME EQUITY LENDING

Policies

1. Do the credit policies for home equity lending address the underwriting standards for all relevant risk factors, such as—
   a. an analysis of a borrower's income and debt levels?
   b. an analysis of a borrower's credit score and credit history versus the loan's size?
   c, the collateral value (including valuation methodology)?
   d. the lien position?
   e. the property type and location?
2. Are the financial institution's risk-and account-management procedures appropriate for the size of the institution's loan portfolio, as well as for the risks associated with the types of home equity lending conducted by the institution?
3. Does the financial institution have reasonable and adequate policies and procedures for home equity problem-loan workouts and loss-mitigation strategies?

Underwriting

4. Has the financial institution purchased insurance products to mitigate the credit risks of its high-LTV (HLTV) residential loans?

   a. If so, do any of those insurance policies have a coverage limit?
   b. Has the institution conducted reasonable and adequate analyses to determine whether the coverage may be exhausted before all loans in the pool covered by the insurance product mature or pay off?
5. Does the financial institution's credit-risk management function oversee the support function(s) for its real estate lending? Does the institution have effective controls and procedures over staff who are responsible for perfecting liens, collecting outstanding loan documents, obtaining insurance coverage (including flood insurance), and paying property taxes?
6. Do the financial institution's underwriting standards include—
   a. a properly documented evaluation of the borrower's financial capacity to adequately service the debt?
   b. an adequately documented evaluation of the borrower's ability to—
      - amortize the fully drawn line of credit over the loan term?
      - absorb potential increases in interest rates for interest-only and variable-rate home equity lines of credit (HELOCs)?
7. Are the analyses and methodologies underlying the institution's evaluation of borrowers reasonable and adequate?
8. Does the financial institution use third parties to originate home equity loans? If so, does the institution—
   a. delegate the underwriting function to a broker or correspondent?
   b. have adequate internal controls for its delegated underwriting?
   c. retain appropriate oversight of all critical loan-processing activities, such as verification of income and employment and the independence of the appraisal and evaluation function?
   d. have adequate systems and controls to ensure that a third-party originator is appropriately managed, is financially sound, provides mortgages that meet the institution's prescribed underwriting guidelines, and adheres to applicable consumer protection laws and regulations?
   e. have a quality-control unit or function that closely monitors (monitoring activities should include post-purchase underwriting reviews and ongoing portfolio-performance-management activities) the quality of loans that the third party underwrites?
   f. have adequate audit procedures and controls to verify that third parties are not being paid to generate incomplete or fraudulent mortgage applications and are not otherwise receiving referral or unearned income or fees contrary to Real Estate Settlement Procedures Act (RESPA) prohibitions?

Collateral Valuation

9. Does the financial institution have adequate collateral-valuation policies and procedures that—
   a. establish criteria for determining the appropriate valuation methodology for a particular transaction (based on the risk in the transaction and loan portfolio)?
   b. set criteria for determining when a physical inspection of the collateral is necessary?
   c. ensure that an expected or estimated value of the property is not communicated to an appraiser or individual performing an evaluation?
   d implement controls to preclude "value shopping?"
   e. require sufficient documentation to support the collateral valuation in the appraisal or evaluation?
10. Does the financial institution use automated valuation models (AVMs) to support evaluations or appraisals? If so, does the institution—
   a. periodically validate the models, to mitigate the potential valuation uncertainty in the model?
   b. adequately document the validation's analysis, assumptions, and conclusions?
   c. implement controls to preclude "value shopping" in its use of AVMs?
   d. back-test a representative sample of evaluations and appraisals supporting loans outstanding?
   e. evaluate the reasonableness and adequacy of its procedures for validating AVMs?

11. Are tax-assessment valuations used as a basis for collateral valuation? If so, is the financial institution able to demonstrate and document the correlation between the assessment value of the taxing authority and the property's market value, as part of the validation process?

Risk Concentrations

12. Does the financial institution have large home equity loan portfolios or portfolios with high-risk characteristics? If so, does the institution—
    a. periodically refresh credit-risk scores on all customers?
    b. use behavioral scoring and analysis of individual borrower characteristics to identify potential problem accounts?
    c. periodically assess utilization rates?
    d. periodically assess payment patterns, including borrowers who make only minimum payments over a period of time or those who rely on the credit line to keep payments current?
    e. monitor home values by geographic area?
    f. obtain updated information on the collateral's value when significant market factors indicate a potential decline in home values, or when the borrower's payment performance deteriorates and greater reliance is placed on the collateral?

    Are the frequency of these actions commensurate with the risk in the portfolio?

Management Information Systems

13. Are the financial institution's real estate lending policies consistent with safe and sound banking practices, and does its board of directors review and approve the policies at least annually?
14. Do the financial institution's management information systems (MIS) for real estate lending—
    a. allow for the segmentation of the loan portfolios?
    b. accurately assess key risk characteristics?
    c. provide management with sufficient information to identify, monitor, measure, and control home equity concentrations?
15. Does the financial institution's management periodically assess the adequacy of its MIS, in light of growth and changes in the institution's risk appetite?
16. Does the financial institution have significant concentrations of HELs or HELOCs? If so, does the MIS include, at a minimum, reports and analysis of—
    a. production and portfolio trends by product, loan structure, originator channel, credit score, loan to value (LTV), debt to income (DTI), lien position, documentation type, market, and property type?
    b. the delinquency and loss-distribution trends, by product and originator channel, with some accompanying analysis of significant underwriting characteristics (such as credit score, LTV, or DTI)?
    c. vintage tracking?
    d. the performance of third-party originators (brokers and correspondents)?
    e. market trends by geographic area and property type, to identify areas of rapidly appreciating or depreciating housing values?
17. Do the financial institution's records identify loans in excess of the supervisory LTV limits as high-LTV (HLTV) loans? Is the aggregate dollar value of such loans reported quarterly to the instution's board of directors? Does the volume of HLTV loans exceed 100 percent of the institution's capital?

Internal Loan Review

18. Does the financial institution conduct annual credit reviews of HELOC accounts? Does the review of HELOC accounts determine whether the line of credit should be continued, based on the borrower's current financial condition?
19. Are the financial institution's authorizations of over-limit home equity lines of credit restricted? Are they subject to appropriate policies and controls?
    a. Does the institution require over-limit borrowers to repay, in a timely manner, the amount that exceeds established credit limits?

b. Is MIS sufficient to enable management to identify, measure, monitor, and control the risks associated with over-limit accounts?

CONCLUSION

1. Does the foregoing information provide an adequate basis for evaluating internal control in that deficiencies in areas not covered by this questionnaire do not significantly impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.

2. On the basis of a composite evaluation, are internal controls adequate, as evidenced by answers to the foregoing questions?

Review the bank's internal controls, policies, practices, and procedures for making and servicing real estate construction loans. The bank's system should be documented completely and concisely and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. Negative responses to the questions in this section should be explained, and additional procedures deemed necessary should be discussed with the examiner-in-charge. Items marked with an asterisk require substantiation by observation or testing.

POLICIES AND OBJECTIVES

*1. Has the board of directors and management, consistent with their duties and responsibilities, adopted and, at least annually, reviewed and approved written construction lending policies that—
   a. outline construction lending objectives regarding—
      - the aggregate limit for construction loans?
      - concentrations of credit in particular types of construction projects?
   b. establish minimum standards for documentation?
   c. define qualified collateral and minimum margin requirements?
   d. define the minimum equity requirement for a project?
   e. define loan-to-value (LTV) limits that are consistent with supervisory LTV limits?
   f. require an appraisal or evaluation that complies with the Federal Reserve real estate appraisal regulation and guidelines?
   g. delineate standards for takeout commitments?
   h. indicate completion bonding requirements?
   i. establish procedures for reviewing construction loan applications?
   j. detail methods for disbursing loan proceeds?
   k. detail project-inspection requirements and progress-reporting procedures?
   l. require agreements by borrowers for completion of improvements according to approved construction specifications, and cost and time limitations?
2. Are construction lending policies and objectives appropriate to the size and sophistication of the bank, and are they compatible with changing market conditions?
3. Has the board of directors adopted, and does it periodically review, policies and procedures that establish and maintain an effective, independent real estate appraisal and evaluation program for the entire bank's lending functions? (The real estate lending functions include commercial real estate mortgage departments, capital-market groups, and asset-securitization and -sales units.)

REVIEWING LOAN APPLICATIONS

1. Does bank policy require a personal guarantee from the borrower on construction loans?
2. Does bank policy require personal completion guarantees by the property owner and/or the contractor?
3. Does the bank require a construction borrower to contribute equity to a proposed project in the form of money or real estate? If so, indicate which form of equity.
4. Does the project budget include the amount and source of the builder's and/or owner's equity contribution?
5. Does the bank require—
   a. background information on the borrower's, contractor's, and major subcontractors' development and construction experience, as well as other projects currently under construction?
   b. payment-history information from suppliers and trade creditors on the aforementioned's previous projects?
   c. credit reports?
   d. detailed current and historical financial statements, including cash flow–related information?

6. Do the borrower's project-cost estimates include—
   a. land and construction costs?
   b. off-site improvement expenses?
   c. soft costs, such as organizational and administrative costs, and architectural, engineering, and legal fees?
   d. interest, taxes, and insurance expenses?
7. Does the bank require an estimated cost breakdown for each stage of construction?
8. Does the bank require that cost estimates of more complicated projects be reviewed by qualified personnel: experienced in-house staff, an architect, a construction engineer, or an independent estimator?
9. Are commitment fees required on approved construction loans?

CONSTRUCTION LOAN AGREEMENTS

1. Is the construction loan agreement signed before an actual loan disbursement is made?

*2. Is the construction loan agreement reviewed by counsel and other experts to determine that improvement specifications conform to—
   a. building codes?
   b. subdivision regulations?
   c. zoning and ordinances?
   d. title and/or ground lease restrictions?
   e. health and handicap access regulations?
   f. known or projected environmental protection considerations?
   g. specifications required under the National Flood Insurance Program?
   h. provisions in tenant leases?
   i. specifications approved by the permanent lender?
   j. specifications required by the completion or performance bonding company and/or guarantors?

*3. Does the bank require all change orders to be approved in writing by the—
   a. bank?
   b. bank's counsel?
   c. permanent lender?
   d. architect or supervising engineer?
   e. prime tenants bound by firm leases or letters of intent to lease?
   f. completion bonding company?

4. Does the construction loan agreement set a date for project completion?
5. Does the construction loan agreement require that—
   a. the contractor not start work until authorized to do so by the bank?
   b. on-site inspections be permitted by the lending officer or an agent of the bank without prior notice?
   c. disbursement of funds be made as work progresses, supported by documentation that the subcontractors are receiving payment and that the appropriate liens are being released?
   d. the bank be allowed to withhold disbursements if work is not performed according to approved specifications?
   e. a percentage of the loan proceeds be retained pending satisfactory completion of the construction?
   f. the lender be allowed to assume prompt and complete control of the project in the event of default? If a commercial project, are the leases assignable to the bank?
   g. the contractor carry builder's risk and workers' compensation insurance? If so, has the bank been named as mortgagee or loss payee on the builder's risk policy?
   h. periodic increases in the project's value be reported to the builder's risk and title insurance companies?
6. Does the construction loan agreement for residential tract construction loans require—
   a. bank authorization for individual tract-housing starts?
   b. that periodic sales reports be submitted to the bank?
   c. that periodic reports on tract houses occupied under a rental, lease, or purchase-option agreement be submitted to the bank?
   d. limitations on the number of speculative houses and the completion of one tract before beginning another?

COLLATERAL

1. Are liens filed on non–real estate construction improvements, i.e., personal property that is movable from the project?
2. When entering into construction loans, does the bank, consistent with supervisory loan-to-value limits—

a. limit the loan amount to a reasonable percentage of the appraised value of the project when there is no prearranged permanent financing?
b. limit the loan amount to a percentage of the appraised value of the completed project when subject to the bank's own takeout commitment?
c. limit the loan amount to the floor of a takeout commitment that is based upon achieving a certain level of rents or lease occupancy?

3. Are unsecured credit lines to contractors or developers, who are also being financed by secured construction loans, supervised by the construction loan department or the officer supervising the construction loan?
4. Does the bank have adequate procedures to determine whether construction appraisal or evaluation policies and procedures are consistently being followed in conformance with regulatory requirements, and that the appraisal or evaluation documentation supports the value indicated in the conclusions?

INSPECTIONS

1. Are inspection authorities noted in the—
   a. construction loan commitment?
   b. construction loan agreement?
   c. tri-party buy-and-sell agreement?
   d. takeout commitment?
2. Are inspections conducted on an irregular basis?
3. Are inspection reports sufficiently detailed to support disbursements?
4. Are inspectors rotated from project to project?
5. Are spot checks made of the inspectors' work?
6. Do inspectors determine compliance with plans and specifications as well as the progress of the work? If so, are the inspectors competent to make the determination?

DISBURSEMENTS

*1. Are disbursements—
   a. advanced on a prearranged disbursement plan?
   b. made only after reviewing written inspection reports?
   c. authorized in writing by the contractor, borrower, inspector, subcontractors, and/or lending officer?
   d. reviewed by a bank employee who had no part in granting the loan?
   e. compared with original cost estimates?
   f. checked against previous disbursements?
   g. made directly to subcontractors and suppliers?
   h. supported by invoices describing the work performed and the materials furnished?

2. Does the bank obtain waivers of subcontractor's and mechanic's liens as work is completed and disbursements are made?
3. Does the bank obtain sworn and notarized releases of mechanic's liens from the general contractor at the time construction is completed and before final disbursement is made?
4. Does the bank periodically review undisbursed loan proceeds to determine their adequacy to complete the projects?
5. Are the borrower's undisbursed loan proceeds and contingency or escrow accounts independently verified at least monthly by someone other than the individuals responsible for loan disbursements?

TAKEOUT COMMITMENTS

1. Does counsel review takeout agreements for acceptability?
2. Does the bank obtain and review the permanent lender's financial statements to determine the adequacy of its financial resources to fulfill the takeout commitment?
3. Is a tri-party buy-and-sell agreement signed before the construction loan is closed?
4. Does the bank require takeout agreements to include a force majeure—an act-of-God clause—that provides for an automatic extension of the completion date in the event that construction delays occur for reasons beyond the builder's control?

COMPLETION BONDING REQUIREMENTS

1. Does the bank require completion insurance for all construction loans?

2. Has the bank established minimum financial standards for borrowers who are not required to obtain completion bonding? Are these standards observed in all cases?
3. Does counsel review completion insurance bonds for acceptability?

DOCUMENTATION

1. Does the bank require and maintain documentary evidence of—
   a. the contractor's payment of—
      - employee withholding taxes?
      - builder's risk insurance?
      - workers' compensation insurance?
      - public liability insurance?
      - completion insurance?

   b. the property owner's payment of real estate taxes?
2. Does the bank require that documentation files include—
   a. loan applications?
   b. financial statements for the—
      - borrower?
      - builder?
      - proposed prime tenant?
      - takeout lender?
      - guarantors/partners?

   c. credit and trade checks on the—
      - borrower?
      - builder?
      - major subcontractor?
      - proposed tenants?

   d. a copy of plans and specifications?
   e. a copy of the building permit?
   f. a survey of the property?
   g. the construction loan agreement?
   h. an appraisal or evaluation and feasibility study?
   i. an up-to-date title search?
   j. the mortgage?
   k. ground leases?
   l. assigned tenant leases or letters of intent to lease?
   m. a copy of the takeout commitment?
   n. a copy of the borrower's application to the takeout lender?
   o. the tri-party buy-and-sell agreement?
   p. inspection reports?
   q. disbursement authorizations?
   r. undisbursed loan proceeds and contingency or escrow account reconcilements?
   s. insurance policies?
3. Does the bank employ standardized checklists to control documentation for individual files, and does it perform audit reviews for adequacy?
4. Does the documentation file indicate all of the borrower's other loans and deposit account relationships with the bank, and include a summary of other construction projects being financed by other banks? Does the bank analyze the status of these projects and the potential effect on the borrower's financial position?
5. Does the bank use tickler files that—
   a. control scheduling of inspections and disbursements?
   b. ensure prompt administrative follow-up on items sent for—
      - recording?
      - an attorney's opinion?
      - an expert review?
6. Does the bank maintain tickler files that provide advance notice (such as 30 days' prior notice) to staff of the expiration dates for—
   a. the takeout commitment?
   b. hazard insurance?
   c. workers' compensation insurance?
   d. public liability insurance?

LOAN RECORDS

*1. Are the preparation, addition, and posting of subsidiary real estate construction loan records performed or adequately reviewed by persons who do not also—
   a. issue official checks or drafts?
   b. handle cash?
   c. reconcile subsidiary records to general ledger controls?

*2. Are the subsidiary real estate construction loan records reconciled at least monthly to the appropriate general ledger accounts? Are reconciling items adequately investigated by persons who do not also handle cash or prepare/post subsidiary controls?

*3. Are loan statements, delinquent account-collection requests, and past-due notices reconciled to the real estate construction loan subsidiary records? Are the reconciliations handled by a person who does not also handle cash?

4. Are inquiries about construction loan balances received and investigated by persons who do not also handle cash?

*5. Are documents supporting recorded credit adjustments subsequently checked or tested by persons who do not also handle cash?
6. Is a delinquent-accounts report generated daily?
7. Are loans in excess of supervisory LTV limits identified in the bank's records, and are the aggregate amounts of such loans reported at least quarterly to the board of directors?
8. Does the bank maintain a daily record summarizing note transaction details (loans made, payments received, and interest collected) to support applicable general ledger account entries?
9. Are note and liability trial balances frequently reconciled to the general ledger by employees who do not process or record loan transactions?

LOAN INTEREST AND COMMITMENT FEES

*1. Are the preparation and posting of loan interest and fee records performed or adequately reviewed by persons who do not also—
   a. issue official checks or drafts?
   b. handle cash?
2. Are any independent interest and fee computations made and compared with or adequately tested to loan interest by persons who do not also—
   a. issue official checks or drafts?
   b. handle cash?

CONCLUSION

1. Does the foregoing information provide an adequate basis for evaluating internal control in that deficiencies in areas not covered by this questionnaire do not significantly impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
2. On the basis of a composite evaluation, are internal controls adequate as evidenced by answers to the foregoing questions?

Concentrations in Commercial Real Estate Lending, Sound Risk-Management Practices
Internal Control Questionnaire
Effective date October 2007

Section 2103.4

CRE CONCENTRATION ASSESSMENTS

1. Are ongoing risk assessments performed to identify commercial real estate (CRE) concentrations?
2. Are CRE concentration limits established and monitored?
3. Is the CRE portfolio stratified into reasonable and supportable segments that have common risk characteristics or sensitivities to economic, financial, or business developments?
4. Are all CRE concentrations reported to senior management and the board of directors on a periodic basis?

RISK MANAGEMENT

1. Has a risk-management framework been established that effectively identifies, monitors, and controls CRE concentration risk? If such a framework has been established, does it address—
   a. board and management oversight?
   b. portfolio management?
   c. management information systems?
   d. market analysis?
   e. credit-underwriting standards?
   f. portfolio stress testing and sensitivity analysis?
   g. the credit-risk review function?

Board and Management Oversight

2. If the bank has significant CRE concentration risk, does it have a strategic plan that addresses the rationale for its CRE concentration levels in relation to the bank's overall growth objectives, financial targets, and capital plan?
3. Has the board of directors or its designated committee—
   a. established policy guidelines and approved an overall CRE lending strategy for the level and nature of CRE exposures, including any specific commitments to particular borrowers or property types, such as multifamily housing?
   b. ensured that the bank's management implements procedures and controls to effectively adhere to and monitor compliance with the bank's lending policies and strategies?
   c. reviewed information that identifies and quantifies the nature and level of risk presented by CRE concentrations, including a review of reports that describe changes in the conditions of the CRE market in which the bank lends?
   d. periodically reviewed and approved CRE risk exposure limits and appropriate sublimits (for example, by nature of concentration) in order to conform to any changes in the bank's strategies and respond to changes in market conditions?

Portfolio Management

4. Does the bank's management regularly perform an analysis of its CRE portfolio, considering factors such as—
   a. portfolio diversification across property types?
   b. the geographic dispersion of CRE loans?
   c. underwriting standards?
   d. the level of pre-sold units or other types of take-out commitments on construction loans?
   e. portfolio liquidity (the ability to sell or securitize exposures on the secondary market)?
5. Has the bank's board of directors and senior management—
   a. (1) regularly evaluated the degree of correlation between related real estate sectors and (2) established internal lending guidelines?
   b. established internal lending guidelines and concentration limits in order to control the bank's overall risk exposure?
   c. developed appropriate strategies to manage CRE concentration levels?
6. Has the bank's management developed a

contingency plan to reduce or mitigate CRE loan concentrations during adverse market conditions? If the bank's contingency plan includes selling or securitizing CRE loans, has management periodically assessed the marketability of the portfolio?

Management Information System

7. Does the bank's management information system (MIS) provide sufficient information to identify, monitor, and manage CRE concentration risk?
8. Is the bank's CRE portfolio stratified by property type, geographic market, tenant concentrations, tenant industries, developer concentrations, and risk rating?
9. Does the bank's MIS identify and aggregate exposures to a borrower, including its credit exposure relating to derivatives?
10. Are the bank's management reports timely and in a format that clearly indicates changes in the portfolio's risk profile?
11. Does the bank's management reporting include a well-defined process whereby management reviews and evaluates CRE concentrations, risk-management reports, and special ad hoc analyses prepared in response to potential market events that could affect the concentration risk in the bank's CRE portfolio?

Credit-Underwriting Standards

12. Are underwriting standards clear and measurable, and do they enable the bank's lending staff to evaluate relevant credit factors?
13. Do the bank's CRE lending policies address the following underwriting standards—
    a. maximum loan amount by type of property?
    b. loan terms?
    c. pricing structures?
    d. collateral valuation?
    e. loan-to-value (LTV) limits by property type?
    f. requirements for feasibility studies and sensitivity analyses or stress testing?
    g. minimum requirements for initial investment and maintenance of hard equity by the borrower?
    h. minimum standards for borrower net worth, property cash flow, and debt-service coverage for the property?
14. Do the bank's lending policies permit exceptions to its underwriting standards for CRE concentrations on a limited basis only?
15. Are permitted exceptions documented; that is, do the documented exceptions describe how the loan transaction does not conform to the bank's lending policy or underwriting standards?
16. Does management analyze trends in exceptions to ensure that the bank's CRE concentration risk remains within established risk-tolerance limits?
17. Does the bank have policies and procedures governing loan disbursements in order to ensure that its minimum requirements for borrower equity are maintained throughout development and construction periods?
18. Do the bank's internal controls consist of an inspection process, documentation on construction progress, tracking of pre-sold units, tracking of pre-leasing activity, and exception monitoring and reporting?

Portfolio Stress Testing and Sensitivity Analysis

19. Are portfolio stress tests or sensitivity analyses performed in order to quantify the impact of changing economic conditions on asset quality, earnings, and capital?
20. If performed, are portfolio stress tests or sensitivity analyses required to focus on the more vulnerable segments of the bank's CRE portfolio? Do they take into consideration the prevailing market environment and the bank's business strategy?

Credit-Review Function

21. Does the bank have an effective, accurate, and timely risk-rating system that supports its credit-review function?
22. Are credit-risk ratings reviewed regularly for appropriateness?

Review the bank's internal controls, policies, practices, and procedures for real estate appraisals and evaluations. The bank's system should be accurately and fully documented and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written appraisal and evaluation policies that define the following:
   a. bank management's responsibility for selecting, evaluating, monitoring, and ensuring the independence of the individual who is performing the appraisal or evaluation?
   b. the basis for selecting staff appraisers and engaging fee appraisers for a particular appraisal assignment and for ensuring that the individual is independent of the transaction; possesses the requisite qualifications, expertise, and educational background; demonstrates competency for the market and property type; and has the required state certification or license if applicable?
   c. procedures for when to obtain appraisals and evaluations?
   d. procedures for prohibiting the use of a borrower-ordered or borrower-provided appraisal?
   e. procedures for monitoring collateral risk on a loan and portfolio basis as to when to obtain a new appraisal or new evaluation, including the frequency, triggering events, scope of appraisal work, valuation methods, and report option?
   f. appraisal and evaluation compliance procedures to determine that appraisals and evaluations are reviewed by qualified and adequately trained individuals who are not involved in the loan-production process?
   g. appraisal and evaluation review procedures to ensure that the bank's appraisals and evaluations are consistent with the standards of USPAP and the Board's regulation and guidelines?
   h. appraisal and evaluation review procedures that require the performance of the review prior to the credit decision, resolution of noted deficiencies, and documentation of the review in the credit file, and, if necessary, obtaining a second appraisal or relying on USPAP's Standard Rule 3 in performing a review or performing another evaluation?
   i. an appropriate level of review for appraisals and evaluations ordered by the bank's agents or obtained from another financial services institution?
   j. adequate level of oversight when the bank uses a third party for appraisal management services?
   k. use of analytical methods and technological tools (such as automated valuation models or tax assessment valuations) in the development of evaluations that is appropriate for the risk and type of transaction and property?
   l. internal controls to prevent officers, loan officers, or directors who order or review appraisals and evaluations from having the sole authority for approving the requested loans?
   m. procedures for promoting compliance with the appraisal independence provisions of Regulation Z (Truth in Lending) for open- and closed-end consumer credit transactions secured by a consumer's principal dwelling?
2. Does the board of directors annually review these policies and procedures to ensure that the appraisal and evaluation policies and procedures meet the needs of the bank's real estate lending activity and remains compliant with the Board's regulation and supervisory guidance?

APPRAISALS

*1. Are appraisals in writing, dated, and signed by the appraiser?
*2. Does the appraisal meet the minimum standards of the Board's regulation and USPAP, and contain sufficient information and analysis to support the bank's decision

to engage in the transaction? Does the appraisal

a. reflect an appropriate scope of work that will provide for credible results, including the extent to which the property is identified and inspected, the type and extent of data research performed, and the analyses applied to arrive at an opinion of market value?
b. disclose the purpose and use of the appraisal?
c. provide an opinion of the collateral market value as defined in the Board's appraisal regulation and further clarified in supervisory guidance?
d. provide an effective date for the opinion of market value?
e. provide the sales history of the subject property for the prior three years?
f. reflect valuation approaches (that is, cost, income, and sales comparison approaches) that are applicable for the property type and market?
g. include an analysis and reporting of appropriate deductions and discounts when the appraisal provides a market value estimate based on the future demand of the real estate (such as proposed construction, partially leased buildings, nonmarket lease terms, and unsold units in a residential tract development)?
h. evaluate and reconcile the three approaches into an opinion of market value estimate based on the appraiser's judgment?
i. explain why an approach is inappropriate and not used in the appraisal?
j. fully support the assumptions and the value rendered through adequate documentation and information on market conditions and trends?
k. evaluate key assumptions and potential ramifications to the opinion of market value if these assumptions are not realized?
l. present an opinion of the collateral's market value in an appraisal report option that addresses the property type, market, risk, and type of transaction?
m. disclose and define other value opinions (such as disposal value of the property or the value of non-real property), if the bank requests such information?

*3. Are appraisals received before the bank makes its final credit or other credit decision or was the loan granted a conditional approval? When loans have conditional approvals pending receipt of an appraisal, confirm that appraisals are received, reviewed, and accepted for the transaction.

*4. If the bank is depending on an appraisal obtained for another financial services institution as support for its transaction, does the bank have appraisal review procedures to ensure that the appraisal meets the standards of the appraisal regulation, including independence? (These types of transactions would include loan participations, loan purchases, and mortgage-backed securities.)

*5. If an appraisal for one transaction is used for a subsequent transaction, does the bank sufficiently document its determination that the appraiser is independent, the appraisal complies with the appraisal regulations, and the appraisal is still valid?

APPRAISERS

1. Are appraisers fairly considered for assignments regardless of their membership or lack of membership in a particular appraisal organization?
2. Before the bank selects an appraiser for an assignment, does the bank confirm that the appraiser has the requisite qualifications, education, experience, and competency for both the property type and market to complete the appraisal?
3. If a bank pre-screens appraisers and uses an approved appraiser list, does the bank have procedures for assessing an appraiser's qualifications, selecting an appraiser for a particular assignment, and evaluating the appraiser's work for retention on the list?
4. The following items apply for large, complex, or out-of-area commercial real estate properties:
   a. Are written engagement letters used when ordering appraisals, and are copies of the letters retained or included in the appraisal report?
   b. Does the bank have procedures for resolving deficiencies in appraisals, including determining when such appraisals should be reviewed by another

appraiser (that is, a USPAP Standard Rule 3—Appraisal Review)?

5. Are appraisers independent of the transaction?
   a. Are staff appraisers independent of the lending, investment, and collection functions and not involved, except as an appraiser, in the federally related transaction? Has a determination been made that they have no direct or indirect interest, financial or otherwise, in the property?
   b. Are fee appraisers engaged directly by the bank or its agent? Has a determination been made that they have no direct or indirect interest, financial or otherwise, in the property or transaction?
   c. Are any appraisers recommended or selected by the borrower (applicant)?
6. If the bank has staff appraisers to perform appraisals or appraisal reviews, does the bank periodically have independent appraisers evaluate their work for quality and confirm that they have the knowledge and competency to perform their work and continue to hold the appropriate state license or certification?
7. If fee appraisers are used by the bank, does the bank investigate their qualifications, experience, education, background, and reputations?
8. Is the status of an appraiser's state certification or license verified with the state appraiser regulatory authority to ensure that the appraiser is in good standing?
9. Does the bank have procedures for filing complaints with the appropriate state appraiser regulatory officials when it suspects the fee appraiser failed to comply with USPAP, applicable state laws, or engaged in other unethical or unprofessional conduct?
10. Are fee appraisers paid the same fee whether or not the loan is granted?
11. Does the bank pay a customary and reasonable fee for appraisal services in the market where the property is located when the appraisal is for an open- and closed-end consumer credit transaction secured by a consumer's principal dwelling as required under Regulation Z?

EVALUATIONS

1. Are the individuals performing evaluations independent of the transaction?

*2. Are the evaluations required to be in writing, dated, and signed?

*3. Does the bank require sufficient information and documentation to support the estimate of value and the individual's analysis?

*4. Are the development and content of the evaluation reflective of transaction risk and appropriate for the property type?

*5. Are the valuation methods used, and does the supporting information in the evaluation provide a reliable estimate of the property's market value as of a stated effective date prior to the credit decision?

*6. If analytical methods or technological tools are used in the development of an evaluation, is the use of the method or tool consistent with safe and sound banking practices?

*7. If an evaluation obtained for one transaction is used for a subsequent transaction, does the bank sufficiently document its determination that the evaluation is still valid?

*8. Are evaluations received before the bank enters into a loan commitment?

*9. Does the bank have evaluation review procedures to ensure that the evaluation meets safe-and-sound banking practices?

*10. If a tax assessment valuation is used in the development of an evaluation, has the bank demonstrated that there is a valid correlation between the tax assessment data and the property's market value?

EVALUATORS

1. Are individuals who perform evaluations competent to complete the assignment?
2. Do the individuals who perform evaluations possess the appropriate collateral valuation training, expertise, and experience relevant to the type of property being valued?
3. Are evaluations prepared by individuals who are independent of the transaction?

MONITORING COLLATERAL VALUES

1. Does the bank have policies to monitor collateral risk on a portfolio and on an individual credit basis?
2. Does the policy address the need to obtain current valuation information for collateral supporting an existing credit that may be modified or considered for a loan workout?
3. Does the criteria for determining when to obtain a new appraisal or new evaluation address deterioration in the credit; material changes in market conditions; and revisions to, or delays in, the project's development and construction?
4. Does the bank sufficiently document and follow its criteria for obtaining reappraisals or reevaluations?

THIRD-PARTY ARRANGEMENTS

1. Did the bank exercise appropriate due diligence in the selection of a third party to perform appraisal management services for the bank?
2. Does the bank have the resources and expertise necessary for performing ongoing oversight of such third party arrangements?
3. Does the bank have the internal controls for identifying, monitoring, and managing the risks associated with the use of the third party?
4. Does the bank adequately document the results of its ongoing monitoring and periodic assessments of the third party's compliance with applicable regulations and with supervisory expectations?
5. Does the bank take timely remedial actions when deficiencies are discovered?
6. Does the bank ensure that the third party selects an appraiser or a person to perform an evaluation who is competent, qualified, independent, and appropriately licensed or certified for a given assignment?
7. Does the bank ensure that the third party conveys to the appraiser or the person who performs the evaluation that the bank is the client?

ANALYTICAL METHODS AND TECHNOLOGICAL TOOLS

1. Does the bank have staff, or if necessary engage a third party, with the requisite expertise and training to manage the selection, use, and validation of an analytical method or technological tool?
2. Does the bank have adequate policies, procedures, and internal controls governing the selection, use, and validation of the valuation method or tool for the development of an evaluation?
3. Does the bank have appropriate policies and procedures governing the selection of automated valuation model (AVM)? For instance, did the bank:
   - Perform the necessary level of due diligence in selecting an AVM vendor and its models, considering how model developers conducted performance testing as well as the sample size used and the geographic level tested (such as county level or zip code).
   - Establish acceptable minimum performance criteria for a model prior to, and independent of, the validation process.
   - Perform validation of the model(s) during the selection process and document the validation process.
   - Evaluate underlying data used in the model(s), including the data sources and types, frequency of updates, quality control performed on the data, and the sources of the data in states where public real estate sales data are not disclosed.
   - Assess modeling techniques and the inherent strengths and weaknesses of different model types as well as how a model(s) performs for different property types.
   - Evaluate the AVM vendor's scoring system and methodology for the model(s).
   - Determine whether the scoring system provides an appropriate indicator of model reliability by property types and geographic locations.
4. Does the bank have procedures for monitoring the use of an AVM(s), including an ongoing validation process?
5. Does the bank maintain AVM performance criteria for accuracy and reliability in a given transaction, lending activity, and geographic location?

6. Has the bank established a criteria for determining whether a particular valuation method or tool is appropriate for a given transaction or lending activity, considering associated risks, including transaction size and purpose, credit quality, and leverage tolerance (loan-to-value)?
7. Does the criteria consider when market events or risk factors would preclude the use of a particular method or tool?
8. Does the bank have internal controls to preclude "value shopping" when more than one AVM is used for the same property?
9. Do the bank's policies include standards governing the use of multiple methods or tools, if applicable, for valuing the same property or to support a particular lending activity?
10. Does the bank have appropriate controls to ensure that the selected method or tool produces a reliable estimate of market value that supports the bank's decision to engage in a transaction?
11. Do the bank's policies and procedures adequately address the extent to which
    - An inspection or research should be performed to ascertain the property's actual physical condition, and
    - Supplemental information should be obtained to assess the effect of market conditions or other factors on the estimate of market value.