INTRODUCTION

The soundness of real estate loans and investments made by financial institutions depends upon the adequacy of the underwriting standards and credit analysis used to support these transactions. A real estate appraisal or evaluation is one of several essential components of the lending process. For the purpose of collateral administration in a loan portfolio, an institution's estimate of value of real property may be supported by an existing or new appraisal or evaluation.

This Handbook Section provides: (1) examiner guidance on what to look for in a savings association's administration of its appraisal and evaluation programs, (2) guidance as to what should be contained in an appraisal report, (3) guidance on the appropriate evaluation of real estate in those circumstances where an appraisal is not required, and (4) a summary of the OTS appraisal regulation.

Responsibilities of Management and the Board of Directors

The savings association's lending policies are a critical component of a sound underwriting policy. An appraisal or evaluation is an integral part of the decision-making process in credit analysis and investment underwriting. The value of real estate taken as loan collateral provides additional support to the borrower's credit capacity because it can provide a secondary repayment source in the event that the primary repayment source - the borrower's cash flow - fails to permit servicing of the indebtedness in a satisfactory manner. Also, appraisals and evaluations play an important role in administering foreclosed properties, both in the determination of a carrying value and in the establishment of a sale price. For other investments, appraisals and evaluations are used to validate the value of interests in real estate.

The soundness of mortgage loans and real estate investments of both the association and those of its service corporations depends to a great extent upon the adequacy of the loan underwriting. An appraisal standard is one of the most important elements of the underwriting policy because appraisal reports contain estimates of value of collateral held or assets owned. The responsibilities of management include the development, implementation, and maintenance of appraisal standards to determine compliance with the appraisal requirements in Part 564 of the OTS regulations.

The board of directors is responsible for adopting and reviewing policies and procedures that establish effective real estate appraisal and evaluation programs. At a minimum, the programs should:

- incorporate prudent standards and procedures for obtaining initial and subsequent appraisals and evaluations;
- be tailored to the institution's size and location and to the nature of its real estate-related activities;
- establish a method(s) to monitor the value of real estate collateral securing an institution's real estate loans; and
- establish the manner in which an institution selects, evaluates, and monitors individuals who perform or review real estate appraisals and evaluations.

Competency, expertise, independence, and ability to render a high-quality written report are the appropriate selection criteria for appraisers and evaluators.[1]

Savings associations and their subsidiaries are also required to comply with § 564.8, which sets forth

[1] To avoid potential conflicts of interest, staff appraisers should not be supervised by loan underwriters, loan officers or collection officers. The OTS recognizes that, in certain cases, it may be necessary for loan officers or other institution-related individuals to perform appraisals or evaluations. Such cases would depend on the institution's particular circumstances. An example would be a small rural institution where the only qualified individual to perform appraisals or evaluation is a loan officer, and separating this person from the loan and collection departments would be difficult. In these situations, the OTS recommends that this individual perform appraisal or evaluation work on loans in which he or she is not otherwise involved. In cases where loan officers or other related individuals perform appraisals, regulated institutions must ensure that the appraisers are licensed or certified and that the appraisals are adequate. Directors and officers should abstain from any vote and/or approval that involves assets on which they have performed an appraisal or evaluation. Sufficient safeguards must be in place to permit appraisers and evaluators to exercise independent judgment.

the responsibilities of management to develop written appraisal policies to ensure that adequate appraisals are obtained consistent with the requirements of the OTS appraisal rule, to institute procedures pertaining to the hiring of qualified appraisers, and to annually review the performance of appraisers.

Appraisal and Evaluation Compliance Procedures (for all real estate-related transactions)

Institutions should establish procedures to ensure appraisals and evaluations satisfy the technical requirements of Part 564, as well as internal policies and procedures. Checklists may be used to assist an institution's personnel in determining the completeness of appraisals and evaluations. Loan files should contain documentation that the appraisal or evaluation received an appropriate technical compliance check. The technical compliance procedures should provide an assessment to detect deficiencies in appraisals and evaluations. If there are deficiencies that render an appraisal's or evaluation's estimate of value unreliable, the institution should obtain a replacement prior to making its final credit decision. Deficiencies that do not affect the estimate of value should be corrected by the individual who conducted the appraisal or evaluation before the transaction is completed.

Audit/Critique Procedures (for a sample of real estate-related transactions)

Management should also test the substance of appraisals and evaluations through audit procedures. An institution's audit procedures should provide for a critique of selected appraisals and evaluations. The criteria to identify transactions subject to this substance critique should be consistent with prudent audit sampling or testing practices and have a bias toward large credit exposures and loans secured by out-of-area properties and specialized types of properties.

The critique should assess the adequacy, reasonableness, and appropriateness of the methods, assumptions and techniques that were used to perform the appraisal or evaluation. An individual who performs critiques, whether an institution employee or an outside auditor or consultant, should have real estate-related training or experience and be independent of the transaction.

The estimate of value in an appraisal or evaluation may not be changed as a result of a critique. Changes to an appraisal's estimate of value are permitted only as a result of a review conducted in compliance with Standard III of the Uniform Standards of Professional Appraisal Practices (USPAP).

Appraisal and Evaluation Review Procedures (for certain real estate-related transactions)

An institution should have appraisal and evaluation review procedures that are separate from the appraisal and evaluation compliance and audit procedures. An institution should establish criteria consistent with prudent practices that designate those real estate-related transactions whose appraisal or evaluation should be reviewed prior to an institution's decision to extend credit or other decision. Moreover, the frequency and scope of appraisal and evaluation reviews should be established by the board of directors as part of the written policy. For example, an institution may determine appraisals and evaluations on all major loans should be reviewed prior to the decision to extend credit.

If an institution needs to perform a review of an appraisal or evaluation, it may incorporate the above-discussed compliance procedures into the review. An individual conducting an appraisal or evaluation review must have appraisal-related training or experience, but need not be state-licensed or state-certified, except as noted below.

An appraisal or evaluation review will determine the adequacy and relevance of the data in the appraisal or evaluation. The reviewer will assess the reasonableness of analysis, opinions, and conclusions in the appraisal or evaluation. The reviewer will also form an opinion as to the appropriateness of the methods and techniques used in the appraisal or evaluation. The reviewer should determine the propriety of any minor adjustments to the data that do not affect the estimate of value of the real property. The reviewer, however, may not change the value of an appraisal or evaluation through the review process. Appraisal and evaluation reviews should be appropriately documented in the file. If

the original appraisal or evaluation is deemed unreliable, a new appraisal or evaluation should be conducted. (If changes in the appraisal are required for the institution's purposes, they can be done by an in-house review appraiser who, for federally related transactions, must be licensed or certified and follow Standard 3 of USPAP.)

Appraisal Management

The association's appraisal policies must ensure that federally related transactions are performed by state-certified or state-licensed appraisers, as appropriate and consistent with § 564.3. Appraisals should reflect professional competence and facilitate the reporting of estimates of market value. Appraisal policies should contain the minimum standards specified under Appraisal Content, comport with safety and soundness, and should be related to the association's lending policies.

Management must develop and adopt guidelines and implement procedures relative to the hiring of appraisers to perform appraisals for the savings association. The guidelines must address, at a minimum, appraiser experience and education requirements that are consistent with the requirements of Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). FIRREA requires that an appraiser's experience and education requirements must, at a minimum, meet those detailed by the Appraisal Standards Board and the Appraiser Qualifications Board of the Appraisal Foundation. The guidelines should also specify that selection of appraisers based on their membership in a specific appraisal organization, or lack thereof, is a prohibited practice.

It is vital that management furnish the appraiser with all information it has available to contribute to the valuation process. Management should furnish the appraiser with an engagement letter and any necessary attachments that may include, but are not limited to, the following information:

- a copy of the savings association's written appraisal policies,
- a copy of the appraisal rule (if not fully included within the savings association's appraisal policies),
- a legal description of the subject property,
- the interest to be appraised,
- the types of value estimates requested,
- financing information,
- income statements of the subject property,
- leases, and
- purchase agreements.

Master engagement letters are acceptable provided the letters contribute to sound underwriting and clarify that the institution does not discriminate against any appraiser based on membership, or lack thereof, in a specific appraisal organization.

Management should review annually the performance of all approved appraisers used within the preceding year to determine compliance with the association's appraisal policies and procedures and the reasonableness of the value estimates reported.

Staff Appraisers

An institution may choose to have its appraisals prepared by a staff appraiser. Such appraisers, however, must be independent of the lending, investment, and collection functions of the institution and have no direct or indirect interest, financial or otherwise, in the properties they appraise. If the only qualified persons available to perform an appraisal are involved in the lending, investment, or collection functions of the institution, appropriate steps must be taken to ensure that the appraisers exercise independent judgment and that the appraisal is adequate. Such steps include prohibiting an individual from performing an appraisal in connection with federally related transactions where the appraiser is otherwise involved and prohibiting directors and officers from participation in any vote or approval that involves assets on which they performed an appraisal.

Fee Appraisers

The savings association, or its agent, must directly engage the appraiser. The appraiser must have no direct or indirect interest, financial or otherwise, in the property or transaction. The savings associa-

tion may accept an appraisal that was prepared by an appraiser engaged directly by another institution subject to Title XI of FIRREA if: (1) the institution that accepts the appraisal has established procedures for review of real estate appraisals and (2) the institution reviewed the appraisal under its established review procedures, found it acceptable, and documented the review in writing.

Appraisals Required

A state-certified appraiser must prepare an appraisal in the following circumstances:

- All federally related transactions having a transaction value of $1,000,000 or more.
- All nonresidential transactions with a value of $250,000 or more.
- All "complex" one- to four-family residential property appraisals rendered in transactions of $250,000 or more. Institutions must determine whether the appraisal required is complex. If during the course of the appraisal a licensed appraiser identifies factors that would result in the property, form of ownership, or market conditions being considered atypical, then the appraisal would be viewed as complex and the institution may either: (1) ask the licensed appraiser to complete the appraisal and have a certified appraiser approve and cosign the appraisal or (2) engage a certified appraiser to complete the appraisal.

A state-licensed or state-certified appraiser must prepare an appraisal in the following circumstance:

- All transactions with values greater than $100,000 that do not require the use of a state-certified appraiser.

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) established December 31, 1992, as the date by which federally regulated depository institutions must use state-certified or state-licensed appraisers to complete appraisals on federally related transactions.

Appraisals Not Required

The appraisal rule requires state-certified or licensed appraisers, as appropriate, to be used for all real estate-related financial transactions except those transactions in which one or more of the following exemptions applies:

- The transaction value is less than or equal to $100,000.
- A lien is placed on real property as collateral solely through an abundance of caution and where the terms of the transaction as a consequence have not been made more favorable than they would have been in the absence of a lien.
- The transaction involves a lease of real estate that is not the economic equivalent of a purchase or sale.
- There is a transaction resulting from a maturing extension of credit, provided that:
  - The borrower has performed satisfactorily according to the original terms;
  - No new monies have been advanced other than what was previously agreed;
  - The credit standing of the borrower has not deteriorated; and
  - There has been no obvious and material deterioration in market conditions or physical aspects of the property that would threaten the institution's collateral protection.
- A regulated institution purchases a loan or interest in a loan, pooled loan, or interests in real property, including mortgage-backed securities, provided that there was an appraisal prepared for each pooled loan or real property interest that met the requirements of the regulation, if applicable, at the time of origination.

Appraisal Content

Appraisals should contain sufficient supporting documentation to enable the reader to understand appraiser's logic, reasoning, judgment, and analysis in reaching a final estimate of value.

The following are the minimum standards for appraisals for federally related transactions.

- Appraisals must conform to the USPAP adopted by the Appraisal Standards Board of the Appraisal Foundation (except for the Departure Provision, which savings associations cannot use). Appraisals must explain steps taken to comply with the Competency Provision of the USPAP.
- Appraisals shall be written and presented in a narrative format or on forms that satisfy the requirements of § 564.4.
- Appraisals must be based on the definition of market value found in § 564.2(f).
  - — Appraisals should be sufficiently descriptive to enable both the savings association's personnel and regulatory staff to ascertain the estimated market value and the rationale for the estimate by providing detail and depth of analysis that reflects the complexity of the real estate appraised. Appraisals must contain sufficient supporting documentation so that the appraiser's logic, reasoning, judgment, and analysis in arriving at a conclusion indicate to the reader the reasonableness of the market value reported. For example, any current agreement of sales, option, or listing of the property should be analyzed and reported, if this information is available to the appraiser.
  - — All appraisal reports must include the market value of the property on the appraisal date. For appraisals of properties where a portion of the overall real property rights or physical assets would typically be sold to the ultimate user(s) over time, reports should include: (1) market value of the property and interest "as is" on appraisal date, (2) market value "as if complete" on appraisal date, and (3) prospective future value of the property and interest upon completion of construction. For appraisals of properties where market conditions indicate that stabilized occupancy is not likely upon completion, reports should include: (1) market value "as is" on appraisal date, (2) prospective future value upon completion of construction, and (3) prospective future value upon reaching stabilized occupancy on the projected date of stabilization.
  - — Appraisals should analyze and report data on current revenues, expenses, and vacancies for the property if it is and will continue to be income-producing. For these existing income-producing properties, appraisals should include actual profit and loss statements, or a statement indicating that such statements are unavailable, and a projection of future operating performance. Current rents and occupancy levels should also be reported.
  - — Appraisal reports should also contain an estimate of the subject property's highest and best use, regardless of whether the actual or proposed use is the highest and best use.
  - — Appraisal reports for proposed projects should be identified, dated and based upon the most recent plans and specifications. For proposed construction, development, or changes in use of a property, the appraisal report should address the project's economic feasibility. (If a feasibility study is used that was prepared by another party, the appraiser should explain the reasoning for accepting or rejecting the study). Appraisals should analyze and report on current market conditions and trends that will affect projected income or the absorption period, to the extent they affect the value of the subject property. Appraisals must analyze and report deductions and discounts (such as holding costs, marketing costs, entrepreneurial profit, leasing commissions, rent losses and tenant improvements) for any proposed construction, any completed properties that are partially leased or leased at other than market rents as of the date of the appraisal, and any tract developments or projects with unsold units.
- Appraisals must follow a reasonable valuation method that addresses the direct sales comparison, income, and cost approaches to market value, reconciles those approaches, and ex-

plains the elimination of each approach not used.

— For the direct sales comparison approach, appraisal reports should contain sufficient information to demonstrate that the comparison transactions were conducted under terms and conditions similar to the proposed transaction. The selected properties should be physically and economically comparable with the subject property, and any adjustments made should be sufficiently explained, including how the adjustment amounts were determined.

- Appraisals must analyze and report in sufficient detail any prior sales of the property being appraised that occurred within the past twelve months for one- to four-family residential properties and the past three years for all other properties. A longer history of comparable sales should be analyzed and reported when such properties have been sold several times over a brief period or when sales prices of such properties have increased or decreased at a significant rate.
- Appraisals should analyze and report a reasonable marketing period for the property.
- Appraisals must identify and separately value any personal property, fixtures, or intangible items that are not real property but that are included in the appraisal and discuss the effect of their inclusion or exclusion on the estimate of market value.
- Appraisals must include in the certification required by the USPAP an additional statement that the appraisal assignment was not based on a requested minimum valuation, a specific valuation, or the approval of a loan.
- Appraisals must include a legal description of the real estate being appraised, in addition to the description required by the USPAP.
- The appraisal should disclose and explain any unavailable pertinent or required information, as well as the date of the value estimates and the date of the report.
- Appraisal reports should contain a certification that states: (1) that the appraiser has no present or prospective interest in the subject property or the parties involved, (2) whether the appraiser made a personal inspection of the subject property, and (3) that to the best of the appraiser's ability, the analyses, opinions, and conclusions were developed and the report was prepared in accordance with the savings association's appraisal standards.

Appraisal Forms

Part 564 of the OTS regulations permits appraisals to be completed on OTS-approved forms that satisfy the requirements of the regulation. Approved forms include those approved by the Federal Home Loan Mortgage Corporation (FHLMC) and the Federal National Mortgage Association (FNMA) for existing or proposed one- to four-family residential properties or existing multifamily properties. FHLMC and FNMA forms are not to be used for proposed tract developments. In addition, on December 3, 1990, OTS announced the availability of a revised commercial/industrial appraisal report form for existing property and a new form for small commercial/industrial property with associated instruction manuals. These forms are available from the Appraisal Foundation, Washington, D.C. For appraisals presented in a narrative format, the requirement for a sales history is waived if such history is unobtainable, and the appraiser certifies that in the report.

Evaluations

Certain real estate-related transactions are exempt from the requirement of Part 564 that a certified or licensed appraiser perform the appraisal. Real estate-related financial transactions that do not require an appraisal include loans of $100,000 or less. Consistent with the regulation, however, those transactions that do not require an appraisal must receive an evaluation of the real estate collateral that reflects prudent lending practices and OTS policies and guidelines.

For transactions that do not require an appraisal by a licensed or certified appraiser under the appraisal regulations, an institution is required to establish, as a prudent practice, an evaluation program and perform an appropriate evaluation of the real estate. The evaluation should result in a determination of value that will assist the institu-

tion in assessing the soundness of the transaction and that will protect an institution's interest in the transaction.

An evaluation need not meet all of the detailed requirements of an appraisal as set forth in Part 564. File documentation should, however, support the estimate of value and include sufficient information for an individual to fully understand the evaluator's analysis. The evaluation should describe the property and its location, and discuss its use, especially if it is nonresidential. The evaluation should include the evaluator's calculations, supporting assumptions for the estimate of value, and, if applicable, a discussion of comparable property values. An evaluation must be written, signed, dated, and include the preparer's name and address. To qualify, an evaluator must be capable of rendering unbiased estimates of value and must have real estate-related training or experience relevant to the type of property.

The scope of an evaluation should be consistent with the complexity of the transaction and type of real estate collateral. An evaluation that supports a more complex transaction generally needs a more detailed analysis. An evaluation for a less complex transaction will generally require a less detailed analysis, and may be based upon information such as the current tax assessed value or comparable property sales from sales data services, such as the multiple listing service. The institution may use its own real estate loan portfolio experience and appraisals prepared in accordance with Part 564 for loans on comparable properties as a basis for an evaluation.

These supervisory guidelines do not preclude an institution from obtaining an appraisal that conforms to the appraisal regulations for any real estate-related financial transaction. For institutions that make loans that may be sold into the secondary market at a later date, the appraisals obtained should meet secondary mortgage market requirements.

Useful Life of Appraisals or Evaluations

An institution should establish criteria to determine whether an existing appraisal or evaluation continues to be valid to support a subsequent transaction. The useful life of an appraisal or evaluation will vary depending upon the circumstances of the property and the market place. An institution's management should determine if there have been material changes to the underlying assumptions in the appraisal or evaluation that affect the original estimate of value.

Examples of factors that could cause material changes to reported values include: the passage of time; the volatility of the local market; the availability of financing; the inventory of competing properties; new improvements to, or lack of maintenance of, the subject property or competing surrounding properties; a change in zoning; or environmental contamination. If the useful life of an appraisal or evaluation has lapsed, an institution should determine whether there is a need to reappraise or reevaluate the real estate.

Reappraisals and Reevaluations

An institution's real estate appraisal and evaluation programs should also include safety and soundness considerations that identify when it is in the institution's interests to reappraise or reevaluate real estate collateral. Some of these considerations are the condition, performance, quality and status of the loan, and the strength of the underlying collateral. In problem situations, such as loan workouts, renewals, or restructurings, or troubled real estate loans, when the institution is more dependent upon the real estate collateral, management should consider the prudence of a reappraisal or reevaluation of the collateral.

Management should also be guided by the November 7, 1991 "Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans" on this issue.

Institutions should document information sources and analyses used to determine the validity of an existing appraisal or evaluation. Reappraisals and reevaluations of collateral must comply with Part 564 and Thrift Bulletin 55 (TB 55), Real Estate Appraisal and Evaluation Guidelines.

Updated Appraisals

An updated appraisal is currently not an acceptable appraisal as defined by Part 564. An institution may, however, use an updated ap-

praisal: (1) to evaluate real estate not subject to the appraisal requirements in Part 564 and (2) to assess the useful life of an appraisal.

Depository Institutions Disaster Relief Act of 1992

Section 2 of the Depository Institutions Disaster Relief Act of 1992 (DIDRA), signed by the President on October 23, 1992, authorizes the federal bank regulatory agencies to make exceptions to statutory and regulatory requirements relating to appraisals for certain transactions. The exceptions are available for transactions that involve real property in major disaster areas when the exceptions would facilitate recovery from the disaster and would not be inconsistent with safety and soundness. Any such exceptions expire not later than three years after the disaster is declared by the President. On November 23, 1992, the OTS, along with the bank regulatory agencies, determined that recovery from Hurricanes Andrew and Iniki and from the Los Angeles Civil Unrest in May 1992 would be facilitated by excepting transactions involving real estate located in the areas directly affected by those disasters from the appraisal requirements of Part 564. A similar exception was granted for the areas affected by the extensive flooding in the Midwest on August 11, 1993 and areas affected by the earthquake in Southern California on February 11, 1994.

While the purpose of § 2 of DIDRA is to remove the impediment to depository institutions making loans and engaging in other transactions that would help to finance reconstruction and rehabilitation of affected areas, the Act does not excuse management from its obligation to ensure that safety and soundness are not compromised by such activity. Lenders should document that the loan will facilitate reconstruction and rehabilitation of the disaster. Loans should be prudently underwritten and contain the best estimate of value available.

Regulator evaluation of specific loans and lending programs should focus on the overall quality of the assets, including loan documentation that supports those assets with unique or unusual circumstances. Regulators should consider any special circumstances that exist and the efforts of the institution to work with borrowers to reconstruct and rehabilitate the community.

Relief under § 2 of DIDRA for areas affected by disasters other than those described in the November 23, 1992, August 11, 1993, and February 11, 1994, orders are only available upon issuance of an order by the OTS Director. If there is a need for such relief in a region, the regional director should submit a request that the Director issue such an order pursuant to the authority provided by § 2 of DIDRA.

Proposed Regulation

On June 4, 1993, the federal bank regulatory agencies published a proposal to revise the appraisal rule. The proposed revisions would increase to $250,000 the threshold level at or below which appraisals are not required and identify additional circumstances when appraisals are not required. In the proposal, the OTS stated that it would, as a matter of policy, require problem institutions or institutions in a troubled condition to obtain appraisals for transactions of more than $100,000. In addition, the proposal would amend existing requirements governing appraisal content and appraiser independence. Specifically, the proposal seeks to remove most of the additional standards currently required by the appraisal regulation in § 564.4 and require only the following:

- Conform to the USPAP adopted by the Appraisal Standards Board of the Appraisal Foundation;
- Be written;
- Set forth a market value; and
- Be performed by state-licensed or certified appraisers in accordance with requirements set forth in the appraisal regulation.

Also, the agencies proposed to amend the appraisal regulations to permit use of appraisals prepared for financial services institutions other than institutions subject to Title XI of FIRREA (nonregulated institutions). This would include appraisals prepared for mortgage bankers. The appraiser would not be allowed to have a direct or indirect interest, financial or otherwise, in the property or the transaction, and must have been directly engaged by the nonregulated institution. Further, the regulated institution would be required to ensure that the

appraisal conforms to the requirements of the regulation and is otherwise acceptable.

Proposed Exemptions

Under the proposed rule published on June 4, 1993, the services of a state-certified or licensed appraiser would not be necessary for the following real estate-related financial transactions:

- The transaction value is $250,000 or less;
- The transaction is not secured by real estate;
- A lien on real estate has been taken for purposes other than the real estate's value;
- The transaction is a business loan that: (1) has a transaction value of less than $1 million and (2) is not dependent on the sale of, or rental income derived from, the real estate taken as collateral as the primary source of repayment;
- The transaction is insured or guaranteed by a United States government agency or United States government-sponsored agency;
- The transaction meets all of the qualifications for sale to a United States government agency or United States government-sponsored agency;
- The regulated institution is acting in a fiduciary capacity and is not required to obtain an appraisal under other law; or
- The OTS determines that the services of an appraiser are not necessary in order to protect federal-financial and public policy interest in real estate-related financial transactions or to protect the safety and soundness of the institution.

The proposed rule would also modify certain of the existing exceptions so that appraisals would not be required when:

- A lien on real estate has been taken as collateral in an abundance of caution;
- The transaction results from an existing extension of credit, provided that there is no obvious or material deterioration in market conditions or physical aspects of the property that threaten the institution's real estate collateral protection; or
- The transaction:
  - — involves the purchase, sale, investment in, exchange of, or extension of credit secured by a loan or interest in a loan, pooled loans, or interests in real property, including mortgaged-backed securities; and
  - — is supported by an appraisal that meets the requirements of Part 564 for each loan or interest in a loan, pooled loan, or real property interest originated after August 24, 1990.

Under the proposed regulation, transactions under $250,000; business loans with a transaction value less than $1 million that are not dependent upon sale or rental income from the property for repayment; and transactions resulting from existing extensions of credit should have an appropriate evaluation of the real estate collateral that is consistent with TB 55 and other supervisory guidance.

Supervisory Considerations

Regulators will review an institution's real estate appraisal and evaluation policies, programs, and procedures as part of the examination process. Regulators will consider the institution's size and the nature of its real estate-related activities in their assessment of the appropriateness of its programs.

In the analysis of individual transactions, regulators will review appraisals or evaluations to determine that the methods, assumptions, and findings are reasonable and in compliance with Part 564. In addition, regulators will review the steps taken by an institution to ensure that the individuals who perform its appraisals or evaluations are qualified and are not subject to any conflicts of interest.

Failure to establish and maintain acceptable programs or to comply with applicable regulations and policies is considered an unsafe and unsound practice. Institutions will be required to correct violations and deficiencies detected in their appraisal and evaluation practices. Appraisers should be independent of the borrower and seller, and of the loan underwriting and collection functions. Be-

ginning January 1, 1993, appraisers must be certified or licensed by their respective states.

Use of Appraisals

Management is responsible for reviewing each appraisal's assumptions and conclusions for reasonableness. Appraisal assumptions should not be based solely on current conditions that ignore the stabilized income-producing capacity of the property. As stated in the November 7, 1991, "Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans," management should adjust any assumptions used by an appraiser in determining value that are overly optimistic or pessimistic. This review and any resulting adjustments to value are solely for management's use and do not involve actual adjustments to an appraisal.

A regulator should analyze the collateral's value as determined by the institution's most recent appraisal or evaluation. A regulator should review the major facts, assumptions and approaches used by the appraiser (including any comments made by management on the value rendered by the appraiser). Under certain circumstances, the regulator may make adjustments to this assessment of value. This review and any resulting adjustments to value are solely for purposes of a regulator's analysis and classification of a credit and do not involve actual adjustments to an appraisal.

If a regulator concludes that an appraisal or evaluation is deficient for any reason, that fact should be taken into account in reaching a judgment on the quality of the loan or investment. In addition, as discussed in the November 7, 1991, "Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans," the estimated value of the underlying collateral may be adjusted for credit analysis purposes when the regulator can establish that any underlying facts or assumptions are inappropriate and the regulator can support alternative assumptions. It is important to emphasize that a regulator's overall analysis and classification of a loan or investment may be based upon other credit or underwriting standards, even if the loan or investment is secured by real property whose value is supported by an appraisal or evaluation.

Corrective Actions

When regulators find substantial indications of unacceptable appraisal practices, they should discuss their findings with the caseload manager and the regional appraisal staff to initiate corrective action. Examples of unacceptable practices include fraudulent omission of critical information, misleading assumptions, manipulation of data to create an unjustified conclusion, ignoring environmental risk, acceptance of compensation contingent upon reporting a predetermined value, and conflicts of interest.

In some instances, review of appraisal reports by the regional appraiser may be appropriate. When examination findings disclose substantial indications of poor appraisal practice, the regional appraiser, with the approval of the regional deputy director, is authorized to refer appraisers to either: (1) the state licensure/certification authority or (2) the professional societies of which the appraiser is a member. The regional appraiser, with the approval of the regional deputy director, is further authorized to request societies to review the subject appraisal reports that prompted the reference. A copy of referral requests originating at each region should be sent to the OTS Appraisal Subcommittee Member, the FFIEC Appraisal Subcommittee, and the Washington Deputy Chief Counsel for Enforcement. The memorandum should describe the basis for referral, identify the security property, identify all appraisers involved, state the professional societies of which each appraiser is a member, and indicate the date of each appraisal report.

In connection with the examination of savings associations, a regional director is authorized to obtain appraisal reports for real estate securing a savings association's loans. The regional director, or designee, may require appraisals of real estate owned (REO) when considered necessary.

Supervisory Review Process

OTS Regulatory Bulletin 4a (RB 4a), "Supervisory Review Process," contains an informal process for reviewing adverse supervisory and examination decisions. Among the decisions subject to review is the appraised value of any property serving as collateral to secure the repayment of any

loan held by the claimant. Institutions are encouraged to raise examination-related disagreements that cannot be resolved during the examination with the regional office. A supervisory decision in dispute may be raised either orally or in writing to the assistant director, regional deputy director, or regional director. The regional office will act within 30 days of receipt of an appeal. If no satisfactory resolution results, an appeal may be filed with the Deputy Director of Regional Operations, Washington, D.C.

REFERENCES

Code of Federal Regulations

Subchapter B: Consumer-Related Regulations

§ 528.2a	Nondiscriminatory Appraisal and Underwriting

Subchapter C: Regulations for Federal Savings Associations

§ 545.32	Real Estate Loans
§ 545.40	Loans on Low-Rent Housing

Subchapter D: Regulations Applicable to all Savings Associations

§ 563.170(b)	Appraisals
§ 563.172	Re-evaluation of Real Estate Owned
Part 564	Appraisals
§ 571.20	Payment for Appraisals

Office of Thrift Supervision Bulletins

RB 4a	Supervisory Review Process
TB 55	Real Estate Appraisal and Evaluation Guidelines

Comment-Rulings

87-1295	Regulations Re Preamble Appraisal Policies and Practices of FSLIC-Insured Institutions and Service Corporations

Other

Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans (November 7, 1991)

Uniform Standards of Professional Appraisal Practice (USPAP)

Real Estate Appraisal
Program

Examination Objectives

To determine the effectiveness of the appraisal function, including:

- The adequacy of policies, procedures, and internal controls;
- The quality of appraisal reports and the reasonableness of value estimates; and
- The competence and independence of appraisers used by the institution.

To identify deficiencies and initiate corrective action as necessary.

Examination Procedures

Level I

Wkp. Ref.

1. Review examination scoping materials related to appraisals. If the review of scoping materials is performed by other regulator(s), obtain a written or verbal summary of the review(s) of items concerning this program. Refer to the examiner in charge (EIC).

   Scoping materials might include: the prior examination report, prior exception sheets and work papers, review of internal/external audit reports, supervisory analysis, correspondence, review of business plan, review of market area economic conditions, review of minutes of the meetings of the board of directors, PERK information, etc.

   _____ _____

2. Review the preceding report of examination and all real estate appraisal-related exceptions noted and determine if management has taken appropriate corrective action.

   _____ _____

3. Evaluate the savings association's policies and procedures for appraisals by reviewing policy statements, procedures manuals, board and committee minutes, etc.

   _____ _____

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4. Evaluate the savings association's written guidelines for hiring appraisers as they pertain to education and experience.

5. Review management's annual evaluation of appraiser performance. The evaluation should address an appraiser's compliance with the savings association's appraisal policy and the reasonableness of value estimates.

6. Based on the findings from procedures 3 through 5, complete the related sections of the General Questionnaire.

7. Review Level II and Level III procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

Level II

8. Complete appraisal line sheets, either as a separate review procedure or in conjunction with the completion of the Real Estate Mortgage Lending program (Section 212) and the Classification of Assets program (Section 260). Based on the information recorded on the line sheets, complete the Appraisal Review Section of the General Questionnaire.

9. From discussions with examiners assigned to the Classification of Assets, Lending Risk Assessment, and Real Estate Mortgage Lending programs, determine the need to review.

   - delinquent loans or loans placed on non-accrual status granted to board-approved appraisers;
   - major loans granted to board-approved appraisers; or

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- commercial loans granted to board-approved appraisers.

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

Level III

11. Determine the need for the services of the regional appraiser. This may include instances where:

    - an appraisal report's estimate of value is unreasonable;
    - the association did not receive an appraisal report for a security property or for real estate owned;
    - an improper basis was used in calculating value;
    - an appraisal is outdated or market conditions have changed; or
    - construction has halted on a security property.

12. After discussion with the regional director, or designee, determine the need for independent appraisals.

Examiner's Summary, Recommendations, and Comments

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Real Estate Appraisal Questionnaire

	Yes	No
General Questionnaire		
Appraisal Policies, Practices and Procedures		
1. Does the savings association have a written appraisal and evaluation policy?		
2. Has the policy been adopted by the board of directors?		
3. Does the policy establish criteria to determine the useful life of a prior appraisal or evaluation?		
4. Does the policy establish criteria that designates when federally related transactions require a new appraisal?		
5. Do appraisal and evaluation policies and procedures reflect the size of the institution and the nature of its real estate activities?		
6. Does the policy require that:		
• appraisals be based upon the definition of market value as set forth in § 564.2(g)?		
• appraisals be presented in a narrative format, except when approved forms are used?		
• appraisals or evaluations be received and analyzed prior to arriving at the final credit or other decision?		
• new appraisals be undertaken when federally related transactions meet certain criteria?		
• appraisals disclose, analyze, and report in reasonable detail any prior sales of the property being appraised that occurred (i) within one year of the date the appraisal was prepared for one- to four-family residential property, and (ii) within three years of the date the appraisal was prepared for all other properties?		

	Yes	No
(Note: see § 564.8(d) for exemptions.)		
• management provide appraisers with a letter of engagement containing:		
— a legal description of the subject property?		
— a description of the interest to be appraised?		
— the various value estimates requested?		
— a copy of the savings association's written appraisal guidelines?		
— a copy of the appraisal rule, if not contained within the association's policy?		
— other pertinent information such as purchase agreements, income statements of the subject property, leases, financing terms, etc.?		
7. Are appraisers paid regardless of loan approval?		
8. Are loan approval and appraisal functions separate?		
9. Are appraisal reports prepared at the request of the lender or its agent?		
If so, who is responsible for ordering appraisals? _____		
10. Who is responsible for reviewing appraisals? _____		
Is the reviewer qualified as to education and experience?		

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Real Estate Appraisal Questionnaire

	Yes	No
11. Does the policy state the conditions when letter updates to appraisals will be permissible?		
12. Does the institution require an evaluation to disclose the name and address of the preparer?		
13. Are review procedures effective? Do they evaluate underlying assumptions, technical analysis and reasonableness of value?		
14. Are pre-funding reviews adequate?		
Hiring Guidelines		
15. Does the institution require appraisers to meet reasonable standards for education, experience, and independence? Is proof of appropriate state license or certification readily available?		
16. Does the institution maintain effective internal controls, such as a list of approved appraisers, to help ensure that only qualified, independent individuals are selected for assignments?		
• Is the process for selecting or removing an appraiser appropriate?		
• Are the criteria used for selecting or removing an appraiser appropriate?		
17. Does the institution unlawfully discriminate on the basis of membership or lack of membership in any particular appraisal organization?		
Annual Performance Review		
18. Does management annually review the performance of all approved appraisers employed or retained within the preceding 12-month period?		
If so, who is responsible for the performance review?		

	Yes	No
Is the reviewer qualified?		
19. Does the review consider:		
• compliance with the savings association's appraisal and evaluation policies and procedures?		
• the reasonableness of the value estimates reported?		
Appraisal Review		
As a separate review, or in conjunction with the Classification of Assets and Real Estate Mortgage Lending programs, complete a Real Estate Appraisal Report Review form (line sheet) for each appraisal reviewed before completing the following questions:		
20. Are appraisal reports prepared for the lender?		
21. Does the savings association use only board-approved appraisers, or appraisers hired by management under board-delegated authority?		
22. Are appraisers' qualifications appropriate for the types of properties being appraised?		
23. Were the appraisals reviewed sufficiently current at the time the loan was funded?		
24. If the appraisal review indicates that changes in value are necessary, for federally related transactions, is the reviewer licensed or certified?		
25. Do appraisals appear discriminatory on the basis of the age or location of the subject property?		
26. Do appraisals:		
• report all three approaches to value, or contain an explanation that supports the omission of one or more approaches?		

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Real Estate Appraisal Questionnaire

	Yes	No
• indicate a properly supported estimate of the highest and best use consistent with the definition of market value, whether or not the proposed use of the property is in fact the highest and best use?		
• identify, by legal description or otherwise, the real estate being appraised as this information is provided to the appraiser by management?		
• identify and reflect the market value of the property rights in the real property being appraised?		
• include any current agreement of sale, option, or listing of the subject property, if available?		
• include a history of sales for comparable properties when such properties have been sold several times during a brief period, or if the sales prices have decreased or increased at an atypical rate for that market?.....		
• base their conclusions upon the most recent plans and specifications for proposed properties?		
• set forth the effective date(s) of the value estimate(s) and the date of the report?..		
• contain summaries of actual annual operating statements for existing income-producing properties, made available to the appraiser by the lender and/or borrower, together with a supported forecast of the most likely future financial performance?		
• include current rents and current occupancy levels?.....		
• set forth all material assumptions and limiting conditions affecting the value conclusion in one separate section within the report?.....		

	Yes	No
• include in the appraiser's certification:		
— a statement as to the appraiser's license/certification number and state of issuance?		
— a statement that the appraiser has no present or prospective interest in either the property being appraised or with the parties involved?		
— a statement indicating whether or not the appraiser made a personal inspection of the subject property?		
— a statement indicating that to the best of the appraiser's ability, the analyses, opinions, and conclusions were developed and the report was prepared in accordance with the appraisal standards of the savings association?		
27. For all properties, do reports include "market value as is on appraisal date?"		
28. For properties wherein a portion of the overall real property rights or physical assets would typically be sold to the ultimate user over a future time period, do reports include the following estimates of value:		
• "market value as is on appraisal date"? .		
• "market value as of complete on appraisal date"?		
• "prospective future value upon completion of construction"?		
29. For properties where anticipated market conditions indicate that stabilized occupancy is not likely, do reports include the following estimates of value:		
• "market value as is on appraisal date"? .		

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Real Estate Appraisal Questionnaire

	Yes	No
• "market value as if complete on appraisal date"?		
• "prospective future value upon completion of construction"?		
• "prospective future value upon reaching stabilized occupancy on the date of stabilization"?		
30. For appraisals that included the cost approach to value:		
• are values for land and improvements presented separately?		
• do cost estimates appear to be reasonable?		
• are land values supported by comparable sales?.....		
• do estimates for depreciation appear reasonable and consistent with estimates of effective age?		
31. For appraisals that included the income approach to value:		
• do potential gross income projections appear reasonable?.....		
• do adjustments for vacancy and credit loss appear adequate?		
• do operating expenses appear reasonable?		

	Yes	No
• do capitalization rates appear reasonable and are they supported by market data?		
32. For appraisals that included the market approach to value:		
• are comparable properties physically similar?.....		
• are comparable properties economically similar?.....		
• are comparable sales sufficiently recent, i.e., substantial changes in the market have not occurred?		
• are adjustments to comparables made for sales with favorable financing?.....		
33. Are market values determined by correlating the values indicated by the individual approaches to value?.....		
34. Based on the loans and appraisals reviewed, is there a significant correlation between classified assets and faulty appraisals?.....		
• If so, can faulty appraisals be traced to certain appraisers or appraisal firms?....		
• Does this indicate weaknesses in the institution's appraisal policies, procedures or internal controls?		
• Is corrective action required for any institution program or policy as a result?		

Comments

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APPRAISAL PRACTICES

Categories of Property

Real estate can be categorized several ways. Real property can be grouped as either existing or proposed, investment or noninvestment, residential or nonresidential. Perhaps the most common method of categorizing real estate is according to its marketability. General wide market acceptance includes residential property, and select commercial and industrial properties. Special purpose includes special-use properties, such as hotels or nursing homes, and single-use properties, such as schools or churches.

Estimating Value: Three Approaches

There are three approaches to estimating value: the cost approach, the income approach, and the market (or sales comparison) approach. Each approach to value has merits for specific property types. All three approaches should be included in an appraisal report unless the appraiser explains and supports the omission of one or more of the approaches.

The Cost Approach

The cost approach to value is based on the value of land as if unimproved and available for improvement to its highest and best use, plus the reproduction or replacement cost of any improvements, less depreciation. The cost approach is seldom synonymous with market value. The justification for the cost approach is the premise that an investor will pay no more for a property than the cost to construct a similar property with equal utility. This approach to value is best used for single-use properties with no similar properties being marketed.

The accuracy of this method is dependent upon proper adjustment for depreciation, as well as the estimate of the market value of the land. There are three types of depreciation: physical deterioration, functional obsolescence, and economic or external obsolescence.

- Physical depreciation represents an impairment of the physical condition of a property's improvements. Causes include wear through normal use, the action of the elements, and structural damage due to fire, vandalism, or other causes. Physical depreciation has both curable and incurable components.

- Functional obsolescence represents impairment of an improvement's value resulting from poor design, inadequacies, superadequacies, or outmoded fixtures and equipment. Functional obsolescence can be curable or incurable.

- Economic or external obsolescence represents impairment in a property's value due to factors external to the property, such as decreased demand or zoning changes. Whereas physical deterioration and functional obsolescence are evident in the property improvements, economic obsolescence is not. This type of depreciation is nearly always incurable.

The Income Approach

The income approach to value discounts the future benefits of ownership of a property to present value. This approach is best used for income-producing properties and has little relevance for a single-family residence that is to be owner-occupied. To arrive at a value estimate, projected net operating income is capitalized, or projected cash flow is discounted at an appropriate interest rate. This rate is driven by a number of factors, including risk, inflationary expectations, opportunity costs, historical returns, and the supply and demand of loanable funds. This rate should be derived from market sales data of comparable properties, and can be developed with any of several capitalization techniques. The accuracy of this method depends upon the reasonableness of estimates for potential gross income, vacancy, credit loss, and operating expenses, as well as the appropriateness of the overall rate used.

Sales Comparison Approach

The market, or sales comparison, approach to value uses market data to draw units of comparison. Information is gathered from recent sales and current listings of properties that are physically and economically similar to the subject property. Comparable properties are then adjusted for any

differences between the comparable and the subject property. Aside from adjusting for physical differences or changes in market conditions, adjustment may be necessary for financing terms. Lower-than-market interest rates, higher-than-normal loan-to-value ratios, and extended amortization periods have the effect of inflating values. When data are drawn from comparable properties where favorable financing is evidenced, appropriate adjustments should be made to reflect cash equivalency. The accuracy of this method is dependent upon the suitability of the comparable properties used.

Final Estimate of Value

Once all appropriate value estimates have been made, the values should be reconciled and a final estimate of value should be derived. Reconciliation should not simply be an averaging of individual value estimates, but should be a well-supported process where the quality and quantity of data are analyzed and properly weighted in reaching one value estimate.

Note that it is inappropriate for appraisal reports to arrive at the value of fractional interests in real estate by subdividing the whole, or to arrive at the value of the whole by summing the fractional interests.

INTRODUCTION

A key component in the evaluation of the quality of an institution's assets is the review of a portion or sample of those assets. Sampling is the process of selecting a limited number of assets from a large group of assets so that conclusions about the quality of the entire portfolio may be drawn from the characteristics of the sample. The objective is to limit the number of assets reviewed while still providing enough information to enable the examiner to draw and support a reliable conclusion about the portfolio without requiring a review of all of the assets. The underlying assumption is that the quality of assets in the sample is representative of the quality of assets in the portfolio. Inherent in the use of a limited sample of assets for review is the risk of sampling error (i.e., the risk that the quality of assets selected for review will not be representative of the portfolio). Generally, sampling risk is reduced by increasing the size of the sample. Large samples are costly and time consuming, so examiners must balance the risk of sampling error against the costs of using large samples. This Section provides several sampling methods to allow examiners to limit the number of assets reviewed while mitigating sampling risks. The application of the guidance in this Section will reduce the likelihood of significant sampling error and will also enable examiners to:

- Select a representative sample of assets for review;
- Determine if the institution is in compliance with both safety and soundness standards and its underwriting policies;
- Analyze the level of reliance that can be placed on the institution's Internal Asset Review (IAR) program for the purpose of including the results of the IAR program in meeting minimum examination review coverage standards; and
- Determine if an expansion of the asset classification review is needed.

As discussed in other chapters of the Thrift Activities Regulatory Handbook, examiners, in addition to performing a review of individual assets and loan files, should base their final assessment of the quality of the portfolio on factors that include the following:

- the adequacy of the institution's underwriting policies and procedures;
- an evaluation of portfolio performance and credit quality;
- the experience and training of personnel; and
- the adequacy of the institution's pre- and post-funding quality control reviews and other internal controls related to the portfolio.

Examiners should use different methodologies for the sampling and testing of two different asset types: homogeneous and non-homogeneous assets. For the purpose of this Handbook Section, "homogeneous assets" are those that amortize monthly and are typically underwritten based on common, uniform standards. They include one- to four-family residential real estate loans, home improvement loans, home equity loans, owner-occupied mobile home loans, amortizing residential property loans, consumer installment loans and leases, credit card balances, personal overdrafts, and loans on deposits. Because homogeneous assets are generally classified based on delinquency status, the examiner's sampling should be directed to the determination of whether the institution uses prudent underwriting standards, rather than the IAR program's classification of such assets.

"Non-homogeneous" assets are those where underwriting criteria are less likely to be uniform and where classification decisions are based on broader considerations than just the delinquency status. Non-homogeneous assets include commercial real estate, commercial, and construction loans; private placement, non-rated, and below-

investment-grade municipal and corporate securities; and other investments (i.e., all assets other than homogeneous assets, cash, high-quality government securities, and high-quality mortgage-backed securities). For these assets, the examiner should use sampling to develop conclusions regarding two issues: first, the quality and reliability of the institution's IAR program for the purpose of including the results of the IAR program in meeting minimum examination sampling coverage standards and, second, the quality of the institution's underwriting standards.

The rest of this Section discusses sampling methodologies for homogeneous assets; sampling methodologies for non-homogeneous assets; review of previously examined assets; and requirements for documenting the sampling method used in the work papers and the Report of Examination (ROE).

Note: Examiners should exclude from their sample, loans made by an eligible institution under the March 30, 1993, "Interagency Policy Statement on Documentation for Loans to Small- and Medium-Sized Businesses and Farms." Under that Policy Statement (the provisions of which were incorporated into OTS Regulation 563.170(c)(10)), institutions that are well- or adequately capitalized under Section 38 of the Federal Deposit Insurance Act (Prompt Corrective Action) that have a composite rating of 1 or 2, are permitted to identify a portion of their portfolio (equal to 20% of their total capital) of small- and medium-sized business and farm loans that will be exempt from examiner review of documentation. Certain 3-rated institutions can apply to use this authority. Institutions should have a written list of the loans assigned to this "exempt portion" of the portfolio. Examiners should review 563.170(c)(10) to ascertain the eligibility requirements and other related factors.

SAMPLING METHODOLOGIES FOR HOMOGENEOUS ASSETS

To determine if loans reviewed are made in accordance with the institution's own underwriting standards, examiners must first review the institution's loan underwriting and asset acquisition policies and internal controls for adequacy. Examiners should also evaluate the structure, administration, scope, and results of the institution's IAR program for homogeneous assets. The IAR program should follow the classification requirements applicable to "slow loans" and "slow consumer loans" discussed in Section 260 of this Handbook.

For homogeneous assets, examiners should sample the assets to detect any asset quality problems that result from poor underwriting standards. Because the examiner will be looking to draw a conclusion about the whole portfolio, the assets selected for review should not be limited to only those underwritten since the last examination. With respect to loans made since the previous examination, examiners should determine if the institution is using prudent underwriting standards and is exercising proper lending controls. With respect to loans made in prior periods, examiners will generally evaluate asset quality by reviewing loan performance history. If seasoned loans are paying as agreed, examiners will forego further review of the asset. If loans are not paying as agreed, examiners will determine the cause of the delinquency, such as poor underwriting or local economic factors, and evaluate the effect that such factors have on the institution's asset quality.

Asset quality problems that result from declining economic conditions will not be considered exceptions unless poor underwriting contributed to the delinquency. However, examiners should factor in the effect that well-underwritten delinquent loans may have on the institution's overall asset quality.

Examiners should also be able to conclude whether the institution is sufficiently complying with applicable regulations and policies. Exhibits 1 and 2 illustrate the decision-making process in sampling homogeneous assets.

As the examiner is seeking to ascertain the quality of the asset portfolio that poses a potential risk to the institution, the examiner should include in the population loans sold with recourse.

Systematic Sample Selection

Initial Sample: For purposes of the review of homogeneous assets, the examiner should generally use numerical interval sampling (described in Appendix D) to select a systematic sample of assets. The sample should not be limited by origination date or performance.

Exhibit 1
Sample Size Selected for Homogeneous Assets

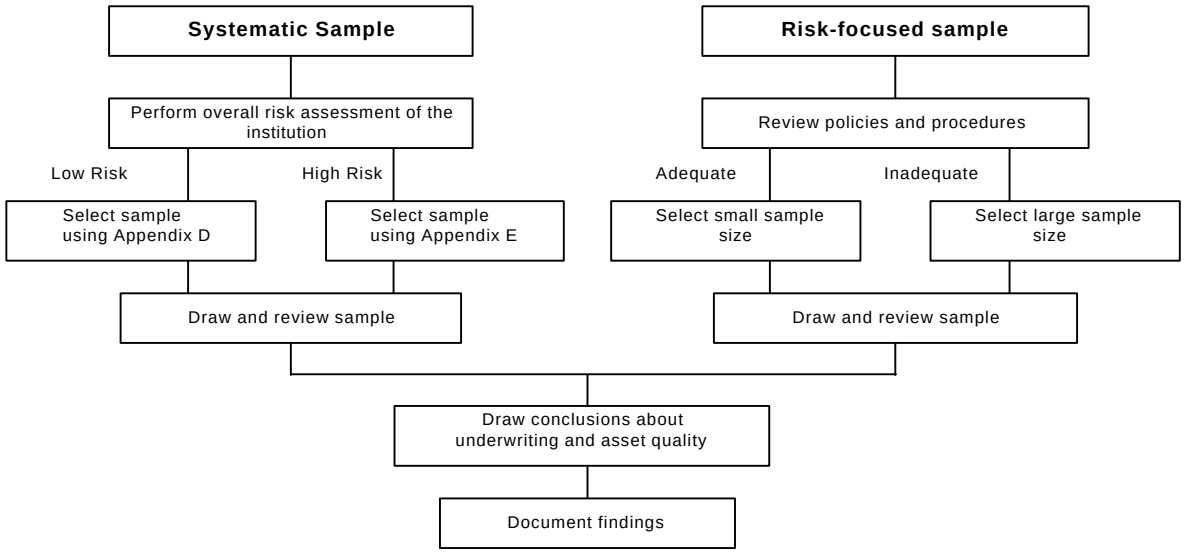
Institutional Risk Profile	Low Risk	High Risk
Adequate Underwriting Policies and Controls	**Minimum**	**Larger**
Inadequate Underwriting Policies and Controls	**Larger**	**Largest**

The above chart shows the level of asset review required under different conditions.

The first block on the left shows that for low-risk institutions with adequate underwriting policies, only a minimum number of assets need to be reviewed.

The lower block on the right indicates that for high-risk institutions with poor underwriting policies, the largest number of assets need to be reviewed.

Exhibit 2
Sample Selection for Homogeneous Assets



Risk-Focused (Judgmental) Sample Selections

In addition to the use of numerical interval sampling, it may be appropriate for the examiner to also select and review a judgmental sample if significant subcategories of assets are not covered by the systematic sample or for other purposes, if determined to be appropriate by the examiner.

After selecting the initial sample of assets as outlined in Appendix D, the examiner should determine whether all significant subcategories of assets are included in the asset sample. The selection of subcategories should be based on an assessment of the riskiness of various subcomponents of the portfolio and the degree of difference in underwriting standards used by the institution for the subcategories. Examiners should seek to include in the total sample (both systematic and judgmental) assets from each significant subcategory of assets for which the thrift has separate underwriting procedures and controls, whether such procedures are written or not.

The institution's internal auditors may provide valuable advice in determining control points in the approval process and determining significant subcategories. Examiners should consider including each of the following subcategories in judgmental samples of homogeneous assets:

- Loan types for which exceptions were reported in the last examination;
- Loans originated by new personnel;
- Loan types where loan volume has increased dramatically;
- Loans sold with recourse; and
- New loan products.

Examiners should use their best judgment and ensure that their sample of homogeneous assets is sufficient to assess underwriting practices and asset quality.

Review of Sample

The selected homogeneous assets should be reviewed by the examiner to ascertain whether the loans made during the review period were underwritten in a prudent manner and in compliance with the institution's policies. (As stated previously, seasoned loans should be evaluated based on their performance history.) For example, for a loan fully secured by a deposit at the institution, the examiner generally only needs to ascertain that the loan is legally secured to satisfy himself/herself that the loan is prudently underwritten. For determining whether an asset is underwritten in a prudent fashion, the examiner should focus on the overall quality of the asset, not merely on documentation. An exception should only be noted if it is material. Note that the underwriting policies of institutions often allow for deviations from the general standards. For example, an institution may have generally applicable debt-to-income ratios for home mortgage loans, but may allow borrowers to exceed those ratios if the loan has other credit strengths such as a low loan-to-value ratio.

For institutions with prudent underwriting standards, examiners should first focus on whether the assets comport with the institution's underwriting policies. Secondly, the examiner should, for any asset that differs from the institution's general standards, review whether the asset is prudently underwritten. "Exceptions," for homogeneous assets, refers only to assets that do not comport with safe and sound lending standards, even if the asset does not adhere to the institution's general underwriting standards, as there are often legitimate reasons for an institution to deviate from its written standards. The definition of "Exception" in Appendix A provides further guidance on reviewing older homogeneous assets.[1]

Appendix D provides additional guidance on expanding the systematic sample of homogeneous assets if exceptions are found. Appendix D also provides guidance on drawing conclusions based on the review of the systematic sample.

If more than the allowable number of exceptions are found within the initial systematic sample of 15 assets, further sampling may help determine if

[1] The sample sizes discussed in this Section should be reduced for institutions with a small number of loans in the population being reviewed. The formula to reduce the sample size is shown in Appendix C.

there is a trend and whether material noncompliance with regulation and policy has, in fact, occurred. If management claims that a significant underwriting exception is an isolated incident, examiners may want to verify this by conducting further sampling. If there is a general pattern of noncompliance with policies and regulations, it is not necessary to fully determine the exact frequency of such noncompliance.[2]

Rather than continuing to enlarge the sample to find every exception, the examiner should focus on why the exceptions occurred, conduct any additional examination procedures needed, and recommend corrective action.

Review of Classifications

Examiners should confirm that the institution's classifications of homogeneous assets are based primarily on delinquency status.

All "slow loans" and "slow consumer credit" – as defined in regulations §§ 561.13, 561.47, and 561.48 – should be considered for classification in accordance with instructions in Handbook Section 260, Classification of Assets.

In addition to the homogeneous assets sampled, examiners should review for classification:

- Homogeneous assets (or commitments) that are unusually large in relation to their portfolios, because these assets are exceptions to the norm and may be incorrectly categorized (e.g., they may be commercial loans); and
- Assets that are related to non-homogeneous assets (such as loans to the same obligors, principals, guarantors, or otherwise for their benefit).

If the review of homogeneous assets reveals a high credit risk group (such as poorly underwritten mobile home loans), that group should be included in the sampling and review procedures for non-homogeneous assets. If such assets are in a very high dollar volume, dollar-proportional sampling, described in Appendix B, is recommended.

SAMPLING METHODOLOGIES FOR NON-HOMOGENEOUS ASSETS

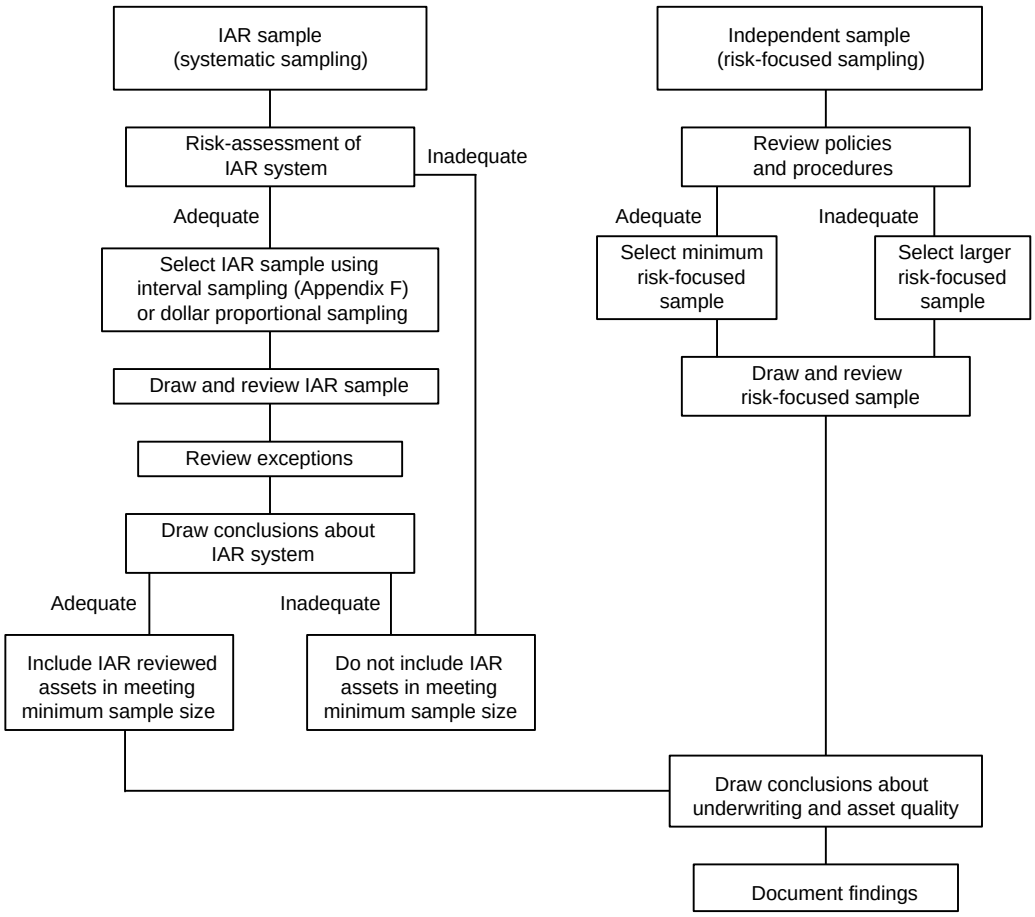
Similar to the sampling of homogeneous assets, in order to determine the quality of the asset portfolio, examiners should sample non-homogeneous assets to ascertain whether the institution is applying prudent underwriting standards and is complying with applicable regulations and policies. Exhibit 3 illustrates the decision-making process in sampling non-homogeneous assets.

Examiners must first review the adequacy of the institution's policies for underwriting and acquiring assets as well as the internal controls in these areas. If an institution has adequate policies, procedures, and controls, then the examiner should use the minimum sampling requirements outlined below to draw conclusions about the institution's asset quality. If, however, an institution has inadequate or nonexistent underwriting policies, procedures, and controls, then the examiner must review a larger sample of assets to ascertain asset quality.

Sampling of non-homogeneous assets should start with an estimate of the extent of adverse classification based on the previous examination report, internal classifications, past-due loan history, and lending policies and procedures. Based on the expected condition of the assets, an initial coverage range should be set for the review of the entire non-homogeneous portfolio. The combined sequential and independent samples should, at a

[2] The difference in the initial sample sizes of 15 or 22 for homogeneous assets is due to the difference in the degree of precision OTS will seek for low-risk versus high-risk institutions (as explained in the "Sampling Methodologies for Homogeneous Assets" Section). The differences in the initial sample sizes for homogeneous and non-homogeneous assets is due to the difference in the degree of confidence or reliability we can place on the sample results. Due to the higher risk nature of non-homogeneous assets, the sample size for non-homogeneous assets was selected to give the examiner a 95% confidence level that the IAR program meets the reliability standards established in this Section. For homogeneous assets, which generally pose a lower risk to institutions, the sample size was selected to give the examiner a 90% confidence level (reliability) that the pool of assets are underwritten in a prudent fashion.

Exhibit 3
Sample Selection for Non-Homogeneous Assets



minimum, total 30% to 50% of the aggregate dollar volume of non-homogeneous assets. The 30% minimum should be used only at the outset of reviews where risk is minimal and conditions ideal, such as in thrifts with excellent policies and controls, a history of no significant asset quality problems, and little recent growth. If the review of the institution's IAR program results in an acceptable number of exceptions, assets included in the IAR program are to be included in meeting this minimum examination sampling coverage standard.

Examiners are to sample two different populations for non-homogeneous assets. First, examiners are to sample assets reviewed by the institution under the institution's IAR program, to determine whether the IAR program is reliable for the purpose of including the results of the IAR program in meeting minimum examination sampling coverage standards. Second, examiners are to sample a relatively large sample of the non-homogeneous assets (including those not included in the IAR program) to ascertain asset quality. This second sampling requirement is referred to as "independent" sampling.

The examiner is expected to sample, at a minimum, 30% of the dollar amount of the non-homogeneous assets. This standard contrasts with homogeneous assets, where there is no minimum sampling percentage that must be achieved. This minimum sampling coverage standard is discussed more fully below.

Evaluation of Internal Asset Review Programs

After a review of the adequacy of the institution's policies for underwriting and acquiring assets (as well as the internal controls in these areas), the examiner should evaluate the institution's IAR program that makes the institution's final classification determinations.

Examiners should assess the structure, administration, scope, and results of the institution's IAR program at each examination that includes a review of asset quality. The institution's IAR program must include frequent sampling of all asset types and result in the internal identification of all major portfolio problems and an accurate assessment of overall asset quality. The examiner should review the institution's documentation of its IAR program's sampling process to ensure that all asset types were adequately sampled.

The IAR program should sufficiently assess risk of loss so that an institution's management may determine appropriate levels of specific and general allowances. Thrift Activities Handbook Section 210, Lending Risk Assessment, and Attachment 1 of Appendix A to Section 261, Adequacy of Valuation Allowances, provide further guidance for evaluating IAR programs.

Examination Use of Internal Classifications

If the structure, administration and scope of the IAR program are deemed to be sufficient, then examiners should sample and test internal classifications for reliability. (Instructions for sampling internal classifications using numerical interval sampling are provided in Appendix E.) If, after analyzing this sample, the examiner determines that the IAR program is reliable, all internally reviewed assets can be included in meeting the 30% minimum examination sampling coverage standard.

If the examiner determines that the IAR program is unacceptable due to its structure or administration, or the internal classifications have more than the allowable number of exceptions when compared to the regulator's classifications, then the examiner should proceed with an independent sampling of assets (discussed below). In such cases, only the assets reviewed by examiners should be included in the minimum examination sampling coverage standards. In order to initiate corrective action, IAR program deficiencies should be discussed with management, in the ROE, and in the meeting with the board of directors.

If examiners determine that an IAR program is severely inadequate, examiners should consider postponing the asset review to allow corrections to be made if it would be a more efficient use of resources and prudent to do so. Such action should only be undertaken in extreme cases, with senior Regional officials' prior approval. Examiners should then comment in the ROE, advise thrift management and directors of IAR program deficiencies noted, and inform them that examiners will return within a specified period to assess whether the deficiencies have been corrected.

It is important to apply this postponement strategy judiciously. If the thrift is financially distressed or is in danger of failing, the asset classification review should not be postponed. It is also important to give thrift management only a minimal time horizon to correct the deficiencies. Examiners must perform a prompt and thorough follow-up review to ensure the success of this strategy. Formal enforcement action, including civil money penalties, should be considered for thrifts failing to correct significant IAR program deficiencies.

IAR program findings for individual assets may be used for examination purposes if individual analyses are found to be reliable, even when the IAR program is incomplete or has deficiencies, such as when the IAR program does not include reviews of insider loans or does not include reviews of loans less than 90 days old. Although an IAR program may be incomplete or inaccurate in some respects, it may serve to inform examiners of problems a thrift has recognized.

Sampling Internally Reviewed Non-Homogeneous Assets

Internal classifications may be sampled to test for acceptance in examination reviews by one of two methods: dollar-proportional sampling and numerical interval sampling. The dollar-proportional methodology is explained more fully in Appendix B; numerical interval sampling for IAR-reviewed

assets is explained more fully in Appendix E. Note that if the examiner uses the dollar-proportional sampling methodology to review the IAR program, the sample must contain no exceptions to be acceptable.

Independent Sampling of Non-Homogeneous Assets

In addition to a review of the assets reviewed under the institution's IAR program, the examiner should undertake a review of an independent sample.

Generally, examiners are expected to perform an independent sample even when an institution's IAR is found to be acceptable and the IAR function has reviewed a level of the institution's non-homogeneous assets that is greater than the level set by the examiner as the desired level of review.

In such cases, the level of review performed by examiners will depend on whether the sampling of IAR assets adequately covered all of the various types of non-homogeneous assets.

Since the IAR sample is randomly selected, it is not likely to include a sufficient cross-section of large loans, certain high-risk loan types, or loans to borrowers that may be near the institution's legal lending limit.

Such loans must be reviewed in the independent sample. For example, if the IAR sample did not pick up any construction or land loans, or other types of non-amortizing loans, then the examiners should review some of the larger non-amortizing loans of this type. Also, if the IAR sample did not include a representative number of loans to the largest borrowers, then the examiners should include such loans in the independent sample. There are often other loans that the independent sample should include as well, such as modifications of large loans or borrowers who have business relationships with thrift directors or officers that were not included in the original sample.

If, however, the IAR sampling performed by the examiners covered the various types of non-homogeneous lending the thrift engaged in, then there may be good reason to limit the size of the independent sample. It is the examiner's responsibility to determine the level and scope of the independent sample.

Expanding the Scope of the Independent Sample

As the examination progresses and the examiner assesses the extent of the thrift's risk of loss, the examiner may need to expand the independent sample size to ensure sufficient review of credit quality. If additional review increases adverse classifications and the need for loss recognition by a material amount (for example, if adverse classifications exceed 50% of GAAP equity capital), the examiner should increase the sample size. If a thrift is suspected of having severe asset quality problems, examiners may need to review 65% to 85% or more of the dollar volume of the non-homogeneous assets. Sampling of these assets should be sufficient to determine the extent of credit quality problems, since any problems will affect valuation allowances and capital. It is usually of little benefit, however, to continue to adversely classify assets once the institution is determined to be tangibly insolvent, other than to ascertain capital levels to a material degree.

When the review of additional assets would not materially increase adverse classifications, loss recognition, or otherwise influence anticipated supervisory decisions, the sample is adequate. At some point, as the sample is increased, the risk in the remaining assets in relation to tangible capital is immaterial. It is up to the examiner's discretion to determine this point.

Independent Sampling Methodologies

Examiners should use either the minimum cut-off or dollar-proportional method to independently select the sample of non-homogeneous assets. Where examiners have used numerical interval sampling to accept the results of an institution's IAR program, examiners should include in their independent samples a review of all assets that have a book value equal to or greater than 5% of GAAP equity capital.

The independent sample should not be limited by origination date or performance. To target the groups of assets that are the most likely to warrant adverse classification in material amounts, the

sample should be supplemented by judgmental selections of assets with high risk of material loss.

The examiner can include in the independent sample assets that were reviewed by the institution under its IAR program but that were not selected in the sample used to assess the IAR program. If the examiner had concluded that the IAR program is reliable and, as part of the independent sample, the examiner reviews these assets and finds that there are a significant number of exceptions between the institution's classifications of these assets and the classifications of the examiner, the examiner should carefully reconsider whether the IAR program is reliable. If the results of the independent sample present a more accurate assessment about the reliability of the IAR program, the examiner should use that conclusion.

General guidance for dollar-proportional, minimum cut-off and judgmental sampling is included in Appendix B and includes a discussion for using the dollar-proportional method for independent sampling.

Review of Independent Sample

The selected assets should be reviewed by the examiner to ascertain whether the assets were underwritten in a prudent manner and in compliance with the institution's policies. An exception should only be noted if it is material. The examiner should also use these reviews to determine appropriate classifications of the sampled assets. Examiners should use the guidance provided in the other Asset Quality sections of the Handbook to assess whether the selected assets were prudently underwritten.

REVIEW OF PREVIOUSLY EXAMINED ASSETS

Analysis of previously examined assets should generally be limited to a quick review of the previous examination line sheets, current performance, and new file information for indications of a material change in the condition or cash flow of the obligor or the collateral. The current balance, performance information, and current financial data should be updated on the previous examination line sheets. In most instances, a quick review of the updated line sheet will be all that is needed to properly classify the asset again.

ASSET REVIEW DOCUMENTATION

Documentation should be in adequate detail to help examiners sample assets for review in the next examination, and should identify records used as a basis for sampling, such as: IAR schedules, alphabetical trial balances, customer information file printouts, and loans-to-one-borrower lists. Work papers must include a description of methods and criteria used to select samples, including the cut-off amounts and initial and supplementary sampling techniques. Documentation should be sufficient to allow a reviewer to identify the assets reviewed, understand the rationale for the selection of assets, and determine the percentage of assets reviewed for each portfolio, the overall coverage of non-homogeneous assets and any exceptions that are found. Information sources, such as officers, credit reports, etc., should be identified if not obvious.

The percent of dollar volume of non-homogeneous assets reviewed by examiners (including the assets reviewed under the IAR program, if tested and found reliable for the purpose of including the results of the IAR program in meeting minimum examination sampling coverage standards) should be included on the lead sheet of the line sheet deck of line sheets and in the asset quality scoping comments in the ROE.

As indicated in the Thrift Activities Asset Review Line Sheets Instructions, examiners should record enough information on each reviewed asset to clearly identify the asset and to arrive at a final defensible classification. Each asset review should only be thorough enough for proper classification. Examiners should attempt to find and record only enough information to pass an asset or, if unable to pass it, record enough information to classify it. The line sheets are not needed when the thrift can provide an adequate substitute such as history cards or IAR worksheets.

REFERENCES

United States Code (12 USC)

Home Owners' Loan Act

§ 1463(c) Stringency of Standards

Code of Federal Regulations (12 CFR)

Subchapter D: Regulations Applicable to All Savings Associations

§ 561.13 Consumer Credit Classified as Loss
§ 561.47 Slow Consumer Credit
§ 561.48 Slow Loans
§ 563.160 Classification of Certain Assets
§ 563.170 Establishment and Maintenance of Records

Office of Thrift Supervision Publications

Thrift Activities Asset Review Line Sheets Instructions (July 1994)

Interagency Policy Statement on Documentation for Loans to Small- and Medium-Sized Businesses and Farms (March 30, 1993)

Sampling
Program

Examination Objectives

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

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

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

Examination Procedures

Wkp. Ref.

Reviewing the Institution's Underwriting Policies

1. Review the general ledger to ascertain the overall characteristics of the loan portfolio. Determine the number of loans held in portfolio for each of the different loan types, i.e., one- to four-family residential loans, consumer loans, etc. Ensure that adequate records are readily available to facilitate the loan sampling review.

_____ _____

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

_____ _____

Testing the Internal Asset Review (IAR) Program

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

_____ _____

4. Review the institution's IAR program pursuant to Section 210, Lending Risk Assessment and Appendix A to Section 261, Adequacy of Valuation Allowances. Review IAR program sampling methodology and obtain schedules of internally reviewed nonhomogeneous assets.

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For homogeneous assets reviewed under the institution's IAR program, determine whether the institution's classifications are based primarily on delinquency status. Proceed with step 7 for reviewing homogeneous assets.

If the policies and procedures of the IAR program are deemed sufficient, select a representative sample of nonhomogeneous assets reviewed in the IAR program and proceed with step 5.

If the IAR program is insufficient, then proceed to step 17 and the procedures that follow for independent review of nonhomogeneous assets or consider postponing the examination asset review, if necessary.

Note: If the IAR program is simply incomplete, e.g., it does not include reviews of a particular category of assets, and the rest of the IAR program is considered acceptable, then the examiner may still proceed with step 5 to determine if the internal classifications of the acceptable portion of the IAR program may be included in the minimum examination sampling coverage standards. The examiner should conduct an independent sampling and review of those categories of assets for which the IAR program is not acceptable.

5. Review the selected assets for classification. If no more than an acceptable number of exceptions in classifications are found, then all assets reviewed in the IAR program and their internal classifications should be included in the minimum examination sampling coverage standards. If an unacceptable number of exceptions in classifications are found, then only assets actually reviewed by examiners should be included in calculating the examination sampling coverage.

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

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Examination Asset Review

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

7. Systematically sample homogeneous assets. If necessary to ensure coverage of significant subcategories of homogeneous assets, judgmentally sample additional assets, such as a wider sample of those assets underwritten or acquired since the previous examination.

_____ _____

8. Review the sample for compliance with prudent underwriting, safety and soundness regulations, internal policies, and possible classification according to instructions in Section 260, Classification of Assets.

_____ _____

9. List all "slow loans" and "slow consumer credit" and tentatively classify them in accordance with Section 260, Classification of Assets.

_____ _____

10. Allow management to review the tentative adverse classifications to identify any that may be controversial. Review files on disputed classifications and revise classifications if appropriate.

_____ _____

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

_____ _____

12. Review exceptions from prudent underwriting practices, and determine if additional sampling or other examination procedures are needed to determine the cause for the exceptions and the corrective action needed. If appropriate, undertake additional sampling.

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13. If necessary, expand samples of any groups of assets suspected to contain material amounts of assets that may warrant classification.

14. Review expanded samples to determine if any assets from the expanded samples should be adversely classified.

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

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

Independent Sampling of Nonhomogeneous Assets (Refer to Exhibit 3 of this Section)

17. Use either the minimum cut-off or dollar-proportional method to select a sample of nonhomogeneous assets. (Refer to Exhibit 1 of Appendix B.) Select an additional sample using the judgmental method.

18. Add all nonhomogeneous asset balances included in the samples (including the assets reviewed by the institution under its IAR program if the examiner finds the IAR program to be acceptable for the purpose of including the results of the IAR program in meeting minimum examination sampling coverage standards). Divide the total of the samples by the total of nonhomogeneous assets. If the percent selected is between 30% and 50%, use the initial samples for review. If not, raise or lower the cut-off amount and make additional judgmental selections to achieve the intended percent.

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19. Review the sampled assets for possible classification and exceptions.

20. After any necessary classifications have been made, if adverse classifications exceed 50% of GAAP equity capital or if any asset group has significant problems, lower the cut-off for that group or make additional judgmental selections of assets for review.

21. If additional review increases classifications by a material amount, increase the sample size for the type of assets in which the problems were found.

22. When severe asset quality problems are known or suspected, it may be necessary to increase the sample size even further to 65% (or higher) of total nonhomogeneous assets to adequately determine the extent of asset quality problems, the need for valuation allowances, and the effect on capital.

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

Conclusion

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

Examiner's Summary, Recommendations, and Comments

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Prepared By: _____
Reviewed By: _____
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SAMPLING TERMINOLOGY

Sampling Terms

Homogeneous Assets: For purposes of this Section, homogeneous assets are one-to four-family residential real estate loans, home improvement loans, home equity loans, owner-occupied mobile home loans, amortizing residential property loans, consumer installment loans and leases, credit card balances, personal overdrafts, and loans on deposits.

Nonhomogeneous Assets: For purposes of this Section, nonhomogeneous assets are considered to be commercial real estate, commercial, and construction loans; private placement, nonrated, and below-investment-grade municipal and corporate securities; and other loans and investments (other than homogenous assets, cash, high-quality government securities and high-quality mortgage-backed securities).

Exception: (1) For purposes of sampling an IAR program, an exception occurs when the regulator's classification of an asset is one or more classifications more conservative than an institution's classification, except for two situations discussed below. "Classifications" for purposes of this Handbook Section are the following: Pass; Special Mention; Substandard; Doubtful; and Loss. For example, if an institution considers an asset Special Mention and the regulator considers it Substandard, this is an exception. Similarly, if an institution classifies an asset as Doubtful and the regulator classifies it as Loss, this is an exception. The two situations where the "one classification worse" standard does not apply are when: (i) the regulator designates an asset as Special Mention and the institution designates it as Pass; and (ii) the regulator classifies an asset as Doubtful and the institution classifies it as Substandard.

For assets with split classifications, where both the regulator and institution have a split classification but of differing amounts, the regulator must consider the materiality of the difference and the methodology used by the institution to determine if the difference is material. For example, if an asset is divided between Substandard and Loss, with the institution indicating a 90/10 split and the regulator indicating an 80/20 split, the regulator should review the methodology the institution used to determine the Loss amount. If the institution's methodology is acceptable, then the classification difference is not considered an exception.

Note: Differences in classification due to timing (e.g., where the regulator is using more current information than was available to the institution when it last reviewed an asset) should not be considered an exception (except if an institution exhibits a pattern of not considering, on a timely basis, new information). Also, no exception should be noted if the institution's classification is more conservative than the regulator's classification.

(2) For purposes of reviewing homogeneous assets, an exception is any asset not underwritten in a prudent, safe and sound fashion. For determining whether an asset is underwritten in a prudent fashion, the regulator should focus on the overall quality of the asset, not on documentation. An exception should only be noted if it is significant. Often, an institution's underwriting policies will have provisions to allow certain deviations from the general underwriting standards when a loan or investment has credit strengths that offset any weaknesses that may be incurred by deviating from the general policy standards. Such loans are not to be automatically considered "exceptions" for the purpose of evaluating an institution's underwriting procedures. Only loans and investments that do not comport with safe and sound lending standards should be considered exceptions.

- For a homogeneous asset that was originated or purchased by the institution since the last examination that included a review of the institution's asset portfolio, the regulator should review the loan file and other relevant information to determine whether sound underwriting standards were followed for the asset to determine if the asset is an "exception" for purposes of this Section.
- For a homogeneous asset that was originated or purchased by the institution prior to the last examination that included a review of the institution's asset portfolio, the review should initially focus on the payment history of the

asset. If the asset has generally remained current, it should not be deemed an exception. For assets that have a history of being delinquent (i.e., 90 or more days past due), the examiner should undertake a review of the asset to determine whether sound underwriting standards were followed when the loan was made or the asset was acquired. If sound underwriting standards were not followed, the asset should be considered an "exception" for purposes of this Section.

Note: Examiners may apply the review standards established above for newer homogeneous assets to older assets (i.e., initially undertake a file review and assess the underwriting of the asset, rather than initially focusing on the payment history) to determine if the asset is an exception.

Materiality: An item is material if its inclusion or omission would change or influence the judgment of a reasonable person. An item is immaterial if its inclusion or omission would have no effect on the examiner's analysis and the outcome of the examination and related supervision. Materiality may vary both with relative amount or quality (the amount or quality of an item compared to other items) and with relative importance (the nature of the item itself). The examiner must use good judgment and professional expertise in determining materiality.

Random Starting Point: A random starting point is the first asset picked from a population for review. The examiner must select the starting point so as to eliminate predictability in the sample selection. The number may be obtained from a random number table, the serial number of a dollar bill, or other appropriate source. The number denotes the first item included in the sample and the place from which the established route starts (e.g., every 29th loan). This starting point should be either less than or equal to the "interval" (either monetary or numerical), i.e., if the examiner will review every 29th loan, the starting point should be selected randomly from one of the first 29 loans.

SAMPLING METHODS

There are two types of sampling discussed in this Section: (1) systematic and (2) nonsystematic (nonstatistical or risk-focused). Both types of sampling should be used in the examination process. An example of systematic sampling is numerical interval sampling. Examples of nonsystematic techniques are minimum dollar cut-off and judgmental sampling.

In general, examiners should use systematic sampling methodologies for homogeneous assets and for testing the reliability of an institution's IAR program for nonhomogeneous assets (for the purpose of including the results of the IAR program in meeting minimum examination sampling coverage standards). If these samples raise concerns, or if a review of the assets selected suggest that major subcategories of assets were not included, the examiner should expand the sample using nonstatistical, risk-focused selection criteria.

More than one sampling technique is often needed when sampling nonhomogeneous assets. Usually, the examiner will select a systematic sample-such as a numerical interval sample-and then select an additional judgmental sample of potential problem assets that were not selected in the systematic sample.

Once a sample is selected, examiners must evaluate the possible risk of loss and the depth of review needed for each asset. A full review of each asset is not necessary merely because the asset has been included in the sample.

Each individual asset review must only be thorough enough to determine the particular attribute for which an examiner is testing. When an examiner is reviewing the reliability of the IAR program for purposes of including the results of the IAR program in meeting minimum examination sampling coverage standards, the asset review should focus on whether the institution's classification coincides with the examiner's classification (e.g., whether there are exceptions in the institution's internal classifications). When examiners review underwriting practices, their asset review should be of sufficient depth to ascertain the institution's application of prudent underwriting standards.

For example, a well-secured and performing loan presents a low risk of loss and usually should be analyzed only to determine the adequacy of cash flows, the borrower's capacity, the perfection of liens, and the reliability of appraisals. In contrast, loans that are nonamortizing, nonperforming, or without adequately controlled collateral present substantially more risk and require in-depth analysis to determine proper classification.

The following are descriptions of the different sampling methodologies to be used to ascertain the reliability of the IAR program (so that its results can be used to meet minimum examination sampling coverage standards for nonhomogeneous assets) and used for the evaluation of the institution's use of prudent underwriting standards (for both homogeneous and nonhomogeneous assets).

For each of these sampling techniques, the thrift's assets must be divided into pools that are similar in terms of the attribute for which the examiner is sampling. In general, homogeneous assets will be divided into just two pools, one- to four-family residential real estate loans and consumer loans. The use of additional pools may be considered if the institution uses significantly different procedures for a particular group of loans. The definition of significantly different procedures would include such criteria as the use of separate underwriting guidelines, the establishment of separate and distinct loan departments or any other characteristic that substantially differentiates a particular group of loans from the general population.

When reviewing the IAR program for nonhomogeneous assets, the examiner need not divide the IAR program-reviewed assets into separate pools. All assets reviewed under an institution's IAR program should be treated as a single pool for sampling purposes. If an institution maintains separate lists of assets reviewed under IAR programs (i.e., by asset type-separate lists for commercial real estate loans, construction loans,

etc.), the examiner should combine the lists into one list for sampling purposes. An exception to this general policy is for larger institutions that have decentralized IAR programs. For example, some large, geographically diverse institutions may have separate IAR programs for different geographic regions. In such cases, the examiner should assess the IAR systems separately.

Systematic Sampling

Numerical Interval Sampling

Numerical sampling is the selection of items based on their numerical order in the portfolio or list.

For thrifts with large portfolios of assets, examiners, from a random start, may select and review a statistically valid, numerical interval sample of assets. This methodology essentially entails the selection of a numeric interval (i.e., every 29th asset). From a random start on a list of assets, the examiner counts each asset and selects the assets at the interval.

After a review of the assets selected, if no exceptions are found, the examiner does not need to expand the sample. Instead, the examiner can conclude that the institution has a reliable IAR program for the purpose of including the results of the IAR program in meeting minimum examination sampling coverage standards (if the examiner is reviewing the IAR-reviewed assets for appropriate classification) or can conclude that there are no asset quality problems that result from poor underwriting standards for the asset pool under review (if the examiner is reviewing homogeneous assets).

If the review discloses 1, 2 or 3 exceptions, then the examiner should expand the sample. The process to expand the sample sizes from the initial sample size is shown in Appendix E. If there are four or more exceptions, then the IAR program does not meet the reliability standards established in this Handbook Section and the examiner cannot include the results of the IAR program in meeting the minimum examination sampling coverage standards for nonhomogeneous assets; for homogeneous assets, 4 or more exceptions means that the examiner should conclude that a significant number of assets in the pool have not been underwritten in a prudent fashion. In such cases, further sampling of the asset pool is not necessary.

As noted in Appendix E, to ensure that OTS does not inappropriately decide that an institution's IAR program does not meet the reliability standards established in this Section or that a pool of homogeneous assets have been underwritten prudently, exceptions should be reviewed by the EIC or another examiner.

The numerical interval sampling guidance provided in Appendix E will provide the examiner with a representative sample of the relevant population of assets. Such a sample will allow the examiner to draw conclusions about the entire population from which the sample was drawn, while minimizing the number of assets that must be reviewed. (Representative sampling should not be equated with random sampling. Random sampling is simply a method of selecting items for inclusion in a sample; it can be used in conjunction with either statistical or nonstatistical sampling. The sampling methodology in the Appendix relies on the numerical interval selection process rather than a random selection process.)

Examiners should also consider taking a judgmental sample of significantly large assets not included in the numerical interval sample, to ensure that the institution is adequately reviewing and classifying these assets. General instructions for judgmental sampling are provided below.

Dollar-Proportional Sampling

Proportional sampling is the selection of items based on the sum of their dollar amounts. With dollar-proportional sampling, the examiner selects the sample by using a running total of asset amounts until a cer-

tain dollar amount (or "interval") is hit. The asset that causes the running total to at least equal the interval is included in the sample. The examiner should start the "adding up" process from a random point on the asset list (as defined in Appendix A). A dollar-proportional sample will consist of all assets that either: (1) are larger than the selected dollar interval or (2) cause the running total of the list to exceed the dollar interval.

For purposes of sampling assets reviewed under an institution's IAR program, a suggested material dollar interval is 3% of GAAP equity capital. Thus, for an institution with $100 million in GAAP equity capital, $3 million is the "interval" that triggers the inclusion of an asset in the sample.

Example: For a thrift with GAAP equity capital of $100 million, the dollar interval is 3%, or $3 million. From a random start on the list of assets, the examiner should start adding the dollar amounts of the assets, moving down the list. When an asset causes the running total to meet or exceed the dollar interval ($3 million in this example), the examiner should select that asset for review. The examiner would then "add up" asset amounts until $3 million is reached again and include the asset that makes the running total equal or exceed $3 million in the sample. Asset amounts may be rounded or truncated to eliminate immaterial amounts for easier adding. For example, a $1,234,567 asset may be rounded to $1,235,000.

The examiner should continue adding assets down the list and select the asset that causes the total to meet or exceed $3 million. Using this example, all individual assets with a book value in excess of $3 million will always be selected for the sample. Further, a selection of smaller assets that cause the running total to meet or exceed $3 million will be selected to be tested.

Dollar-proportional sampling method counts dollar amounts of assets relative to the interval size rather than number of assets.

Note: This method, with some minor differences, may also be used instead of the minimum cut-off method to independently sample nonhomogenous assets.

Nonsystematic or Risk-Focused Sampling

There are two types of nonsystematic or risk-focused sampling discussed in this Appendix: minimum cut-off sampling and judgmental sampling.

Minimum Cut-Off Sampling

Minimum cut-off sampling is an efficient method to analyze nonhomogeneous assets to help determine the thrift's risk of loss. This sampling method selects all assets with a balance (or commitment) equal to or greater than a cut-off amount. Exhibit 1 of this Appendix shows the basic steps to select the assets to be reviewed in minimum cut-off sampling. This sampling methodology can be used to review the underwriting standards used by an institution for its nonhomogeneous assets.

Judgmental Selection

Judgmental selection is used to: (1) sample nonhomogeneous assets that have a greater than normal probability of being adversely classified and (2) expand a systematic sample for homogeneous assets if significant subcategories of assets are not covered by the sample.

For nonhomogeneous assets, Exhibit 2 of this Appendix lists asset groups that may have greater than normal risk of material loss. When selecting assets to review for material risk of loss, the examiners' professional judgment is more important than strict adherence to general procedures and coverage standards. For this reason, judgmental sampling should be used to supplement systematic sampling.

Judgmental sampling may also be used to supplement systematic samples during the examiner's review of the institution's IAR program or of systematic sampling of the underwriting of homogeneous assets. For example, the examiner may judgmentally select assets that were not selected in a numerical interval sample of the internally reviewed assets. Also, if an asset is selected for review from a sample and the borrower has multiple credits with the institution, the examiner should use his/her judgment as to whether to include the entire set of related credits in the sample. For example, if the examiner believes that reviewing all the associated credits will enhance his/her ability to assess whether the initially selected asset is a safe and sound asset, the examiner should include the associated credits.

If a review of judgmentally selected assets reveals problems, additional judgmental sampling can help pinpoint causes and help devise solutions. For example, the examiner may determine that underwriting exceptions or adverse classifications are attributable to one branch office or a single time period. Additional sampling, concentrating on the affected assets, might disclose that the problems are attributable to a single loan officer or broker, or to substitute employees performing unfamiliar duties.

Exhibit 1
Minimum Cut-Off Sampling

- Determine the approximate book value of the nonhomogeneous assets in the portfolio. This can be done with internal management reports or a Thrift Financial Report.
- Set a target range for the percent of that book value to be reviewed. For a portfolio with no indication of serious problems, the initial range for the minimum cut-off and judgmental samples combined would be 30% to 50% of the dollar volume of nonhomogeneous assets.
- Select a cut-off for the dollar value of the balances of assets to be reviewed. A good starting point might be 0.25% of total assets or 2.5% of the thrift's GAAP equity capital, rounded to a convenient number. Select all assets at and above the dollar cut-off in the population being sampled.
- Calculate the percentage dollar volume selected. If the percent selected is significantly different from the target percent, adjust the cut-off so that the percent selected falls within the target range. The assets selected should be reviewed and recorded on Thrift Activities Asset Review line sheets.

Note: Dollar-proportional sampling may be used to independently sample nonhomogeneous assets instead of the minimum cut-off method since it also selects assets with individual book values over a certain material dollar interval/amount (as well as smaller assets). This method is particularly useful for portfolios with an extreme variance in dollar amounts or that cannot be divided between homogeneous and nonhomogeneous assets.

The dollar-proportional sampling procedures for testing the underwriting of nonhomogeneous assets (the "independent sample") are similar to the dollar-proportional sampling procedures for testing the institution's IAR program. A key difference is that the dollar interval is usually not the same, since the purposes for these two examination procedures are different. For independent sampling of nonhomogeneous assets, a starting point for the material dollar interval might be 0.25% of total assets or 2.5% of the thrift's equity capital, rounded to a convenient number.

When using this technique to sample nonhomogeneous assets, the examiner should supplement the dollar-proportional procedures discussed earlier in this Appendix with the following:

- Determine the total book value of the nonhomogeneous assets in the portfolio.
- Set a target range for the percent of that book value to be reviewed.
- Select the assets using the process described earlier and determine the percentage dollar volume selected.
- If the sample is too large or too small, either decrease the sample size by eliminating some smaller assets or increase the sample size by lowering the minimum cut-off. (This is far more efficient than rerunning the dollar proportional selection.)
- When the sample is within the target range, review and record pertinent information on each sampled asset on individual Thrift Activities Asset Review line sheets.

Exhibit 2
Asset Groups with High Risk of Material Loss

Troubled assets, including assets:

- With principal or interest past due for 30 days or more;
- Renewed without interest collection;
- With extended maturities or due dates;
- With significant capitalized interest;
- That are restructured troubled debts; or
- In nonaccrual status.

Loans identified as problems, including loans:

- Previously classified by examiners;
- Internally classified;
- On the thrift's problem list or watch list; or
- Identified in director or committee minutes, audits, or other sources, as having more than normal risk.

Loans to borrowers in groups who present special risk, including loans to:

- Insiders (officers, directors, stockholders);
- Insiders of other financial institutions;
- Related interests of insiders;
- Entities with classified loans elsewhere;
- Customers with overdrafts or cash items; or
- Guarantors and principals of commercial borrowers.

Loans with collateral or repayment sources presenting special risk, including loans:

- In specific high-risk markets (e.g., commercial construction, land speculation and development, leveraged buy-outs, new enterprises, commercial fishing, farming, extraction industries, restaurants, and dealers in mobile homes, new and used cars, home appliances, or farm implements); or
- Out-of-territory.

Participations that are:

- Purchased (both nonhomogeneous assets and portfolios of homogeneous loans); or
- Sold with recourse.

Other assets with special risks, including:

- Loans to facilitate sale of real estate owned;
- Risky concentrations of assets;
- Nonaccrual investments;
- Real estate owned or in judgment;
- Defaulted debt securities; or
- Assets not confirmed by auditors attempting positive confirmations.

DETERMINING THE NUMBER OF ASSETS TO REVIEW FOR SMALL POPULATIONS

As discussed in the Handbook Section, examiners are to systematically select assets for review from the population of assets. The initial sample sizes (of 29, 22, or 15) were selected based on an "in population size. Sampling chapters in statistical textbooks also contain a formula ("finite correction factor") that can be used to "scale down" the level of assets that need to be reviewed, based on the number of assets in a population.

The formula is:

$$\text{sample size} = \frac{n}{1+(n/\text{population size})}$$

Where "n" is the sample size selected based on an infinite population size, and "population size" is the actual number of assets in the group of assets being reviewed.

For example, if the initial sample size is 29, it can be "scaled down" as follows:

$$\text{sample size} = \frac{29}{1+(29/\text{population size})}$$

- If the population size is 1000, the sample = 28.
- If the population size is 500, the sample = 27.
- If the population size is 100, the sample = 22.
- If the population size is 50, the sample = 18.

As discussed in the Handbook Section, examiners are to systematically select assets for review from the population of assets. The initial sample size of 15 was selected based on an "in population size. Sampling chapters in statistical textbooks also contain a formula ("finite correction factor") that can be used to "scale down" the level of assets that need to be reviewed, based on the number of assets in a population.

For example, if the initial sample size is 15, it can be "scaled down" as follows:

$$\text{sample size} = \frac{15}{1+(15/\text{population size})}$$

- If the population size is 100, the sample = 13.
- If the population size is 50, the sample = 12.

SEQUENTIAL SAMPLING FOR HOMOGENOUS ASSETS FOR LOW-RISK INSTITUTIONS

Summary

The examiner will undertake "sequential sampling," under which an initial sample of 15 loans is initially reviewed to determine if the loans made during the review period are prudently underwritten, and if seasoned loans are performing as agreed. If the review discloses no exceptions, no additional loans should be reviewed. If exceptions (as defined in Appendix A) are noted, the sample size is increased as detailed in the chart below, until either the number of exceptions is within the acceptable tolerance or the number of exceptions total 4 or more.

Sample Size	Number of Exceptions Allowed
15	0
25	1
34	2
43	3

If the number of exceptions is within the tolerable limit, an examiner can conclude, with a 90% confidence level (reliability), that the pool of assets are underwritten in a prudent fashion. Specifically, there is only a 10% risk that the population error rate (e.g., the number of assets that are not underwritten prudently) exceeds 15%.

If 4 or more exceptions are found, the sample results indicate that the examiner should conclude that a significant number of assets in the pool of assets have not been underwritten in a prudent manner (or, for seasoned loans, are paying as agreed).

To ensure that a significant number of assets in the pool of assets are inappropriately decided to be exceptions, exceptions should be reviewed by the EIC or another examiner. This review, like the initial review, should focus on whether the assets were underwritten in a safe and sound fashion, as discussed in Appendix A. The results of this review should be used for purposes of determining if the institution is prudently underwriting the pool of assets.

Process

Step 1: The institution's assets should be divided into separate pools based on the underwriting policies the institution uses. As noted in Appendix B, homogeneous assets will generally be divided into just two pools, one- to four-family residential real estate loans and consumer loans.

Step 2: From each pool, the examiner should systematically select 15 assets for review, unless the sample size can be reduced in accordance with Appendix C.

- One method to systematically select the assets for review is to assign each asset in the pool a number, starting from 1. The examiner should then divide the total number of assets in the pool by 15 to get the "numeric interval" to be used to select the loans to review.

  For example, if there are a total of 900 one- to four-family residential real estate loans, the examiner should divide 900 by 15, which equals 60 (900/15 = 60). 60 is the "numeric interval" - the examiner will review every 60th loan. The examiner should start selecting loans from a random starting place between the 1st and 60th loan. If loan number 3 is the first asset selected for review, the examiner should next select loan number 63 (3 + 60), then loan number 123 (63 + 60), and so on, until all 15 loans have been selected for the sample.

Step 3: The examiner should then review the assets selected.

- For loans made since the preceding examination, the review should focus on whether the loans were underwritten in a safe and sound fashion, and whether the institution is exercising proper lending controls. For loans made in prior periods, examiners will generally evaluate asset quality by reviewing loan performance. Exceptions are defined in Appendix A.

  If the institution has adequate written policies on the underwriting of a given category of

loans, the examiner should determine whether the sample of loans were underwritten in accordance with those policies. For any loan in the sample that deviates from the institution's written policies, the examiner should focus on whether the loan was nonetheless prudently underwritten. If the institution does not have adequate written policies for the underwriting of a given type of loan, the examiner should just focus on whether the sampled loans were prudently underwritten.

Examiners should refer to other Thrift Activities Regulatory Handbook sections for guidance on safe and sound underwriting on various loan types.

The definition of "Exception" in Appendix A provides further guidance on reviewing older homogeneous assets.

- If no exceptions are found (e.g., all 15 loans are underwritten in a prudent fashion), the examiner can conclude that the whole pool is underwritten in a prudent fashion and the examiner should proceed to Step 4.
- If exceptions are noted, the sample size should be expanded in accordance with the chart above, until either the number of exceptions is within the acceptable tolerance or the number of exceptions total 4 or more.

Step 4: The examiner should document his/her conclusions about the institution's underwriting of homogeneous assets, and should state any recommendations for necessary corrective measures, in the appropriate work papers and, if necessary, in the Report of Examination.

SEQUENTIAL SAMPLING OF ASSETS REVIEWED UNDER IAR PROGRAMS

Summary

The examiner will undertake "sequential sampling," under which a small sample of assets is initially reviewed to determined if the IAR program is reliable for the purpose of including the results of the IAR program in meeting minimum examination sampling coverage standards. If, after analyzing the sample, the examiner determines that the IAR program's results are acceptable, all internally reviewed assets can be included in meeting the minimum examination sampling coverage standards. The sample size is increased if "exceptions" (as defined in Appendix A of this Sections) are found in the initial sample. Examiners may conclude that the institution has an acceptable IAR program if an acceptable number of exceptions are found. Once 4 or more exceptions are found however, the IAR program does not meet the reliability standards established in this Handbook Section and the examiner can only include the assets he or she independently reviews in meeting the minimum examination sampling coverage standard.

The chart below summarizes the sample discussed more fully below under "Process" and the maximum number of exceptions allowable:

Sample Size	Number of Exceptions Allowed
29	0
46	1
61	2
76	3

If 4 or more exceptions are found, the IAR program does not meet the reliability standards established in this Handbook Section, and the examiner can only include the assets he or she independently reviews in meeting the minimum examination sampling coverage standard.

If fewer than 4 exceptions are found, an examiner can conclude, with a 95% confidence level (reliability), that the IAR program meets the reliability standards established in this Section. Specifically, there is only a 5% risk that the population deviation rate (e.g., the number of internally reviewed assets that are inappropriately classified) exceeds 10%.

To ensure that OTS does not inappropriately decide that an institution's IAR program does not meet the reliability standards established in this Section, exceptions should be reviewed by the EIC or another examiner. This review, like the initial review, should focus on whether reviewer's classifications of the assets are the same as the institution's classification of the assets. The results of this review should be used for purposes of determining if the IAR program is reliable for the purpose of including the results of the IAR program in meeting minimum examination sampling coverage standards.

Process

Note: All of the assets reviewed by the institution under its IAR program should be considered one population of assets.

Step 1: The examiner should systematically select 29 assets for review from the population of assets reviewed under the IAR program, unless the sample size can be reduced in accordance with Appendix C.

- One method to systematically select the assets for review is to assign each asset in the pool a number, starting from 1. The examiner should then divide the total number of assets in the pool by 29 to get the "numeric interval" to be used to select the loans to review.

  For example, if there are a total of 900 assets, the examiner should divide 900 by 29, which equals 31 (900/29 = 31). 31 is the "numeric interval" — the examiner will review every 31st asset. The examiner should start selecting assets from a random starting place between the 1st and 31st asset. If asset number 3 is the first asset selected for review, the examiner should next select assets number 34 (3 + 31), then asset number 65 (34 + 31), and so on, until all 29 assets have been selected for the sample.

Step 2: The examiner should then review the 29 assets.

- The review should focus on whether the examiner's classifications of the assets are the same as the institution's classifications of the assets. An exception should be noted as discussed in Appendix A of this Section.

  Examiners should refer to Thrift Activities Regulatory Handbook Section 260, Classification of Assets, for guidance on classification.

- If there are no exceptions in the classification of the 29 assets, then the examiner can conclude that the institution has a satisfactory IAR program for the purpose of including the results of the IAR program in meeting minimum examination sampling coverage standards and all internally reviewed assets can be included in meeting the minimum examination sampling coverage standards. The examiner should proceed to Step 3.

- If exceptions are noted, the sample size should be expanded in accordance with the chart above, until either the number of exceptions is within the acceptable tolerance or the number of exceptions total 4 or more.

Step 3: The examiner should document his/her conclusions about the reliability of the institution's IAR program for the purpose of including the results of the IAR program in meeting minimum examination sampling coverage standards, and should state any recommendations for necessary corrective measures in the appropriate work papers and, if necessary, in the Report of Examination.

INTRODUCTION

The loan portfolio is the largest and most important group of assets in a savings association's balance sheet, therefore the association's financial health is directly proportional to that of its loan portfolio. There are two major risks inherent in lending operations: (1) credit risk, or the risk that a borrower will fail to repay the interest and principal payments of the loan as agreed, and (2) insufficient net earnings (after providing for loan losses), i.e., net earnings will not be sufficient to cover the institution's interest costs and operating expenses.

Low-quality loan portfolios, with excessive loan losses and nonearning assets, was one of the primary reasons for capital deterioration and, ultimately, the failure of savings associations in the 1980s. In order to remain healthy and profitable, a savings association must progressively manage its lending risks by establishing sound lending policies and ensuring that they are carried out by experienced and competent lending staff.

This Section of the Handbook examines the elements of a sound lending policy and outlines some of the major causes of loan problems. It is intended to assist the regulator in pulling together results of examination programs performed in specific lending departments. With these results, the regulator can evaluate the quality of the entire loan portfolio and the effectiveness of loan portfolio management.

Lending Policy

A written lending policy provides the foundation for building a sound loan portfolio. Lending policies must be specific for each institution, however, and management should consider the expertise of its lending personnel, the needs of the institution, and the needs and nature of its community when developing the institution's lending policies.

On December 31, 1992, OTS issued 12 CFR 563.100-101, Real Estate Lending Standards. Identical rules were issued by each of the other federal banking agencies. The rule requires savings associations to adopt written real estate lending policies and procedures and provides guidelines on the scope and overall content of such policies. The Real Estate Lending Standards Rule is discussed more thoroughly in Thrift Activities Handbook Section 212, Real Estate Mortgage Lending.

OTS does not have a specific regulation that requires savings associations to have written lending policies for loans not secured by real estate (or otherwise covered by 563.100-101); however, savings associations are expected to adopt written, well-defined policies that govern their non-real estate lending activities.

A savings association's policy should promote the following objectives:

- To approve and service loans on a safe and sound basis;
- To uphold the board of directors' fiduciary responsibility to invest the institution's funds profitably for shareholders or members while protecting depositors; and
- To serve the legitimate credit needs of the community.

A lending policy should also:

- Clearly state to management the board of directors' objectives in the composition and risk of the loan portfolio.
- Apply to loan purchases and loan participations as well as to loans originated by the institution.
- State the types of reports required by the directorate to monitor the institution's activities.
- Address the servicing, collection, and charge-off of loans.

- Be reviewed periodically by the board of directors to ensure that policy remains appropriate as market conditions change.

The regulator may find that some loans do not comply with an institution's written policies and procedures. The regulator must determine if exceptions to policies are specifically approved as exceptions or if they are a continuing practice that pose a threat to the institution. Policy exceptions may be appropriate in certain instances; however, the reasons for the exceptions should be well documented in the loan file and approved by the board of directors, its delegates, or a committee thereof. Frequent exceptions to a policy may mean that the policy needs revision or may indicate the more serious problem of management's unwillingness or inability to follow policy.

The elements of a sound loan policy are outlined below.

Market Area: The institution's geographic market area should be clearly defined and consistent with the institution's business plan and Community Reinvestment Act (CRA) Statement objectives. The majority of lending activity should occur within this defined market area. When loans are made outside the area, they should be carefully documented, with comments as to the benefits and risks of exceeding the boundary of the lending territory.

Loan Types: The lending policy should state the desired composition of the loan portfolio by loan type. The targeted levels should be based on the expertise of lending personnel, the liability structure of the institution, profitability and competition factors, portfolio diversification policy, and the anticipated credit needs of the community. Specific departmental lending policies should outline borrower qualifications and documentation standards for each type of loan offered.

Maximum Maturities: Loans should be granted with realistic repayment plans. Maturity scheduling should be related to the anticipated source of repayment, the purpose of the loan, and the useful life of the collateral. For each type of loan, the lending policy should state the maximum number of months over which loans may be amortized or the maximum length of time to maturity. Specific procedures should be developed for unique situations such as balloon payments and modification of the original terms of a loan.

Loan Pricing: The rates charged for loans should reflect the institution's cost of funds, overhead, credit risk premium, and a reasonable profit, yet must be priced at a level that is competitive in the market.

*Financial An*alysis: Extension of credit on a safe and sound basis requires complete and accurate financial information on the borrower. Complete credit information is not only required at the time the loan is originated, but also must be updated periodically to determine the borrower's continuing ability to service the debt. The lending policy should define the financial statement requirements for audited, nonaudited, fiscal, interim, operating, cash flow, and other statements for businesses and individuals at various borrowing levels. The requirements should be written to indicate clearly that any credit data exception will constitute a violation of the institution's lending policy. In the case of loans secured by real estate, the credit file should contain evidence that the loan was not granted solely on the basis of the appraised value of the security property. An appraisal is only one of many tools necessary to underwrite a loan adequately. Documentation of adequate income to service the proposed debt and proper loan approval(s) should be included in the loan file.

"No-Doc" and "Low-Doc" Loans: Loans granted without evidence of the borrower's financial ability to service the debt are often referred to as "no-doc" loans. No-doc loans violate § 563.170(c)(1). The term "low-doc" refers to loans granted by a lender who obtains less financial information and credit history documentation than it obtains for borrowers who have a less substantial equity position in the mortgaged collateral. Low-doc loans should be granted only pursuant to prudent policies approved by the board of directors and clear procedures that are fully understood by loan underwriting staff. A lender must always analyze and document a borrower's current financial condition and capability to repay the loan on a timely basis.

Because of their higher level of delinquencies and defaults, low-documentation loans should receive a higher level of scrutiny than other loans. Some of the data gathered suggest that underwriting these loans may not have been prudent, with evidence of material overstatement of borrowers' income and understatement of debts.

Regulators should be aware of the secondary market limitations associated with low-documentation loans. Both the Federal National Mortgage Association (FNMA) and the Federal Home Mortgage Loan Corporation (FHLMC) limit the purchase of loans that have less than industry-standard documentation. The purchase of such loans has been limited to a negotiated basis, and usually with credit enhancements required.

A high volume of low-doc loans in proportion to total lending should be considered a warning signal of unsafe and unsound lending, which suggests the need to analyze the payment record of seasoned low-doc loans in the portfolio. Another indicator of possible problems would be the presence in the portfolio of low-doc loans rejected by the secondary market.

Limitation on Aggregate Loans Outstanding: As a guide in limiting the total amount of loans outstanding, relationships to other balance sheet accounts should be established primarily to ensure an adequate level of liquidity. In setting such limitations-which are usually expressed relative to deposits, capital, or total assets-various factors such as credit demand, the volatility of the deposit structure, and the credit risks involved must be considered.

Limits and Guidelines for Purchasing Loans: If sufficient loan demand exists, lending within the institution's market or trade area is safe, promotes customer relationships, fosters the well-being of the area, and develops additional business. The lending policy should limit the number of loans purchased from any one outside source and also state an aggregate limit for such loans. The lending policy should also require that purchased loans meet the same underwriting standards applied to direct loans originated by the institution.

Limits and Guidelines for Concentrations of Credit: Concentrations of credit depend heavily on a key factor (such as a common industry or employer), and when weakness develops in that key factor, every individual loan in the concentration may be affected. Certain types of concentrations may be unavoidable (or even desirable, such as single-family mortgage loans in the association's primary lending area). The directorate should evaluate the risks associated with concentrations and identify those that should be limited or avoided. The lending policy should require that all concentrations be monitored and reported to the board of directors on a periodic basis. Portfolio diversification policies and strategies should be written and implemented when the need is shown by the monitoring reports.

Loan-to-Value Ratios: The lending policy should outline the maximum amount in relation to the collateral value that the institution will advance on a given type of collateral.

Loan Authority: The lending policy should establish limits for each lending officer, based on the officer's experience and tenure with the institution. Lending limits, however, should also be set for group authority. A group of officers should be allowed to approve larger loans than individual members can. Reporting procedures and the frequency of meetings for loans requiring group approval should be defined.

Collection and Charge-Offs: Effective collection policies and procedures can reduce lending risk and prevent many loan losses. The lending policy should define delinquent credit obligations and should dictate the appropriate reports to be submitted to the board. The reports should be sufficiently detailed to enable an assessment of the risk, loss potential, and alternative courses of action. The policy should require a followup collection notice procedure that is systematic and progressively stronger. Guidelines should be established to ensure that all accounts are presented to and reviewed by the board for charge-off when they reach a stated period of delinquency.

Credit Underwriting

Section 39(a) of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) requires the federal bank regulatory agencies to prescribe standards relating to credit underwriting. In a pro-

posed regulation published on November 18, 1993, the agencies established the general parameters of safe and sound credit underwriting practices. The standards, if adopted, would require each institution to establish and maintain prudent credit underwriting practices that:

- are commensurate with the types of loans the institution will make and consider the terms and conditions under which they will be made;
- consider the nature of the markets in which loans will be made;
- consider, prior to credit commitment, the borrower's overall financial condition and resources, the financial responsibility of any guarantor, the nature and value of any underlying collateral, and the borrower's character and willingness to repay as agreed;
- establish a system of independent, ongoing credit review with appropriate communication to management and to the board of directors;
- take adequate account of concentration of credit risk; and
- are appropriate to the size of the institution and the nature and scope of its activities.

Loan Documentation Standards

Section 39(a) of FDICIA also requires the federal bank regulatory agencies to prescribe standards relating to loan documentation. The proposed regulation requires institutions to maintain sufficient loan documentation to:

- enable the institution to make an informed lending decision and to assess risk as necessary on an ongoing basis;
- identify the purpose of the loan and the source of repayment and assess the ability of the borrower to repay the indebtedness;
- ensure that any claim against a borrower is legally enforceable;
- demonstrate appropriate administration and monitoring of a loan; and
- take account of the size and complexity of a loan.

The proposed regulation provides a standard against which compliance can be measured, while at the same time allowing for differing approaches to loan documentation.

On March 30, 1993, the agencies issued a joint policy statement regarding documentation of small- and medium-sized business and farm loans. Under that policy statement, well-managed, well- or adequately-capitalized institutions are allowed to establish a "basket" of small- and medium-sized business and farm loans that will not be subject to examiner criticism based on documentation. Regulators should review the policy statement if the association being examined has used this authority.

In an effort to make the loan documentation requirements for banks and thrifts consistent, the OTS amended loan documentation regulation 12 CFR 563.170(c)(1)-(7) to conform to the interagency policy statement. In addition, as part of the final rulemaking action on Section 39 of FDICIA, OTS may significantly revise the current regulatory loan documentation requirements.

Loan Problems

When reviewing an institution's lending functions, the regulator should be aware that many institutions have had serious problems because directors failed to establish sound lending policies and procedures or failed to monitor conformity of lending practices with lending policies. Major sources and causes of "problem" credits are:

Self-Dealing: Excessive lending to affiliated persons and instances of conflicts of interest necessitate significant supervisory action. For this reason, to prevent conflicts of interest, the lending policy should include guidelines for loans to affiliated persons. Self-dealing occurs in many forms, but usually as an over-extension of credit on an unsound basis to directors, officers, employees, or large shareholders or their interests.

Anxiety for Income: When an institution's management is under pressure to invest excess funds or increase earnings, it may be tempted to invest

in high-risk activities not specified in the business plan or lending policy. The earnings potential, however, should not be permitted to outweigh the principle of soundness whereby credits carry undue risks or unsatisfactory repayment terms.

Incomplete Credit Information: Many problem loans can be avoided by verifying credit information provided by borrowers and performing a thorough credit analysis before approving the credit. Complete credit information is the only acceptable and reasonably accurate method for determining a borrower's financial capacity. Comprehensive financial statements, including operating results and other relevant information, should be obtained. The loan file should contain documentation specifying the loan's purpose and a well-defined primary source of repayment. The loan file should also contain evidence that all documentation was analyzed by qualified institution personnel and not used only as "file filler." All information used in the underwriting of a credit should be documented in the loan file.

Failure to Obtain or Enforce Repayment Agreements: The vast majority of borrowers fully intend to repay their loans on inception. Nonetheless, failure to establish proper and realistic repayment provisions or failure to enforce repayment agreements are common causes of loan problems. Repeated renewals and extensions to borrowers may indicate that lending personnel did not adequately underwrite the original loan.

Complacency: The following characteristics manifest complacency and should be guarded against:

- Lack of adequate supervision of old and familiar borrowers;
- Dependence on oral information furnished by borrowers rather than reliable, written financial data; and
- Optimistic view toward known credit weaknesses based on past survival of recurrent hazards and distress.

Lack of Supervision: Many loans that were sound at inception developed into problems and losses because of lack of supervision of the borrower's financial affairs over the loan's lifetime.

Technical Incompetence: Lending personnel must have the technical ability to analyze and evaluate financial statements and other credit information that pertain to the type of credit being granted. When a full understanding of the nature of the credit and the risk involved is lacking, unwarranted losses are certain to develop.

Poor Selection of Risks: Following is a list of some general loan types that fall within the category of poor risk selection:

- Loans to purchase or develop properties, or to finance the establishment of businesses, where the institution advances an excessive proportion of the required capital relative to the equity investment of the owners;
- Loans based solely on the expectation of successfully completing a business transaction;
- Loans for speculative purchases of securities or goods;
- Loans carried without adequate collateral margins of security; and
- Loans made because of other benefits, such as community influence or large deposit balances.

Over-Lending: This is a weakness that may be found when otherwise competent lending personnel fail to adhere to prudent underwriting standards. Loans beyond the reasonable capacity of the borrower to repay are unsound. It is as jeopardizing to lend too much money to a fundamentally sound financial risk as it is to lend to an unsound risk. It is, therefore, important to determine a sound borrower's safe, maximum loan level.

The general limitation for loans to one borrower is 15% of a thrift's capital and surplus; the limit for loans fully secured by readily marketable collateral, i.e., actively traded securities, is an additional 10% of capital and surplus. These limitations are the maximum legally permissible; safe and sound operation may dictate that the thrift follow a lower, more prudent limit. The re-

strictions on loans to one borrower are discussed further in Thrift Activities Section 211, Loan Portfolio Diversification.

Competition: When an institution is under pressure to increase or maintain market share in a highly competitive market, it may compromise sound credit principles. Temporary gains in growth, however, will ultimately be outweighed by the cost of unsound loans.

INTERNAL LOAN REVIEW

The Competitive Equality Banking Act of 1987 resulted in regulations that require each insured institution to classify its own assets on a regular basis.

While the regulations apply to all assets held by an insured institution, this section addresses only the evaluation of systems implemented by institutions to monitor lending portfolio risk. Accordingly, the examination procedures are designed to enable regulators to evaluate the quality and effectiveness of the internal loan review function. If it is determined that problem loans are being identified in a timely manner and that the institution's internal loan classification ratings prove to be reasonably accurate, it may not be necessary to perform an analysis of the remaining portfolio provided the internal review is current and there have been no material changes since the last review.

It is important the regulator recognize that while an internal loan review system may take many forms, e.g., reliance on loan officers to identify problem loans, review of junior officers' loans by a senior lending officer, use of a qualified, part-time person, or an independent department staffed with credit analysts, effective systems have the following common objectives:

- To help minimize loss by the early identification of credit weaknesses;
- To provide essential information for determining the adequacy of valuation allowances;
- To monitor compliance with policies, procedures, laws, and regulations;
- To provide senior management and the board of directors with an objective assessment of the overall quality of the loan portfolio; and
- To help ensure the integrity of financial reports.

An effective system of internal loan review incorporates both a high degree of independence (by the credit review staff) and also uses loan officers (who may be more knowledgeable but less independent) to serve as the first line of defense in identifying emerging problem loans. Because of their frequent contact with borrowers, loan officers should normally be able to identify potential problems before they are apparent to others.

While independence is ideally achieved through establishing an independent department staffed with credit analysts, cost and volume considerations may not justify such a system in smaller institutions. Nevertheless, independence can be maintained provided credit analysts do not have control over the loans they review and are not a part of, or influenced or controlled by anyone associated with, the loan approval process.

In addition to independence and the importance of lending officers being held accountable for promptly reporting their problem credits, regulators should also consider the following factors when evaluating the overall quality and adequacy of an institution's internal loan review system:

- Accuracy of internal loan classification ratings;
- Qualifications and independence of loan review personnel;
- Frequency of reviews;
- Method of loan selection;
- Scope of the review;
- Depth of the review;
- Work paper and report distribution; and
- Follow-up.

Classifications should accurately reflect the risk of nonrepayment. If an institution's classification

system differs from the categories outlined in the classification of assets regulation § 563.160, it should ensure that the definitional criteria of its categories closely parallels those contained in the regulation to both promote accuracy in filing quarterly reports and enable regulators to efficiently test the accuracy of the classification ratings.

The qualifications of loan review personnel, including level of education, experience, and extent of formal credit training should all be evaluated.

Internal reviews should be conducted on a regular basis for all lending areas. The percentage of the portfolio selected for review should provide reasonable assurance that the results of the review have identified all major problems in the portfolio and reflect the quality of the portfolio as a whole.

The review should include, in addition to a "cut" or sampling of the portfolio, large loans past due, nonaccrual, renewal, and restructured loans; loans previously classified; insider loans; and interrelated or common-interest loans.

The review should include an analysis of selected loans for credit quality, concentrations, sufficiency of credit and collateral documentation and proper lien perfection, proper approval by the loan officer and/or loan committee(s), adherence to any loan agreement covenants, compliance with internal policies and procedures and laws and regulations.

The internal review process should contain provisions whereby it maintains a list of loans reviewed, the date of the review, and credit rating summations to substantiate assigned credit classification ratings, including "pass" loans, and should be prepared on all loans reviewed that exceed an established dollar size. The results of the loan review should be submitted to the board of directors at least quarterly. In addition to reporting current findings, comparative trends should also be presented to enable the directorate to spot significant changes in the overall quality of the portfolio.

Findings should be reviewed with appropriate loan officers and department managers and regular reports should be made to the board of directors. Responses of present or planned corrective action of all deficiencies and loans with identified weakness should be required, as well as the time frames for correction.

In addition to the above, as further means of ensuring that the internal loan review function successfully achieves the outlined objectives, the internal loan review program should be in writing and be approved by the board of directors as a visible sign of management's and the directorate's full support of and commitment to the program.

Environmental Risk and Liability

Environmentally related hazards can be a source of high risk and potential liability to an insured institution or service corporation in connection with its mortgage or commercial loans and real estate investments. Potential environmental problems may exist in a myriad of forms such as asbestos insulation, underground storage tanks, surface impoundments, septic tank systems, or oil and gas wells.

Thrift problems with pollution and hazardous waste contamination have grown as federal, state, and local governments have passed comprehensive environmental regulations and laws imposing liabilities on landowners and others for cleaning up the environment. Thrifts must be aware of and concerned with regulations that impose clean-up liability on an absolute or strict liability basis, particularly when governments have the right to assign liability to persons or entities no longer holding title to the property.

Thrift Bulletin 16 (TB 16), issued on February 6, 1989, discusses the following potential categories of risks that a savings association can face from making loans secured by environmentally contaminated property.

Potential Risks and Liabilities to Institutions

There are at least eight basic categories of risk that an association can face as a result of environmentally contaminated property. These include:

(1) The risk that the collateral for a real estate loan or property to be acquired may be drastically reduced in value after discovery of the existence of hazardous waste contamination.

(2) The risk that the borrower cannot repay the loan if the borrower must also pay for the cost of cleaning up the contaminated property. The cost for cleanup in many cases can be significant and may exceed the institution's encumbrance on the property.

(3) The risk that a mortgage loan may lose priority to a cleanup lien imposed under the laws of those states that require super priority liens for the cost of cleanup. In each of these super lien states, a lien granted to the state securing the cost of cleaning up hazardous waste contamination may have priority over a lender's mortgage.

(4) The risk that a lender may be liable to the extent of any credit extended to any debtor who has operated property containing hazardous wastes, has generated such waste, or has transported it in an improper manner. This risk extends to all creditors, not just those who hold as collateral the property containing the hazardous waste.

(5) The risk that the thrift may become directly liable for the cost of cleaning up a site if it forecloses on a contaminated property or becomes involved in the management of a company that owns or operates a contaminated facility, or is involved in decisions pertaining to the disposal of toxic or hazardous waste.

(6) The risk that a lender may not be able to pursue its foreclosure remedies and may have no practical alternative but to give up its loan security, and the right to recover on the loan itself. This could lead to charging off the loan balance.

(7) The risk that the borrower does not maintain collateral or property with an environmental risk potential in an environmentally sound manner.

(8) The risk, aside from the statutory liabilities that can be imposed for toxic waste contamination, of potential liability for personal injury or property damage.

To address these potential risks and liabilities, thrifts should develop internal underwriting and risk management procedures and revise their mortgages, guarantees, indemnities, contracts, and other loan documents to protect themselves against potential environmental hazards and to maintain the value of their loans and real estate investments.

Purpose of Environmental Risk Policy

As indicated in TB 16, the most expeditious means by which a thrift institution may commence protective action against environmental risks and liabilities is to develop and implement a written environmental risk policy. Such a policy will serve several critical purposes. It will:

(1) establish a level of due diligence in all real estate transactions;

(2) establish a means of identifying excessive environmental risk in properties being considered as collateral or for acquisition, or in properties being analyzed prior to foreclosure, or to meet standards set by buyers in the secondary market;

(3) minimize environmental contamination of the borrower's property through the life of the loan by alerting institution staff to a potential problem property and providing for collateral monitoring and periodic property inspections throughout the loan term;

(4) establish guidelines for a satisfactory inquiry into the uses of property and for other protective actions as needed to qualify for the defense of "innocent landowner" in the event that it acquires, through foreclosure or otherwise, a contaminated property that it could not have reasonably known to be contaminated. Note: "innocent landowner" is a term used to denote an exception from liability for an individual or entity who acquires property unaware of the presence of hazardous material. The landowner must not have conducted, permitted, or contributed to the release of hazardous substances and must have had, after appropriate inquiry, no knowledge of the pollution at the time the property was acquired; and

(5) support the institution's adherence to the principles of safety and soundness.

Environmental Risk Policy Components

TB 16 also details 12 elements that a comprehensive environmental risk policy should address. In addition, TB 16 provides a brief description of each of the various types of environmental risk reports that savings associations may need to use.

REFERENCES

Code of Federal Regulations (12 CFR)

Subchapter C: Regulations for Federal Savings Associations

§ 545.46	Commercial Loans

Subchapter D: Regulations Applicable to All Savings Associations

§ 561.4	Affiliate
§ 561.13	Consumer Credit Classified as a Loss
§ 561.18	Director
§ 561.24	Immediate Family
§ 561.32	Normal Lending Territory
§ 561.35	Officer
§ 561.47	Slow Consumer Credit
§ 561.48	Slow Loans
§ 563.41	Loans and Other Transactions with Affiliates and Subsidiaries
§ 563.43	Loans by Savings Associations to their Executive Officers, Directors and Principal Shareholders
§ 563.93	Loans to One Borrower
§ 563.100-101	Real Estate Lending Standards
§ 563.160	Classification of Certain Assets
§ 563.170	Examination and Audits; Appraisals; Establishment and Maintenance of Records
§ 564	Appraisals

Office of Thrift Supervision Bulletins

RB 15	Covered Asset Sales
TB 16	Environmental Risk and Liability

OTS and FHLBB Resolutions

83-241 Geographic Lending Restrictions ¶ 37,362.041

84-580 Geographic Lending Restrictions ¶ 37,362.551

Lending Risk Assessment Program

Examination Objectives

To determine the adequacy of policies, practices, procedures, and controls regarding loan portfolio management.

To determine if lending personnel are in compliance with lending policies.

To determine the overall quality of the loan portfolio and identify sources or causes of any deficiencies that have resulted or may result in greater-than-normal losses.

To determine compliance with applicable laws, rulings, and regulations.

Examination Procedures

The examination procedures of this section are intended to bring together the results of the examination programs for specific loan departments so the regulator can arrive at an overall evaluation of the entire portfolio. As such, the EIC or assisting examiner responsible for "Asset Quality" should take added precautions to avoid duplication of efforts by ensuring an exchange of information and results from each examiner responsible for the asset quality sections.

Level I

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1. Review scoping materials related to this area.

_____ _____

2. Obtain and review the following:

   a. A copy of written policies and procedures covering all lending functions;

   b. Reports furnished to the board and loan committee for their meetings; and

   c. Lists of directors, officers, principal shareholders, and their interests.

_____ _____

3. Review the preceding report of examination and all lending risk-related exceptions noted and determine if management has taken appropriate corrective action.

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4. Review the lending policies and any updates thereto and, as needed, abstract appropriate excerpts relative to:

   a. Distribution of loans by category;

   b. Geographic limitations;

   c. Industry concentration limitations;

   d. Allowable or desirable ratios of various categories of loans to other balance sheet accounts;

   e. Lending authorities of committees and officers;

   f. Any prohibited types of loans;

   g. Maximum maturities for various types of loans;

   h. Interest-rate structure and loan pricing;

   i. Minimum down payments for various types of loans;

   j. Collateral appraisal policies, including persons authorized to perform appraisals and lending values of various types of property;

   k. Financial information requirements by types of loans, especially low-doc loans;

   l. Guidelines for purchasing loans or participations; and

   m. Guidelines for loans to affiliated persons and organizations.

5. Review the institution's Environmental Risk Policy. If the institution does not have a formal Environmental Risk Policy, review formal and informal controls in place to address environmental risk.

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6. In cases where more than one lending policy exists, determine that policies are internally consistent by reviewing the guidelines previously obtained.

7. Review minutes of the loan committee meetings to obtain:

   a. Present members and their attendance record;

   b. Scope of work performed; and

   c. Any information deemed useful in the examination of specific loan categories or other areas of the institution.

8. Through discussion with management, evaluate the quality of the internal loan review personnel, considering:

   a. Level of education;

   b. Significant experience;

   c. Availability and participation in continuing education programs;

   d. Membership in professional organizations;

   e. Training methods; and

   f. Level, quality, and independence of supervision.

9. Analyze the overall internal loan review process. Determine:

   a. Method of loan selection;

   b. Manner in which the loan is analyzed;

   c. Type of report generated;

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d. Use of results by appropriate institution personnel;

e. That procedures are in effect to monitor compliance with loan terms and loan agreements;

f. Any possible internal restrictions placed on the review function personnel;

g. Which internal grade classification qualifies a credit for the problem loan list; and

h. Procedures required to remove a loan from criticized or problem loan list.

10. Request the following reports from the institution, by department, as of the examination date, unless otherwise specified:

a. Past-due loans, including:

- Single-payment notes 30 days or more past maturity;
- Single-payment notes with interest due at specified intervals and demand notes on which interest is due and unpaid for 30 days or more;
- Consumer, mortgage, or term loans, payable in regular installments, on which one installment is due and unpaid for 30 days or more; and
- Identification of any low-doc loans included in such reports.

This report should include the following information, if possible:

- Name of the obligor
- Original amount of the loan
- Outstanding amount of the loan
- Date the loan was made
- Due date

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- Terms of the loan
- Number of payments the loan is delinquent
- Date of the borrower's last payment
- Interest billing cycle
- Date up to which interest is paid.

For large loans, the report should also include:

- Purpose of the loan
- Any action being taken

b. Loans in a non-accrual status;

c. Loans on which interest is not being collected in accordance with the terms of the loan;

d. Loans whose terms have been modified by a reduction of interest rate (other than refinanced single-family home loans) or principal payment, by a deferral of interest or principal, or by other restructuring of repayment terms;

e. Loan participations purchased and sold;

f. Loans sold in full since the previous examination;

g. Loans considered problem loans by management (this report may be either as of the examination date or as submitted to the loan review committee, loan committee, or board of directors);

h. Loan commitments and contingent liabilities (letters of credit, etc.);

i. Extensions of credit to employees, officers, directors, principal shareholders, and their interests;

j. Extensions of credit to officers, directors, and principal shareholders of other institutions;

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k. Miscellaneous loan debit and credit suspense accounts;

l. Current interest-rate structure and loan pricing; and

m. Officers' current lending authority.

11. Compare reports furnished to the board and the loan committee, and those received from the institution in step 10, to identify any material differences and to ensure that they are transmitted to the board in a timely manner.

12. Perform the following steps for past-due loans:

a. Compare the following to determine any material inconsistencies:

- The past-due loan schedule in step 10.
- Delinquency reports submitted to the board.
- List of loans considered "problem" loans by management.
- Delinquency lists submitted for regulatory purposes.

b. Scan the delinquency lists submitted to the board to determine that reports are sufficiently detailed to evaluate the risk factor.

c. Compile current aggregate totals of past-due loans, including overdrafts not paid in 15 days.

13. If, between examinations, the institution has sold loans, in whole or in part, that have been criticized or that the regulator has reason to believe would be criticized if reviewed, prepare a memorandum to the regional office. The memorandum should include the following minimum information:

a. Name and location of the institution transferring credits;

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b. Name and location of the receiving institution;

c. A list by name, amount, and classification (or suggested classification), of each borrowing relationship criticized;

d. Total number and dollar amount of assets transferred;

e. Total number and dollar amount of problem assets, together with other appropriate information;

f. Actual or approximate date of transfer; and

g. Any other pertinent information.

14. Distribute the applicable schedules and other information to the regulators performing the loan examination programs.

(Note: Before proceeding to step 15, review Lending Risk Assessment Questionnaire questions 16 through 28. These questions were designed to assist the regulator in determining the extent of internal loan review and aid in its evaluation.)

15. Obtain a list, including credit rating, of all loans reviewed since the last examination and, if available, analytical summations supporting that rating.

16. Summarize findings, obtain management responses, and update programs and the continuing examination file (CEF) with any information that will facilitate future examinations. File exception sheets in the general file.

17. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

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Level II

18. Using a sampling technique, test the population of loans analyzed by the institution since the last examination to determine if problem loans are being identified. Accomplish that by reviewing internal comments on both "passed" and classified loans to determine if appropriate criteria have been considered.

19. If it is determined that problem loans are being identified:

    a. Forward a summary, by borrower, of all loans passed by the internal loan review to the examiners responsible for the specific loan department examinations.

    b. Instruct those examiners to determine which loans passed by the internal loan review are contained in their sample.

    c. Request those examiners to scan the credit file for all passed loans to determine the current validity of "pass" classifications by:

    - Comparing present credit facility with that in place at the review;
    - Comparing present financial information with that used at the review;
    - Reviewing any ancillary support for the debt that was not in place at the review; and
    - Determining that no material changes have taken place in the borrower's relationship with the bank.

    If the classification is valid, do not analyze further. If the institution's review of an individual loan is considered out of date, analyze in the normal manner.

    d. Request departmental examiners to compute the percentage of loans bearing invalid internal classifications to the total of the passed loans.

20. Reach a conclusion regarding the scope and adequacy of the loan review function based on comparing the results from the examiner's final loan classifications to the findings of

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the loan review department, keeping in mind the timeliness of the current internal review.

21. Determine general distribution characteristics of the loan portfolio by:

    a. Determining the percentage of total loans in specific classes.

    b. Comparing loan category distributions with policy guidelines.

22. Obtain the results of loan department examinations and perform the following:

    a. Determine any failure to adhere to internally established policies, practices, procedures, and controls.

    b. Compare the various department results to determine the extent of nonadherence and if it is system-wide.

    c. Organize the exceptions in order of relative importance.

    d. Organize violations of laws, rulings, and regulations.

    e. Determine the aggregate amount of classified and special mention loans.

    f. Compile a list of all loans not supported by current and satisfactory credit information.

    g. Compile a list of all loans not supported by complete collateral documentation.

    h. Determine the aggregate amount of out-of-area loans, if expected to be significant.

    i. Compute the following ratios and compare with computations from prior examinations:

        - Aggregate past-due loans to loans outstanding;
        - Aggregate classified loans to total capital;

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- Aggregate loans not supported by current and satisfactory credit information to gross loans outstanding;
- Aggregate loans not supported by complete collateral documentation to gross loans outstanding; and
- Aggregate concentrations of credit to total loans outstanding.

23. Send a "Summary of Problem Loans" to the examiner assigned to Capital Adequacy.

24. Compare management's list of problem loans from step 10 with the list of classified loans to determine the extent of managerial knowledge or recognition of their own loan problems.

25. Determine, through information previously generated, the causes of existing problems or weaknesses within the system that present potential for future problems.

26. Determine, through examiners assigned to consumer lending functions, if the institution has adhered to the board's policy in classifying "slow consumer credit" and "slow consumer credit classified as loss."

27. Send the following information to the examiner assigned to Adequacy of Valuation Allowances:

    a. A list of loans considered problem loans by management;

    b. A list of classified loans; and

    c. A list of rebooked charged-off loans.

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28. Summarize the overall findings relating to:

    a. The quality of internal policies, practices, procedures, and controls regarding functions;

    b. The general level of adherence to internal policies, practices, procedures, and controls;

    c. The scope and adequacy of the internal loan review system;

    d. The quality of the entire loan portfolio;

    e. The composition and trend in portfolio (identify changes that occurred or are expected to occur);

    f. The quality of management with respect to the lending function;

    g. Expectations for continued sound lending or correction of existing deficiencies;

    h. Promises made by management for correction of deficiencies; and

    i. Loans to insiders and their interests, if problems are identified.

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

Examiner's Summary, Recommendations, and Comments

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Lending Risk Assessment Questionnaire

	Yes	No
General Questionnaire		
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 distribution of loans in commercial, real estate, and installment categories?		
b. Establish geographic limits for loans?..		
c. Establish guidelines for aggregate outstanding loans in relation to other balance sheet categories?.....		
d. Establish 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 appraisal policy?.....		
i. Establish minimum financial information required at inception of credit?.....		
j. Establish limits and guidelines for purchasing loans?.....		
k. Establish guidelines for loans to affiliates/affiliated persons?.....		
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?		
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 at their regular meetings (at least monthly):		
a. Past-due single-payment notes?		
b. Notes on which interest only is past due?.....		
c. Term loans on which one installment is past due? (These might be listed in aggregate for smaller loans, such as consumer and mortgages, depending on the size of the institution.)		
d. Total outstanding loan commitments?		
e. Loans requiring special attention?		
f. Loan modifications, renewals, or restructured loans?.....		
4. Are reports submitted to the board or its committees rechecked by a designated individual for possible omissions before their submission?.....		
5. Are written applications required for all loans?.....		
6. Are credit files maintained for all borrowers?		
7. Does the credit file contain information on:		
a. The purpose of the loan?.....		

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Lending Risk Assessment Questionnaire

	Yes	No
b. The planned repayment schedule?		
c. The disposition of the loan proceeds? .		
8. Does the institution require periodic submission of financial statements by all commercial borrowers (including commercial real estate borrowers whose loans are not fully secured by readily marketable collateral?)		
9. Is a system maintained to ensure that current financial information is requested and received?		
10. Does the institution require submission of audited financial statements based on dollar amount of commitment (if so, state the dollar minimum $_____)?		
11. Does the institution 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 additional advances?.....		
15. Is there an internal review system (it may be a function of loan servicing or the internal audit department) that covers each department and:		
a. Rechecks interest and maturity date computations?.....		
b. Reexamines notes for proper execution, receipt of all required supporting papers, and proper disclosure forms?.....		

	Yes	No
c. Determines that loan approvals are within the limits of the institution's lending authority?.....		
d. Determines that notes are being initially approved by the loan officer?..		
e. Ascertains that new loans are within the limitations set for the borrower by corporate resolution?		
f. Rechecks the preparation of maturity and interest notices?.....		
g. Examines entries to various general ledger loan controls?.....		
h. Confirms collateral and loans with customers on a test basis?		
16. Does the institution have a loan review section or the equivalent?.....		
17. Is the loan review section independent of the lending function?.....		
18. Are the initial results of the loan review process submitted to a person or committee that is also independent of the lending function?		
19. Are all loans exceeding a certain dollar amount selected for review?.....		
20. Do lending officers recommend loans for review?		
21. Is a method, other than those detailed in steps 19 or 20, used to select loans for review (if so, provide details)?		
22. Are internal reviews conducted at least annually for all lending areas?.....		
23. In an officer identification system, are guidelines in effect that define the consequences of an officer withholding a loan from the review process?.....		

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Lending Risk Assessment Questionnaire

	Yes	No
24. Is the institution's problem loan list periodically updated by the lending officers?		
25. Does the institution maintain a list of loans reviewed indicating the date of the review and the credit rating?		
26. Does the loan review section prepare summations to substantiate credit ratings including "pass" loans?		
27. Are loan review summations maintained in a central location or in appropriate credit files?		
28. Are follow-up procedures in effect for internally classified loans including an updated memorandum to the appropriate credit file?		
29. Are loan records retained in accordance with record retention policy and legal requirements?		
30. Are new notes microfilmed daily?		

	Yes	No
31. Is a systematic and progressively stronger follow-up notice procedure used for delinquent loans?		
32. Does the institution maintain records in sufficient detail to generate the following information by type of advance:		
a. The cost of funding loans?		
b. The cost of servicing loans including overhead?		
c. The cost factor of probable losses?		
d. The programmed profit margin?		
33. Has the institution conducted industry studies for those industries in which it is a substantial lender?		

Comments

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INTRODUCTION

Loan portfolio diversification is a means of controlling credit risk through the allocation of loan funds among different industries, borrower groups, and locations. Diversification can protect a thrift from loss due to regional economic recession, failure of a critical industry, or any factor affecting a group of loans having similar risk characteristics. Diversification by exchange of assets, such as mortgages for securities, or by adding a new loan product, opening a new marketing territory, or otherwise expanding to new prudent lending areas may present better opportunity for profit than traditional lending. Diversification may enable a thrift to:

- Take advantage of operational and marketing synergies;
- Use staff, data processing, advertising, and other resources more efficiently;
- Open up additional profit potential in new markets (which can be especially important if the thrift is facing a saturated market); and
- Avoid the dangers of credit concentration.

CREDIT CONCENTRATIONS

In risk analysis, a concentration is a significantly large volume of assets that a thrift has advanced or committed to an individual or a group of borrowers related by a common dependency or a common risk characteristic. For example, in a concentration, borrowers may be engaged in, or dependent upon, one industry; or loans may have been originated in one geographic location, or purchased from a single source, regardless of the number of borrowers or loans. The common characteristic in a concentration may be high loan-to-value ratios or it may be similar collateral. Purchased mortgage servicing rights (PMSR) may be a concentration. In concentrations, weaknesses in a common factor can adversely affect many loans.

In addition to assets such as outstanding loans, securities, and deposits, concentrations include unfunded legally binding loan commitments and letters of credit. Such obligations, if not monitored and controlled by management, can expose the thrift to unnecessarily large risk through concentrations. Refer to the definition of *Concentration of Credit* in the glossary for additional details.

Assets with a common dependency should be recognized as a concentration if they exceed 25% of core capital and general valuation allowances (see TFR), or exceed 2% of total assets when the institution is undercapitalized. Special circumstances, such as when a concentration has an especially high risk of loss, may warrant a stricter standard, such as 1% of assets.

All concentrations are not inherently objectionable. Some credit concentrations are desirable, for example: home purchase loans when diversified by location or payment sources. Also, if they are properly controlled through underwriting standards, concentration of credit may allow a thrift to take advantage of special staff expertise or available demand.

Thrift management should identify concentrations and assess their size and individual risk so policies and plans can be adjusted accordingly. At a minimum, management should identify, monitor, and regularly report significant concentrations to the board of directors to provide a basis for board policy.

Regulators should monitor concentrations and should conduct a more in-depth periodic review of them than of diversified areas of the loan portfolio. Regulators should evaluate management's control of concentrations and use of diversification to limit or prevent excessive risk of loss. Concentrations of assets with abnormally high risk of loss should be considered for adverse classification and be considered in determining the adequacy of valuation allowances. (See Thrift Activities Handbook Section 261, Adequacy of Valuation Allowances.)

If findings merit report comments, regulators must carefully justify their analyses and conclusions. Regulators should point out to thrift management that extending or committing additional credit to a concentration of risky assets is an unsafe and unsound practice. When concentrations present an unacceptable risk, greater attention to diversification of assets should be recommended to management. For unavoidable concentrations, strict underwriting standards should be followed to limit credit risk.

Thrift Policies

Occasionally, regulators will encounter a thrift without diversification policies and plans. Under such circumstances, regulators should recommend the establishment of minimum standards for monitoring concentrations, such as monthly concentration reports to the board of directors. Diversification policies and strategies should be written and implemented when the need is shown by the monitoring reports.

The thrift's written policies should address loan portfolio diversification and concentration of credit. Diversification may also be addressed in the board of directors minutes, the thrift's lending or risk management policies, and the strategic plan.

A diversification policy should contain quantified goals and objectives wherein the composition of loan portfolio mix and limits in dollar amount or percentage of assets are established for each loan category. The policy must not be overly restrictive; it must be flexible enough to allow timely reaction to changing conditions in a thrift's asset mix, its servicing area, and local, national, and international economies.

It is essential that the policy address various types of concentrations of credit, including geographically, industrially, or economically related individuals or other groups of related borrowers. In addition, the policy should establish limits for loans with similar collateral such as office space, warehouses, shopping centers, nursing homes, apartments, and land development.

The policy should limit the total amount of purchased loans and limit loans purchased from, or serviced by, each seller or servicer. Overreliance on one source for purchased loans or servicing exposes the thrift to operations risk as well as credit risk and should be avoided.

The policy should elaborate on how quantified objectives will influence the control of credit risk. This policy should stress that underwriting standards for purchased loans and participations must be the same as for thrift-originated loans. Complacency (the purchaser's dependence on the originator for underwriting without the purchaser using audit verification for compliance with strict standards) is an unacceptable practice.

Diversification Strategy

After the thrift has set quantified goals and objectives for diversification, it must develop a written strategy to achieve these objectives. The strategy should address each loan type for the loan portfolio.

Management must monitor economic and financial conditions of geographic locations, industries, and groups of borrowers in which a thrift has invested heavily. Management must change strategies as conditions warrant. For example, changes in directorship or control, demography (the age, income, or size of a population), regulations, and the thrift's goals and objectives may affect a thrift's diversification strategy.

Often, a thrift's unique characteristics will affect diversification. For example, a thrift's location may restrict diversification in originations; the local economy may depend on one major industry or employer; the thrift may lack management expertise or adequate staffing to purchase and service out-of-territory loans and participations. Inexperienced officers or employees may limit or delay the implementation of new lending strategies. Marginal liquidity or funding may restrain diversification. A small thrift may have insufficient resources to start up a new loan product or market.

If regulations or the thrift's unique characteristics inhibit diversification in the origination of assets, the sale or exchange of assets may facilitate diversification into permissible areas. When concentrations are unavoidable, more diligence in

monitoring and controlling related risk is necessary, and additional capital may be required for the safety and soundness of the thrift.

PARTICIPATIONS

Loan participating as a seller (lead) or buyer (participant) can facilitate diversification of loan portfolios. Loan participating is the buying and selling of shares of loans, usually denoted as a percentage interest in principal and interest. Participation loans are often originated with contractually committed participants. Large loans are also participated after origination and funding in order to diversify a portfolio and provide liquidity.

A participation should be covered by a detailed participation agreement. The agreement should set all terms, conditions, and understandings between and among the lead lender and participants. Participation agreements typically establish the sharing of payment proceeds, expenses, losses, and servicing responsibilities and rights.

For each participation bought or sold, each lead and each participant should be aware of contingent liabilities from both contractual and fiduciary duties and the rights and obligations of each party concerning servicing under various circumstances. For this reason, participation agreements and loan documentation should be structured with legal counsel on behalf of the interests of each participant and the lead. Additionally, § 563.170(c)(6) of the regulations requires a legal opinion on whether a participation loan is sold with or without recourse.

Until the 1980s, participations were often regarded as the best loans in a lender's portfolio. Participants often (to the consternation of regulators) accepted the word of the lead lender that the loans were of excellent quality with very low risk of loss. Lead lenders staked their considerable reputations on the quality of participations sold.

In the early 1980s this situation changed dramatically as banks and thrifts experienced extreme liquidity and earnings problems. Some lenders, in desperation (sometimes fraudulently), sold participations in weak loans and securities, sometimes using devious sales techniques. In some cases, leads sold all interests in the loans, retaining only servicing. Unwary participants had to absorb losses, which were unanticipated because of inadequate participation documents, poor loan documentation, and faulty servicing.

In many cases lead lenders, who had previously enjoyed admirable reputations, experienced capital failure, leaving the servicing and liquidation of participated loans to be decided in litigation among participants and, too often, their receivers. Inadequate participation documentation has resulted in participants being deemed by courts as unsecured creditors of an insolvent lead rather than owners of an undivided interest in a loan.

Participation lending and investing involves both credit and fiduciary risk and requires due diligence on behalf of all parties. Safety and soundness requires each lender (lead or participant) to:

- thoroughly analyze proposed participation loans for credit quality and compliance with laws and regulations;
- maintain complete and current document and credit files;
- the documentation requirements of § 563.170 of the regulations apply to both leads and participants.)
- independently assess primary and secondary sources of repayment; and
- stay aware of conditions affecting the collectibility of the loan.

Each lead must:

- fully disclose current status and pertinent findings to participants to avoid liability for fiduciary irresponsibility in the event of default;
- avoid the appearance of conflicts of interest with those of the participants; and
- scrupulously comply with all terms of the participation agreement.

Additionally, each participant should obtain and independently analyze information on the current status of the borrower, such as is provided in credit reports, and make site inspections where appropriate. When a lead or a borrower exhibits credit problems, participants should take defensive legal actions to protect their interests.

LEGAL LIMITS TO INVESTMENTS

The Home Owners' Loan Act (HOLA) at 12 USC § 1467a(m) and § 584.6 of the Regulations for Savings and Loan Holding Companies require thrifts to meet the Qualified Thrift Lender test or face specified consequences. As the result of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), effective December 19, 1991, savings associations will qualify their status as Qualified Thrift Lenders if the association's actual thrift investment percentage (ATIP) equals or exceeds 65% for 9 out of the last 12 months. The calculation of the ATIP is done by dividing the amount of a savings association's qualified thrift investment (QTI) by the association's portfolio assets. Included as a part of an association's QTI is qualifying real estate owned (REO), defined as REO that would otherwise constitute QTIs. (For additional information see Thrift Activities Handbook Section 270, Qualified Thrift Lender Test.)

The Federal Deposit Insurance Act (FDIA) at 12 USC § 1831e provides that state thrifts may not engage in activities not permitted for federal thrifts unless the state thrifts comply with the fully phased-in capital requirements of HOLA and the FDIC has determined that the activity would pose no significant risk to the deposit insurance fund. The FDIA prohibits state thrifts from acquiring or retaining equity investments not permitted for federal thrifts. Divestiture of nonconforming equity investments by all thrifts is required as quickly as can be prudently done by July 1, 1994. The FDIA at § 1831e(d) prohibits acquisition and retention of junk bonds (as defined therein) and requires divestiture as quickly as can prudently be done by July 1, 1994. The related FDIC rules and regulations are found at 12 CFR § 303.13. For more discussion of these subjects refer to Thrift Activities Handbook Section 220, Investment Securities, and Section 230, Equity Investments.

The HOLA at 12 USC § 1464(c) provides investment authorities and limits for federal thrifts. The FDIA applies the federal limits to state thrifts. The OTS has further limited some investment authorities. For example, § 545.35(b) of the regulations limits aggregate loans on nonresidential real estate to 400% of total capital (risk-based capital) and § 545.46 limits aggregate commercial-purpose loans to 10% of assets. (Note: at § 1464 Note (a) the HOLA provides that the limits of § 1464(c) do not require divestiture of nonconforming loans and investments that were lawful under § 1464(c) when made.) Refer to other sections of this Handbook related to specific asset types.

The HOLA further limits all thrift lending to one borrower at 12 USC § 1464(u). Section 545.75 includes commercial paper and corporate debt securities with loans in applying the loans-to-one-borrower limits of § 563.93.

LOANS TO ONE BORROWER LEGAL LENDING LIMITS

Section 301 of FIRREA, which added § 5(u) to the HOLA (12 USC § 1464(u)), effective August 9, 1989, provides that § 5200 of the Revised Statutes (12 USC § 84) shall apply to thrifts in the same manner and to the same extent as it applies to national banks. The limits of 12 USC § 84 are implemented by the Office of the Comptroller of the Currency (OCC) in 12 CFR § 32, which relies upon capital and surplus as defined in 12 CFR § 3.100. (Note this exception: 12 CFR § 32.7 does not apply to thrifts.) FIRREA also provides Special Rules that permit loans up to $500,000 for any purpose, and provide different limits for loans to develop domestic residential housing units.

Section 563.93 of the regulations incorporates the loan limits for national banks, providing more stringent rules where necessary. The rule provides more detailed regulatory implementation of statutory requirements for Special Rules and other provisions; it provides that a thrift's investment in the commercial paper and corporate debt securities of one issuer shall be subject to the loans-to-one-borrower (LTOB) limit, and it establishes a separate limit for investment by a thrift in certain highly rated debt obligations.

The general limit for loans to one borrower is 15% of a thrift's unimpaired capital and unimpaired surplus as calculated under national bank accounting guidelines (hereafter designated as LTOB capital and surplus). The limit for loans fully secured by readily marketable collateral (that is, actively traded securities) is an additional 10% of LTOB capital and surplus. (The use of the additional 10% assumes compliance with the 15% limit.) A thrift may also invest up to another 10% of its LTOB capital and surplus in one issuer's commercial paper (if it is rated in the highest category by at least two nationally recognized rating services) or corporate debt securities (if they are rated in the two highest categories by a nationally recognized rating service). These limits are the maximum legally permissible for thrifts; safe and sound operation may dictate that thrifts follow lower, more prudent limits.

The rule applies, in large measure, the lending limit regulations and codified interpretations of the OCC under 12 CFR §§ 32 and 3.100. The OTS will give substantial weight to the OCC's noncodified legal opinions interpreting the national bank lending limits, and will regard them as strong evidence of safe and sound banking practices, but the OTS regards these opinions as advisory only.

Section 563.93 of the regulations applies to loans and extensions of credit made by a savings association and its subsidiaries. This section does not apply to loans made by a savings association to its subsidiaries or to its affiliates. The terms subsidiary and affiliate have the same meanings as those defined in section 563.41.

In applying regulations, regulators should generally follow the principle that when a loan is legal when made, it stays legal even if it becomes nonconforming; and if illegal when made, it stays illegal, even if it becomes conforming.

Exceptions

The HOLA at 12 USC § 1464(c) specifically authorizes unlimited investment authority in specified debt and equity issues of FNMA, FHLMC and the Federal Home Loan Banks. Such specified investments are not limited by § 563.93. Section 563.93(a) exempts loans to all affiliates and subsidiaries.

Congress, in 12 USC § 84, lists 10 exceptions. The OCC further explains these exceptions in 12 CFR § 32.6. Section 32.6(e) provides that loans to or guaranteed by a federal agency are not subject to the lending limits. Section 32.102(b) provides that sales of fed funds with a maturity of one business day or sold under a continuing contract allowing cancellation without prior notice are not "loans and extensions of credit" for lending limit purposes. Neither are deposits. (Fed funds, deposits, and hedged securities are conditionally limited by § 563.96. Sales of fed funds with a maturity of more than one business day are also subject to the § 563.93 lending limits.) The OCC's regulation at § 32.108 provides that the lending limits do not apply to accrued or discounted interest.

LTOB Capital and Surplus

Because bank and thrift accounting are different, the LTOB limits cannot always be calculated from the TFRs. The rule defines "unimpaired capital and unimpaired surplus" as the definition of "capital and surplus" in 12 CFR § 3.100 and requires bank accounting standards as found in the Federal Financial Institutions Examination Council (FFIEC) bank call report instructions. The calculation of LTOB capital and surplus is done according to OCC bank reporting requirements when materially different from OTS thrift reporting requirements. The OCC's regulations define the term "capital and surplus" to generally mean GAAP capital plus general allowances for loan losses with several adjustments and limits.

The capital transition rule for intangible assets in § 3.3 applies to all intangible assets (other than PMSR) - such as core deposit intangibles, goodwill, and favorable leaseholds - only as they meet the requirements of § 3.3. A thrift must have purchased the intangible asset prior to April 15, 1985 and accounted for it in accordance with OCC guidance for banks before including the asset in its calculation of the LTOB limits. In general, OCC guidance provides that intangibles must be amortized over the estimated average life or the actual life per GAAP, provided that the amortization period cannot exceed 15 years (irrespective of thrift accounting). If these requirements are

met, the intangible asset may be included in LTOB capital and surplus in an amount not to exceed 25% of the sum of items listed in § 3.100(a) and (c)(1). PMSR and other intangibles may not exceed the balances computed under OCC standards irrespective of book values. Refer to Appendices A and B of this Handbook section for additional guidance.

Under § 563.93, the amount of a thrift's LTOB capital and surplus must be calculated as of the thrift's most recent periodic report (quarterly) required to be filed with the OTS prior to the date of granting or purchasing the loan or otherwise creating the borrower's obligation to repay funds. If the level of LTOB capital and surplus has changed by a material amount, subsequent to the filing of the report, the changes must be included in a new calculation.

One Borrower

For a definition of "one borrower" the rule references the OCC's definition of the term "person" as stated in 12 CFR § 32.2(b) and includes the term "financial institution" as presently defined at § 561.19. This is "any bank or savings association" as defined in the FDIA at 12 USC § 1813.

The loans and extensions of credit to one person are attributed to other persons when the loans or extensions of credit are used for the "direct benefit" of the other persons, or when a "common enterprise" is deemed to exist between such persons per § 32.5 of the OCC regulations.

Loans to partnerships are always attributed to the general partners, but the direct benefit test or common enterprise test must be met for partnership loans to be attributed to limited partners.

Debt guaranteed by a person is attributed to the guarantor if it meets either of these tests or if the guarantor has become an obligor under the terms of the guarantee. When loans to one borrower exceed the limits due to debts attributed to the borrower as guarantor only because of default, the debts are deemed legal but nonconforming and they prevent additional legal commitments or loans from being made to the guarantor.

Recordkeeping

If a thrift or operating subsidiary makes a loan to any one borrower, of an amount more than the greater of $500,000 or five percent (5%) of capital and surplus, the records of the lender shall include documentation showing that the loan was made within the LTOB limits. For such documentation the lender may require, and may accept in good faith, a certification by the borrower identifying the persons, entities, and interests described in the definition of one borrower.

Prudent loan underwriters may wish, however, to document compliance with the legal lending limits for all significant loans, even loans for amounts less than the aforementioned thresholds. Thrifts should document and explain any adjustments made between thrift accounting and bank accounting used in computing the LTOB limits. Such documentation facilitates review by regulators as well as aiding the thrift in assuring compliance with the regulation.

Loans

The term "loans and extensions of credit" is defined as any direct or indirect advance of funds, originated or purchased, including obligations of makers and endorsers arising from the discounting of commercial paper, to a person (borrower) per 12 CFR § 32.2(a). This includes charged-off loans, but not loans rendered legally unenforceable under bankruptcy or other reasons. Under § 563.93 of the regulations, a thrift must add any loans it has made to a borrower with any corporate debt securities and commercial paper held by the thrift that were issued by the same borrower and the aggregate amount is subject to the thrift's general limits.

Commitments

Historically, a loan commitment was not deemed by the OCC to be "made" until funded. Banks encountered difficulty if they entered into a commitment within the lending limits (underline commitment) but experienced a drop in capital in the intervening period before the commitment was actually funded. Because the historical approach required that the lending limits be applied when

the loan was "made," and it was not "made" until the later date of funding, the lower lending limit reflecting the capital drop would apply. Section 32.2(d) of the OCC regulations remedies this problem by permitting underline commitments to be deemed "made" when entered into. Thus, by treating such commitments as having been "made" prior to the drop in capital, the higher lending limit would apply.

The OTS views the expiration of an unfunded or partially funded loan commitment, or any restructuring of the commitment, as an opportunity for a thrift to bring the loan commitment into conformance with the thrift's current lending limit. Thus, where a thrift has entered into and funded or partially funded a loan commitment that was within the thrift's lending limit when made, and the thrift's lending limit subsequently declines, the thrift may renew that portion of the loan commitment that has been funded as a legal, although nonconforming, term loan. An unfunded loan commitment, or the unfunded portion of any loan commitment, which would exceed the thrift's lending limit if made on the date of the renewal, may not be renewed legally.

Thrifts may advance additional funds to a borrower pursuant to a legally binding loan commitment (written or unwritten) that was within the thrift's lending limit when made. It is incumbent upon the thrift to establish, either by a written agreement or by other file documentation, that a commitment represents a legally binding commitment to fund. If doubt exists as to the legally binding nature of the commitment, the thrift must have a well-reasoned opinion of counsel that firmly concludes that the commitment is legally binding.

In general, loan commitments for which the prospective borrower has paid no fee to the thrift are presumed to be not legally binding. Such agreements typically contain broad provisions permitting the lender to decline to fund on subjective grounds that, in effect, render the commitment unenforceable. This presumption may be proven wrong with convincing evidence such as a legal opinion.

When a thrift is confronted with a request for a binding commitment that may exceed the lending limit now or in the future, prudent lending practice dictates that the thrift take precautions to permit escape from such a dilemma. Such actions include a protective clause in the commitment that would release the thrift from its obligation if funding the loan would result in a loan amount in excess of the legal limit (an overline).

Section 32.2(f) created a new class of legally binding loan commitments for national banks - "qualifying commitments to lend." A qualifying commitment to lend is a binding written commitment to lend that, when combined with all other outstanding loans and qualifying commitments to the borrower, is within the bank's lending limit on the date of the commitment and that has not been disqualified. A "disqualified" commitment to lend is created in the following manner: If a bank makes a loan or extension of credit that causes the bank to exceed its lending limit when the new loan amount or extension of credit is combined with all other outstanding loans and legally binding loan commitments, the unfunded commitments become "disqualified" loan commitments. These newly "disqualified" loan commitments can only be funded if, at the time of funding, the additional loan amount, when added to the total amount of loans and qualifying loan commitments outstanding, is within the institution's LTOB limit. Thus, unlike other legally binding loan commitments, disqualifying loan commitments cannot automatically be funded at latter dates. OTS allows savings associations to use this authority providing associations include in their commitments a clause that releases them from the obligation to fund the commitment if funding would cause a LTOB violation.

Renewals

The renewal of a loan does not constitute a new loan for lending limit purposes provided no new funds are advanced by the thrift to the borrower and a new borrower is not substituted for the original obligor. The renewal of a nonconforming loan presents an opportunity to the thrift to bring the loan into conformance with the lending limits. This includes attempting to have the debtor partially repay the nonconforming loan or obtain another institution's nonrecourse participation in the loan to bring it into lending limit compliance. Thus, the thrift must make and document best ef-

forts to bring the loan into conformance prior to renewal. If these efforts are unsuccessful, the thrift may renew, restructure, or modify the nonconforming loan, provided that there is no substitution of borrowers or additional advance of funds. Circumstances that indicate a deliberate purpose to evade the law and to extend unauthorized lines of credit are to be deemed violations of the statutory limits made applicable by FIRREA, thus exposing the directorate to liability.

Upon the expiration of a partially funded loan commitment, only the funded portion may be renewed if this amount exceeds the thrift's lending limit and only if best efforts were first made to bring it into compliance. This renewed portion shall then be treated as a legal, although nonconforming, term loan. If the borrower subsequently repays a portion of the outstanding balance owed to the thrift, new funds may not be advanced (or re-advanced) to the borrower until the outstanding balance of the loan is brought within the thrift's lending limits.

Loans to Facilitate Sales

OTS policy concerning sale financing for any assets is identical to that of the OCC. A purchase money note with no advance of funds is not a "loan" for lending limit purposes. In sales financing, only advances of new funds are "loans" subject to the limits of § 563.93. OTS does not object to sale financings that do not involve an advance of funds nor place the lender in a more risky situation, provided the sale is not to the borrower who defaulted on a loan that resulted in the thrift owning the asset in question.

Use of Salvage Powers to Exceed Loans to One Borrower Limitations

It has long been the position of the OTS and its predecessor that a federal savings association has inherent or implied authority to take whatever steps may be necessary to salvage an investment, provided: (1) the steps taken are an integral part of a reasonable and bona fide salvage plan and (2) the steps taken do not contravene a specific legal prohibition. (The OTS does not consider the LTOB limitation to be a specific legal prohibition within the meaning of the salvage powers doctrine.) State-chartered savings associations have similar authority under state law. Traditionally, salvage powers have provided the legal justification for savings associations to hold, operate (if necessary), and invest additional funds (if necessary) in property acquired as a result of, or in lieu of, foreclosure prior to resale of that property.

General Policy

A savings association may use its salvage powers to exceed the LTOB limitation provided it is able to demonstrate that its excess investments are being made pursuant to a reasonable and bona fide salvage plan. Excess investments that are not made pursuant to such a plan are illegal and could trigger enforcement action by the OTS. The plan should be expressly approved by the board of directors.

The LTOB limitation is a critical safety and soundness standard that is intended to prevent savings associations from placing themselves at risk by concentrating too great a portion of their assets in any single borrower. Given the importance of this standard for the maintenance of safe and sound operations and the unique risks presented when a savings association exceeds this standard in the context of a salvage operation, the OTS will carefully review any use of salvage powers to exceed the LTOB limit.

The OTS encourages savings associations to notify regional OTS supervisory officials before engaging in any significant salvage operation. For the reasons explained above, the need to consult with regional supervisory officials is especially great when salvage powers will be used to exceed the LTOB limitation, since safety and soundness considerations will affect whether a proposed use of salvage powers is appropriate.

Accordingly, a savings association that intends to make a salvage powers investment in excess of its LTOB limitation should first contact the appropriate OTS regional director to ensure that the regional director does not object to the association's judgment that the proposed salvage plan is appropriate prior to exceeding the LTOB limitation. This advance notice should reduce the potential for misunderstanding between the savings association and OTS as to the

appropriateness of a significant salvage operation. (An association need not contact its regional director before making reasonable delinquent tax or insurance payments necessary to protect the association's security interest in the property. In such instances, an association should still document that such action is necessary and appropriate.)

Regional directors, in their review of the risks posed by proposed salvage plans, will take into consideration an institution's past history of salvage operations, the financial condition of the institution, and its ability to undertake the risks attendant to salvage operations. In general, regional directors will defer to an institution's judgment on the advisability of a specific salvage operation if the institution is well-managed and well-capitalized.

The level of scrutiny given to a salvage plan will also vary depending on the foreclosure status of the asset being salvaged, as explained below:

Assets acquired as a result of, or in lieu of, foreclosure

Once an asset has been acquired as a result of, or in lieu of, foreclosure, the LTOB limitation no longer applies directly to subsequent investments in that asset. In such situations, however, the OTS uses the LTOB limitation as a prudential standard to identify significant salvage operations that may require special scrutiny to ensure that they are being prudently conducted. This includes salvage operations on foreclosed assets held in the insured institution and those held in subsidiaries. (For purposes of measuring whether the LTOB limit has been exceeded, the OTS will aggregate all of a savings association's investments in the property in question regardless of whether those investments occurred before or after foreclosure.)

The OTS recognizes that the payment of certain operating expenses (such as taxes and insurance or expenses to prevent deterioration of the investment) may be prudent steps necessary to minimize the potential for loss pending the disposition of repossessed assets. Some capital expenditures, such as those necessary to put collateral property in final form for occupancy or sale, may also be prudent. However, the burden of demonstrating that capital expenditures are reasonable is greater than for operating expenditures, since capital expenditures are likely to be much more substantial.

When reviewing a proposed salvage plan, regional directors will, in addition to the factors identified above, consider whether the plan: (1) is necessary to enable the association to salvage its existing investment, (2) is necessary to protect the value of the foreclosed property (e.g., the additional investments will result in a more marketable property), (3) is in the best interest of the association, and (4) will reduce the risks associated with the foreclosed property.

Loans in the process of foreclosure

A loan will be deemed to be in the process of foreclosure if a savings association has begun the process necessary to foreclose or to take a deed in lieu of foreclosure and is actively pursuing that process, but has not yet acquired title to the property securing the loan.

Although regional directors will use the same standards outlined in the section above to review salvage plans that call for investments in excess of LTOB limits in loans in the process of foreclosure, they will also take account of the additional risks associated with investing funds in a property that has not yet been acquired by the association. Under these circumstances, a savings association should also demonstrate that the timing of its proposed investment (i.e., before foreclosure) is reasonable.

Troubled loans not in the process of foreclosure

Although a savings association may also use its salvage powers to invest funds in excess of its LTOB limits in a troubled loan that is not in the process of foreclosure, the burden of demonstrating that this type of salvage operation is prudent is high. Regional directors will assess whether a savings association has made a compelling showing that the standards outlined in the section titled "Assets acquired as a result of, or in lieu of, foreclosure" have been met and that the association's decision to delay or forego foreclosure is consistent with safe and sound operations.

Special Rules

A thrift may make loans to one borrower under one of two Special Rules. The first provides for loans for any purpose up to $500,000 as a minimum for the 15% and 10% general limits; the second provides for loans to develop domestic residential housing units, not to exceed the lesser of $30,000,000 or 30% of the thrift's LTOB capital and surplus. A third Special Rule in HOLA at 12 USC § 1464(u)(2)(B) is implemented by the regulation at the 15% general limit and applies to new funds advanced with the sale of REO as grouped with all other loans to the one borrower, and is of no advantage. Loans made under these Special Rules may not be made in addition to the general limit of 15% of LTOB capital and surplus.

Special Rule For Housing Development

"Residential housing unit" includes homes (including condominiums and cooperatives), combinations of homes and business property, real estate used for primarily residential purposes other than a home (but which may include homes), combinations of such real estate and business property involving only minor business use, farm residences and combinations of farm residences and commercial farm real estate, property to be improved by the construction of such structures, or leasehold interests in the above real estate.

In applying this definition, thrifts will also be required to apply the present regulatory definitions of terms included within the § 541.23 definition of "residential real estate," to include the definitions of "home" (§ 541.14), "combination of home and business property" (§ 541.3), "combination of residential real estate and business property involving only minor or incidental business use" (§ 541.4), and "single-family dwelling" (§ 541.25). The term "domestic," as used in this section, includes units located within the geographic area where OTS-regulated thrifts are chartered.

The rule defines the term "to develop" to include the various combinations of phases necessary to produce housing units as an end product. This includes: (1) acquisition, development, and construction; (2) development and construction; (3) construction; (4) rehabilitation; or (5) conversion. It is crucial that domestic residential housing units be the end product; the mere acquisition of real estate for holding or for later developing will not fulfill the purposes of this Special Rule.

Permanent financing of either individual units within a development or of a multi-unit complex is permissible under this Special Rule provided that the financing is related to any of the five combinations of construction phases.

For a thrift to avail itself of the residential housing unit Special Rule, the thrift must satisfy five prerequisites that are set forth in the statute and the regulation:

1. The purchase price (cash or cash equivalent) of each single-family dwelling unit, the development of which is financed under this Special Rule, may not exceed $500,000. This requirement is to apply literally to the actual final sales or purchase price.

2. The thrift must be, and continue to be, in compliance with the fully phased-in capital standards. The term "fully phased-in capital standards" is defined as the standards that will be in effect as of January 1, 1995, at the expiration of all phase-in requirements set forth in §§ 567.2, 567.5, and 567.9 of the regulations.

If the thrift falls out of compliance with this capital requirement it may no longer avail itself of this Special Rule until it again qualifies and, if eligible, submits a notice or, if ineligible for the notice procedure, applies for and receives a new order from the regional director. The OTS will permit thrifts to continue funding a legally binding loan commitment made under this Special Rule if the thrift should fall out of compliance with its fully phased-in capital requirement, provided such binding commitment to the borrower was made when the thrift was in compliance.

3. A thrift eligible under 12 CFR § 516.3 for using the notice procedure must submit the notice prior to using the higher limit and must have received a written approval (order) by the regional director. For a thrift that is not eligible under § 516.3 for the notice procedure, the thrift must submit an application to the regional director re-

questing approval to use the Special Rule for Housing Development. Following application by a thrift, the regional director, by order, must have permitted the thrift to use the higher limit.

Such an order does not constitute a "waiver" of the LTOB limits, but merely permission to use the Special Rule. Such order may contain additional requirements or set forth additional conditions or restrictions governing the exercise of this Special Rule. Moreover, the regional director has the right to rescind any such order, as well as the authority to generally impose more stringent restrictions on a thrift's loans to one borrower if it is determined that such restrictions are necessary to protect the safety and soundness of the thrift under the HOLA at 12 USC § 1464(u)(3).

4. All loans made under this Special Rule are limited in the aggregate to 150% of the thrift's LTOB capital and surplus. Neither loans made under the $500,000 Special Rule, nor loans made under the general limit fall within this 150% limit.

5. Loans made by a thrift under this Special Rule must comply with the loan-to-value requirements applicable to federal thrifts found in § 545.32(d).

Guidelines for Approval of Use of Special Rule For Housing Development

A regional director may provide a blanket approval for a thrift to use higher LTOB limits for lending to develop domestic residential housing upon determination that the higher limits pose no undue risk to the safety and soundness of the thrift.

Thrifts desiring the higher LTOB limits must either (1) file a notice with the regional director, if the thrift is eligible to use the notice procedure under § 516.3 or (2) apply to the regional director for approval. Notices and applications must include sufficient information to permit a thorough evaluation of the merits and risks of approving the higher LTOB limits.

Applications for approval of use of the special rule for housing development will be processed in accordance with Section 920 of the Application Processing Handbook, Lending Exceptions - Loans to One Borrower.

Expanded Transition Lending Authority

To qualify for this transition authority, an association must first meet its fully phased-in capital requirement; that is, the capital standards that will be in effect as of January 1, 1995. Second, an association must not be designated a problem association. The term "problem" as it is used here, is defined as any association that: (1) has a composite CAMEL rating of 4 or 5; (2) is undercapitalized under prompt corrective action standards; (3) is subject to a capital directive or cease and desist order, a consent order, or a formal written agreement, relating to the safety and soundness or financial viability of the association, unless OTS informs it otherwise; or (4) has been designated, by OTS, a problem association or one in troubled condition.

The rule provides that during the period beginning August 9, 1989 through December 31, 1990, qualifying thrifts' total loans and extensions of credit to one borrower could not exceed 60% of LTOB capital and surplus. During the period beginning January 1, 1991 through December 31, 1991, qualifying thrifts' loans and extensions of credit to one borrower could not exceed 30% of capital and surplus. After December 31, 1991, all loans and extensions of credit to one borrower by qualifying thrifts must be within the regular limits found in § 563.93(c)(1), (c)(2), and (d). Since August 9, 1989, all other thrifts that did not qualify to use the temporary transition authority must comply with the regular lending limits.

The expanded authority permits funding to continue on projects begun before FIRREA's enactment where disbursements were halted due to imposition of the new lending limits. This expanded authority gave qualifying thrifts more time to establish loan participation networks to serve the financing needs of major borrowers, thus fostering continuation of profitable relationships. If a thrift's post-transition lending limit will not be sufficient to accommodate major borrowers in the future, the thrift should actively seek competent lending partners during the transition period to be able to continue serving these borrowers with adequate funding under lower lending limits.

Qualifying thrifts may have used the expanded lending authority as soon as they provided the regional director with a certification form (OTS Form 1516 available from the regional office) indicating the thrift's intent to use the transition lending authority. This procedure was intended to provide the regional office staff with advance notice when the form is requested of a thrift's possible intent to use the expanded authority.

For safety and soundness reasons, the regional director may have restricted a thrift's right to use the expanded transition lending authority generally, or to restrict its use with respect to particular loans or extensions of credit. Regional directors may formally restrict lending or may disqualify a thrift by designating it a problem association.

This temporary transition authority applied to only two types of lending:

(1) new loans to develop domestic residential housing units where the final purchase price of each single-family dwelling unit, the development of which is financed under the transition authority, does not exceed $500,000; and

(2) loans to complete the development of residential and nonresidential projects that were incomplete as of FIRREA's enactment and where the qualifying thrift had advanced funds secured by real property under a loan or extension of credit prior to enactment. Qualifying thrifts must carefully consider whether providing funds to complete such pre-FIRREA projects is consistent with safe and sound practice and considered risk analysis.

The only loans permitted under this transition authority, whether new residential development loans or loans to complete a pre-FIRREA project, were those loans and extensions of credit that:

- are fully secured by a first lien on real estate per § 545.32(c);
- comply with the applicable loan-to-value requirements that apply to federal thrifts per § 545.32(d);
- provide that the borrower is personally liable for the full indebtedness arising from the loan or extension of credit; and
- receive prior approval of the qualifying thrift's board of directors.

To protect against a potential deficiency, the OTS required that the loan documents provide that the borrower is personally liable for the debt. This ensures that the thrift has full recourse against the borrower as well as the collateral.

The rule provided that the amount of a qualifying thrift's loans to all borrowers that exceeds 15% of LTOB capital and surplus shall not, in the aggregate, exceed 150% of LTOB capital and surplus during the period beginning January 1, 1991 through December 31, 1991.

This 150% aggregate limit is applied to the amount of loans to all borrowers that exceeds 15% of LTOB capital and surplus, including loans made under authority of the Special Rule for loans to develop domestic residential housing units. However, consistent with the exclusion of the "first" 15% from the aggregate limit, a qualifying thrift's loans made under the authority of the additional 10% lending limit for loans secured by readily marketable collateral under § 563.93(c)(2) will not be included in the 150% aggregate limit. Moreover, should a qualifying thrift use the $500,000 Special Rule (because the transition amount would be less), the $500,000 loans will also not fall within the aggregate limit.

Regulators are to carefully review expanded transition authority loans made to complete projects to ensure that all regulatory conditions are met, that such projects were clearly under way but incomplete as of enactment, and that limited funding to complete such projects is demonstrated to be economically prudent and consistent with safety and soundness. In monitoring compliance with this rule, regulators should closely scrutinize the lending practices of thrifts that have recently experienced an unusually rapid growth in assets or that have experienced a change in ownership or a change in officers or directors. Any abuse of the expanded transition lending authority should result in immediate enforcement action to prevent

recurrence and should address remuneration from directors for any resultant losses.

SUPERVISORY CONCERNS

Regulators are responsible for assessing how well management and the board of directors formulate, implement, and monitor policies that address concentrations, self dealing, anxiety for income, complacency, poor selection of risks, inexperience, and adequacy of controls. A major area of concern is the thrift's business philosophy, which should be stated in the mission statement of the business plan. Regulators should determine whether the practices and the current loan portfolio mix agree with the overall mission of the thrift. Where concentrations involve credit risk, additions to loss allowances or additional capital must be available to absorb possible losses.

In examining and supervising thrifts, regulators should determine whether:

- the institution is in compliance with laws and regulations;
- directors and management are adequately involved and not complacent;
- there is an adequate review process to monitor concentrations and loan quality;
- management and the directorate receive adequate and timely reports and require strict control procedures; and
- the thrift has adequately experienced staff in all lending areas.

Regulators should identify existing and potential problems and present solutions to obtain positive corrective action.

REFERENCES

United States Code (12 USC)

Chapter 2: National Banks

§ 84	Lending Limits

Chapter 3: Federal Reserve System

§ 371c	Banking Affiliates
§ 371c-1	Restrictions on Transactions with Affiliates
§ 375b	Loans to Insiders

Home Owners' Loan Act

§ 1464(c)	Investment Authority
§ 1464(u)	Limits on Loans to One Borrower
§ 1464 note	Transitional Rules
§ 1467a	Holding Companies
§ 1467a(m)	Qualified Thrift Lender Test
§ 1468	Transactions with Affiliates and Loans to Insiders

Federal Deposit Insurance Act

§ 1813	Definitions
§ 1831e	Activities of Thrifts

Code of Federal Regulations (12 CFR)

Chapter I: Comptroller of the Currency
Part 3: Minimum Capital (for National Banks)

§ 3.3	Transitional Rule (Intangible Assets)
§ 3.100	Capital and Surplus
§ 3.100 Appendix A, Section 2	Components of Capital

Part 32: Lending Limits (for National Banks)

§ 32.2(a)	Loans
§ 32.2(b)	Person
§ 32.2(d)	Commitment
§ 32.2(f)	Disqualified Loan Commitments
§ 32.5	Combining Loans
§ 32.6	Exceptions
§ 32.102	Federal Funds Sold
§ 32.108	Interest and Discount

Chapter III: Federal Deposit Insurance Corporation
Subchapter A: Procedures and Rules of Practice

§ 303.13	Applications by Thrifts

Chapter V: Office of Thrift Supervision
Subchapter C: Regulations for Federal Savings Associations

§ 541.3	Combination Home and Business
§ 541.4	Combination Residential and Business
§ 541.14	Home
§ 541.23	Residential Real Estate
§ 541.25	Single-Family Dwelling
§ 545.32	Real Estate Loans
§ 545.35	Other Real Estate Loans
§ 545.46	Commercial Loans
§ 545.74	Service Corporations
§ 545.75	Commercial Paper and Corporate Debt

Subchapter D: Regulations Applicable to All Savings Associations

§ 561.19	Financial Institutions
§ 563.41	Loans and Other Transactions with Affiliates and Subsidiaries
§ 563.43	Restrictions on Loans, Other Investments, and Real and Personal Property Transactions Involving Affiliated Persons
§ 563.93	Loans to One Borrower
§ 563.96	Bank Accounts, Fed Funds, Deposits
§ 563.170(c)	Records
§ 567	Capital Requirements
§ 571.12	Application Processing Guidelines
§ 571.13	Participation Interests in Pools of Loans
§ 584.6	Qualified Thrift Lender Test

Office of Thrift Supervision Resolutions on LTOB Rules

90-498 Federal Register Vol.55, No.59 page 11294
90-1266 Federal Register Vol.55, No.132 page 28144

Loan Portfolio Diversification Program

Examination Objectives

To determine if the established policies, procedures, and controls regarding loan portfolio diversification adequately ensure safety and soundness, profitability, and compliance with laws and regulations.

To determine if the officers and employees of the thrift are aware of the policies and are conforming to them.

To determine the loan portfolio mix and assess the effects on credit risk.

To evaluate management's awareness of potential strengths and problem areas of the loan portfolio mix.

To assess risk reduction efforts and surrounding factors where concentrations exist.

Examination Procedures

Level I

Wkp. Ref.

1. Review scoping materials applicable to loan portfolio diversification, and if other examiners reviewed items concerning this program, obtain a written or oral summary of their findings. Scoping materials include: reports from the examiner performing the lending risk assessment; the National Financial Monitoring System; the continuing examination file (CEF), if applicable; the supervisory correspondence file; the prior examination report; and the preliminary examination response kit (PERK). It may be helpful to complete Questionnaire 211, Loan Portfolio Diversification.

_____ _____

2. Obtain and review written policies, procedures, strategic plans, and board of directors' minutes or work papers derived from these sources. From these sources, record management's goals and objectives on loan portfolio diversification (see Program 210, Lending Risk Assessment):

   - Determine whether the lending policy addresses avoidance of or otherwise covers specific concentrations of credit.
   - Determine if the goals and objectives concerning the mix of the loan portfolio are quantified.

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Wkp. Ref.

- Ascertain whether the quantified goals and objectives constitute a change in management's direction from the previous examination.
- Note who has authority to determine mix.
- Verify that guidelines and procedures on minimizing credit risk through diversification are disclosed to lending personnel.
- Determine how compliance with policy is ensured and monitored.

3. Review the preceding report of examination and all loan portfolio diversification-related exceptions noted and determine if management has taken appropriate corrective action.

4. Economic conditions: Evaluate procedures for monitoring local, regional, national, and international economic conditions as appropriate for the thrift.

5. Review regulatory limits and loans-to-one-borrower work papers and the asset-limitations work paper from the PERK and comment on violations of thrift goals as well as of state and federal regulations.

6. Through the review of gathered information, observations, and discussions with management and other personnel, determine:

   - The adequacy of established policies, procedures and strategic plans for addressing safety and soundness, including internal controls, profitability, and compliance with laws and regulations;
   - The level of compliance with policies, procedures and strategic plans;
   - Management's competence to carry out duties and responsibilities in a manner that provides for profitability, safe and sound operations, and compliance with laws and regulations;

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- The adequacy of management reports and information systems to provide management and directors with accurate decision-making information and the ability to monitor compliance with internal guidelines and regulatory investment limits and limits on loans to one borrower;
- The level of compliance with laws and regulations;
- The existence, cause, and extent of any factors that threaten or enhance future viability of the thrift; and
- Corrective action to be recommended or required.

7. Complete the General Questionnaire.

8. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

Level II

9. List all significant concentrations of credit, with dollar amounts and percentages of total assets or of capital and allowances as applicable. This should include totals on participations purchased from each source. The analysis will disclose the composition of the loan portfolio as of a recent convenient date. Significant changes and trends in the composition on a comparable date should be noted with management's comments as to why significant changes occurred.

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

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Loan Portfolio Diversification Program

Wkp. Ref.

Examiner's Summary, Recommendations, and Comments

Exam Date: _____
Prepared By: _____
Reviewed By: _____
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Loan Portfolio Diversification Questionnaire

General Questionnaire

	Yes	No
1. Has the institution established written goals and objectives for diversifying the loan portfolio?		
2. Has a strategy for diversifying loans been written?		
3. What management reports are used to monitor various concentrations of credit? List reports.		
4. Are these same reports given to the board of directors?		
5. If the institution does not have a written policy on loan portfolio diversification, ask management to elaborate upon the following:		
• The percentage of loans to assets that the institution strives to maintain.		
• The composition of the loan portfolio.		
• The geographic areas in which loans are originated or purchased.		
• The various concentrations that have been identified.		
• Do these concentrations expose the institution to more than acceptable risk? (with explanation)		
• What efforts have been taken to reduce risky concentrations and/or minimize the risk they present?		
6. What areas of the loan portfolio mix does the institution anticipate changing in the next 12 to 24 months? State in dollar and percentages.		
7. Does management anticipate introducing a new loan product within the next 12 to 24 months?		
8. Does management anticipate originating or purchasing loans from any new geographic locations?		
9. What means does the institution use to monitor the economic conditions of territories outside their lending area?		
10. List the sources from which loans are purchased.		
11. Describe any risk reduction efforts and factors besides diversification that the institution has implemented to limit risk from concentrations.		

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Loan Portfolio Diversification Questionnaire

Comments

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LOANS TO ONE BORROWER LENDING LIMITS WORKSHEET

This worksheet is intended to assist regulators in computing LTOB capital and surplus and the various loans to one borrower lending limits. Use consolidated figures per OCC and FFIEC bank call report instructions as of date of commitment and date of funding. Refer to 12 CFR §§ 3.3, 3.100 and 3. Appendix A, Section 2, and OCC Handbook for National Bank Examiners pages 220.1 and 220.2.

Source of Data: Date:

(1)	Common Stock	$ _____	
(2)	Perpetual Preferred Stock	_____	
(3)	Capital Surplus	_____	
(4)	Undivided Profits	_____	
(5)	Reserves for Contingencies and Other Capital Reserves (Excluding Accrued Dividends on Perpetual and Limited Life Preferred Stock)	_____	
(6)	FSLIC & FDIC Net Worth Certificates	_____	
(7)	Minority Interests in Consolidated Subsidiaries	_____	
(8)	Allowances for Loan and Lease Losses	_____	
(9)	MINUS Intangible Assets	(_____)	
(10)	Subtotal [SUM OF (1) through (9)] [12 CFR ¤3.100(a) and (c)(1)]	_____	(10)
(11)	Purchased Mortgage Servicing Rights [lesser of FMV or GAAP amortized cost]	_____	(11)
(12)	Subtotal [SUM OF (10) and (11)] [12 CFR ¤3.100(a), (c)(1) and (2)] _____	(12)	
(13)	20% of (12)	_____	
(14)	Mandatory Convertible Debt	_____	
(15)	Lesser of (13) or (14)	_____	(15)
(16)	Subtotal [SUM OF (12) and (15)] [12 CFR ¤ 3.100(c)(3)]	_____	(16)
(17)	50% of (16)	_____	
(18)	Mandatory Convertible Debt Not Included in (15) Above,	_____	
	Limited Life Preferred Stock,	_____	
	Subordinated Notes and Debentures	_____	
	Subtotal	_____	

(19)	Lesser of (17) or (18) [12 CFR 3.100 (c)(4)]		_____	(19)
(20)	25% of (10)	_____		
(21)	Intangible Assets (Other Than Purchased Mortgage Servicing Rights) Purchased Prior to April 15, 1985, and Accounted for In Accordance with OCC requirements (amortization in 15 years or less)	_____		
(22)	Lesser of (20) or (21) [12 CFR 3.100(g)(2)]		_____	(22)
(23)	[SUM OF (16), (19), and (22)]			
		Total LTOB Capital and Surplus	_____	
(23)				
(24)	15% of (23)	_____		
(25)	$500,000	_____		
(26)	[greater of (24) or (25)]	**General Lending Limit**	_____	
(27)	[10% OF (23)] (see note below)	**Additional Secured Lending Limit with Readily Marketable Collateral**	_____	
(28)	[Same as 27] (see note below)	**Additional Secured For Rated Commercial Paper & Securities**	_____	
(29)	30% of (23)	**Transitional 12-31-91 Limit**	_____	
(30)	$30,000,000			
(31)	[lesser of (29) or (30)]	**If Approved, Limit for Loans to Develop Domestic Residential Housing Units** _____		
(32)	60% of (23)	**Transitional 12-31-90 Limit**	_____	

Reconcile differences between thrift reporting and bank reporting used in this calculation, if any.

Note: The additional 10% for items #27 and #28 is not allowable if item #25 is greater than item #24 [12 CFR 563.93(d)(1)].

SUMMARY OF OCC ACCOUNTING GUIDANCE

Qualified Intangible Assets For Inclusion in Capital

Intangible assets (other than qualified purchased mortgage servicing rights (PMSR) already included in primary capital) are qualified under a transition rule in 12 CFR ¤ 3.3 for inclusion in capital and surplus provided they were purchased prior to April 15, 1985 and are accounted for in accordance with instructions of the OCC. The maximum inclusion of qualified intangibles is equal to 25% of those items listed in 12 CFR ¤ 3.100(a) and (c)(1) [line 10 on Appendix A of this Handbook section.] This inclusion is done after Primary and Secondary Capital have been calculated per instructions from the OCC's Bank Accounting Unit.

OCC accounting instructions for intangibles require that purchased intangibles must be recorded according to GAAP and amortized over their useful life, not to exceed 15 years.

An accelerated method should be used when the asset's value is based upon declining earning amounts, such as for core deposit intangibles and PMSR.

Core deposit intangibles and organizational costs cannot be amortized over periods exceeding 10 years and five years, respectively.

Organizational costs should be amortized using the straight-line method. Straight-line amortization should be used for all other intangibles and may be used when it does not differ materially from a GAAP-required accelerated method.

Cumulative amortization should never be less than that determined by using a straight-line method.

Source: *Comptroller's Handbook for National Bank Examiners*, pages 220.1 and 220.2, March 1990.

INTRODUCTION

Mortgage lending provides funds for the acquisition or holding of residential and commercial real estate and has long been a traditional activity of the thrift industry. Loans are generally long-term in nature and are secured by the real property. Institutions engage in real estate mortgage lending to promote home ownership and to foster economic development in their market area, thereby providing a source of low-risk investment for the institution. In addition, institutions are increasingly looking to the origination and sale of mortgage loans in the secondary market as an alternative to portfolio lending in order to reduce the interest-rate risk associated with funding long-term assets with short-term liabilities and to generate fee income from servicing loans that have been sold. These activities represent unique risks and are addressed in the Mortgage Banking sections of the Thrift Activities Regulatory Handbook.

Types of Real Estate Lending

Historically, savings associations have concentrated their lending activities on the financing of residential real estate, typically single-family residences, and multifamily apartment units. More recently, associations have become active in a wider range of real estate lending, including the financing of commercial and other nonresidential real estate.

Residential mortgage lending typically involves the construction, purchase, or refinancing of single-family or multifamily real estate. Commercial real estate lending, often referred to as income property lending, typically involves the construction, purchase or refinancing of commercial retail, industrial, and other nonresidential properties to be used in a business operation or held for investment. Because multifamily residential properties are operated as businesses, they are also considered by some to be commercial real estate.

This Handbook Section discusses the general characteristics and risks involved in the permanent financing of residential and income property real estate. Construction lending is more fully discussed in Handbook Section 213.

Real Estate Lending Standards Rule

In an effort to curtail abusive real estate lending practices and reduce risks to the depository insurance funds and enhance the safety and soundness of insured depository institutions, Congress passed the Federal Deposit Insurance Corporation Improvement Act of 1991. Section 304 of the Act requires each federal banking agency (the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Office of Thrift Supervision [the agencies]) to adopt uniform regulations prescribing standards for extensions of credit secured by liens on or interests in real estate or made for the purpose of financing the construction of a building or other improvements to real estate, regardless of whether a lien has been taken on the property.

In establishing these standards, the agencies had to consider: (1) the risk posed to the depository insurance fund by such extensions of credit; (2) the need for safe and sound operation of depository institutions; and (3) the availability of credit.

On December 31, 1992, the agencies adopted a final rule prescribing real estate lending standards that requires each insured depository institution to adopt and maintain written internal real estate lending policies that are consistent with safe and sound banking practices and appropriate to the size of the institution and the nature and scope of its operations.

The policies must establish:

- Loan portfolio diversification standards;

- Prudent underwriting standards, including loan-to-value (LTV) ratio limits that are clear and measurable;
- Loan administration procedures for the institution's real estate portfolio; and
- Documentation, approval, and reporting requirements to monitor compliance with the institution's real estate lending practices.

The institution's written real estate lending policies must be reviewed and approved by the institution's board of directors at least annually. Further, each institution is expected to monitor conditions in its real estate market to ensure that its lending policies continue to be appropriate for current market conditions. Finally, the rule establishes that the lending policies established by the institution should reflect consideration of the Interagency Guidelines for Real Estate Lending Policies adopted by the agencies in conjunction with the final rule.

The final Real Estate Lending Standards rules of the four banking agencies were published in the Federal Register on December 31, 1992 and became effective on March 19, 1993. The rule applicable to savings associations, together with the Interagency Guidelines, are contained in 12 CFR 563.100-101. Also, several regulations under 12 CFR 545.32, that established regulatory LTV ratio and term limitations, were amended or rescinded with the issuance of the new rule. Such limits will now be established by each association's board of directors and should be embodied in its real estate lending policies.

During examinations, regulators should determine if associations have adopted adequate written internal real estate lending policies in conformity with 12 CFR 563.100-101 and that their lending staff are adhering to those policies. It should be noted that the underwriting guidelines and LTV ratio limitations established by the Interagency Guidelines are guidelines, not absolute requirements.

The interagency real estate lending guidelines discuss the need for each institution to have comprehensive and consistent lending policies that have been approved by the board of directors. The guidelines cover several important aspects of lending policies: (1) loan portfolio management, (2) underwriting standards, (3) loan administration, (4) supervisory LTV ratio limits, and (5) the treatment of loans in excess of the supervisory LTV limits and exceptions to the general lending policy.

"Loan Portfolio Management" stresses the need for an institution's real estate lending policies to contain an outline of the scope and distribution of the institution's credit facilities and the manner in which real estate loans are made, serviced and collected, and lists several particular items that should be addressed.

"Underwriting Standards" lists several relevant factors that prudent underwriting should address, such as the capacity of the borrower, or income from the property to service the debt, and the overall creditworthiness of the borrower.

"Loan Administration" lists loan administration procedures that the institution's loan policies should address, such as documentation standards, collateral administration, and loan extensions and modification.

"Supervisory Loan-to-Value Limits" states that institutions should establish their own individual LTV ratio limits that should not exceed the following supervisory limits:

Loan Category	Percent
Raw land	65
Land development	75
Construction:	
Commercial, multifamily,(1) and other nonresidential	80
Improved Property	85
Owner-occupied one- to four-family and home equity	(2)

(1) Multifamily construction includes condominiums and cooperatives.

(2) A loan-to-value limit has not been established for permanent mortgage loans on owner-occupied, one- to four-family residential property. However, for any such loan with a loan-to-value ratio that

equals or exceeds 90% at origination, an institution should require appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral.

"Loans in Excess of the Supervisory Loan-to-Value Limits" discusses when loans in excess of the supervisory LTV limits may be appropriate and establishes guidelines to limit such loans based on the institution's capital.

Regarding the supervisory LTV ratio limitations, for example, an association may determine that it is appropriate to make certain loans in excess of the supervisory limits. These loans will not automatically be subject to criticism, however, as long as the loans have other credit strengths that outweigh the additional risks inherent in the granting of a loan with minimal borrower equity. Conversely, some loans with LTV ratios at or below the supervisory LTV ratio limits may be subject to criticism for other reasons, such as a loan to a borrower with an unstable financial position, or a loan on a property with inadequate debt service coverage (when the repayment of the loan is dependent on income from the security property), or loans with other unacceptable risks. In essence, associations cannot ignore the higher risks presented with high LTV loans and they cannot over emphasize LTV ratios. They must take into consideration all credit factors when underwriting a real estate loan.

See Appendix A to this Section for answers to the many commonly asked questions about the Real Estate Lending Standards and Guidelines.

Income-Producing Property Lending

There are many types of income-producing properties, including commercial retail and industrial properties, churches, hotels, and multifamily residential properties. Each of these assets present different qualities and risks for a lender. In general, commercial real estate loans have a shorter term than residential real estate loans and, consequently, carry less interest-rate risk than fixed-rate, single-family mortgage loans. According to Office of Thrift Supervision (OTS) net charge-off data, however, nonresidential real estate loans experienced approximately six times the level of net charge-offs as one- to four-family mortgage loans in 1992, and multifamily residential mortgage loans experienced approximately three times the net charge-offs of one- to four-family mortgage loans. Savings associations should be aware of the additional risks of commercial real estate lending.

Nevertheless, commercial real estate lending is necessary for the economic health and development of our communities. If commercial real estate loans are prudently underwritten and the lender properly manages the risks, such loans can be both safe and profitable.

On November 7, 1991, the agencies issued general guidelines on commercial real estate lending. Included in the issuance were discussions of the evaluation and classification of problem commercial real estate loans. The policy statement emphasizes that the evaluation of real estate loans is not based solely on the value of the collateral, but on a review of the borrower's willingness and capacity to repay and on the income-producing capacity of the properties.

The policy statement also provides guidance on how regulatory personnel should analyze the value of collateral. In general, regulators should consider the institution's appraisals of collateral (or internal evaluations, when applicable) to determine value and review the major facts, assumptions, and approaches used in determining the value of the collateral. Regulators need to avoid challenges to underlying assumptions that differ in only a limited way from assumptions that would normally be used for the property under review. Nonetheless, when reviewing the value of the collateral and any related management adjustments, regulators should ascertain that the value is based on assumptions that are both prudent and realistic, and not on overly optimistic or overly pessimistic assumptions.

The policy statement covers a wide range of specific topics, including:

- The general principles that regulators should follow in reviewing commercial real estate loan portfolios;
- The indicators of troubled real estate markets, projects, and related indebtedness;

- The factors regulators should consider in their review of individual loans, including the use of appraisals and the determination of collateral value;
- A discussion of approaches to valuing real estate, especially in troubled markets;
- The classification guidelines followed by the agencies, including the treatment of guarantees; and
- The factors considered in the evaluation of an institution's allowance for loan and lease losses.

The policy statement is intended to ensure that all supervisory personnel, lending institutions, and other interested parties have a clear understanding of the agencies' policies regarding commercial real estate lending. Regulators should review the policy statement before commencing an examination of an institution with a significant level of commercial real estate loans.

Regulatory Review of Commercial Real Estate Loans

Loan Policy and Administration Review

As part of the analysis of an institution's commercial real estate loan portfolio, regulators should review lending policies, loan administration procedures, and credit risk control procedures. The maintenance of prudent written lending policies, effective internal systems and controls, and thorough loan documentation are essential to the institution's management of the lending function.

The policies governing an association's real estate lending activities must include prudent underwriting standards that are periodically reviewed by the board of directors and clearly communicated to the institution's management and lending staff. The association must also have credit risk control procedures that include, for example, prudent internal limits on exposure, an effective credit review and classification process, and a methodology for ensuring that the allowance for loan and lease losses is maintained at an adequate level. The complexity and scope of these policies and procedures should be appropriate to the size of the institution and the nature of the association's activities, and should be consistent with prudent banking practices and relevant regulatory requirements.

Indicators of Troubled Real Estate Markets and Projects, and Related Indebtedness.

In order to evaluate the collectibility of an institution's commercial real estate loan portfolio, regulators should be alert for indicators of weakness in the real estate markets served by the institution. They should also be alert for indicators of actual or potential problems in the individual commercial real estate projects or transactions financed by the institution.

Available indicators, such as permits for, and the value of, new construction, absorption rates, employment trends, and vacancy rates, are useful in evaluating the condition of commercial real estate markets. Weaknesses disclosed by these types of statistics may indicate that a real estate market is experiencing difficulties that may result in cash flow problems for individual real estate projects, declining real estate values, and ultimately, in troubled commercial real estate loans.

Indicators of potential or actual difficulties in commercial real estate projects may include:

- An excess of similar projects under construction.
- Construction delays or other unplanned adverse events resulting in cost overruns that may require renegotiation of loan terms.
- Lack of a sound feasibility study or analysis that reflects current and reasonably anticipated market conditions.
- Changes in concept or plan (for example, a condominium project converted to an apartment project because of unfavorable market conditions).
- Rent concessions or sales discounts resulting in cash flow below the level projected in the original feasibility study or appraisal.

- Concessions on finishing tenant space, moving expenses, and lease buy-outs.
- Slow leasing or lack of sustained sales activity and increasing sales cancellations that may reduce the project's income potential, resulting in protracted repayment or default on the loan.
- Delinquent lease payments from major tenants.
- Land values that assume future rezoning.
- Tax arrearages.

As the problems associated with a commercial real estate project become more pronounced, problems with the related indebtedness may also rise. Such problems include diminished cash flow to service the debt and delinquent interest and principal payments.

While some commercial real estate loans become troubled because of a general downturn in the market, others become troubled because they were originated on an unsound basis. Common examples of these types of problems include:

- Loans with no or minimal borrower equity.
- Loans on speculative undeveloped property where the borrowers' only source of repayment is the sale of the property.
- Loans based on loan values that have been driven up by rapid turnover of ownership, but without any corresponding improvements to the property or supportable income projections to justify an increase in value.
- Additional advances to service an existing loan that lacks credible support for full repayment from reliable sources.
- Loans to borrowers with no development plans or noncurrent development plans.
- Loans on special use properties for which there is little or no demand.
- Loans made with inadequate regard for the debt load and paying capacity of the borrower.
- Unsound loans to affiliated persons or their interests.
- Renewals, extensions, and refinancings that lack credible support for full repayment from reliable sources and that do not have a reasonable repayment schedule.

Regulator Review of Individual Loans, Including the Analysis of Collateral Value.

The focus of an examiner's review of a commercial real estate loan, including binding commitments, is the ability of the loan to be repaid. The principal factors that bear on this analysis are the income-producing potential of the underlying collateral and the borrower's willingness and capacity to repay under the existing loan terms from the borrower's other resources, if necessary. In evaluating the overall risk associated with a commercial real estate loan, regulators should consider a number of factors, including the character, overall financial condition and resources, and payment record of the borrower; the prospects for support from any financially responsible guarantors; and the nature and degree of protection provided by the cash flow and value of the underlying collateral. However, as other sources of repayment for a troubled commercial real estate loan become inadequate over time, the importance of the collateral value in the analysis of the loan necessarily increases.

The appraisal regulations of the federal bank and thrift regulatory agencies require institutions to obtain appraisals when certain criteria are met. Management is responsible for reviewing each appraisal's assumptions and conclusions for reasonableness. Appraisal assumptions should not be based solely on current market conditions that ignore the stabilized income-producing capacity of the property. Management should adjust any assumptions used by an appraiser in determining value that are overly optimistic or pessimistic.

A regulator should analyze the collateral value as determined by the institution's most recent appraisals (or internal evaluation, as applicable). A regulator reviews the major facts, assumptions, and approaches used by the appraiser (including any comments made by management on the value rendered by the appraiser). Under the circumstances described below, the regulator may make adjustments to this assessment of value. This review and any resulting adjustments to value are

solely for purposes of a regulator's analysis and classification of a credit and do not involve actual adjustments to an appraisal.

A discounted cash flow analysis is an appropriate method for estimating the value of income-producing real estate collateral. This analysis should not be based solely on the current performance of the collateral or similar properties; rather, it should take into account, on a discounted basis, the ability of the real estate to generate income over time based upon reasonable and supportable assumptions.

Stabilized income generally is defined as the yearly net operating income produced by the property at normal occupancy and rental rates; it may be adjusted upward or downward for actual current market conditions.

The real estate appraisal regulation of the federal bank and thrift regulatory agencies include a requirement that an appraisal: (1) follow a reasonable valuation method that addresses the direct sales comparison, income, and cost approaches to market value; (2) reconcile these approaches; and (3) explain the elimination of each approach not used. A discounted cash flow analysis is recognized as a valuation method for the income approach.

When reviewing the reasonableness of the facts and assumptions associated with the value of the collateral, regulators should evaluate:

- Current and projected vacancy and absorption rates;
- Lease renewal trends and anticipated rents;
- Volume and trends in past due leases;
- Effective rental rates or sale prices (taking into account all concessions);
- Net operating income of the property as compared with budget projections; and
- Discount rates and direct capitalization ("cap") rates.

The capacity of a property to generate cash flow to service a loan is evaluated based upon rents (or sales), expenses, and rates of occupancy that are reasonably estimated to be achieved over time. The determination of the level of stabilized occupancy and rental rates should be based upon an analysis of current and reasonably expected market conditions, taking into consideration historical levels when appropriate. The analysis of collateral values should not be based upon a simple projection of current levels of net operating income if markets are depressed or reflect speculative pressures but can be expected over a reasonable period of time to return to normal (stabilized) conditions. Judgment is involved in determining the time that it will take for a property to achieve stabilized occupancy and rental rates.

Regulators should not make adjustments to appraisal assumptions for credit analysis purposes based on worst-case scenarios that are unlikely to occur. For example, a regulator should not necessarily assume that a building will become vacant just because an existing tenant who is renting at a rate above today's market rate may vacate the property when the current lease expires. On the other hand, an adjustment to value may be appropriate for credit analysis purposes when the valuation assumes renewal at the above-market rate, unless that rate is a reasonable estimate of the expected market rate at the time of renewal.

When estimating the value of incoming-producing real estate, discount rates and "cap" rates should reflect reasonable expectations about the rate of return that investors require under normal, orderly, and sustainable market conditions. Exaggerated, imprudent, or unsustainably high or low discount rates, "cap" rates, and income projections should not be used. Direct capitalization of nonstabilized income flows should also not be used.

Assumptions, when recently made by qualified appraisers (and, as appropriate, by institution management) and when consistent with the discussion above, should be given a reasonable amount of deference. Regulators should not challenge the underlying assumptions, including discount rates and "cap" rates used in appraisals, that differ only in a limited way from norms that would generally be associated with the property under review. The estimated value of the underlying collateral may be adjusted for credit analysis

purposes when the regulator can establish that any underlying facts or assumptions are inappropriate and can support alternative assumptions.

It is also important to recognize that commercial properties represent a wide variety of unique and specialized uses that may represent increased risk to the lending institution, particularly if the institution is forced to look to the sale of the property to satisfy the debt. The holding costs associated with the extended marketing time to sell specialized property, the cost to convert the property to wider uses with greater market demand, and a selling value that may or may not be the same as its appraised value are all unique risks associated with lending on highly specialized properties.

As a result of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), loans on the security of liens on nonresidential real property are subject to limitations of 400% of a federal association's capital. This limitation also applies to state-chartered associations. This change in the limitation does not require the divestiture of any loan that was lawful when made.

One- to Four-Family Residential Lending

Among the safest loans in an association's portfolio are loans to individuals secured by their personal residences. As stated earlier in this section, loan loss rates for one- to four-family permanent loans are much lower than the loss rates for any other loans. Such loans often present less credit risk than commercial and multifamily real estate loans because the risk of default is spread over many small loans rather than a few large loans and because most institutions use standard underwriting criteria for such loans.

Single-family mortgage loans do entail risks - interest-rate risk, default risk, and the risk that properties in a community may experience price declines. These risks can be managed, however, through the establishment and adherence to sound underwriting procedures.

Just as for commercial real estate lending, savings associations must ensure that the borrower maintains sufficient equity in the property and has stabilized and sufficient income to make payments. Also, associations should have established procedures to verify borrower provided information (such as sending out verification of deposit [VOD] letters and verification of income [VOI] letters).

The adoption by the board of directors and implementation by management of a sound real estate loan policy is the best means by which an institution can build and maintain a sound mortgage loan portfolio. If properly formulated, communicated to all lending personnel, and monitored, it serves to guide, direct, and control the decisions of lending officers consistent with the directorate's responsibility and objective of granting loans on a sound and collectible basis. Because each institution is unique, there is no single policy that can best serve all institutions; rather, each institution needs to tailor its policy and procedures to its own specific needs and characteristics. Nevertheless, there are common elements that are found in sound lending policies. These are discussed in Thrift Activities Regulatory Handbook Section 210, Lending Risk Assessment.

It should be noted that the Chief Counsel previously opined that two particular types of securities upon which federal associations may lend include the security of a first lien on a leasehold estate of qualifying term, where such estate is limited to a leasehold interest in an apartment, and secondly, loans secured by a mobile home park.

An institution's real estate lending policy and procedures should include an appraisal program. (For a discussion of appraisal requirements, refer to Thrift Activities Regulatory Handbook, Section 208, Real Estate Appraisal.)

It is important that an institution's real estate loan policy and procedures be augmented by a strong system of internal controls. These controls should emphasize segregation of duties, where appropriate, and provide for the timely receipt, review (both initially and ongoing, as needed), and follow-up of all necessary mortgage loan documentation. Additionally, in order to monitor the credit quality of the portfolio and the loan officer's compliance to or conformity with loan policy and procedures, a system of internal loan

review should be implemented. The objectives and elements that compose effective internal loan review systems are contained in the Thrift Activities Regulatory Handbook Section 210, Lending Risk Assessment.

The degree of risk inherent in a real estate mortgage loan depends on the borrower's ability and willingness to repay the loan, the loan amount in relation to the present and future value of the real property over the anticipated life of the loan, and the rate of interest. The institution's real estate loan policy should ensure that loans are granted based on the borrower's ability to properly service the debt.

There have been instances when institutions have made real estate loans based on the purchase price of real estate where the purchase price has included settlement and loan closing charges. While this practice is not inherently unsafe or unsound, it does have potential risks. There could be cause for concern if there are large discrepancies between the appraised value and the purchase price of the property.

Institutions have also made real estate loans based on the purchase price of a condominium or cooperative unit, net of a discount to an existing tenant. This discount is applied as a credit toward the down payment to assist tenants who may otherwise be displaced as a result of a condominium or cooperative conversion. This benefits both the tenant who is unable to make the required down payment and the developer who wishes to avoid displacing tenants.

Artificially inflating the cost of a condominium or cooperative unit so that an amount may be deducted as a discount, however, is not a true discount and is not permissible. Regulators should, therefore, carefully review records on this type of loan to ensure that the loan is not based on an inflated appraisal.

Adjustable-Rate Mortgage Loans

The use of adjustable-rate mortgage (ARM) loans by savings associations can be traced to the early 1980s, when the savings and loan industry was under significant interest-rate pressure. Unlike the conventional fixed-rate mortgage, whose interest rate usually holds constant over the life of the loan, the interest rate associated with an ARM is based on the movement of a predetermined index. The rate is usually set as the function of the predetermined index plus an incremental amount established at the initiation of the loan. This incremental amount is commonly referred to as the gross margin. The combination of the index rate and the gross margin are referred to as the fully indexed rate. Depending on the type of index the ARM is based on, the interest accrual rate can change monthly (11th District Cost Of Funds Index [COFI]) or annually (Constant Maturity Treasury Index [CMTI]). Some ARMs are structured such that there are limits on the amount of the increases and decreases in the interest accrual rate as the result of changes in the underlying rate index. The borrower's monthly payment amount is recalculated at predetermined dates to assure full amortization of the loan over its remaining life at the current fully indexed interest rate. This date is referred to as the payment-adjustment date. Some ARMs are structured such that there are limits on the amount of the increases and decreases in the borrower's monthly payment amount as the result of the required payment adjustment.

Teaser Rates-One feature commonly associated with the ARM product (fixed-rate products also) is the "teaser" or low introductory interest rate. This includes situations where borrowers receive a short-term subsidy or "buy down" of the loan rate from the seller. Teaser rates are used to attract borrowers to do business with the lender (or seller) versus the competition. Teaser rates reduce the initial interest accrual and monthly payment during the period that the teaser is in effect, usually 3 to 12 months. At the expiration of the teaser-rate term, the borrower's monthly interest accrual is calculated at the fully indexed rate, as defined above. Because of the competitive nature of the home mortgage industry, some associations offer borrowers "deep" teaser rates. These rates are significantly lower than the fully indexed rate. Using the deep teaser to qualify a borrower will cause some borrowers to qualify for loans that they would not have qualified for under normal circumstances, under the assumption that their ability to pay will increase with time. The OTS does not support this assumption and is concerned about the potential for increased credit risk, par-

ticularly when the LTV ratio exceeds 80%. The qualification of borrowers at below-market rates is considered an unsafe and unsound practice. Associations should generally qualify borrowers at the fully indexed mortgage rate as of the date of commitment. An exception to this policy is when a thrift institution engages in a program of immediately selling such loans, without recourse, to non-thrift third parties, thereby removing the credit risk from its own portfolio.

Interest Rate Buydowns-Similar to the use of teaser or low introductory rates to attract borrowers to conduct business with savings associations, a home builder or some other third party may use a buydown program as an incentive to potential home buyers to purchase their particular property.

In such an arrangement, a home builder or other third party pays the lender at closing a sum sufficient to cover a portion of the interest payments due from the borrower during the initial years of the loan term. Although there is no formal agreement between the home builder and the lender, the arrangement is reflected in a written agreement between the borrower and the lender, whereby the lender agrees to accept from the borrower monthly payments based on the 'bought-down' interest rate for the initial adjustment period of the loan.

OTS regulations place no restrictions on such arrangements. The adjustable mortgage provisions of 12 CFR § 545.33 do not set limitations on periodic and lifetime interest-rate adjustments. Thus, association management has the flexibility to develop buydown programs provided they are underwritten and structured in a safe and sound manner.

Accounting Treatment-Where the buydown payment is in the form of a single, lump sum representing a portion of the interest due during the buydown period, the payment shall be included with other deferred fees and loan costs to determine the net deferred fees for the loan. Such net deferred fees should be amortized over the life of the loan using the interest (level yield) method pursuant to SFAS No. 91.

It should be noted that the accounting requirement described above is not limited to buydown payments on adjustment mortgage loans. Such accounting would be required for any type of loan, whether fixed-rate or adjustable-rate, in connection with which a buydown payment is made.

Appraisals-The existence of a buydown arrangement must be taken into consideration in arriving at an appraisal of the property. If the amount of the buydown is reflected through an increase in the property's sale price to a level higher than on an identical property in the local market on which no buydown is offered, then the appraisal should reflect this fact.

Negative Amortization-One unique feature of some ARMs is the ability for them to negatively amortize. Unlike the conventional fixed-rate mortgage, where the interest accrual rate and annual payment are held constant over the life of the loan, and a portion of each monthly payment reduces the outstanding principal balance of the loan, some ARMs are structured such that the outstanding principal balance can increase, even though the borrower's monthly payments are current. There are two scenarios where this can happen: (1) when, because of increases in the interest accrual rate, the monthly payment is insufficient to cover the interest expense; and (2) when, because of payment-adjustment limitations at the payment-adjustment date, the adjusted payment is insufficient to cover the interest expense at the current interest rate required to amortize the loan balance over the remaining life of the loan.

Pricing of ARMs

The pricing of products and services offered by savings associations must foster a safe and sound thrift industry. Pricing should be competitive and free from collusion by market participants. At a minimum, however, the pricing of mortgage loans should provide sufficient yield to cover the operating expenses, funding costs, and risk premium attendant to the extension of credit. The pricing of mortgage loans at a rate or on terms that do not provide a reasonable expectation of avoiding losses is an unsafe and unsound practice.

Some thrifts may be pricing ARMs improperly as a result of a lack of understanding of the implicit

"options" or risks associated with ARMs. There should be a reasonable expectation that "promotional" mortgage loans, such as adjustable mortgage loans that feature "teaser" rates, minimum fees, binding caps, and optional conversion to fixed-rate mortgage loans, will yield a sufficient return over the life of the loan to avoid losses by the insured institution.

With discounted ARMs, institutions quote an initial interest rate and a spread or margin over the index rate to be used in determining subsequent rates. A discount results because the initial rate tends to be significantly lower than the sum of the current value of the index plus the margin. Interest rate change limitations or caps can be yield-depressing. If a cap exists, the loan contract should specify whether it is applicable to the discounted rate or the index plus the margin. If applied to a steeply discounted initial rate, the loan will suffer a large yield concession should the index rate rise during the early years of the loan. If the loan has an overall rate change cap applicable to the initial discounted rate, then it is possible that the lifetime maximum rate would be below the current rate on fixed-rate loans, thereby defeating the purpose of an adjustable-rate mortgage. Caps should not be established in a manner that permanently depresses or allows little flexibility on the yield.

Moreover, interest-rate changes may lead to steep increases in payment burdens and subsequent delinquencies if borrowers are originally qualified at the discounted rate with high payment-to-income ratios. The steeper the rate discount, the larger the periodic rate change cap or the higher the qualifying income ratio, the more likely the possibility of delinquency. It is important that institutions assess a borrower's ability to qualify by measuring current income against projected payments that will result from the interest-rate change. Lenders should also remember to consider the potential for increase in a borrower's income and compare that figure against anticipated higher payments.

In addition to the mispricing of embedded options, institutions should be aware of the repricing risk associated with different indices. The 11th District Cost of Funds is typically a lagging market index. Regulators should also be aware of the use of two distinct one-year maturity Treasury rate series. The institution must specify whether it intends to use, as an index, the Treasury bill rate quoted on a discount basis or on the constant-maturity yield rate. The latter is quoted on a bond-yield basis. Its rate is always higher than the discount rate. The mortgage documents should state precisely which index is used. Advertising and promotional material should in no way imply that the indexes are the same.

The OTS is particularly concerned about insolvent and undercapitalized institutions pricing ARMs without adequately analyzing the potential for losses. Such institutions may be tempted to "grow" out of their problems by making economically unsound loans. Such activity is considered a high-risk strategy, and insolvent and undercapitalized thrifts may not undertake such a strategy. Regulatory Bulletin 3a-1 ("Policy Statement on Growth for Savings Associations") states that the regulatory policy toward insolvent and undercapitalized institutions is one of low or no growth. An exception to this policy may be granted where the regional director (or designee) in order to maintain an insolvent institution's franchise value, approves controlled low-risk growth. Growth through the pricing of products and services without regard to avoiding losses is high-risk, and should not be approved.

Savings associations should carefully price ARMs with a full understanding of the risks associated with these instruments. It is the responsibility of the regional director (or designee) to monitor loan activity by thrifts and to stop such activity when it appears to be an unsafe and unsound practice or is not in the best interest of the insurance fund. Where regional directors (or designees) believe the pricing of ARMs is unsafe and unsound or is not in the best interest of the insurance fund, they should require a pricing analysis by the institution to demonstrate that mortgage loans are priced to recover the institution's operating expenses, funding costs, and risk premium. If an undercapitalized institution cannot demonstrate a reasonable expectation of avoiding losses, regional directors (or designees) should exercise their authority to halt such practices.

Example of Pricing of ARMs

One method to determine if thrifts are appropriately pricing ARMs is to compare the expected returns on originated ARMs with yields on comparable ARMs in the secondary market.

Specifically, a comparison can be made with secondary market data to determine whether the points received by the institution for originating the ARM compensate the institution for the discount that would be demanded by the secondary market to accept the risks of that ARM. If the discount required by the secondary market is larger than the fee received by the institution for originating the ARM, that may suggest the institution is not pricing its ARMs to avoid losses.

For example, if market conditions are such that an ARM pass-through certificate (PC) with a given margin (the fixed spread between an index value and the interest rate) and initial loan rate with a market price of 97 1/2, ARMs in the mortgage pool backing such a PC would need to impose an origination fee of at least 2 1/2 points to break even. Thus, if an ARM with similar characteristics as the ARMs in the PC were quoted by an originating institution with less than 2 1/2 points being charged to a borrower, it would appear to be inadequately priced. The originator could not recoup its costs by selling the ARM loan in the secondary market.

Documentation

Regulatory requirements state what types of records must be maintained for each loan made or purchased. The underlying philosophy concerning the documentation requirements does not stop with just being able to prove that each loan is properly documented. Each of the required documents serves a valuable purpose in the underwriting process and should be evaluated, analyzed, and relied upon by lending personnel. Regulators, during the loan review process, should be able to determine that the documentation has been used by the lending personnel for the purposes for which it was intended. Following is a partial list of documents required by § 563.170 of the regulations with respect to loans secured by real estate:

- Loan Application: signed by the borrower or its agent, that must disclose the purpose of the loan and the identity of any security property;
- Promissory Note: evidencing the borrower's obligation to repay the loan, executed by the borrower or its agent;
- Deed of Trust or Mortgage Instrument: evidencing the creation of a security interest in the described real estate for the benefit of the lender, signed by the borrower or its agent;
- Appraisal Report: prepared at the request of the lender, by an appraiser approved by the board of directors consistent with the lender's appraisal policy; it should disclose the market value of the security offered by the borrower as of a specific date;
- Financial Statement and/or Credit Report: documents traditionally used in underwriting a credit request; they should be current at the time of application and signed by the borrower disclosing its ability to repay the loan or a written credit report. The following guidelines should be used as to what constitutes a "current" financial statement:
  - For individual borrowers seeking to purchase, refinance, or construct a one- to four-family dwelling, financial statements should reflect the borrower's financial condition as of the day of application.
  - For individuals or businesses seeking to purchase, refinance, construct, or develop commercial properties, audited financial statements may not exceed 15 months of age. Tax return statements must be for the immediately preceding taxable year.
  - For individuals or businesses seeking to purchase, refinance, construct, or develop commercial properties, unaudited financial statements should be dated and verified as close to the date of commitment as possible, but in all cases within six months of the commitment date.
  - Common sense and prudent underwriting should always prevail. Borrowers whose profit and loss fluctuates considerably should be more carefully scrutinized and

financial statements should reflect more recent data than those for borrowers whose business histories reflect a stable income stream.

- Approval: approval sheet or committee minutes showing the entity responsible for approving the request, along with the terms and conditions of the approval;
- Inspection Reports: for construction and development loans, a record that demonstrates that the work for which each disbursement is sought has been completed;
- Title Policy/Opinion of Title: affirming the description, validity, and priority of the lender's lien on the real estate security for the loan; and
- Settlement Statement/Disclosure Statement: evidence proving that the lender provided the borrower, upon closing and application, a loan settlement statement and disclosure statement setting forth in detail the charges or fees payable by the borrower to the lender.

Some institutions may have policies and procedures in effect that allow no-doc or low-doc loans. No-doc loans refer to loans with no borrower financial information or credit history documentation on file. A no-doc loan is clearly a regulatory violation and an unsafe and unsound lending practice because it lacks the performance of a financial and credit analysis. Consequently, a no-doc loan may result in enforcement action being taken by the OTS. Low-doc loans refer to loans with less financial information and credit history documentation on file than is customarily obtained on a borrower. The granting of a low-doc mortgage loan, when done in compliance with regulatory requirements and prudent underwriting standards, is not in and of itself an unsafe and unsound lending practice. An institution that adopts a low-doc mortgage lending policy must exercise even greater care and underwriting judgment than usual in order to rely on borrower-provided certifications and documentation.

Because of their higher level of delinquencies and defaults, low-documentation loans should receive increased scrutiny. Data gathered on certain low-documentation loan programs indicate that the underwriting for some of the loans was imprudent, and there is evidence of material overstatement of borrower income and an understatement of obligations.

Regulators should be aware of the secondary market limitations associated with low-documentation loans. Both the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) limit the purchase of loans that have less than industry-standard documentation. The purchase of such loans has been limited to a negotiated basis, and usually with credit enhancements required.

Special Rule For Small-Business and Farm Loans

On March 30, 1993, the agencies issued a joint policy statement regarding documentation of small- and medium-sized business and farm loans. Under that policy statement, well managed (those with CAMEL ratings of 1 or 2), well- or adequately capitalized institutions are allowed to establish a "basket" of small- and medium-sized business and farm loans that will not be subject to examiner criticism based on documentation. (On September 8, 1993, OTS issued Thrift Bulletin (TB) 61, which allowed certain 3-rated institutions to apply to use this authority.) The total amount of an institution's loans under this program, however, could not exceed 20% of its total capital, and individual loans are limited to $900,000. Also, institutions are still expected to comply with OTS loans to one borrower and appraisal regulations, as applicable. Under the proposed safety and soundness regulations (discussed below), the interagency policy statement would continue to apply.

In an effort to make the loan documentation requirements for banks and thrifts consistent, the OTS amended its loan documentation regulation of 12 CFR 563.170(c)(1) through (7) to conform to the interagency policy statement for documentation of small- and medium-sized business and farm loans.

Proposed Interagency Credit Underwriting and Loan Documentation Standards

Section 39(a) of the Federal Deposit Insurance Corporation Improvement Act of 1991 requires

the federal bank regulatory agencies to prescribe standards relating to credit underwriting and loan documentation. In the proposed regulation issued on November 18, 1993, the agencies established the general parameters of safe and sound credit underwriting practices. The proposed standards would require each institution to establish and maintain prudent credit underwriting practices that:

- are commensurate with the types of loans the institution will make and consider the terms and conditions which they will be made;
- consider the nature of the markets in which loans will be made;
- consider, prior to credit commitment, the borrower's overall financial condition and resources, the financial responsibility of any guarantor, the nature and value of any underlying collateral, and the borrower's character and willingness to repay as agreed;
- establish a system of independent, ongoing credit review with appropriate communication to management and to the board of directors;
- take adequate account of concentration of credit risk; and
- are appropriate to the size of the institution and the nature and scope of its activities.

The proposed regulation also would require institutions to maintain sufficient loan documentation to:

- enable the institution to make an informed lending decision and to assess risk as necessary on an ongoing basis;
- identify the purpose of the loan and the source of repayment and assess the ability of the borrower to repay the indebtedness;
- ensure that any claim against a borrower is legally enforceable;
- demonstrate appropriate administration and monitoring of a loan; and
- take account of the size and complexity of a loan.

The proposed regulation provides a standard against which compliance can be measured, while at the same time allowing for differing approaches to credit underwriting and loan documentation. When the agencies issue the final rule, OTS will review the need for the current regulatory documentation requirements of 12 CFR 563.170.

Loan Participations

Purchased whole or participation interests in real estate loans require much of the same documentation as loans originated by an institution. Section 563.170(c)(1) sets forth the documentation required of loans secured by real estate. Section 563.170(c)(3) sets forth the documentation required of loan purchases or participations.

Lead Lender's Responsibility ¾ It is important for institutions to remain aware of their duties, both contractual and fiduciary, in participation lending. The lead lender (the seller or institution responsible for initiating the participation agreement with other institutions) is responsible for obtaining all documentation required by § 563.170(c)(1). The lead lender should provide copies of this information, as required by § 563.170(c)(3), and its underwriting standards to each participating institution. Institutions and their legal counsels should ensure that regulatory requirements are adhered to for new as well as existing participation loans.

Purchasing Association's Responsibility ¾ Associations that purchase participation loans must obtain adequate documentation from the lead lender and properly analyze the purchased loan for credit quality. Purchasers should subject participation loans to the same critical review and documentation requirements as those originated by the purchasing association. In addition, the purchasing association should continually monitor the participation loan to ensure the lead lender is fulfilling its duties and responsibilities. At a minimum, purchasers should be alert to any modification of the loan terms or changes in credit quality.

The recordkeeping requirements for participation interests in a mortgage pool are outlined in Statement of Policy § 571.13.

Mortgage Blanket Hazard Insurance

Section 571.4 requires savings associations to include in its loan contracts provisions that require the maintenance of such hazard insurance as will protect the savings association from loss in the event of damage to or destruction of the real estate securing the savings association's loans.

A number of insurance companies have devised mortgage blanket hazard insurance policies for use by mortgage lenders, thereby eliminating the need to hold and supervise separate policies for each borrower. To be acceptable from a legal and supervisory standpoint, the following minimums should be covered:

- The policy should insure the association against hazards customarily insured against by mortgage lenders in the area in which the association operates and in an amount determined to be adequate by the board of directors.
- The policy should clearly state the specific actions, practices, and procedures to be performed by the association as a condition of the issuance and continuance of the policy in order to realize any claim thereunder.
- The policy should clearly and fully state the manner by which the insured qualifies for settlement of any insured loss, including the conditions for the manner of settlement.
- The policy should provide that the insurer give the savings association at least 60 days advance notice of cancellation or notice of refusal to renew.
- The policy should clearly state, and include as part of the contract between the parties, that the insured association will, as a condition of this insurance, perform the following five (5) acts:
  - — require borrowers to maintain fire and extended-coverage insurance in the amount of the lesser of the loan balance or the replacement value, with the association named as the mortgagee;
  - — affirm at closing the actual existence of valid insurance as required;
  - — not inform or imply to any person that hazard insurance is unnecessary or is not to be maintained;
  - — upon learning that hazard insurance will terminate, procure fire and extended-coverage insurance as necessary and pay the premiums to prevent the lapse of adequate protection of the property; and
  - — cooperate with the insurers in distributing, at least annually, reminder memorandums to the borrower that hazard insurance shall be maintained.

A blanket hazard insurance policy meeting the minimum standards, as set forth above, will (1) provide an acceptable measure of protection for the interests of the savings association and its borrowing members and (2) evidence compliance with the requirements of § 571.4.

Late Charges

Section 545.34 allows a savings association to include in its loan contract a provision that allows for the imposition of late charges because of any delinquent periodic payment. A savings association does not, however, have the authority to impose or collect late charges unless (1) the borrower has signed an agreement that obligates him or her to pay late charges imposed as a result of late payment of a mortgage or (2) an appropriate state statute authorizes the late charge. The prohibition on collection of late charges without appropriate authorization applies to loans originated or purchased by the savings association.

Section 545.34 further prohibits the deduction of late charges from the regular periodic installment payment on a mortgage loan. This prohibition remains in effect even though the association may be preparing the loan to be sold and the purchaser's agreements state to the contrary.

Note: The Office of the Chief Counsel has opined that savings associations are not prohibited from

refusing to accept a loan payment because of unpaid late charges.

REFERENCES

United States Code (12 USC)

§ 1464	Home Owners' Loan Act: Loans or
(5)(c)(1)	Investments Without Percentage of Assets Limitations
§ 1464(5)(c)(2)	Home Owners' Loan Act: Loans or Investments Limited to a Percentage of Assets or Capital
§ 1464(5)(c)(3)	Loans or Investments Limited to 5 Per Cent of Assets

Code of Federal Regulations (12 CFR)

Subchapter C: Regulations for Federal Savings Associations

§ 545.32	Real Estate Loans
§ 545.33	Home Loans
§ 545.34	Limitations for Home Loans Secured by Borrower Occupied Property
§ 545.35	Other Real Estate Loans
§ 545.36	Loans to Acquire or to Improve Real Estate
§ 545.38	Insured and Guaranteed Loans
§ 545.39	Loans Guaranteed Under the Foreign Assistance Act of 1961
§ 545.40	Loans on Low Rent Housing
§ 545.41	Community Development Loans and Investments
§ 545.44	Mortgage Transactions with FHLMC
§ 556.11	Prepayment Penalty on Mortgage Loans
§ 556.17	Effect of Loan Participations on Status of Borrowing Members

Subchapter D: Regulations Applicable to All Savings Associations

§ 563.41	Loans and Other Transactions with Affiliates and Subsidiaries
§ 563.43	Restrictions on Loans, Other Investments, and Real Personal Property Transactions Involving Affiliated Persons
§ 563.44	Loans Involving Mortgage Insurance
§ 563.48	Flood Disaster Protection
§ 563.93	Loans-to-One Borrower
§ 563.97	Loans in Excess of 90 Percent of Value
§ 563.100-101	Real Estate Lending Standards
§ 563.170	Examinations and Audits; Appraisals; Establishment and Maintenance of Records
§ 563.172	Reevaluation of Real Estate Owned
§ 563.173	Forward Commitments
§ 564	Appraisals
§ 571.4	Hazard Insurance
§ 571.13	Participation Interests in Pools of Loans

Subchapter G: Regulations for Federally Related Mortgage Loans

§ 590.3	Operation

Office of Thrift Supervision Bulletins

RB 3a-1	Policy Statement on Growth for Savings Associations
RB 15	Covered Asset Sales
TB 16	Environmental Risk and Liability
TB 26	Substitute Mortgage Insurance for Ticor Mortgage Insurance Corporation (TMIC) Loans
TB 31-3	Securities Disclosure Obligation Arising as a Result of Regulatory Bulletin 3a
TB 31-8	New Transactions with Affiliates and Insider Lender Rules for Thrifts
TB 36-1	Guidelines on Interest, Prepayment, and Loan Origination Rates
TB 37a	Use of Appraisal Information in Loan Risk Analysis
TB 61	Interagency Policy Statement on Documentation for Loans to

	Small- and Medium-Sized Businesses and Farms

Financial Accounting Standards Board, Statement of Financial Accounting Standards

No. 5	Specifies GAAP Accounting for Losses and Contingencies
No. 91	Specifies GAAP Accounting for Loan Fees
No. 114	Accounting by Creditors for Impairment of a Loan

Other References

11/7/91	Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans
3/30/93	Documentation for Loans to Small- and Medium-Sized Businesses and Farms

Federal National Mortgage Association Underwriting Guidelines

Thrift Activities Handbook Section 410, Financial Records and Reports

Real Estate Mortgage Lending Program

Examination Objectives

To determine if policies, practices, procedures, and internal controls regarding real estate loans are adequate.

To assess management's conformance with established guidelines.

To evaluate the real estate loan portfolio for credit quality, collectibility, and sufficiency of loan collateral.

To assess the scope and adequacy of the audit function.

To ensure compliance with applicable laws and regulations.

To identify the strengths of the real estate lending function.

To initiate corrective action when policies, practices, procedures, objectives, or internal controls are deficient or when violations of law or regulations have been noted.

Examination Procedures

Level I

Wkp. Ref.

1. Review the real estate lending policies and procedures for adequacy, given the volume and type of lending activity, and for conformity with 12 CFR § 563.100-101. Specifically, the review should focus on whether the policies and procedures address and are adequate with regard to:

    a. Geographic limits;

    b. Acceptable types of properties;

    c. Lending authority for committee and individual officers;

    d. Minimum standards for documentation, amount, and frequency of financial information on borrowers for different types of mortgage loans, especially "low-doc" loans;

    e. Minimum standards for qualification of borrowers for various loan products, such as ARMs and teaser-rate loans;

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f. Maximum loan-to-value ratios or loan-to-purchase price ratios;

g. Maximum maturities;

h. Amortization requirements;

i. Procedures for reviewing real estate loan applications;

j. Internal controls regarding the mortgage documents and the preparation, posting, and reconciliation of loan records;

k. Collection and charge-off procedures;

l. Mortgage blanket hazard insurance;

m. Policy review and approval by the board of directors at least annually; and

n. Compatibility with the business plan and current market conditions.

2. In conjunction with the examiner(s) performing the audit programs (Thrift Activities Regulatory Handbook Sections 350, External Audit, and 355, Internal Audit), review the scope and depth of the work performed by internal and external auditors in the real estate lending area. Obtain a list of any deficiencies or exceptions contained in the latest review and determine if the association made the appropriate corrections.

3. Obtain and review the following information, as it pertains to real estate lending, from the examiner(s) responsible for Thrift Activities Regulatory Handbook Section 210, Lending Risk Assessment:

a. Lending, appraisal, and collection policies and procedures;

b. Past-due loans;

c. Loans in a nonaccrual status;

d. Loans for which interest is not being collected in accordance with the terms of the loan;

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e. Loans whose terms have been modified by a reduction of interest rate or principal payment, by a deferral of interest or principal, or by other restructuring of repayment terms;

f. Loan participations purchased and sold;

g. Loans sold in full since the previous examination;

h. Loans considered "problem loans" by management;

i. Loan commitments and contingent liabilities;

j. Extensions of credit to employees, officers, directors, principal shareholders, and their interests;

k. Extensions of credit to officers, directors, and principal shareholders of other institutions;

l. Current interest-rate structure and loan pricing;

m. Officers' current lending authority;

n. Pertinent reports furnished to the board of directors and the loan committee; and

o. Underwriting and collection experience of "low-doc" loans.

4. Review the preceding report of examination and all real estate lending-related exceptions noted and determine if the association made the appropriate corrections.

5. Summarize findings, obtain management responses, and update programs and the continuing examination file (CEF) with any information that will facilitate future examinations. File exception sheets in the general file.

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6. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

Level II

7. Using an appropriate sampling technique, select loans for review. (For details on sampling, refer to Section 209 of the Thrift Activities Regulatory Handbook.)

8. Transfer relevant information from the trial balance to the Thrift Activities Loan Review line sheets, where appropriate, including indication of any past-due, nonaccrual, or problem status.

9. Prepare Thrift Activities Loan Review line sheets for any loans not in the sample that require in-depth review. Types of loans to be considered in this portion of the review include:

   a. Loans granted and participations purchased since the previous examination;

   b. Loans sold in full since the preceding examination;

   c. Multiple loans to the same borrower or related group of borrowers, particularly those that represent a concentration of credit;

   d. Loan commitments and other contingent liabilities;

   e. Syndication loans;

   f. Loans to affiliated persons; and

   g. “Low-doc” loans.

10. Obtain the institution’s credit or loan files on the loans selected for review. While

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analyzing the loan, test for compliance with the institution's established policies, procedures, and controls. The following considerations may be beneficial during the loan review process:

a. The credit quality of the loan. Consider the adequacy of primary and secondary sources of repayment, including the value, quality, and liquidity of the security property and other collateral support. Financial statements from the current and previous periods, as well as loan officers' memoranda and correspondence, should also be considered to identify unfavorable or adverse trends.

b. The adequacy of any secondary support afforded by guarantors and endorsers.

c. Compliance with established policy and procedures.

d. Compliance with applicable laws and regulations.

e. The lack of current and complete financial information or that the information obtained was not reviewed, analyzed, and evaluated.

f. Deficient collateral documentation.

g. Compliance with provisions of any loan agreements.

h. Adherence of the original amount of the loan to the lending officer's authority.

i. Adherence of the interest rate charged and terms to the established parameter of the interest-rate schedule.

j. The appearance of preferential treatment or actual or potential conflicts of interest on loans to affiliated persons.

k. Excessive debt ratios, i.e., high monthly mortgage payments relative to borrower income.

l. A loan advertising program indicating that the institution relies on collateral only or predominantly rather than the borrower's ability to repay.

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11. Ensure that the Objectives of this Handbook Section have been met. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective

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measures, on the appropriate work papers and report pages.

Level III

12. Reconcile the real estate loan trial balance to the general ledger and review reconciling items for reasonableness.

13. For participation loans purchased and sold and loans sold in full since the preceding examination:

    a. Determine whether the institution is aware of both the lead lender's and the purchasing association's responsibilities relating to loan participations sold or purchased.

    b. Test participation certificates and records and determine that the parties share in the risks and contractual payments on a pro rata basis.

    c. Determine whether the books and records properly reflect the institution's liability.

    d. Determine whether the institution exercises controls and procedures over loans sold and loans serviced for others similar to those it exercises for loans in its own portfolio.

    e. Investigate any loans or participations sold immediately prior to the examination to determine whether any were sold to avoid criticism during the examination.

14. For FHA-insured loans and VA-guaranteed loans:

    a. Determine that a valid certificate of insurance or guaranty is on file by reviewing management's procedures to obtain such insurance or guaranty or by test checking a representative sample of such loans.

    b. Determine that required delinquency reports are being submitted.

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15. For discounted or "teaser" ARMs:

    a. Determine if the institution's current pricing structure or policy is sufficient to recover the institution's operating expenses, funding cost, and risk premium. If not, determine the soundness of management's strategy, such that: deeply discounted ARMs, even in periods of stable or falling interest rates, may not reach profitability until at least two or three repricings occur; any interest-rate movement above the yearly interest-rate cap must be absorbed by the institution; and refinancing existing ARMs at lower rates offered on new ARMs reduces the opportunity to recoup initial losses in subsequent repricings.

    b. Determine if the institution's lending policies and procedures and underwriting guidelines adequately address the increased default risk by qualifying borrowers' at or near fully indexed rates.

Examiner's Summary, Recommendations, and Comments

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Real Estate Mortgage Lending Questionnaire

	Yes	No
General Questionnaire		
Real Estate Loan Policies		
1. Has the board of directors adopted written real estate loan policies that define:		
a. Geographic lending areas?		
b. Acceptable types of properties?		
c. Lending authority of committees and individual officers?		
d. Minimum financial information required for borrowers of specific types of mortgage loans?		
e. Minimum appraisal standards for real estate mortgage loans?		
f. Maximum advance as a percentage of appraised value or purchase price?		
g. Limits on the amount of negative amortization allowed on a mortgage compared with its current market value?		
h. Maximum loan maturities?.....		
i. Sound review standards for real estate loan applications that require the underwriting analysis/decision be documented?		
j. Minimum standards for loan documentation?		
k. Limitations on the number or amount of loans involving any individual borrower or contractor?.....		
l. Limitations on the number, type, or amount of loans purchased or sold by the institution?		
m. Minimum standards for qualification of borrowers for various loan products (ARMs, Teaser Rate, etc.)?.....		

	Yes	No
2. Are loan underwriting standards reviewed at least annually to determine if they are compatible with changing market conditions?		
3. Does the institution have written collection policies and procedures that are approved by the board of directors?		
4. Does the institution have a written schedule of fees, rates, terms, and collateral requirements for all new loans?		
Appraisal Practices		
5. Has the board of directors:		
a. Adopted an appraisal policy?		
b. Developed written hiring policies for appraisers?.....		
c. Developed a review system for appraisers?.....		
6. Has the board of directors adopted a current approved appraiser list and are appraisers approved before they are used?		
7. Are current agreements of sale, option, or listing information made available to appraisers?		
8. Are appraiser's fees based upon a set fee and not the granting of the loan or the appraised value of the property?.....		
9. If staff appraisers are used, does the institution periodically have test appraisals made by independent appraisers in order to check the accuracy of appraisal reports?....		
10. If appraisers who are not employees of the institution are used, does the institution adequately investigate their report quality, reputation, and qualifications?		
11. Do loan approval and appraisal functions maintain adequate independence internally?.....		
12. Does the institution not use borrower-supplied appraisal reports?.....		

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Real Estate Mortgage Lending Questionnaire

	Yes	No
13. Are appraisal review personnel identified and given specific guidelines to determine the adequacy of the appraisal?		
14. Are appraisers paid the same amount whether or not the loan is granted?.....		
Collateral		
15. Does the institution have a sound policy of cross-collateralizing security properties for major borrowers?		
16. Are loan advances supported by written evidence or reinspection of property?		
17. If supplemental collateral is held on loans, is it secured and a record of its status maintained?.....		
18. Is written acknowledgment obtained from the borrower for the pledging of savings accounts or the assignment of life insurance policies?		
Loan Documentation		
19. Are procedures in effect to ensure compliance with the requirements of government agencies insuring or guaranteeing the loans?.....		
20. Has a system for maintaining adequate loan document files been established including:		
a. A check sheet to assure that required documents are received and on file?....		
b. Inspection performed by internal loan review personnel?		
21. Are procedures in effect to protect notes and other documents from theft or damage?		
22. Are all real estate loan commitments issued in written form?.....		
23. 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 institution's legal lending limit?		

	Yes	No
Loan Interest and Commitment Fees		
24. Is the preparation of interest earned or loan fees subsidiary journals reviewed by personnel who do not issue checks or handle cash?.....		
25. Are interest and fee computations made and tested by persons who do not also issue checks/drafts or handle cash?		
26. Does the institution properly account for deferred and earned loan fees?.....		
Recordkeeping		
27. Is the preparation and posting of subsidiary loan records performed or reviewed by persons who do not also issue official checks/drafts or handle cash?		
28. Are the subsidiary loan records reconciled daily with the appropriate general ledger accounts and are reconciling items investigated by persons who do not also issue official checks/drafts or handle cash?		
29. Are delinquent account collection requests and past-due notices checked to the trial balances used in reconciling loan subsidiary records to general ledger accounts and are they handled by persons who do not also issue official checks/drafts or handle cash?		
30. Are detailed statements of account balances and activity mailed to mortgagors at least annually?		
31. Are inquiries about loan balances received and investigated by persons who do not also handle cash?		
32. Are documents supporting recorded credit adjustments checked or tested by persons who do not also handle cash?.....		
33. Is a daily record maintained summarizing loans made, payments received, and interest collected to support applicable general ledger accounts?.....		

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Real Estate Mortgage Lending Questionnaire

	Yes	No
34. Are note and liability ledger trial balances prepared and reconciled to controlling accounts by employees who do not process or record loan transactions?		
35. Are records and files for serviced loans segregated and identifiable?		
36. Is an overdue accounts report generated on a timely basis?		
37. Are loan officers prohibited from processing loan payments?		
38. Are loan payments received by mail recorded upon receipt independently before being sent to and processed by a note teller?		
39. Are advance loan payments adequately controlled if they are not immediately credited to the loan account?		

	Yes	No
Insurance and Escrow		
40. Does the institution have a mortgage blanket hazard insurance policy?		
41. Is there an effective, formalized system for determining whether insurance premiums are current on collateral properties?		
42. Does the institution require that insurance policies include a loss payable clause to the institution?		
43. Are disbursements for taxes and insurance supported by records showing the nature and purpose of the disbursements?		
44. If advance deposits for taxes and insurance are not required, does the institution have an effective system for determining whether taxes and insurance have been paid?		

Comments

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Questions and Answers on Real Estate Lending Standards (RELS) Regulation and Guidelines

1. Are pre-March 19, 1993 loans included in the calculation of the 30% and 100% limits on "loans in excess of the supervisory Loan-to-Value (LTV) ratio limits?"

   ANSWER: No. All pre-March 19, 1993 loans are grandfathered, though we still retain supervisory authority to stop inappropriate or unsafe and unsound lending practices.

2. a. What is the private mortgage insurance (PMI) requirement for home mortgage loans?

   ANSWER: The requirement is that home mortgage loans of 90% LTV ratio or greater have "appropriate" PMI or readily marketable collateral. There is no requirement to have PMI coverage that would bring the effective LTV ratio down to 80%. Of course, the risk-based capital rule gives favorable treatment to 80% or less LTV ratio home loans. If an association made a 95% loan and required PMI only down to 90%, it would not be placed in the 50% risk-weight category.

   b. Can a thrift originate 100% LTV ratio loans without PMI?

   ANSWER: A thrift can originate 100% LTV ratio home mortgage loans without PMI, though they would be included in the 100% "Loans in excess of the supervisory LTV limits" loan category. While regulators would not take exception to a moderate amount of such loans, the institution may be criticized if the loans were underwritten in a manner that would make them unsafe and unsound.

3. What is the loan category for a loan to a borrower to purchase a developed residential lot where the roads and sewers, etc., are in place, but there are no immediate plans to build a home?

   ANSWER: The loan should be treated as a land development loan. Although the purpose of the loan is not to develop the lots, the end product is the same. Note that when the agencies established 75% as the maximum supervisory LTV ratio limit for land development loans, we did not expect all of an institution's loans in this category to be 75%. Those loans with higher risk would be expected to be made at lower LTV ratios, and those with a lower level of risk, such as loans to purchase finished lots, could be made at the maximum LTV ratio.

4. Do deposits in excess of $100,000 count as "financial instruments" for "readily marketable collateral?"

   ANSWER: Yes.

5. How would the maximum supervisory LTV ratio limit be calculated for loans fully cross-collateralized by two or more properties or secured by a collateral pool of two or more properties?

   ANSWER: For cross-collateralized loans, the maximum loan that could be made within the supervisory LTV ratio limits would be based on the following formula: [(Value of each property X appropriate maximum LTV ratio) - senior liens].

6. What is the loan category of a loan to construct a single-family home, where the borrower has a take-out commitment (made by either the same lender or a different lender) for permanent financing when completed?

   ANSWER: A construction-permanent loan secured by a single-family residence to the owner-occupant will be treated as a permanent mortgage loan for purposes of categorizing the loan in the supervisory LTV ratio limits, i.e., there is no maximum supervisory LTV ratio limit, but if the LTV ratio equals or exceeds 90%, the loan should have credit enhancement in the form of PMI or readily marketable collateral.

   A construction loan by one lender with the permanent take-out by a second lender will be treated as a one- to four-family construction loan (with an 85% supervisory LTV ratio limit) until construction is complete and the loan is refinanced by the permanent lender. If the second, permanent lender is a closely held affiliate of the construction lender, then the loan can be treated as a permanent loan.

7. Are unsecured loans (with loan proceeds used to purchase real estate) subject to the rule?

   ANSWER: No, but the loan should be underwritten to much tighter standards than secured loans because the willingness and ability of the borrower to repay the loan would be the only source of repayment. In essence, such loans should be made at similar rates and terms as other unsecured loans made by the institution.

8. Are loans underwritten as “unsecured” loans where the lender takes a security interest in real estate at borrower’s request (i.e., for tax purposes) subject to the RELS rule?

   ANSWER: No, provided that the real estate collateral was truly taken as an abundance of caution and the underwriting criteria and loan terms were more indicative of an unsecured loan.

9. How should institutions categorize, for supervisory LTV ratio limit purposes, second mortgage loans that are not principal residences?

   ANSWER: Unless such residences meet the Internal Revenue Service (IRS) test of residency, the loans are considered improved property loans (85% LTV ratio limit) since they are not owner-occupied one- to four-family residences. (The definition of owner-occupied requires that the home be the borrower’s principal residence.) If the loan is made with an LTV ratio higher than 85%, it would be placed in the larger 100% of capital “bucket” (which does not have a principal residence requirement).

   Loans that meet the IRS test of residency are treated as owner occupied one- to four-family residences.

10. How should loans under the FHA Title I program be treated?

    ANSWER: Similar to OTS’s capital rule treatment of such loans, FHA Title I program loans are not considered guaranteed loans, so if the loans are made with LTV ratios of 90% or higher without PMI, they would go in the loans in excess of the supervisory limits “bucket.”

11. Does readily marketable collateral include cash surrender value of life insurance?

ANSWER: Yes, however, the following conditions should be met: (1) the institution must hold the insurance policy and a legally binding hypothication agreement with the policy owner; (2) the institution must have a written statement from the insurance company that it will honor the hypothication agreement; and (3) the institution can only count the "net realizable" value of the policy (i.e., the cash surrender value less any required IRS or local tax withholdings).

12. Does the RELS rule cover mobile homes?

ANSWER: The rule applies to real estate loans. Loans secured by "manufactured homes" that are affixed to real property are real estate loans and the RELS rule applies to them. For manufactured home loans, the current § 545.45 applies. Manufactured homes are different than "mobile home" loans in that they are built to the "HUD-code."

Other "similar" personal property - mobile homes, RVs, etc. - are chattel and are not considered home loans under our rules. A loan secured by only a mobile home is a consumer loan and the RELS rule would not apply. If the loan is secured by a mobile home and a lot, the security property would be categorized as chattel and land (either raw land or a developed lot) and the lot loan would be subject to the RELS rule unless the real estate collateral was taken only as an abundance of caution.

13. How should loans guaranteed by either the federal government or state governments be treated for purposes of the Supervisory LTV ratio limit if the guarantee is less than the loan amount?

ANSWER: All loans guaranteed by the U.S. Government or its agencies and all loans backed by the full faith and credit of a state government are excluded from the supervisory LTV ratio limit guidelines. Consequently, such guaranteed loans should not be categorized as "loans in excess of the supervisory LTV ratio limit." As with all assets, however, if an institution has significant risk exposure on a guaranteed loan, an examiner may criticize and, if appropriate, adversely classify the asset.

14. Do we include nonowner occupied one- to four-family loans in the 100% of capital exception bucket?

ANSWER: Yes. Nonowner occupied one- to four-family loans are subject to the 85% LTV ratio for improved property loans and such loans with LTV ratio greater than 85% are placed in the 100% exception bucket.

15. Are loans in excess of the supervisory limit secured by developed lots for one- to four-family residential homes placed in the 100% of capital exception bucket?

ANSWER: Yes. All loans related to one- to four-family residential properties go into the 100% exception bucket. For developed lots, the lots should be in a one- to four-family residential subdivision and properly zoned to be treated as one- to four-family residential properties.

16. What is the treatment of home improvement loans?

ANSWER: Home improvement loans are treated like permanent mortgages, not construction loans.

17. If an institution has a firm take-out commitment on a construction loan, can it be treated as an excluded transaction under the fourth exclusion (loans to be sold)?

ANSWER: No.

18. How do you determine the supervisory LTV ratio limits for multistage projects?

ANSWER: The LTV ratio for multistage projects is ultimately limited by the LTV ratio applicable to the final stage of the loan. Institutions should establish, as part of their loan administration policies, procedures on loan disbursements. In general, prudent loan disbursement means that funding of the initial acquisition of raw land should not exceed 65% of the cost of the land and funding the development stage should not exceed 75% of the costs of development, etc.

19. For "value," should institutions use retail value or discounted value?

ANSWER: Thrifts should use appraised value as determined in accordance with 12 CFR Part 564. The guidelines reference our appraisal rule, which should be used for the term "value." For projects where individual units will be sold over a multi-year period, yet funds will largely be disbursed at the beginning of that period, the appraised value should reflect the discounted net cash flows of the project, not the gross retail value of all the units.

20. For cross-collateralized loans, we calculate the maximum LTV ratio based on a weighted-average method. If the one loan in the pool is over the LTV ratio limits, what goes into the high LTV ratio "bucket?"

ANSWER: If the weighted-average LTV ratio of the pool is over the maximum supervisory LTV ratio, the whole pool goes into the bucket. If the weighted-average LTV ratio is less than the supervisory maximum, nothing goes into the bucket, even if one loan is above the maximum supervisory LTV ratio. This is in recognition that with cross-collateralization, the institution has "excess LTV ratio cushion" in one loan to "cover" another loan's lack of LTV ratio cushion. Conversely, if all the excess cushion is used, then the whole pool presents a higher degree of risk. This will give institutions an incentive to structure pools to exclude any loans that might cause the pool to be put in the bucket, but that is acceptable. We can review any individual loan for safety and soundness, and institutions should only be making prudent loans.

INTRODUCTION

This Section of the Handbook discusses some of the general characteristics and major risk factors associated with construction lending and outlines some of the controls necessary to manage and contain related risks.

Construction lending provides funding for the development of residential and commercial properties and may also provide purchase money or working capital for the acquisition and development of land to be used for construction. Construction loans often serve as a form of interim financing until permanent financing is secured by the developer or buyer. Construction loans are generally secured by a first mortgage or deed of trust and may be backed by a purchase or take-out agreement from a permanent lender. With proper underwriting and controls, construction lending can offer significant profits in a short time. This high rate of return, however, is commensurate with the risks of this type of lending.

Real Estate Lending Standards Rule

OTS regulation § 563.100-101, Real Estate Lending Standards Rule, was adopted by the Office of Thrift Supervision (OTS) in concert with the other federal banking agencies on December 31, 1992. The rule requires each insured depository institution to adopt and maintain written internal real estate lending policies that are consistent with safe and sound banking practices and appropriate to the size of the institution and the nature and scope of its operations. It applies to extensions of credit secured by liens on or interests in real estate or made for the purpose of financing the construction of a building or other improvements to real estate, regardless of whether a lien has been taken on the property. The rule is more fully discussed in Section 212, Real Estate Mortgage Lending.

Examiners assigned to the construction/development lending phase of the examination should determine that the institution's written construction lending policies: (1) are in writing, (2) have been approved by the board of directors, (3) promote safe and sound lending and are in compliance with § 563.100-101.

The Real Estate Lending guidelines establish the following standards that pertain to construction/development loans.

For development and construction projects, and completed commercial properties, the institution's policy should establish, commensurate with the size and type of project or property:

- Requirements for feasibility studies and sensitivity and risk analysis (e.g., sensitivity of income projections to changes in economic variables, such as interest rates, vacancy rates, or operating expenses).
- Minimum requirements for initial investment and the maintenance of hard equity by the borrower (e.g., cash or unencumbered investment in the underlying property).
- Minimum standards for net worth, cash flow, and debt service coverage of the borrower or underlying property.
- Standards for the acceptability of and limits on nonamortizing loans.
- Standards for the acceptability of and limits on the use of interest reserves.
- Preleasing and presale requirements for income-producing property.
- Presale and minimum unit release requirements for non-income-producing property.
- Limits on partial recourse or nonrecourse loans and requirements for guarantor support.
- Requirements for take-out commitments.
- Minimum covenants for loan agreements.

Construction Loan Risk Factors

Construction loans are susceptible to a number of major risk factors, such as:

- Uncertainty associated with securing permanent financing for the project. Unknown future interest costs of permanent financing is a risk faced by any thrift engaged in construction lending, whether or not it is also the permanent lender;
- Insufficient experience or capacity of the contractor to meet the challenges of the specific construction project;
- Risk of diversion of progress payments or fraud; and
- The contractor's inability to complete construction within cost and time limitations.

Clear warning signs that indicate problems have been encountered with construction loans include:

- Delinquency in the payment of interest;
- Inspection reports citing departures from approved specifications or other adverse comments. They may reflect higher costs or, in the case of building to lesser specifications, the intent to divert loan proceeds;
- Draws requested ahead of schedule for work yet to be completed or draws not taken on schedule, indicating the possibility of slow sales where residential construction is concerned;
- Additional working capital loans to a troubled developer; and
- Restructuring take-out restrictions that could not be complied with.

Risk Containment

The best method for limiting risks and avoiding costly mistakes is to establish and implement sound policies and procedures. Although policies and procedures should be tailored to the different types of construction lending undertaken by the institution, the following major elements will typically be found in sound construction lending policies and programs:

- Construction loan application review and approval procedures that, at a minimum:
  - — Define acceptable types of construction loans, including limitations on aggregate construction loans and for particular types of construction projects;
  - — Require borrowers to contribute and maintain equity in their project. Requiring land to be bought with funds from another source, limiting loan funds to be used for land acquisition, and requiring a first lien on land are all steps that provide protection to the lender. A common practice of prudent lenders is to loan no more than 50% to 65% for land acquisition costs or provide no more than 50% to 65% of current appraised value on land. The collateral margin provided by the borrower's equity serves to protect the lender from loss in the event of cost overruns or slow sales. Secondary market investors in income property construction loans typically set a maximum loan-to-value ratio of 70%;
  - — Require limitations as to percentage of cost or value for construction loans that do not carry prearranged permanent financing and that are subject to the association's own take-out commitment; and
  - — Provide for the satisfactory investigation of the character, expertise, and financial standing of all related parties in assuring that the developer, contractor, and subcontractors have demonstrated the capacity to successfully complete the type of project to be undertaken. The credit file should include background information on the developer (borrower) and any relevant third parties describing their experience on similar projects.
- Minimum standards of documentation, including:
  - — Specific, reasonable, and supportable cost estimates. Regulators should at all times

be able to determine the nature of project costs and the extent to which these costs contribute to collateral value.

— Clearly identified sources of repayment. Such sources as contracted anchor tenants in a mall, a primary tenant in an office development, or sales of housing units would be appropriate. Although the use of interest reserves is common, it is preferable to ensure loan servicing from known funding sources, such as other investments of the borrower or cash provided by initial investors, until the project is producing a positive cash flow. A feasibility study should project cash flow adequate to service debt and ensure orderly liquidation of principal. A projected debt service coverage of anywhere from 110% when tenants are financially stable and under contract, to 150% for speculative properties, is a reasonable underwriting requirement;

— Specific plans for permanent financing. The plans should include requirements and standards for take-out commitments, tri-party (buy/sell) agreements, and "completion" or corporate bonds. The take-out commitment supports the source of repayments and is issued by the lender that provides the permanent financing. The amount of the take-out commitment should be adequate to cover principal and interest that has not otherwise been planned from other sources. The expiration date and restrictions in the take-out commitment should be reasonable.

All requirements should be met and approved by the permanent lender prior to construction and the institution should ensure that the issuer is financially capable of honoring its commitment. The building and loan agreement, which is entered into by the institution, the builder, and the property owner, outlines the performance responsibilities of each party and generally contains certifications that plans and specifications conform to all applicable laws and are approved by appropriate interested parties. It also contains certain covenants that protect the lender's interest during the term of construction.

The tri-party (buy/sell) agreement is entered into by the borrower and the construction and permanent lenders. It contains provisions protecting the interest of each lender, such as preventing the permanent lender from withdrawing the take-out commitment because of unacceptable documentation or unforeseen developments such as the death of a principal before permanent loan documents are signed.

The "completion" or corporate bond, which is written by an insurance company, guarantees that all loan proceeds will be expended on the construction property. It does not warrant completion in the event of cost overruns. Some institutions are reluctant to require a completion or corporate bond because performance by the surety may involve litigation, and any change in plans or specifications or a failure to notify the bonding company of default or exception may nullify the protection of the bond;

— Appropriate insurance. The lender should assure that the project is at all times protected from liability and various hazards through builder's risk and hazard insurance protection, if not otherwise provided. Title protection should ensure perfected liens, preferably through insurance from before the start of construction through completion. All liens should be paid or otherwise cleared to the satisfaction of the title insurer.

- A formal system of loan administration, inspection, and disbursements. Loan administration should have definite control procedures to prevent overpayment and ensure that liens are paid and released. Controls should involve segregation of duties, site inspections, budget comparisons, and dual approval of disbursements. Records should be kept that can show that remaining funds in LIP are adequate for completion. Records of expenses should be complete and subject to audit, independent of the loan administration staff. The percentage of completion of the project and the percentage of funds expended

should be easily determinable at any time. If regulators are not comfortable with the control procedures on a major project, an additional site inspection should be done to ensure that progress is as reported in the credit files.

— Inspections. For major projects, architect or engineering inspection reports, independent of the borrower, should be required with each draw to ensure work is done to specifications. A representative of the lender should at least occasionally inspect the site to ensure work is done as reported. The loan administration staff should compare site inspection reports to construction plans and specifications preferably prior to disbursement. Inspection reports should state compliance with plans and specifications, support disbursements, and state whether or not the project is progressing as anticipated.

— Disbursements. Disbursements are generally prearranged and are based upon either a standard payment plan that calls for fixed payments at the end of specified stages of construction or a progress payment plan, which is usually based on monthly disbursements up to a stated percentage of value with a stated percentage held back until the project is completed. Under each plan, a percentage of the loan is usually retained until a notice of completion has been filed and the stipulated period under which liens may be filed has lapsed. Disbursements should be properly authorized and supported by the inspection report. Receipted bills of work performed and materials furnished, and lien waivers should be obtained as disbursements are made. A release of mechanic's liens should also be obtained from the general contractor at the time construction is completed and before final disbursement. Appropriate institution personnel should compare draws with cost estimates to ensure that budgets are met or cost overruns are provided for. Prudent lenders often will hold back part of loan advances, requiring the developer to put equity into each phase of construction. This may be done by holding 10% or 20% of construction costs until the project is finished. Such holdbacks can be started with the initial draw, so that funds are paid out at the rate of, for example, 80% of expenses, resulting in a delay for full loan funding until correction of errors, completion, and final disposition of the project is ensured to the satisfaction of the end user or permanent lender.

— Lien Releases. The principal balance of an acquisition-and-development loan is generally repaid through lien release payments. Depending on the type of project (development of single-family lots, condominium conversion, or tract home building), as each unit is sold, the proceeds are used to (1) pay interest on the outstanding balance, (2) repay a portion of the principal, (3) cover the developer's overhead and expenses, and (4) provide the developer a profit.

Section 545.36(c) requires that "the principal balance of the loan shall be reduced by an amount at least equal to that portion of the outstanding loan balance attributable to the value of the property to be released" (i.e., the lien release must be at least 100% of the unit's proportional share of the loan balance).

Prudent lenders, however, often require the developer to pay lien releases greater than the proportional share of the loan value of the unit sold (often 110% to 125%). Otherwise, the loan will not be repaid until the last unit is sold. The latter is undesirable because the most marketable units often sell first, leaving the loan secured by less desirable, hard to sell units.

For example, assume Lot Development, Inc. (LDI) is developing 100 single-family lots that are projected to sell (on average) for $30,000 each. The project was appraised for $2 million, based on the discounted net cash flows from the lot sales. Prudent Federal agreed to loan LDI $1.5 million (75% of the appraised value of the project). As part of its construction loan agreement with LDI, Prudent required

a lien release payment for each lot sold and released equal to 125% of the loan amount proportional to the lot. If the lots are deemed equal in value, the lien release would be calculated as follows:

$1,500,000/100= $15,000 x 125% = $18,750.

With a 125% lien release, the loan will be fully repaid at the sale of the 80th lot ($1.5 million/$18,750=80). If a 110% lien payment were required instead, the release would be $16,500 and the loan would be repaid at the sale of the 91st lot ($1.5 million/$16,500=91).

The Thrift Activities Construction Loan Review line sheet is intended as a tool for examiners to use in reviewing these underwriting and classification criteria for major construction loans. This work sheet provides general questions on loan underwriting, a review guide for disbursement procedures and controls, comparisons of funds available with funds needed for completion, a review of interest reserves, and space for a summary of a site inspection. Some examination procedures require its use.

Developer's Profit and Interest Reserves

Developer's profit and interest expense, from the inception of a project until sell-out or break-even leasing, are legitimate development costs. As such, they should be budgeted along with all other development costs when determining the adequacy of loan and equity funds to cover all expenses associated with a development.

Because developer's profit and interest expense are recognized costs of developing a project, construction lenders should control the funding of these expenses through the Loans in Process (LIP) account.

Developer's Profit

Developer Profit in the Funding of a Loan. Developer profit and overhead costs should be funded by investor's equity, sales, or rents, and not construction loan funds. Such expenses do not contribute to collateral value unless the project is successful, meaning the project has been completed and the properties sold or leased up. Paying a developer a profit for an incomplete project removes his/her incentive to complete and sell the units in a real estate project and has in the past led to financial problems for some institutions.

Developer Profit and REO. The institution must always ensure that it has sufficient funds (or borrower equity) in a project to complete construction. This includes all hard costs as well as amounts for interest reserves, overhead and developer's profit. If the institution should have to foreclose on the project, it would incur such items in its own development costs because it would either have to sell the project (and usually provide the financing) at an amount that would allow the new developer to cover all costs and earn a profit, or it would have to hire a developer to take over and complete the project and pay for the developer's services.

Interest Reserves

LIP proceeds allocated to interest, whether generated from loan funds or deposits from the borrower, should be clearly designated for payment of interest.

Construction lenders should analyze the adequacy of the estimated interest expense as projected by the borrower/developer to cover completion of the project. Projected timing of loan draws should be provided by the applicant. The lender should analyze the timing of principal repayments/projected income in concert with the projections. The adequacy of remaining interest reserves should be continually monitored in an effort to determine whether they are sufficient. Delays in construction and slower-than- anticipated selling or leasing progress can adversely affect the sufficiency of interest reserves. Any deficiency in interest reserves is a matter of serious concern and should be cause for protective measures by the lender to control costs and to secure additional funds to cover the shortfall. The requirement on the borrower to cover any LIP shortfall should be incorporated in the loan documents.

Acquisition, Development, and Construction (ADC) Arrangements

Loans for the purpose of acquiring, developing, and constructing improvements to real estate can be treated three different ways for accounting purposes, depending on the specific circumstances of the transaction. Significant accounting differences as to the recognition and timing of interest and fee income occur, depending on whether the transaction is a loan, a joint venture in real estate, or an investment in real estate. Refer also to Thrift Activities Regulatory Handbook Section 230, Equity Investments.

Beginning January 1, 1989, all savings associations and their affiliates should classify and account for ADC loans and arrangements in accordance with generally accepted accounting procedures (GAAP). (GAAP on ADC arrangements is currently set forth in the American Institute of Certified Public Accountants' Practice Bulletin 1, Exhibit I, "ADC Arrangement," published in the February 10, 1986 issue of the CPA Letter.)

Because some ADC transactions are treated by associations as loans when in fact they should be treated as investments, income and capital can be overstated. Transactions containing the additional risk associated with an investment involve more risk to the lender than a loan does. These transactions typically involve speculative projects and, because the borrower cannot yet demonstrate the ability to completely repay the loan, it is inappropriate to recognize market interest rates and portions of loan fees as income before the project's success has been proven.

If the association will receive a majority of the project's profits, the transaction should be treated as an investment in real estate, and interest, fees, and profits in excess of the association's cost of funds should be deferred and offset against the investment in the loan. See Statement of Financial Accounting Standards (SFAS) Nos. 67 and 66.

If the lender's profit participation is 50% or less, the entire arrangement is accounted for as a loan or a real estate joint venture, depending on the circumstances. At least one of the characteristics of a loan, as outlined below, or a qualifying personal guarantee should be present for the arrangement to be accounted for as a loan. Otherwise, real estate joint venture accounting would be appropriate. See Standards of Practice No. 78-9 and SFAS No. 34 as modified by SFAS No. 58.

ADC loans that are more properly treated as joint ventures or investments in real estate typically contain substantially more risk than loans do. The difference between a transaction properly treated as a loan versus one properly treated as a joint venture or investment is that, for a loan, the following generally occur:

- The borrower has a substantive equity investment in the project from its inception;
- The lender has recourse to substantive assets of the borrower other than the ADC projects or the borrower has provided an irrevocable letter of credit from a creditworthy, independent third party to the lender for a substantial amount of the loan over the entire term of the loan;
- A reasonably conditioned full take-out commitment has been obtained from a creditworthy, independent third party; or
- Noncancellable sales contracts or lease commitments are in effect.

A joint venture or investment transaction typically involves the following in addition to a profit participation:

- The lender provides all or substantially all of the funds to acquire and complete the project, including loan and commitment fees;
- The lender funds all interest due during the development and construction by adding interest to the loan balance;
- The lender has no recourse to any assets of the borrower other than the ADC project or has a personal guaranty from the borrower of little or questionable value; or
- The loan is structured so that during project development, the loan is unlikely to go into default and therefore be foreclosed because no

payments are required until the improvements are finished.

REFERENCES

Code of Federal Regulations (12 CFR)

Subchapter C: Regulations for Federal Savings Associations

§ 545.32	Real Estate Loans
§ 545.36	Loans to Acquire or to Improve Real Estate
§ 545.37	Combination Loans

Subchapter D: Regulations Applicable to All Savings Associations

§ 561.30	Nonresidential Construction Loan
§ 563.93	Loans to One Borrower
§ 563.100-101	Real Estate Lending Standards
§ 563.170(c)	Establishment and Maintenance of Records
§ 567.5(c)	Total Capital (Assets Required to be Deducted)
§ 567.6(a)(1)(iv)	100 Percent Risk Weight

Office of Thrift Supervision Bulletins

TB 16	Environmental Risk and Liability

Financial Accounting Standards Board, Statement of Financial Accounting Standards

No. 34	Capitalization of Interest Cost
No. 58	Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method
No. 66	Accounting for Sales of Real Estate
No. 67	Accounting for Costs and Initial Rental Operations of Real Estate Projects

American Institute of Certified Public Accountants Pronouncement

Practice Bulletin 1, Exhibit I, “ADC Arrangement”

Construction Lending Program

Examination Objectives

To determine if policies, practices, procedures, and internal controls regarding real estate construction loans are adequate.

To verify that management is operating in conformance with the established guidelines.

To evaluate the construction loan portfolio for credit quality, collectibility, and collateral sufficiency.

To assess the scope and adequacy of the audit function.

To ensure compliance with applicable laws and regulations.

To identify the strengths and weaknesses of the construction lending function.

To initiate corrective action when policies, practices, procedures, objectives, or internal controls are deficient or when violations of laws or regulations have been noted.

Examination Procedures

Level I

Wkp. Ref.

1. Review the construction lending policy and procedures for adequacy given the volume and type of lending activity. Determine if the policy conforms to 12 CFR §563.100-101, Real Estate Lending Standards. Specifically, focus on whether the policy and procedures address and are adequate with regard to:

    a. Geographic limits.

    b. Lending authority for committee and individual officers.

    c. Procedures for reviewing construction loan applications.

    d. Borrower financial strength requirements.

    e. Acceptable loan types and features.

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f. Agreements required by borrowers for completion of improvements in accordance with approved construction specifications and cost and time limitations.

g. Qualified collateral and minimum margin requirements.

h. Acceptable appraisal techniques.

i. Acceptable feasibility report standards.

j. Inspection procedures.

k. Methods of supervising loan proceed disbursements.

l. Standards for take-out commitments.

m. Completion bonding requirements.

n. Minimum standards for documentation.

o. Internal controls regarding construction loan documents and separation of duties in the areas of the preparation, posting, and reconciliation of loan records, and in the areas of loan approvals, appraisals, disbursements, and inspections.

p. Collection and charge-off procedures.

q. Review and approval by the board of directors at least annually.

r. Compatibility with the business plan and current market conditions.

s. Aggregate limitation for construction loans.

2. In conjunction with the regulator(s) performing the audit programs (Thrift Activities Handbook Sections 350, External Audit, and 355, Internal Audit), review the scope and depth of the work performed by internal and external auditors in the construction lending area. Obtain a list of any deficiencies or exceptions contained in the latest review and determine if the association made the appropriate corrections.

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3. In conjunction with the examiner performing Thrift Activities Handbook Section 210, Lending Risk Assessment, obtain and review the following information and schedules as they pertain to construction lending:

   a. Lending policy and procedures.

   b. Appraisal and feasibility report standards for construction projects.

   c. Construction loan trial balance, undisbursed loan proceeds (LIP) trial balance, and listing of contingency and escrow accounts.

   d. Past due loans.

   e. Loans in a nonaccrual status.

   f. Loans in which interest is not being collected in accordance with the terms of the loan.

   g. Loans whose terms have been modified by a reduction of interest rate or principal payment, by a deferral of interest or principal, or by other restructuring of repayment terms.

   h. Loan participations purchased and sold.

   i. Loans sold in full since the previous examination.

   j. Loans considered “problem loans” by management.

   k. Loans that are overdisbursed.

   l. Loan commitments and contingent liabilities.

   m. Extensions of credit to employees, officers, directors, principal shareholders, and their interests.

   n. Extensions of credit to officers, directors, and principal shareholders of other institutions.

   o. Current interest-rate structure/loan pricing.

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p. Level of each officer's current lending authority.

q. Pertinent reports furnished to the board of directors and loan committee, including reports required by the board pursuant to its written real estate lending policies and 12 CFR 563.100-101.

4. Review the preceding report of examination and all construction lending-related exceptions noted and determine if the association made the appropriate corrections.

5. Summarize findings, obtain management responses, and update programs and the continuing examination file (CEF) with information that will facilitate future examinations. File exception sheets in the general file.

6. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

Level II

7. Reconcile the construction loan trial balance and undisbursed loan proceeds and contingency or escrow accounts to the general ledger and review reconciling items for reasoableness.

8. Using an appropriate sampling technique, select loans for review and transcribe appropriate information to the Construction Loan Review and other Thrift Activities line sheets, where appropriate, including indication of any past-due, nonaccrual, or problem status. (For details on sampling, refer to Section 209 of the Thrift Activities Regulatory Handbook.)

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9. Prepare Construction Loan Review line sheets for any loans not in the sample that require in-depth review based on information contained in the above schedules. In performing this step, also consider including the following:

   a. Loans granted and participations purchased since the previous examination.

   b. Loans sold in full since the preceding examination.

   c. Multiple loans to the same borrower or related group of borrowers, particularly those that represent a concentration of credit.

   d. Loan commitments and other contingent liabilities.

   e. Loans to affiliated persons.

   f. Tract loans.

   g. Out-of-territory loans.

10. Obtain the association's credit or loan files on the loans to be reviewed. In conjunction with analyzing the loans, test for compliance with the association's established policies, procedures, and controls. In analyzing the loans determine and consider the following:

   a. Analyze the loan for credit quality by determining the adequacy of primary and secondary sources of repayment, including the value, quality, and liquidity of the security property and any other collateral support. Financial statements from previous and current periods, as well as loan officer memoranda and correspondence, should be analyzed to determine the existence of any unfavorable or adverse trends.

   b. Whether the amount of construction loans and their estimated completion dates correspond to the amounts and expiration dates of the take-out commitments or completion bonds.

   c. The financial strength and reliability of take-out or permanent lenders.

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d. Whether bonding companies and the permanent lenders have approved of any modifications to the original agreements.

e. Whether properties securing construction loans without prearranged permanent financing will be readily saleable when completed.

f. Whether inspection reports are maintained and reviewed by persons independent of the inspector and whether they support disbursements to date.

g. Whether the amount of undisbursed loan funds is sufficient to complete the project.

h. Whether title records reflect the primacy of the institution's lien position.

i. Whether adequate builder's risk insurance is maintained.

j. The adequacy of any secondary support afforded by guarantors and endorsers.

k. Compliance with established policy and procedures.

l. Compliance with applicable laws and regulations.

m. Loans not supported by current and complete financial information.

n. Loans in which collateral documentation is deficient.

o. Compliance with provisions of any loan agreements.

p. Whether the original amount of the loan was within the lending officer's authority.

q. Whether the interest rate charged and terms are within the established parameters of the interest-rate schedule and whether loans to affiliated persons of this or other institutions represent preferential treatment and actual or potential conflicts of interest.

11. For participation loans purchased and sold and loans sold in full since the preceding examination:

a. Test participation certificates and records and determine that the parties share in the risks and contractual payments on a pro rata basis.

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b. Determine that the books and records properly reflect the institution's liability.

c. Determine that the institution exercises controls and procedures over loans sold and loans serviced for others similar to those it exercises for loans in its own portfolio.

d. Investigate any loans or participations sold immediately prior to the examination to determine whether any were sold to avoid criticism during the examination.

12. For FHA-insured loans and VA-guaranteed loans:

a. Determine that a valid certificate of insurance or guaranty is on file by reviewing management's procedures to obtain such insurance or guaranty or by test checking a representative sample of such loans.

b. Determine that required delinquency reports are being submitted.

13. Determine if construction loan agreements for acquisition and development loans require prudent release payments.

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

Examiner's Summary, Recommendations, and Comments

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Construction Lending Questionnaire

	Yes	No
General Questionnaire		
Construction Loan Policies and Objectives		
1. Has the board of directors adopted written construction lending policies that:		
a. Establish procedures for reviewing construction loan applications?		
b. Require agreements by borrowers for completion of improvements in accordance with approved construction specifications and cost and time limitations?		
c. Define qualified collateral and minimum margin requirements?		
d. Identify acceptable appraisal or valuation techniques?		
e. Specify inspection procedures?		
f. Define methods of disbursing loan proceeds?		
g. Delineate standards for take-out commitments?		
h. State completion bonding requirements?		
i. Establish minimum standards for documentation?		
j. Outline aggregate limit for construction loans?		
k. Specify extensions of credit in particular types of construction projects?		
2. Are construction lending policies and objectives reviewed at least annually to determine if they are compatible with changing market conditions?		

	Yes	No
Construction Loan Applications		
3. Does the institution require:		
a. A history of the contractor's prior construction experience and a schedule of other projects the contractor currently has under construction?		
b. Trade reputation credit checks, current and historical financial statements?		
4. Do project cost estimates include:		
a. Land and construction costs?		
b. Related off-site expenses?		
c. Legal services and insurance expenses?		
d. Loan interest?		
5. Are estimated cost breakdowns available for each stage of construction?		
6. Are cost estimates of more complicated projects reviewed by qualified personnel, i.e., an architect, construction engineer, or independent estimator?		
7. Do construction borrowers contribute equity to a proposed project in the form of money or real estate and is it included in the budget?		
8. Are commitment fees required on construction loans?		
9. Does the institution require:		
a. Personal guarantees by the borrower?		
b. Personal completion guarantees by the contractor?		

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Construction Lending Questionnaire

	Yes	No
Construction and Loan Agreements		
10. Are construction and loan agreements signed prior to actual loan disbursement? ...		
11. Are construction and loan agreements reviewed by experts:		
a. To determine that building specifications conform to appropriate codes, ordinances, and restrictions? ...		
b. To ensure a perfected lien position?....		
12. Are all change orders approved in writing? .		
13. Do construction and loan agreements set a specific date for project completion and sell out?.....		
14. Do construction and loan agreements require that:		
a. The contractor not start work until authorized to do so by the institution? .		
b. On-site inspections be permitted?		
c. Disbursement of funds be based upon progress of the project?		
d. The institution be allowed to withhold disbursements if work is not performed in accordance with approved specifications?		
e. A portion 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?.....		
g. The contractor have builder's risk and hazard insurance?		

	Yes	No
h. For projects that are developed in phases, does the institution authorize individual starts and require periodic sales reports?		
Collateral		
15. Does the institution use first liens on real estate in order to secure collateral?.....		
16. Are chattel mortgages taken on real estate construction improvements?.....		
17. Do construction loans have take-out commitments that are predicated upon achievement of a specified minimum rent or lease occupancy?.....		
18. Are construction loans that are subject to the institution's own take-out commitment limited to a percent of the appraised value of the completed project?		
19. In conjunction with construction loan review, are unsecured lines of credit to contractors periodically monitored by management?....		
Appraisals		
20. Are feasibility studies obtained and do they support the viability of new development projects?		
21. Are appraisals approved in writing by the permanent lender where construction loans are subject to a take-out commitment?.....		
22. Does the institution have an internal review procedure by appropriately qualified personnel to determine whether construction appraisal procedures are consistently being followed and that appraisal documentation supports the appraiser's conclusions?.....		

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Construction Lending Questionnaire

	Yes	No
Inspections		
23. Are inspections conducted on a timely basis in order to allow monitoring of the project during all stages of construction?		
24. Are sites inspected for environmental risk and liability (refer to TB 16)?.....		
25. Are inspection reports sufficiently detailed and documented to support disbursements?		
26. Are inspection and disbursement functions segregated?.....		
27. Are inspectors rotated?.....		
28. Are spot checks made of the inspector's work?		
29. Do inspectors have sufficient expertise to determine compliance with plans and specifications?		
Disbursements		
30. Does a review of the undisbursed loans in process (LIP) account indicate that there are sufficient funds to complete projects? ...		
31. Are disbursements:		
a. Advanced on a percentage of completion method?.....		
b. Made only after reviewing complete written inspection reports?.....		
c. Subject to written preauthorization by the contractor, inspector, and authorized officer?		
d. Compared with original cost estimates and previous disbursements?.....		

	Yes	No
32. Does the institution obtain waivers of subcontractors' and materialmen's liens as work is completed and disbursements made?.....		
33. Does the institution obtain sworn and notarized releases of mechanics' liens from the general contractor at the time construction is complete and before final disbursements?		
Take-out Commitments		
34. Are take-out agreements reviewed by counsel for enforceability?		
35. Are the financial statements of permanent lenders obtained and reviewed to determine their financial viability?.....		
36. Does the institution require take-out agreements to include 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		
37. Does the institution require a completion bond for all construction loans?		
38. Has the institution established minimum financial standards for borrowers who are not required to obtain completion bonding?		
39. Does legal counsel review completion bonds for acceptability?		
Documentation		
40. Does the institution require that documentation files include:		
a. Loan applications?.....		
b. Financial statements for the borrower, builder, and guarantors?.....		

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Construction Lending Questionnaire

	Yes	No
c. Credit and trade checks on the borrower and builder?		
d. A copy of plans, specifications, and the building permit?		
e. A survey of the property?		
f. Construction and loan agreements?		
g. Appraisal and feasibility study?		
h. Up-to-date preliminary title search?		
i. Assigned tenant leases or letter of intent to lease?		
j. Copy of take-out commitment?		
k. Copy of the borrower's application to the take-out lender?		
l. Inspection reports?		
m. Disbursement authorizations?		
n. Undisbursed loan proceeds and contingency or escrow account reconcilements?		
o. Insurance policies?		
41. Are standardized check lists used to control documentation for individual files?		

	Yes	No
42. Do documentation files note all of the borrower's other loan and deposit account relationships?		
43. Does the institution maintain tickler files that will give at least 30 days advance notice before expiration of:		
a. Take-out commitment?		
b. Hazard insurance?		
c. Public liability insurance?		
Construction Loan Accounting Records		
44. Is the preparation, addition, and posting of subsidiary real estate construction loan records performed and adequately reviewed by persons who do not also issue official checks or drafts or handle cash?		
45. Are the subsidiary real estate construction loan records reconciled, at least monthly, to the appropriate general ledger accounts and reconciling items adequately investigated by persons who do not also handle cash?		
46. Are documents supporting recorded credit adjustments checked or tested subsequently by persons who do not also handle cash?		

Comments

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INTRODUCTION

Commercial loans are extensions of credit to finance commercial or industrial business activities other than for the acquisition or holding of real estate (although real estate may be used in part to secure such loans). Commercial loans may be secured or unsecured and include equipment financing loans, business lines of credit, and working capital loans. Loans to individuals for business purposes are also categorized as commercial loans.

A number of factors motivate thrift institutions to engage in commercial lending activities. First, commercial loans offer more attractive yields than loans with less credit risk. Second, because many commercial loans are short-term in nature and often contain variable-rate pricing features, commercial lending generally poses less interest-rate risk than residential mortgage loans. Third, commercial lending provides the opportunity to enhance growth and income through the cross-selling of services, particularly to owners and employees of small and medium-sized firms. Fourth, it enables institutions to achieve greater portfolio diversification, which mitigates the cyclical nature of a portfolio dominated by real estate.

The fact that federally chartered savings associations are presently restricted to investing no more than 10% of total assets in commercial loans should not serve to downplay the importance of or lessen the attention given to the commercial lending area by regulators. While many thrifts have been reluctant to use their expanded powers to make commercial loans, many of those that have, in order to compete with commercial banks and gain market share, have provided financing to businesses during the start-up and early growth stages of operation, when the risks are highest. Institutions involved in early-stage financing must recognize the risks and keep them within reasonable bounds. Failure to do so may result in credit losses that outweigh the benefits the institution is attempting to achieve through portfolio diversification.

The thrift industry's cautious move thus far into commercial lending may be due in part also to the lack of expertise in this area and the high cost of acquiring and developing that expertise. For this reason, the quality of the commercial lending staff is an important consideration for the institution contemplating or planning entry into the commercial lending arena and for the regulator in assessing the overall adequacy and effectiveness of an existing commercial lending function. In addition, management (directors and officers) should carefully evaluate the likely credit-risk levels, the potential for profitability, the compatibility of commercial lending with the thrift's overall strategic goals, the necessary staff expertise, and the demand for prudently underwritten commercial loans.

Types of Commercial Lending

Commercial loan terms vary depending on the needs of the borrower and considerations of the institution, such as the life of any pledged collateral and the cash-flow sources of the business. Firms engaged in manufacturing, distribution, retailing, and service-oriented business often use short-term working capital loans.

Seasonal Loans

Seasonal loans provide funds for a firm's seasonal financing needs. Seasonal loans have a self-liquidating feature. They are repaid at the end of the business cycle when the business converts inventory and receivables into cash. Working capital loans are usually secured by inventory and accounts receivable.

Manufacturing firms use such loans to build up their inventories of finished goods in order to meet increasing sales demand. Farmers may use seasonal loans to finance the planting, cultivation, and harvesting of crops.

Seasonal lending is often financed through a revolving line of credit (line). The credit decision is

often made well in advance of funding so that funds are available when they are needed. The borrower then obtains advances on the line in order to finance its business activities and pays down the line as inventory and accounts receivable are converted to cash and the debt is liquidated. The process is repeated the next season without the need to apply for a new loan. A prudent lender will often require that the line be paid off completely at least once a year. The lender will also require and monitor periodic financial statements from the borrower in order to determine the creditworthiness of the borrower on an ongoing basis.

Term Loans

Term business loans, granted for the acquisition of capital assets such as plants and equipment, have assumed an increasing importance to businesses. If a business wants to purchase equipment to enhance its operational efficiency, term loans allow the business to finance the purchase over the economic life of the asset and thereby preserve working capital for short-term needs. Term loans, however, often carry greater risks than short-term advances because of the length of time the credit is outstanding.

Although a borrowing company may be financially healthy when the loan is made, it may experience financial difficulties during the loan term. Also, the collateral value could deteriorate over time. (An example of this is the rapid decline in the price of oil in the early 1980s, which had a disastrous effect on oil exploration companies and the value of oil drilling equipment.) Because of the potential for additional risks, term loans are usually secured and require regular amortization payments. Also, loan agreements may contain restrictive covenants during the life of the loan.

Accounts Receivable Financing

Accounts receivable financing is a specialized area of commercial lending in which borrowers assign their interests in accounts receivable to the lender as collateral. Borrowers often include: businesses that, because of rapid growth, need year-round financing in amounts too large to justify unsecured credit; nonseasonal businesses that need year-round financing because working capital and profits are insufficient to permit periodic account cleanups (where the loan is fully repaid); businesses with inadequate working capital for its volume of sales and type of operation; and businesses whose previous unsecured borrowings are no longer warranted because of various credit factors.

Advantages of accounts receivable financing from the borrower's viewpoint include:

- the efficiency in which an expanding operation can be financed because borrowing capacity expands as sales increase;
- the borrower's ability to take advantage of purchase discounts because the company receives immediate cash on its sales and is able to pay trade creditors on a satisfactory basis;
- a revolving, expanding line of credit; and
- actual interest paid may be no more than that for a fixed-amount unsecured loan.

Advantages of accounts receivable financing from the lender's viewpoint are that it:

- generates a relatively high-yield loan, new business, and a depository relationship;
- permits continuing lending relationships with long-standing customers whose financial conditions no longer warrant unsecured credit; and
- minimizes potential loss when the loan amount is tied to a percentage of the accounts receivable collateral.

Although accounts receivable loans are collateralized, it is important to analyze the borrower's financial statements. Even if the collateral is of good quality and in excess of the loan, the borrower must demonstrate financial progress. Full repayment through collateral liquidation is normally a solution of last resort.

Commercial lenders use two basic methods to make accounts receivable advances. The first method is "blanket assignment," where the borrower periodically informs the lender of the

amount of receivables outstanding on its books. Based on that information, the lender advances a percentage of the outstanding receivables. (The percentage is generally determined by the institution's lending policies and is specified in the loan agreement.) The receivables are usually pledged on a non-notification basis and payments on receivables are made directly to the borrower who then remits them to the lender. The lender applies all or a portion of such funds to the borrower's loan.

The second method is "ledgering the accounts," where the lender receives duplicate copies of the invoices together with the shipping documents and delivery receipts. Upon receipt of satisfactory information, the lender advances a percentage of the outstanding receivables. The receivables are usually pledged on a notification basis. With this method, the lender maintains complete control of the funds paid on all pledged accounts by requiring the borrower's customer to remit directly to the lender.

In the area of accounts receivable financing, an institution's lending policy should address the minimum level of credit information needed for the loan (such as statements of condition, operating and cash flow statements, and an itemized list of the borrower's real estate holdings). The policy should also address the maintenance of an accounts receivable loan agreement that establishes:

- percentage advance against acceptable receivables,
- a maximum dollar amount due from any one account debtor,
- the disclosure of financial information on debtor accounts,
- criteria for "acceptable receivables" in light of the turnover of pledged receivables,
- the aging of pledged receivables, and
- allowable concentrations of debtor accounts.

Finally, the institution's internal audit department should periodically confirm a sample of accounts receivable amounts with the borrower's customers.

Secured Versus Unsecured Lending

Some lenders make unsecured commercial loans where no specific pledge of collateral is obtained from the borrower. A lender may make unsecured commercial loans if it has determined that the borrower is financially strong, it has a long history of satisfactory credit performance, and if the extension of credit is relatively small in relation to the company's net worth. Unsecured loans are usually made for short-term financing purposes. Periodic financial analysis of the borrower's financial condition is essential to the lending arrangement.

Combination Commercial and Real Estate Loans

Often commercial business loans are secured in part by accounts receivable, inventory, or other commercial property, and in part by commercial real estate. If the loan would only be made under the terms and conditions offered by the lender with the additional real estate collateral, the loan should be categorized as a real estate loan and is subject to the Real Estate Lending Standards rule discussed in Handbook Section 212, Real Estate Mortgage Lending. Often, however, the lender takes a security interest in the commercial real estate solely through an "abundance of caution," meaning that the lender would have granted the loan under essentially the same terms and conditions without the additional real estate collateral. In such cases, the loan can be categorized as a commercial business loan and would not be subject to the Real Estate Lending Standards rule.

Risk Containment

If management decides to implement a commercial lending program, it must formulate, adopt, and implement a sound underwriting policy to guide staff and to ensure prudent risk-taking in relation to the thrift's capital. The degree to which an institution is successful both in competing in the commercial loan market and in properly managing and controlling credit risk will depend to a large extent on the soundness of its lending practices. The best means for achieving sound loan

portfolio management are the development and implementation of:

- Comprehensive written policies, procedures, and controls covering all aspects of the lending function; and
- Systems to monitor portfolio quality and adherence to policies and procedures.

Evaluation of a thrift's program and its underwriting policy should center on whether:

- the loans follow the guidelines set forth in the institution's policy,
- the loans meet regulatory requirements, and
- the policy and the loans conform to safe and sound practices.

While each institution operates with its own set of unique characteristics, which necessitates tailoring lending policy and procedures to individual goals, objectives, strategies, strengths, and weaknesses, it should be recognized that all sound loan policies contain certain common elements. These components, and the major sources or causes of problem credits that they are designed to prevent, are outlined and discussed in detail in the Thrift Activities Regulatory Handbook Section 210, Lending Risk Assessment. The elements that make up effective systems of internal loan review are also discussed in that section.

Guidelines on Safe and Sound Administrative Procedures

The following are standards that exemplify critical components of a commercial lending program. The list is not exhaustive but rather focuses attention on key areas. An institution should develop a policy appropriate to its own operations.

Objectives. The policy should state clearly the external and internal goals of the institution's commercial lending function. Examples of the former would include community service and target-market goals. Examples of the latter would include the integration of the commercial lending function into the asset/liability and profit planning strategies of the thrift.

Policy Development. The association's commercial lending policy should address the following elements:

- Types of loans and investments to be made and those to be avoided, based on their high-risk nature or the institution's lack of experience with such loans.
- An explanation of what constitutes acceptable collateral and the means of obtaining liens against such collateral as well as margin values required.
- Policy on obtaining guarantees/endorsements.
- Acceptable parameters with respect to maximum maturities, amortization requirements, and line of credit renewals.
- Procedures for handling loan requests that do not meet articulated policy statements but are deemed worthy of consideration.
- Credit file content requirements, such as loan offering sheets, records of officer, committee and board approvals, financial statements and analysis, and memoranda supporting analysis of the credit.

The policy should not be viewed as static. It should be reviewed periodically to ensure that it reflects current and reasonably anticipated competitive economic and money market conditions. The initiation and revision process should provide for input from lenders and marketing officers; evaluation and modification by senior management; and adoption, after thorough evaluation and analyses, by the board of directors. Consistency of the policy with the institution's strategic business plan is important.

Administration. The board of directors may delegate the underwriting authority but should remain responsible for the overall lending program. The underwriting policy should contain clear lines of authority and responsibility to ensure that it is communicated to and practiced by lending and investment personnel. Corrective action should be taken when the policy is violated.

Lending Authority. Lending and investment authority should be clearly stated in dollar terms for

individual officers and for officers working in concert. For example, an individual officer may be authorized to approve or commit to loans and investments up to $50,000. Two officers together each approving the same loan package, may be authorized to approve loans and investments up to $100,000. The policy should also define levels of approval or commitment requiring prior loan committee or board approval.

The board of directors should ratify all significant commercial loans either prospectively or through a subsequent events reporting system. Dollar volume lending limits for a single borrower should be expressed in terms of the total liability of the borrower, not the dollar volume of the credit request under consideration. Loan officers presenting or considering a credit must determine all liabilities owed or likely to be owed (actual and contingent) to the institution. Examples would be other related or indirect loans, overdrafts, lines of credit, and letters of credit.

Loan Committee. The policy should set forth the composition of the loan and investment committee(s), the frequency of meetings, and loan and investment approval responsibilities. Rotational board membership is advisable so that all directors are exposed to the commercial lending process in depth. The loan and investment committee organization should also provide for a regular review of existing problem credits, the identification of problem relationships, and the development of action plans to enforce remedial action.

Pricing the Product. The policy must contain a framework for pricing decisions that takes into account types of credit, competitive market conditions, quality of the credit, liquidity of the collateral, availability of loanable or investable funds, compensating deposit balances, and the potential for or advisability of cross marketing other institution services.

Credit Underwriting Criteria

As discussed more fully in Section 212, Real Estate Mortgage Lending, the agencies have issued a proposed safety and soundness regulation that prescribes standards relating to credit underwriting. While these proposed standards offer a useful guide for examiners to assess an institution's credit underwriting policies, the application of sound underwriting principles to the lending process can also be considered within the framework of the five "C's" of credit: character, capacity, collateral, capital, and conditions.

Character: A positive assessment of the borrower's character is essential to the approval of any loan. The quality of character, however, is a particularly important credit consideration in the context of small business lending because, as a measure of the borrower's willingness and commitment to honor his or her financial obligations, it may help to compensate for weaknesses in other areas such as capital. The borrower's payment record on existing and previous loans with the institution and his or her credit history with other lenders provide evidence of the quality of the borrower's character that should be documented in the loan file. The borrower's reputation in his or her business or industry and in the community are also relevant to the assessment of character.

Capacity: The capacity to successfully operate the business and to repay debt are critical considerations. It is important that the lender have a clear understanding of the purpose of the loans and the source of repayment so that the terms of the loan can be structured in a way that is consistent with realistic prospects of repayment. Indications of either inadequate or questionable capacity to repay the debt are key factors that will affect a regulator's decision to adversely classify a loan.

The loan file should contain sufficient information on the borrower's financial condition, income, liquidity, current and projected cash flows, contingent liabilities, and other relevant factors to demonstrate the financial capacity of the business and, secondarily, any guarantors, to repay the loan. Insight into the financial capacity of the borrower may also be obtained by contacting trade groups and businesses with which the borrower does business, and through an analysis of deposit account relationships and tax returns. The accuracy of information on financial statements provided by the borrower and any guarantors should be confirmed by the lender.

In business start-up situations, the lender should obtain sales and profit projections and periodically compare actual operating performance against those projections.

In addition to financial capacity, savings associations should also assess the managerial capacity of the borrower. Management experience, knowledge, and past accomplishments in the borrower's particular business or industry are important considerations that should be reflected in the borrower's file.

Collateral: Although collateral will normally be a secondary source of repayment, for small business loans it may be an indispensable credit factor to support the decision to make the loan. When collateral is necessary to support the prudent underwriting of a loan, the agencies expect that the credit file will reflect an accurate valuation and contain documentation that reflects a perfected security interest and, where appropriate, hazard insurance. When loans are secured by a business' accounts receivable or inventory, the credit file should include documentation that appropriate controls have been established to protect the lender's interests. For example, the lender should periodically verify the existence and value of the receivables and obtain and confirm reports on the aging of the receivables. For inventory financing, lenders should establish requirements to curtail portions of loans collateralized with outdated or unsaleable inventory.

In some situations, however, collateral may not be critical to the credit decision and may have been taken primarily through an abundance of caution, or to ensure that it is not later pledged to another lender. In such cases, the agencies believe that it is appropriate to balance the cost of valuing and monitoring the collateral against its importance in the credit decision. For example, regulators should not be critical of a lender's decision to forego the expense of a formal appraisal if, through an abundance of caution, a mortgage is taken on the real estate.

Capital: Borrowers should demonstrate that they have sufficient capital and cash flow to withstand economic downturns. Many small businesses, however, are relatively thinly capitalized and illiquid and do not have access to external sources of capital. Very often, the small business must rely on bank or thrift borrowings, secured by equity in business assets or the personal assets of the business owner, to finance growth or to assist the business through a difficult period. Savings associations are encouraged to find ways to accommodate the credit needs of small businesses in their communities without exposing themselves to unwarranted credit risk.

Conditions: The economic environment and the market in which a business is competing are key factors that will contribute to the success or failure of a business. The credit analysis supporting loans to small businesses should reflect a consideration of these external factors, including, for example, the market for the products of the business, the customer base, the level of competition, any competitive advantage or disadvantage the business may have, and the likely effect of national and local economic conditions on the success of the business.

Loan Analysis. Commercial lending and attendant credit analysis should focus on the borrower's ability to repay through cash flow generated in the normal course of the creditor's business operations. Seasonal/working capital lines should be analyzed to determine the ability to repay through conversion of current assets to cash in the normal operating cycle of the business. Term credit analysis should evaluate the ability to repay through cash flow generation (profits adjusted for non-cash expenses). Such analysis should be based on current and complete financial data such as comparative balance sheets, detailed income and expense data, and statements of the sources and uses of funds between fiscal periods. Supplementary interim financial statements may be useful but should never be the sole basis for a credit decision. These statements can be flawed due to the use of estimates and timing differences in recognizing transactions that can materially distort reported results. Statements, once procured, should be periodically reviewed and updated as necessary, even after the loan has been granted. If the primary source of repayment is gone, the loan should be considered as possessing a well-defined weakness. See Section 260, Classification of Assets, for additional information.

The importance of collateral positions, endorser/guarantor support, and other such factors used to improve the credit position should not be minimized. Collateral liquidation, however, is a last resort for repayment, not a primary factor to be relied upon in the decision to extend credit. The maturity and amortization terms of a loan should be negotiated in relation to the useful life of the asset being financed, taking into account both physical usefulness and the likelihood of technological obsolescence.

Specialized asset-based financing for items such as supervised accounts receivable or inventory lending and factoring to relatively undercapitalized firms is appropriate only for institutions willing to invest in the specialized lending staff and operational procedures necessary to police such high-risk credits.

Participation Credits. There is no inherent objection to investing in commercial credits through the vehicle of participation loans. The association, however, may not transfer the responsibility for risk analysis to the lead institution. Each participating institution is responsible for arriving at its own credit decision based on adequate credit information. Inability to obtain sufficient data from the lead lender to properly evaluate the credit mandates that the credit participation be denied. Please refer to the discussions in Handbook Section 211, Loan Portfolio Diversification and Section 212, Real Estate Mortgage Lending, for additional guidance on participations.

Follow-up of Credit Relationships. Risk controls are critical at the outset of the relationship. Careful follow-up of the relationship is also necessary to ascertain the borrower's current and ongoing financial condition. Collateral inspection, calls on customers, inspection of business premises, trade checks, and the obtaining and evaluation of interim financial statements are standard follow-up techniques. Term loan contract provisions should be carefully monitored to determine departures from agreements with the thrift since any such departures may signal a developing problem, a potential default, or a compromise of the thrift's position with respect to funds owed or collateral pledged.

Outside Support. Institutions should take advantage of outside support systems and educational opportunities to develop and enhance lending and investment expertise.

Experienced and competent legal assistance is particularly important in developing a commercial lending function. Properly executed legal documentation is critical in establishing and maintaining collateral liens, endorser/guarantor liability, and in working out problem credits through restructuring, liquidation, or rehabilitation of the credit.

Marketing Risk Assumption. Associations entering the commercial lending field must be careful to maintain credit quality while developing loan volume. A prudent lender will not approve a credit that is not fully understood. Lenders must be comfortable with the business, source of repayment, value and lien status of collateral, quality and character of management, and any other critical factor bearing upon evaluation of the credit.

Lending to Small Businesses

On March 30, 1993, in response to the concerns about the availability of credit to small business borrowers, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the Federal Reserve Board (the agencies) issued the "Interagency Policy Statement on Documentation for Loans to Small- and Medium-sized Businesses and Farms." The agencies issued this policy statement to confirm their support for lending to small businesses on a sound basis and to clarify their expectations as to appropriate minimum standards for analyzing and documenting such loans.

Because of resource and other practical constraints, the financial information and business plans and projections supporting loans to small-business borrowers will often be less extensive and less detailed than would ordinarily be provided by big-business borrowers. The agencies recognize that, in the absence of audited financial statements and sophisticated business plans, prudent underwriting decisions can still be made

based on more limited, but reliable, financial data when that information is combined with the lender's personal knowledge and past experience with the borrower and his or her business. The guiding principle that the agencies will follow in the evaluation of the loan underwriting and loan administration practices of financial institutions with respect to small-business lending will continue to be that each institution should maintain documentation that provides its management with the ability to:

- Make an informed lending decision and to assess risk as necessary on an ongoing basis;
- Identify the purpose of the loan and the source of repayment;
- Assess the ability of the borrower to repay the indebtedness in a timely manner;
- Ensure that a claim against the borrower is legally enforceable; and
- Demonstrate appropriate monitoring of the loan.

Review of Loans to Small-Business Borrowers

The agencies' examination review policy is that regulators are to primarily determine if the institution's policies, practices, procedures, and internal controls are adequate and to determine if lending personnel are operating within established policy.

Regulators routinely evaluate and test policies and procedures to determine whether they are adequate to ensure that the institution maintains adequate financial information on the borrower and a perfected security interest in pledged collateral (if the collateral is an integral part of the lending decision). Regulators should also evaluate the institution's procedures for ensuring that collateral valuations are performed in a timely manner. An excess volume of credit or collateral exceptions may subject the institution's loan administration practices to criticism.

When evaluating loans to small-business borrowers, regulators should apply the standard interagency classification definitions. Institutions are strongly encouraged to document credit files for small-business borrowers as completely as possible. The performance of the loan in accordance with reasonable terms, however, will be the primary consideration in evaluating small-business loans. Regulators should not automatically conclude that minor inadequacies in written loan documentation are indicative of loan weaknesses that warrant adverse classification. A regulator's analysis should focus on the borrower's ability to repay the loan (through cash flows generated by the normal course of business operations), rather than on documentation in the loan file.

In determining the appropriate rating for a loan, regulators should give consideration to all relevant information on repayment prospects, including qualitative assessments by the loan officer based on his or her knowledge of and prior experience with the borrower.

The March 30, 1993, joint policy statement also addressed a special policy for the documentation of small- and medium-sized business and farm loans. Under that policy statement and Thrift Bulletin (TB) 61 (issued on September 8, 1993), well-managed, well- or adequately capitalized institutions are allowed to establish a "basket" of small- and medium-sized business and farm loans that will not be subject to examiner criticism based on documentation. Under the proposed safety and soundness regulations, the interagency policy statement would continue to apply.

In an effort to make the loan documentation requirements for banks and thrifts consistent, the OTS amended its loan documentation regulation at 12 CFR § 563.170(c)(1) through (7) to conform to the interagency policy statement.

REFERENCES

United States Code (12 USC)

§ 1464(c)	Investment Authority

Code of Federal Regulations (12 CFR)

Subchapter C: Regulations for Federal Savings Associations

§ 541.5	Commercial Paper
§ 541.20	Loans
§ 545.12	Demand Deposit Accounts
§ 545.31	Election Regarding Classification of Loans or Investments
§ 545.46	Commercial Loans
§ 545.48	Letters of Credit
§ 545.50(c)	Consumer Loans
§ 545.53	Finance Leasing
§ 545.74	Service Corporations
§ 545.78	Leasing

Subchapter D: Regulations Applicable to All Savings Associations

§ 563.43	Loans to Affiliated Persons
§ 563.93	Loans to One Borrower
§ 563.160	Classification of Certain Assets
§ 563.170	Establishment and Maintenance of Records

Office of Thrift Supervision Bulletin

TB 61	Interagency Policy Statement on Documentation for Loans to Small- and Medium-Sized Businesses and Farms

Other References

Interagency Policy Statement on Documentation for Loans to Small and Medium-Sized Businesses and Farms

Uniform Commercial Code - Section 9, Secured Transactions

Other Commercial Lending Program

Examination Objectives

To determine if policies, practices, procedures, and internal controls regarding commercial loans are adequate.

To determine if lending personnel are operating in conformance with the established guidelines.

To evaluate the commercial loan portfolio for credit quality, collectibility, and sufficiency of collateral.

To determine the adequacy of the audit function(s) in this area.

To determine compliance with applicable laws and regulations.

To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

Examination Procedures

Level I

Wkp. Ref.

1. Review the commercial lending policies and procedures for adequacy, given the volume and type of lending activity.

_____ _____

2. In conjunction with the regulator(s) performing the review of the audit programs (Sections 350 and 355), review the scope and depth of the work performed by internal and external auditors in the commercial lending area. Obtain a list of any deficiencies noted in the latest review.

_____ _____

3. Review adequacy of management reports to the board of directors to assure that policies and procedures are consistently followed.

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4. Obtain from the regulator assigned Section 210, Lending Risk Assessment, the following reports and schedules, if applicable to the commercial loan area:

   a. Lending and collection policies and procedures.

   b. Past due loans.

   c. Loans in a nonaccrual status.

   d. Loans on which interest is not being collected in accordance with terms of the loan.

   e. Loans whose terms have been modified by reduction of interest rate or principal payment, by a deferral of interest or principal, or by other restructuring of repayment terms.

   f. Participations purchased and sold.

   g. Loans sold in full since the preceding examination.

   h. Loan commitments and other contingent liabilities.

   i. Loans secured by stock of other depository institutions.

   j. Extensions of credit to employees, officers, directors, principal shareholders, and their interests.

   k. Extensions of credit to officers, directors, and principal shareholders of other institutions.

   l. Miscellaneous loan debit and credit suspense accounts.

   m. Loans considered problem loans by management.

   n. The current interest-rate structure/loan pricing.

   o. Officers' current lending authority.

   p. Useful information resulting from the review of minutes of the loan committee.

   q. Reports furnished to the loan committee.

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r. Reports furnished to the board of directors.

s. Loans classified at the previous examination.

t. List of rebooked charged-off loans.

u. Nature and extent of loans serviced.

5. Review the preceding report of examination and all commercial lending exceptions noted and determine if the association made the appropriate corrections.

6. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

Level II

7. Reconcile or review the reconcilement of the commercial loan trial balance to the general ledger and review reconciling items for reasonableness.

8. Perform the following using the loan commitment and contingent liability schedule:

   a. Reconcile appropriate contingency totals to memorandum ledger controls.

   b. Review reconciling items for reasonableness.

9. Using an appropriate sampling technique, select loans for review and transcribe appropriate information to the line sheets, where appropriate, including indication of any past-due, nonaccrual, or problem status. (See Section 209, Sampling.)

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10. Prepare line sheets for any loans not in the sample that, based on information contained in the above schedules, require in-depth review.

11. Obtain the institution's credit or loan files for all borrowers for whom line sheets were prepared and analyze for credit quality, adequacy of loan and collateral documentation, and compliance with established policies, procedures, and controls. In analyzing the loans, determine and consider the following:

    a. Analyze the loan for credit quality by determining the adequacy of primary and secondary sources of repayment, including the value, quality, and liquidity of any collateral support. Financial statements from previous and current periods, as well as loan officer memoranda and correspondence, should be analyzed to determine the existence of any unfavorable or adverse trends.

    b. The adequacy of any secondary support afforded by guarantors and endorsers.

    c. Compliance with established policy and procedures.

    d. Compliance with applicable laws and regulations.

    e. Loans not supported by current and complete credit information.

    f. Loans in which collateral documentation is deficient, including collateral verification and inspection by loan officers.

    g. Compliance with provisions of any loan agreements.

    h. Whether the original amount of the loan was within the lending officer's authority.

    i. Whether the interest rate charged and terms are within the established parameters of the interest-rate schedule and whether loans to affiliated persons of this or other institutions represent preferential treatment or actual or potential conflicts of interest.

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12. For participation loans purchased and sold and loans sold in full since the preceding examination:

    a. Test participation certificates and records and determine that the parties share in risks and contractual payments on a pro rata basis.

    b. Determine that the books and records properly reflect the institution's liability.

    c. Determine that the institution exercises controls and procedures over loans sold and loans serviced for others similar to those it exercises for loans in its own portfolio

    d. Investigate any loans or participations sold immediately prior to the examination to determine whether any were sold to avoid criticism during the examination.

13. For loans in the sample, check the central liability file on borrower(s) indebted above the cutoff or borrower(s) displaying credit weaknesses or suspected of having additional liability in other loan areas.

14. Perform the following steps for past-due loans:

    - Compare the following and determine any material inconsistencies:

      — The past-due loans provided to the examiners.

      — Delinquency reports submitted to the board.

      — List of loans considered problem loans by management.

      — Delinquency levels provided on reports to the Office of Thrift Supervision.

15. Determine projected loan growth.

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16. Determine general distributional characteristics of the commercial loan portfolio by:

    a. Determining percentage of total loans in specific classes.

    b. Comparing loan category distributions with policy guidelines.

17. Compare management's list of problem loans with classified loans to determine management's knowledge of its future problems.

18. Determine the causes of existing problems or weaknesses within the system that present potential for future problems.

19. Determine compliance with laws, rulings, and regulations pertaining to commercial lending.

    a. Review loans to affiliates with respect to adherence to regulatory requirements, institution procedures, and regional office policy statements.

    b. Review loans to affiliated persons with respect to the regulatory limitation of $100,000 per person (pursuant to 12 USC § 563.43).

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

Examiner's Summary, Recommendations, and Comments

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Other Commercial Lending Questionnaire

	Yes	No
General Questionnaire		
Commercial Loan Policies		
1. Has the board of directors adopted written commercial loan policies that:		
a. Establish procedures for reviewing commercial loan applications?.....		
b. Define qualified borrowers?		
c. Establish minimum standards for documentation?		
2. Are commercial loan policies reviewed at least annually to determine if they are compatible with changing market conditions?.....		
Commercial Loan Records		
3. Is the preparation and posting of subsidiary commercial loan records performed or reviewed by persons who do not also:		
a. Issue official checks or drafts singly?...		
b. Handle cash?.....		
4. Are the subsidiary commercial loan records reconciled daily with the appropriate general ledger accounts, and are reconciling items investigated by persons who also do not handle cash?		
5. Are delinquent account collection requests and past-due notices checked to the trial balances that are used in reconciling commercial loan subsidiary records with general ledger accounts, and are they handled only by persons who do not also handle cash?		
6. Are inquiries about loan balances received and investigated by persons who do not also handle cash?.....		

	Yes	No
7. Are documents supporting recorded credit adjustments checked or tested subsequently by persons who do not also handle cash?		
8. Is a daily record maintained summarizing note transaction details to support applicable general ledger entries?.....		
9. Are frequent note and liability ledger trial balances prepared and reconciled with controlling accounts by employees who do not process or record loan transactions?....		
10. Is an overdue account report generated frequently?		
11. Are subsidiary payment records and files pertaining to serviced loans segregated and identifiable?.....		
Loan Interest		
12. Is the preparation and posting of interest records performed or reviewed by persons who do not also:		
a. Issue official checks and drafts singly?		
b. Handle cash?		
13. Are the independent interest computations made and compared or tested with initial interest record by persons who do not also:		
a. Issue official checks and drafts singly?		
b. Handle cash?		
Collateral		
14. Are multicopy, prenumbered records maintained that:		
a. Detail the complete description of collateral pledged?.....		
b. Are typed or completed in ink?		

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Other Commercial Lending Questionnaire

	Yes	No
c. Are signed by the customer?		
d. Are designed so that a copy goes to the customer?		
15. Are functions of receiving and releasing collateral to borrowers and of making entries in the collateral register performed by different employees?.....		

	Yes	No
16. Is negotiable collateral held under joint custody?		
17. Are receipts obtained and filed for released collateral?		
18. Are securities and commodities valued and margin requirements reviewed at least monthly?		

Comments

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INTRODUCTION

A letter of credit substitutes the creditworthiness of a strong financial institution for that of an individual or a corporation. This concept has been used in financing the international shipment of merchandise for centuries. Today, letters of credit are also used in a wide variety of other commercial financing transactions, such as securing a real estate development loan, guaranteeing obligations involving the private placement of securities, and assuring payment in the event of nonperformance of an obligated party.

During the 1980s, thrifts significantly increased their issuances of letters of credit, particularly standby letters. A contributing factor to this development is that by issuing letters of credit, an institution can increase its earnings without disbursing funds, thus, not affecting its tangible and core capital requirement. (It does, however, increase its risk-based capital requirement.) The institution charges a fee for the risk of default or nonperformance by the customer. No funds are disbursed and the institution's level of assets remains virtually unchanged. However, various forms of letters of credit have different effects on risk-based capital requirements and loans-to-one-borrower limits.

It is important for regulators to look beyond the contingent liability figures that appear on the institution's records and be concerned with the risk elements present in the institution's practices regarding letters of credit issuance. Examiners should then assess the institution's system of controls that can mitigate those risks, including experienced staff, proper documentation, and the quality of underwriting. The letter of credit portfolio requires a review, both internally by the institution and also by regulators, as thorough as the lending review. A default or nonperformance by the account party of a letter of credit will have the same effect as a default on a loan, that is, a loss of capital.

To adequately evaluate the institution's portfolio, it is important for the examiner to understand the concept of letters of credit, know how they are used, and be aware of related documentation and accounting practices. Refer to related glossary entries. There are two major types of letters of credit: the commercial letter of credit and the standby letter of credit.

Commercial Letter of Credit

The commercial letter of credit (LOC) is commonly used as a means of financing the sale of goods between a buyer and seller. Generally, a seller will contract with a buyer on an open-account basis, whereby the seller ships the goods to the buyer and submits an invoice. To avoid the risk of nonpayment, the seller may require the buyer to provide a commercial letter of credit. To satisfy the requirement, the buyer applies to an issuing institution, requesting the institution to issue a letter of credit containing specified terms and conditions in favor of the seller (beneficiary). If approved, the buyer (account party) agrees to reimburse the institution for payments drawn against the letter. The commercial letter of credit can be used to finance one shipment or multiple shipments of goods. Once documents are submitted providing evidence that the goods have been shipped in accordance with the terms of the letter of credit, the seller can draw against the issued letter of credit through a documentary draft or a documentary demand for payment. The buyer reimburses the institution (either through deposits to a deposit account or through drawing down on a line of credit previously approved by the institution). Thus, letters of credit can be secured by cash deposits, a lien on goods shipped or other inventory, accounts receivable, or other forms of collateral. Commercial letters of credit "sold for cash" (that is, secured by cash deposits) pose very little risk to an institution as long as the bank ensures that the beneficiary provides the proper documents prior to making payment on the draft. If credit is extended to pay for the goods, the subsequent loan presents the same credit risks associated with any other similar loan.

Standby Letter of Credit

The standby letter of credit (SBLOC) is an irrevocable commitment on the part of the issuing institution to make payment to a designated beneficiary if the institution's customer, the account party, defaults on an obligation. The SBLOC differs from the commercial letter of credit in that it is not dependent upon the movement of goods. Where the commercial letter of credit reduces the beneficiary's risk of nonpayment under contract for the sale of goods, the SBLOC reduces the risks of default or nonperformance under a contract. SBLOCs may be financially oriented, whereby an account party agrees to make payment to the beneficiary, or it may be service oriented, whereby a service is to be performed by the account party. SBLOCs are subject to loans-to-one-borrower limits of § 563.93 of the regulations and 12 CFR 32. Commercial letters of credit are not.

Unlike a commercial letter of credit, a demand for payment against an SBLOC is generally an indication that something is wrong. The nonperformance or default that triggers payment under the standby letter of credit often signals the financial weakness of the customer, whereas payment under a commercial letter of credit suggests that the account party is conducting its business as usual. Standby letters of credit are usually unsecured, but may be secured by a deposit or other form of collateral.

The uses of SBLOCs are practically unlimited. The more common areas of use include:

Real Estate Development: A mortgagee will condition its loan commitment upon a cash contribution to a project by the developers. Although the lender insists that the developers have some equity in the project, the developer may have funds tied up in other construction. The parties often use the letter of credit to satisfy the equity requirement without the need for a cash deposit.

Fulfilling Municipal Regulations: Most municipalities will require a standby letter of credit as security for a developer who is seeking the approval of bids on various improvement projects, such as buildings, roads, and utility services.

Securing Notes: A lender will often ask its obligor to secure the balance of a promissory note with a SBLOC.

Performance: The standby letter of credit serves in the nature of a performance bond. Often the seller of goods will have the borrower obtain a commercial letter of credit to ensure payment; simultaneously, the buyer will have the seller obtain a standby letter of credit to ensure that the goods are delivered when agreed and in acceptable condition.

Securities: The standby letter of credit serves to guarantee obligations involving the private placement of securities, such as revenue and development bonds. Industry ratings of such paper will be higher and a lower interest rate will generally be given if a SBLOC secures against default.

More recently, standby letters of credit have been used to provide credit support for credit card and auto loan securities.

Benefits

The primary reason that an institution may issue a letter of credit is to provide a financial service for a creditworthy customer. Through the use of a letter of credit, a customer can often obtain a less expensive source of funds than would be possible through direct financing from the institution. For example, the customer may be able to take advantage of a seller's credit terms with the backing of a letter of credit to substantiate creditworthiness. The institution receives a fee for providing the service. The institution also hopes to build a better working relationship with its customers who may bring in other profitable banking business.

Uniform Commercial Code

Both the issuer and the beneficiary of letter of credit contracts are obligated to conform to a uniform set of rules governed by Article 5 of the Uniform Commercial Code (UCC). These rules are addressed under the Uniform Customs and Practices for Documentary Credits. The UCC is a set of articles adopted by the domestic states, whereas the Uniform Customs and Practices involves all international guidelines for trading

goods and services. Local laws and customs vary and must be followed under advice of counsel.

Elements of a Letter of Credit

When issuing a letter of credit, federal thrifts are subject to the following requirements of § 545.48 of the regulations:

- Each letter of credit must conspicuously state that it is a letter of credit;
- The issuer's undertaking must contain a specified expiration date or be for a definite term and must be limited in amount;
- The issuer's obligation to pay must be solely dependent upon the presentation of conforming documents as specified in the letter of credit and not upon the factual performance or nonperformance by the parties to the underlying transaction; and
- The account party must have an unqualified obligation to reimburse the issuer for payments made under the letter of credit.

To the extent that funds are advanced under a letter of credit without compensation from the account party, the account shall be treated as an extension of credit subject to percentage-of-asset limitations applicable to the institution.

The letter of credit involves at least three parties and is three separate and distinct contracts:

- A contract between the account party and the beneficiary under which the account party has an obligation of payment or performance;
- A contract between the account party and the issuer of the letter of credit. The issuer is the party obligated to pay when the terms of the letter of credit are satisfied. The account party agrees to reimburse the issuer for any payments made; and
- A contract between the issuer and the beneficiary, whereby the issuer agrees to pay the beneficiary in compliance with the terms and conditions of the letter.

Revocable or Irrevocable

Letters of credit can be issued in either revocable or irrevocable form. The revocable letter of credit is rarely used, because it may be amended or canceled by either party without the consent of the other. Most letters of credit are issued as irrevocable, which stipulate that no changes may be made to the original terms of the letter of credit without the full consent of all parties.

Risks in Issuing LOCs

An institution must be aware of the credit risks that are associated with letters of credit and issue them only when its resources are adequate to cover any resultant losses. Although letters of credit are not originally made as loans, they may lead to loans if payment is made and account parties cannot meet their obligation to reimburse the institution. Therefore, the institution must implement the same underwriting guidelines for letters of credit as is prudent for other extensions of commercial credit that are recorded on the balance sheet. (Refer to Thrift Activities Regulatory Handbook, Section 214, Other Commercial Lending.)

The importance of adequate documentation cannot be overemphasized. Commercial letters of credit are part of a continuous flow of transactions evolving from letters of credit to sight drafts to acceptances. Repayment may depend upon the eventual sale of the goods involved, yet the goods may not provide adequate collateral protection. Thus, the proper handling and accuracy of the required documents is of primary concern. Letters of credit are frequently issued via tested telex, which verifies the authenticity of the sender (usually another bank). No institution should honor a letter of credit presented by a beneficiary without first confirming its authenticity.

Commercial letters of credits involving imports must be considered unsecured (by the goods being shipped from abroad) until the goods have passed customs, the security documents specified in the letter of credit have been presented, and the goods have been verified and controlled.

Letters of credit are subject to fraud risks from both customers and insiders. Standby letters of credit can be used by officers or directors as a vehicle for obtaining credit at another institution to avoid the scrutiny associated with obtaining insider loans from their institution. Consequently, the issuance of letters of credit should be subject to the same strict internal controls as the extension of credit. Such controls include: segregation of duties, the requirement of dual or multi-level authorizations and segregation of duties between the issuing, recordkeeping, acceptance, and payment functions.

Risks in Honoring LOCs

Honoring another institution's LOC or acceptance requires strict verification procedures as well as dual authorization by the honoring thrift. Reasons for strict procedures and authorizations are numerous. The issuer may be unable or unwilling to honor an LOC or SBLOC, claiming the document to be fraudulent, or a forgery, or the signer to have been unauthorized. Before honoring any other institution's LOC, a thrift should confirm in writing that the LOC is valid and will be honored under specified conditions. Agreements with issuers for accepting LOCs issued by tested telex should provide specific conditions under which they will be honored. To minimize risks of loss, compliance with the conditions must be strict-not merely substantial. Testing LOCs should involve two or more persons through dual authorization or segregation of duties to prevent fraud by employees in this process.

SBLOCs Issued As Surety For Revenue Bonds

Standby letters of credit may be issued in conjunction with the development of a property financed with tax-free revenue bonds. In these transactions, a government agency, typically a local housing authority or regional development authority, sells bonds to investors to finance the development of a specific project. Once the bonds are issued, the proceeds are placed with a trustee and then loaned at less-than-market rates to the developer of the project. The government agency has no liability; the bond investors have recourse against only the specific project. The bonds are exempt from federal taxation and generally carry below-market interest rates since they are issued by the agency. The below-market-rate loan that is granted to the developer enables the government agency to encourage development without expending tax dollars.

Because the bonds are secured by only the project, typically an SBLOC is obtained from a thrift or a commercial bank to provide additional security to the bond holders. The SBLOC is usually for an amount above the face amount of the bonds, so that the bondholders' accrued interest between interest payment dates is also secured. Moreover, the thrift generally secures its SBLOC with a lien against the property that is junior to the authority or trustees' lien.

The trustee receives periodic payments from the developer and then pays the bondholders their periodic interest payments and the thrift its letter of credit fee. In the event of a default by the developer, the trustee will draw upon the SBLOC to repay the bondholders. If such a default occurs, the thrift is then in the position of the lender for the project.

The structure of the transaction requires the thrift issuing the SBLOC to assume virtually all of the risk. In the event any problems occur, the bondholders will be repaid by calling the SBLOC, leaving the government agency with no liability. Because of these concerns, the primary underwriting consideration is the ability of the collateral property to service the debt. Appraisals should be obtained and debt service coverage requirement calculations should include both the favorable rate obtained through the revenue bonds and market interest rates. The operations of the collateral property should also be monitored on an ongoing basis. If new construction is involved, the progress should be monitored and any cost overruns should be identified and addressed.

In reviewing these transactions, the regulator must be aware of the risk that the thrift has assumed. Pricing should be a key consideration since the thrift is vulnerable to any losses that may occur. Because the purpose of these bonds is to encourage development, marginal projects that would not be feasible under conventional financing are often financed in this manner. The collateral should be valued using market value unaffected

by the specialized financing because the specialized financing may be unavailable to a purchaser.

Without the benefit of a substantial guarantor or equity in the collateral, these SBLOCs present more-than-normal risk of loss and are likely to be substandard or worse. Protection against loss may be provided by a long-term lease from a major tenant of an industrial property, or a housing authority lease with a government funding commitment or guaranty.

Although most of the SBLOCs contain periodic renewal features, the examiner must be aware that the thrift cannot relieve itself from liability simply by choosing not to renew the SBLOC. Virtually all of the bond issues require a notice of nonrenewal prior to the expiration of the SBLOC. If such notice is received by the trustee, it is normally considered an event of default and the existing SBLOC is generally drawn upon by the trustee. As a result, the thrift should be continuously monitoring both the project and the status of the bonds. Evidence should be contained in the file regarding the property's occupancy, its cash flow position, and the status of the bonds. In addition to the current status of interest payments, any sinking fund requirements contained in the bond indenture should also be verified and compliance monitored. Instances have been reported where financial institutions found it expedient to buy the revenue bonds at a discount rather than honor an SBLOC.

Policies and Procedures

Maintaining adequate written policies and procedures and monitoring letter of credit activities are part of the fiduciary and oversight responsibilities of the board of directors. Generally, policies and procedures governing the institution's issuance of letters of credit are contained in a section of the loan policy manual.

The letter of credit policy should thoroughly explain the institution's procedures in issuing both commercial letters of credit and standby letters of credit. It should outline desirable and undesirable issuances, designate persons authorized to issue letters of credit, and define the recordkeeping and documentation requirements, including the need to establish separate files for each issuance.

If several lending departments issue letters of credit, the policy should be explicit in charging responsibility for file maintenance and recordkeeping. A separate file containing an exact copy of each outstanding letter of credit and all the supporting documentation that the underwriter used in making the decision to issue the letter should be included in the file. This documentation should be the same as the financial documentation used for originating any other form of credit, which includes current financial statements, current income statements, purpose, collateral security documentation, proof of lien position, borrowing authorization, all correspondence, and officers' memoranda.

In addition, the file must contain the documentation associated with any disbursements or payments made. For a commercial letter of credit, these documents may include:

- The draft (sometimes called the bill of exchange), which is the demand for payment;
- The commercial invoice, a document describing the goods being shipped (prepared by the seller and signed by the account party);
- The bill of lading, which documents that shipment of the goods has taken place and gives the issuer an interest in the goods in the event the account party defaults;
- The insurance certificate that provides evidence that the seller has procured insurance;
- The consular documents, stating that the shipment of goods satisfies the import/export regulations; and
- The certificates of origin and inspection, which state that the goods originated in a specified country, to guard against the substitution of second-quality merchandise.

The documents associated with standby letters of credit are far less complicated than the commercial letter of credit. Often no document is

necessary to support the beneficiary's draw upon it. This is what is referred to as a clean standby letter of credit and should be discouraged due to the possible legal expense of defending any action taken in honoring or dishonoring a draw without specific documentary requirements. At a minimum, standby letters of credit should require a copy of the contract between the account party and beneficiary, and a beneficiary's certificate asserting that the account party has not performed according to the contract or has defaulted on the obligation.

Banker's Acceptance

When the beneficiary presents a draft to the issuer in compliance with the terms of a commercial letter of credit, the method of honoring the draft is acceptance. The issuer will stamp the word "accepted" across the face of the draft, which makes the instrument negotiable. Thus, the institution upon which the draft is drawn converts what was originally an order to pay into an unconditional promise to pay. Payment terms on a letter of credit vary from sight for a sight draft (which must be paid on acceptance) to 180 days for time drafts. There is a ready market for these instruments, because they are backed by the full faith and credit of the institution. Payment must be made at maturity by the accepting institution, whether or not it is reimbursed by its customer. Because of this, acceptances are readily negotiable, and a beneficiary may "sell" accepted time drafts to other financial institutions for a discount, based on the number of days remaining until payment is to be made by the issuing institution. Acceptances are governed by Article 3 of the UCC and any rights the parties have under acceptance are subject to the rules of that article.

Accounting Issues

Statement of Financial Accounting Standards (SFAS) No. 91 stipulates that:

> If the institution's experience with letters of credit indicates that the likelihood that the commitment will be exercised is remote, the commitment fee shall be recognized over the commitment period on a straight line basis as service fee income. If the commitment is subsequently exercised during the commitment period, the remaining unamortized fee should be recognized over the life of the loan as an adjustment of yield.[1]

Since letters of credit represent a contingent liability to the issuing institution, they must be disclosed in the financial statements in accordance with generally accepted accounting principles (GAAP). In accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standard (SFAS) No. 5, the nature and the amount of a standby letter of credit must be disclosed in the institution's financial statement.

In addition, SFAS No. 5 requires that if a loss contingency is probable and can be reasonably estimated, a charge to income must be accrued.

Classification of SBLOCs

It may be appropriate to adversely classify an SBLOC if draws under the SBLOC are probable and a credit weakness exists. For example, deterioration of the financial standing of the account party could jeopardize performance under the letter of credit and result in the requirement of payment to the beneficiary. Such a payment would result in a loan to the account party and could result in a collection problem, especially if the SBLOC were unsecured. Thus, if payment is probable, and the account party does not have the ability to repay the institution, adverse classification is warranted. (Please refer to Handbook Section 260, Classification of Assets, for detailed procedures on asset classification.)

REFERENCES

Code of Federal Regulations (12 CFR)

Chapter I: Office of the Comptroller of the Currency

§ 32.2(d) Contractual Commitment to Advance Funds

[1] Financial Account Standards Board, *Statement of Financial Accounting Standards, SFAS No. 91*, "Accounting for Nonrefundable Loan Fees and costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases."

§ 32.2(e) Standby Letter of Credit

Chapter V: Office of Thrift Supervision
Subchapter C: Regulations for Federal Savings Associations

§ 545.48 Letters of Credit

Subchapter D: Regulations Applicable to All Savings Associations

§ 563.93 Loans-to-One-Borrower Limitations

FDIC Regulations

Part 337 Unsafe and Unsound Banking Practices
§ 337.2 Standby Letters of Credit

Comment-Rulings

FHLBB Resolution 83-241 as amended
Letters of Credit ¶ 37,362.034*

Financial Accounting Standards Board, Statement of Financial Accounting Standards

SFAS No. 5 Accounting for Losses and Contingencies
SFAS No. 91 Accounting for Nonrefundable Loan Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases

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* The reference is to a paragraph number in the Supervisory Service, Savings and Community Bankers of America, Chicago, Illinois.

Letters of Credit
Program

Examination Objectives

To determine if the policies, procedures, and controls regarding letters of credit adequately ensure safety and soundness, profitability, and compliance with laws and regulations.

To determine if officers and employees are knowledgeable and qualified to perform their duties and responsibilities associated with letters of credit in a manner that ensures safety and soundness, profitability, and compliance with policies and procedures.

To determine if financial records and management reports provide accurate and necessary information to management and directors.

To determine the adequacy of the audit and internal loan review function(s) over letters of credit.

To evaluate the credit risk associated with the issuance of letters of credit and whether management is aware of those risks.

To evaluate the institution's documentation and underwriting of letters of credit, which should evidence the financial stability and credit quality of the borrower, collateral sufficiency, and collectibility.

To determine compliance with laws and regulations.

To initiate corrective action when deficiencies exist that could affect safety and soundness, or when violations of laws or regulations have been noted.

Examination Procedures

Level I

Wkp. Ref.

1. Review the institution's current policy on letters of credit. Verify that the board of directors has adopted the policy and that the guidelines adequately address safety and soundness (including internal controls), desirable and undesirable issuances, limits of authority, profitability, and compliance with laws and regulations.

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2. Obtain pertinent financial records (including the trial balance) and management reports that the institution has for this area. From these reports prepare a work paper on the following:

   a. List the dollar amount of the institution's total outstanding letters of credit (separately for both standby and commercial letters of credit).

   b. Compute the ratios of outstanding letters of credit issued to total loans, total assets, and regulatory capital. Contrast and note trends from the previous examination.

   c. Assess liquidity risk from LOCs and SBLOCs.

3. Scan the management reports for areas of concern and comment on these concerns in the work papers. Areas to consider are:

   a. Letters of credit issued for officers, directors, and their interests;

   b. Letters of credit issued for officers and directors of other financial institutions;

   c. Letters of credit criticized during the previous examination;

   d. Letters of credit that are in excess of percentage of asset limitations; and

   e. Payments made on standby letters of credit within the past year; status of the resultant loans.

4. Determine through discussions and other appropriate verification methods, if management has taken corrective action relative to:

   a. Prior examination report comments and prior examination exceptions;

   b. External and internal audit and internal loan review exceptions; and

   c. Any enforcement/supervisory actions and directives.

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Wkp. Ref.

5. Coordinate contingent liability and other information with examiners assigned to other loan areas. Add standby letters of credit to the borrowers' aggregate loans and determine if credits are in compliance with the loans to one borrower limits, §563.93 of the regulations.

6. Complete the General Questionnaire.

7. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

Level II

8. Review the trial balance that lists each outstanding letter of credit and review the institution's reconcilement of the account to the general ledger. Determine the reasonableness of reconciling items.

9. Select and review a sample of the outstanding letters of credit, including import LOCs. Coordinate with the examiner assigned to lending risk assessment. (For details on sampling, refer to Section 209 of the Thrift Activities Regulatory Handbook.)

10. Read and determine that each of the letters of credit selected for review complies with the requirements of § 545.48 of the regulations (if applicable) and constitutes a letter of credit rather than a guarantee.

    a. Each letter of credit should conspicuously state that it is a letter of credit.

    b. The issuer's undertaking must contain a specified expiration date or be for a definite term and must be limited in amount.

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c. The issuer's obligation to pay must be solely dependent upon the presentation of conforming documents as specified in the letter of credit and not upon the factual performance or nonperformance by the parties to the underlying transaction.

d. The account party must have an unqualified obligation to reimburse the issuer for payments made under the letter of credit.

e. Check to see how verification for authenticity is performed prior to approving the release of funds.

11. Prepare regulator review sheets (215A.1) or line sheets for each selected sample and include the customer's aggregate letter of credit liability. The following detail should be noted on the review sheet of each outstanding letter of credit:

- Serial number
- Undrawn amount
- Date of issuance
- Expiration date of the credit
- Name of the beneficiary
- The manner in which the draft is to be drawn
- Purpose of the letter of credit

Note whether it is:

- Commercial or standby
- Issued or confirmed
- Revocable or irrevocable
- Negotiable or nonnegotiable

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- Revolving
- Transferable
- Assignable

Note whether the approval application is on file and whether the terms of the letter of credit are in agreement with it.

12. Obtain loan files for all borrowers for whom review sheets were prepared. Complete the sheets from the information obtained from the file. Analyze the underwriting and quality of the letter of credit the same as for asset classification, and:

    a. Review compliance with provisions of letter of credit agreements.

    b. Compare the amount of letters of credit outstanding with the lending officer's authority.

    c. Ascertain compliance with the institution's established commercial loan policy.

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

Level III

14. Compare fees charged with the fee schedule(s) and determine that terms are within established guidelines.

Examiner's Summary, Recommendations, and Comments

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Letters of Credit
Questionnaire

General Questionnaire	Yes	No
1. Is there a written letter of credit policy that has been approved by the board of directors?		
2. Is the policy on letters of credit reviewed annually by the board of directors and noted in the board minutes?		
3. Is a daily record maintained that summarizes transactions on letters of credit?		
4. Who is responsible for the preparation and posting of subsidiary records on letters of credit? Give name and title of specific department officer. _____ _____		
5. Has the institution made commitments on letters of credit that are not issued?.....		

	Yes	No
6. Are letters of credit reviewed for soundness of quality and included, when applicable, on the institution's problem asset list?		
7. Has the institution had to pay on a demand draft without reimbursement from the customer?		
8. Were any loans granted as a result of payment on a letter of credit?		
9. Were any losses recognized as a result of payment on a letter of credit?		
10. Are lending officers frequently informed of maturing letters of credit?		
11. Are letters of credit recorded and assigned consecutive numbers?		
12. Are there any outstanding lawsuits involving letters of credit?		
13. Does the institution's audit function review for compliance with policies and procedures?		

Comments

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Regulator Review

Institution: _____

Exam Date: _____

Docket No.: _____

LOC # _____

Account Party: _____

Amount of Letter of Credit $_____ Undrawn Amount $_____

Beneficiary: _____ Date of Issuance: _____ Expiration Date: _____

Purpose of Letter of Credit: _____

_____

Documents Needed To Honor Draft:_____

_____

Circle Appropriate Information:

Issued or Confirmed	Negotiable or Nonnegotiable	Commercial
Revocable or Irrevocable	Revolving	Standby
Transferable	Assignable	

Is an approved application on file and does it agree with the terms of the letter of credit? Yes or No

Security Pledged: _____ Estimate of Value $_____

Examiner's Comments Regarding the Underwriting and Documentation:

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INTRODUCTION

Floor plan lending is a form of inventory financing for sellers of retail goods in which each loan advance is made against a specific piece of collateral. Items subject to floor plans include automobiles, manufactured homes, large home appliances, furniture, equipment, boats, and other types of merchandise sold under a sales finance contract. The goods are then sold for cash or under a finance contract, with the sale of inventory the normal repayment source. When inventory is not sold as expected, however, the dealer may be required by the loan agreement to repay the debt with other cash sources.

Floor plan lending involves a high level of risk requiring expertise, experience, and extensive controls. But certain benefits are provided, including: the loans are interest-rate sensitive and could, therefore, complement a fixed-rate, long-term loan portfolio; the institution can cross-sell services by providing financing to the purchasers of the inventory; and the institution's asset base can be diversified. Floor plan borrowers are often primary sources of indirect dealer lending through thrift purchases of retail loans made by dealers.

Floor Plan Lending

Floor plan loans involve three parties: the supplier of goods, the dealer, and the financial institution. This results in a complex set of legal documents that govern the structure of the arrangement that facilitates inventory purchases by a dealer by guaranteeing payment to the supplier. For this reason, suppliers often provide buy-back agreements to repurchase slow inventory within specified time limits. To secure payment for the amounts advanced, the financial institution must perfect its security interest. Generally, Article 9 of the Uniform Commercial Code (UCC) requires entering into a security agreement with the dealer and providing public notice of this security interest. However, the method of perfecting a security interest varies from state to state, and there are numerous divergences from the UCC.

When a dealer first enters into the financing arrangement with an institution, a master loan agreement is executed. The master loan agreement establishes the basic conditions of the relationship between the dealer and the financial institution. It normally grants the lender a continuing security interest in the dealer's inventory, receipts, and accounts receivable and should also contain provisions for insurance, dealer reserves, and curtailments.

In most institutions, the evidence of debt is the trust receipt. There are generally two methods by which trust receipts are created. An institution may enter a drafting agreement, similar to a letter of credit, with a manufacturer. In this situation the institution agrees to pay documentary sight drafts covering shipments of merchandise to the dealer. The sight drafts often require sight of evidence of the dealer's receipt of merchandise and the manufacturer's statement of origin (MSO). The drafts are payable when the inventory is received or, if the manufacturer permits, after a grace period that allows the dealer to prepare the inventory for sale. The drafting agreement usually limits the number of units, the per unit cost, and the aggregate cost that can be shipped at one time, and includes the buy-back agreement.

The merchandise remains with the dealer until sold and is evidenced by trust receipts. Title documents, such as MSOs, should be held by the institution. All the documents should be inspected physically, as should the merchandise, during the floor plan inspection to prevent dual financing.

Trust receipts are also created when merchandise is shipped under an invoice system. The dealer receives the merchandise, accompanied by invoices and titles (or MSOs) where appropriate. The dealer presents the documents to the institution, which then pays the invoice, attaching duplicates to the trust receipt, which is signed by the borrower. Depending on the type of inventory

and dealer, the title may remain with the institution or be released.

Used car inventories are financed with titles or under trust receipts, with a list of the units and their loan values attached to the receipts. The regulator should determine that the security interest has been properly perfected, or that titles are held by the thrift. (The thrift should follow advice of legal counsel on this matter.)

There are two basic forms of repayment for floor plan loans. The lender may receive either cash or indirect loans produced from the sale of inventory. Floor plan lending is ideally structured so that the debt is repaid from the sale of the collateral before the collateral depreciates to a liquidation value that is below the loan amount. If the inventory is sold, the institution will either require cash from the dealer or will provide the purchaser with a loan and will retire the flooring debt.

As mentioned, the loan is ideally repaid as the inventory is sold. However, a curtailment provision, that requires periodic principal reductions if inventory does not sell within a specified period of time, is also required of the dealer. Curtailments are usually set forth in the loan agreement and establish the required timing and percentage reduction in principal for each loan. Curtailment requirements are structured so that reductions are made in the debt to exceed the market depreciation of the collateral. This is necessary, because stale inventory may depreciate precipitously. Regulators must determine that the structure of the curtailment arrangement is adequate to protect against loss on the loan.

Flooring is a complex and time-intensive process. As a result, operating costs can be high and interest margins should also be very high. Profitability is often marginal due to the credit risk involved combined with inadequate interest margins. To supplement income from this source, the lender often relies on the additional income generated from quality indirect loans granted to purchasers of the dealer's inventory. If the institution does not receive an adequate portion of loans generated by the dealer, or if the loans are of inferior quality, the relationship may be of questionable value to the institution.

Loan Underwriting Considerations

Floor plan lending exhibits a high degree of risk. In addition to the risks associated with inventory financing, the institution is unable to exercise full control over the floored items. Dealer debt ratios are often high, the collateral margin is low, and the collateral depreciates steadily. The inability of the lender to exercise control over the inventory means that the dealer can possibly sell out of trust.

A dealer sells out of trust when the inventory is sold but the funds are not immediately remitted to the lender to retire the corresponding debt. This situation usually occurs when the dealer is experiencing cash flow shortages or critical financial problems. The lender's recourse to prevent this includes: regularly monitoring financial performance of the dealer; regularly inspecting and verifying the inventory; controlling title documents; and, if necessary, placing physical controls over the inventory. Bonded warehouses are often used to control inventory.

An institution must take certain actions to minimize risk. It must first establish prudent policies for floor plan lending. These policies include limits on the size of the floor plan lending portfolio. In addition, it must define qualified borrowers based on their ability to pay, credit histories, and reputations. Lending limits should be established for each dealer and for each type of product being floor planned.

Floor plan checks must be done at least monthly, but more frequently depending on the reputation and financial condition of the dealer. The inspectors should be rotated regularly as an additional quality control measure. Inventory audit servicers may be used to assist inspections, but should not be relied upon without oversight. The checks include: inspection of the inventory to determine its existence and condition, a follow-up to determine the existence of items that were missing at the last inspection, inspection of identifying documents and comparison with the inventory (verification of serial numbers), and mileage checks on vehicles to determine that depreciation is not occurring at a rate faster than expected.

An important facet of an institution's relationship with a dealer is the dealer reserve and operating deposit accounts, which represent both a compensating balance and a tool by which the loan officer can monitor customer activity. A review of the flow of funds into and out of the account may reveal that inventory has been sold without debt reduction, that the dealer is incurring abnormal expenses, or that unreported financial activity has occurred that might warrant a reconsideration of the credit arrangement.

Institutions must establish and maintain adequate dealer reserve accounts by "holding back" a percent of sales in excess of debt service requirements. The dealer reserve accounts must be replenished when losses occur. Finally, if problems begin to develop, the institution must take immediate action to prevent losses.

Because dealers typically have low capital levels, a close and frequent review of the dealer's financial condition is necessary. When analyzing financial data, institutions should review the number of units sold and the profitability of these sales. They should compare the number of units sold with the number financed to ensure that inventory levels are not excessive. Institutions should monitor the value of the collateral when placing the loan and by continuously inspecting it to determine its condition. Institutions should impose curtailments to keep collateral values in line with the principal and interest balances. The book value of inventory should be compared with the book value of debt used to finance inventory.

Other procedures include: establishing lending authorization limits, lines of authority, and dual authorization requirements for loan approvals; perfecting security interests; and conducting internal loan reviews.

Regulatory Considerations

Federal thrifts are authorized to make floor plan loans-pursuant to 12 USC 1464(c)(2)(D) of the HOLA and 12 CFR § 545.50(c) of the regulations- up to 30% of assets. Section 563.170(c)(2) of the regulations establishes minimum documentation requirements. Perfection of security interests on floor plan loans is governed by Section 9 of the UCC but may also vary with state law.

Indirect Dealer Lending

Indirect loans are retail loans that are purchased from a seller of retail goods (dealer). The loans are originally granted to consumers by the dealer to finance the purchase of retail products. These loans are often called "dealer paper," "indirect paper," or "loan paper." In many cases the institution may have also provided the dealer with floor plan financing to purchase the inventory being sold.

There are two basic arrangements for the purchase of retail loans and sale contracts from dealers: recourse and nonrecourse.

With nonrecourse purchases, the institution assumes full responsibility for underwriting the retail loan. Although the dealer writes the loan, the thrift carries all of the risk. Therefore, the contracts should fully conform to the institution's underwriting requirements. Also, controls must be implemented to ensure that the dealer is complying with consumer regulations.

Institutions should segregate accounting and reporting for indirect loan accounts by dealer to determine the reliability of the dealer from the quality of loan paper the institution receives and to determine the profitability of the dealer indirect account. Otherwise, indirect loans should be treated like other consumer loans for underwriting, monitoring, collection, and control and ensuring that consumer regulations are followed by the dealer. (Refer to Thrift Activities Regulatory Handbook Section 217, Consumer Lending.)

With recourse agreements, the institution purchases the contract from the dealer but can also exercise recourse by requiring the dealer to repurchase the contract or pay any deficiencies in the event of nonperformance by the borrower. The arrangement with the dealer will vary depending on the loan agreement terms. Typically, at some point in the delinquency, the institution must notify the dealer and charge back the contract. If this is not handled as stipulated in the recourse agreement, the institution may forfeit its option to require repurchase by the dealer. All past-due

loans with recourse must be considered direct debt of the dealer if the dealer is liable for the debt under the recourse agreement.

Although recourse agreements provide additional protection for the thrift buying dealer paper, recourse is no substitute for prudent retail loan underwriting. Unless underwriting is performed in the same manner as with nonrecourse loans, the institution must consider recourse loans both as loans to the dealer and to the borrower. Therefore, a master loan agreement with the dealer is needed, with a thorough underwriting and monitoring of performance. If too many of the dealer's indirect loans go bad, the dealer will also go into default. Primarily, recourse agreements can be considered a repossession and sale service for the indirect lender, providing little credit protection.

An institution usually requires a dealer reserve account. This is a deposit account used to charge back nonperforming loans to the dealer. The account is controlled by the lender. The account is credited with discounts earned by the dealer on the sale of notes to the institution. Dealer reserves must be rigidly controlled for contract compliance, and generally should not be used to bring past-due accounts current but should be used to pay off past-due accounts in full.

One common practice that can cause earnings problems for institutions is for the dealer to receive a fee or discount without a dealer reserve. Institutions have miscalculated the resulting lower yield on the dealer paper.

Dealer lending relationships require analysis similar to that for commercial loans. The legal agreements and controls required for indirect lending are complex. The regulator assigned to Thrift Activities Regulatory Handbook Section 210, Lending Risk Assessment, should be notified of indirect lending activity to determine the degree of review required. With recourse, dealer paper is provided exceptional treatment under 12 CFR 32.6(h) for loans-to-one-borrower limits.

Manufactured-Home Financing

Manufactured-home financing can involve both dealer floor plan lending and indirect retail lending. 12 USC 1464(c)(1)(J) and § 545.45 of the regulations contain the manufactured-home-lending authority for federal thrifts. This section applies to "HUD-code mobile homes" and not to prefab, modular, or panelized housing components. This discussion sets forth guidelines that, under § 545.45 (c) and (d) are sound practices for mobile-home-loan investments and should be carefully considered in a thrift's operation and in the examination of a manufactured-home loan financing program.

The successful operation of a manufactured-home lending program depends largely on an institution's knowledge of and relationship with manufactured- home dealers in its lending area. There will be instances when the purchaser will seek direct financing, but dealers will usually constitute the major source of purchase loans. A dealer's sales are normally closed and financed on the dealer's lot. In most instances, the loan is "made" by a dealer and "sold" to a permanent lender. Thrifts are authorized certain practices that are intended to foster a good business relationship with dealers. The most important of these is the authority to make wholesale or floor plan loans on the dealer's inventory. However, due to the high risk of loss in this market, certain precautions should be observed.

Dealer Approval

Thrifts should do business with dealers only after formal approval by their board of directors. Dealer approval should be based on careful analysis of the dealership and should include review of at least the following documents:

Dealer Loan Application: The application should show the locations of all of the sales and storage lots operated by the dealer as well as the dealer's primary business address. It should name all manufacturers supplying the dealer and include a general description of the type and price ranges of units the dealer sells. Advertising literature is helpful. The application should state that each mobile-home manufacturer subscribes to the Truth in Invoicing Practices Statement adopted by the Manufactured Housing Institute. This statement requires disclosure of all discounts and updates applicable to individual units, but not volume discounts or rebates. The applications should also state whether the dealer is willing to

sign recourse or repurchase agreements in favor of the institution. Terms of a manufacturer or supplier's buy-back or repurchase agreement should be provided. The application should name all persons having a proprietary interest in the dealership and state the amount of that interest in terms of percentage of the whole.

Balance Sheet: A current balance sheet of the dealership, certified to be true and accurate, and signed by the dealer should be reviewed. A statement dated not earlier than the last business day of the preceding month is considered current. Financial statements of any guarantors should be reviewed.

Profit and Loss Statement: A profit and loss statement for the last fiscal year, supplemented by a similar statement for the months since the close of that year should be reviewed. To ensure that a dealer maintains high financial standards, current balance sheets and profit and loss statements should be obtained at least every month. These monthly statements should be reviewed by senior officers.

Credit Report: Written credit reports on the dealer and principals from a recognized credit reporting agency should be reviewed.

On-Site Review of Dealer Operations: An officer should prepare a written report of findings from an on-site visit to the dealer's place of business, indicating a review of sales and inventory areas and the accounting system.

The purpose of the board's reviewing the above items is to ensure that thrifts limit their relationships to dealers who show sufficient financial strength to maintain a viable dealer operation, as well as sound business ethics, integrity, and common sense. This will be reflected in the quality of the assets originated through individual dealers.

Dealer Supervision

After a dealer has been approved by the directors, an institution may operate through that dealer to the extent permitted by regulation. The following should be considered when doing business with any dealer:

Inventory Financing: § 545.45 of the regulations authorizes federal thrifts to make loans to finance both wholesale and retail purchases of mobile homes. Wholesale lending, or inventory financing, is a necessary part of manufactured-home lending since most dealers are not sufficiently capitalized to finance their own inventory. It has become customary for inventory financing to be provided by the same lenders who fund the retail loans. While inventory- finance loans are interest bearing, they also encourage a good business relationship with the dealer as a source of retail loans. In addition to the dealer investigation discussed above, the following are some of the considerations that should be negotiated in establishing a dealer relationship.

- An average successful dealer operating in a normal economy will turn over his stock approximately four times each year (as measured by the cost of sales divided by inventory). This fixes the average need for the inventory finance term at 90 days, which should be considered maximum by a lending institution.
- In the event a dealer is unable to sell the merchandise within the original inventory finance term, the loan may be renewed for successive 90-day periods, but the due date of the second renewal should not be later than nine months from the date of the original loan. Inventory refinancing should be limited since a dealer's inability to reduce inventory indicates a serious marketing problem and will lead to stale unsalable inventory.
- At the first renewal of any inventory finance loan, the dealer should be required to pay all interest to date and at least a 10% curtailment of the principal. Thereafter 10% or 20% curtailments and interest should be established in negotiations. The purpose of the curtailments is to both limit risk of loss to the thrift and to push the dealer into moving slow inventory, by wholesale if necessary, to minimize losses and strengthen the dealership.
- Disbursement of new inventory finance loans should be based on the original copy of the manufacturer's invoice, which is retained in the institution's file. To ensure that the manufacturer is paid for the merchandise, loan

proceeds should always be made payable- either directly to the manufacturer or to the manufacturer and the dealer jointly-by draft payable on sight of the manufacturer's statement of origin (MSO) if possible.

- It should be recognized by thrifts that some dealers will finance inventory with two or more lenders simultaneously. Even when inventory financing is limited to one lender, that lender should not expect to make a retail loan on every unit sold. Some units will be sold for cash, other purchasers will have arranged their own financing, and still others will simply not meet the standards required by the institution.

- If an institution makes any inventory financing loans to a dealer, the institution is responsible for determining that the merchandise so financed is not sold out-of-trust, i.e., sold without repaying the institution's wholesale loan. The only effective way of doing this is to make unannounced physical inventories of that merchandise at least monthly. Individuals doing the inventory check should be rotated from time to time, or accompanied by a witness or auditor to deter collusion with the dealer. The records of the inventories should be retained in the dealer file along with the application for approval, financial statements, etc. If the inventory should reveal that any merchandise has been sold out-of-trust, steps should be taken to see that the loan on that merchandise is repaid immediately. The institution should investigate the facts regarding such sale and determine if fraud was involved. If so, effective measures should be undertaken to prevent or limit loss.

- Recourse and buy-back (repurchase) provisions are customary procedures in manufactured- home lending. They are intended to provide the lender with an additional margin of safety and to ensure the quality of loans made to the dealer. A recourse or repurchase agreement may be given by a manufacturer to a dealer to support an inventory finance loan.

Indirect Retail Lending: Retail purchase loans are usually completed and the home delivered to the customer before the loan is presented to the institution for purchase.

However, underwriting standards should be established by the institution's board of directors, relating to the credit and financial ability of the borrower, as well as loan-to-price ratio, amount, and term of the loan, and other pertinent factors. The approval of a dealer is an expression of willingness to accept those loans that meet the institution's standards, and no obligation to buy loans should be made or implied.

For every loan made or purchased by the thrift, the following documents should be retained in the thrift's loan file:

- A security agreement enforceable in the jurisdiction where the collateral is located, whereby the thrift can acquire title and repossess the collateral property in the event of a default;
- Original credit application;
- Credit report submitted by a credit reporting agency;
- Original copy of manufacturer's invoice; and
- Copy of the retail sales contract.

An institution must maintain a continuous register of loans originated through a dealer in order to have readily available knowledge of its status with that dealer. The following items are considered the minimum:

- Loan number,
- Amount of loan,
- Date of loan, or date of purchase,
- Borrower's name,
- Dealer's name,
- Recourse provision included in assignment,
- Repurchase provision included in assignment,
- Interest rate,

- Term of loan, and
- Date loan repaid.

Dealer indirect loans are sometimes bought with recourse. Recourse means that the dealer is liable to the lender at any time for the unpaid balance of a defaulted sales contract or note, less the amount of unearned interest. In exercising this provision, the lender passes all of its title rights to the dealer who acquires title to the property. Enforcing this provision would protect the lender against all loss if it were applied to every defaulted contract, provided the dealer remains capable of buying the contracts. It is important to consider that the indiscriminate enforcement of the recourse provision could quickly exhaust a dealer's resources and is, therefore, no substitute for prudent loan underwriting.

A dealer buy-back or repurchase agreement is somewhat less demanding on the dealer. This agreement typically states that the dealer will actually repossess the defaulted unit for the lender. The dealer then has the option of buying or reselling the unit at a price based on the dealer's market and the condition of the unit. If the price is less than the thrift's carrying value of the unit, the deficit is absorbed as a loss by the thrift.

Regulators should investigate any material losses that the thrift sustains under a repurchase agreement and ascertain if the institution's interests were protected to the fullest practical extent.

It is a practice in manufactured-home lending for the dealer to participate in the retail financing charge with the lender through the operation of dealer reserves. Dealers and lenders have looked upon this as a legitimate source of income to the dealer. In such an arrangement, the dealer writes a loan to yield, say 18%, and then discounts the loan to the thrift to yield, say 14%, with the discount credited to the dealer reserve account. Normally, the discount is set aside in this reserve at the time a loan is made or purchased. The typical reserve agreement states that the purpose of reserve is to absorb losses, and that amounts not so used will be paid to the dealer periodically on a percentage basis.

As loan amounts increase and loan terms lengthen, the practices of recourse and participatory financing may become less desirable. Dealers may be reluctant to participate in such long-term financing and lenders may be reluctant to accept this type of long-term liability. Thrifts should recognize this possibility when developing lending policies.

Section 545.45 (d)(2) of the regulations establishes a maximum term for retail loans of 20 years, for both new and used manufactured homes. This is, in effect, unlimited. Thrifts should establish reasonable retail loan terms based upon the quality of construction and expected durability of the home, assuming normal maintenance.

Particular care should be exercised in determining the loan term for a used manufactured home. The condition of the home should be given the most consideration since an older home will depreciate slowly if it is well maintained.

A thorough on-site inspection affords the best means of ascertaining the condition of a used home. Inspections should be conducted by qualified persons and the overall condition of the home should be evaluated. Particular attention should be given to such major items as plumbing, electrical, and fuel systems.

Well-prepared inspection reports are excellent aids to the lender in the determination of the loan term, and should be retained in the loan file.

Section 545.45 of the regulations does not prescribe maximum amounts, related to value, that thrifts may lend on manufactured homes. However, manufactured home loans are limited to 90% of the buyer's cost of items specified in the regulation. Implicit in this regulation is the requirement that a minimum 10% down payment must be paid by the borrower. Any portion of the loan balance (principal and earned interest) that exceeds wholesale value is unsecured and reliant entirely on the borrower's ability to repay.

The ability of the borrower to pay principal, interest, taxes, insurance, and site rent or acquisition costs should be carefully considered. Low-income borrowers may not be able to afford as high a percent of income for housing as moderate-income

borrowers due to limited discretionary income and an inability to save for unexpected expenses and interruption in employment. Individual borrower's cash flow, living expenses, credit history, and employment history are very important factors to consider in addition to collateral in the underwriting of loans.

Two dealer practices can serve to increase a manufactured-home lender's risk exposure. These two practices are the selling of mobile homes at excessive mark-ups and the giving of buyers' rebates.

Prior to determining the amount of the loan on a new manufactured home, the institution should have a copy of the executed retail sales contract and the manufacturer's invoice. These documents should be retained in the loan file. Since a portion of the dealer's mark-up (profit) will often be included in the amount financed, thrifts should compare the retail selling price of the home with the manufacturer's invoice price. This comparison will show those instances where a dealer's mark-up exceeds the local market's acceptable profit margins. Excessive mark-ups dilute a borrower's real equity in the home and the financing of such mark-ups exposes the institution to additional unsecured risk. Such mark-ups can serve to mask undisclosed rebates (a form of fraud against lenders), which would further dilute the borrower's equity and increase the institution's exposure. Furthermore, the lender is then funding the dealer's profit while absorbing the dealer's risk on the sale.

While reasonable mark-ups are acceptable, thrifts should avoid including total sales price in the financing formula when homes are being sold in excess of the local market-accepted profit margins. A prudent limit on retail sale financing is dealer's invoice cost or wholesale value. This lets the thrift finance the dealer's cost but not the dealer's profit. The dealer's profit is funded by the down payments. A hold-back arrangement may allow a thrift to hold dealer profit-included in loan proceeds-in a dealer reserve account, provided that losses on loans from the dealer will be absorbed by the reserve account. This allows the dealer to have more profit financed by the thrift in exchange for the dealer's carrying more risk of loss.

To reduce excess inventory, increase volume, etc., dealers will at times offer the buyer a rebate or discount. These discounts may be structured so that they reduce the borrower's down payment and thereby raise the actual ratio of loan to buyer's cost. When such discounts are offered, thrifts should adjust the loan amount of the home to reflect these discounts.

Loan amounts on used manufactured homes should be based on the wholesale value of the home as determined in the local market area. Values may be determined by an appraisal by a qualified manufactured-home appraiser, value guides, or other generally accepted systems of valuation used in the local area.

Thrifts should ascertain that appropriate insurance protection is continuously in force, covering all units financed. Credit insurance, similar to mortgage insurance, is available and should be used when needed for underwriting considerations. As a minimum, insurance coverage should include:

- A comprehensive manufactured-home policy or equivalent with loss payable to the thrift for the investment in the loan; or
- A lender's single-interest policy in favor of the institution.

Servicing Corporations: The use of a servicing corporation can be an important adjunct to manufactured- home financing. Employing the expertise of a well- established servicer relieves the lender of many of the details of this complex field and can minimize losses. Thrifts are authorized to engage the services of servicing companies, but should observe the following precautions:

- Before engaging the services of any company, the thrift should make a careful review of the background and strength of the firm. It is important that the company have an excellent record of meeting its obligations in settling defaulted contracts, as well as have a sound financial structure. A thrift should investigate the performance records of more than one company and should select the one that seems best qualified.

- The minutes of the institution's board of directors' meeting should reflect consideration and approval of the servicing company. Financial statements, proposals, and servicing contracts should be retained in the institution's records.
- An institution should not enter into a contract that requires the investment of a specified sum in mobile home loans in a given period of time.
- An institution should retain the option of establishing its own credit standards as well as its right to reject loans.
- As with all contracts, they should be approved by the thrift's legal counsel.

Mobile Home Loan Portfolios: Thrifts whose service corporations engage in manufactured-home lending should monitor such operations closely. Such service corporations should apply sound underwriting standards when originating loans and should be fully staffed in order to properly service such loans. Since service corporations may sell whole loans to the parent, while retaining none of the risk, thrifts should assure themselves that the service corporation does not become a mere "production center" with little or no regard for proper underwriting and servicing.

Subject to certain conditions, § 545.45 of the regulations permits federal thrifts to sell and purchase participation interests in manufactured-home chattel paper on a nationwide basis.

Thrifts purchasing participations in manufactured home loan portfolios under this nationwide authority should assure themselves through detailed loan reviews and audit confirmations that they are purchasing quality loans that fully conform to applicable regulations and prudent underwriting standards. The purchaser should also assure itself that the entity servicing its loans has an adequately staffed office capable of rendering the expected servicing under strict control procedures. Purchase contracts are often negotiated with a buy-back provision for rejected loans during a brief period to allow the purchaser to confirm the credit quality of the purchased loans.

Problems with purchased portfolios have included: previously past-due loans rewritten with capitalized interest; loans financing assumptions of loans on repossessed collateral identified as new; loans without timely credit checks on borrowers; loans for which borrowers were not qualified as having ability to pay. Due diligence loan reviews should identify these details and prevent losses from purchases of poorly underwritten portfolios.

REFERENCES

United States Code (12 USC)

§ 1464(c)(1)(J)	Home Improvement and Manufactured-Home Loans
§ 1464(c)(2)(D)	Consumer Loans

Code of Federal Regulations (12 CFR)

Chapter I: Office of the Comptroller of the Currency

§ 32.6(h)	Discount of Consumer Paper

Chapter V: Office of Thrift Supervision
Subchapter C: Regulations for Federal Savings Associations

§ 545.45	Manufactured-Home Financing
§ 545.50(c)	Loans to Dealers in Consumer Goods

Subchapter D: Regulations Applicable to All Savings Associations

§ 563.170(c)(2)	Records
§ 590	Preemption of State Usury Laws
§ 591	Preemption of State Due-on-Sale Laws

Floor Plan and Indirect Lending Program

Examination Objectives

To determine if policies, procedures, and controls regarding floor plan lending adequately ensure safety and soundness, profitability, and compliance with laws and regulations.

To determine if officers and employees are qualified and performing their duties and responsibilities in a manner that ensures safety and soundness, profitability, and compliance with policies and procedures.

To determine if financial records and management reports provide accurate and necessary information to management and directors.

To determine the adequacy of the audit and the internal loan review function in this area.

To determine compliance with laws and regulations.

To evaluate the floor plan lending portfolio for credit quality.

To evaluate credit standards and control procedures applied to dealer indirect loans and to purchased portfolios of retail paper.

To initiate corrective action when deficiencies exist that could affect safety and soundness or when violations of laws or regulations have been noted.

Examination Procedures

Level I

Wkp. Ref.

1. Review scoping material related to this program.

_____ _____

2. Request the institution to supply:

   - Schedule of curtailment requirements for each dealer;

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- Schedule of approved floor plan lines for each dealer including outstanding balances;
- Delinquent curtailment billing report;
- Drafting agreements and amount of outstanding drafts; and
- Delinquent interest billings, date billed, and amount of past-due billings.

3. Obtain from the regulator assigned Thrift Activities Regulatory Handbook Section 210, Lending Risk Assessment, reports and schedules applicable to the floor plan and dealer indirect lending areas.

4. Determine the institution's policies and procedures and if they are sound and consistently followed through:

- Review of policy statements, underwriting guidelines, and manuals;
- Interviews with management;
- Review of minutes (or recap provided by the regulator reviewing minutes) applicable to this area; and
- Review of internal and external audit reports and management letters related to dealer-related credits.

5. Review the qualifications, capabilities, and expertise of loan officers in relation to their responsibilities. Determine each officer's current lending authority.

6. For indirect lending, review the adequacy of recourse and repurchase provisions if applicable. Determine whether dealer guarantees provide the institution with adequate protection if the borrower defaults.

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protection if the borrower defaults.

7. Review adequacy of dealer reserve agreements if applicable.

8. Consider rejection rates of loans referred by dealers to determine the independence and adequacy of loan underwriting.

9. Determine if the association corrected deficiencies mentioned in prior examination and audit reports.

10. Determine the scope of the examination based on an evaluation of internal controls and work performed by the internal and external auditors and internal loan review officer. Consult with the regulator assigned to Lending Risk Assessment to determine scope of review.

11. Determine causes of existing problems or weaknesses within the system that present the potential for future problems.

12. Determine compliance with laws, rulings, and regulations pertaining to floor plan lending and dealer indirect lending.

13. Complete the General Questionnaire.

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14. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

Level II

15. Review the reconcilement of the subsidiary ledgers for floor plan loans to the general ledger. Investigate any large reconciling items.

16. Using an appropriate sampling technique, select borrowers for examination. Prepare Thrift Activities Loan Review line sheets for dealer loans and retail portfolios. (For details on sampling, refer to Section 209 of the Thrift Activities Regulatory Handbook.)

17. While completing the procedures listed below, analyze credit files of all borrowers for whom line sheets were prepared for: credit quality, adequacy of loan and collateral documentation, and compliance with the internal loan review policy. Document findings on the line sheets.

- Review the loan files for the following loan underwriting information:
  - Financial analysis and credit history;
  - Current, reliable financial statements;
  - Current auto dealer financial statements;
  - Current memoranda detailing visits to dealership and trends in dealer's operations; and
  - Determine whether the dealer's retail loans are examined periodically for quality.
- Review the loan files for the following documentation:

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— An underwriting memorandum setting forth required documentation for original loan approval on file;

— Documents that are correctly executed, notarized, etc.;

— Liens filed in the appropriate jurisdiction;

— Title documents matching trust receipts;

— Supplier/manufacturer buy-back agreements;

— Curtailment agreements in compliance with the loan policy. Ascertain any violations of the curtailment agreements; and

— Verification of collateral values.

- Summarize the following:

  — Wholesale agreements between the institution and the dealer;

  — Agreements between the manufacturer and the institution;

  — Evidence that the security interest has been perfected;

  — Details of any guarantees that may be held; and

  — Details of any other collateral held.

- Review compliance with the terms of the loan agreement and with the floor plan lending policy.

- Note exceptions on the worksheet and list the date of the loan, name of the credit, and the dollar amount outstanding.

18. For past-due loans compare the following and determine any material inconsistencies.

- The past-due loans provided to the examiners;

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- Delinquency reports submitted to the board;
- List of loans considered problem loans by management; and
- Delinquency levels provided on reports to the Office of Thrift Supervision.

19. Review recent floor plan checks and determine:

- Are inventory checks performed monthly?
- Are there any units not seen in the last 60 days?
- Are floor plan checks rotated among the institution's personnel or audit services at least quarterly?
- Are floor checks performed on a surprise basis?
- Are discrepancies reconciled and explained?

20. Outside services are often used in servicing dealer loans and in performing inventory floor checks. If service companies are used, determine the following from discussion with management:

- Was a formal contract approved by the proper level of management?
- Were financial statements and references checked?
- Are performance objectives established and monitored?
- Does the local jurisdiction require service company licensing, and is the required licensing on file with the institution?

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

Level III

22. Select a sample of loans for account balance verification procedures with the borrowers.

23. Perform a physical verification of collateral for selected accounts.

Examiner's Summary, Recommendations, and Comments

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Floor Plan and Indirect Lending Questionnaire

	Yes	No
General Questionnaire		
Lending Policies		
1. Has the board of directors, consistent with its duties and responsibilities, adopted written floor plan and indirect lending policies that:		
• Establish procedures for reviewing loan applications?		
• Define qualified borrowers?		
• Establish minimum standards for documentation?		
2. Are lending policies reviewed at least annually to determine if they are compatible with changing market conditions?		
3. What has been the rejection rate for loan referrals of indirect loans by the institution for each dealer? _____		
4. Are underwriting policies, procedures, and controls adequate to prevent unsafe and unsound lending practices?		
5. Does the management possess the expertise necessary to underwrite this type of lending?		
Loan Records		
6. Is the preparation and posting of subsidiary floor plan loan records performed or reviewed by persons who do not also:		
• Issue official checks or drafts singly?		
• Handle cash or checks?		

	Yes	No
7. Is a daily record maintained summarizing note transaction details, i.e., loans made, payments received, and interest collected, to support applicable general ledger account entries?		
8. Is an underwriting memorandum on file that sets forth required documentation for original loan approval ?		
9. Are documents properly executed, notarized, etc.?		
10. Have UCC's been filed in the appropriate jurisdiction and are receipts on file?		
11. Are loans properly recorded and notification of such on file?		
12. Is there a system in place to refile liens in order to maintain perfection of the security interest?		
Collateral		
13. Are physical inventories conducted at least monthly and on a surprise basis?		
14. Are more frequent physical inventories conducted if the dealer is experiencing financial difficulties?		
15. Are individuals performing these checks rotated?		
16. Do inventory inspections include, as a minimum, the following: serial number verification, inventory of equipment and furnishings, condition and location of asset, and accounting for assets sold out of trust or rented?		
17. Are trade-ins inspected and appraised for reasonableness of value?		
18. Is the quality and sufficiency of the loan collateral, and the volume and rate of inventory turnover adequate?		

Exam Date: _____
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Reviewed By: _____
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Floor Plan and Indirect Lending Questionnaire

	Yes	No
Loan Administration		
19. Is the loan administration process adequate regarding:		
• Credit and financial analysis?		
• Collateral policies and procedures?.....		
• Enforcement of curtailment and buy-back agreements?		
• Segregation of duties for authorizing and funding disbursements?.....		
20. Is purchased retail paper subject to thorough underwriting review and confirmation with borrowers?.....		

Comments

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INTRODUCTION

OTS defines consumer credit as credit extended to individuals for personal, family, or household purposes. Consumer credit includes the financing or refinancing of:

- automobiles
- mobile homes
- boats
- personal use aircraft
- other recreational vehicles
- furniture and appliances
- other consumer durable goods.

Consumer credit also includes loans for other personal financial needs, including the granting of overdraft lines of credit and the purchase of consumer loan accounts from retailers or other lenders.

Savings associations also grant home improvement and home equity loans for consumer purposes. Because these are typically large-dollar, long-term loans secured by real estate, OTS classifies them as real estate loans.

Some institutions may also originate small-dollar, business-purpose installment loans based on the credit capacity of the borrower rather than an in-depth analysis of the business. These loans are sometimes underwritten and processed in the same department with the consumer loans, so therefore, may be part of the consumer loan review during examinations. However, for purposes of determining a thrift's investment limits under the Home Owners' Loan Act (HOLA) Section 1464, Part 5(c), the thrift must categorize these small-dollar, business purpose installment loans as business loans. To assess the borrower's total liability to the thrift, aggregate these small-dollar, business purpose installment loans with any other commercial loans to the same borrower.

REGULATORY CONSIDERATIONS

HOLA limits a federal savings association's investment in consumer loans to 35 percent of assets when aggregated with the institution's commercial paper and corporate debt securities. The institution may only invest amounts in excess of 30 percent of assets in loans made directly by the institution.

For the purpose of determining compliance with the lending and investment limitations under HOLA, a federal association does not have to aggregate its consumer loans with education loans, home improvement loans (even when made without real estate security), deposit account loans, and credit card loans or extensions of credit made in conjunction with credit cards.[1] HOLA provides a separate authority and investment limit for each of those loan types.

OTS's lending and investment rule (12 CFR Part 560) requires each savings association to conduct its lending activities prudently and use lending standards that meet the following objectives:

- Are safe and sound.
- Ensure adequate portfolio diversification.
- Are appropriate for the size and condition of the institution, the nature and scope of its operations, and conditions in its lending market.

The regulation also requires that each association monitor the condition of its portfolio and the adequacy of any collateral securing the loans.

[1] While people often use credit card accounts for consumer purposes, a federal savings association's ability to invest in them is authorized under a separate section of the HOLA. See Handbook Section 218 for a discussion of credit card accounts.

A consumer lending portfolio comprises many small amortizing loans with relatively short maturities. Since consumer loans are generally small, your review should focus on the following areas:

- Overall policies, procedures, and internal controls
- System support
- Management and staff capabilities
- Product pricing
- Portfolio performance.

You should structure your examination review to determine whether the institution has identified and is monitoring and controlling the risks associated with its consumer lending programs.

You will generally review a sample of loans to test compliance with internal guidelines and requirements. The depth of such sampling will depend on the adequacy of the internal loan review process and the scope of the internal audit program. (Refer to Thrift Activities Regulatory Handbook Section 209, Sampling.) It is often unproductive to analyze a large number of individual credit files to determine portfolio asset quality. Your review of overall portfolio performance, including delinquency and charge-off reports, is more effective for this purpose. Such reports can also be used as a basis for classifying assets.

In addition to evaluating the current portfolio condition, you should also identify potential problems that could result from any of the following practices:

- Overly permissive lending policies.
- Lack of adherence to established policies.
- Poor internal controls.
- Potentially dangerous concentrations.
- Poor collection procedures.
- Failure to act promptly when changes in economic or market conditions call for changes in lending standards or procedures.

PORTFOLIO CHARACTERISTICS

Consumer loans may be secured or unsecured, open-end or closed-end, direct or indirect. These characteristics affect the level of risk and type of underwriting procedures required.

Secured versus Unsecured

With secured loans, the institution requires the borrowers to pledge assets as collateral for the loan. Institutions usually base the collateral required on the level of risk, the borrower's credit history, and the lender's policy. Typically, when a consumer loan finances the purchase or refinance of an asset, the collateral will consist of the item being purchased. However, institutions cannot use "household goods" [defined at § 535.1(g)] to secure a loan, other than when credit is used to purchase the items secured.

If the institution obtains collateral, it should perfect its security interest in the collateral. The institution should recognize that the market value of personal property such as automobiles and recreational vehicles will likely decline over time, and lenders typically receive only a wholesale price for repossessed property. Therefore, it is prudent to match the loan amortization period to the estimated depreciation or useful life of the security property.

With regard to unsecured loans, the institution is depending on borrowers' promise and ability to repay their loans. Therefore, institutions usually limit unsecured loans to borrowers with sound credit backgrounds. Moreover, because an individual's financial condition may change over time, institutions generally grant unsecured loans for shorter time frames than secured loans.

For both unsecured and secured consumer loans, the borrower's cash flow is the primary repayment source. This may come from the borrower's employment, business, investments, or other reliable sources, including social security, other government benefits, child support, and alimony.

Open-end versus Closed-end Loans

OTS defines open-end credit as a credit in which the creditor takes the following steps:

- Extends credit under a plan that contemplates repeated transactions.
- Imposes a periodic finance charge on any outstanding unpaid balance.
- Provides a reusable credit line. (In other words, the customer can re-borrow any repaid portion of the outstanding balance.)

Credit cards, home equity lines of credit, and checking overdraft lines of credit are the most common forms of open-end credit. We refer to most other consumer credit with fixed payment terms as closed-end or installment credit.

Direct versus Indirect

Consumer loans may also be direct or indirect. When an institution originates the loan, it is a direct loan. If a seller of retail goods (dealer) originates the loan and then sells it to the institution, it is an indirect loan. Satisfactory performance of indirect lending often stems from the structure of the agreement with the dealers and the institution's oversight of the performance of loans from each dealer. Thrift Activities Regulatory Handbook Section 216, Floor Plan and Indirect Lending, discusses the basic characteristics of indirect lending.

ORGANIZATIONAL STRUCTURE

Institutions generally divide their consumer loan departments into four functional areas: acquisition, servicing, payment processing, and collection.

- The acquisition area originates loans. The personnel handle applications from individuals or through dealers (sellers of retail goods). They also gather and review credit information and decide to approve or reject the loans.
- The servicing area disburses loan proceeds; processes loan forms; prepares payment books; controls notes, collateral, and documentation; and prepares various reports (such as reports on delinquencies, extensions, renewals, and irregular payments).
- The payment area receives, processes, and posts all payments the institution receives.
- The collection area provides the follow-up, adjustment, and other activities involved with delinquent loans.

Consumer lending requires a trained and experienced staff. The level of required expertise depends on the degree of risk and complexity of the lending activity. Manufactured-home and time-share lending, for example, are areas that require substantial expertise.

CONSUMER LENDING POLICIES AND PROCEDURES

The success of a consumer lending operation depends on the institution's policies, procedures, systems, and controls. When reviewing an institution's consumer lending activities, you should determine that management has implemented policies and procedures to identify, measure, monitor, and control the credit and other risks associated with its consumer lending program.

The board of directors plays a critical role in the development of the institution's lending policies and procedures. The board should adopt policies that require comprehensive written procedures for the following areas:

- Reviewing and approving loan applications.
- Determining credit lines.
- Providing acceptable documentation standards.

The board should regularly review these policies to determine whether they are adequate and compatible with changing strategies and market conditions.

An institution should also align its consumer lending policy with the goals of its business plan. Management should perform a cost-benefit analysis that evaluates the required and probable return, amount of capital the institution will invest in start-up costs, and expected operating expenses and credit losses under various economic conditions.

The loan underwriting policy should clearly identify the following elements:

- The types of loans the institution will and will not accept.
- Any unique risks or characteristics of particular types of loans.
- Specific lending authority for each officer and group of officers.

The board of directors should set loan approval criteria based on the borrower's credit history, ability to pay, stability of income, and debt-to-income ratios. Other items that the board should address include loan-to-value ratios, collateral values, and loan terms. The primary consideration is always the creditworthiness of the borrower.

The institution's underwriting policies for consumer credit should also consider the borrower's overall debt load, generally measured by the borrower's total monthly payment obligations divided by gross monthly income. While some lenders establish a relatively low maximum allowable debt-to-income ratio (such as 40 percent, for example), others may establish a higher acceptable limit (such as 50 percent). The board of directors should establish effective underwriting standards, including debt-to-income ratios that are prudent and appropriate for the products offered in the institution's lending area. You should review these policies for adequacy and effectiveness in producing a quality loan portfolio that does not expose the institution to inordinate levels of credit risk.

Adequate loan pricing is also an essential element of a consumer loan policy. In defining its loan pricing, the institution should reflect market conditions, credit and interest rate risks, funding costs, direct and indirect operating expenses, expected credit losses, and desired profit margin. An institution should reevaluate its loan pricing formula when market conditions change or any time its loans fail to provide a reasonable profit relative to the risks undertaken.

Sound underwriting policies are not sufficient without other portfolio management guidelines. The board should require management to monitor the application of policies and procedures, including internal loan review. Senior management and the board should receive adequate reports to monitor portfolio composition, delinquencies, and losses.

In addition, institutions should develop sound policies for the collection and timely charge-off of delinquent consumer loans. Effective collection procedures can minimize losses. The timely reporting of delinquency and credit losses allow management and the board to monitor the effectiveness of the institution's underwriting standards and controls. Effective collection procedures also assist them in evaluating the success of consumer products and the overall lending operation.

Delinquency and loss trend analysis allows for early correction of developing problems and provides a basis for determining the adequacy of the Allowance for Loan and Lease Losses (ALLL).

Classification

Because most consumer loans are small, homogeneous, and uniformly underwritten, they are generally classified based on their payment status rather than an individual review of each loan. This relieves you and institution staff from the burden of having to individually review each retail credit.

OTS adopted the Interagency Uniform Retail Credit Classification and Account Management Policy, issued by the Federal Financial Institutions Examinations Council (FFIEC).

The policy statement provides guidance on:

- Standards for re-aging delinquent accounts.

- The classification of accounts when the borrower is deceased or filed for bankruptcy protection, or the account involves fraud.
- The classification of loans secured by one- to four-family residential mortgages.

The guidance states that institutions should classify closed-end consumer credit as:

- Substandard when loans become contractually delinquent 90 to 119 cumulative days.
- Loss when they become contractually delinquent 120 days or more.

Institutions should classify their open-end consumer credit as:

- Substandard when loans become contractually delinquent 90 to 179 days.
- Loss when they are 180 days or more contractually delinquent.

These classification standards are not absolute, however. If management can clearly demonstrate that a delinquent loan is *well-secured and in the process of collection*, they do not have to classify the loan. See CEO Memo No. 103 for the Uniform Retail Credit Classification Policy.

CHARACTERISTICS OF SPECIFIC TYPES OF CONSUMER LOANS

There are many types of consumer loans, each having unique characteristics and risks. We provide a brief overview of the major categories below.

Debt Cancellation Contracts

Institutions may directly provide debt cancellation contracts on originated loans, subject to certain safeguards. Debt cancellation typically provides for the repayment of a loan in the event of the borrower's death or disability, with exceptions for late payments, late charges, loans in default and deaths due to suicide.

The association should not retain any recourse related to debt cancellation if it sells such loans. In addition, an association offering debt cancellation must either obtain insurance to cover its loss exposure or establish reasonable actuarial reserves (or some combination of reserves and insurance) for the loss risk.

Housing-Related Consumer Loans

Housing-related consumer loans may include equity term loans and lines of credit, home improvement loans, and manufactured-home loans. Interest on consumer loans secured by qualified residences (such as second mortgage and home equity loans) is generally deductible in calculating federal income taxes if the loan does not exceed the borrower's basis in the home. Because of their favorable tax treatment, home equity loans have become very popular.

Home improvement loans differ from home equity loans. Home improvement loans may only be used to repair, equip, alter, or improve residential real property. In addition, home improvement loans may be conventional or Federal Housing Administration (FHA)-insured. Most importantly, thrifts may invest in home improvement loans without limitation under a separate authority under the HOLA. The thrift does not aggregate home improvement loans with other consumer credit to determine compliance with the HOLA's investment limitations.

Under the HOLA, a thrift may also invest in manufactured home loans without limitation. For reporting purposes, the thrift classifies manufactured-home loans on the Thrift Financial Report as either real estate loans or mobile home loans, depending on the documentation of the collateral value. If the home is fixed to a permanent site on which the lender holds a mortgage, the institution can classify it as a real estate loan.

The value of the manufactured home can fluctuate more than traditional housing, and they often depreciate more rapidly. This type of lending poses greater risks than conventional home lending due to the collateral value uncertainties and the mobility of the housing unit. Thrift Activities Regulatory Handbook Section 216, Floor Plan

and Indirect Lending, provides general guidelines for manufactured-home lending.

Although institutions grant home improvement and home equity loans for consumer purposes, they typically secure the loans with real estate and classify them as real estate loans. The Real Estate Lending Standards rule, 12 CFR §§ 560.100-101, requires an institution to establish prudent written real estate lending standards that consider the supervisory loan-to-value ratio (LTV) limits in the Interagency Real Estate Lending Guidelines appended to that rule. Any loan secured by a one- to four-family residence with an LTV of 90 percent or higher should have private mortgage insurance or readily marketable collateral and other credit strengths that offset the higher risks associated with loans with low borrower equity. Such loans, when aggregated with other loans in excess of the supervisory LTV limit, will receive increasing regulatory scrutiny and should not exceed 100 percent of total capital.

A loan secured by real estate is normally a real estate loan for purposes of 12 CFR §§ 560.100-101 and is subject to the Real Estate Lending Standards rule, whether it is fully or partially secured by real estate. The real estate lending standards rule lists nine exceptions, for example, when such loans are sold promptly without recourse and when the real estate collateral is taken as an abundance of caution.

A real estate secured loan may qualify for the abundance of caution exception and be considered a consumer loan if it is well-supported by other collateral and the value of the real estate is small in relation to the other assets securing the loan.

Abundance of caution does not include cases where the borrower's credit is sufficiently strong that the institution does not deem it necessary to take collateral, but does so anyway. See Handbook Section 212, Real Estate Lending.

Direct Auto Loans

Direct auto loans represent one of the largest categories of consumer loans. Some of the primary considerations you should consider for auto loans are:

- Borrower credit debt-load requirements.
- Acceptable loan-to-value ratios.
- Verification of the condition and market value of the vehicle.
- Acceptable age of autos taken as collateral.
- Acceptable maturities.
- Pricing to reflect all costs relating to the lending program.
- Insurance requirements.
- Lien perfection.

The auto loan files should contain the application, a copy of the sales agreement, a current credit report on the borrower, income verification, evidence of current property insurance coverage, and proof of lien perfection. Depending on state law, this likely includes the original certificate of title with the institution's lien recorded on the document. Institutions engaging in auto lending should have policies and procedures for the recovery of collateral from delinquent accounts and the sale of repossessed vehicles.

You should confer with the examiner assigned to the Lending Overview section. Evidence of significant auto loan charge-offs, delinquencies, or increases in delinquencies should alert the reviewer to weaknesses in the lending program. This includes inappropriate underwriting policies, collection efforts, or repossession activities.

Other Secured Loans

Other categories of secured consumer loans include boat and recreational vehicles, aircraft, savings accounts, and loans secured by other collateral, including furniture, appliances, and jewelry. Savings account loans typically exhibit the least credit risk because the borrower's savings account fully secures the loan. The other types of secured loans can pose significant risk because the collateral may have a low resale value and can be difficult to repossess. Two key factors when originating these types of loans are the borrower's ability and willingness to repay the debt.

Boats, recreational vehicles, and farm equipment (particularly small tractors and related implements) can exhibit collateral values highly dependent on local market conditions. For these types of secured credits, the institution should base collateral valuation techniques on regional valuation reference guides and local, rather than national, conditions.

Unsecured Consumer Lending

Unsecured consumer loans include open-end credit (including overdraft protection and credit cards) and personal loans. While people often think of credit cards to individuals for household purposes as consumer loans, HOLA authorizes them under a separate lending authority. Thus, the institution does not aggregate credit cards with other consumer loans to determine compliance with HOLA's percentage of assets limitations. Refer to Thrift Activities Regulatory Handbook Section 218, Credit Card Lending, for further detail.

If improperly underwritten, unsecured loans are among the riskiest types of loans due to the absence of security. Moreover, the institution has limited control over the consumer's overall debt level given the abundance of available consumer credit. Institutions must carefully evaluate the creditworthiness of the borrower because there is no collateral to fall back on should the borrower default. Some institutions often require a creditworthy cosigner or guarantor when making loans to borrowers with limited or marginal credit histories. If there is a cosigner, § 535.3 of the regulations imposes specific disclosure requirements on member institutions. (Refer to the Compliance Activities Regulatory Handbook Section 355, Unfair or Deceptive Acts, for further detail.)

Education Loans

Federal savings institutions may invest in education loans under a separate HOLA authority. Therefore, institutions do not have to aggregate education loans with other consumer loans to determine compliance with HOLA's lending limits. Education loans can be either relatively safe high-yield investments or risky specialized consumer loans. The risk depends on whether a government agency guarantees the debt and whether the institution is in compliance with the insuring agency's rules regarding the program.

Government insurance is available because students typically have low incomes and unproven credit histories, making them unattractive credit risks. The Student Loan Marketing Association (Sallie Mae) came into being in 1972 to further this purpose, and serves as a secondary market and warehouse facility for student loans. The Commissioner of Education, or a state or a non-profit private institution with which the Commissioner has an agreement, insures the loans.

Institutions should verify that the borrower is attending the school indicated and paying tuition bills.

Time Share Loans

Time share loans represent the financing of a consumer's purchase of a shared interest in vacation or resort property. Purchasers will then "own" a week in their favorite vacation resort and may return to the resort each year on the particular week. Once purchased, the owner only pays a fee for maintenance and membership in a national registry that allows owners to trade their week for visits to other resorts. Often, however, these fees are very high.

Developers frequently sell time shares to buyers for many times the aggregate value of the units. For example, a week in a typical resort will sell for $8,000 to $15,000, depending on the season. Thus, total sales may be $500,000 or more for a unit the resort manager paid less than $200,000 to build. As a result, time share resale prices are a fraction of what the buyer/borrower paid for them. If borrowers have to sell the property, they often do so at a substantial loss. Moreover, some resorts sell time shares with no clear or definable interest in the real estate.

Time share lending combines features of real estate investment, consumer lending, and hotel management. The hybrid nature of the time share and its untested legal status make the value of the

collateral questionable. The negative publicity surrounding time share operations and misrepresentations of lien positions by developers or loan brokers further complicates this situation. Time share lending requires considerable expertise due to its complexity and risk. In addition, end loan lenders should evaluate both the overall viability of the time share project and the creditworthiness of the end loan borrower.

Subprime Lending

Subprime lending is the practice of extending credit to individuals with poor credit histories. In a joint interagency policy statement on subprime lending, dated March 1, 1999, OTS, together with the banking agencies stated, "If the risks associated with this activity are not properly controlled, the agencies consider subprime lending a high-risk activity that is unsafe and unsound." (See the Interagency Policy Statement in Appendix A.)

The interagency policy statement defines subprime lending as the practice of extending credit to borrowers who exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers. The institution typically measures risk of default by credit/repayment history, debt-to-income levels, or credit scores.

Subprime borrowers represent a broad spectrum of debtors. They range from those who exhibit repayment problems due to an adverse event, such as job loss or medical emergency, to those who persistently mismanage their finances and debt obligations. Subprime lending does not include making loans to borrowers who have had minor, temporary credit difficulties but are now current; nor does it include loans to borrowers with normal credit histories that subsequently deteriorate.

In addition to direct extensions of credit, this guidance also applies to the purchase of the following:

- Subprime loans from other lenders, including delinquent or credit-impaired loans purchased at a discount.
- Subprime automobile or other financing "paper" from lenders or dealers.
- Loan companies that originate subprime loans.

Many institutions entering the subprime lending business have discovered that they grossly underestimated the default rates and collection costs associated with these loans. Furthermore, several experienced non-bank subprime specialists have suffered material losses despite their considerable expertise in this field of lending. Because an economic downturn will tend to adversely affect subprime borrowers earlier and more severely than standard risk borrowers, the institution should determine if it is prudent to begin or expand a subprime lending program at the current stage of the economic cycle.

Due to their higher risk, subprime loans command higher interest rates and loan fees than those offered to standard risk borrowers. These loans can be profitable, provided the lender charges a price sufficient to cover higher loan loss rates and overhead costs related to underwriting, servicing, and collecting the loans.

The ability to securitize and sell subprime portfolios at a profit while retaining the servicing rights has made subprime lending attractive to a larger number of institutions, further increasing the number of subprime lenders and loans. A number of financial institutions, however, have experienced significant losses attributable to ill-advised or poorly structured subprime lending programs. This has brought greater supervisory attention to subprime lending and the ability of insured depository institutions to manage the unique risks associated with this activity.

Institutions should recognize the additional risks inherent in subprime lending and determine if these risks are acceptable and controllable given the institution's staff, financial condition, size and level of capital support. Institutions that focus on subprime lending or enter the subprime lending business as anything more than an occasional, exception-based activity, should have board-approved policies, procedures and internal controls that identify, measure, monitor, and control these additional risks.

A separate, formal subprime policy is not necessary if institutions only occasionally grant subprime loans. However, a formal procedure should be in place for approving, documenting, and monitoring such exceptions to policy.

In light of the risks associated with this type of lending, OTS may impose higher minimum capital requirements or place investment limitations on institutions engaging in subprime lending. You should determine whether their subprime lending program is safe and sound, based on the following criteria:

- Magnitude of the risks assumed.
- Controls the institution has in place.
- Capital available to support this activity.

Business Loans

It may be more effective for you to review loans to small businesses when you review the consumer loan portfolio, particularly those with relatively small balances. Although institutions may underwrite these loans as consumer loans, they exhibit risk and underwriting elements distinct from most consumer loans.

Confirming a reliable source of repayment is critical to the small business loan underwriting process. A small business, along with a small business owner with no other income source, is dependent on the enterprise to generate adequate revenues to cover its cost of goods and operating expenses. Therefore, underwriting guidelines should consider the stability of the borrower's or business' cash flows, key operating trends, adequacy of capital to cover risks, and management's ability to react to its particular operating niche.

Financial data can be sketchy, as small enterprises may employ limited accounting systems and records. Even so, the institution should obtain a complete copy of the business' or owner's last three Federal income tax returns and recent credit report. The institution should also analyze any other available business-related financial statements.

Along with revenue, expense and net income trends, you should be alert to slow inventory turnaround or increasing accounts receivables. Depending on the size of the credit, the institution should have available a recent copy of the business' aging list for accounts receivable. Also, depending on the size of the loan and the institution's underwriting standards, you should inquire about insurance coverage, outstanding litigation, franchise requirements, lease terms and obligations, and management depth.

CREDIT SCORING

Credit scoring systems assess the creditworthiness of potential borrowers and simplify/streamline the underwriting process for small-balance consumer loans. Thrifts often use credit scoring systems that assign numerical rankings to individuals based on available financial and demographic data. The credit scoring models then convert these rankings into scores, with higher scores indicating lower risk. The most widely used scoring systems are external systems available through credit bureaus. However, thrifts can purchase or develop a system to use internally and often use an internal and external system in conjunction.

Scoring systems can be an effective lending tool if the institution uses them properly. Before implementing a scoring system, a thrift must thoroughly study the characteristics of its loan product and customer base and what it expects the scoring system will achieve. The thrift then uses this information to adapt the system to their needs. This can be quite a complicated process and requires expertise to be effective. Following implementation, periodic review of the system, called validation, is necessary as the system ages and the customer base changes. Management should not implement scoring unless they are willing to devote the time and attention necessary to ensure that the system performs as expected and remains effective.

LAWS AND REGULATIONS AFFECTING CONSUMER LOANS

You should be familiar with all applicable consumer regulations. Section 300 of the Compliance

Activities Regulatory Handbook discusses consumer regulations in detail. See the References at the end of this section for other OTS regulations, memoranda, and policy statements that apply to consumer loans. State usury laws establish maximum interest rates on loans. If an institution violates the state usury law, it may suffer some penalty such as forfeiture of interest. Consult state law to determine compliance. OTS has preempted most state usury laws for "federally related loans," which may include some consumer loans. Consult Part 590 of the regulations to review federal preemption of state usury statutes.

REFERENCES

United States Code (12 USC)

§1464(c)(2)(D)	Consumer Lending Authority
§1464(c)(3)(A)	Education Loans Authority

Code of Federal Regulations (12 CFR)

Part 535	Prohibited Consumer Credit Practices
§560.1	General Lending Standards
§560.2	Applicability of Law: (Preemption of State Usury Laws)
§560.3	Definitions
§560.30	General Lending and Investment Powers of Federal Savings Associations
§560.31	Election Regarding Categorization of Loans or Investments
§560.93	Lending Limitations
§560.101-102	Real Estate Lending Standards

Consumer Lending
Program

Examination Objectives

To determine if the established policies, procedures, and strategic plans regarding consumer lending adequately address safety and soundness, profitability, and compliance with laws and regulations.

To determine if institution officers and employees conform to the established guidelines.

To determine if officers and employees are able to perform their duties and responsibilities in a manner that ensures safety and soundness, profitability, and compliance with laws and regulations.

To determine if financial records and management reports provide accurate and necessary information to assist management and the directors in fulfilling their responsibilities.

To determine the adequacy of the audit function(s) in this area.

To determine the adequacy of the internal loan review function in this area.

To evaluate the credit quality of the consumer lending portfolio.

To initiate corrective action when deficiencies exist that could affect safety and soundness, or when you identify violations of laws or regulations. (Examination and supervisory personnel may initiate corrective action depending on regional office policy.)

Examination Procedures

Level I

Wkp. Ref.

1. Review scoping materials related to this program.

_____ _____

2. Coordinate with the examiner assigned the review of the institution's lending policies and procedures to determine the accuracy of the policies and procedures through:

   - Review of policy statements, underwriting guidelines, and manuals.

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Wkp. Ref.

- Review of compliance with the consumer lending projections set forth in the business plan.
- Interviews with management.
- Review of minutes related to this area.

3. Determine whether management and the board periodically review objectives and related policies, and communicate any changes to the appropriate personnel.

4. Obtain the following reports and schedules applicable to the consumer loan area:

- Delinquent loans.
- Classified loans.
- Loans for which interest is not being collected in accordance with terms of the loan.
- Loans where the institution has modified terms by reduction on interest rate or principal, or by other restructuring of repayment terms.
- Extensions of credit to insiders.
- The overdraft report and the list of individuals authorized for overdraft protection.
- Miscellaneous loan debit and credit suspense accounts.
- Loans considered problem loans by management.
- The current interest-rate structure and schedule of fees.
- Useful information resulting from review of minutes of the loan committee.
- Reports furnished to the loan committee.
- Reports furnished to the board of directors.

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Wkp. Ref.

- Loans classified during the previous examination.
- The nature and extent of loans serviced.

5. Determine if the institution engages in high-risk consumer lending, such as subprime lending, the purchase of high-risk or subprime loans from other institutions, or the purchase of subsidiaries that engage in subprime lending. If so, complete the subprime lending procedures in Appendix B.

6. Determine whether the classification and charge off of delinquent consumer credit are in compliance with the institution's policies and the Interagency Uniform Retail Credit and Account Management Policy. (See CEO Memo No. 103.)

7. Review the adequacy and accuracy of management reports.

8. Review the qualifications, capabilities, and expertise of consumer loan officers in relation to their responsibilities.

9. Ascertain compliance with laws, rulings, and regulations pertaining to consumer lending.

10. Document whether the institution corrected deficiencies mentioned in prior examination reports and audit reports.

11. Review the institution's use of modeling and credit scoring.

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- Detail the types of models/scorecards used (for instance, generic/custom, vendor, etc.), by application.
- Determine whether the development process is consistent with the institution's ability to undertake risk and its desired portfolio objectives.
- Evaluate the ongoing monitoring and maintenance process in view of the portfolio's performance.

12. Determine that the institution uses all scorecards for purposes consistent with the development process/populations. If not (for instance, applied to an entirely different product, new/unproven geographic area, etc.), assess the possible results.

13. Review the documentation supporting the institution's scoring models to:

- Ensure the scoring models are empirically derived and statistically sound.
- Ensure the institution periodically monitors the factors and customer characteristics to determine whether they continue to effectively predict credit performance.
- Determine whether the credit scores permit the institution to predict overall risk and the potential impact on collection activities.
- Determine that the models stress test the population so they are able to predict delinquencies and losses over varying economic conditions.

14. Review management of the institution's scoring system to ensure that:

- Systems continue to reflect current underwriting standards and risk parameters.
- Management maintains a portfolio chronology log to record significant events related to the credit acquisition process for each consumer portfolio. Review the log.

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- The institution revalidates the scorecards as necessary. Review the report of the last validation.
- The institution supervises and maintains the scoring systems in accordance with vendor-provided specifications and recommendations (as specified in the scoring manual).

15. Complete the General Questionnaire.

16. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

Level II

17. Test a sample of loans for compliance with established policies and procedures. (For details on sampling, refer to Section 209 of the Thrift Activities Regulatory Handbook.) The extent of testing will depend on preliminary findings, and the review of work performed by the auditors and internal loan review personnel.

18. Review the reconcilement of the subsidiary ledgers for consumer loans with the general ledger. Investigate any large unreconciled items.

19. If policies, procedures, and reports are determined to be inadequate, it may be necessary to review loans for asset quality. If so, select borrowers for examination review using an appropriate sampling technique. If the outstanding balance or credit line of a large-dollar, high-risk loan is material, consider including some of these loans for individual classification review. (Discuss such large dollar loans with the examiner assigned to Thrift Activities Regulatory Handbook Section 211.)

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20. Analyze credit files for all borrowers for whom you prepared line sheets for the following concerns:

    - Credit quality (earnings, indebtedness, credit history, loan modifications).
    - Adequacy of loan and collateral documentation (loan-to-value ratios, age of collateral, perfection of security interests, evidence of hazard insurance).
    - Compliance with the loan policy.

21. Analyze the institution's pricing of its consumer loans to determine if it considers all costs, including expected losses, operating expenses, and cost of funds in the pricing model. (The institution should do this for each loan product.)

22. Review the institution's loan modification/extension/rewrite/deferral policy. Determine if the policy is reasonable and complies with the Interagency Uniform Retail Credit Classification and Account Management policy.)

23. Review delinquency and repossession reports. Determine if the institution tracks delinquencies and loan losses by product type and by production facility, such as loan officer, branch office, or outside broker.

24. Determine if the institution has taken steps to curtail or modify problem lending, whether it be due to poor underwriting policies and procedures, the risks inherent in a particular loan type, or deficiencies in the loan production facility.

25. Determine the adequacy of collection procedures and whether practices conform to policy. Consider whether the institution takes the following steps:

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- Actively use and maintain up-to-date collection cards (contact records).
- Accord special handling for first payments defaults.
- Make timely telephone contacts and follow up broken promises of payment within a reasonable period.
- Ensure outside repossession agents are licensed and bonded.
- Account for repossession separately by customer name, loan balance, date of repossession, and dealer origin.
- The institution has written procedures for the disposal of repossessed property that require the institution to dispose of vehicles in a timely manner (standard 15 days after the expiration of the customer redemption period). Determine whether the institution documented the method of sale and received competitive bids.

26. Determine projected loan growth.

27. Ensure that the examination meets the Objectives of this Handbook Section. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

Level III

28. Select a sample of accounts and perform direct verification with the borrower.

29. Reconcile or perform verifications of any accounts as necessary.

Examiner's Summary, Recommendations, and Comments

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Consumer Lending Questionnaire

	Yes	No
General Questionnaire		
Consumer Loan Policies		
1. Has the board of directors adopted written consumer loan policies that:		
• Establish procedures detailing loan underwriting guidelines such as: debt/income ratios, loan-to-value ratios, job stability requirements, credit history requirements, acceptable collateral, and loan terms for each type of loan?		
• Establish standards for determining credit lines?		
• Establish minimum standards for documentation?		
2. Does the board review consumer loan policies at least annually to determine if they are compatible with the current business plan and the marketplace?		
Segregation of Duties		
3. Are persons who perform or review the preparation and posting of subsidiary consumer loan records prohibited from:		
• Issuing official checks or drafts singly? ..		
• Handling cash or checks?		
4. Are persons who perform or review the preparation and posting of interest records prohibited from:		
• Issuing official checks or drafts singly? ..		
• Handling cash or checks?		
5. Are persons who receive and investigate inquiries about loan balances prohibited from also handling cash and checks?		
If not, who receives and investigates inquiries?_____		

	Yes	No
6. Are persons who subsequently review or test documents supporting recorded credit adjustments prohibited from also handling cash and checks?		
If not, who reviews and tests?_____		
7. Are persons who investigate reconciling items prohibited from also handling cash? .		
Loan Approval		
8. Do authorized officers conduct loan approvals?		
9. When amounts are significant, does the institution require two authorized signatures to effect approval or a status change in an individual customer account?		
Physical Security of Documents		
10. If secured property is marketable security or small personal property, does the association have physical control of the security? If so, is it:		
• Under the supervision of an officer?.....		
• Kept under dual control?.....		
• Kept in a fireproof container?		
• Inventoried periodically and maintained in a log?		
• Released under controlled procedures and in a timely manner once proof of loan pay-off has been received?.....		
Collateral		
11. Does the association maintain records that:		
• Detail the complete description of collateral pledged?		
• Are signed by the customer?		

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	Yes	No
12. When collateral value is high, does the association require that two officers review and approve the release?		
Balancing of Subsidiary Ledgers to the General Ledger		
13. Does the association reconcile at least monthly the subsidiary consumer loan records to the appropriate general ledger accounts?		
Disbursements of Loan Proceeds		
14. Does the association segregate disbursement and loan approval responsibilities?....		
Operating Review System		
15. Has the association developed procedures for monitoring compliance with established controls?		
16. Has the association assigned employee(s) to:		
• Review new loan documentation?		
• Determine proper segregation of duties and prohibit loan officers from processing loan payments?.....		
• Recompute the amount of discount on new loans?.....		
• Review entries to unearned discount or income accounts?.....		
• Determine accurate and prompt posting of payments?		

	Yes	No
• Test check postings to general ledger at least weekly?		
Other		
17. Does the association maintain a daily record summarizing loan transaction details, e.g., loans made, payments received, and interest collected, to support applicable general ledger entries?		
18. Does operating management produce and review an exception report that encompasses extensions, renewals, or any factors that will result in a change in customer account status?		
19. Does management establish collection policies so that:		
• A delinquent notice is sent prior to a loan becoming 30 days past due?.....		
• Collection effort is intensified when a loan becomes two payments past due?		
• Records of collection efforts are maintained in the customer's file?		
20. Does the institution engage in subprime consumer lending activities?.....		
21. Does the institution purchase consumer loans from others?		
22. Does the institution engage in indirect consumer lending?		

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Consumer Lending
Questionnaire

Comments

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Interagency Guidance on Subprime Lending

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Background and Scope

Insured depository institutions have traditionally avoided lending to customers with poor credit histories because of the higher risk of default and resulting loan losses. However, in recent years a number of lenders[1] have extended their risk selection standards to attract lower credit quality accounts, often referred to as subprime loans. Moreover, recent turmoil in the equity and asset-backed securities market has caused some non-bank subprime specialists to exit the market, thus creating increased opportunities for financial institutions to enter, or expand their participation in, the subprime lending business. The federal banking agencies have been monitoring this development and are providing guidance on this activity.

For the purposes of this guidance, "subprime lending" is defined as extending credit to borrowers who exhibit characteristics indicating a significantly higher risk of default than traditional bank lending customers.[2] Risk of default may be measured by traditional credit risk measures (credit/repayment history, debt to income levels, etc.) or by alternative measures such as credit scores. Subprime borrowers represent a broad spectrum of debtors ranging from those who have exhibited repayment problems due to an adverse event, such as job loss or medical emergency, to those who persistently mismanage their finances and debt obligations. Subprime lending does not include loans to borrowers who have had minor, temporary credit difficulties but are now current. This guidance applies to direct extensions of credit; the purchase of

[1] The terms "lenders," "financial institutions," and "institutions," in this document refer to insured depository institutions and their subsidiaries.

[2] For purposes of this paper, loans to customers who are not subprime borrowers are referred to as "prime."

subprime loans from other lenders, including delinquent or credit impaired loans purchased at a discount; the purchase of subprime automobile or other financing "paper" from lenders or dealers; and the purchase of loan companies that originate subprime loans.

Due to their higher risk, subprime loans command higher interest rates and loan fees than those offered to standard risk borrowers. These loans can be profitable, provided the price charged by the lender is sufficient to cover higher loan loss rates and overhead costs related to underwriting, servicing, and collecting the loans. Moreover, the ability to securitize and sell subprime portfolios at a profit while retaining the servicing rights has made subprime lending attractive to a larger number of institutions, further increasing the number of subprime lenders and loans. Recently, however, a number of financial institutions have experienced losses attributable to ill-advised or poorly structured subprime lending programs. This has brought greater supervisory attention to subprime lending and the ability of insured depository institutions to manage the unique risks associated with this activity.

Institutions should recognize the additional risks inherent in subprime lending and determine if these risks are acceptable and controllable given the institution's staff, financial condition, size, and level of capital support. Institutions that engage in subprime lending in any significant way should have board-approved policies and procedures, as well as internal controls that identify, measure, monitor, and control these additional risks. Institutions that engage in a small volume of subprime lending should have systems in place commensurate with their level of risk. Institutions that began a subprime lending program prior to the issuance of this guidance should carefully consider whether their program meets the following guidelines and should implement corrective measures for any area that falls short of these minimum standards. If the risks associated with this activity are not properly controlled, the agencies consider subprime lending a high-risk activity that is unsafe and unsound.

Capitalization

The federal banking agencies believe that subprime lending activities can present a greater than normal risk for financial institutions and the deposit insurance funds; therefore, the level of capital institutions need to support this activity should be commensurate with the additional risks incurred. The amount of additional capital necessary will vary according to the volume and type of subprime activities pursued and the adequacy of the institution's risk management program. Institutions should determine how much additional capital they need to offset the additional risk taken in their subprime lending activities and document the methodology used to determine this amount. The agencies will evaluate an institution's overall capital adequacy on a case-by-case basis through on-site examinations and off-site monitoring procedures considering, among other factors, the institution's own analysis of the capital needed to support subprime lending. Institutions determined to have insufficient capital must correct the deficiency within a reasonable timeframe or be subject to supervisory action. In light of the higher risks associated with this type of lending, the agencies may impose higher minimum capital requirements on institutions engaging in subprime lending.

Risk Management

The following items are essential components of a well-structured risk management program for subprime lenders:

Planning and Strategy. Prior to engaging in subprime lending, the board and management should ensure that proposed activities are consistent with the institution's overall business strategy and risk tolerances, and that all involved parties have properly acknowledged and addressed critical business risk issues. These issues include the costs associated with attracting and retaining qualified personnel, investments in the technology necessary to manage a more complex portfolio, a clear solicitation and origination strategy that

allows for after-the-fact assessment of underwriting performance, and the establishment of appropriate feedback and control systems. The risk assessment process should extend beyond credit risk and appropriately incorporate operating, compliance, and legal risks. Finally, the planning process should set clear objectives for performance, including the identification and segmentation of target markets and/or customers, and performance expectations and benchmarks for each segment and the portfolio as a whole. Institutions establishing a subprime lending program should proceed slowly and cautiously into this activity to minimize the impact of unforeseen personnel, technology, or internal control problems and to determine if favorable initial profitability estimates are realistic and sustainable.

Staff Expertise. Subprime lending requires specialized knowledge and skills that many financial institutions may not possess. Marketing, account origination, and collections strategies and techniques often differ from those employed for prime credit; thus it may not be sufficient to have the same lending staff responsible for both subprime loans and other loans. Additionally, servicing and collecting subprime loans can be very labor intensive. If necessary, the institution should implement programs to train staff. The board should ensure that staff possesses sufficient expertise to appropriately manage the risks in subprime lending and that staffing levels are adequate for the planned volume of subprime activity. Seasoning of staff and loans should be taken into account as performance is assessed over time.

Lending Policy. A subprime lending policy should be appropriate to the size and complexity of the institution's operations and should clearly state the goals of the subprime lending program. While not exhaustive, the following lending standards should be addressed in any subprime lending policy:

- Types of products offered as well as those that are not authorized;
- Portfolio targets and limits for each credit grade or class;
- Lending and investment authority clearly stated for individual officers, supervisors, and loan committees;
- A framework for pricing decisions and profitability analysis that considers all costs associated with the loan, including origination costs, administrative/servicing costs, expected charge-offs, and capital;
- Collateral evaluation and appraisal standards;
- Well defined and specific underwriting parameters (i.e., acceptable loan term, debt to income ratios, loan to collateral value ratios for each credit grade, and minimum acceptable credit score) that are consistent with any applicable supervisory guidelines;[3]
- Procedures for separate tracking and monitoring of loans approved as exceptions to stated policy guidelines;
- Credit file documentation requirements such as applications, offering sheets, loan and collateral documents, financial statements, credit reports, and credit memoranda to support the loan decision; and

[3] Extensions of credit secured by real estate, whether subprime or otherwise, are subject to the Interagency Guidelines for Real Estate Lending Policies, which establish supervisory Loan-to-Value (LTV) limits on various types of real estate loans and impose limits on an institution's aggregate investment in loans that exceed the supervisory LTV limits. See 12 CFR Part 34, subpart D (OCC); 12 CFR Part 208, appendix C (FRB); 12 CFR Part 365 (FDIC); and 12 CFR 560.100-101 (OTS) for further information.

- Correspondent/broker/dealer approval process, including measures to ensure that loans originated through this process meet the institution's lending standards.

If the institution elects to use credit scoring (including applications scoring) for approvals or pricing, the scoring model should be based on a development population that captures the behavioral and credit characteristics of the subprime population targeted for the products offered. Because of the significant variance in characteristics between the subprime and prime populations, institutions should not rely on models developed solely for products offered to prime borrowers. Further, the model should be reviewed frequently and updated as necessary to ensure that assumptions remain valid.

Purchase Evaluation. Institutions that purchase subprime loans from other lenders or dealers must give due consideration to the cost of servicing these assets and the loan losses that may be experienced as they evaluate expected profits. For instance, some lenders who sell subprime loans charge borrowers high up-front fees, which are usually financed into the loan. This provides incentive for originators to produce a high volume of loans with little emphasis on quality, to the detriment of a potential purchaser. Further, subprime loans, especially those purchased from outside the institution's lending area, are at special risk for fraud or misrepresentation (i.e., the quality of the loan may be less than the loan documents indicate).

Institutions should perform a thorough due diligence review prior to committing to purchase subprime loans. Institutions should not accept loans from originators that do not meet their underwriting criteria, and should regularly review loans offered to ensure that loans purchased continue to meet those criteria. Deterioration in the quality of purchased loans or in the portfolio's actual performance versus expectations requires a thorough reevaluation of the lenders or dealers who originated or sold the loans, as well as a reevaluation of the institution's criteria for underwriting loans and selecting dealers and lenders. Any such deterioration may also highlight the need to modify or terminate the correspondent relationship or make adjustments to underwriting and dealer/lender selection criteria.

Loan Administration Procedures. After the loan is made or purchased, loan administration procedures should provide for the diligent monitoring of loan performance and establish sound collection efforts. To minimize loan losses, successful subprime lenders have historically employed stronger collection efforts such as calling delinquent borrowers frequently, investing in technology (e.g., using automatic dialing for follow-up telephone calls on delinquent accounts), assigning more experienced collection personnel to seriously delinquent accounts, moving quickly to foreclose or repossess collateral, and allowing few loan extensions. This aspect of subprime lending is very labor intensive but critical to the program's success. To a large extent, the cost of such efforts can represent a tradeoff relative to future loss expectations when an institution analyzes the profitability of subprime lending and assesses its appetite to expand or continue this line of business.

Subprime loan administration procedures should be in writing and at a minimum should detail:

- Billing and statement procedures;
- Collection procedures;
- Content, format, and frequency of management reports;
- Asset classification criteria;
- Methodology to evaluate the adequacy of the allowance for loan and lease losses (ALLL);
- Criteria for allowing loan extensions, deferrals, and re-agings;
- Foreclosure and repossession policies and procedures; and

- Loss recognition policies and procedures.

Loan Review and Monitoring. Once loans are booked, institutions must perform an ongoing analysis of subprime loans, not only on an aggregate basis but also for sub-portfolios. Institutions should have information systems in place to segment and stratify their portfolio (e.g., by originator, loan-to-value, debt-to-income ratios, credit scores) and produce reports for management to evaluate the performance of subprime loans. The review process should focus on whether performance meets expectations. Institutions then need to consider the source and characteristics of loans that do not meet expectations and make changes in their underwriting policies and loan administration procedures to restore performance to acceptable levels.

When evaluating actual performance against expectations, it is particularly important that management review credit scoring, pricing, and ALLL adequacy models. Models driven by the volume and severity of historical losses experienced during an economic expansion may have little relevance in an economic slowdown, particularly in the subprime market. Management should ensure that models used to estimate credit losses or to set pricing allow for fluctuations in the economic cycle and are adjusted to account for other unexpected events.

Consumer Protection. Institutions that originate or purchase subprime loans must take special care to avoid violating fair lending and consumer protection laws and regulations. Higher fees and interest rates combined with compensation incentives can foster predatory pricing or discriminatory "steering" of borrowers to subprime products for reasons other than the borrower's underlying creditworthiness. An adequate compliance management program must identify, monitor and control the consumer protection hazards associated with subprime lending.

Subprime mortgage lending may trigger the special protections of "The Home Ownership and Equity Protection Act of 1994," Subtitle B of Title I of the Riegle Community Development and Regulatory Improvement Act of 1994. This Act amended the Truth-in-Lending Act to provide certain consumer protections in transactions involving a class of non-purchase, closed-end home mortgage loans. Institutions engaging in this type of lending must also be thoroughly familiar with the obligations set forth in Regulation Z, 12 C.F.R. §226.32, and Regulation X, the Real Estate Settlement Procedures Act (RESPA), 12 USC §2601, and adopt policies and implement practices that ensure compliance.

The Equal Credit Opportunity Act makes it unlawful for a creditor to discriminate against an applicant on a prohibited basis regarding any aspect of a credit transaction. Similarly, the Fair Housing Act prohibits discrimination in connection with residential real estate-related transactions. Loan officers and brokers must treat all similarly situated applicants equally and without regard to any prohibited basis characteristic (e.g., race, sex, age, etc.). This is especially important with respect to how loan officers or brokers assist customers in preparing their applications or otherwise help them to qualify for loan approval.

Securitization and Sale. Some subprime lenders have increased their loan production and servicing income by securitizing and selling the loans they originate in the asset-backed securities market. Strong demand from investors and favorable accounting rules often allow securitization pools to be sold at a gain, providing further incentive for lenders to expand their subprime lending program. However, the securitization of subprime loans carries inherent risks, including interim credit risk and liquidity risk, that are potentially greater than those for securitizing prime loans. Accounting for the sale of subprime pools requires assumptions that can be difficult to quantify, and erroneous assumptions could lead to the significant overstatement of an institution's assets. Moreover, the practice of providing support and substituting performing loans for nonperforming loans to maintain the desired level of performance on securitized pools has the effect of masking credit quality problems.

Recent turmoil in the financial markets illustrates the volatility of the secondary market for subprime loans and the significant liquidity risk incurred when originating a large volume of loans intended for securitization and sale. Investors can quickly lose their appetite for risk in an economic downturn or when financial markets become volatile. As a result, institutions that have originated, but have not yet sold, pools of subprime loans may be forced to sell the pools at deep discounts. If an institution lacks adequate personnel, risk management procedures, or capital support to hold subprime loans originally intended for sale, these loans may strain an institution's liquidity, asset quality, earnings, and capital. Consequently, institutions actively involved in the securitization and sale of subprime loans should develop a contingency plan that addresses back-up purchasers of the securities or the attendant servicing functions, alternate funding sources, and measures for raising additional capital.

Institutions should refer to Statement of Financial Accounting Standards No. 125 (FAS 125), "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," for guidance on accounting for these transactions. If a securitization transaction meets FAS 125 sale or servicing criteria, the seller must recognize any gain or loss on the sale of the pool immediately and carry any retained interests in the assets sold (including servicing rights/obligations and interest-only strips) at fair value. Management should ensure that the key assumptions used to value these retained interests are reasonable and well supported, both for the initial valuation and for subsequent quarterly revaluations. In particular, management should consider the appropriate discount rates, credit loss rates, and prepayment rates associated with subprime pools when valuing these assets. Since the relative importance of each assumption varies with the underlying characteristics of the product types, management should segment securitized assets by specific pool, as well as predominant risk and cash flow characteristics, when making the underlying valuation assumptions. In all cases, however, institutions should take a conservative approach when developing securitization assumptions and capitalizing expected future income from subprime lending pools. Institutions should also consult with their auditors as necessary to ensure their accounting for securitizations is accurate.

Reevaluation. Institutions should periodically evaluate whether the subprime lending program has met profitability, risk, and performance goals. Whenever the program falls short of original objectives, an analysis should be performed to determine the cause and the program should be modified appropriately. If the program falls far short of the institution's expectations, management should consider terminating it. Questions that management and the board need to ask may include:

- Have cost and profit projections been met?
- Have projected loss estimates been accurate?
- Has the institution been called upon to provide support to enhance the quality and performance of loan pools it has securitized?
- Were the risks inherent in subprime lending properly identified, measured, monitored and controlled?
- Has the program met the credit needs of the community that it was designed to address?

Examination Objectives

Due to the high-risk nature of subprime lending, examiners will carefully evaluate this activity during regular and special examinations. Examiners will:

- Evaluate the extent of subprime lending activities and whether management has adequately planned for this activity.

- Assess whether the institution has the financial capacity to conduct this high-risk activity safely without an undue concentration of credit and without overextending capital resources.
- Ascertain if management has committed the necessary resources in terms of technology and skilled personnel to manage the program.
- Evaluate whether management has established adequate lending standards and is maintaining proper controls over the program.
- Determine whether the institution's contingency plans are adequate to address the issues of alternative funding sources, back-up purchasers of the securities or the attendant servicing functions, and methods of raising additional capital during a period of an economic downturn or when financial markets become volatile.
- Review securitization transactions for compliance with FAS 125 and this guidance, including whether the institution has provided any support to maintain the credit quality of loans pools it has securitized.
- Analyze the performance of the program, including profitability, delinquency, and loss experience.
- Consider management's response to adverse performance trends, such as higher than expected prepayments, delinquencies, charge-offs, customer complaints, and expenses.
- Determine if the institution's compliance program effectively manages the fair lending and consumer protection compliance risks associated with subprime lending operations.

Richard C. Spillenkothen
Director, Division of Banking
Supervision and Regulation
Board of Governors of the Federal Reserve System

James L. Sexton
Director, Division of Supervision
Federal Deposit Insurance Corporation

Emory W. Rushton
Senior Deputy Comptroller for
Bank Supervision Policy

Richard M. Riccobono
Deputy Director
Office of Thrift Supervision

Subprime Lending Program

Examination Procedures

Use the following examination procedures to assess an institution's subprime lending activities. Choose only those procedures needed, based on the level of risk and size of the institution's subprime lending activities. Seldom will you need to perform all procedures. You should also coordinate the use of these procedures with procedures performed by other examiners to avoid duplication. **Furthermore, you should test and verify enough underlying transactions to confirm that the institution's actual practices are consistent with stated policies, practices, and management reports. Significant variances normally indicate a need for closer examination scrutiny.**

These procedures are generic so you may apply them to all types of lending. You will, however, need to add any specific procedures for the type of subprime lending you review. Finally, these procedures deal primarily with safety and soundness issues. Consumer compliance issues can also pose significant risk for institutions that engage in subprime lending. For additional guidance, examiners should refer to the *OTS Compliance Activities Handbook.*

Level I

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The following Level I procedures will provide you with an overview of an institution's subprime lending activities and the risks involved. You should perform these procedures in institutions that have material amounts of subprime lending. You should perform only those procedures necessary to meet examination objectives. **Note: examinations seldom require all steps.**

1. Review the following information to understand the examination scope and history and the institution's level of subprime lending:

   - The scope memorandum issued by the examiner in charge.
   - The previous examination findings.
   - Comments of the external and internal auditors (including any quality control staff) and their reports to management.
   - Management's responses to examiner and auditor recommendations and comments. Determine whether management corrected deficiencies mentioned in prior examinations, audit reports, and management letters or supervisory correspondence.

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- Institution reports on subprime portfolios.

2. Evaluate the content of the most recent management reports and reports prepared for the board of directors relating to subprime lending. Determine if the reports are adequate.

3. Review the monthly financial information provided to senior management, and evaluate its usefulness and accuracy. Review the most recent fiscal year-end and current year-to-date financial information for subprime products, and compare to budgets and forecasts. Discuss any significant variances with management.

4. Review management's budget and capital plan for subprime products. Assess reasonableness, trends, and actual versus projected performance for the respective products.

5. Assess the adequacy and reasonableness of the institution's lending policies and procedures used to manage subprime portfolios. Pay particular attention to any changes since the last examination. Review policies to ensure that they address:

   - Lines of authority and segregation of duties
   - Underwriting limits
   - Concentrations of credit (for instance, geographic, product type, broker, source of recourse)
   - Permissible types of loans
   - Underwriting criteria (maximum acceptable debt-to-income, scorecard cutoffs, etc.)
   - Required/eligible collateral
   - Collateral valuation guidelines/methods

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- Exception processes
- Credit grading ("A," "B," "C," etc. paper)
- Cure programs (for example, re-agings, extensions, renewals, rewrites)

6. Determine whether all appropriate staff use and adhere to the lending policies and procedures. Determine the adequacy of exception reporting.

7. Determine whether management and the board of directors review the policies at least annually in light of the portfolio's performance and the institution's strategic goals.

8. Evaluate the institution's staffing, training, and compensation plans for its subprime operations. Assess staff adequacy in light of portfolio volume and performance.

9. Review the institution's underwriting process to determine the level of automation, use of credit scoring models, and the override/exception process.

10. Review delinquency and loss reports on a product-by-product basis and by acquisition channel. Determine if delinquency levels are in line with projections.

11. Review the institution's process for pricing subprime products, including:
    - The use of risk-based pricing.
    - How competitor pricing affects the institution's pricing.
    - How pricing models are maintained.

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12. Assess the process used by risk management to measure and monitor risk by product, vintage, solicitation, and account source. Ensure that a process exists to report problems to senior management and, if there are problems noted, that the institution promptly takes corrective action.

13. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

Level II

The following Level II procedures require a more detailed examination of institution practices. You should perform only those procedures necessary to make an informed assessment of the institution's subprime lending activities. Not all procedures will be applicable for a given institution. Moreover, the examiner in charge may omit applicable procedures if the volume of subprime lending is small in relation to the institution's size or when the overall exposure to loss is low.

14. Review a sample of loans made during the review period (including some new accounts originated in the past quarter). Evaluate whether loans are consistent with current underwriting guidelines, and whether the institution notes and monitors exceptions and overrides in accordance with policy.

15. Assess the adequacy of exception reporting, and determine if the institution's response to significant variations is appropriate. Determine whether the level of exceptions results in higher levels of delinquencies and losses, indicative of weaknesses in the underwriting process.

16. Determine the adequacy of the institution's verification procedures, and ensure that, at a minimum, they routinely confirm residence, employment, and income for subprime borrowers.

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17. Evaluate the adequacy of management information systems (MIS), and reporting for subprime lending activities, and determine whether management monitors appropriate key measurements (for example, approval/override rates, etc.).

18. Review the institution's marketing process. Determine whether the institution:

- Tests new products before launching a large-scale lending program.
- Has controls and reporting in place to monitor marketing plans and activity.
- Uses application scoring models or other targeting techniques.

19. Determine whether the institution has guidelines that govern purchasing subprime loans originated elsewhere. Assess the reasonableness of those guidelines. Consider whether processes are in place to ensure that purchased loans are consistent with the institution's underwriting criteria, and the institution is able to reject loans that do not meet its criteria.

20. Assess the adequacy of the process used to "approve" brokers and other origination sources. Be alert for any concentration risks and insider or affiliate relationships. Ensure that:

- Management maintains a current and complete list of all vendors.
- The institution actively manages vendor relationships including:
  - Maintenance of current and complete contracts (inclusion of appropriate clauses, receipt of audit reports, financial statement requirements, etc., monitoring for adherence to terms/performance guidelines; information for renegotiation).
  - Annual review of vendor audit reports and financial condition.

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— Development of necessary controls (for example, restricting access to institution information).

21. Assess the adequacy of the documentation supporting pricing decisions and models. Determine that assumptions used are reasonable and complete, and that it appropriately captures all relevant income and expense categories.

22. Determine the adequacy of the institution's quality control and internal audit processes (for example, frequency, scope, accuracy, and meaningfulness of conclusions).

23. Determine the adequacy (substance and timing) of management response and follow-up on audit and quality assurance findings. Evaluate the training and qualifications of quality control staffing, and evaluate the reasonableness of reporting lines.

24. Determine if the institution uses and properly applies credit scoring in the subprime lending functions.

25. Assess the structure, management, and staffing of the collections department. Assess the appropriateness of the institution's collection strategies.

26. Evaluate various cure programs used, such as re-aging, fixed payment, Consumer Credit Counseling Services, and forgiveness. Specifically:

- Determine what programs are in place or planned and review written policies.
- Verify that management monitors and analyzes the performance of each program.

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- Assess the current and potential impact of such programs on reported performance and profitability, including allowance implications.

27. Evaluate the adequacy of the institution's classification and charge-off policy by:

- Determining that it adheres to the guidance of the FFIEC Uniform Retail Credit Classification Policy.
- Reviewing automated data processing parameters used for classification and charge-offs. These parameters should correspond to those described in the charge-off policy. (If not, discuss the differences with management and request appropriate corrective action.)
- Determining how the institution loads accounts scheduled for charge-off into a charge-off queue or other system for loss. Specifically:
  - Determine the circumstances, if any, that would delay a charge-off.
  - Determine when the institution recognizes losses (daily, weekly, or monthly).

28. Evaluate whether the allowance for loan and lease loss policy specifically identifies subprime lending portfolios. Determine if:

- The institution has a written description of the process used to determine the adequacy of the allowance.
- The analysis documents the factors considered in evaluating subprime portfolios.
- Charge-off policies are consistent with the FFIEC's Uniform Retail Credit Classification and Account Management Policy.

29. Review the institution's most recent quarterly evaluation of the allowance. Determine whether the institution's allowances for subprime portfolios are reasonable and supported.

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30. Determine whether the institution funds subprime lending portfolios by securitizing the receivables.

31. Evaluate the performance of institution-issued securities supported by subprime loans. Determine whether:

- Performance trends are stable, improving, or deteriorating.
- Early amortization or other credit enhancement triggers are nearing their set-off points. If so, discuss with management the potential cash flow and reputation risk issues.

32. Discuss with management how the institution determines accounting treatment for securitized assets. Review the institution's process for valuing residual assets associated with securitized subprime portfolios. Determine whether:

- Assumptions (prepayment speeds, loss forecasts, and discount rates) are reasonable and conservative.
- The institution uses the cash-out method for valuing cash flows.
- The institution uses static pool cash collection analysis to support cash flow assumptions.

33. Determine whether any recourse provisions (such as over-collateralization) are in the securitization agreement or if the institution has provided recourse through non-contractually required credit support. For example, does the institution routinely repurchase past-due loans from securitized asset pools. If so, the examiner should investigate the risk-based capital and recourse implications with examiners performing the review of capital adequacy.

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34. Review a sample of investor account reconciliations. Determine whether monthly investor reports are accurate and promptly submitted.

35. Ensure that the examination meets the Objectives of this Handbook Section. State your findings and conclusions, including:

- The level of risk in the institution's subprime lending activities, including:
  - Credit quality of the subprime portfolios, taking into account trends in portfolio performance, delinquencies, and losses.
  - Compliance with established guidelines.
  - Compliance with applicable laws, rulings, and regulations.
- Quality of risk management, including:
  - Adequacy of policies and underwriting standards.
  - Adequacy of processes, including planning.
  - Management's ability to conduct its retail lending in a safe and sound manner.
  - Adequacy of control systems, including loan review, audit, and management information systems.
- Deficiencies noted during the examination.

36. In consultation with the examiner in charge, determine whether the risks identified are significant enough to merit bringing them to the board's attention in the Report of Examination (ROE). If so, prepare examination comments, including any necessary corrective measures, discuss these with management, and record management's comments in the ROE. If you determine deficiencies are not significant enough to include them in the ROE, discuss them and any recommendations you may have with management and record them along with management's response in the work papers.

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37. Prepare a memorandum or update the work program with any information that will facilitate future examinations. Organize and reference work papers in accordance with OTS guidance.

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INTRODUCTION

Credit card lending is a type of revolving unsecured credit accessed by the borrower when purchasing merchandise or obtaining cash advances. Credit card operations include numerous activities that can be separated and performed by more than one contractor. A savings institution may perform some or all of the followings functions:

- Solicit cardholders;
- Underwrite and establish credit lines;
- Issue cards;
- Solicit retail merchants and others to accept cards;
- Establish limits for merchant authorizations;
- Establish networks for cash advances;
- Process merchant transactions to customer accounts;
- Send monthly statements; and
- Perform collection activities.

Types of Credit Card Operations

An institution may be involved in a credit card plan in one of three ways: as agent, sublicensee, or licensee.

Agent. This is the most limited form of participation. The institution receives credit card applications from customers and sales drafts from merchants and forwards such documents to licensees (described below). The institution is accountable for the documents during the process of receiving and forwarding the applications.

Sublicensee. The institution maintains accountability for credit card loans and merchants' accounts. It may also maintain its own center for processing payments and drafts and embossing credit cards.

Licensee. A licensee performs the functions of a sublicensee, and in addition may perform transactions processing and credit card embossing services for sublicensees. The licensee also acts as a regional or national clearinghouse for sublicensee institutions.

Components of Income

Credit card operations generate income in various ways. First, the institution can collect fees from borrowers for annual membership and for cash advances. It also collects fees from merchants for deposited transactions and for the use of imprinters. Interest income is collected from cardholders for outstanding credit balances; fees are also collected from other institutions for providing processing services.

Credit card lending is a high-overhead operation due to various factors, including:

- The high volume of transactions;
- The cost of credit analysis compared with the average balance outstanding;
- The cost of monitoring and controlling the use of the credit line; and
- The cost of collections and charge-offs.

The institution must establish adequate cost accounting and cost control systems to achieve and maintain profitability of the operation. The institution must perform a comprehensive risk/return trade-off analysis whenever changes in underwriting standards or other critical factors are contemplated.

Credit Card Risks and Controls

Credit card advances are loans and should be evaluated as such. Policies, procedures, and con-

trols designed to minimize credit risk should be similar to those for other consumer loans. (See the Thrift Activities Regulatory Handbook Section 217, Consumer Lending, for more details.) But credit card lending is also characterized by unique risk factors.

As with any open-end form of consumer credit, institutions must establish credit limits for individual customers. The nature of credit card loans presents an additional risk because institutions can exert only limited control over paydowns or the acquisition of additional cards by the borrower. As a result, the borrower's debt can pay off or accumulate beyond control anytime.

The greatest risk involves the screening of applicants since most losses occur with new account holders. More seasoned portfolios typically experience much smaller losses. Adequate screening of applicants reduces the risk of both default and fraud. Institutions should follow the same screening procedures as used for other types of unsecured consumer credit, including: the applicant's credit history, job stability, and ability to pay. Given the need for comprehensive screening procedures, the mass marketing of preapproved cards without credit underwriting is inconsistent with sound underwriting and substantially increases the risk of borrower default and fraud.

Credit underwriting requires the constant analysis of data comparing the payment patterns and revenues from various groupings of accounts to determine current controllable risk factors. Credit limits and marketing efforts must consider current risk factors to control portfolio credit risk. Prescreened mailing lists should be sampled and tested for compliance with underwriting criteria before mass mailing.

Institutions may wish to consider the use of special credit reporting houses for applicant information and reviewer training. In addition, losses that do occur should be reported in a manner that identifies the underwriter who approved the line of credit and the underwriting criteria followed, such as credit-scoring systems used or specific underwriting factors of the borrowers. The regulator should evaluate not only the policies and procedures to prevent losses, but also the strength of internal controls and operating procedures. Collection efforts must be prompt and frequent.

Credit Card Misuse and Fraud

Credit card fraud is divided into two broad areas: the misuse of credit cards and the misuse of credit. Misuse of credit cards also includes counterfeit transactions. This type of fraud occurs when merchants falsify transaction slips using real or false card numbers, or by altering the amounts on transaction slips. Counterfeit fraud also includes fraudulent telemarketing operations whereby consumers are persuaded to divulge their account numbers for "too-good-to-be-true" offers. Such schemes have cost financial institutions millions of dollars in a short time. For this reason, merchants must be carefully screened and underwritten for the amount of two month's anticipated receipts (the amount that could be lost if receipts are fraudulent). Victim fraud involves the use of another person's identification to apply for credit or the use of another person's card as identification for obtaining cash.

Institutions avert the misuse of credit cards by establishing controls that prevent employees from intercepting cards, merchants from obtaining control of cards, and customers from making fraudulent use of lost or stolen cards. These controls include: dual control of plastic blanks, embossing equipment, authorization of accounts, and undelivered cards that have been authorized and embossed; software controls to prevent access to both account numbers and personal identification numbers (PINs) or personal security identifiers (PSIs); review of merchant and borrower activity for unusual patterns and for compliance with activity limit; sending of lost and stolen card lists to merchants and rewards for capturing cards; and remote transaction authorization devices for merchants' use.

The misuse of credit also takes several forms. Shotgun fraud results when an individual floods the market with credit applications (often containing false information), hoping that several credit card issuers will grant credit. With "new i.d." fraud, an individual becomes a "new" person by using the name and social security number of someone else, sometimes a deceased person. With credit alterations, applicants delete or modify

their own credit records. “Credit clinics” use loopholes in the Fair Credit Reporting Act to change credit histories of poor credit risks.

Regulatory Considerations

Due to the high volume of low-balance accounts, review of individual files for credit quality is inefficient. Instead, the regulator should first determine the adequacy of the following: policies, procedures (including underwriting guidelines and internal controls), management reports (especially exception reports), internal loan review practices, pricing policies, and charge-off policies. A review of a sample of loans to determine compliance with internal guidelines may be appropriate. If reports are determined to be accurate, classification of the assets is usually performed by applying a uniform system to the delinquent loans listed on the report(s).

The regulator’s attention should be directed toward determining the adequacy of overall systems and results. An institution will not sustain a successful credit card operation if its systems are inefficient. If individual accounts require additional personal attention by the staff, profitability will be compromised.

Credit card use is an expanding and diversifying part of the financial services industry. Regulators may find that some thrifts may be allowing customers to use credit cards with several applications: automatic teller machines (ATMs), point of sale (POS) terminals, telephone bill paying, account transfers, and debit card programs. For federal institutions, these applications are covered by § 545.141 of the regulations for remote service units (RSUs). Such uses are forms of electronic funds transfer (EFT) and require close attention to operational and systemic controls. Regulators must review related control procedures closely to determine if both customers and thrifts are adequately protected from improper use of credit cards through RSUs.

Charge-Off Procedures

The identification of unfavorable trends must include the review of past-due percentages, and income and loss trends with comparisons by underwriting criteria. Management should monitor such trends closely. Unfortunately, in thrifts that lack a well enforced charge-off program, loss ratios are often meaningless for periods of less than a year. This delays recognition and implementation of any necessary corrective action. For more information on charge-off regulations and procedures for open-end consumer loans, consult Thrift Activities Regulatory Handbook Section 217, Consumer Lending, and § 561.13 of the regulations.

Regulations Affecting Credit Cards

A number of consumer regulations affect credit card loans. Regulation Z, in particular, establishes specific rules for open-end consumer credit. Regulators need to be familiar with these regulations. They are discussed in detail in the Compliance Activities Handbook. Other memoranda and policy statements that apply to credit cards are provided in the appendices.

Accounting

The following accounting rules apply to credit card lending:

- Annual card fees should be recorded as deferred income and amortized into income over the period of time the customer has use of the card. Usually a straight-line method of amortization is used.
- Fees charged for merchant and interchange transactions are usually accrued as receivables and taken into income at the time of the transaction.
- Interest income is recognized using the level-yield method as deemed collectible.

Securitization

Securitization has become an increasingly popular method for issuers to remove credit card receivables from their balance sheet. This same approach has been used for other types of receivables, including automobiles and real estate mortgages. Securitization involves the pooling and repackaging of debt obligations into securities

that can then be sold in the secondary market. The presence of a secondary market also increases the effective liquidity of an institution's portfolio. (See the Mortgage Banking Sections of the Thrift Activities Regulatory Handbook, for further information.)

An institution packages its credit card receivables into security form, then markets those securities through an underwriter or through private placement. To qualify as an outright sale, the receivables must be assigned to a third party (e.g., trustee) that has no recourse back to the institution. If recourse remains in the form of a contingent liability, the receivables are not removed from the institution's balance sheet. The spread between the yield payable by cardholders and the yield to investors goes into a reserve fund that investors may tap in case of default. As a backup, another institution may issue a standby letter of credit guaranteeing a fixed percentage of the securities. The issuer typically retains servicing rights.

When an institution is relying on the secondary market as a source of funding for the loans that are originated, the regulator should focus on determining whether the required underwriting standards are strictly adhered to. An unexpected buy-back of loans or nonfunding when expected could negatively affect operations.

REFERENCES

United States Code (12 USC)

Home Owners' Loan Act

§ 1464(b)(4)	Credit Cards
§ 1464(c)(2)(D)	Consumer Loans

Code of Federal Regulations (12 CFR)

Subchapter B: Consumer-Related Regulations

§ 533.1	Electronic Funds Transfers Subject to Regulation E

Subchapter C: Regulations for Federal Savings Associations

§ 545.51	Credit Cards
§ 545.141	Remote Service Units

Subchapter D: Regulations Applicable to All Savings Associations

§ 561.13	Consumer Credit Classified as Loss
§ 561.47	Slow Consumer Credit
§ 563.93	Loans-to-One Borrower Limitation
§ 563.170(c)(2)	Records Required
§ 563.170(e)	Use of Data Processing Services

Interagency Advisory on Credit Card-Related Merchant Activities (November 15, 1993)

Credit Card Lending
Program

Examination Objectives

To determine if the policies, procedures, and controls regarding credit cards adequately ensure safety and soundness, profitability, and compliance with laws and regulations.

To determine if officers and employees are qualified and performing their duties in a manner that ensures safety and soundness and compliance with policies and procedures.

To determine if financial records and management reports provide accurate and necessary information to management and directors.

To determine the adequacy of the audit and internal loan review function in this area.

To evaluate the credit card portfolio for credit quality.

To initiate corrective action when deficiencies exist that could affect safety and soundness, or when violations of laws or regulations have been noted.

Examination Procedures

Level I

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1. Review scoping materials related to credit card lending.

_____ _____

2. Obtain from the regulator assigned Thrift Activities Regulatory Handbook Section 210, Lending Risk Assessment, the reports and schedules applicable to the credit card area. Review management reports, especially exception reports, related to this area. Assess the adequacy of the reported information.

_____ _____

3. Evaluate the institution's policies and procedures for adequacy of underwriting controls and monitoring, documentation requirements, and collection procedures through:

   - Review of policy statements, underwriting guidelines and manuals;

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- Interviews with management; and
- Review of minutes or recaps of the minutes related to this area.

4. Determine whether objectives and related policies are reviewed periodically with any changes communicated to the appropriate personnel.

5. Complete the general questionnaire and address any negative responses.

6. Review the qualifications, capabilities, and expertise of credit card loan officers in relation to their responsibilities.

7. Determine whether the association corrected deficiencies mentioned in prior examination reports and audit reports.

8. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

Level II

9. Review the reconcilement of the subsidiary ledgers for credit card loans to the general ledger. Investigate any large reconciling items.

10. If internal policies, procedures, and exception reports are determined to be unreliable, select borrowers for review using an appropriate sampling technique. Also perform testing procedures if the institution mass markets credit cards. Review the rejection rates for credit card applications received through mass marketing. (Coordinate with the

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regulator assigned to Lending Risk Assessment.) Obtain minimal samples of all types of accounts. (For details on sampling, refer to Section 209 of the Thrift Activities Regulatory Handbook.) Include:

- A sampling of credit card accounts opened since the preceding examination;
- Accounts of employees, officers, directors, major stockholders, and their interests;
- Accounts of officers and directors of other institutions;
- Accounts in excess of their credit limits; and
- Accounts with unusually large credit limits.

11. Analyze credit files of borrowers for credit quality (earnings, indebtedness, credit history, loan modifications, overline status) and compliance with the loan policy.

12. Review past-due accounts and charge-offs.

- Determine if charge-offs are performed in accordance with the institution's policies and regulatory requirements. Review the past-due account report and test for accuracy. Individual accounts not charged off in accordance with regulatory requirements should be reviewed and discussed with management.
- Review the institution's policies regarding the accrual of interest on past-due loans. Determine whether the accrual policy conforms to Generally Accepted Accounting Principles (GAAP).
- Review procedures regarding the automatic reissuance of expired cards to obligors. Ascertain whether procedures preclude automatic reissuance of expired cards to obligors with charged-off balances or an otherwise unsatisfactory credit history with the institution.

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13. Determine if the institution has adequate inventory controls over unissued or unmailed cards.

    - If the institution maintains an inventory of unissued credit cards, determine if the cards are under dual control and audited regularly.

14. Review instances of merchant, customer, or employee fraud that occurred between examinations.

    - Determine whether suitable internal controls were instituted to prevent a recurrence.
    - Ascertain whether applicable regulatory and law enforcement authorities were notified of criminal activity.

15. Determine if collection practices are proper and in conformance with policy. Review written collection procedures and test check customer contact records.

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

Examiner's Summary, Recommendations, and Comments

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Credit Card Lending Questionnaire

	Yes	No
General Questionnaire		
If the institution acts only as the agent (refer to Thrift Activities Regulatory Handbook Section 218) for a credit grantor, it is not necessary to use the questionnaire.		
Credit Card Policies and Procedures		
1. Has the board of directors adopted written credit card policies that:		
• Establish the type of activity, acceptable return, acceptable level of risk, and level of commitment of resources and assets?		
• Establish detailed procedures for reviewing credit card applications?		
• Establish standards for determining credit lines?		
• Establish minimum standards for documentation?		
• Establish collection procedures?		
2. Are credit card policies reviewed by the board and management at least annually?		
Credit Card Records		
3. Are preparation and posting of subsidiary credit card records performed or reviewed by persons who do not also:		
• Issue official checks and drafts?		
• Handle cash and checks?		
4. Are subsidiary credit card records reconciled daily to appropriate general ledger accounts, and are reconciling items investigated by persons who do not also originate entries or handle cash and checks?		

	Yes	No
5. Are delinquent account past-due notices handled only by persons who do not also handle cash and checks?		
6. Are inquiries about loan balances received and investigated by persons who do not also handle cash and checks?.....		
7. Are documents supporting recorded credit adjustment checked or tested subsequently by persons who do not handle cash and checks?.....		
8. Is a daily record maintained summarizing transaction details, such as charges, cash advances, payments received, and interest and fees collected to support applicable general ledger account entries?		
9. Are two authorized signatures required to effect a status change regarding individual customer accounts?		
10. Are file maintenance changes reviewed and compared with approved change requests?		
11. Is an exception report produced and reviewed by management that encompasses extensions, renewals, overlines, or other factors that would result in a change in customer account status? ...		
12. Is an overdue accounts report generated for each billing cycle?.....		
Loan interest and merchant discount		
13. Are the preparation and posting of interest and fees performed or reviewed by persons who do not also:		
• Issue official checks and drafts?.....		
• Handle cash and checks?.....		
14. Are sales drafts posted promptly to customer accounts?.....		

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Credit Card Lending Questionnaire

	Yes	No
15. Are merchants carefully screened with credit underwriting criteria?		
16. Are items missing from a merchant's remittance of sales charged back to the merchant, or otherwise adjusted satisfactorily?		
17. Are merchants' accounts monitored for number and frequency of missing, rejected, or otherwise unsatisfactory items?		
18. Are merchants' accounts subject to holding for collected balances?		
19. Are all holdover items cleared daily?		
20. Are merchants' accounts monitored for unusual volume fluctuations?		
21. Are all rejected items cleared the following day?		
22. Is a review of rejected drafts and payments made by someone independent of the processing clerks?		
23. Is incoming mail maintained under dual control?		
24. Are service charge policies universally applied to accounts?		
25. Are all internally prepared entries affecting customer account records approved and reviewed by an officer?		
26. Are records of those entries maintained and reviewed?		
27. Is there a separate control account for accounting for merchants' accounts payable?		
28. Are the merchants' accounts paid on a regular basis?		

	Yes	No
29. Are merchants' discount computations checked periodically by someone other than the person who made the original computations or who prepared the original input data?		
Card Issuance and Control		
30. Are records of issued cards balanced daily to the electronic data processing report total of new and reissued cards?		
31. Is the daily record of issued, spoiled, and on-hand cards at the embossing unit reconciled by someone independent of the embossing unit?		
32. Is the institution certain that the card manufacturer is financially responsible and reputable?		
33. Is the card manufacturer required to provide adequate security controls over cards during all phases of processing and shipping?		
34. Are incoming shipments of cards:		
• Examined for tampering?		
• Placed in joint custody?		
• Verified to shipping documents under joint custody?		
• Properly entered on the record of cards received?		
35. Are unissued cards kept under effective dual control and accounted for in each of the various steps in encoding, embossing, stuffing, and mailing?		
36. Are cards embossed for issuance only upon receipt of properly authorized written instructions?		

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Credit Card Lending Questionnaire

	Yes	No
37. Are adequate controls maintained over any cards that were embossed and not issued to customers?		
38. Is the embossing area restricted to prevent unauthorized access?		
39. Does the embossing machine have a key controlled counter?		
40. If so, is it locked when not in use?		
41. Are there adequate controls over the use of encoding equipment?		
42. Is locked storage space provided for cards during employee meals and coffee breaks?		
43. Are cards spoiled during the embossing process destroyed under dual control?		
44. Are both employees present during destruction required to sign the destruction register?		
45. Are at least two persons present while cards are being processed?		
46. Do employees embossing cards maintain a record of:		
• Cards received from master supply?		
• Cards embossed on a daily basis?		
• Cards spoiled and subsequently destroyed?		
• Cards returned to master supply?		
47. Is certification of blank cards made at least monthly by someone who is not involved in card handling?		
48. Is the reserve supply of blank cards under dual custody?		

	Yes	No
49. Are cards placed in envelopes for mailing under joint custody and checked to the issuance register at the same time?		
50. Are cards maintained in joint custody before, during, and after mail processing until they have been delivered to the U.S. Post Office?		
51. Are cards sent by registered mail?		
52. Is control established over cards returned from the Post Office as undeliverable so that:		
• The mail is opened under joint custody?		
• The returned cards are placed under dual control?		
• Cards for which a correct address can be found are immediately remailed?		
• Cards for which no address can be found are destroyed?		
• The same controls are also established on cards returned by the customer for cancellation?		
• An expiration date is printed on each card?		
• A system is established to retrieve cards if a problem develops?		
53. Are test or demonstration cards adequately controlled?		
54. If cards are issued at more than one location (such as at branches) have card control procedures been established for these locations?		
55. If cards are produced by vendors, have the contracts for services been reviewed by legal counsel?		

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Credit Card Lending Questionnaire

	Yes	No
56. Are cards mailed to customers in envelopes with a return address that does not identify the institution's name or usual place of business?		
57. Are returned cards controlled and accounted for by individuals other than those with card issuer or system operations responsibilities?		
58. Is it against policy for the institution to mail unsolicited cards?		
59. Are cards that were left inadvertently or captured at Remote Service Unit (RSU) locations properly controlled?		
60. Are plastic cards and personal identification numbers (PINs) always mailed separately and on different dates?		
61. After the card is issued, is there a follow-up mailing to inquire if the customer received the card and the PIN?		
62. Are "hot" card lists and expiration dates used to limit the period of exposure when a card is lost, stolen, or otherwise misused?		
Personal Security Identifiers (PSIs)		
63. Are PSIs or Personal Identification Number (PINs) controlled with system-access controls and printed only in blind envelopes?		
64. In the event a customer's PIN is lost or forgotten:		
a. Have adequate control procedures been established for old PIN cancellation and new PIN issuance?		
b. Is there accountability on the persons initiating such transactions?		
65. Is the PIN encrypted or disguised when:		
a. transmitted over public access telephone lines?		
b. stored in computer files?		
66. Has all documentation relating to encryption, decryption, and PIN generation been properly secured?		
67. In the unlikely event that management insists on having access to both customer account numbers and PINs, have adequate compensating controls been implemented?		
68. If PINs and corresponding account numbers appear in a format where they could be matched, are controls maintained to prevent compromising situations?		
Application Review		
Review the following control procedures for each type of RSU application, such as: ATM, POS, telephone bill paying, transfers, and debit cards.		
Interchange or Terminal Sharing		
69. If terminals are shared, does the written agreement among institutions clearly identify the rights and responsibilities of all parties, including installation, maintenance, and training of employees and customers?		
70. Does the agreement cover responsibilities in the event of equipment failure?		
71. Have data storage and forward procedures been established to update records after a system pause in operations?		
72. Can the institution identify the terminal or communications device from which data are entering?		
73. Is there a daily settlement procedure for each shared device?		

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Credit Card Lending Questionnaire

	Yes	No
Operational Controls		
74. Are transactions promptly posted to customer accounts?.....		
75. Are "hot" card and suspect lists properly updated and distributed?		
76. Do exception reports meet the needs of management, user, and audit departments?		

	Yes	No
77. Do exception reports receive appropriate daily review?		
78. Are customer names and addresses protected from unauthorized changes?		
79. Are procedures manuals adequate to ensure continuity in the maintenance of control procedures?		

Comments

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INTRODUCTION

A lease is a contract between the owner of a property, the lessor, and a person or company authorized by the lease contract, the lessee, to use the property. The lease contract specifies the lease term, the amount and frequency of lease payments, and who is responsible for insurance, property maintenance and repairs. Leasing allows the lessee to use the property without making a large cash outlay or incurring additional debt.

There are two types of leases:

- Operating or general leases – short-term leases; the lessor is often responsible for the maintenance of the property.
- Financing leases – also called capital leases; longer-term leases that the lessee uses as a means of financing his or her acquisition of a property.

With operating leases, the lessor often leases property to several different lessees over the property's economic life. Examples of this type of leasing often include: leasing of computer systems and heavy equipment.

Financing leases often cover much of the economic life of the leased property. They are very similar to purchase financing. Examples of a financing lease include: an airline using a long-term lease to acquire its fleet of aircraft and ground support equipment; and companies and consumers using automobile leases to acquire their vehicles.

Savings associations typically structure lease contracts so that the association realizes return on the investment from three sources:

- Contractual payments from the lessee.
- Disposition of the asset at the termination of the lease.
- Income tax deferral benefits from depreciating the property.

If properly managed, leasing activities may enhance a thrift's asset diversification and product mix, improve its ability to compete in its market, and provide a favorable return on the investment. While leasing can provide benefits to both the lessor and lessee, leasing can be quite complicated and risky. Prior to engaging in any leasing activities, the institution must determine if it has adequate staff and capital resources to conduct such activities safely and profitably. It must also identify, measure, monitor, and control the risks.

In this section we discuss four topics:

- Regulatory considerations, including a discussion of investment authority and restrictions for both general leasing and finance leasing.
- Underwriting and portfolio management considerations.
- Tax considerations, including the Internal Revenue Service (IRS) requirements for determining if lease payments are fully deductible as expenses.
- Accounting considerations, including a brief discussion of the methods for recording leases.

REGULATORY CONSIDERATIONS

Federally chartered savings associations may engage in both operating leasing (referred to in OTS regulations as general leasing) and finance leasing. Each are allowable under different statutory lending and investment authority.

General Leasing

The Home Owners' Loan Act of 1933 (HOLA) §1464 authorizes federal thrifts to invest up to 10 percent of their assets in tangible personal prop-

erty acquired for the purpose of rental or sale. Personal property includes items such as vehicles, manufactured homes, machinery, equipment, and furniture. Section 560.41(d) of the regulations specifically allows general leasing activities within this investment authority.

Within the general leasing authority, savings associations can make several different types of leases with different purposes and duration. Service leases (or operating leases) are a type of general lease. These typically provide for financing and maintenance services, include an option to cancel, and often are relatively short-term. Savings associations commonly make service leases for computer systems and other equipment.

Businesses often prefer general leasing to financing leasing because, in terms of structure, it is less restrictive. An institution may enhance its profitability and product offering by providing businesses a flexible instrument such as a general lease. However, the lack of standard requirements can expose the institution to substantial risk resulting from the following circumstances:

- Lack of demand for the re-inventoried property.
- Inadequate contracts.
- Unexpected depreciation in asset values.
- Asset obsolescence.
- Abuse of property by the lessee.
- A poor resale market.
- Lack of staff expertise in purchasing and disposing of leased property.

Under the general leasing authority, institutions may grant leases for consumer or business purposes, but do not have to aggregate such leases with other commercial or consumer loans for the purpose of determining the institution's compliance with investment limits. Instead, general leases are grouped together and limited to 10 percent of assets.

Successful general leasing requires extensive expertise. The board of directors should adopt prudent policies and procedures in accordance with OTS regulations and policy guidance, and management should closely monitor the institution's compliance with such policies. Institution personnel should follow prudent credit underwriting practices and have extensive knowledge of assets purchased for leasing.

Leasing staff should also be familiar with the accounting and tax issues and be able to structure leases to minimize risks and ensure adequate pricing to cover all costs and provide an adequate profit. Management should also stay current with changes in tax law, accounting standards, customer demand, and other economic factors that may significantly affect its leasing program.

Finance Leasing

OTS may consider certain lease arrangements to be the functional equivalent of loans. Because the authorization for financing leases comes from HOLA's lending authority, federal savings associations that want to make financing leases under such authority must structure them as the functional equivalent of loans. Institutions must aggregate finance leases with loans for the purpose of determining compliance with the HOLA investment limits. Finance leases are not, however, aggregated with general leases for determining the 10 percent of assets limit.

As with general leases, institutions may make finance leases for tangible personal property such as vehicles, airplanes, manufactured homes, machinery, equipment, and furniture. Institutions may make a finance lease for consumer or commercial purposes. OTS regulation 12 CFR §560.41(c) specifies several requirements that must be met for a lease to qualify as a financing lease. To consider a lease the functional equivalent of a loan, the institution must structure it to meet the following requirements:

- The lease must be a net, full pay-out lease, that the lessee cannot cancel, notwithstanding the possible early termination of the lease.

A “full pay-out lease” is a lease on which the institution:

- receives full payment of amounts it invests in the leased property, plus a reasonable return on the investment over the term of the lease; and
- does not depend on the sale of the property at the end of the lease term for more than 25 percent of the original cost of the property.

- Realization of the lessor's investment must primarily depend on the creditworthiness of the lessee, not the estimated sales price (residual value) of the leased property. “Realization of the investment” means the institution can reasonably expect to get back its full investment in the property, plus financing costs during the lease term from lease payments, tax benefits, and the sale of the property at lease end. The estimate of the sales price of the property at lease end must be reasonable.
- At the termination of the lease, the institution must liquidate or re-lease the property as soon as practical. The institution must reevaluate and record at the lower of fair market value or book value any property held in anticipation of re-leasing.

In addition to being the functional equivalent of a loan, to qualify as a financing lease, the institution cannot have direct or indirect involvement in the operation of the property over the lease term and it cannot provide any of the following services during the lease term:

- Servicing, repair, or maintenance of the property.
- Purchasing parts or accessories, unless included in the full pay-out requirement.
- Lending replacement or substitute property while the leased property is serviced.
- Purchasing insurance for the lessee (except where the lessee failed to discharge a contractual obligation to do so).
- Renewing any license, registration, or filing fee for the property unless necessary to protect the institution's interest as an owner or financier of the property.

The characteristics of finance leasing eliminate some of the risk associated with short-term, general leases. The institution, however, is still subject to credit risks, risks associated with estimating residual values at lease end, and the risk of repossession. We discuss in the following section the steps institutions should take in underwriting and servicing leases.

Underwriting and Portfolio Maintenance Considerations

Historically, institutions focused more on finance leasing than on operating leases. This is due in large part to the characteristics of finance leasing which limit an institution's responsibility for the leased equipment and pass such costs on to the lessee. Lease financing expanded in recent years with the involvement of brokers/servicers who pool leases and offer institutions shares in these pools. Moreover, due to market demands for automobile financing, institutions are making shorter-term leases that often do not meet OTS or accounting requirements for financing leases, yet allow lessees to acquire and use the leased vehicles. Thus, institutions may need to underwrite and structure such operating leases similar to financing leases.

Regardless of how the institution structures the lease, the underwriting considerations the institution should apply in leasing are basic to the administration of any credit portfolio and are just as important in lease financing. The institution must know the borrower (lessee). This includes evaluating the lessees character and credit history as evidence of their willingness to repay the lease obligation as agreed. The institution should evaluate the lessee’s income and financial resources to demonstrate their ability to meet the lease obligation according to the terms established. The institution should also carefully review the collat-

eralization and workout covenants (which are often unique) to ensure contracts are written to reduce its risks.

The leasing staff's ability to realistically estimate the value of the leased property at the end of the lease is second only to credit underwriting in importance with respect to the success of any leasing program. Staff may obtain estimates from various industry pricing guides, such as Kelly Blue Book and the National Automobile Dealer's Association (NADA), which look at trends in used car prices and project future retail and wholesale prices for various vehicle makes and models. It is important that the institution use conservative estimates based on wholesale, rather than retail values. This is because the institution will likely sell the leased property at wholesale to a wholesaler or retailer at lease end.

Finally, an institution should obtain a clear title to the leased equipment to enable its repossession and liquidation in the event of the lessee's default.

While thrift management and examiners should be aware of the various lease underwriting and portfolio maintenance issues (see the General Questionnaire at the end of this Section), a few areas merit particular attention.

Documentation

Institutions must be thoroughly familiar with the documentation evidencing the lease financing and its operation. Lease financing documentation is similar to the documentation for any secured financing and includes the following documents:

- A lease financing agreement evidencing the lease obligation, including payment amounts and the lease term.
- A security agreement that establishes the lessor's right to the leased property in event of default.
- A financing statement filed under the Uniform Commercial Code (UCC) that perfects the lessor's right in the property.
- An assignment from the original lessor, passing rights under the financing arrangement to the institution (only if it purchases the lease from a broker or invests in a pool of leases).

Management must understand the documentation regardless of the structure of the transaction. Legal counsel familiar with leasing and answerable to the institution should thoroughly review the documentation. There should be clear recourse to the collateral in the event of a default by the lessee.

Regardless of whether it is originating the financing leases directly, or purchasing them through a third party or in a pooled arrangement, the institution should have control of the documentation. Not only can the institution readily monitor the documents; but, in certain situations, possessing the actual lease can provide a distinct advantage in the perfection and recovery of collateral and the ability to take control of cash flow from leases.

The board and management should have an effective working knowledge of the leasing operation, backed up by thorough, institution- specific policies and procedures.

Servicers

Servicers of lease pools have been known to make arrangements to replace delinquent leases with performing leases, or to advance payments to cover delinquent leases. Both of these situations have led to complacency on the part of thrifts investing in the lease pools and lack of attention to the quality and performance of leases accepted. Regardless of any take-out arrangements that may exist, the thrift must be aware of the composition and performance of its lease portfolio. This is crucial if the servicer fails and the thrift assumes control of the pools.

Lending Limitations

Both general and financing leases are considered loans or extensions of credit for purposes of 12 CFR §§ 560.93, 563.41, 563.42, and 563.43. Thus, the amount of funds advanced on behalf of the lessee/borrower, together with any other extensions of credit, must be aggregated and meet

OTS's loans to one borrower, transactions with affiliates, and insider lending rules.

With respect to the loans to one borrower rule, if an institution uses its general leasing authority to lease property it already owns, such as its previously leased or repossessed property, the limitations of 12 CFR § 560.93 may not apply. This is because such extensions of credit are excluded from the definition of a loan. (See the Office of the Comptroller of the Currency's (OCC's) definition in 12 CFR § 32.2(j)(iii).)

Loans to a third party to finance their leases, especially pools, can exhibit characteristics that result in the credits being considered loans to the originating or brokering company, rather than loans to the individual lessees. This can result in a violation of the regulatory limitations for loans to one borrower.

Section 32.3(b)(10) of the OCC's regulations (12 CFR § 560.93 applies to thrifts) sets forth criteria that the institution must meet for OTS to treat a loan to a leasing company as separate loans to underlying lessees. These criteria include:

- Institution evaluation of the creditworthiness of the lessee on a lease-by-lease-basis.
- The loan to the leasing corporation is without recourse.
- The institution has a valid security interest in the leased equipment.

Any institution engaging in a leasing program must be able to document how and why the lease financing conforms to the lending limitation regulations.

The provision, by a thrift, of a lease financing or credit line to a leasing company in no way lessens the need to secure, understand, and retain information and analyses on the underlying lessees, as noted above.

Leveraged Leases

Leveraged leasing is a three-party arrangement involving:

- The lessee, who leases the property and makes lease payments, thus providing cash flow.
- The lessor, who purchases the property for the lessee and provides some equity funding (commonly called the equity participant).
- The lender (long-term creditor), who provides funding for the purchase of the property.

In a leveraged lease, the lessor purchases the asset by providing only a percentage (usually 20 to 40 percent) of the capital needed. The lender provides the balance of the purchase price to the lessor. The security provided to the lender includes a first lien on the equipment and an assignment of the lease and lease payments.

If the asset purchase price is very large, there may be several equity owners (lessors) and debt holders. In this case, an owner trustee may be named to hold title to the asset and to represent the equity owners.

The lessor, as the owner, can depreciate the property for income tax purposes, based on the total cost of the asset, not just the invested amount. The lessor will also receive the portion of the rental payments attributable to the difference the lessor charges for the lease and the rate he or she pays the lender.

For example, an airline leases an aircraft costing $100 million for 15 years at $12.5 million each year (representing a 9 percent lease rate). The lessor obtains a 15-year bank loan for $80 million at an interest rate of 7.5 percent with payments of $9.06 million. At the end of the lease, the lessor expects to sell the aircraft for $20 million. The airline is responsible for all operating expenses, maintenance, and insurance. If everything goes as planned, the cash flows to the lessor will be as follows:

Year 1	
Lessor's down payment:	-$20.00 million
Years 1-15	
Lease income:	$12.50 million
Loan payment:	-$ 9.06 million
Yearly net cash flow:	$ 3.44 million

Lessor's annual depreciation expense:
$80 million / 15 years = $ 5.33 million
(This will cover the lease income and result in excess depreciation of $2.11 million that can offset the lessor's other income.)

Year 15
Sale price at end of lease: $20 million
(The lessor receives the amount of the initial investment.)

If realized, the above cash flows result in a 35 percent return to the lessor. However, leveraging cuts both ways. The early termination of the lease and forced liquidation of the property can result in equally large losses.

Leveraged lease financing provides lessors with the ability to leverage their capital into a larger lease(s) than they could fund with their capital alone — hence the name "leveraged leasing." Savings associations can participate in leveraged leases either as the lessor or as the financing institution. They can do so either directly or through a subsidiary. However, such activities are highly risky and the institution must control such risks. Failure to control such risks will subject the institution to criticism and possible supervisory action.

One of the risks of leveraged lease transactions is their complexity, stemming from the large dollar amounts and number of parties involved, and the unique relationship between the parties. Legal expenses and administrative costs associated with leveraged leasing generally limit its use to financing for large capital investments.

Because of the complexity, institutions should have qualified staff with a current working knowledge of all aspects of leasing, including the risks involved, applicable laws and regulations, and tax consequences. Moreover, when structuring leveraged leases, institutions should consider all relevant aspects of how the leasing activities will affect the institution, including capital requirements, estimated future cost of funds, and cash flows. The return on the institution's investment in leveraged leases depends largely on these factors, and even a slight change in the variables can affect profitability.

As with financing and operating/general leases, the residual value of the property at lease-end is a major element of the return on the investment. The institution should carefully estimate and support the value. Because leveraged leases generally involve the financing of very costly property, institutions should periodically inspect properties for condition and possible misuse to prevent rapid deterioration of the value of the property before the lease term expires. Institutions should also monitor properties for obsolescence or market value decline, to assist in structuring profitable lease programs in the future.

Institutions should carefully scrutinize the financial capacity of all parties involved in the lease. Should the lessee default, the lessor will have to repay the loan if they want to recapture at least a part of their investment. Thus, an institution should not enter into a leveraged lease as the lender unless the lessor has the capacity to maintain the lease for a time in the event the lessee defaults.

Consumer Leasing

A large part of the leasing done by thrifts is consumer leasing of vehicles and other personal property. This type of leasing creates a homogeneous portfolio of leases that, if underwritten properly, may involve less credit risk than business use leasing. Underwriting consumer leases is very similar to underwriting consumer loans, with three major exceptions:

- The lease terms are often shorter and may not provide for the full pay-out of the acquisition cost of the leased property.
- Down payments (capital reduction costs) and monthly leases payments are typically lower than loan purchase payments, so there is no equity build-up.
- Profitability is dependent on the lessor receiving proceeds from the sale of the leased property. Actual proceeds may be much less than proceeds estimated at the beginning of the lease.

Originating leases to consumers requires adherence to the Federal Reserve Board's Regulation M (12 CFR Part 213). This regulation requires comprehensive disclosures for leases of personal property with a contractual obligation of up to $25,000 and a term of more than four months. These may be general or financing leases. Regulation M provides a model disclosure form. Thrifts engaging in consumer leasing must thoroughly understand and comply with Regulation M.

Strategies to Mitigate Risks Associated with Leasing

As mentioned previously, leasing activities may involve considerable risks. Such risks may stem from the failure of the lessee to meet the terms of the lease contract or the inability of the institution to accurately estimate cash flows from the lease, such as tax advantages or the residual value of the property at lease-end.

With each lease transaction, the institution should compute the internal rate of return, considering lease payments, estimated tax benefits, the estimated residual value at expiration of the lease, and the cost of funds. (The Thrift Activities Regulatory Handbook Section 440, Present Value Analysis, discusses lease calculations.) Any change in variables during the lease term will affect the rate of return.

Each lease agreement should clearly state the type of lease structure and identify the specific characteristics that qualify the lease for the designated tax and accounting classifications.

To effectively minimize these risks, the leasing department should exhibit several key characteristics:

- Comprehensive and prudent written policies, procedures, and internal controls.
- Expert knowledge of the assets acquired for leasing (specifically in the areas of market demand, purchasing, disposition, market value depreciation over time, and appraisal techniques).
- Expertise and experience with structuring lease contracts and perfecting security interests in the leased property.
- Procedures for the periodic reviews of policies to determine consistency with changes in the tax laws, accounting requirements, and market conditions.

TAX CONSIDERATIONS

Tax benefits to the lessee generally stem from the lessor’s ability to depreciate the property over a shorter time than the property’s economic life. This results in a tax deferral, not the elimination of tax liability. The deferred taxes must be paid when the property is either sold or taken out of service. Therefore, such benefits are more pronounced with long-term leases than with short-term leases.

The lessee also has tax benefits. The full amount of the annual lease payments as well as the cost of operating the property is a deductible business expense for income tax purposes if the Internal Revenue Service (IRS) agrees that a particular contract is a genuine lease and not simply an installment sale called a lease. This makes it important that a lease contract be written in a form acceptable to the IRS. The IRS considers the inclusion of the following components to meet the requirements of a bona fide lease transaction:

- The term should be less than the useful life of the property; otherwise, the lease may be regarded as a form of sale.
- The rent should provide a reasonable return to the lessor.
- The renewal option should be bona fide. This requirement may be met by giving the lessee the first option to meet an equal bona fide outside offer.
- Any purchase option should not be less than fair market value.

IRS requirements may change periodically; therefore, the institution should continually monitor tax law changes.

ACCOUNTING CONSIDERATIONS

Generally Accepted Accounting Principles (GAAP) regarding lease accounting are very extensive. The institution should refer to GAAP specifically for a detailed understanding of the accounting and reporting requirements of lease transactions. SFAS No. 13 discusses the accounting for capital[1] leases and operating leases from the perspective of the lessor and the lessee.

You should ascertain that the institution is using proper accounting treatment and appropriately recording lease transactions. In certain cases, institutions have accepted leases that purport to be straight financing leases of new equipment but, in actuality, are the sale and leaseback by the lessee of the lessees current machinery and/or equipment. You should carefully review sale/leaseback transactions. Often, failing businesses use sale/leasebacks to generate cash flow.

Lease classification is generally dependent upon six criteria for lessors and four criteria for lessees. If any one of the following four common criteria for both lessors and lessees are met, the lease may qualify as a capital lease:

- The lease transfers ownership of the property to the lessee by the end of the lease term.
- The lease contains a bargain purchase option.
- The lease is equal to 75 percent or more of the estimated life of the leased property. This criterion is not used for purposes of classifying the lease if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use.
- The present value at the beginning of the minimum lease term of the lease payments equals 90 percent or more of the fair value of the leased property.

Lessors must meet two additional criteria:

- The collectibility of the minimum lease payments is reasonably predictable.
- No important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease.

Lessor

If, at inception, a lease meets any one of the first four criteria and both of the last two criteria, the lessor typically classifies the lease as a direct financing lease. Thus, the lessor records as assets the present value of total lease receivables (aggregate rentals due under the lease) and the residual value. The lessor records the excess of these combined assets over the actual cost of the leased asset as unearned income. Subsequently the lessor amortizes the unearned income over the life of the lease on the level yield basis. Lease rental payments received reduce the recorded asset.

If none of the first four criteria are met or at least one of the last two criteria is not met, the lessor records the lease as an operating lease. Thus, the lessor records the cost of the leased asset on the balance sheet and depreciates the asset using the lessor's normal depreciation policy. Lease payments received are recorded in income as rent over the lease term.

Lessee

If, at inception, a lease meets any one of the first four criteria, the lessee classifies the lease as a capital lease. The lessee records an asset and a liability equal to the present value of the minimum lease payments exclusive of any executionary costs the lessor will pay.

If none of the first four criteria is met, the lessee records the lease as an operating lease. The lessee records the lease payment as accrued expense on a regular basis.

[1] The accounting definition of capital leases is very similar to OTS's financing leases.

REFERENCES

United States Code (12 USC)

Home Owners' Loan Act of 1933

§1464 (c)(2)(C) Investments in Personal Property
§1464 (c)(2)(D) Consumer Loans and Certain Securities

Code of Federal Regulations (12 CFR)

§559.4 What activities are pre-approved for service corporations?
§560.30 General Lending and Investment Powers
§560.41 Leasing
§560.93 Lending Limitations
§563.41 Transactions with Affiliates (TWA)
§563.42 Additional TWA Standards
§563.43 Loans to Insiders

Financial Accounting Standards Board, Statement of Financial Accounting Standards

No. 13 Accounting for Leases
No. 27 Accounting for Sales with Leasebacks
No. 98 Accounting for Leases

Leasing Activities
Program

Examination Objectives

To determine if the policies, procedures, and controls regarding leasing activities adequately ensure safety and soundness, profitability, and compliance with laws, regulations, and established guidelines.

To determine the quality of the assets through an analysis of underwriting and lease production, including: creditworthiness, collectability, collateral sufficiency, lease terms and other variables.

To determine if the institution employs qualified officers and employees that can adequately perform their duties and responsibilities associated with leasing.

To determine if financial records and management reports provide accurate and necessary performance and asset quality information to management and the board of directors.

To determine if any contingent liabilities exist with regard to the institution's leasing activities and whether they affect its overall soundness.

To initiate corrective action when deficiencies exist that could affect safety and soundness, or when you note violations of laws or regulations.

Examination Procedures

Level I

Wkp. Ref.

1. Review scoping materials related to leasing, including the following reports and schedules:

    - Lease trial balance listings.
    - Delinquent leases.
    - Classified leases.
    - An itemization of repossessed and returned leased property.
    - A report of the disposition of repossessed and returned property.
    - Leases in which payments are not collected in accordance with the terms of the lease.

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- Leases whose terms have been modified by reduction on interest rate or principal, or by other restructuring of repayment terms.
- Leases sold since preceding examination.
- Lease commitments and contingent liabilities.
- Extensions of lease credit to affiliated persons.
- Miscellaneous lease debit and credit suspense accounts.
- The current interest rate structure.
- The minutes of appropriate committee.
- Reports on leasing activities furnished to the board of directors.
- The current status of leases classified during the previous examination.
- A listing of rebooked charged-off leases.
- The nature and extent of leases serviced for others.
- Month-end lease account balance and total delinquency since the previous examination.

2. Evaluate the institution's policies and procedures through review of policy statements, underwriting guidelines and manuals, interviews with management, and review or recaps of board minutes.

- Determine if accounting and tax issues are adequately addressed in policies and procedures.
- Determine whether objectives and related policies are reviewed periodically and any changes communicated to the appropriate personnel.

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Leasing Activities
Program

Wkp. Ref.

3. Review management reports, especially exception reports, related to this area. Assess the adequacy and accuracy of the reported information.

4. Review the qualifications, capabilities, and expertise of leasing officers in relation to their responsibilities.

5. Determine whether the institution corrected deficiencies mentioned in prior examination reports.

6. Complete the General Questionnaire.

7. Review the Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

Level II

8. Review the reconcilement of the subsidiary ledgers for leasing to the general ledger. Investigate any large reconciling items.

9. Select leases for review using an appropriate sampling technique. (For details on sampling, refer to Section 209 of the Thrift Activities Regulatory Handbook.) Include all of the following in your review:

   - A sample of leases per Handbook Section 209.
   - Lease accounts of employees, officers, directors, major stockholders, and their interests.

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- Lease accounts of officers and directors of other institutions.
- Lease accounts related to significant borrowers.
- Lease accounts in excess of their credit limits.

10. Analyze a sample of credit files for lessors for credit quality (earnings, indebtedness, credit history, collateral, loan modifications) and compliance with the credit policy.

11. Review lease repossessions and charge-offs.

- Determine if the institution performs charge-offs in accordance with its policies and regulatory requirements. Review the current past-due account report and test for accuracy. Review and discuss with management individual accounts not charged-off in accordance with regulatory requirements.
- Determine if collection practices are proper and conform to policy. Review written collection procedures and test check customer contact records.
- Review listings of charged-off leases and recoveries and prepare or update the carry forward work paper showing charge-offs and recoveries as a percentage of outstanding leases.
- Determine and discuss with management causes of any adverse trends or significant fluctuations. Excessive lease losses are the product of weak lending and collection policies and provide a good indication of the soundness of the lease department's operations.
- Determine if the leasing operation has rejected leases offered by brokers or third parties, or if the leasing operation accepts into portfolio all leases offered. An absence of rejected leases can be an indicator of weak credit policies and procedures.

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12. Ensure that the examination meets the Objectives of this Handbook Section. State your findings and conclusions, and appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

Level III

13. Review any leveraged leases the institution has undertaken as lessor lender. Determine if the institution structured the lease in a safe and sound manner and that it complies with all OTS's loans to one borrower, transaction with affiliates, and insider lending rules.

14. Determine if the institution has adequate inventory controls over property held for leasing.

15. Inspect large lease properties for which the leases are past due.

Examiner's Summary, Recommendations, and Comments

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Leasing Activities Questionnaire

General Questionnaire

	Yes	No
1. Does the institution have objectives, policies, procedures, and controls specific to the leasing activity and are they adequate regarding:		
• Accounting designation of financial and operating leases?		
• Credit and accounting analysis?		
• Tax considerations for both lessees and lessors?		
• Collection and lease service record keeping?		
2. Does the institution's board of directors review and approve these objectives, policies, procedures, and controls?		
3. Has the board set limits for the leasing activity?		
4. Does the board receive periodic reports on the performance and quality of the leasing portfolio?		
5. Has counsel for the thrift, with expertise in leasing, reviewed the leasing activity? (In particular, counsel should closely scrutinize security agreements/ assignments, participation agreements and servicing contracts.)		
6. Does the institution have adequate expertise in the individual leasing areas?		
7. Does the institution refrain from undue reliance upon broker/seller/servicers to answer questions on lease pools?		
8. Are seller/servicers making payments on lease pools, potentially masking problems?		

	Yes	No
9. Does the institution retain written documentation of initial underwriting and ongoing analysis?		
10. Are lease financing and general leasing identified separately and distinctly, with accounting and tax criteria clearly identified?		
11. Does the institution have an adequate procedure for financial analysis? (The institution should obtain financial information on lessees and lease servicers; and require regular updates as warranted, particularly for commercial accounts.)		
12. Does the institution have proper controls for the maintenance of leasing records?		
13. Does the institution retain on thrift premises or under the thrift's control lease files, including the original lease and security agreements?		
14. Does the institution issue lease commitments in writing?		
15. Does management monitor and report to the board of directors delinquent lease payments?		
16. Does the institution take appropriate collection action on delinquent lease accounts?		
17. Does the institution place delinquent lease accounts in non-accrual status as required in the TFR instructions and GAAP?		
18. Does the institution appropriately note, value, book, and control repossessions?		
19. Do qualified thrift personnel complete valuation reports on repossessed property from an independent party or source?		
20. Does the institution ensure the control, inspection, maintenance, and insurance of lease property?		

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Leasing Activities Questionnaire

	Yes	No
21. Does the institution use reliable techniques to estimate the value of the property at the end of the lease term? Does the institution adequately support the estimate?.....		
22. Did the thrift determine the true rate of return on the lease portfolio? Does that return provide adequate risk compensation?		
23. Does the institution obtain and review audited financial statements on seller/ servicers of lease pools?		
24. Does the thrift aggregate leases with the institution's other extensions of credit and limit them in accordance with loans-to-one-borrower rule § 560.93? Do the leases constitute an unacceptable credit concentration?.....		

	Yes	No
25. Did the institution properly assess the Allowance for Loan and Lease Losses for the lease portfolio?		
26. Are lending or other transactions with principals of a lease broker/servicer appropriate?.....		
27. Are there indications that the lease broker has cash flow problems such as an altered business strategy or lease sales to individual investors?.....		
28. Is there a high number of out-of-area leases in the portfolio, rendering collections difficult and expensive?		

Comments

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INTRODUCTION

Asset securitization is the process by which loans or other credit exposures are pooled and reconstituted into securities, with one or more classes or positions that may be sold. It generally involves a multi-step process in which an institution transfers illiquid on-balance-sheet assets, such as loans, leases, or other assets, to a special purpose wholly owned subsidiary, which, in turn, transfers them to a trust. The trust then issues securities, certificates, notes, or interests to investors.

Through securitization, the trust/issuer redistributes the credit risk of an asset pool among a tiered structure of securities, with the most senior security having first priority on the cash flows generated by the asset pool and the most junior position, the last or lowest priority. The most junior position in a securitization structure is often referred to as the residual interest. Typically, the institution transferring the assets holds some of the highest risk positions associated with the securitization transaction, including the residual interest.

Securitization can be an important component of an institution's overall business strategy. An increasing number of institutions are using asset-backed securitization to access new and diverse funding sources, manage concentrations, and improve financial performance ratios, while, at the same time, effectively serving the needs of their borrowers. Assets most often securitized by savings associations include credit card and auto receivables, residential first mortgages, and home equity loans.

Primary Benefits

Securitization can be an effective financial intermediation and risk management tool. For the originator/seller in a securitization, the benefits include the freeing of capital to allow additional lending, the ability to retain servicing, which provides an income source, the ability to produce a return on off-balance-sheet assets with reduced credit or liquidity risks, and lower capital costs.

For investors, asset-backed securities offer a collateralized security that generally has a good return with little credit risk, improved marketability over purchased loan pools, and assets that are underwritten and serviced by an experienced lender. Borrowers also benefit because securitization makes more credit available at terms that are more favorable and at a lower cost than if the loans were not securitized.

While the benefits can be substantial, the risks, which exist throughout all phases of the securitization process and continue while the securities remain outstanding, can also be substantial. This Section addresses those risks.

Primary Risks

Managing the risks of securitization activities can pose a greater challenge to institutions than managing traditional lending activities. Securitization risks can be both less obvious and more complex. Securitization, like traditional lending, can involve credit risk, concentration risk, interest rate risk (including prepayment risk), operational risk, liquidity risk, reputation risk, and funding risk.

Moreover, these risks may be in concentrations and forms unfamiliar to a traditional lender. The types of risks that an institution faces can vary substantially, based on its role(s) in the securitization process and the nature of its activities, including the transaction structure(s), activity level, volume of transactions, the risk profile of securitized assets, and any increased concentrations (by product, funding sources, or otherwise), and the amount and type of concentrated credit risk retained by the institution.

The Securitization Cash Flow Waterfall

Unlike loan participations, which share in credit risk proportionately, a securitization can create a complex structure of securities and interests with multiple levels of risk and returns. The cash flow (interest and principal payments) from the pool of

transferred assets supports the payments to all the securities and interests in a securitization. Generally, the most senior security is paid in full first, then the next most senior, and on down the tiered structure. The most junior security, typically the residual interest, is paid last and only if sufficient funds remain after all the more senior claims are paid in full. It is the nature and properties of this cash flow "waterfall" that is at the heart of securitization risk analysis.

The residual interest, usually retained by the thrift, is not only the riskiest of all the positions but also the one most difficult to value. Because market prices are not usually available for retained interests, institutions often use models to estimate their values. The institution's use of a valuation model introduces its own risks. The model itself may be flawed, the assumptions used in it may be unrealistic, or the sensitivity of the results to changes in loss estimates, prepayment speeds, or discount rates may be underestimated. An institution's vulnerability to "model risk" can be severe.

Examination Approach

This section provides guidance on assessing the risks created by an institution's securitization activities and evaluating how well the institution manages them. It focuses primarily on the role of the institution as financial intermediary, that is, as loan originator, packager, servicer, credit enhancer, underwriter, or trustee, rather than as an investor in securities.

This section describes:

- The characteristics of a sound asset securitization function and prudent risk management practices.
- Relevant accounting treatment, which can affect an institution's reported measures of profitability, reserve requirements, and capital.
- Supervisory considerations that should be incorporated in any assessment of the risks that securitization activities present to an institution.

The institution's board of directors and management are ultimately responsible for having policies in place that ensure that the economic substance of all the institution's risk exposures is fully recognized and reflected in risk management systems and internal capital adequacy allocations.

During the examination, you should determine whether the institution fully recognizes the risks of securitization. Institution management should perform all of the following:

- Identify, quantify, and monitor all risks.
- Communicate regularly the extent and significance of these risks in reports to senior management and the board of directors.
- Stress test the securitization programs to identify the extent of its loss exposure and possible liquidity disruptions.
- Maintain adequate allowances for losses, carrying values of assets retained, sufficient capital levels, and contingency funding sources.

You should be concerned when, among other considerations, an institution's management does not fully understand the risks inherent in its securitization activities or fails to fully reflect such risks in its management systems and internal capital allocations. Such circumstances constitute an unsafe and unsound practice. Consistent with the Interagency Guidance on Asset Securitization contained in Appendix A, institutions that lack effective risk management programs or engage in practices that present safety and soundness concerns will be subject to more frequent supervisory reviews, more stringent capital requirements, or other supervisory responses. The OTS Regional Director could require a downgrade of an institution's supervisory (CAMELS) rating under such circumstances.

THE SECURITIZATION PROCESS

The securitization process redistributes risk by breaking up the traditional role of the lender into a number of specialized roles: originator, servicer, credit enhancer, underwriter, trustee, and investor. Depository institutions may be involved in several of these roles. They often specialize in a particular role or roles to take advantage of their specific expertise or economies of scale. The types and levels of risk to which a particular institution is exposed will depend on its role in, and management of, the securitization process.

In scoping the examination, you should review the business plan to obtain an understanding of the institution's role(s) and overall activities. You should also review the relationship of the institution with its holding company and affiliates, as they may be involved in the securitization process. Their involvement could include holding interests, providing staff and resources in support of the securitization program, as well as potentially providing credit enhancements in subtle forms. You should read the various agreements associated with each securitization. As discussed later in this section, these include the pooling and servicing agreement, as well as any series supplement, which provide explicit detail on the structure and design of the particular asset-backed security and responsibilities of each party to the transaction.

The primary difference between whole loan sales or participations and securitized pools of loans is the structuring process. Before loan pools can be converted into securities, they are typically restructured to modify the nature of the risks and returns to the investors. Structuring includes the isolation and distribution of credit risk, usually through credit enhancement techniques, and use of trusts and special purpose entities to address ownership issues and to manage cash flows generated by the loan pools.

Generally, the structure of a transaction is governed by the terms of the pooling and servicing agreement, and for master trusts, each series supplement. The pooling and servicing agreement is the primary contractual document between the seller/servicer and the trustee. This agreement documents the terms of the asset transfer and the responsibilities of the seller/servicer.

The securitization process consists of four primary phases, which occur virtually simultaneously:

- Phase 1: The institution/transferor segregates assets for transfer to a special purpose entity (SPE), a bankruptcy-remote, wholly owned subsidiary.
- Phase 2: The SPE then transfers the assets received from the institution to a Qualifying Special Purpose Entity (QSPE). A servicer is designated for the transferred assets, who is contractually bound by the terms of the servicing agreement.
- Phase 3: The QSPE/issuer, with assistance from an underwriter, structures the security(ies) and obtains necessary credit enhancements to improve the rating assigned by a rating agency and the marketability of the securities to be issued to the public.
- Phase 4: The QSPE/issuer sells interests in the transferred asset pool(s) in the form of securities, notes, or certificates. *Note:* Institutions can use their corporate debt (12 CFR § 560.40) or pass-though (12 CFR § 560.32) investment authority to invest in certain asset-backed securities.

Phase 1: Pool/Segregate Assets for Transfer

This phase involves the borrowers and transferor/originator. The transferor originates and often services the loans that generate the cash flows supporting the securitization structure. The borrowers make payments on the underlying loans. Therefore, the performance of the asset-backed security is largely dependent on the ability of the borrower to repay the loan consistent with the terms of the loan agreement. Even though the loans are transferred, the originator maintains the customer relationship with the borrowers.

Asset Selection

Securitization involves the conveyance of loans to an SPE and ultimately to the QSPE. For revolving type assets, this conveyance includes the amount of receivables and certain designated accounts on a specific cutoff date, plus the option for the QSPE to purchase new receivables that arise from those designated accounts subsequent to the cutoff date. The accounts are subject to eligibility criteria and specific representations and warranties of the transferor.

The transferor designates which accounts will be transferred. The selection is carried out with an eye towards creating a portfolio whose performance is not only predictable but also consistent with the target qualities of the desired security. Other selection criteria might include geographic location,

maturity date, size of credit line, or age of the account relationship.

Account selection can either be random, to create selections that are representative of the total portfolio held by the institution, or inclusive, so that all qualifying receivables are transferred. In random selections, the transferor determines how many accounts are needed to meet the target value of the security. It then selects accounts randomly (for example, every sixth account is selected from the eligible universe).

Pooling by Asset Type

The collateral supporting a securitization often defines its structure. For example, installment loans dictate a substantially different structure than revolving lines of credit. Installment loans, such as those made for the purchase of automobiles, trucks, and recreational vehicles, have defined amortization schedules and fixed maturity dates. Revolving loans, such as credit cards and home equity lines of credit, have no specific amortization schedules or final maturity date. Revolving loans can be extended and repaid repeatedly over time, more or less at the discretion of the borrower.

Installment Loan Pools/Transactions.

A typical installment contract asset-backed security, which in some ways resembles a mortgage pass-through security, provides investors with an undivided interest in a specific pool of assets supporting the securitization.

The repayment terms for most installment contract asset-backed securities call for investors to receive a portion of all the interest and principal received by the trust each month. The trust certificate usually stipulates that investors will receive a stated monthly interest payment on the outstanding balance of their certificates. The amount of principal included in each payment depends on the amortization of the underlying collateral, plus any prepayments that are received during the month. Prepayments shorten the average life of the issue.

Revolving Asset Pools/Transactions.

The typically short lives of receivables associated with revolving loan products, such as credit cards and home equity lines of credit, require issuers to modify the structures used to securitize the assets. For example, a static portfolio of credit card receivables typically has a life of between five and ten months. Because such a life is too short for efficient security issuance, securities backed by revolving loans are structured in a manner to facilitate management of the cash flows. Rather than distributing principal and interest to investors as received, the securities distribute cash flow in stages: a revolving phase, followed by an amortization phase. During the revolving period, only interest is paid. Principal payments are reinvested in additional receivables as, for example, customers use their credit card or take additional draws on their home equity lines. At the end of a revolving period, the amortization phase begins, where principal payments are made to investors along with interest payments. Because the principal balances are repaid over a short time, the life of the security is largely determined by the revolving period.

Borrower Characteristics

Because cash flows are more predictable with homogenous asset pools, institutions will further group loans by considering other characteristics, for example, borrower credit quality.

Institutions often assign borrowers a letter grade based on their credit quality. At the top of the rating scale, ‘A’ quality borrowers have relatively pristine credit histories; at the bottom of the scale, ‘D’ quality borrowers usually have severely blemished credit histories. The categories are by no means rigid. In fact, credit evaluation problems exist because one originator’s ‘A-’ borrower may be another originator’s ‘B’ or ‘C’ borrower. Nevertheless, the terms ‘A’, ‘Alt-A’, and ‘B/C’ paper are widely used.

Segmenting borrowers by grade allows outside parties such as rating agencies to compare performance of a specific company or underwriter more readily with that of its peer group.

Phase 2: Creation of a Securitization Vehicle

The creation of a securitization program involves two steps: (1) the creation of a SPE by the institution, and (2) the formation of a QSPE by the

subordinate organization, which actually issues the asset-backed securities.

Step 1: Creating a SPE

An institution, as the originator/transferor, establishes a wholly owned subordinate organization to serve as the SPE. The institution transfers the assets to the SPE. On the institution's books, the transfer is treated as a sale or a financing in accordance with GAAP as detailed in FASB 140, Securitization Accounting. (Refer to "Accounting Treatment" in this section.) Generally, a SPE is designed so that the possibility that the institution (or its creditors) could reclaim the assets is remote. For example, any residual cash flow due to the SPE is pledged back to the QSPE. Then, if OTS closes the institution, there are no assets in the SPE for the creditors to attach because a counterparty pledge agreement exists between the SPE and QSPE.

Step 2: Forming a QSPE

The SPE transfers the assets to the QSPE, which then issues the asset-backed securities, completing the securitization process. The cash raised by the sale of securities is used to compensate the SPE and institution for the transferred assets.

The senior securities issued by the QSPE typically have a sufficient increase in credit and yield protection provided by a subordinated retained beneficial interest or other means to merit the high credit rating sought by investors.

Role of the Trustee

The QSPE generally designates a third party trustee to administer, for a fee, the trust that holds the underlying assets supporting the securitization. Acting in a fiduciary capacity, the trustee is primarily concerned with preserving the rights of the investor. The responsibilities of the trustee will vary for each issue and are delineated in a separate trust agreement. Generally, the trustee:

- Oversees the disbursement of cash flows as prescribed by the indenture or pooling and servicing agreement.
- Monitors compliance with appropriate covenants by the parties to the agreement.
- Replaces the servicer if it fails to perform in accordance with required terms.
- Receives, throughout the life of the transaction, periodic financial information from the originator and servicer delineating, among other things, amounts collected, amounts charged off, and collateral values.
- Reviews financial information received to ensure that the underlying assets produce adequate cash flow to service the securities.
- Declares, when necessary, a default or an early amortization triggering event.

If problems develop in the transaction, the trustee focuses on the obligations and performance of all parties associated with the security, particularly the servicer and credit enhancer.

Servicing Transferred Assets

The trustee selects a servicer to collect interest and principal payments on the loans or leases in the pool of transferred assets and then transmit these funds to investors (or a trustee representing them).

The originator/transferor usually continues to service the portfolio after securitization. (The only assets with an active and deep secondary market for servicing contracts are mortgages.) The servicer typically retains a fixed percentage of the outstanding loan balances as a servicing fee.

The responsibilities of the institution as the servicer for a securitized portfolio include all of the following:

- Customer service and payment processing for borrowers.
- Collection actions in accordance with the pooling and servicing agreement.
- Default management and collateral liquidation.
- Providing administrative support for the benefit of the trust that is duty bound to protect the interests of investors.
- Preparing monthly information reports.
- Remitting collection of payments to the trust.

- Providing the trustee with monthly instructions for the disposition of trust assets.

The servicer usually prepares its reports on a monthly basis, with specific format requirements for each performance and administrative report. The servicer distributes the reports to the investors, the trustee, the rating agencies, and the credit enhancer.

Phase 3: The Issuer Structure

The QSPE is typically structured as a trust, in one of the following forms:

- Grantor trust.
- Owner trust.
- Revolving asset trust.

Each type of trust typically issues different types of securities. In choosing a trust structure, the thrift institution seeks to ensure that the transaction insulates the assets from the reach of the thrift and its creditors, and that the issuer, securitization vehicle, and investors receive a favorable tax treatment.

Grantor Trust

In a grantor trust, the certificate holders (investors) are treated as beneficial owners of the assets sold. The net income from the trust is taxed on a pass-through basis as if the certificate holders directly own the receivables. To qualify as a grantor trust, the structure of the deal must be passive – that is, the trust cannot engage in profitable activities for the investors, and there cannot be multiple classes of interest. Grantor trusts are commonly used when the underlying assets are installment loans whose interest and principal payments are reasonably predictable and fit the desired security structure.

Owner Trust

In an owner trust, the assets are usually subject to a lien of indenture through which notes are issued. The beneficial ownership of the trust's assets is represented by certificates, which may be sold or retained by the issuer. An owner trust, properly structured, will be treated as a partnership under the Internal Revenue Code of 1986. A partnership like a grantor trust is effectively a pass-through entity under the Internal Revenue Code and does not pay federal income tax. Instead, each certificate holder, including the special purpose entity, must separately take into account an allocated share of income, gains, losses, deductions, and the credits of the trust. Like a grantor trust, the owner trust is expressly limited in its activities by its charter, although owner trusts are typically used when the cash flows of the assets must be managed to create bond like securities. Unlike a grantor trust, the owner trust can issue securities in multiple series with different maturities, interest rates, and cash flow priorities.

Revolving Asset Trust

This trust may be structured either as a stand-alone or master trust. The stand-alone trust is simply a single group of accounts whose receivables are sold to a trust and used as collateral for a single security, although there may be several classes within that security. When the issuer intends to issue another security, it simply designates a new group of accounts and sells their receivables to a separate trust. As the desire for additional flexibility, efficiency, and uniformity of collateral performance for various series issued by the same issuer increased, the stand-alone structure evolved into the master trust structure.

Master trusts allow an issuer to sell a number of securities and series at different times from the same trust. All of the securities rely on the same pool of receivables as collateral. In a master trust, each certificate of each series represents an undivided interest in all of the receivables in the trust. The structure provides the issuer with much more flexibility. The issuer can issue a new series from a master trust at a lower cost and with less effort than creating a new trust for every issue. In addition, the credit evaluation of each series in a master trust is much easier since the pool of receivables will be larger and less susceptible to seasonal or demographic concentrations. Credit cards, home equity lines of credit, and other revolving assets are usually packaged in these structures. A revolving asset trust is treated as a security arrangement and is ignored for tax purposes.

Credit Enhancements

Credit enhancements protect investors when the cash flows from the underlying assets are insufficient to pay the interest and principal for a security in a timely manner. An issuer uses credit enhancements to improve a security's credit rating, and, therefore, its pricing and marketability.

Aside from the coupon rate paid to investors, the largest expense in structuring an asset-backed security is the cost of credit enhancements. Issuers constantly attempt to minimize the costs associated with providing credit protection to investors.

Credit enhancements come in several different forms, although they can generally be divided into two main types: external (third party or seller's guarantees) or internal (structural or cash flow driven).

External/Third Party Credit Enhancements

As a general rule, third party credit enhancers must have a credit rating at least as high as the rating sought for the security. Third party credit support is often provided through a letter of credit or surety bond from a highly rated bank or insurance company. Currently, there are only a few highly rated third party credit enhancers. Further, there is the possibility that the ratings assigned to a third party credit enhancer could be lowered. Although it rarely happens, such an event could cause the security itself to be downgraded. As a result, issuers are relying less and less on third party credit enhancements.

Third party letter of credit. For issuers with credit ratings below the level sought for the security issued, a third party may provide a letter of credit to cover a certain amount of loss or percentage of losses. Any draws on the letter of credit protection are often repaid (if possible) from subsequent excess cash flows from the securitized portfolio.

Recourse to seller. Primarily used by nonbank or thrift issuers, the originator/transferor provides a limited guarantee covering a specified maximum amount of loss on the pool.

Surety bonds. Third party surety bond providers, usually triple-A rated mono-line insurance companies, generally provide a guarantee for 100 percent of the principal and interest payments.

Internal Credit Enhancements

Among internal enhancements, the securitized assets and transaction's cash collateral accounts provide most of the credit support. These cash collateral accounts and separate junior classes of securities protect the senior class by absorbing losses before the cash flows from the senior certificate are interrupted.

Senior/subordinate structures can be layered so that each position benefits from all the credit protection of the positions subordinate to it. The junior positions are subordinate in the payment of both principal and interest to the senior positions in the securities.

A typical security structure may contain any of the following internal enhancements, which are presented in order from junior to senior, that is, from first to absorb losses to the last:

Excess spread. The excess spread is created from the monthly portfolio yield on the receivables supporting an asset-backed security. The excess spread is generally greater than the coupon's servicing costs and expected losses for the issued securities. Any remaining finance charges after funding, servicing costs, and losses, is called excess spread. This residual amount may eventually revert to the institution/seller as additional profit. However, it is available for the trust to cover any losses that are greater than what is normally expected for the portfolio. Such losses may arrive from higher than projected charge-offs or servicing costs, or lower than projected revenues.

Cash collateral accounts. These are segregated trust accounts, fully or partially funded at the outset of the deal. They can be drawn on to cover shortfalls in interest, principal, or servicing expenses if excess spread is reduced to zero. The account can be funded by the issuer, but may be funded by a loan from a third party financial institution. This loan will be repaid from the proceeds of the trust assets, but only after all secured certificate holders have been paid in full.

Collateral invested amount (CIA). The CIA is a privately placed ownership interest in the trust assets, subordinate in payment rights to all investor certificates. It may be referred to as a residual interest in the trust or the "equity piece," because a seller often creates and holds this interest to provide credit support for the issue. It may, however, be sold to an outsider.

Like a layer of subordination, the CIA serves the same purpose as the cash collateral account. It makes up for shortfalls if excess spread is insufficient. If the CIA absorbs losses, it can be reimbursed from any available excess spread. The CIA is usually an uncertificated ownership interest.

Subordinate security classes. Subordinate security classes are junior in claim to other debt. They are repayable only after other classes of the security with higher claims have been satisfied. Some securities may contain more than one class of subordinated debt, and one subordinated class may have a higher claim than other such positions.

Performance-based enhancements. Most securities contain performance related features designed to protect investors (and credit enhancers) against portfolio deterioration. Poor portfolio credit performance can trigger additional safeguards, such as an increase in the spread account available to absorb losses or the accelerated repayment of principal (early amortization).

The earliest performance-based enhancement typically requires the capture of excess spread within the trust to provide additional credit protection when the portfolio begins to show signs of deterioration. If delinquencies and loss levels continue to deteriorate, early amortization may occur in revolving securitizations. Early amortization triggers are usually based on a three-month rolling average to ensure that amortization is accelerated only if the pool's performance is consistently weak.

However, you should criticize covenants that cite supervisory thresholds or adverse supervisory actions as triggers for early amortization events or the transfer of servicing as unsafe and unsound banking practices.[1]

Illustration of Credit Enhancement/Loss Positions

To illustrate the credit enhancement concept, losses in a hypothetical securitization would be absorbed as follows.

First loss tranche. Usually the residual interest, is typically retained by the originator and is established at the normal expected rate of portfolio credit losses. The excess spread, which funds the residual interest, normally should absorb expected portfolio losses, so that the credit support provided by the originator's investment provides an additional cushion against unexpected losses.

Second loss tranch. Referred to as the cash collateral account, typically covers losses that exceed the originator's retained interest. This second level of exposure is usually capped at some multiple of the pool's expected losses (customarily between three and five times these losses), depending on the desired credit ratings for the senior positions. A high grade, well capitalized credit enhancer that is able to diversify the risk often absorbs this risk.

Senior tranches. Investors that buy the asset-backed securities themselves bear the lesser credit risk of the senior tranches. These are often divided into a senior tranch and a mezzanine tranch. Although these investors are exposed to other types of risk, such as prepayment or interest rate risk, senior level classes of asset-backed securities typically have less exposure to credit loss because of the credit support offered by the junior tranches as well as other credit enhancements.

Obtaining Ratings for the Securities

The originator or pool sponsor will often negotiate with the rating agencies about the type and size of the internal and external credit enhancements. The size of the enhancement is dictated by the credit quality of the asset pool and the rating desired for the senior security. For example, to achieve the same rating, a security based on a poorer quality

[1] See "Interagency Advisory on the Unsafe and Unsound Use of Covenants Tied to Supervisory Actions in Securitization Documents," May 23, 2002.

asset pool will require a greater level of credit enhancement. For the highest rating, the rating agencies require that the level of protection be sufficient to shield the senior security against a depression scenario set of events.

Rating agencies perform a critical role in structured finance – evaluating the credit quality of the transactions. Such agencies are credible because they possess the expertise to evaluate various underlying asset types, and because they do not have a financial interest in the securities. Ratings are important because investors generally accept ratings by the major public rating agencies in lieu of performing their own in-depth due diligence investigation of the underlying assets or servicer.

The issuer determines whether it will seek a rating for its securities based on recommendations from the underwriter. Most nonmortgage asset-backed securities are rated. The large public issues are rated because the investment policies of many corporate investors require ratings. Private placements are often rated because qualifying buyers such as financial institutions and insurance companies are significant investor groups. Financial institutions use ratings to satisfy regulatory and board of director requirements, and insurance companies use ratings to assess capital reserves against their investments. Many regulated investors, such as life insurance companies, pension funds, and, to some extent, commercial banks can purchase only limited amounts of securities rated below investment grade.

The rating agencies review four major areas:

- Quality of assets being sold.
- Abilities and strength of the originator/servicer.
- Soundness of the transaction's overall structure.
- Quality of the credit support.

From this review, the agencies assess the likelihood that the security will pay interest and principal according to the terms of the trust agreement. The rating agencies focus on the credit risk of the asset-backed security. They do not express an opinion on market value risks arising from interest rate fluctuations, prepayments, or on the suitability of an investment for a particular investor.

Phase 4: Issuing Interests in the Trust

Depository institution issuers have two primary concerns regarding the securitizations. They seek to ensure the following:

- A security interest in the assets securitized is perfected.
- The security is structured to preclude the FDIC's voiding the perfected security interest.

By perfecting security interest, a lender protects the trustee's property rights from third parties who may have retained rights that impair the timely payment of the debt service on the securities. Typically, a trustee requires a legal opinion stating that the trust has a first priority perfected security interest in the pledged receivables. In general, filing Uniform Commercial Code documents is sufficient for unsecured consumer loan receivables such as credit cards. For other types of receivables, additional steps (title or mortgage assignments and recordings, etc.) may be required to perfect the trust's security interest in the receivables and the underlying collateral.

The underwriter is responsible for advising the seller on how to structure the security, and for pricing and marketing it to investors. Underwriters are often selected based on their relationships with institutional investors and for their advice on the terms and pricing requirements of the securities market. They are also generally familiar with the legal and structural requirements of regulated institutional investors.

The largest purchasers of securitized assets are pension funds, insurance companies, fund managers, and to a lesser degree, thrift institutions and commercial banks. The most compelling reason for investing in an asset-backed security has been their return relative to other assets of comparable quality and risk.

On the closing date of the transaction, the receivables are transferred, directly or indirectly, from the institution to the qualifying special purpose vehicle (trust). The trust issues certificates representing beneficial interest in the trust, investor certificates, and, in the cases of revolving asset structures, a transferor or seller certificate.

Investor's Certificate

Investor certificates are sold in either public offerings or private placements, and the proceeds, net of issue expenses, are remitted to the seller. There are two main types of investor interest in securitized assets, a discrete interest in specific assets, and undivided interest in a pool of assets. The first type of ownership interest is issued for asset pools that match the maturity in cash flow characteristics of the security. The second type of ownership interest is used for short-term assets such as credit card receivables or advances against home equity lines of credit. For the short-term assets, new receivables are generated and added to the pool as existing receivables liquidate. The investors' interest in the pool automatically applies to the new receivables.

Seller's Interest

When receivables backing securities are short term or turn over rapidly, as do trade receivables or credit cards, the issuer must actively manage the cash flows associated with receivables. One objective is to keep the outstanding principal balance of the investor's interests equal to the certificate amounts. To facilitate this equalization, an interest, known as the seller's or transferor's interest, is not allocated to investors, but retained by the seller. The seller's interest serves two primary purposes: to provide the cash flow buffer when account payments exceed account purchases and to shore up reductions in the receivable balance attributable to dilution and noncomplying receivables.

To calculate the size of the seller's interest, subtract the amount of securities issued by the trust from the balance of the principal receivables in the trust. The seller's interest is generally not a form of credit enhancement for the investor interest; however, it may be, and if so, evaluate it as such.

Types of Asset-Backed Securities

Asset-backed securities may be structured as "pass-throughs" or "pay-throughs."

Pass-through Securities

Under a pass-through structure, the cash flows from the underlying pool of assets are passed through to investors on a pro rata basis.

The payment distribution for securities backed by installment loans is tied to loan performance. Interest is customarily paid monthly, and the principal included in each payment will depend on the amortization schedule and prepayment rate of the underlying collateral.

Pay-through Securities

For revolving asset types such as credit cards, trade receivables, home equity lines, the cash flow has two phases:

- The revolving period.
- The principal pay down period, or amortization phase.

During the revolving period, investors receive their pro rata share of the gross portfolio yield based on the principal amount of their certificates and coupon rate. The remaining portion of their share of the finance charges above the coupon rate is available to pay the servicing fees and to cover any charge-offs, with residual amounts generally retained by the seller or credit enhancement provider as excess spread.

The cash flow waterfall for credit card securities may look like this (percentages are based on investors' pro rata share of the outstanding receivables):

Revenue	
• Finance charges	14.0%
• Annual fees	0.5%
• Late fees and other fees	1.2%
• Bank interchange	1.8%
Gross portfolio yield	**17.5%**
Expenses	
• Investor coupon	6.0%
• Servicing expense	2.5%
• Charge-offs	5.5%
Total expenses	**14.0%**
Excess spread	**3.5%**

A decline in the actual performance of the loan pool from the original assumptions can quickly erode the expected spread.

During a revolving period, the issuer uses monthly principal collections to purchase new receivables generated in the designated accounts or to purchase a portion of the seller's participation if there are no new receivables. If a percentage of the seller's interest falls below the prescribed level of principal outstanding because of a lack of new borrowings from the designated accounts, new accounts may be added.

The amortization period occurs next. During the amortization period, the trust no longer uses the investor's share of principal collections to purchase replacement receivables. It returns these proceeds to investors as received.

This is the simplest form of principal repayment. However, because some investors prefer more stable returns of principal, some issuers have created structures to accumulate principal payments in a trust account rather than simply passing principal payments through to the investors as received.

For example, the trust may pay principal on a specific, or "bullet" maturity date. Bullet maturities are typically either hard or soft, depending on how the structure pays when funds in the accumulation account are not sufficient to pay the investors in full on the scheduled maturity date. Under a hard bullet structure, a third party guarantee covers any shortfall. Under a soft bullet structure, the trust distributes the entire accumulation account to the investors and pays additional funds as received. Soft bullet structures usually include an expected maturity date and a final maturity date.

MANAGING SECURITIZATION ACTIVITIES

Institutions that have enjoyed the full range of benefits offered by securitization have established proper management systems and controls to oversee and monitor all aspects of the securitization process. Because of the risks involved in securitization, first time securitizers should thoroughly review each step of the proposed transaction before committing to it.

Institutions should develop a business plan to establish parameters for its securitization activities. The business plan should establish policies for the securitization activity, including:

- How the activity fits within the institution's overall strategic plan.
- A performance measurement process.
- A list of potential counterparties (credit enhancers, underwriters, trustees, etc.).
- A process by which management and the board of directors can be assured that adequate controls, procedures, systems, and risk analysis techniques will be maintained throughout all phases of the securitization process.

The business proposal should at least provide a description of the following:

- Proposed products, markets, and business strategy.
- Risk management considerations.
- Methods to measure, monitor, and control risk.
- Accounting, tax, and regulatory implications.
- Legal implications.
- Necessary information system enhancements or modifications.

Many key parties will be involved, including accounting, information technology, finance, legal, audit, credit risk, and senior line management. All affected departments should review and comment on the proposal. A rigorous approval process for new products and activities lessens the possibility that management might underestimate the level of due diligence needed for proper risk management and the ongoing resources required for effective process management.

Independent Risk Management Function

Institutions engaged in securitizations should have an independent risk management function commensurate with the complexity and volume of securitization activity and overall risk exposure. The risk management function should ensure that securitization policies and operating procedures, including clearly articulated risk limits, are in place

and appropriate for the institution's circumstances. A sound asset securitization policy should include or address, at a minimum:

- A written and consistently applied accounting methodology.
- Regulatory reporting requirements.
- Valuation methods, including FAS 140 residual value assumptions, and procedures to formally approve changes to those assumptions.
- Management reporting.
- Exposure limits and requirements for both aggregate and individual transaction monitoring.

It is essential that the risk management function monitor origination, collection, and default management practices. This includes regular evaluations of the quality of underwriting, soundness of the appraisal process, effectiveness of collections activities, ability of the default management staff to resolve severely delinquent loans in a timely and efficient manner, and the appropriateness of loss recognition practices.

Because the securitization of assets can result in current recognition of anticipated income, the risk management function should pay particular attention to the types, volumes, and risks of assets being originated, transferred, and serviced. Both senior management and the risk management staff must be alert to any pressures on line managers to originate abnormally large volumes or higher risk assets in order to sustain ongoing income needs. Such pressures can lead to a compromise of credit underwriting standards. This may accelerate credit losses in future periods, impair the value of retained interests, and potentially lead to funding problems.

The risk management function should also ensure that appropriate management information systems (MIS) exist to monitor securitization activities. Reporting and documentation methods must support the initial valuation of retained interests and ongoing impairment analyses of these assets. Pool performance information has helped well-managed institutions to ensure, on a qualitative basis, that a sufficient amount of economic capital is being held to cover the various risks inherent in securitization transactions.

The absence of quality MIS will hinder management's ability to monitor specific pool performance and securitization activities more broadly. At a minimum, MIS reports should address the following:

- ***Securitization summaries for each transaction***. The summary should include relevant transaction terms such as collateral type, facility amount, maturity, credit enhancement and subordination features, financial covenants (termination events and spread account capture "triggers"), right of repurchase, and counterparty exposures. Management should ensure the summaries are distributed to all personnel associated with securitization activities.
- ***Performance reports by portfolio and specific product type***. Performance factors include gross portfolio yield, default rates and loss severity, delinquencies, prepayments and payments, and excess spread amounts. The reports should reflect performance of assets, both on an individual pool basis and on total managed assets. These reports should segregate specific products and different marketing campaigns.
- ***Vintage analysis for each pool using monthly data***. Vintage analysis helps management understand historical performance trends and their implications for future default rates, prepayments, and delinquencies, and, therefore, retained interest values. Management can use these reports to compare historical performance trends to underwriting standards, including the use of a validated credit-scoring model, to ensure loan pricing is consistent with risk levels. Vintage analysis also helps in the comparison of deal performance at periodic intervals and validates retained interest valuation assumptions.
- ***Static pool cash collection analysis***. This analysis entails reviewing monthly cash receipts relative to the principal balance of the pool to determine the cash yield on the portfolio, comparing the cash yield to the accrual yield, and tracking monthly changes. Management should compare the timing and amount of cash flows received from the trust with those projected as part of the FAS 140 retained interest valuation analysis on a monthly basis. Some master trust

structures allow excess cash flow to be shared between series or pools. For revolving asset trusts with this master trust structure, management should perform a cash collection analysis for each master trust structure. These analyses are essential in assessing the actual performance of the portfolio in terms of default and prepayment rates. If cash receipts are less than those assumed in the original valuation of the retained interest, this analysis will provide management and the board with an early warning of possible problems with collections or extension practices, and impairment of the retained interest.

- ***Sensitivity analysis***. Measuring the effect of changes in default rates, prepayment or payment rates, and discount rates will assist management in establishing and validating the carrying value of the retained interest. Management should perform stress tests at least quarterly. Analyses should consider potential adverse trends and determine "best," "probable," and "worst case" scenarios for each event. Other factors to consider are the impact of increased defaults on collections staffing, the timing of cash flows, "spread account" capture triggers, overcollateralization triggers, and early amortization triggers. An increase in defaults can result in higher than expected costs and a delay in cash flows, decreasing the value of the retained interests. Management should periodically quantify and document the potential impact to both earnings and capital, and report the results to the board of directors. Management should incorporate this analysis into their overall interest rate risk measurement system.[2] Examiners will review the analysis conducted by the institution and the volatility associated with retained interests when assessing the Sensitivity to Market Risk component rating.
- ***Statement of covenant compliance***. Management should affirm at least monthly compliance with deal performance triggers as defined by the pooling and servicing agreements. Performance triggers include early amortization, spread capture, changes to overcollateralization requirements, and events that would result in servicer removal.

During initial due diligence for securitization transactions, the underwriter (often an investment banker), the rating agencies, and the independent outside accountants thoroughly review the institution's securitization process. The institution's internal oversight is also critically important throughout the process and while any securities are still outstanding.

The institution's risk control unit should report directly to a senior executive to ensure the integrity of the process. The unit, which should evaluate every role the institution has in securitization, should pay special attention to the origination and servicing operations. In the origination area, the unit should take significant samples of credit actions, verify information sources, and track the approval process.

In the servicing area, the unit should track payment processing, collections, and reporting from the credit approval decision through the management and third party reporting process. The purpose of these reviews is to ensure that activities are consistent with policy and trust agreements and to detect operational weaknesses that might leave the institution open to fraud or other problems. Risk managers often suggest policies or procedures to prevent problems, such as documenting exceptions to the institution's policies. You should follow up on any irregularities discovered in the audits and discuss them with senior management.

Monitoring Securitization Transactions

Management should use the MIS reports to monitor the performance of the underlying asset pools for all outstanding deals. Although the institution may have sold the ownership rights in controlling the assets, the institution's reputation as an underwriter or servicer remains exposed. To control the effect of deterioration in pools originated or serviced by the institution, management should have a systematic monitoring process to track pool quality and performance throughout the life of the transactions.

[2] Under the Joint Agency Policy Statement on Interest Rate Risk, institutions with a high level of exposure to interest rate risk relative to capital will be directed to take corrective action. Thrift institutions can find OTS guidance on interest rate risk in Thrift Bulletin 13a - Management of Interest Rate Risk, Investment Securities, and Derivative Activities.

Management reports on revolving transactions (credit cards, home equity lines, etc.) should cover, at a minimum:

- The portfolio's gross yield.
- Delinquencies.
- Number and status of re-aged accounts.
- Charge-off rates.
- The base rate (investor coupon plus servicing fees).
- Monthly excess spread.
- The rolling three month average excess spread.
- The monthly payment rate.
- Servicing advances.

Management reports of securities backed by installment loans (automobiles, equipment leases, etc.) should cover, at a minimum:

- The charge-off rate.
- The net portfolio yield.
- Number and status of extended, deferred or rewritten accounts.
- Delinquencies (by age and severity).
- Principal prepayment speeds.
- Outstanding principal compared to original security size.
- Servicing advances.

SECURITIZATION RISKS

The primary risks associated with securitization activities are related to strategic planning, credit, earnings and capital management, liquidity, credit quality of the remaining on-book portfolio after securitization, servicing, compliance, market, reputation, and fiduciary/trustee exposures.

The types and amounts of risk will vary with the roles played by financial institutions in the securitization process, transaction structures, activity volumes, the risk and duration of underlying assets, and the amount of credit risk of any retained interests.

The purpose of your review is to assess the effect of the various securitization risks on the institution's overall financial condition and performance. The risks are often difficult to identify completely, as their form may be masked by holding company, affiliate, and servicing relationships within the corporate structure.

You should determine whether management promptly and properly identifies and controls the risks from the institution's securitization activities, and that capital levels reflect these risks. Your conclusions from this evaluation will determine an institution's CAMELS composite and component ratings, other risk assessments, and the adequacy of its capital.

Effective securitization risk management requires the institution to do the following:

- Understand and control the amount of risks involved in the entire transaction.
- Identify the risks transferred from one party to another, and the risks it retains.

Invariably, the selling institution will retain some risks of the securitization. Securitization transactions often receive substantial attention early in their lives, but the level of scrutiny often declines over time. Many of the problems that institutions have experienced, such as rising delinquencies and charge-offs, inaccurate investor reporting, and bad publicity, occurred in the later stages of the transaction. The institution should carefully supervise and monitor a transaction for the entire duration of its involvement.

The following subsections highlight the primary risks and management practices that should be in place at financial institutions involved in asset-backed securitization.

Strategic Risk

Strategic risk is the risk to earnings and capital arising from adverse business decisions or their improper implementation. This risk involves the compatibility of an organization's strategic goals, the business strategies developed to achieve those goals, the resources deployed against those goals, and the quality of implementation.

Securitization is an activity that can involve almost every major role played by a financial institution, including lending, servicing, credit enhancing, financial engineering, fiduciary, and distributing. The strategic decision to participate in securitization should be made in the context of an institution's overall growth, profitability objectives, funding alternatives, operational capacities, and capital strength.

The assessment of an institution's strategic risk exposure includes the long term effects of securitization operations, profitability, and asset/liability management. Exposure increases when transactions are undertaken without due consideration of their long term internal resource requirements. For example, while the existing systems and collection department resources may be adequate for current operations, securitization transactions are often accompanied by rapid growth in the volume of lending and the need for more timely and precise reporting requirements. At a minimum, this may require improved computer systems and software and dedicated collections, operational, and reporting personnel.

Prudent Risk Management Practices

Institutions should integrate securitization activities into critical planning processes, such as the firm-wide strategic plan, asset/liability management plan, contingency funding plans, and the capital plan. Management should consider measures of retained risk and/or the potential exposure of earnings and capital in each of these areas under expected and stressed market conditions.

Management and the board of directors of first time securitizers should ensure that the proposed process has been thoroughly reviewed by all affected departments before the first transaction. Securitizers should assign responsibility for managing securitization to a dedicated individual or department. The manager or group should have the experience and skills to understand the various components of securitization and the authority to communicate and act across product and department lines. The manager should consider the effects that proposed changes in policies or procedures on origination or servicing may have on outstanding or future securitization issues. Management should understand and approve any material changes to a securitization program. A rigorous approval process for new products or activities lessens the risk that management may underestimate the level of due diligence required for risk management or the ongoing resources required for process management.

Credit Risk

A post-mortem analysis of failed securitizers usually points to poor underwriting, poor credit management, and/or the originator's penchant for investing in extremely high risk assets. During the early stages of the securitization, originators believed that when their loans were securitized and sold, most credit risk was transferred to the investors. This assumption has been proven repeatedly to be inaccurate, as credit losses on the asset pools have often been the root cause of the failures of such securitizers.

Securitizers often underestimate the credit risks retained in portfolios they have securitized. While the originating/selling institution may transfer some of its credit risk to investors in a securitization, it will often retain substantial interests (of various forms) in the asset pool. The interests retained by the institution often provide credit support for the rest of the pool, and thus embody a concentrated form of credit risk.

The retained credit risk of the underlying assets is the greatest risk of securitization. Any shortfall in the cash flows due to losses in the loan pool affects the value of the interests providing credit support first, as those interests are the last to be paid. As a result, the residual interest holder is in a "*first dollar loss*" position and is exposed to the credit and other risks from the entire loan pool.

Because originating institutions will absorb virtually all of the expected losses and most of the unexpected losses from both on-balance-sheet and securitized loan pools, the best overall protection against credit risk is to generate high quality loans. Institutions can only accomplish this through the establishment and maintenance of sound credit standards, a strong, independent internal loan review function, and effective internal controls over all its lending and servicing activities.

It is also critical that experienced lending managers, not investment bankers, marketing, or other vol-

ume-oriented parties, set and maintain the institution's lending standards. Sustained periods of dramatic growth and aggressive "teaser-rate" and other "special offers" are often early indicators of market-driven lending programs that may indicate compromised lending standards.

If an institution engages in high volumes of poor quality lending, it will be exposed to a substantial level of credit risk. Institutions should not assume that they can "manage" the additional levels of risk by transferring much of the credit risk through securitizations, higher pricing, and high loan volumes. Loan volume often creates more problems than it solves. Large spreads created by high loan pricing often prove inadequate, as losses and prepayments can easily exceed projections.

Charging higher interest rates for high risk borrowers may seem like an attractive strategy. However, borrowers will avoid those high rates if they can. For example, if subprime borrowers' credit condition improves, they are likely to refinance their existing loans into ones with lower rates. As a result, excess servicing spreads disappear, making residual interest-only (IO) strips based upon them worthless. If, on the other hand, their financial condition worsens, they default and again the express spread disappears.

Overly optimistic projections of loan performance have led securitizers to undertake larger and larger volumes of high risk loans. The sheer volumes of these loans create servicing, collections, operating expense, information systems, and liquidity challenges. When such problems are combined with higher than projected losses, the institution may fail. Consequently, institutions should be conservative in estimating pool performance projections.

Poorly designed employee compensation plans have resulted in poorly performing asset pools. Compensation plans for the lending, underwriting, and servicing staff should balance short term and long-term interests. You should consider criticizing plans that disproportionately reward production staff based on the volume of originations without regard to underwriting standards. Servicing compensation should not be tied to incentives that encourage collection staff to re-age or renew loans in an effort to mask true delinquency levels.

Some red flags to consider when evaluating the origination and account management activities of institutions with securitization programs include:

- Poor underwriting.
- Poor credit risk management.
- The originator's penchant for investing in extremely high risk assets and then retaining residual interests in the securitization.
- Disproportionate production pay incentives.

Prudent Risk Management Practices

Management should be diligent in its ongoing managing and monitoring of credit risk in securitization activities. A key component of managing credit risk is proper product offering, underwriting, and account management activities. Consequently, an institution should select a sound loan program, then properly underwrite, and manage the underlying assets. Management should identify, measure, monitor, and control the credit risk retained by the institution.

Loss Exposure

Management must evaluate how much risk the institution retains after the securitization. In most securitization structures, credit risks are allocated so that the transferor, with its retained interests, bears default losses up to a predefined point, typically at a level based on historical losses and projected performance. The transferor's exposure is a function of its retained interests, including the excess portfolio yield. As pool performance deteriorates and charge-offs increase, excess spread, which would normally be returned to the institution, declines. Once the excess spread is exhausted, the risk of credit default customarily shifts to the credit enhancers, typically up to some additional multiple of projected losses. Only losses above these multiples are borne by investors.

Remaining On-Balance-Sheet Exposure

Securitization prices and marketability increase with the quality of the underlying assets and the predictability of their cash flows. Higher quality assets also require less credit support in the form of excess collateral or seller-retained interests. This

may tempt institutions to "cherry pick" loans that go into the securitized portfolios, leaving lower quality loans on their balance sheets. If this significantly increases the risk profile of the institution, you should consider requiring additional capital and allowance for loan losses for its remaining on-balance-sheet assets. This risk is addressed more fully below in the section on adverse selection.

Moral Recourse

Most prospectuses of asset-backed securities clearly state, "The offering is not an obligation of the issuing institution." Despite this absence of a legal obligation, an issuer may feel compelled to protect its name and reputation in the securitization marketplace by providing support for poorly performing asset pools. Because issuers in the past have taken steps to prevent ratings downgrades or early amortizations, investors may have come to expect sponsors to support distressed issues.

The decision to provide support for poorly performing asset pools is difficult. It entails the immediate cost of the noncontractual support given, and it may entail other accounting, legal, and regulatory issues. If an institution provides support for one securitization, OTS may disallow the sale treatment on some or all of the issuer's other securitized transactions. This can have a critical impact on earnings and capital.

You should realize, however, that rescuing an issue from early amortization and losing the sale treatment may be the better of two unfavorable outcomes, since early amortization could affect future securitization activities, as well as the ratings of the institution's other transactions. Nevertheless, you should review such actions and consider the likelihood that the institution will find itself compelled to provide such support for its other issues.

Other Securitization Risks

Modeling and Valuation Risk

Institutions that securitize assets should follow FAS 140 in accounting for their securitized transactions. Under this accounting rule, transactions that qualify as a sale must recognize any "gain-on-sale" at the time of the securitization. This gain is effectively an acceleration of earnings that flow through to the equity account on an after-tax basis. The capitalized asset, commonly a residual asset or IO strip, represents the present value of the anticipated future excess spread cash flow. The recorded investment in these assets and the resulting contributions to earnings and equity are dependent on assumptions related to the life of the asset and the future timing and amount of cash flows, including charge-offs, loss severity, prepayment rates, and discount rates.

The process of accelerating earnings based on future expectations increases the potential for earnings and capital volatility. While federally insured depository institution regulatory capital requirements require dollar-for-dollar risk-based capital coverage of IO strips, any material impairment of these assets will result in declines to GAAP earnings and capital levels. Notwithstanding the coverage required under regulatory capital rules, sudden and sizeable write-downs or restatements of earnings and capital may trigger concerns among funds providers, shareholders, customers, and employees.

Residual interests in securitized loans can be among the most volatile assets on the balance sheet. Institutions may have to take large write-downs of residual interests if actual conditions vary from the assumptions management uses in its valuation model or if the model itself is flawed. For example, institutions may have to write-down IO strips if prepayment speeds are faster than assumed, portfolio yields are lower than expected, asset quality performance is less than anticipated, or appropriate discount rates are higher than assumed.

During an examination, you should review all aspects of the valuation process. Several red flags may exist that warrant a detailed review of an institution's modeling and valuation process, including:

- Inconsistency and over optimism in the initial and ongoing valuation of residual interests.
- Questionable valuation methods have included incorrect cash flow modeling, unsupported loss assumptions, inaccurate prepayment estimates, and inappropriate discount rates. *Note:* As residuals typically have no liquid secondary market, their estimated market values are diffi-

cult to verify. This lack of verifiability has sometimes led to disagreements with institutions and their accounting firms about proper valuation.

- Poor documentation with which to confirm that underlying assumptions are well supported, reasonable, and consistent.
- Significant differences between assumptions and actual performance.

Residual interests are exposed to a significant level of credit and interest rate risk that make their values extremely sensitive to changes in the underlying conditions. As a result, their value may provide little real capital support, particularly in times of stress.

You should review the original assumptions used in the valuations, compare them with actual performance, and require valuation adjustments if the underlying assumptions are not reasonable or properly supported.

The method and key assumptions used to value the retained interests and servicing assets or liabilities must be reasonable and fully documented. The key assumptions in all valuation analyses should be conservative, logical, and consistent. It is important that management quantifies the assumptions at least quarterly and maintains supporting documentation for all changes made. Institution policies should define the acceptable reason for changing assumptions and require appropriate management approval.

Subprime Residual Valuation Issues

Securitized subprime loan pools present an even greater challenge for the proper valuation of residuals and servicing rights for several reasons. First, by definition, subprime loans are extensions of credit to borrowers with weak credit histories. The ability of these borrowers to make loan payments is very sensitive to changes in economic conditions. A slowdown in the economy can lead to a substantial increase in subprime mortgage delinquencies, while having little impact on the performance of prime mortgages.

Second, given the relative newness of subprime lending, institutions' involvement in the subprime market has also not been tested during a period of prolonged economic downturn. Higher than expected default rates reduce the value of residual assets, as these are in the most junior position, and of the servicing rights, as future payments cease and collection costs increase when loans default.

Third, subprime borrowers will refinance their loans to reduce the interest they pay both if overall interest rates drop, and if their credit ratings improve. This second aspect (credit-induced prepayment) is a phenomenon not experienced with prime mortgages, and further complicates the valuation of subprime servicing rights.

Other Credit Issues

Stress testing. Institutions should use cash flow projection models to estimate the performance and value of their securitized asset pools. These models trace projected funds through the proposed transaction structure, and account for distribution of cash flows through a variety of performance scenarios. Typically, loan performance and the resulting cash flows will vary significantly, depending on differing market and economic conditions. Institutions should subject their proposed structures to several iterations of stress testing to provide better insight into the potential loss exposures of the institution, of other credit enhancers, and of investors under most likely and worst case scenarios.

The effectiveness of modeling in providing useful performance projections depends on the originator's adherence to prudent underwriting standards. Models can become outdated or results skewed because of incomplete or inaccurate information. To control potential weaknesses in the models, management should back-test their model results regularly, revalidating the logic and algorithms used and ensure the integrity of the data entry and assumptions.

Vintage analysis. Thrift management should perform vintage analysis to track delinquency, foreclosure, and loss ratios for similar products over comparable time periods. The objective is to identify sources of credit quality problems early so that management can take corrective action.

Because loans do not reach peak delinquency levels until they have seasoned for several months or even years, tracking the payment performance of loans

over time allows the institution to evaluate the quality of newer loans over comparable timeframes. It then can benchmark a new loan cohort against previous groups to predict the effect that aging will have on its future performance.

Prudent Risk Management Practices

Management should use conservative and well-supported assumptions when determining the value of residual assets. Even well supported assumptions can change due to changes in the marketplace. Management should perform periodic stress testing of assumptions to identify and quantify the potential impact to earnings and capital levels of deviations from the assumptions being used. An independent third party, who may include independent auditors or others, should validate the assumptions and modeling process to ensure accuracy.

Management information systems should track historical performance as well as actual cash collections. Management should compare the timing and amount of cash flows received from the trust with those projected as part of the residual valuation analysis. Vintage analyses and monitoring of current positions and trends against early warning triggers are also standard tools that institutions use to oversee securitization activities.

As part of the ongoing residual valuation process, the unit responsible for valuing the residual asset should discuss the forecasts used to develop assumptions with the business unit responsible for underwriting. The units should discuss any changes in underwriting and their potential impact to valuation assumptions including default rates, prepayment speeds, and loss severity. The underwriting group should also work with the servicing area to ensure technology and staffing resources are sufficient to manage potential increases in delinquencies and default levels.

Liquidity Risk

Liquidity risk arising from securitization activities can be heightened by over dependence on a single segment of the capital markets. Securitization transactions involving unfunded or revolving credit lines may be a drain on an institution's liquidity position if the institution has to make future advances on these accounts. This risk threatens firms that do not control maturities of individual securitized transactions with overall planned balance sheet growth. In certain situations, servicing obligations may also require the institution to advance funds to investors and other parties prior to receiving payments from underlying borrowers.

A concentration or over reliance on any funding source or market, including the asset-backed markets, can increase liquidity risk. Over reliance exists if an institution is not able to meet its strategic objectives without that specific funding source. Due to the credit sensitive nature of the capital markets, securitization may be subject to market disruptions, either temporary or long term in nature.

Liquidity risk is directly related to the degree of dependence on securitization as a funding source. Disruptions in the asset-backed securities market or deterioration in an institution's financial condition, particularly its asset quality or servicing capabilities, may limit the asset-backed securities market as a reasonably priced source of liquidity.

Extensive reliance on securitization as a funding source creates incentives for institutions to engage in questionable market practices to ensure the continued availability of funding. Most, if not all, of the pressures associated with institutions retaining risk and implicitly supporting past issue securitizations are based on the desire to maintain ongoing access to securitization markets.

This pressure grows exponentially when securitization becomes the only viable method of funding ongoing operations and meeting business objectives. The substantial fixed costs associated with establishing and maintaining origination and servicing facilities and staff require a continual high volume of originations and securitizations. Competitive pressures from firms entering this business have also exacerbated these problems by narrowing margins and increasing prepayments as borrowers refinance, leaving one lender for another that offers a better deal.

Both the scheduled and early amortization of outstanding asset-backed securities containing revolving or unfunded credit lines may result in the institution having to fund any new advances itself, with its own on-balance-sheet cash resources. In

each case, the originating institution must make a decision to grant future advances to customers or to terminate the credit relationship. If the accounts are of reasonable credit quality, the institution's trade-off is one of maintaining desired customer relationships at the cost of on-balance-sheet funding.

Other liquidity issues related to securitization that can affect the institution's cash position include servicer obligations and/or liquidity agreements. As a servicer for certain asset types, a financial institution may be responsible for managing the timing differences between payments on the underlying collateral and the scheduled note payments by making advances. In addition, the institution may act as a liquidity agent for its own securitization transaction or may provide a liquidity facility for third parties.

Prudent Risk Management Practices

Current and planned securitization activities should be a critical factor in both day-to-day liquidity management and the contingency funding planning processes. Ideally, the institution's investor base will be deep and diverse. Concentrations among just a few sources raise the risk of losing access to the capital markets at a reasonable cost. Management should allocate the appropriate resources to expand its investor base.

Management should actively control the scheduled maturities for their outstanding securitization transactions. An institution with several issues maturing at the same time may experience difficulty accessing the securitization market if there has been some type of market disruption. In addition, problems facing other issuers of a similar product type or asset class may result in a temporary increase in funding costs, even for an institution whose portfolio is performing as expected. Rating agencies will also consider the mix of funding and maturity ranges for an issuer. Issuers need to maintain and regularly demonstrate the flexibility to manage transaction maturities and fund assets in different markets in the event of a disruption in the asset-backed securities market.

Securitization of assets that contain revolving and/or unfunded credit lines require management to prepare for the possible funding of future advances on the institution's balance sheet as a result of either scheduled or early amortization. The liquidity implications of financing new advances under scheduled amortization can be managed by staggering the maturity periods of transactions and through the maintenance of sound underwriting and servicing processes.

Although the probability of an early amortization event may be extremely low, the impact of such an occurrence will likely be quite severe. Management should continually monitor the performance of the underlying asset pool and other factors that might trigger an early amortization. Effective monitoring will allow the institution to better manage the situation. Beyond enhanced monitoring systems and treasury preparations, institutions that securitize these types of assets should also maintain an adequate level of capital to facilitate access to alternative funding sources.

Management should understand the obligations under the various types of servicing agreements and liquidity facilities and incorporate into ongoing liquidity planning. Management should incorporate expected and unexpected cash requirement into liquidity plans, and maintain adequate levels of capital to cover this potential funding obligation.

All outstanding transactions should be monitored as part of day-to-day liquidity management. The contingency planning process should contemplate both short and long term interruptions in the asset-backed market. At a minimum, contingency plans should explore a series of progressively severe funding scenarios and practical alternative sources to meet short run liquidity requirements. The need for the plan to identify alternate sources or contingency business plans will increase in direct proportion to the prospect that the institution may lose access on economically reasonable terms. Access to several alternative sources should enable institutions to ride out market disruptions or buy enough time to restore market confidence without facing a liquidity crisis. The maintenance of a strong capital base is a primary line of defense that should provide comfort to prospective fund providers.

You should determine the degree of an institution's reliance on securitization as a funding source. In general, firms establish policy limits on the percent of an asset class that can be securitized. However,

these limitations would vary depending upon the institution's contingency funding plan, liquidity sources, capital position, and overall strength of risk management.

Adverse Selection, ALLL, and Capital

Securitization lends itself to the use of a diverse pool of high quality assets that provide a reasonably predictable cash flow stream. This can result in institutions securitizing their higher quality assets, leaving comparatively lower quality assets, and perhaps assets with more concentrated risk characteristics, on the balance sheet. This pattern is particularly evident at institutions executing their first few transactions as well as with asset classes where an asset-backed market has not yet fully developed. In either case, if not controlled, the consequences can be inadequate capital and/or allowance for loan and lease losses (ALLL) at the institution or for a specific group of loans in the loan portfolio.

When an institution securitizes receivables, it makes certain representations and warranties regarding those receivables. If some receivables do not meet the representations and warranties provided by the seller, the seller might have to repurchase any deficient receivables or substitute them for qualifying receivables. If the institution repurchases defective receivables or makes substitutions, its balance sheet may both increase in size and decline in quality. This may present a supervisory concern should such repurchases or substitutions be significant.

At institutions where gains from the sale of securitized assets are a significant portion of earnings and/or capital, the annuity-like earnings stream that would have existed if the assets remained on the balance sheet will be diminished. The combination of infrastructure investment and accounting ramifications often makes earnings and capital growth highly dependent on future origination volumes. The high volume nature of securitization along with the accompanying investment in infrastructure (particularly technology and personnel) creates an incentive for management to reduce underwriting standards in an attempt to maintain origination volume. This would be exacerbated in a broadly declining credit environment.

Compensation plans with a short term orientation also may provide incentive for employees to generate high volumes of loans at the expense of quality controls. Adverse implications exist not only for retained loans, but also for the quality of the institution's capitalized assets associated with a sale and the institution's reputation in the market if one or more vintages of loans are markedly sub-par.

Prudent Risk Management Practices

As management contemplates its initial and ongoing use of securitization, it should perform pro forma assessments of capital and the ALLL. Management should formally consider the implications of disproportionately higher quality assets being sold and comparatively lower quality assets being retained. Management should also adjust both capital and ALLL levels as needed to reflect the remaining mix of assets relative to both quality and concentration characteristics.

Management reports should monitor the performance of the underlying asset pools for all deals. To control the impact of deterioration in pools originated or serviced, a systematic reporting process should be in place allowing management to track pool quality and performance throughout the life of the transaction.

If the credit environment deteriorates or the institution does not have the appetite or capability to manage continued growth, prudence would dictate a reduction in originations. For institutions relying heavily on securitization gains, contingency plans should exist either to absorb the less productive overhead into the existing earnings and capital structure or to employ technology and personnel in alternative activities.

Both you and institution management should review the underwriting standards for loans originated by third parties and the institution's quality assurance process to verify compliance with the institution's internal underwriting standards. Pay special attention to issuers who securitize loans originated by outside third parties, to ensure volume pressures do not result in systematic or uncontrolled degradation of retained and securitized asset quality. Also review the incentive pay structure of internally generated production.

Management should also plan for the risk associated with having to reacquire "defective" receivables. If an issuer is active in the securitization market and has a proven track record, the risk related to representations and warranties is likely to be relatively small. In contrast, inexperienced issuers and institutions with previous problems relating to representations and warranties may face greater risk, warranting incrementally higher levels of capital support.

Servicing and Operational Risk

Retaining the servicing on securitized portfolios can help thrift institutions increase their loans under management and achieve economies of scale in areas where they may have a comparative advantage due to technology, skilled personnel, and facilities.

Securitization transactions are governed by detailed, lengthy, and complex contracts. Management must fully understand the institution's servicing obligations under these contracts, and must have the resources, including capital, to fulfill its obligations.

The servicer's primary contractual responsibilities are the collection and transmittal of funds received from the underlying borrowers to the trustee and/or investors, account maintenance and recordkeeping, performance reporting, and collection of past due accounts.

Servicing obligations can pose a risk to earnings and capital should the cost of servicing securitized assets exceed projections or expected revenue not materialize. Servicing costs and revenues are a function of volume, the quality of assets being serviced, the structure of the transactions (revolving or amortizing), the maturity/duration of the underlying assets, including the speed of prepayments, the technology used, the complexity of the servicing process, and the ability and experience of servicing personnel.

Servicing subprime loans is riskier than servicing prime loans. It is easy to underestimate the high cost of servicing such loans or the speed that performing loans will be prepaid. Subprime loans default more frequently than prime loans, and, as a result, have far more repossessions and foreclosures than prime loans. A subprime servicer must have a larger collection staff, facilities, systems, administrators, legal support, and capital to meet its servicing contractual obligations. If credit conditions unexpectedly deteriorate, servicing costs can rise substantially, changing servicing from an asset to a liability.

Institutions that retain servicing in a securitization are vulnerable to additional pressures. The value of their residual interest in the securitization is typically based in part on the excess servicing spread. To maintain the recorded value of its residual interest, the institution, as a servicer, may feel pressured to delay recognition of delinquencies and losses in the asset pool it services. It may do so to maintain the appearance that the income is there to support the current valuation of its residual interest.

Prudent Risk Management Practices

Management should ensure that the personnel, technology, and reserves, including capital, are in place to support the associated transaction risks. To reduce the institution's exposure, management should evaluate staffing, skill levels, and the capacity of systems to handle the projected type and volume of transactions.

When contemplating and implementing uses of technology, institution management should engage in a rigorous analytic process to identify and quantify risks and establish risk controls to manage exposures. Before engaging in securitization, management should ensure the servicing platform provides timely and accurate information on both securitized assets and the on-balance-sheet portfolio. The servicing personnel and platform should be compatible with new types of borrowers and/or products offered. A quality assurance process should monitor reports regarding asset quality and analyze customer complaints regarding servicing problems.

The expected growth in the volume of securitized assets and its impact on servicing capabilities should be a critical part of long-range technology planning. Ongoing periodic reviews of system capacity should consider the types of assets being serviced (revolving vs. nonrevolving, prime vs. subprime, etc.) and the expected lives of the securitization transaction and the underlying assets. Since effective servicing platforms are heavily reliant

upon the use of technology and information systems, management must ensure appropriate back-up systems and contingency plans are in place and tested periodically.

Compliance Risk

Consumer laws and regulations, including fair lending and other antidiscrimination laws, affect the underwriting and servicing practices of institutions even if the receivables are later securitized. Therefore, institutions do not eliminate compliance risk simply through the securitization process. Assets originated for securitization purposes and those that have been securitized should be included within the institution's compliance program.

As previously noted, securitization lends itself to higher quality and diverse asset pools. Because of the need for predictable cash flows imposed by the secondary market, management may be less likely to originate loans in certain geographic areas or to borrowers below minimum income levels. Banks and thrifts that concentrate origination and servicing activities in high quality asset types may, albeit unintentionally, engage in "economic" redlining.

Prudent Risk Management Practices

Institutions should ensure that firm-wide capital levels sufficiently compensate for the compliance risk associated with both on-balance-sheet assets as well as assets originated but sold via securitizations. Specifically, the capital allocation process and level of capital held for compliance risk related to securitized assets should be similar, if not identical, to capital for compliance risk associated with on-balance-sheet receivables. Internal audits or quality control reviews for compliance should not segregate assets based upon their securitization status.

Senior management with securitization programs should be cognizant of the possibility of fair lending violations and must meet the requirements of the Community Reinvestment Act as well as the institution's own corporate responsibility objectives.

Market Risk

Securitization can provide matched funding, and, if transactions are structured carefully, can be an effective means of managing market risks. Institutions often hedge interest rate risk inherent in securitization transactions. However, some market participants erroneously assume that the seller no longer faces market risks, including interest rate risk, simply because the receivables are transferred off the balance sheet.

Depending on the structure, the excess spread received by the seller may be subject to fluctuations in interest rates. For example, the seller faces interest rate risk when fixed rate receivables are used to support a floating rate asset-backed security. If this transaction is left unhedged, as interest rates rise the coupon paid to investors increases while the portfolio yield remains constant, resulting in less excess spread received by the seller.

The seller may still be exposed to market risk even in transactions where floating rate securities are supported by floating rate receivables. The timing and magnitude of the rate change on the asset-backed security coupon may not match the timing and magnitude of the rate change on the underlying receivables. Management of institutions that securitize receivables must accurately assess the source and amount of market risk inherent in the structure and ensure that its risk management processes consider this risk.

Some issuers may access the nondollar securitization market by issuing certificates denominated in a foreign currency. If the underlying assets were denominated in U.S. dollars, any fluctuation in the value of the foreign currency relative to the U.S. dollar would directly affect the cash flows available to investors. As a result, the asset-backed securities market requires protection against potential currency risk in the form of a currency swap. Depending upon the financial stability of the third party and the structure of the swap, the institution may be subject to counterparty risk from the third party.

Prudent Risk Management Practices

Institutions that securitize receivables must accurately identify the source and quantify the amount of market risk inherent in each transaction. Institution management should monitor and control risk levels within the context of firm-wide earnings and economic value at risk limits. Institution-wide interest rate and currency risk management processes must consider all sources of market risk and ensure that capital is adequate relative to the risk assumed. The institution's independent credit approval process should review and approve all counterparties.

Fiduciary/Trustee Risk

A trustee's main responsibility is to represent the interest of the certificate holders, particularly during an event of default, including an early amortization. Other responsibilities include monitoring covenant compliance, authentication of the asset-backed securities, and enforcement of remedies during an event of default as defined in the governing document.

The structure of an asset-backed securitization transaction must be legally sound and adequately distinguish the duties and responsibilities of the transaction parties in a clear and logical manner. The trustee must be able to defend the true sale aspect of the transaction on behalf of the security holders. The trustee must ensure that the trust maintains a security interest in the underlying assets and that the entity status of the trust remains intact.

After an asset-backed securitization closes, the trustee and the servicer are normally the only entities that retain ongoing contractual duties. To fulfill its duties, the trustee is dependent on getting timely and accurate information from the servicer. A primary duty of the trustee is to assume the role of successor servicer in the event that the original servicer is removed or terminated. The trustee is most likely to be required to step in as the successor servicer if there is an event of default and subsequent termination and removal of the servicer. The successor servicer ensures that collections and other cash flows remain uninterrupted and that distributions continue to be paid to certificate holders. When the role of servicing is transferred to the trustee or a successor servicer, the portfolio is typically underperforming, servicing records are incomplete, and significant operational remediation is required.

The appointment as trustee is typically packaged with related agency appointments of registrar, paying agent, and successor servicer. The trustee may also be asked to perform "nontraditional" roles. These enhanced agency roles include calculation agent, document custodian, tax reporting agent, and back-up servicer.

Because of the complexities of an asset-backed securitization, the trustee is at greater risk of an operational error than on a typical capital markets transaction. Operational errors may include an incorrect or missed distribution, misapplication of funds between transaction participants, incorrect investment of funds, lost collateral documentation, and the untimely or missed notification of a significant event.

Prudent Risk Management Practices

Trustee organizations must be staffed by personnel experienced in securitization and knowledgeable of a variety of asset types and transaction structures. The trustee must have an effective risk control and monitoring system. This includes appropriate account acceptance procedures, ongoing self-assessment and account review procedures, and an audit program.

Qualified trustees should have experienced account managers with a proven record of administering similar structured transactions and a familiarity of the specific asset type. Trust officers should be adequately trained in trust administration, information systems, ethical business practices, and customer service.

Trustee organizations must make significant investments in operational systems technology. The business requires a large operational staff to handle the intricate securities processing requirements such as providing registrar and bond recordkeeping services, funds disbursements, and document custodian services.

If the trustee is the successor servicer, it must either be ready to directly assume servicing responsibilities or have a well-developed plan in place to transfer servicing responsibilities to a third party.

The essential requirements for a back-up servicer include sophisticated systems, collection expertise, and an analytical staff to fulfill the servicing duties.

If the trustee serves as back-up or successor servicer and is unable to fulfill all or any part of the administrative and/or operational requirements internally, it may engage the services of a third party vendor. The appointment of a third party vendor does not replace the successor or back-up servicer's liability or contractual obligations on the transaction; however, through the engagement of a third party vendor, some or all of the relevant administrative duties can be outsourced.

Reputation Risk

Exposure to reputation risk is essentially a function of how well the internal risk management process is working in each of the risk categories affected by securitization and the manner and efficiency with which management responds to external influences on proprietary transactions. Reputation risk has a "qualitative" nature, reflecting the strength of an organization's franchise value and how other market participants perceive it.

Asset performance that falls short of expectations will reflect poorly on the underwriting, servicing, and broader risk management capabilities of the originator. Because the asset performance of securitized pools is often publicly disclosed and monitored by market participants, securitization can highlight problems that were less apparent when reported as a smaller component of overall portfolio performance.

The pricing of asset-backed securities in the marketplace reflects a number of factors including liquidity of the security, structure of the transaction and asset performance. Typically, firms perceived to have strong risk management processes and demonstrate predictable historical performance are rewarded with more efficient deal execution and tighter pricing over the life of the transaction. Notably, institutions that are experiencing problems or are perceived to be vulnerable to stressed conditions have seen their asset-backed securities trade with significantly wider bid-offer spreads and higher yields.

Prudent Risk Management Practices

For securitization activities, reputation risk is essentially a function of the quantity, discipline, and commitment of the risk management practices for each of the areas discussed above. If an institution appropriately evaluates and manages the risk in other risk categories, reputation risk should be relatively low and a comparatively lower level of capital should be needed to maintain market confidence during normal as well as stressed periods.

ACCOUNTING CONSIDERATIONS

Institutions should follow Statement of Financial Accounting Standards Statement 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SFAS 140), for the accounting treatment of securitizations of pooled consumer assets, including credit card debt, auto loans, home equity loans and other consumer debt. SFAS 140 replaced SFAS Statement 125.

SFAS 140 provides accounting and reporting standards for transfers and servicing of financial assets and extinguishments of liabilities. These standards are based on the consistent application of a financial-components approach that focuses on legal control and recognizes that financial assets and liabilities can be divided into a variety of components. Under this approach, after a transfer of financial assets, an institution recognizes the financial and servicing assets it controls and the liabilities it has incurred, derecognizes financial assets for which control has been surrendered, and derecognizes liabilities extinguished. SFAS 140 provides consistent standards for distinguishing transfers of financial assets that are sales from those that are secured borrowings.

A transfer of financial assets in which the institution surrenders control over those assets is accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

- The transferred assets have been isolated from the transferor and put presumptively beyond the

reach of the transferor and its creditors, even in bankruptcy or other receivership.

- Each transferee (or, if the transferee is a qualifying special purpose entity (QSPE), each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange the assets and provides more than a trivial benefit to the transferor.
- The transferor does not maintain effective control over the transferred assets through either (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or (2) the ability to unilaterally cause the holder to return specific assets, other than through a clean-up call.

An institution recognizes transfers of assets sold, records the value of servicing rights and any other assets retained, records liabilities assumed, and recognizes into current income any gain or loss on the sale when a legal change in control is deemed to have taken place and the assets have been transferred to an unconsolidated vehicle such as a QSPE.

If a legal change in control of the assets has not taken place, generally accepted accounting principles will classify such a transaction as a secured borrowing. The assets will remain on the transferors' books, it must record any funds it receives as a liability and not recognize any gain or loss.

Accounting for Transfers and Servicing of Financial Assets

Institutions transferring financial assets in a securitization shall measure liabilities and derivatives assumed or incurred at fair value, if practicable. You should discuss the accounting with your Regional Accountant if fair value information is unavailable. Institutions shall measure servicing assets and other retained assets by allocating their previous carrying amount between assets sold and retained interest, based on their relative fair values at the date of transfer.

Gain or loss recognition for relatively short term receivables such as credit card balances, trade receivables, and dealer floor plan loans sold to a relatively long term revolving securitization trust is limited to the receivables that exist and have been sold (and not those that will be sold in the future pursuant to the revolving nature of the deal). Recognition of servicing assets is also limited to the servicing for the receivables that exist and have been sold.

A revolving securitization involves a large initial transfer of balances generally accounted for as a sale. Ongoing, smaller subsequent months' transfers funded with collections of principal from the previously sold balances are each treated as separate sales of new balances with the appropriate gain or loss calculation. The recordkeeping burden necessary to comply with these techniques is quite onerous, particularly for master trusts. You should consult your Regional Accountant with questions about accounting for ongoing replacement of balances.

Servicing assets and liabilities should be amortized in proportion to and over the period of estimated net servicing income or loss. A valuation allowance is recorded for servicing assets for the excess of book amount over fair value. Servicing liabilities are reported at fair value.

SFAS 140 states that a transferor may derecognize a liability if, and only if, either (a) the debtor pays the creditor and is relieved of its obligations or (b) the debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor. SFAS 140 requires securitizers to disclose information about accounting policies, value, cash flows, key assumptions made in determining fair values of retained interest, and the sensitivity of those fair values to changes in assumptions. The statement requires securitizers to disclose (a) the total principal amount outstanding, the portion that continues to be recognized, (b) delinquencies, at the end of the period, and (c) credit losses during the period for securitized assets and other managed assets.

SFAS 140 differentiates between transfers of financial assets where the transferor has no continuing involvement with the transferred assets or with the transferee, and transactions where the transferor has some continuing involvement with the assets or the transferee, including recourse, servicing, agree-

ments to reacquire the assets, options written or held, and pledges of additional collateral. The seller's continuing involvement raises questions about whether a sale has actually taken place or if the parties to the transaction should account for it as a secured borrowing with pledge of collateral.

Recognition and Measurement of Servicing Assets and Liabilities

An institution as a seller must recognize either a servicing asset or servicing liability for each servicing contract when it undertakes an obligation to service loans.

An institution must initially measure servicing assets or liabilities that have been purchased or assumed at fair value. Fair value is presumed to be the price paid. Servicing assets should be amortized in proportion to and over the period of estimated net servicing income. Servicing liabilities should be amortized in proportion to and over the period of estimated net servicing losses. Servicing assets should be assessed for impairment based on fair value. Servicing liabilities should be carried at fair value.

Assets Subject to Prepayment

Interests in securitizations, such as interest-only strips, residuals, seller's or retained interest, tranches or other financial assets that can contractually be prepaid or settled in a manner that the holder would not recover substantially all of its recorded investment, should be valued at fair value and classified as available-for-sale or trading in accordance with SFAS 115, Accounting for Certain Investments in Debt and Equity Securities.

Fair Value

The fair value of an asset or liability is the amount at which that asset or liability could be bought or sold, incurred or settled, in a current transaction between willing parties (that is, not part of a forced sale or liquidation). A quoted market price in an active market is the best evidence of fair value and should be used as the basis for measuring fair value, if available.

Institutions should estimate fair value based on the best information available when quoted market prices are not available, considering prices for similar assets and liabilities and the results of any available valuation techniques. Examples of valuation techniques include the present value of estimated cash flows, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis.

The seller should record those assets at zero when it is not practical to estimate fair value of assets. The seller should recognize no gain on the transaction when it is not practical to estimate the fair value of liabilities and should record those liabilities at the greater of:

- The excess, if any, of the fair value of assets obtained less the fair value of other liabilities incurred, over the sum of the carrying value of the assets transferred.
- The amount that would be recognized in accordance with SFAS No. 5, Accounting for Contingencies, as interpreted by SFAS Interpretation No. 14.

Effective Date

SFAS 140 is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after March 31, 2001, and for recognition and reclassification of collateral for fiscal years ending after December 2000.

CAPITAL CONSIDERATIONS

OTS's capital regulation places strict limits on the amount of high risk credit-enhancing residuals a savings institution may hold in addition to a dollar-for-dollar capital requirement for all residuals.

The term "recourse" refers to an institution's retention, in form or in substance, of any credit risk directly or indirectly associated with an asset it has sold. A recourse obligation typically arises when an institution transfers an asset in a sale (a sale according to generally accepted accounting principles) and retains an obligation to repurchase the asset or to otherwise absorb losses on the asset. Examples of recourse obligations include:

- Assets sold under an agreement to repurchase.
- Credit-enhancing representations and warranties related to sold assets.
- Retained loan servicing with an agreement under which the savings association is responsible for losses associated with the loans serviced, with the exception of Servicer Cash Advances as defined. See 12 CFR §567.1.
- Clean-up calls on assets sold (except for clean-up calls that are 10 percent or less of the original pool balance and that are exercisable at the option of the savings association).
- Credit derivatives that absorb more than the institution's pro rata share of losses on transferred assets.
- Loan strips sold where the maturity of the transferred portion of the loan is shorter than the commitment under which the loan is drawn.

Recourse can also be implicit. Implicit recourse generally arises when a thrift institution repurchases assets, absorbs losses, or otherwise supports assets that it has sold, in instances where it is not contractually required to do so.

An institution can guaranty, purchase, or assume a recourse exposure from another organization. These exposures are referred to as direct credit substitutes. A purchased subordinated security is an example of a direct credit substitute.

Recourse exposures can also take the form of residual interests. However, residual interests are typically on-balance-sheet assets, in contrast to the above examples of recourse exposures that are off-balance-sheet. Residual interests have credit risk that exceeds a pro rata share of the total credit risk on the transferred assets. A retained on-balance-sheet first loss piece of a securitization is an example of a residual interest. Other examples include spread accounts, cash collateral accounts, and credit-enhancing interest-only strips.

Capital Requirements

There are special capital requirements for recourse exposures and residual interests:

- An institution must hold dollar-for-dollar risk-based capital for most residual interests – that is, one dollar of capital for every one dollar of residual interests.
- In addition to the dollar-for-dollar risk-based capital requirement for a residual, if the asset also meets the definition of credit-enhancing interest-only strip (a subset of residual interest), then the institution must deduct from core capital (that is, tier 1 leverage capital), the amount of credit-enhancing interest-only strips that exceed 25 percent of core capital.
- A ratings based approach allows an institution to reduce its capital requirement for lower risk, highly rated recourse exposures (including direct credit substitutes and residual interests, but excluding credit-enhancing interest-only strips).
- The capital treatment for most recourse exposures is "gross-up," whereby an institution must hold capital for the full amount of the transferred assets as if they were still on the balance sheet.

There is an exception to this treatment for qualifying mortgages (1-4 Family Loans that would receive a 50 percent risk weight) that a thrift institution has sold, if the sales contract allows only a 120-day return period. The loans must have been originated within one year prior to sale.

There is also an exception to the gross-up treatment for low-level recourse exposures where recourse is legally and contractually limited to an amount less than the on-balance-sheet capital requirement.

For additional material on capital requirements for residual interests, recourse, and direct credit substitutes, refer to Appendix B of this Section, and to 12 CFR §567.1 (definitions) and §567.6 (risk weights).

SUPERVISORY FOCUS

While OTS generally believes that securitization can be beneficial to thrift institutions, it must be done in a safe and sound manner. To do so, the institution must identify, measure, manage, and control the associated risks as outlined in this Handbook Section. In particular, examiners should scrutinize high risk lending activities done through

securitizations that the institution would not or could not undertake directly.

We are also concerned with inappropriate valuation techniques that an institution might use to value its retained interests. Such valuations must be fully documented, based on reasonable assumptions, and regularly analyzed for any subsequent change in performance and resulting value impairment.

The best evidence of fair value is a quoted market price in an active market. If unavailable, fair value may be estimated. Such estimates must be based on reasonable, supportable, and currently valid assumptions. If an estimate of fair value is not practical, the asset should be recorded at zero in financial and regulatory reports.

Unforeseen market events that affect performance of loans supporting a retained interest can quickly alter its value. Without appropriate internal controls and independent oversight, an institution that securitizes assets may inappropriately generate "paper profits" or mask actual losses through flawed loss assumptions, inaccurate prepayment rates, and inappropriate discount rates. Liberal and unsubstantiated assumptions can result in material inaccuracies in financial statements, and subsequent write-downs of retained interest. If such interest represents a substantial portion of the institution's capital, such devaluations could result in the failure of the institution.

Regulatory Requirements and Guidelines on Securitization

In response to the increased use of securitizations by institutions, the banking agencies published the *Interagency Guidance on Asset Securitization* in December 1999 (Securitization Guidance), which addressed supervisory concerns with risk management and oversight of these securitization programs. (See Appendix A.) The Securitization Guidance highlighted the most significant risks associated with asset securitization, emphasized concerns with certain residual interests generated from the securitization and sale of assets, and set forth fundamental risk management practices that the agencies expect institutions that engage in securitization activities to implement. In addition, the Guidance stressed the need for management to implement policies and procedures that include limits on the amount of residual interests that may be carried as a percentage of capital.

The Guidance states that critical components for an effective oversight program include the following:

- Independent risk management commensurate with the complexity of the securitization activities.
- Comprehensive audit and loan review coverage.
- Appropriate valuation and modeling methodologies.
- Accurate and timely risk-based capital oversight.
- Prudent internal limits to control the amount of equity capital at risk.

Supervisory Focus

In preexamination planning as well as in conducting onsite work, you should focus your attention on institutions, and areas within institutions, that have unproven personnel, unfamiliar risk management systems, and riskier activities. Higher risk assets and rapidly growing activity volumes often translate into more challenging origination, processing, collection, reporting, and oversight responsibilities. Supervisory expectations for risk management practices and capital coverage should be proportional to the level and duration of the risks from the underlying assets, as well as the growth rate of business activities.

You should determine whether the institution's securitization activities are conducted in a safe and sound manner and in accordance with the Securitization Guidance mentioned above as well as OTS capital regulations. You should also compare the asset performance of outstanding securitizations to industry benchmarks on both a spot and trend basis. In evaluating an institution's securitizations relative to the industry, you should consider factors related to the risk, valuation, and the pricing of the underlying assets.

If either the risk or pricing of those assets is out of balance, then a smaller than normal excess spread would be a signal of higher risk to the institution. Credit spreads in the capital markets can also pro-

vide signals on which institutions and individual securities are underperforming.

Rating agencies will typically require greater levels of credit enhancement based on the structure of the securitization, the expected performance of the underlying assets and the experience of the issuer. You should evaluate and understand the difference in subordination levels required by the ratings agencies across issuers of similar assets, structures and securities. You should focus on institutions and transactions that have material adverse variances from benchmarks. During the examination process, determine the reason(s) for adverse performance, security structures, and/or pricing. Ensure management is taking appropriate actions to control the situation, and that capital is adequate for the risk.

You should review the institution's valuations of and controls over securitization activities. When you identify inappropriate valuation assumptions, weak risk management practices or lax internal controls, you should direct the institution to take immediate corrective action. In situations where the institution cannot provide objective and verifiable support for the valuation of retained interests, you should classify the assets Loss and disallow them as an asset for regulatory capital purposes.

REFERENCES

United States Code (12 USC)

Chapter 2: National Banks

§ 84	Lending Limits

Home Owners' Loan Act

§ 1464 (c)	Investment Authority
§ 1468	Transactions with Affiliates and Loans to Insiders

Federal Deposit Insurance Act

§ 1813	Definitions
§ 1831e	Activities of Thrifts

Code of Federal Regulations (12 CFR)

Chapter V: Office of Thrift Supervision

§ 560	Lending and Investment
§ 560.30	General Lending and Investment Powers
§ 560.101	Real Estate Lending standards
§ 561.19	Financial Institutions
§ 563.41	Loans and Other Transactions with Affiliates and Subsidiaries
§ 563.43	Restrictions on Loans, Other Investments, and Real and Personal Property Transactions Involving Affiliated Persons
§ 567	Capital Requirements

Joint Agency Issuances

Interagency Guidance on Asset Securitization Activities – December 13, 1999 (Attachment A).

Interagency Guidance on Capital Treatment for Recourse, Direct Credit Substitutes, and residual interests – November 29, 2001 (Appendix B).

Interagency Questions and Answers on the Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations – May 23, 2002.

Interagency Advisory on the Unsafe and Unsound Use of Covenants Tied to Supervisory Actions in Securitization Documents – May 23, 2002.

Interagency Guidance on Implicit Recourse in Asset Securitizations – May 23, 2002.

Interagency Guidance on the Regulatory Capital Treatment of Accrued Interest Receivable Related to Credit Card Securitizations – May 17, 2002.

Interagency Advisory on the Accounting Treatment of Accrued Interest Receivable Related to Credit Card Securitization – December 4, 2002.

Accounting Issuances

Financial Accounting Standards Board

Statement of Financial Accounting Standards No. 140, September 2000.

Asset-Backed Securitization Program

Examination Objectives

To determine the level of risk exposure presented by asset securitization activities and evaluate that exposure's impact on the overall financial condition of the thrift, including the impact on capital requirements and financial performance.

To determine whether the thrift is properly identifying, measuring, monitoring, and controlling the risks associated with its securitization activities.

To determine whether the thrift's strategic or business plan for asset securitization adequately addresses resource needs, capital requirements, and profitability objectives.

To determine the adequacy of asset securitization policies, practices, procedures, objectives, internal controls, and audit functions over securitization activities and valuations.

To determine that securitization activities are properly managed within the context of the thrift's overall risk management process.

To determine the quality of operations and the adequacy of Management Information Systems (MIS).

To determine compliance with applicable laws, rulings, regulations, and accounting practices.

To initiate corrective action when policies, practices, procedures, objectives, or internal controls are deficient, or when you note violations of law, rulings, or regulations.

Examination Procedures

Securitization activities present unique and sometimes complex risks. The level and type of securitization activity varies significantly among institutions. To support examination flexibility and efficiency in this environment, the examination procedures are organized as follows:

The examination procedures in the first overview section will help you determine how the thrift securitizes assets and the general level of management and board oversight. The procedures in the functions section supplement the overview section and you will typically use them for more in-depth reviews of operational areas. The procedures in Overall Conclusions will ensure that you meet the objectives of these procedures.

Many of the steps in these procedures require you to gather information from or review information with examiners in other areas, particularly those responsible for originating assets used in securitized pools (e.g., retail consumer lending, mortgage banking, credit card lending). To avoid duplicating examination procedures already being performed in these areas, you should discuss and share examination data related to asset securitization with examiners from these other areas before beginning these procedures.

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Asset-Backed Securitization Program

You should cross-reference information obtained from other areas in your examination work papers. When information is not available from other examiners, you should request it directly from the thrift.

Given the complexity and level of risks presented by securitization activities, the retail specialist or senior field staff examining the securitization activities of an institution should closely coordinate their activities with the examiner-in-charge (EIC). The final decision on the scope of the examination and the most appropriate way to obtain information rests with the EIC.

Overview

Wkp. Ref.

1. Obtain and review the following documents:

   - Previous examination findings related to asset securitization and management's response to those findings.
   - The most recent regulatory profile detailing the securitization activity and current risk profile of the thrift institution.
   - Most recent internal/external audits addressing asset securitization and management's response to significant deficiencies.
   - Recent monitoring reports (e.g., financial analysis reports, etc.).
   - Scope memorandum issued by the EIC.
   - Strategic or business plan for asset securitization.
   - All written thrift policies or procedures related to asset securitization.
   - A description of risk monitoring system for securitization activities and a copy of all related MIS reports, including tracking reports, exposure reports, valuation reports, and profitability analyses, etc.
   - A summary or outline of all outstanding asset-backed issuances. Include the following information for each outstanding security in your work paper file:

     — The origination date, original deal amount, current outstanding balance, legal maturity, expected maturity, maturity type (hard bullet, soft bullet, controlled amortization, etc.), revolving period dates, current coupon rates, gross yield, loss rate, base rate, excess spread amounts (one month and three month), monthly payment rates, and the existence of any interest rate caps.

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— The amount and form of credit enhancements on an issuance-by-issuance basis (overcollateralization, cash collateral accounts, spread accounts, etc.).

— Performance triggers relating to early amortization events or credit enhancement levels.

- Copies of (or access to) pooling and servicing agreements and/or series supplements for major asset types securitized or those targeted at this exam.
- Information detailing the potential contractual or contingent liability from guarantees, underwriting, and servicing of securitized assets.
- Copies of the compensation programs, including incentive plans, for personnel involved in securitization activities.
- Current organizational chart for the asset securitization unit.
- A list of board and executive or senior management committees that supervise the asset securitization function, including a list of members and meeting schedules. In addition, minutes documenting meetings held since the last examination should be available for review.

2. Determine whether any material changes have occurred since the last review regarding originations and purchases, servicing, or managing securitized portfolios.

3. Based on results from the previous steps and discussions with the EIC and other appropriate supervisors, determine the scope and objectives of the examination including which of the following examination procedures are necessary to meet examination objectives. You should tailor the procedures to the specific activities and risks faced by the thrift institution.

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4. As examination procedures are performed, test for compliance with established policies and confirm the existence of appropriate internal controls. Identify any area that has inadequate supervision or poses undue risk, and discuss the need to perform additional or expanded procedures with the EIC.

Management Oversight

5. Review the thrift's securitization business plan. Determine it is appropriate for the securitization activities of the thrift and that it has been reviewed by management and approved by the board of directors.

6. Consider whether the business plan is reasonable and achievable in light of the thrift's capital position, size, and expertise of staff, market conditions, and current economic forecasts.

7. Determine whether the thrift has and is following adequate policies and operating procedures for securitization activities. At a minimum, policies should address:

- Permissible securitization activities including individual responsibilities, and limits.
- Authority levels and responsibility designations covering:
  - Transaction approvals and cancellations.
  - Segregation of duties.
  - Counterparty approvals for all outside entities the thrift is doing business with (originators, servicers, packagers, trustees, credit enhancers, underwriters, and investors).
  - Systemic transaction monitoring.

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— Pricing approvals.

- Risk exposure limits by:

  — Type of assets under securitization.

  — Individual transaction dollar size.

  — Aggregate transactions outstanding (because of the moral recourse implicit in the thrift institution's name on the securities).

  — Geographic concentrations of transactions (individually and in aggregate).

  — Maturities of transactions (particularly important in evergreen deals, that is, credit cards and home equity lines).

  — Originators (for purchased assets), credit enhancers, trustees, and servicers.

- Quality standards for all transactions in which the thrift plans to participate. Standards should extend to all counterparties conducting business with the thrift institution.

- Minimum MIS reports to be presented to senior management and the board or appropriate committees. (During reviews of applicable meeting minutes, ascertain which reports are presented and the depth of discussions held).

8. Review the organizational structure and determine who is responsible for coordinating securitization activities.

   - Determine whether the board of directors or appropriate committee and management have a separate securitization steering committee. If so, review committee minutes for significant information.

   - Determine who is responsible for major decisions and how final decisions are executed.

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9. Assess the expertise and experience of management responsible for securitization activities. Conduct interviews and review personnel files and resumes to determine whether management and other key staff members possess appropriate experience or technical training to perform their assigned functions.

10. Review incentive plans covering personnel involved in the securitization process.

- Determine that management approves incentive plans and orients plans toward quality execution and long term profitability rather than high volume, short term asset production and sales.
- Ensure that senior management and the board of directors are aware of any substantial payments or bonuses made under these plans.

11. Evaluate the pricing system used in all aspects of securitization. Determine whether decision makers use an effective pricing system to determine whether prospective transactions will be profitable and monitor cash flows and the profitability of ongoing securitizations.

Risk Management

12. Determine whether the risk management process is effective and based on timely and accurate information. Evaluate its adequacy in managing significant risks in each area of the securitization process.

- Ascertain whether management has identified all significant risks in each of the thrift's planned roles.
- Determine how management monitors and controls these risks.

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13. Determine that appropriate legal counsel has reviewed the thrift's obligations from securitization activities and all pertinent legal documents.

    - Also, ensure that an independent party checks the financial and statistical information in the prospectus for accuracy.

14. Determine that the scope of credit and compliance reviews includes loans originated for securitization or purchased for that purpose.

    - Ascertain appropriateness of scope, frequency, independence, and competency of reviews in view of the thrift's activity volume and risk exposure.
    - Credit and compliance reviews should include:
      - Loans on the thrift's books and not yet securitized.
      - Loans in process of being securitized.
      - Completed deals that bear the thrift institution's name or in which the thrift has ongoing responsibilities (servicer, trustee, etc.).
      - How the securitization process affects the overall credit quality of the nonsecuritized portfolio.

Portfolio Management

15. Determine whether management's assessment of the quality of loan origination and credit risk management includes all managed assets (receivables in securitization programs and on-balance-sheet assets). This assessment should include reports detailing both on-balance-sheet assets and off-balance-sheet assets. The assessment should include:

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- A review of the number and dollar volume of existing past-due loans, early payment defaults, and repurchased loans from securitized asset pools. The review should also compare the thrift's performance to industry and peer group averages.
- An analysis of the cause of delinquencies and repurchases.
- The effect on delinquencies and losses of altered underwriting practices, new origination sources, and new products.
- Determination of whether repurchases or other workout actions compromised the sales status of problem credits or related assets.
- Credit quality trends of each overall portfolio (e.g., score distribution).

16. Determine whether the thrift performs periodic stress tests of securitized asset pools. Determine whether these tests:

- Consider the appropriate variables affecting performance according to asset or pool type.
- Are conducted well in advance of approaching designated early amortization triggers.
- Are adequately documented.
- Reveal the financial impact of adjusting the asset capitalized on the balance sheet.

17. If third parties provide credit or liquidity enhancements for thrift-sponsored asset-backed securities, determine whether their credit rating has been downgraded recently or whether their credit quality has deteriorated. If so, determine what actions the thrift has taken to mitigate the effects of these events.

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18. Assess whether the institution has adequately integrated securitization activities into liquidity planning. Consider whether:

- The cash flows from scheduled maturities of revolving asset-backed securities are coordinated to minimize potential liquidity concerns.
- The impact of unexpected funding requirements due to early amortization events are factored into contingency funding plans for liquidity.
- The effect of not being able to securitize additional asset pools are factored into liquidity concerns.

Internal and External Audit

19. Review the thrift's internal audit program for securitization activities. Determine whether it includes objectives, written procedures, an audit schedule, and reporting systems that are appropriate in view of the thrift's volume of activity and risk exposure.

- Review the education, experience, and ongoing training of the internal audit staff and evaluate its independence and expertise in auditing securitization activities.
- Determine whether comprehensive audits of all securitization areas are conducted in a timely manner. Ensure that the scope of internal audit includes:
  - An evaluation of compliance with pooling and servicing agreement requirements.
  - Periodic verification of the accuracy of both internal and external portfolio performance reports.
  - A determination of the accuracy of other internally generated reports that are provided to senior management and the board of directors.
- Review management's responses to audit reports for timeliness and implementation of corrective action when appropriate.

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20. Review the most recent engagement letter, external audit report, and management letter of the external auditors that address the institution's securitization activities. Determine:

- To what extent the external auditors rely on the internal audit staff and the internal audit report.
- Whether the external auditor rendered an opinion on the effectiveness of internal controls for the major products or services related to securitization.
- Whether management promptly and effectively responds to the external auditor's concerns and recommendations. Assess whether management makes changes to operating and administrative procedures that are appropriate responses to report findings.
- The level of testing the external auditors performed on the various capitalized assets values, and including the periodic impairment analysis and methodologies associated with the audit process.

Management Information Systems

21. Review management information systems to determine whether they provide appropriate information for monitoring securitization activities.

- Evaluate reports produced for each capacity in which the thrift is involved, including:
  - Tracking reports to monitor overall securitization activity.
  - Performance reports by portfolio and specific product type. Reports should reflect performance of both assets in securitized pools and total managed assets. Reports should include:
    - Credit quality (e.g., delinquencies, losses, portfolio aging, accounts re-aged).
    - Profitability (by individual transaction and product type).

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— Actual performance compared with expected performance (portfolio yields, other fee income, monthly principal payment rates, purchase rates, charge-offs, etc.).

— Cost to service.

- Evaluate whether:

— The frequency and detail of report generation is commensurate with volume and risk exposure.

— Reports are distributed to, and reviewed by, appropriate management, board committees, or both.

22. Determine whether investor reporting is accurate and timely. Compare internal performance reports with those provided to investors. Determine the controls used by the institution to insure accurate reporting. *Note:* Examiners can supplement this procedure by comparing internal reports with information reported by external sources (such as Bloomberg, Fitch, and Moody's). Bring discrepancies to management's attention immediately.

Accounting and Risk-Based Capital

23. Determine whether the thrift is classifying securitization transactions appropriately as "sales" or "financings," and that the thrift has a system to ensure that independent personnel review transactions and evaluate and concur with accounting treatment.

24. For transactions that qualify for sales treatment under FAS 140, review the written policies and procedures to determine whether they:

- Allocate the previous book-carrying amount between the assets sold and the retained interests based on their fair market values on the date of transfer.

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- Adjust the net proceeds received in the exchange by recording, on the balance sheet, the fair market value of any guarantees, recourse obligations, or derivatives such as put options, forward commitments, interest rate swaps, or currency swaps.
- Recognize gain or loss only on assets sold.
- Continue to carry on the balance sheet any retained interest in the transferred assets. Such balance sheet items should include servicing assets, accrued interest receivable, beneficial debt or equity interests in the special purpose entity, or retained undivided interests.

25. Determine whether the asset values and periodic impairment analyses for servicing assets and rights to future excess interest (IO strips) are consistent with FAS 140 and regulatory accounting requirements.

- Determine whether the thrift has a reasonable method for determining fair market value of the assets.
- Determine whether recorded servicing and IO strip asset values are reviewed periodically and adjusted for changes in market conditions.
- For servicing assets, verify that:
  - Servicing assets are appropriately stratified by predominant risk characteristics (e.g., asset type, interest rate, date of origination, or geographic location).
  - All impairments are recognized through a valuation allowance to the servicing asset.
  - Impairment is assessed at least quarterly.
  - Assumptions and calculations are documented and consistent with industry norms.
  - Servicing assets are not recorded at a value greater than their original allocated cost.

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— Servicing fees are at market terms and the relationship is profitable to the thrift.

- Compare actual servicing costs to contract rates and determine if a servicing liability should be recorded (Servicing Costs are greater then Adequate Compensation "the amount of benefit of servicing that would fairly compensate a substitute servicer").

- For IO strip assets, verify that:

  — Valuation considers changes in expected cash flows due to current and projected volatility of interest rates, default rates, and prepayment rates.

  — IO strips are recorded at fair market value consistent with available-for-sale or trading securities.

  — The fair value is based on the assumptions including forecasted excess spread (gross yield, less investor coupon, less servicing cost, less credit losses), discount rate, receivable life, and the amount of assets securitized.

- Determine that servicing assets and IO strips are accorded appropriate risk-based capital treatment.

26. For revolving trusts, review procedures for accounting for new sales of receivables to the trust.

- Verify that accrued interest on receivables sold is accounted for properly and does not contain a possible recourse provision.

- Determine whether gain or loss is properly booked.

- Sample and/or determine the initial credit quality verses the current credit quality of the securitized assets.

- Determine if the assets being transferred to the master trust are lowering the remaining credit quality of the on-book portfolio.

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27. Determine whether the thrift maintains capital reserves for securitized assets in accordance with OTS policy and capital regulations. Determine whether the method for calculating the reserves is reasonable. Please refer to the discussion in Appendix B.

Recourse Transactions

28. Determine whether the thrift transfers loans with recourse. If so, determine whether:

- Written policies guide management with respect to the type and amount of recourse it can offer.
- Adequate management information systems exist to track all recourse obligations.
- Asset sales with recourse are reported appropriately in Thrift Financial Report.
- The thrift's systems prevent it from making payments greater than its contractual obligation to purchasers if recourse is limited.

29. Determine whether the thrift has developed written standards for refinancing, renewing, or restructuring loans previously sold in asset-backed securities transactions. The written standards should:

- Distinguish a borrower's valid desire to reduce an interest rate through renewal or refinancing from an attempt to salvage weak credits through renewal, refinancing, or restructuring.
- Prevent the thrift from repurchasing distressed loans from the securitized credit pool and disguising their delinquency in the thrift's loan portfolio.
- Determine the extent and reason for all repurchases of assets transferred or sold.
- Compare the actual repurchases to the contractual obligation to repurchase the receivable.

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Securitization Functions

The following guidelines supplement the procedures in the Overview Section. You will often perform these procedures by product (loan) type and you should coordinate them with other examination areas to avoid duplication of effort.

Originations

30. Determine whether senior management or the board is directly involved in decisions concerning the quality and types of assets that are to be securitized as well as those to be retained on the balance sheet. Ensure that written policies:

- Outline objectives relating to securitization activities.
- Establish limits or guidelines for:
  - Quality of loans originated.
  - Maturity of loans originated.
  - Geographic dispersion of loans.
  - Acceptable range of loan yields.
  - Credit quality.
  - Acceptable types of collateral.
  - Types of loans.

31. Determine whether the credit standards for loans to be securitized are the same as the ones for loans to be retained.

- If not, ascertain whether management consciously made this decision and that it is clearly stated in the securitization business plan.
- If higher quality loans are to be securitized in order to gain initial market acceptance, determine whether the thrift limits the amount of lower quality assets it

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originates or retains. Also, determine whether the allowance for loan and lease losses (ALLL) and capital are adjusted for the higher proportion of risk in total assets. In addition, ensure that the ALLL is not based solely on historical trends but rather based on projected loss rates given the planned portfolio quality shifts.

- Determine whether there are sufficient administrative and collection personnel on hand to properly administer and collect lower quality credits and anticipated volume of problem loans.

- Ensure that the same level of collection effort is expended for both nonsecuritized and securitized portfolios. If collection efforts are different, determine the impact on the thrift's nonsecuritized portfolio.

32. Ensure that there is a complete separation of duties between the credit approval process and loan sales/securitization effort. Determine whether lending personnel are solely responsible for:

- The granting or denial of credit to customers.

- Credit approvals of resale counterparties.

33. Ensure that loans to be sold or securitized are segregated or otherwise identified on the books of the originating thrift. Also, determine that the thrift is following appropriate accounting standards regarding market valuation procedures on assets held for sale.

34. If loans are granted or denied based on a credit scoring system, ascertain whether the system was developed based on empirically derived data. Ensure that it is periodically revalidated.

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Purchased Loans

35. Determine whether the thrift has written procedures on acquiring portfolios for possible securitization. If so, determine whether the procedures are adequate given the volume and complexity of the potential purchases.

36. Evaluate management's method of determining whether prospective asset purchases meet the quality standards represented by the seller. Ensure that the process considers whether purchased assets are compatible with the thrift's data systems, administration and collection systems, credit review talent, and compliance standards, particularly consumer protection laws.

37. Evaluate the credit quality of the loans purchased to the bank's current credit standards. If the acquired portfolio is of lower credit quality or does not meet the thrift's current credit standards, ensure proper approvals from both senior management and the board were obtained.

38. If the thrift has recently purchased a portfolio for use in a securitization transaction, review the due diligence work papers to assess their adequacy and compliance with policy.

39. Determine whether the thrift conducts post-purchase reviews on acquired portfolios and, if so, what procedures are used. Identify who receives the results and whether appropriate follow-up action is taken (changes in quality standards, due diligence procedures, termination of counterparty relationships, etc.). In addition, determine if the thrift effectively tracks the performance of the acquired portfolio.

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40. Ensure that operating systems segregate or otherwise identify loans being held for resale. Review accounting practices to ensure appropriate treatment of assets held for resale.

41. Evaluate the measures taken to control pipeline exposure.

- If presales are routine, determine whether credit approval and diversification standards for purchasers are administered by people who are independent of the asset purchasing and packaging processes.
- Evaluate the reasonableness of limits on inventory positions that are not presold or hedged.
- If assets held for resale are required to be hedged, ensure that controls over hedging include:
  - An approved list of hedging instruments.
  - Minimum acceptable correlation between the assets held for sale and the hedging vehicle.
  - Maximum exposure limits to unhedged loan commitments under various interest rate simulations.
  - Credit limits on forward sale exposure to a single counterparty
  - A prohibition against speculation.
  - Acceptable reporting systems for hedging transactions.

Servicing

42. Determine whether written policies are in place for servicing activities that:

- Outline objectives for the servicing department.

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- Specify procedures for valuing retained servicing rights.
- Require legal counsel to review each transaction for conflicts of interest when the thrift institution serves in multiple capacities.

43. Determine whether MIS reports for the servicing operation provide adequate information to monitor servicing activities.

44. Evaluate management's planning process for future servicing activities.

45. Determine whether the thrift has contracted for an appropriate amount of errors and omissions insurance to cover the risks associated with the added transaction volumes from securitization activities.

46. Determine whether internal or external auditors review the servicing function. Determine whether they:

- Verify loan balances.
- Verify notes, mortgages, security interests, collateral, etc., with outside custodians.
- Review loan collection and repossession activities to determine that the servicer:
  - Promptly identifies problem loans.
  - Charges off loans in a timely manner.
  - Follows written guidelines for extensions, renegotiations, and renewal of loans.
  - Clears stale items from suspense accounts in a timely manner.

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— Accounts for servicing fees properly (by amortizing excess servicing fees, for example).

Collections

47. Review policies and procedures for collecting delinquent loans.

- Determine whether collection efforts are consistent with pooling and servicing agreement guidelines.
- Determine whether the thrift documents all attempts to collect past-due payments, including the date(s) of borrower contact, the nature of communication, and the borrower's response/comment.
- Evaluate methods used by management to ensure that collection procedures comply with applicable state and federal laws and regulations.
- Evaluate any collection procedures, that are different between the pooling and servicing agreement and the thrift's standard practices.

Overall Conclusions

48. Prepare a summary memorandum detailing the results of the asset securitization examination. Address the following:

- Adequacy of risk management systems, including the thrift institution's ability to identify, measure, monitor, and control the risks of securitization.
- Adequacy of the strategic plan or business plan for asset securitization.
- Adequacy of policies and operating procedures and adherence thereto.
- Quality and depth of management supervision and operating personnel.

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- Adequacy of management information systems.
- Propriety of accounting systems and regulatory reporting.
- Compliance with applicable laws, rulings, and regulations.
- Adequacy of audit, compliance, and credit reviews.
- Recommended corrective action regarding deficient policies, procedures, or practices and other concerns.
- Commitments received from management to address concerns.
- The impact of securitization activities on reputation risk, strategic risk, credit risk, transaction risk, operational risk, liquidity risk, and compliance risk.
- The impact of securitization activities on the thrift institution's earnings and capital given the potential risk associated with capitalized assets. Further, assess core operating income verses securitization income flows.
- The thrift institution's future prospects based on current securitization market trends.
- Other matters of significance.

49. Discuss examination findings and conclusions with the EIC. Based on this discussion, set up a meeting with thrift management to share findings and obtain any necessary commitments for corrective action.

50. Ensure that your review meets the objectives of this Handbook Section. State your findings and conclusions, and appropriate recommendations for any necessary corrective measures on the appropriate work papers and report pages.

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Examiner's Summary, Recommendations, and Comments

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Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Board of Governors of the Federal Reserve System
Office of Thrift Supervision

December 13, 1999

INTERAGENCY GUIDANCE ON ASSET SECURITIZATION ACTIVITIES

BACKGROUND AND PURPOSE

Recent examinations have disclosed significant weaknesses in the asset securitization practices of some insured depository institutions. These weaknesses raise concerns about the general level of understanding and controls among institutions that engage in such activities. The most frequently encountered problems stem from: (1) the failure to recognize and hold sufficient capital against explicit and implicit recourse obligations that frequently accompany securitizations, (2) the excessive or inadequately supported valuation of "retained interests,"[1] (3) the liquidity risk associated with over reliance on asset securitization as a funding source, and (4) the absence of adequate independent risk management and audit functions.

The Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Office of Thrift Supervision, hereafter referred to as "the Agencies," are jointly issuing this statement to remind financial institution managers and examiners of the importance of fundamental risk management practices governing asset securitization activities. This guidance supplements existing policy statements and examination procedures issued by the Agencies and emphasizes the specific expectation that any securitization-related retained interest claimed by a financial institution will be supported by documentation of the interest's fair value, utilizing reasonable, conservative valuation assumptions that can be objectively verified. Retained interests that lack such objectively verifiable support or that fail to meet the supervisory standards set forth in this document will be classified as loss and disallowed as assets of the institution for regulatory capital purposes.

[1] In securitizations, a seller typically retains one or more interests in the assets sold. **Retained interests** represent the right to cash flows and other assets not used to extinguish bondholder obligations and pay credit losses, servicing fees and other trust related fees. For the purposes of this statement, **retained interests** include over-collateralization, spread accounts, cash collateral accounts, and interest only strips (IO strips). Although servicing assets and liabilities also represent a retained interest of the seller, they are currently determined based on different criteria and have different accounting and risk-based capital requirements. See applicable comments in Statement of Financial Accounting Standard No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" (FAS 125), for additional information about these interests and associated accounting requirements.

The Agencies are reviewing institutions' valuation of retained interests and the concentration of these assets relative to capital. Consistent with existing supervisory authority, the Agencies may, on a case-by-case basis, require institutions that have high concentrations of these assets relative to their capital, or are otherwise at risk from impairment of these assets, to hold additional capital commensurate with their risk exposures. Furthermore, given the risks presented by these activities, the Agencies are actively considering the establishment of regulatory restrictions that would limit or eliminate the amount of certain retained interests that may be recognized in determining the adequacy of regulatory capital. An excessive dependence on securitizations for day-to-day core funding can also present significant liquidity problems - either during times of market turbulence or if there are difficulties specific to the institution itself. As applicable, the Agencies will provide further guidance on the liquidity risk associated with over reliance on asset securitizations as a funding source and on implicit recourse obligations.

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DESCRIPTION OF ACTIVITY

Asset securitization typically involves the transfer of on-balance sheet assets to a third party or trust. In turn the third party or trust issues certificates or notes to investors. The cash flow from the transferred assets supports repayment of the certificates or notes. For several years, large financial institutions, and a growing number of regional and community institutions, have been using asset securitization to access alternative funding sources, manage concentrations, improve financial performance ratios, and more efficiently meet customer needs. In many cases, the discipline imposed by investors who buy assets at their fair value has sharpened selling institutions' credit risk selection, underwriting, and pricing practices. Assets typically securitized by institutions include credit card receivables, automobile receivable paper, commercial and residential first mortgages, commercial loans, home equity loans, and student loans.

While the Agencies continue to view the use of securitization as an efficient means of financial intermediation, we are concerned about events and trends uncovered at recent examinations. Of particular concern are institutions that are relatively new users of securitization techniques and institutions whose senior management and directors do not have the requisite knowledge of the

effect of securitization on the risk profile of the institution or are not fully aware of the accounting, legal and risk-based capital nuances of this activity. Similarly, the Agencies are concerned that some institutions have not fully and accurately distinguished and measured the risks that have been transferred versus those retained, and accordingly are not adequately managing the retained portion. It is essential that institutions engaging in securitization activities have appropriate front and back office staffing, internal and external accounting and legal support, audit or independent review coverage, information systems capacity, and oversight mechanisms to execute, record, and administer these transactions correctly.

Additionally, we are concerned about the use of inappropriate valuation and modeling methodologies to determine the initial and ongoing value of retained interests. Accounting rules provide a method to recognize an immediate gain (or loss) on the sale through booking a "retained interest;" however, the carrying value of that interest must be fully documented, based on reasonable assumptions, and regularly analyzed for any subsequent value impairment. The best evidence of fair value is a quoted market price in an active market. In circumstances where quoted market prices are not available, accounting rules allow fair value to be estimated. This estimate must be based on the "best information available in the circumstances." [2] An estimate of fair value must be supported by reasonable and current assumptions. If a best estimate of fair value is not practicable, the asset is to be recorded at zero in financial and regulatory reports.

History shows that unforeseen market events that affect the discount rate or performance of receivables supporting a retained interest can swiftly and dramatically alter its value. Without appropriate internal controls and independent oversight, an institution that securitizes assets may inappropriately generate "paper profits" or mask actual losses through flawed loss assumptions, inaccurate prepayment rates, and inappropriate discount rates. Liberal and unsubstantiated assumptions can result in material inaccuracies in financial statements, substantial write-downs of retained interests, and, if interests represent an excessive concentration of the institution's capital, the demise of the sponsoring institution.

Recent examinations point to the need for institution managers and directors to ensure that:

- Independent risk management processes are in place to monitor securitization pool performance on an aggregate and individual transaction level. An effective risk management function includes appropriate information systems to monitor securitization activities.

- Conservative valuation assumptions and modeling methodologies are used to establish, evaluate and adjust the carrying value of retained interests on a regular and timely basis.

- Audit or internal review staffs periodically review data integrity, model algorithms, key underlying assumptions, and the appropriateness of the valuation and modeling process for the securitized assets retained by the institution. The findings of such reviews should be reported directly to the board or an appropriate board committee.

[2] FAS 125, at par. 43

- Accurate and timely risk-based capital calculations are maintained, including recognition and reporting of any recourse obligation resulting from securitization activity.

- Internal limits are in place to govern the maximum amount of retained interests as a percentage of total equity capital.

- The institution has a realistic liquidity plan in place in case of market disruptions.

The following sections provide additional guidance relating to these and other critical areas of concern. Institutions that lack effective risk management programs or that maintain exposures in retained interests that warrant supervisory concern may be subject to more frequent supervisory review, more stringent capital requirements, or other supervisory action.

INDEPENDENT RISK MANAGEMENT FUNCTION

Institutions engaged in securitizations should have an independent risk management function commensurate with the complexity and volume of their securitizations and their overall risk exposures. The risk management function should ensure that securitization policies and operating procedures, including clearly articulated risk limits, are in place and appropriate for the institution's circumstances. A sound asset securitization policy should include or address, at a minimum:

- A written and consistently applied accounting methodology;

- Regulatory reporting requirements;

- Valuation methods, including FAS 125 residual value assumptions, and procedures to formally approve changes to those assumptions;

- Management reporting process; and

- Exposure limits and requirements for both aggregate and individual transaction monitoring.

It is essential that the risk management function monitor origination, collection, and default management practices. This includes regular evaluations of the quality of underwriting, soundness of the appraisal process, effectiveness of collections activities, ability of the default management staff to resolve severely delinquent loans in a timely and efficient manner, and the appropriateness of loss recognition practices. Because the securitization of assets can result in the current recognition of anticipated income, the risk management function should pay particular attention to the types, volumes, and risks of assets being originated, transferred and serviced. Both senior management and the risk management staff must be alert to any pressures on line managers to originate abnormally large volumes or higher risk assets in order to sustain ongoing income needs. Such pressures can

lead to a compromise of credit underwriting standards. This may accelerate credit losses in future periods, impair the value of retained interests and potentially lead to funding problems.

The risk management function should also ensure that appropriate management information systems (MIS) exist to monitor securitization activities. Reporting and documentation methods must support the initial valuation of retained interests and ongoing impairment analyses of these assets. Pool performance information has helped well-managed institutions to ensure, on a qualitative basis, that a sufficient amount of economic capital is being held to cover the various risks inherent in securitization transactions. The absence of quality MIS hinders management's ability to monitor specific pool performance and securitization activities more broadly. At a minimum, MIS reports should address the following:

Securitization summaries for each transaction - The summary should include relevant transaction terms such as collateral type, facility amount, maturity, credit enhancement and subordination features, financial covenants (termination events and spread account capture "triggers"), right of repurchase, and counterparty exposures. Management should ensure that the summaries are distributed to all personnel associated with securitization activities.

Performance reports by portfolio and specific product type - Performance factors include gross portfolio yield, default rates and loss severity, delinquencies, prepayments or payments, and excess spread amounts. The reports should reflect performance of assets, both on an individual pool basis and total managed assets. These reports should segregate specific products and different marketing campaigns.

Vintage analysis for each pool using monthly data - Vintage analysis helps management understand historical performance trends and their implications for future default rates, prepayments, and delinquencies, and therefore retained interest values. Management can use these reports to compare historical performance trends to underwriting standards, including the use of a validated credit scoring model, to ensure loan pricing is consistent with risk levels. Vintage analysis also helps in the comparison of deal performance at periodic intervals and validates retained interest valuation assumptions.

Static pool cash collection analysis - This analysis entails reviewing monthly cash receipts relative to the principal balance of the pool to determine the cash yield on the portfolio, comparing the cash yield to the accrual yield, and tracking monthly changes. Management should compare the timing and amount of cash flows received from the trust with those projected as part of the FAS 125 retained interest valuation analysis on a monthly basis. Some master trust structures allow excess cash flow to be shared between series or pools. For revolving asset trusts with this master trust structure, management should perform a cash collection analysis for each master trust structure. These analyses are essential in assessing the actual performance of the portfolio in terms of default and prepayment rates. If cash receipts are less than those assumed in the original valuation of the retained interest, this analysis will provide management and the board with an early warning of possible problems with collections or extension practices, and impairment of the retained interest.

Sensitivity analysis - Measuring the effect of changes in default rates, prepayment or payment rates, and discount rates will assist management in establishing and validating the carrying value of the retained interest. Stress tests should be performed at least quarterly. Analyses should consider potential adverse trends and determine "best," "probable," and "worst case" scenarios for each event. Other factors to consider are the impact of increased defaults on collections staffing, the timing of cash flows, "spread account" capture triggers, over-collateralization triggers, and early amortization triggers. An increase in defaults can result in higher than expected costs and a delay in cash flows, decreasing the value of the retained interests. Management should periodically quantify and document the potential impact to both earnings and capital, and report the results to the board of directors**.** Management should incorporate this analysis into their overall interest rate risk measurement system.[3] Examiners will review the analysis conducted by the institution and the volatility associated with retained interests when assessing the Sensitivity to Market Risk component rating.

Statement of covenant compliance - Ongoing compliance with deal performance triggers as defined by the pooling and servicing agreements should be affirmed at least monthly. Performance triggers include early amortization, spread capture, changes to over-collateralization requirements, and events that would result in servicer removal.

VALUATION AND MODELING PROCESSES

The method and key assumptions used to value the retained interests and servicing assets or liabilities must be reasonable and fully documented. The key assumptions in all valuation analyses include prepayment or payment rates, default rates, loss severity factors, and discount rates. The Agencies expect institutions to take a logical and conservative approach when developing securitization assumptions and capitalizing future income flows. It is important that management quantifies the assumptions on a pool-by-pool basis and maintains supporting documentation for all changes to the assumptions as part of the valuation process, which should be done no less than quarterly. Policies should define the acceptable reasons for changing assumptions and require appropriate management approval.

An exception to this pool-by-pool valuation analysis may be applied to revolving asset trusts if the master trust structure allows excess cash flows to be shared between series. In a master trust, each certificate of each series represents an undivided interest in all of the receivables in the trust. Therefore, valuations are appropriate at the master trust level.

In order to determine the value of the retained interest at inception, and make appropriate adjustments going forward, the institution must implement a reasonable modeling process to comply with FAS 125. The Agencies expect management to employ reasonable and conservative valuation

[3] Under the Joint Agency Policy Statement on Interest Rate Risk, institutions with a high level of exposure to interest rate risk relative to capital will be directed to take corrective action. Savings associations can find OTS guidance on interest rate risk in Thrift Bulletin 13a - Management of Interest Rate Risk, Investment Securities, and Derivative Activities.

assumptions and projections, and to maintain verifiable objective documentation of the fair value of the retained interest. Senior management is responsible for ensuring the valuation model accurately reflects the cash flows according to the terms of the securitization's structure. For example, the model should account for any cash collateral or over-collateralization triggers, trust fees, and insurance payments if appropriate. The board and management are accountable for the "model builders" possessing the necessary expertise and technical proficiency to perform the modeling process. Senior management should ensure that internal controls are in place to provide for the ongoing integrity of MIS associated with securitization activities.

As part of the modeling process, the risk management function should ensure that periodic validations are performed in order to reduce vulnerability to model risk. Validation of the model includes testing the internal logic, ensuring empirical support for the model assumptions, and back-testing the models with actual cash flows on a pool-by-pool basis. The validation process should be documented to support conclusions. Senior management should ensure the validation process is independent from line management as well as the modeling process. The audit scope should include procedures to ensure that the modeling process and validation mechanisms are both appropriate for the institution's circumstances and executed consistent with the institution's asset securitization policy.

USE OF OUTSIDE PARTIES

Third parties are often engaged to provide professional guidance and support regarding an institution's securitization activities, transactions, and valuing of retained interests. The use of outside resources does not relieve directors of their oversight responsibility, or senior management of its responsibilities to provide supervision, monitoring, and oversight of securitization activities, and the management of the risks associated with retained interests in particular. Management is expected to have the experience, knowledge, and abilities to discharge its duties and understand the nature and extent of the risks presented by retained interests and the policies and procedures necessary to implement an effective risk management system to control such risks. Management must have a full understanding of the valuation techniques employed, including the basis and reasonableness of underlying assumptions and projections.

INTERNAL CONTROLS

Effective internal controls are essential to an institution's management of the risks associated with securitization. When properly designed and consistently enforced, a sound system of internal controls will help management safeguard the institution's resources, ensure that financial information and reports are reliable, and comply with contractual obligations, including securitization covenants. It will also reduce the possibility of significant errors and irregularities, as well as assist in their timely detection when they do occur. Internal controls typically: (1) limit authorities, (2) safeguard access to and use of records, (3) separate and rotate duties, and (4) ensure both regular and unscheduled reviews, including testing.

The Agencies have established operational and managerial standards for internal control and information systems.[4] An institution should maintain a system of internal controls appropriate to its size and the nature, scope, and risk of its activities. Institutions that are subject to the requirements of FDIC regulation 12 CFR Part 363 should include an assessment of the effectiveness of internal controls over their asset securitization activities as part of management's report on the overall effectiveness of the system of internal controls over financial reporting. This assessment implicitly includes the internal controls over financial information that is included in regulatory reports.

AUDIT FUNCTION OR INTERNAL REVIEW

It is the responsibility of an institution's board of directors to ensure that its audit staff or independent review function is competent regarding securitization activities. The audit function should perform periodic reviews of securitization activities, including transaction testing and verification, and report all findings to the board or appropriate board committee. The audit function also may be useful to senior management in identifying and measuring risk related to securitization activities. Principal audit targets should include compliance with securitization policies, operating and accounting procedures (FAS 125), and deal covenants, and accuracy of MIS and regulatory reports. The audit function should also confirm that the institution's regulatory reporting process is designed and managed in such a way to facilitate timely and accurate report filing. Furthermore, when a third party services loans, the auditors should perform an independent verification of the existence of the loans to ensure balances reconcile to internal records.

REGULATORY REPORTING

The securitization and subsequent removal of assets from an institution's balance sheet requires additional reporting as part of the regulatory reporting process. Common regulatory reporting errors stemming from securitization activities include:

- Failure to include off-balance sheet assets subject to recourse treatment when calculating risk-based capital ratios;
- Failure to recognize retained interests and retained subordinate security interests as a form of credit enhancement;
- Failure to report loans sold with recourse in the appropriate section of the regulatory report; and
- Over-valuing retained interests.

An institution's directors and senior management are responsible for the accuracy of its regulatory reports. Because of the complexities associated with securitization accounting and risk-based capital treatment, attention should be directed to ensuring that personnel who prepare these reports maintain

[4] Safety and Soundness Standards 12 CFR Part 3 (OCC), 12 CFR Part 570 (OTS).

current knowledge of reporting rules and associated interpretations. This often will require ongoing support by qualified accounting and legal personnel.

Institutions that file the Report of Condition and Income (Call Report) should pay particular attention to the following schedules on the Call Report when institutions are involved in securitization activities: *Schedule RC-F: Other Assets*; *Schedule RC-L: Off Balance Sheet Items*; and *Schedule RC-R: Regulatory Capital*. Institutions that file the Thrift Financial Report (TFR) should pay particular attention to the following TFR schedules: *Schedule CC: Consolidated Commitments and Contingencies, Schedule CCR: Consolidated Capital Requirement, and Schedule CMR: Consolidated Maturity and Rate.*

Under current regulatory report instructions, when an institution's supervisory agency's interpretation of how generally accepted accounting principles (GAAP) should be applied to a specified event or transaction differs from the institution's interpretation, the supervisory agency may require the institution to reflect the event or transaction in its regulatory reports in accordance with the agency's interpretation and amend previously submitted reports.

MARKET DISCIPLINE AND DISCLOSURES

Transparency through public disclosure is crucial to effective market discipline and can reinforce supervisory efforts to promote high standards in risk management. Timely and adequate information on the institution's asset securitization activities should be disclosed. The information contained in the disclosures should be comprehensive; however, the amount of disclosure that is appropriate will depend on the volume of securitizations and complexity of the institution. Well-informed investors, depositors, creditors and other bank counterparties can provide a bank with strong incentives to maintain sound risk management systems and internal controls. Adequate disclosure allows market participants to better understand the financial condition of the institution and apply market discipline, creating incentives to reduce inappropriate risk taking or inadequate risk management practices. Examples of sound disclosures include:

- Accounting policies for measuring retained interests, including a discussion of the impact of key assumptions on the recorded value;
- Process and methodology used to adjust the value of retained interests for changes in key assumptions;
- Risk characteristics, both quantitative and qualitative, of the underlying securitized assets;
- Role of retained interests as credit enhancements to special purpose entities and other securitization vehicles, including a discussion of techniques used for measuring credit risk; and
- Sensitivity analyses or stress testing conducted by the institution showing the effect of changes in key assumptions on the fair value of retained interests.

RISK-BASED CAPITAL FOR RECOURSE AND LOW LEVEL RECOURSE TRANSACTIONS

For regulatory purposes, recourse is generally defined as an arrangement in which an institution retains the risk of credit loss in connection with an asset transfer, if the risk of credit loss exceeds a pro rata share of the institution's claim on the assets.[5] In addition to broad contractual language that may require the selling institution to support a securitization, recourse can also arise from retained interests, retained subordinated security interests, the funding of cash collateral accounts, or other forms of credit enhancements that place an institution's earnings and capital at risk. These enhancements should generally be aggregated to determine the extent of an institution's support of securitized assets. Although an asset securitization qualifies for sales treatment under GAAP, the underlying assets may still be subject to regulatory risk-based capital requirements. Assets sold with recourse should generally be risk-weighted as if they had not been sold.

Securitization transactions involving recourse may be eligible for "low level recourse" treatment.[6] The Agencies' risk-based capital standards provide that the dollar amount of risk-based capital required for assets transferred with recourse should not exceed the maximum dollar amount for which an institution is contractually liable. The "low level recourse" treatment applies to transactions accounted for as sales under GAAP in which an institution contractually limits its recourse exposure to less than the full risk-based capital requirements for the assets transferred. Under the low level recourse principle, the institution holds capital on approximately a dollar-for-dollar basis up to the amount of the aggregate credit enhancements.

Low level recourse transactions should be reported in Schedule RC-R of the Call Report or Schedule CCR of the TFR using either the "direct reduction method" or the "gross-up method" in accordance with the regulatory report instructions.

If an institution does not contractually limit the maximum amount of its recourse obligation, or if the amount of credit enhancement is greater than the risk-based capital requirement that would exist if the assets were not sold, the low level recourse treatment does not apply. Instead, the institution must hold risk-based capital against the securitized assets as if those assets had not been sold.

Finally, as noted earlier, retained interests that lack objectively verifiable support or that fail to meet the supervisory standards set for in this document will be classified as loss and disallowed as assets of the institution for regulatory capital purposes.

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[5] The risk-based capital treatment for sales with recourse can be found at 12 CFR Part 3 Appendix A, Section (3)(b)(1)(iii) {OCC}, 12 CFR Part 567.6(a)(2)(i)(c) {OTS}. For a further explanation of recourse see the glossary entry "Sales of Assets for Risk-Based Capital Purposes" in the instructions for the Call Report.

[6] The banking agencies' low level recourse treatment is described in the Federal Register in the following locations: 60 Fed. Reg. 17986 (April 10, 1955) (OCC); 60 Fed. Reg. 8177 (February 13, 1995) (FRB); 60 Fed. Reg. 15858 (March 28, 1995)(FDIC). OTS has had a low level recourse rule in 12 CFR Part 567.6(a)(2)(i)(c) since 1989. A brief explanation is also contained in the instructions for regulatory reporting in section RC-R for the Call Report or schedule CCR for the TFR.

INSTITUTION IMPOSED CONCENTRATION LIMITS ON RETAINED INTERESTS

The creation of a retained interest (the debit) typically also results in an offsetting "gain on sale" (the credit) and thus generation of an asset. Institutions that securitize high yielding assets with long durations may create a retained interest asset value that exceeds the risk-based capital charge that would be in place if the institution had not sold the assets (under the existing risk-based capital guidelines, capital is not required for the amount over eight percent of the securitized assets). Serious problems can arise for institutions that distribute contrived earnings only later to be faced with a downward valuation and charge-off of part or all of the retained interests.

As a basic example, an institution could sell $100 in subprime home equity loans and book a retained interest of $20 using liberal "gain on sale" assumptions. Under the current capital rules, the institution is required to hold approximately $8 in capital. This $8 is the current capital requirement if the loans were never removed from the balance sheet (eight percent of $100 = $8). However, the institution is still exposed to substantially all of the credit risk, plus the additional risk to earnings and capital from the volatility of the retained interest. If the value of the retained interest decreases to $10 due to inaccurate assumptions or changes in market conditions, the $8 in capital is insufficient to cover the entire loss.

Normally, the sponsoring institution will eventually receive any excess cash flow remaining from securitizations after investor interests have been met. However, recent experience has shown that retained interests are vulnerable to sudden and sizeable write-downs that can hinder an institution's access to the capital markets, damage its reputation in the market place, and in some cases, threaten its solvency. Accordingly, the Agencies expect an institution's board of directors and management to develop and implement policies that limit the amount of retained interests that may be carried as a percentage of total equity capital, based on the results of their valuation and modeling processes. Well constructed internal limits also serve to lessen the incentive of institution personnel to engage in activities designed to generate near term "paper profits" that may be at the expense of the institution's long term financial position and reputation.

SUMMARY

Asset securitization has proven to be an effective means for institutions to access new and diverse funding sources, manage concentrations, improve financial performance ratios, and effectively serve borrowing customers. However, securitization activities also present unique and sometimes complex risks that require board and senior management attention. Specifically, the initial and ongoing valuation of retained interests associated with securitization, and the limitation of exposure to the volatility represented by these assets, warrant immediate attention by management.

Moreover, as mentioned earlier in this statement, the Agencies are studying various issues relating to securitization practices, including whether restrictions should be imposed that would limit or eliminate the amount of retained interests that qualify as regulatory capital. In the interim, the Agencies will review affected institutions on a case-by-case basis and may require, in appropriate circumstances, that institutions hold additional capital commensurate with their risk exposure. In

addition, the Agencies will study, and issue further guidance on, institutions' exposure to implicit recourse obligations and the liquidity risk associated with over reliance on asset securitization as a funding source.

CAPITAL TREATMENT FOR RECOURSE, DIRECT CREDIT SUBSTITUTES, AND RESIDUAL INTERESTS

On November 29, 2001, OTS and the other federal banking agencies issued a new capital rule for recourse, direct credit substitutes, and residual interests in asset securitizations. The new capital rule addresses many aspects of risk resulting from asset securitization. While it integrates some aspects of OTS's existing capital rules and guidance for recourse and direct credit substitutes, the new rule is far more extensive because of a very complex, evolving securitization marketplace. This Appendix outlines and highlights some aspects of the rule that pertain to securitizations. However, because of the complex nature of the rule, you should also refer to the rule itself and its extensive preamble published in the Federal Register, both of which are available on the OTS web site.

In addition, you can find the definitions pertaining to the new rule along with other terms used in the OTS capital regulations in 12 CFR §567.1, and the capital treatment from the new rule in §567.6(b). Refer also to CEO Letter No. 162, "Implicit Recourse in Asset Securitizations," and to CEO Letter No. 163, "Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations." These CEO letters, issued by OTS on May 23, 2002, provide important supplementary information.

You should also note that through the rule's reservation of authority, OTS will look to the substance of a transaction regardless of how the allocation of risk is categorized by others. OTS may find that the proposed capital treatment by the thrift does not appropriately reflect risk to the institution. OTS may then require the thrift to apply another risk weight, conversion factor, or treatment that OTS deems appropriate.

Recourse, In General

The term "recourse" refers to an institution's retention, in form or in substance, of any credit risk directly or indirectly associated with an asset it has sold. A recourse obligation typically arises when an institution transfers an asset in a sale (a sale according to generally accepted accounting principles) and retains an obligation to repurchase the asset or to otherwise absorb losses on the asset. Examples of recourse obligations include:

- Assets sold under an agreement to repurchase.
- Credit-enhancing representations and warranties related to sold assets.
- Retained loan servicing with an agreement under which the savings association is responsible for losses associated with the loans serviced (except for Servicer Cash Advances as defined in §567.1).
- Clean-up calls on assets sold (except for clean-up calls that are 10 percent or less of the original pool balance and that are exercisable at the option of the savings association).
- Credit derivatives that absorb more than the savings association's pro rata share of losses on transferred assets.
- Loan strips sold where the maturity of the transferred portion of the loan is shorter than the commitment under which the loan is drawn.

Recourse can also exist implicitly. Implicit recourse generally arises when a thrift institution repurchases assets, absorbs losses, or otherwise supports assets that it has sold, in instances where it is not contractually required to do so. Refer also to CEO Letter No. 162.

As with other off-balance-sheet exposures, you must convert a recourse exposure to an on-balance-sheet asset by obtaining a credit equivalent amount. In the case of a simple loan sale with recourse, which may or may not involve asset securitization, you convert the entire balance of the loans sold to an on-balance-sheet asset using the 100 percent conversion factor. (For information about converting off-balance-sheet assets to on-balance-sheet assets using conversion factors, refer to §567.6(a)(2), as well as the Thrift Financial Report Instruction Manual.)

In many instances, an institution retains a recourse exposure that is limited in dollar amount or as a percentage of assets transferred, but is designed to absorb the first losses that occur for the entire pool of transferred assets. The recourse exposure thus

absorbs more than its pro rata share of losses. As a result, the general capital treatment for most recourse exposures is "gross-up," whereby the institution must hold capital for the full amount of the transferred assets as if they were still on the balance sheet. OTS applies this relatively rigorous capital treatment because the recourse exposure receives more than its pro rata share of risk; it has the concentrated risk of all of the assets senior to it in the pool.

Therefore, using the required gross-up approach you obtain the credit equivalent amount by multiplying the full amount of the credit-enhanced assets for which the savings institution directly or indirectly retains or assumes credit risk by a 100 percent conversion factor. You assign this credit equivalent amount to the risk-weight category appropriate to the obligor in the underlying transaction after considering any associated guarantees or collateral. However:

- A thrift institution does not have to hold recourse capital for Qualifying 1-4 Family Loans that a thrift institution has sold, if the sales contract allows only a 120-day period for return of those loans. The loans must have been originated within one year before sale. This exception would apply to a simple loan sale as well as a sale of loans into a securitization.
- There is an exception to the gross-up treatment for low-level recourse exposures where recourse is legally and contractually limited to an amount less than the on-balance-sheet capital requirement. OTS limits the capital requirement to the maximum exposure rather than the full capital charge.
- A ratings based approach allows an institution to reduce its capital requirement for lower-risk, highly rated recourse exposures – Section C below.

Example: Recourse Sale of Loans

Thrift has sold $100 in Qualifying 1-4 Family (that is, 50 percent risk weight) Loans into a securitization with an agreement to repurchase them for up to 180 days: Capital requirement (until the recourse period expires) is: ($100) x (100% conversion factor) x (50% r.w.) x (8%) = $4

Note: If the sales agreement limited the recourse to 120 days or less, there would be no capital requirement.

When a thrift's recourse exposure is in a "first loss" or other subordinated position, the thrift must gross-up the entire pool above it (all the more senior exposure), before converting it to an on-balance-sheet credit equivalent amount. However, the ratings-based approach can apply (see Ratings-Based Approach Section).

Example: Recourse Sale with a First Loss Position Using Gross-up

An institution has retained the "1st dollar loss" subordinated interest of $5 in a securitization of $100 in Qualifying 1-4 Family Loans. Capital requirement is ($100) x (50% r.w.) x (8%) = $4. That is, the thrift must gross-up its exposure to include all exposures that are more senior to the piece that the thrift owns (in this case the entire pool). This example assumes that the first dollar loss position is not a credit-enhancing IO Strip (See Residual Interests Section below).

Example: Low-Level Recourse

An institution contractually limits its maximum recourse exposure to less than the normal on-balance-sheet capital requirement for the assets sold with recourse. For example, if an institution sells a $100,000 mortgage loan with 1 percent recourse, it is liable for $1,000 in losses. Instead of requiring the savings association to hold $4,000 in capital (assuming the loan qualifies for 50 percent risk weight), OTS requires the institution hold $1,000 in capital, the maximum recourse exposure.

Direct Credit Substitutes

An institution can guaranty, purchase, or assume a recourse exposure from another organization. We generally refer to these exposures as direct credit substitutes. A purchased subordinated security is an example of a direct credit substitute. Direct credit substitutes can be on- or off-balance-sheet. Examples of such direct credit substitutes include:

- Financial standby letters of credit that support financial claims on a third party that exceed the

savings institution's pro rata share of the financial claim.

- Purchased subordinated interests that absorb more than their pro rata share of losses from the underlying assets.

When a thrift purchases a subordinated asset-backed security or similar interest, the thrift generally must gross-up the risk exposure in order to determine the capital requirement. This means that the thrift must hold capital against the total amount of the subordinated security plus all assets senior to it. However, the low-level recourse rule can apply to direct credit substitutes, and the ratings-based approach may apply (see Ratings-Based Approach Section below).

Example: Direct Credit Substitute – Purchased Subordinated Interest

An institution has purchased the "1st dollar loss" subordinated interest of $5 in a securitization of $100 in Qualifying 1-4 Family Loans. Capital requirement is ($100) x (50% r.w.) x (8%) = $4. That is, the thrift must gross-up its exposure to include all exposures that are more senior to the security that the thrift owns (in this case the entire pool). This example assumes that the first dollar loss position is not a credit-enhancing IO Strip (See Residual Interests Section below).

Capital Treatment for Residual Interests

Residual interests are on-balance-sheet risk exposures arising from sales (transfers) of financial assets that expose a thrift to credit risk on those transferred assets that exceeds a pro rata share of any claim that the thrift has on the assets. Residual interests do not include interests purchased from a third party, except for credit-enhancing interest-only strips (see below). A primary example of a residual is a retained subordinated interest on assets formerly owned by the institution.

The standard capital treatment for most residual interests is dollar-for-dollar. That is, the thrift must hold one dollar in capital for every one dollar in residual interests.

Example: Residual Interests

An institution has retained the "first dollar loss" subordinated interest of $15 in its own securitization of $100 in Qualifying 1-4 Family Loans. The risk based capital requirement is $15. (That is, $1 of capital for $1 of residual interests – dollar-for-dollar capital.)

There are two approaches to reporting dollar-for-dollar capital on the TFR:

- The super risk-weight approach, where you multiply the asset balance by 12.5, before risk weighting it. Because 12.5 is the reciprocal of 8 percent, after multiplying the asset by the 8 percent risk-based capital requirement, the result is dollar-for-dollar capital.
- The simplified method, where you deduct the exposure from total capital.

Credit-Enhancing Interest-Only Strips

Credit-enhancing interest-only strips (IOs), whether retained or purchased, pose higher risk than most other residuals. If a thrift has a concentration of more than 25 percent of Tier One Capital in IOs, it must deduct from Tier One Capital, the portion of IOs that exceeds 25 percent of Tier 1 Capital.

Example: Credit-Enhancing IO Strip

The institution has the "1st dollar loss" subordinated interest (whether retained or purchased) that is a credit-enhancing IO strip, of $15 in a securitization of subprime auto loans. Core Capital is $40 at onset. The thrift does not have any other IOs.

(1) 25% of $40 is $10. $15 exceeds $10 by $5, so you deduct $5 from Core Capital.

(2) New Core Capital is $35.

(3) The institution must also hold $10 in Risk-Based Capital for this exposure because you deduct the same amount, $5, as above from the IO strip. The thrift must hold dollar-for-dollar risk-based capital against the remaining balance.

The Ratings-Based Approach

The ratings-based approach allows for the possibility of a lower risk-based capital requirement (reflecting less risk) for certain recourse, direct credit substitutes, and residual interests arising from asset securitization. Ratings must be from one or more Nationally Recognized Statistical Rating Organizations (NRSROs). (See §567.1, i.e. Standard & Poors, Moody's, and Fitch Ratings.)

There are exceptions:

- Credit-enhancing IO strips are not eligible for the Ratings-Based Approach.
- Bonds not in security form are not eligible.
- Bonds not backed by assets are not eligible.

In general, the following schedule applies to long-term ratings:

Long-Term Rating Category	*Examples*	*Risk Weight*
Highest or second highest investment grade.....	*AAA or AA*	*20%*
Third highest investment grade....	*A*	*50%*
Lowest investment grade.....	*BBB*	*100%*
One category below investment grade.....	*BB*	*200%*
More than one category below investment grade, or unrated.....	*B or unrated*	*Not eligible for ratings-based approach.*

Note: There is also a separate short-term rating table. Refer to the regulations.

The Ratings-Based Approach makes a distinction between "traded" and "nontraded" positions. Nontraded positions require the following:

- An external rating by more than one NRSRO
- Minimum rating assigned by each NRSRO that meets all of the following:
  - Long Term: At least one category below investment grade.
  - Short Term: Investment Grade.
  - Rating must be publicly available.
  - Rating must be based on the same criteria as for traded positions.

Note: The capital regulations allow for use of a thrift's internal ratings in limited circumstances after initial and ongoing OTS approval. The thrift must use software and ratings that correspond credibly and reliably to the NRSRO ratings.

Program Ratings

Program Ratings can be used for certain risk exposures in specific secondary market loan programs. A thrift may make use of program ratings after OTS has reviewed the nature of the program and accepts, under specific conditions, a rating assigned to a particular risk exposure that the thrift retains. The rating must correspond credibly and reliably with an NRSRO rating.

SECURITIZATION INFORMATION REQUESTS

You may find the following data, to be supplied by the institution before the examination, useful in your examination efforts. The information should be for the most recent quarter end. In addition, you should ask the thrift to summarize all significant adjustments to its policy or practices associated with the securitization activity since the last examination.

Risk Management

1. A copy of the strategic or business plans for asset securitization activities.

2. Primary and contingency liquidity funding plans as they relate to securitization activities.

3. Copies of all written policies and procedures on asset securitization, that cover the following:

   a. Establishing and monitoring adherence to risk limits, include:

      i. Exposure limits for both aggregate and individual transactions.

      ii. Procedures on how changes can be made to those limits or exceptions approved.

   b. Hedging and correlation requirements.

   c. Accounting methodology, including written standards for:

      i. Initial valuation of assets and liabilities arising out of securitization activities.

      ii. Recording gains on sale.

      iii. Periodic valuation of residual and servicing assets.

      iv. Investor account management.

      v. Interest and fee accruals.

      vi. Delinquency reporting.

   d. Sensitivity analysis, including:

      i. Policies that govern acceptable methodologies and assumptions.

      ii. Procedures used to formally approve changes to assumptions.

   e. Internal controls.

   f. Internal audit.

   g. Collection practices.

   h. Loss migration.

   i. Investor reporting.

4. A listing and account description of all general ledger accounts associated with the securitization function and corresponding SC or SO Thrift Financial Report (TFR) line items.

5. A copy of the most recent performance statistics for securitizations reported to the trustee.

6. Copy of current organizational chart of the asset securitization unit of the bank including phone numbers for each individual.

7. A list and meeting schedules for all board and/or senior management committees that oversee asset securitization activities. Please make meeting minutes available for our review.

8. Access to the prospectus or series supplement and pooling and servicing agreement for each outstanding transaction.

9. Information detailing the potential contractual or contingent liability from guarantees, underwriting, and servicing of securitized assets.

10. Provide a list of all third party vendors (accountants, rating agency personnel, investment bankers, law firms, etc.) used by the institution for securitized or serviced assets, including:

    a. Services rendered.

    b. The contact person for each vendor.

c. Access to contracts.

d. Copies of the latest analysis as to assessment of performance.

e. Most recent audit report, either by you or third party.

f. The latest financial analysis on the company contracted.

Residual Valuation

11. A description of your residual valuation modeling process, and the validation of the model.

12. A copy of the residual valuation model input and output supporting the values reported in the most recent TFR and initial value estimate.

13. Documentation either internal or external used to support the assumptions used to value the retained interests (discount rate, gross yields, default rate, loss severity rate, prepayments) for both the initial and current estimates.

Management Information Systems

14. A description of the risk measurement and monitoring system for securitization activities and copies of all related MIS reports (that is, tracking reports, exposure reports, valuation reports, profitability analyses, etc.) for the most recent TFR filing.

15. A copy of management reports used for tracking and monitoring the performance of loan production with different characteristics for the last month end and most recent TFR filing.

16. A credit score distribution for your production (nonsecuritized) and outstanding servicing portfolio (securitized).

17. Securitization summaries for each outstanding transaction (see attached sample report format).

18. Performance reports by portfolio and specific product type. Performance factors include gross portfolio yield, default rates and loss severity, delinquencies, prepayments, and excess spread amounts.

19. Vintage analysis for each pool securitized using monthly data.

20. Copies of your most recent static pool cash collections analyses.

21. Sensitivity analysis as required by FAS 140.

22. Statement of covenant compliance for all relevant deal triggers.

23. The most recent quarter end summary report from both nonsecuritized and securitized assets detailing the number of accounts and dollars outstanding for assets that have been:

    a. Modified.

    b. Re-written.

    c. Extended.

    d. Restructured.

    e. Repurchased.

    f. Re-aged.

    g. Assumed.

    h. Made to facilitate.

Regulatory Reporting and Risk-Based Capital

24. Access to the supporting work papers, and a description of how the IO strip, servicing assets, and other credit enhancing assets are reported on the TFR.

25. A schedule supporting the core and risk-based capital calculations for the securitization activity.

FAS 140

26. Copies of the general ledger entries demonstrating the initial entries made when a deal was closed (i.e., removing transferred assets from the books and recording retained interests).

27. A description of current accounting practices for loan fees and costs.

28. The most recently completed impairment analysis and initial valuation calculation for servicing assets and liabilities, interest-only strip securities/residuals. Please identify clearly how current and future monthly cash flows from securitizations support current asset carrying values.

29. The most recently completed impairment analysis and initial valuation calculation for servicing assets. Explain your procedures and methods.

30. Please provide the valuation and accounting treatment for overcollateralization balances and retained portions of securitizations.

Audit

31. A copy of the most recent Internal Audit Plan and a listing of current audit ratings and outstanding audit findings, by area specific to the securitization function.

32. Copies of the most recent internal and external audit reports addressing asset securitization and management's response to deficiencies. In addition, access to external audit work papers to be made available upon request.

Servicing Practices

33. A description of the current processes, time frames, and procedures, for timely loss recognition and nonaccrual treatment for defaulted loans.

34. A description of the terms and conditions for re-aging, extension, modification, and loss mitigation activities. Please provide the monthly reports used to monitor these activities.

35. A copy of the most recently prepared management report for servicing that outlines operational results. Please include securitization and loan portfolio vintage level delinquency, roll rates, loss severity factors, and cumulative loss-to-date information.

36. Provide a list of servicing fees received and evidence that the fee represents adequate compensation pursuant to SFAS No. 140.

37. Identify and explain any recourse provisions in servicing contracts.

38. A listing of all servicer advances on a per transaction basis and whether or not such advances have credit enhancing features.

Market Acceptance

39. Access to the Correspondence file(s) showing requests from and responses to rating agencies, investors, etc.

40. A copy of all investor, rating agency, or other third party audits of servicing activities and PMI companies, and insurance wrap companies.

41. Rating changes on outstanding securities, if any.

42. Are there tranches that are nonrated, but more senior in the securitization structure to rated tranches.

INTRODUCTION

The term equity investment covers a wide range of investments. Many of these investments are not permissible for federal savings associations because of their inherent risk. Equity investments are riskier than loans and other permissible investments because all creditors are paid in full before investors' claims are paid. The return on equity often requires a sale, rather than amortization from known cash flow streams. Because of the greater risk of loss, savings associations should be extraordinarily cautious when making equity investments. Sound internal policies and procedures and effective diversification of equity investments by individual savings associations is extremely important to limit overall portfolio risk. Certain equity investments will not require the same level of review that is necessary for equity investments that possess higher risk factors. An equity investment of moderate risk has the following characteristics:

- The savings association is a passive investor in an entity engaged in permissible savings association activities.
- The savings association's liability does not exceed its investment.

The Home Owners' Loan Act (HOLA) and Office of Thrift Supervision (OTS) regulations substantially limit a federal savings association's direct equity investment authority. Permissible equity investments nevertheless can present substantial risk to the savings association. Your review should reflect the level of risk involved. You should consider the following items when determining the scope of your review:

- The adequacy of oversight by the board of directors.
- Compliance with sound internal policies and procedures for the acquisition, management, and monitoring of equity investments.
- Composition of the equity investment portfolio.
- Regulatory capital levels.
- Equity investment/loan concentrations.

This Section provides an overview of the following areas:

- Equity investments authorized for federal savings associations.
- Types of equity investments and applicable limitations.
- Potential safety and soundness concerns associated with these investments.

PERMISSIBLE EQUITY INVESTMENTS

Unless stated otherwise, this Section specifically refers to a federal savings association's authority to make equity investments. State-chartered savings associations must consult applicable state laws and regulations to determine whether similar authority exists. The Federal Deposit Insurance Act (FDIA) at 12 USC §1831e(c) limits state savings associations' equity investment authority to the type and amount permissible for federal savings associations. Federal law pre-empts state laws permitting extensive equity investments by state-chartered savings associations. In the event that states have equity investment regulations that are more restrictive than OTS regulations, state savings associations must adhere to the more stringent standard.

HOLA §5(c)(1) contains a list of investments, which include securities of certain government sponsored entities, that are permissible for federal savings associations.

This list substantially limits a federal savings association's authority to purchase an equity interest (for example, common or preferred stock) in a corporation that is not a subordinate organiza-

tion. As discussed further below, the association can make certain de minimis community development-related investments as well as pass-through investments. The association can also acquire personal property for sale or lease and make certain real estate investments.

Notwithstanding the limited scope of allowable equity investments, such investments could present substantial risk to the investing savings association. In addition to establishing the association's authority to make the investment, consider the following:

- Adequacy of internal policies, procedures, and controls for the acquisition, management, and monitoring of equity investments.
- Accuracy of the accounting treatment for, and valuation of, equity investments.
- Compliance with OTS's capital standards, savings association financial reporting requirements, and asset classification policy.
- Whether a significant concentration of assets exists, including equity investments in, and loans to, related entities. For example, limited partnerships that share a common third-party investor or joint ventures that derive cash flow from a single project.

Congress grandfathered some equity investments of federal savings associations chartered before October 15, 1982, or that converted from a mutual savings bank charter before August 9, 1989. See 12 USC §1464(i)(4). Federal savings associations, however, must file notice with the Federal Deposit Insurance Corporation (FDIC) regarding grandfathered equity investments. Notwithstanding available grandfathered status under §1464(i)(4), §1828(m)(3) of the FDIA may prohibit or limit the grandfathered authority.

A federal savings association may have the FDIC's approval consistent with 12 CFR §303.13(d) to retain an impermissible investment that a former state-chartered savings association held on August 8, 1989. In such cases, the savings association should provide access to records documenting such approval or an acceptable divestiture plan.

TYPES OF EQUITY INVESTMENTS

Equity Securities

For OTS regulatory purposes, equity securities can include corporate stock, investments in joint ventures, profit-sharing arrangements and loans having profit-sharing features. Federal thrifts may invest in the following types of equity securities consistent with applicable statutory and regulatory standards. (Also, see discussion of subordinate organizations and pass-through investment authority.)

- Securities of U.S. government-sponsored corporations. (12 USC §1464(c)(1)). Federal thrifts may invest in the securities of the following government-sponsored corporations without investment limit:
  - Federal National Mortgage Association (Fannie Mae)
  - Government National Mortgage Association (Ginnie Mae)
  - Federal Home Loan Mortgage Corporation (Freddie Mac)
  - Student Loan Marketing Association (Sallie Mae)
  - Federal Home Loan Bank

Federal thrifts may also invest in Federal Agricultural Mortgage Corporation (Farmer Mac) common stock in nominal amounts necessary to enable them to sell agricultural loans to Farmer Mac and participants in Farmer Mac's secondary market program.

- National Housing Partnership Corporations and related partnerships and joint ventures. (12 USC §1464(c)(1)(N))
- Business development credit corporations up to the lesser of 0.5 percent of total outstanding loans or $250,000. (12 USC § 1464(c)(4)(A))
- Shares of an open-ended management investment company that is registered with the SEC under the Investment Company Act of 1940.

(12 USC §1464(c)(4)(D)). *Note:* The portfolio of the open-ended investment company must consist only of investments that a federal savings association by law or regulation, without limitation as to percentage of assets, may invest in, sell, redeem, hold, or otherwise deal in.

- Shares in minority enterprise small business investment companies established for the purpose of aiding the members of a Federal Home Loan Bank. The thrift's investment must not exceed one percent of its assets. (12 USC §1464(c)(4)(D))

- Shares in bankers' banks or their holding companies that have depository institutions or depository institution holding companies as investors in an amount up to 10 percent of the federal thrift's capital stock and unimpaired surplus. (12 USC §1464(c)(4)(E))

SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, requires that the association report most equity securities at fair value (available-for-sale), rather than at amortized cost. Refer to the Thrift Financial Report (TFR) Instruction manual for guidance on reporting such investments.

For a detailed discussion of savings association investment policies and procedures, refer to the Investment Securities handbook section. Also, Handbook Section 410, Financial Records and Reports, addresses accounting considerations for determining the accuracy of savings association financial reporting.

De Minimis Investments

Section 560.36 authorizes a federal savings association to invest in community development investments of a type permitted for a national bank under 12 CFR Part 24. Savings associations may invest in such community development projects up to the greater of one-fourth of one percent of total capital or $100,000. Generally, these would be investments that primarily benefit the following groups or areas:

- Low- and moderate-income individuals.
- Low- and moderate-income areas.
- Areas targeted for redevelopment by local, state, tribal, or federal government. This includes federal enterprise communities and federal empowerment zones.

These investments provide or support one or more of the following activities:

- Affordable housing, community services, or permanent jobs for low- and moderate-income individuals.
- Equity or debt financing for small businesses.
- Area revitalization or stabilization.
- Other activities, services, or facilities that primarily promote the public welfare.

Under § 560.36, there are no restrictions as to control, geographic location, ownership, or organizational structure.

Given the limited investment authority, these investments should not have a significant effect on the parent federal savings association's financial condition.

Personal Property Acquired for Sale or Lease

Typically, federal savings associations acquire personal property for lease at the request of a customer wanting lease financing, usually for very expensive items such as mainframe computers, earth-moving equipment, and fleets of vehicles. Handbook Section 219, Leasing Activities, further discusses personal property acquired for sale or lease.

Pass-Through Investments

Federal savings associations, in accordance with §560.32, may make limited investments, on a pass-through basis, in certain preapproved entities that hold only assets or engage in activities permissible for federal savings associations. Pass-through investment authority enables federal savings associations to join with others to engage in

an activity. Joint participation has the potential to reduce capital outlays and operating costs and enhance profitability, or serve other bona fide business objectives without jeopardizing safety and soundness. A federal savings association that meets all of the following conditions may make pass-through investments without prior notice to OTS:

- The federal savings association invests no more than 15 percent of total capital in any one entity.
- The book value of the aggregate pass-through investments does not exceed 50 percent of total capital after making the investments.
- The investment would not give the association direct or indirect control of the company. See the definition of control in 12 CFR §362.2(e).
- The federal savings association's liability does not exceed the amount of the investment.
- The company falls into one of the following categories:
  - Limited partnership. A limited partnership classifies its members as either general or limited partners. Under this structure, the general partner is personally liable for the partnership's obligations, whereas the limited partner enjoys limited liability as long as it does not materially participate in the business of the partnership.
  - Open-end mutual fund. These are investment vehicles registered with the SEC under the Investment Company Act of 1940. The investment company must restrict its portfolio by its investment policy. The company's investment policy may only change if authorized by shareholder vote. The investment company's portfolio must consist solely of investments that a federal savings association can make directly.
  - Closed-end investment trust. A closed-end trust differs from an open-end fund in that it typically has a fixed number of shares, but is like an open-end fund in that it trades on a stock exchange.
  - Limited liability company (LLC). LLCs are neither corporations nor partnerships yet they combine the limited liability of a corporation with the tax benefits of a partnership. A key advantage of the LLC is that it provides limited liability to all of its members and managers, regardless of their level of participation in the entity's business activities. The members are the owners of the LLC and may be individuals, corporations, general or limited partnerships, LLCs, trusts estates or other entities.
  - Entity that a federal savings association would invest in primarily to use the company's services (for example, data processing). A federal savings association may invest in a jointly owned corporation established to provide services for several users. The objective of such an investment is the receipt of services rather than engagement in a speculative investment through stock investment.

When making a pass-through investment, a federal association must comply with all the statutes and regulations that would apply if it were engaging in the activity directly. For regulatory reporting purposes, to calculate a federal association's lending and investment limits, the association should aggregate a proportionate share of the entity’s assets with the assets the association holds directly. Loans that a savings association makes to the entity are subject to the LTOB rule in the same manner as loans by a savings association to any third party.

To make pass-through investments that do not meet the standards in §560.32, a federal savings association must provide OTS with 30 days advance notice. During the 30-day review process, OTS may require the association to file an application to obtain written approval prior to making the investment.

Subordinate Organizations

Part 559 of OTS regulations deals with savings associations' authority to establish and operate subordinate organizations, for example, operating subsidiaries, service corporations and their lower-tier entities. For various business reasons, for example, tax considerations or efforts to limit potential liability, a savings association may prefer to make permissible investments through a subordinate organization in accordance with 12 CFR Part 559. Operating subsidiaries must limit their assets and activities to those authorized for federal savings associations. A service corporation can engage in additional lines of business specified in §559.4 not otherwise allowed at the savings association level.

Handbook Section 730 contains detailed examination guidance for reviewing such investments. The guidance addresses the following primary considerations in the review of a subordinate organization's operations:

- The potential effect of the subordinate organization's operations on the parent savings association.
- Compliance with OTS notification or, if applicable, application process.
- Compliance with applicable investment restrictions detailed in 12 CFR Part 559.
- Maintenance of separate corporate identities.
- Any indications of insider abuse.

Accounting for a savings association's investment in a subordinate organization should follow GAAP as set forth in Statement of Financial Accounting Standards (SFAS) No. 94 and Accounting Principles Board (APB) Opinion No. 18. Under GAAP, a savings association may account for investments in subordinate organizations by one of three methods:

- Consolidation
- Equity method
- Cost method.

Accurate accounting for investments in subordinate organizations is important to ensure that the books of the parent adequately reflect the carrying value of the entities. See Handbook Section 430, Appendix C, to assess whether the savings association has followed OTS savings association financial reporting standards for investments in majority-owned or unconsolidated subordinate organizations. OTS's capital rule generally refers to a majority-owned subordinate organization as a subsidiary. (See also the TFR Instructions.)

Equity Interest in Real Estate Investments (REI)

Real estate investments include ownership interests in raw land, residential or commercial development projects, or established rental properties. GAAP rules also include in REI loans with equity characteristics. Such lending includes certain project lending that in essence constitutes investments. An element characteristic of an investment is that the lender shares in profits. Although certain types of REI may qualify as loans under §1464(c), they remain REI for reporting purposes. However, REI does not include interests in real estate acquired for the savings association's own use, such as office facilities, and other reasonable business purposes as authorized in 12 CFR §560.77. Also, REI does not generally include real estate owned (REO) obtained in the settlement of debts previously contracted. The savings association should classify as REI real estate acquired in settlement of debts, if they intend to hold the real estate for investment purposes or if the savings association will not dispose of the real estate within five years (or a longer period as approved by OTS). A detailed discussion of real estate development activities is beyond the scope of this Section. Handbook Section 740, Real Estate Development, however, contains guidance on this subject. Also, Section 212, Real Estate Mortgage Lending, Section 208, Real Estate Appraisal, Section 260, Classification of Assets, and Section 251, Real Estate Owned and Other Repossessed Assets, provides relevant guidance.

REI Authorized in HOLA §5(c)(3)(A)

HOLA §5(c)(3)(A) limits REI investments of federal savings associations to those that are community-development related and certain investments preapproved for service corporations.

Federal savings associations may invest up to two percent of assets in REI to further community development pursuant to HOLA §5(c)(3)(A). Federal savings associations must aggregate these REI investments with loans allowed under HOLA §5(c)(3)(A) to determine compliance with a statutory five percent of assets limit. To be permissible for investment, real estate must be located in areas receiving concentrated development assistance under Title I of The Housing and Community Development Act of 1974 (HCDA), or subject to an OTS no-action letter. Savings associations can make the investments in the following ways:

- Directly.
- As de minimus investments (see §560.36).
- Through investment vehicles authorized for federal savings associations that include subordinate organizations (as defined in §559.2).
- On a pass-through basis using investments authorized in §560.32 (for example, limited partnerships).

Indirect investments in real estate projects are subject to the same investment limits that apply to any direct REI. Include indirect investments in real estate projects in determining compliance with the overall five percent of assets statutory investment or loan limit. When making real estate investments through an entity, the savings association should obtain a written commitment that the entity will comply with applicable OTS standards for such investments, and routinely monitor compliance.

A common investment vehicle for making a community-development related REI is an investment in a Low Income Housing Tax Credit (LIHTC) limited partnership. In making such investments, savings associations generally rely on the authority in HOLA §5(c)(3)(A) to invest on a pass-through basis.

Therefore, such investment must meet the standards in §560.32 (Pass-Through Investments) including the individual and aggregate investment limits.

The Tax Reform Act of 1986 authorized LIHTC programs. LIHTCs are a popular mechanism to provide equity to affordable multi-family housing projects. Most LIHTC projects use a limited partnership structure. The partnership raises equity in the project by selling limited partnership interests and uses the proceeds to support development or rehabilitation of affordable multifamily housing. The tax credits, as well as any profits or losses from the property, flow through to the limited partners.

To minimize the risk of tax credit recapture or project failure, a savings association can participate in a LIHTC fund that diversifies investments among several LIHTC projects. Of course, the underlying REI must be permissible pursuant to HOLA 5(c)(3)(A). Diversification among several projects, however, does not eliminate a savings association's risk. In reviewing such investments, you should determine whether the savings association has other relationships that are dependent upon the success of a particular LIHTC-related project. This may be an indication of a savings association's asset concentration in a particular project. Extensions of credit to the project or guarantee of third-party loans to the project by the savings association are indications of project concentration.

REI Authorized for Service Corporations

Through service corporations, federal savings associations can engage in additional activities not permissible for federal savings associations to perform directly. Service corporation activities are either preapproved by regulation or OTS determines the activities to be reasonably related to the business of financial institutions. Section 12 CFR §559.4 lists the preapproved service corporation real estate activities and includes the following:

- Acquiring real estate in accordance with a prudent program of property development for:
  - prompt development or subdivision
  - construction of improvements
  - resale or leasing to others
  - construction
  - use as manufactured home sites.

- Acquiring improved real estate or manufactured homes for:
  - rental or resale
  - remodeling
  - renovating or demolishing
  - rebuilding for sale or rental
  - offices and related facilities of a stockholder of the service corporation.

Therefore, in addition to certain REI authorized in HOLA 5(c)(3)(A), a savings association can make permissible REI in an amount up to its service corporation investment limit. Generally, the service corporation investment limit is three percent of assets provided any amount over two percent relates to community development activities.

As noted above, investments in service corporations must comply with the standards in Part 559, including applicable investment limits. Service corporations, for example, are subject to various ownership and geographic restrictions. Such restrictions, however, do not apply to the establishment of a savings association's lower-tier entities. For monitoring compliance with applicable statutes, regulations, and OTS policy, it is important that the savings association's internal records indicate the authority for any REI. (Refer to Handbook Section 730, Subordinate Organizations, for a discussion of service corporation and lower-tier investment authority.) Also, there are regulatory capital implications for real estate service corporations. Savings associations must deduct from capital any direct investments (both debt and equity) they or subordinate organizations make in subsidiaries engaged in activities that are not permissible for national banks. Handbook Section 120, Capital Adequacy, discusses this subject.

Refer also to the OTS Guide to the Federal Laws Governing Community Development Activities of Savings Associations. Appendix D of the guide addresses capital standards for REI and lists community development related investments permissible for national banks.

Real Estate Loans with Equity Investment Characteristics

REI includes loans with equity investment characteristics because they are, in essence, equity investments in the projects being financed even though such loans are permissible under 12 USC §1464(c). REI, for example, may include the following types of loans:

- Land loans and nonresidential construction loans with loan-to-value (LTV) ratios greater than 80 percent.

- Interest capitalized as part of a real estate loan balance in accordance with GAAP.

- Loans or advances to, and guarantees issued on behalf of, partnerships or joint ventures in which a savings association holds an equity interest in real property as determined under GAAP.

You should carefully scrutinize loans with equity characteristics because they present risks similar to other types of equity investment. This supervisory oversight is necessary because such loans are permissible investments for savings associations. These loans are not equity investments under the capital rule to the extent they are permissible investments for national banks. With one exception, these loans are generally risk weighted at 100 percent instead of being deducted when computing risk-based capital. The exception pertains to land loans and nonresidential construction loans with LTV ratios greater than 80 percent. Savings associations must include in the 100 percent risk-weight category the portion of the loan that represents 80 percent of the project's value. In addition, they must deduct dollar-for-dollar from total capital the portion of the loan in excess of 80 percent LTV.

A significant type of loan that often falls within the definition of equity investment is the highly

leveraged acquisition, development, and construction (ADC) loan. OTS may consider an ADC loan an equity investment if it possesses any of the following characteristics:

- The lender participates in the expected profit upon completion of the project.
- The lender supplies virtually all funds for the project, including the funds to cover loan origination fees and interest on the loan. The borrower, although having title to the project, has little or no equity investment in it.
- The only security for the loan is the ADC project itself and, therefore, the lender has no recourse to other assets of the borrower.
- The structure of the arrangement precludes default or foreclosure during the project's development because there are no requirements for interim payments. This means that the loan can never become delinquent before its maturity date.

Accounting and Reporting for REI

Beyond verifying that REI comply with rules and regulations, you should verify that the savings association's financial reports properly reflect these investments. REI include the purchase price or original cost less depreciation of all equity interests in real property as determined in accordance with GAAP. Savings associations and others must carry REI at the lower of the carrying amount or fair value less cost to sell as prescribed by SFAS No.121. The cost of the real estate should include the original purchase price plus allowable items, such as:

- Cost of construction.
- On-site and off-site improvements.
- Costs of architectural and engineering studies.
- Interest during the construction period (as required by SFAS No. 34).
- Certain pre-acquisition costs meeting the criteria specified in paragraph four of SFAS No. 67.
- Property taxes and insurance incurred during the development period prior to the property being substantially complete as addressed in paragraph six of SFAS No. 67.

Depreciation begins when a project is substantially complete and held available for occupancy. Charge all carrying costs to expense when incurred. You should consider a property substantially complete and available for occupancy no later than one year from cessation of major construction activity.

Handbook Section 251, Real Estate Owned and Other Repossessed Assets, contains guidance on accounting for sales of real estate. When the seller, for example, receives a note on a sale of real estate, it is necessary to adjust the sales price to the estimated fair value of the note. Refer to APB No. 21 for a detailed discussion of determining the appropriate sales price that will affect the gain or loss on the sale.

Internal Controls for REI

In evaluating risk, you should determine whether the savings association is prudently managing the REI portfolio. You should have access to information indicating the authority that the savings association relied on for making REI or loans with equity investment characteristics. You should assess the adequacy of internal policies and procedures for REI. There is often a direct relationship between the competence and expertise of individuals managing a project and its risk and profitability. Therefore, you should also review the savings association’s real estate investment strategy and decision-making analyses (for example, risk versus return assessment, project feasibility, expertise of individuals managing the project, real estate appraisals, financing commitments). You should document all information relating to management's investment analysis consistent with the savings association's (or if applicable, its subordinate organization’s) internal policies and procedures. The analysis can provide substantial insight into the level of risk involved and facilitate an assessment of performance projections against actual results.

It is the responsibility of the savings association to ensure that any investment in real estate is safe and sound. Additionally, internal procedures should address the monitoring of REI. For example, subsequent appraisal reports may be necessary as dictated by prudent management policy. Examples requiring subsequent appraisal reports include the following situations:

- The marketplace suffers a decline.
- The property remains on the market for an extended time period.
- A change in the property or circumstances affects its sale or development.

Finally, you should perform, as appropriate, the examination procedures contained in Handbook Section 740, Real Estate Development, which also provides guidance on assessing risk associated with REI.

ADDITIONAL SUPERVISORY CONSIDERATIONS AND REGULATORY REQUIREMENTS

As discussed above, a savings association's internal policies and procedures should address prudent standards for the acquisition and monitoring of equity investments. Internal controls include the plan, procedures, and records that management uses in making decisions, maintaining reliable financial records, and safeguarding assets. Savings associations and their subordinate organizations should monitor the adequacy of internal control systems. (Refer to Handbook Section 340, Internal Controls.)

For investments in real estate, for example, internal procedures should address the pre-acquisition analysis performed to support the investment decision. This includes obtaining valid appraisals and feasibility studies. It also includes the management oversight of various phases of real estate development or property management. In addition to guidance concerning specific equity investment authority, an assessment of the following considerations may be appropriate for determining the effect of equity investments on the savings association's financial condition.

Asset Concentrations

There are substantial limitations on the levels of permissible equity investments. Nevertheless, a concentration of such assets may present safety and soundness concerns. In assessing risk associated with asset concentrations, consider both loans to and equity investments in related entities.

There is a concentration if the savings association extends a substantial level of equity investments, loans, or guarantees of debt to the following:

- An individual
- An entity
- A project
- A group of borrowers or investors.

There is also a concentration if there is a relationship of common dependency or a common risk characteristic. A savings association may make equity investments in entities that are related in some manner. They share a common third-party investor or otherwise depend on the cash flow generated by a single operation or project. Section 560.32 limits a savings association's pass-through investments in the aggregate to 50 percent of capital. However, the savings association's overall exposure may include the amount of any loans, subject to applicable loans-to-one-borrower restrictions, to these entities or to individuals investing in such entities (for example, general partner or developer). Also, while a savings association's direct REI cannot, in the aggregate, exceed two percent of assets, a service corporation may invest up to three percent of assets in the same real estate projects. This amount is in addition to any loan authority available to the savings association or subordinate organization.

Savings association management should adequately address such equity investment concentrations through policies and procedures that minimize potential risk presented to the savings association. At a minimum, management should identify, monitor, and regularly report significant concentrations to the board of directors to provide a basis for board policy. Refer to Handbook Section 211, Loans to One Borrower, for

additional guidance on assessing asset concentrations.

Internal Asset Classification Systems

Savings associations must periodically evaluate their equity investments and make any appropriate adjustments to the carrying value. You should consider relevant documentation supporting such values during the examination. Also, the savings association's and its subordinate organization's assets should reflect GAAP valuation standards. Finally, equity investments are subject to classification consistent with standards in 12 CFR §560.160 and related OTS policy. For guidance in this area, refer to Handbook Section 260, Classification of Assets.

Conflicts of Interest

Conflicts of interest occur when the interests of a savings association clash with the personal interest of individuals or the business interests of entities associated with the savings association. Each savings association should develop a policy on conflicts of interest and a code of conduct for their officers and other employees. The existence of such a policy is particularly important if a strong potential for conflict exists, such as, numerous REI involving affiliates. A savings association must prohibit a person involved in a particular conflict associated with a transaction from participation in the savings association's approval process. (Refer to Handbook Section 330, Management Assessment, for guidance on identifying potential conflicts of interest.)

Transactions with Affiliate (TWA) Rules

The TWA Rules contained in §§563.41 and 563.42 place quantitative and qualitative restrictions on loans and certain other transactions entered into by the savings association or its subsidiaries with affiliates. TWA regulations may affect REI or personal property transactions involving an affiliate or insider. (See Handbook Section 380.)

OTS Capital Treatment

Handbook Section 120, Capital Adequacy, contains guidance that will help you determine the treatment of various types of equity investments under OTS's capital rule contained in Part 567. The capital treatment for equity investments, for the most part, depends on the savings association's percentage ownership interest and whether the investment is permissible for national banks. Savings associations must deduct from capital for reporting purposes equity investments that are not permissible for national banks.

The actual capital calculations for deducting non-includable investments differ among equity investments that are subsidiaries (for example, majority-owned, control exists) and those accounted for under the equity or cost accounting method. Savings associations must deduct investments in (including loans to) non-includable subsidiaries from core capital. In addition, savings associations must deduct other non-subsidiary equity investments not permissible for national banks from total capital.

OTS Reporting Requirements

The savings association's internal controls should ensure the proper reporting of equity investments in financial reports. These reports must also be in accordance with GAAP. Under OTS TFR instructions, there are three elements that determine the appropriate reporting for equity investments:

- The investment authority that the savings association relies upon.
- The savings association's percentage ownership interest.
- Whether the investment is permissible for national banks.

For example, a savings association would report investment in a non-consolidated subordinate organization under the equity or cost method of accounting on line item SC 50 of the Statement of Condition of the TFR.

The institution should consolidate the operations of a majority-owned subordinate organization(s) with the parent savings association on a line-by-line basis. However, institutions should report other permissible equity securities, for example, common and preferred stock including Freddie Mac and Fannie Mae stock and shares of mutual funds accounted for pursuant to SFAS No. 115, on SC 140 (Equity Securities except FHLB Stock). Savings associations should report FHLB stock on SC 690 (Other Assets). A savings association should report direct investments in real estate, including those held by consolidated subsidiaries on SC 45 (Real Estate Held for Investment). The TFR Instructions provide additional guidance.

REFERENCES

United States Code (12 USC)

Home Owners' Loan Act

§1464(c)	Investment Authority
§1468(a),(b)	Affiliate Transactions

Federal Deposit Insurance Act

§1828(m)	Activities of Savings Associations and Subsidiaries
§1831e(c)	Equity investments

Code of Federal Regulations (12 CFR)

FDIC Rules and Regulations

§303.13	Applications and Notices by Savings Associations
§303.13(d)	Equity investments

OTS Rules and Regulations

Part 559	Subordinate Organizations
§560.30	General Lending and Investment Powers
§560.32	Pass-through Investments
§560.36	De minimis Investments
§560.37	Real Estate for Office and Related Facilities
§560.41	Leasing
§560.93	Lending Limitations
§560.121	Investment in State Housing Corporations
§560.160	Asset Classification
§560.172	Re-evaluation of Real Estate Owned
§563.41	Loans and Other Transactions with Affiliates and Subsidiaries
§563.42	Additional Standards Applicable to Transactions with Affiliates
Part 567	Capital

Accounting Principles Board (APB) Opinions

No. 18	Equity Method of Accounting for Investments in Common Stock
No. 21	Interest on Receivables and Payables

Financial Accounting Standards Board, Statement of Financial Accounting Standards (SFAS)

No. 34	Capitalization of Interest Cost
No. 67	Accounting for Sales of Real Estate
No. 94	Consolidation of All Majority-Owned Subsidiaries
No. 115	Accounting for Certain Investments in Debt and Equity Securities

Other References

AICPA Audit and Accounting Guide, Banks and Savings Institutions

Equity Investments
Program

Examination Objectives

To determine whether the savings association is correctly categorizing and valuing equity investments.

To evaluate the quality of equity investments and their effect on the financial condition and performance of the savings association.

To determine whether the savings association makes equity investments in accordance with applicable laws and regulations.

Examination Procedures

Level I

Wkp. Ref.

1. Obtain a list of the savings association's equity investments and review related scoping materials. *Note*: Evaluate the savings association's investments in subordinate organizations under separate examination procedures contained in Section 730. As necessary, obtain information relevant to this program from persons reviewing subordinate organizations.

   Verify that the savings association properly categorizes equity investments. Ensure that equity investments comply with applicable statutory, regulatory or policy standards (for example, investment limits, activities restrictions.)

   _____ _____

2. Review the preceding report of examination and all equity investment-related exceptions noted and determine if management has taken appropriate corrective action.

   _____ _____

3. Identify an equity investment or any concentration of equity investments that could have a significant effect on the savings association's overall financial condition taking into consideration the adequacy of valuations and internal asset classifications.

   _____ _____

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4. Assess the adequacy of the savings association's equity investment policies with consideration given to the following areas:

   - The acquisition and monitoring of equity investments, for example, risk/return analysis and objectives, appraisal policy, due diligence performed, tracking relevant economic indicators, projections versus investment performance.
   - Establish carrying values consistent with GAAP, the savings association internal asset classification policy, and appropriate valuation allowances.
   - Accounting for equity investments on savings association financial reports; approaches for identifying and controlling risk for various categories of equity investments.
   - Board of director's oversight. This includes the frequency of the review of policies and procedures. Does the board of directors require approval for equity investments that represent a certain percentage of capital, involve an affiliate or insider or present a potential conflict of interest?
   - Compliance with applicable statutory, regulatory or policy standards.

5. For any REI, verify that management conducted an independent and complete evaluation of the project and the reputation of individuals involved, (for example, partners, members, developers), as well as their experience, expertise, and financial capabilities. (Do partners have the capacity to meet financial and other obligations? Can personal guarantees be enforced?)

6. Assess the adequacy of management's expertise in relation to the savings association equity investment portfolio and related goals and objectives.

7. Analyze the savings association's future equity investment plans in relation to its business plan and overall condition.

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8. For pass-through investments, confirm that the savings association appropriately limits the amount of its investment. Review a savings association's obligations stated in contracts, agreements, and other legally binding arrangements to ensure that the association's potential liability is limited to the amount of its investment. Provisions in such contracts, agreements, or arrangements would include the sharing of profits and losses among investors and additional funding requirements.

9. Confirm that the savings association properly reports equity investments when calculating regulatory capital. (Refer to Handbook Section 120, Capital Adequacy, and the Thrift Financial Report Instructions for guidance.)

10. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

Level II

11. Identify any equity investments that involve a potential conflict of interest or circumstances in which any affiliate or insider (savings association officer, director, or major shareholder) has benefited directly or indirectly from the savings association's equity investment.

12. If weaknesses exist within internal accounting procedures, reconcile the savings association's current reported equity investments to an audited financial statement.

13. If REI are material, perform any appropriate and relevant procedures detailed in Handbook Section 740, Real Estate Development.

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14. Ensure that the examination meets the Objectives of this Handbook Section. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages. Update the continuing examination file, if applicable.

Examiner's Summary, Recommendations, and Comments

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Equity Investments Questionnaire

	Yes	No
General Questionnaire		
1. Does the thrift's asset review and classification program cover equity investments?.....		
2. If state chartered, is the thrift complying with statutory and regulatory investment limits under state law if more restrictive than federal limits?.....		
3. Does the thrift's internal audit program adequately cover equity investments?.....		
4. Does the thrift adequately monitor compliance with its equity investment policies and procedures?.....		
5. Does the thrift have definitive written investment plans for each equity investment?		
6. Is the thrift complying with its investment plans?		
7. Is the association in compliance with the statutory investment limits prescribed by the HOLA and FDIA?.....		
8. Does the thrift apply the consolidation method to applicable EIs of operating subsidiaries for the purpose of determining its aggregate level of investments?		
9. Are equity investment management reports and information systems adequately providing management and directors with decision-making information and the ability to monitor compliance with established guidelines?.....		
10. Does the institution maintain records for each equity interest in a real estate investment (REI) parcel (e.g., showing capital items, expenses, rentals)? Are such files complete?.....		

	Yes	No
11. Does the institution reconcile ledgers for the individual REI properties to the general ledger at least monthly?.....		
Frequency?_____		
12. Does the thrift maintain insurance coverage on REI including liability coverage where advisable?.....		
13. Does the thrift maintain adequate control over REI rental income?		
14. Are agents who collect REI rents and/or manage properties bonded?.....		
15. Does the thrift properly control REI security deposits?		
16. Does the thrift maintain adequate control over all REI disbursements?.....		
17. Does the thrift physically inspect all REIs at least quarterly?		
18. Has the thrift imposed limitations on the securities investment authority of officers?.		
19. Does the thrift require dual authorization of investment security transactions?.....		
20. Do procedures preclude the custodian of the thrift's securities from:		
• having sole physical access to security documents?		
• preparing release documents without the approval of authorized persons?		
• preparing release documents not subsequently examined or tested by a second custodian?.....		
• performing more than one of the following transactions:		
— execution of trades?.....		

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Equity Investments Questionnaire

	Yes	No
— receipt or delivery of securities?		
— receipt and disbursement of proceeds?		
21. Does the thrift physically safeguard securities to prevent loss or unauthorized removal or use?		
22. Are registered securities held only in the name (or street name) of the thrift or subordinate organization?		
23. Do thrift and subordinate organization records of investment securities show all pertinent data describing the security, its location, pledged or unpledged status, premium amortization, discount accretion, and dividends declared or interest earned, accrued, and collected?		
24. Do periodic statements the thrift receives from securities brokers reflect:		
• trading activity for the period?.....		
• open positions at the end of the period?.		
• market value of open positions?.....		
• unrealized gains and losses?		
• cash balances in accounts?.....		

	Yes	No
25. Does someone independent of both the trading and recordkeeping functions receive the periodic statements?		
26. Does the thrift reconcile the periodic statements to all of the thrift's accounting records?		
27. Do persons who do not have direct, physical, or accounting control of accounts balance EI subledgers at least annually to the appropriate general ledger accounts? ..		
28. Do persons who do not have direct, physical, or accounting control of the assets prepare and post EI subledgers?		
If not, do persons who do not have direct, physical, or accounting control of the assets test the preparation and postings?		
29. Does the thrift maintain supporting documents for all entries to EI accounts?...		
30. Does management report acquisitions and dispositions of EIs to the board of directors?		
31. Does the board of directors review EI policies at least annually to determine if they are compatible with changing regulatory restrictions and market conditions?.....		

Comments

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INTRODUCTION

A savings association must sometimes renegotiate loan terms to assist borrowers who are unable to meet the original terms of their loans, and maximize recovery of loans to these borrowers. Such renegotiation may result in the savings association making modifications that result in loan terms it normally would not accept. These may include:

- A lower interest rate or even no interest.
- A reduction in principal.
- A lengthier term to maturity.
- A transfer of assets from the borrower.
- The substitution or addition of a new borrower.
- Some combination of these modifications.

This renegotiation, where the savings association grants concessions to the debtor/borrower, results in a troubled debt restructuring or TDR.

Troubled debt restructurings are compromises of indebtedness designed to improve collection or reduce losses on problem loans. Savings association policy and practice should require strict controls such as dual authorization requirements and monitoring by a senior committee to prevent unneeded compromises from occurring.

Generally accepted accounting principles (GAAP) for TDRs are set forth in the following Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards (SFAS):

- No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings, as amended by SFAS Nos. 114 and 121 (SFAS No. 15).
- No. 114, Accounting by Creditors for Impairment of a Loan, as amended by SFAS No. 118 (SFAS No. 114).

Troubled debts also require an evaluation of the probable loss from collection, as defined by SFAS No. 5, Accounting for Contingencies, as amended by SFAS No. 114 (SFAS No. 5).

This Section of the Handbook describes the following areas:

- Troubled debt restructurings.
- Accounting for TDRs, specifically SFAS No. 114 and Handbook Section 260, Classification of Assets.
- Loans to one borrower.
- Classification.

TROUBLED DEBT RESTRUCTURINGS

According to SFAS No. 15, a TDR occurs when a savings association grants a concession it would not otherwise consider because of economic or legal reasons pertaining to the debtor's financial difficulties. A TDR may include, but is not limited to, the following transactions or any combination of the following transactions:

- The transfer of assets from the debtor to the creditor to satisfy all or part of the indebtedness when the fair value of the assets received is less than the recorded investment in the receivable. The assets transferred may be receivables from third parties, real estate, or other assets.
- Issuance of an equity interest by the debtor to the creditor to satisfy all or part of a debt. The debtor must not grant the interest pursuant to existing terms for converting debt to equity.
- Modification of the terms of debt such as the following:
  - A reduction of the interest rate for the remaining term.

— An extension of the maturity date with a stated interest rate lower than the current market rate for new debt with similar risk.

— Reduction in the outstanding principal amount due, or a reduction in the accrued interest due.

- Substitution or addition of debtor(s) when the substitute or additional debtor(s) control, are controlled by, or are under common control with the original debtor. When substitute or additional debtor(s) has no relationship with the original debtor after the restructuring, the association should account for the restructuring as a new loan in partial satisfaction of the original borrower's loan. In this situation, recognize any losses resulting from the new financing using the fair value of the new loan.

Not all concessions granted by the creditor constitute a TDR. For example, the following situations do not constitute a TDR:

- The assets received by the creditor for full satisfaction of the debt have a fair value equal to or greater than the recorded investment in the receivable.
- The creditor reduces the interest rate on the debt to reflect a decrease in the market interest rate.

Periods of declining interest rates may make refinancing of loans appealing to borrowers whose current contractual interest rates are higher than market interest rates. However, the value of the pledged collateral may decline. OTS encourages savings associations to work constructively with creditworthy borrowers, including instances where the refinancing of real estate-related loans involves an adjustment of the existing loan rates to current market rates. OTS will not criticize a savings association solely for refinancing or renegotiating a loan to a current market rate, even if the pledged collateral declined in value. OTS will evaluate refinanced and renegotiated loans based on the borrower's creditworthiness and repayment capacity.

ACCOUNTING

SFAS Nos. 5, 15, and 114 prescribe GAAP for TDRs. SFAS No. 114 significantly changed GAAP for loss recognition in a TDR involving modification of terms.

SFAS No. 114 defines as impaired a loan subject to a TDR. Impairment of a loan exists when current information and events indicate that the savings association will be unable to collect "all amounts due" according to the contractual terms of the original loan agreement. All amounts due according to the contractual terms means the savings association will collect both the contractual interest payments and the contractual principal payments of the loan as scheduled in the loan agreement. A loan is not impaired during a delay in payment of the loan, if the creditor expects to collect all amounts, including interest at the contractual rate for the period of delay. Base support for collection of all amounts due upon the cash flow from the project and/or borrower, not the fair value estimate of the collateral.

SFAS No. 114 requires measurement of impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate. However, as a practical expedient, it allows measurement of impairment based on the loan's observable market price, or the fair value of the collateral if the loan is collateral-dependent. A collateral-dependent loan is a loan where expected repayment depends solely on the underlying collateral. An impairment occurs when the present value of expected future cash flows (or, alternatively, the observable market price of the loan or the fair value of the collateral) is less than the recorded investment in the loan. The recorded investment in the loan includes accrued interest, net deferred loan fees or costs, and unamortized premium or discount.

SFAS No. 114 and Thrift Activities Handbook Section 260, Classification of Assets, require that savings associations measure impairment based on the fair value of the collateral less costs to sell when foreclosure is probable. In addition, Section 260 requires savings associations to value and classify troubled, collateral-dependent loans on the collateral's fair value. Under Section 260, associations should not use the present value of the

expected future cash flows or the loan's observable market price to value troubled, collateral-dependent loans. Thus, OTS has restricted savings associations to a single option, the fair value of the collateral (less costs to sell), for troubled, collateral-dependent loans. (See Thrift Activities Handbook Section 260 for OTS policy regarding Valuation and Classification of Troubled, Collateral-Dependent Loans.)

The effective interest rate for a loan is the rate of return implicit in the loan. A savings association should consider estimated costs to sell, on a discounted basis, in the measure of impairment if those costs would likely reduce cash flows available to repay or otherwise satisfy the loan.

The cost to sell an asset generally includes the estimated incremental direct costs to transact the sale of the asset such as broker commissions, legal and title transfer fees, and closing costs. Generally, costs to sell exclude insurance, security services, and utility costs.

An association recognizes an impairment by doing one of the following:

- Creating a valuation allowance with a corresponding charge to provision for loan losses.
- Adjusting an existing valuation allowance for the impaired loan with a corresponding charge or credit to provision for loan losses.

Savings associations recognize losses for TDRs involving a modification of terms in accordance with the provisions of SFAS No. 114. Therefore, the association should base the effective interest rate for such loans on the original contractual rate, not the rate specified in the restructuring agreement.

Effective Date and Transition

SFAS No. 114 became effective for fiscal years beginning after December 15, 1994. For TDRs restructured before the effective date of SFAS No. 114, savings associations may continue to account for and disclose them in accordance with SFAS No. 15, as long as the restructured loan remains unimpaired based on the terms specified in the pre-SFAS No. 114 restructuring agreement. If such a TDR fails to perform as agreed, or if the savings association again restructures the loan, the effective interest rate reverts back to the contractual interest rate of the original loan.

The OTS policy regarding troubled, collateral-dependent loans (including collateral-dependent TDRs) is similar in many respects to certain provisions of SFAS No. 114. Thrift Activities Handbook Section 260 and SFAS No. 114 may require recognition and measurement of impairment independent of any TDR.

Timing

A TDR may occur before, at, or after the stated maturity of the debt. Time may elapse between the restructuring agreement and the effective date of the new terms of the restructuring. For GAAP purposes, the date of consummation of the restructuring agreement is the recognition date for the restructuring, not necessarily the completion date of the restructuring paperwork.

OTS acknowledges a TDR's existence when there is an agreement between the savings association and the borrower consummating the restructuring. A TDR is presumed to exist if senior management of the savings association and the borrower reach an oral agreement and memorialize the agreement in written documentation, such as a memorandum to the files, setting forth the terms of the TDR.

An oral agreement may reflect the restructuring of a loan, but is not a long-term substitute for a written agreement. The association should document in writing the consummation of a TDR within a reasonable time frame. Normally, complete restructuring occurs within six months. A claim becomes dubious when negotiations continue for a long period without producing a final written agreement for a loan restructuring. The issue of timing is important when applying GAAP because it determines when and if a savings association should account for a problem loan as a TDR under SFAS No. 15.

Receipt of Assets

The association should record assets transferred in partial or total repayment of indebtedness, including an equity interest in the debtor, at their

fair value less cost to sell. Fair value is the amount the debtor could reasonably expect to receive from a current sale between a willing buyer and a willing seller; that is, other than a forced or liquidation sale.

Savings associations should measure the fair value of an asset by the market value if an active market exists. If no market exists for the assets transferred, the association should use a forecast of expected cash flows from the asset, discounted at a rate commensurate with the risk involved to arrive at the fair value.

Repossession in Substance

A creditor cannot avoid accounting for an asset at its fair value by simply avoiding a formal foreclosure. In accordance with SFAS No. 114, a savings association treats an impaired collateral-dependent real estate loan as a repossession in substance (reported as REO) once it takes possession of the collateral. This treatment stands even if the lender has not obtained legal title. Examples of taking possession include managing the collateral, proceeding with the foreclosure process, and marketing the project for sale. Savings associations base loss recognition for other troubled collateral-dependent loans on the fair value of the collateral less costs to sell if they do not anticipate full payment of the amounts due. Such loans remain in the loan category.

If a repossession in substance occurs, you should consider whether an independent appraisal is necessary. Regulation 12 CFR § 563.170 empowers OTS officials to obtain independent appraisals.

Disclosure

A savings association must disclose a loan modified and accounted for as a TDR in its audited financial statements and on reports to OTS. Audited financial reports should disclose the following information pertaining to all impaired loans including TDRs, as required in SFAS Nos. 15 and 114, if material:

- The total recorded investment in the impaired loans at the end of each period, and (1) the amount of that recorded investment for which there is a related allowance for credit losses, and (2) the amount of that recorded investment where there is no allowance.
- The creditor's interest income recognition policy including the method of recording cash receipts.
- The activity in the allowance for credit losses account, including the balance in the allowance for credit losses account at the beginning and end of each period, additions charged to operations, direct write-downs charged against the allowance, and recoveries of amounts previously charged off.

There is an exception to these disclosure requirements. There is no need to include a TDR involving a modification of terms in the disclosures in the years after the restructuring if both of the following conditions exist:

- The restructuring agreement specifies an interest rate equal to or greater than the rate that the creditor was willing to accept at the time of restructuring for a new loan with comparable risk.
- The loan is not impaired based on the terms specified by the restructuring agreement.

Returning Nonaccrual Loans to Accrual Status

A 1993 interagency policy statement outlines a program of interagency initiatives to reduce impediments to the availability of credit to businesses and individuals.

TDR Multiple Note Structure

The agencies conformed their reporting requirements for TDR structures involving multiple notes.

A typical example of a TDR multiple note structure is where the savings association restructures the original troubled debt with the borrower and splits the debt into two notes. The first note, or the "A" note, represents the portion of the original loan principal amount that the savings association expects to collect in full, along with contractual interest. The second note, or the "B" note, repre-

sents the portion of the original loan that the savings association charges off.

Under interagency guidance, a lender may return the "A" note to accrual status conditioned on satisfaction of the following:

- The restructuring qualifies as a TDR, as defined by SFAS No. 15, and there is economic substance to the restructuring.
- The association must charge-off the portion of the original loan represented by the "B" note before or at the time of the restructuring. The association must support the charge-off by a current, well-documented credit evaluation of the borrower's financial condition and prospects for repayment under the modified terms.
- There is reasonable assurance of repayment and of performance in accordance with the modified terms of the "A" note.
- There is a sustained period of repayment performance (generally a minimum of six months), either immediately before or after restructuring, in accordance with the modified terms, involving payments of cash or cash equivalents.

The savings association would initially disclose the "A" note as a TDR. The savings association could eliminate such disclosure in the year following the restructuring, provided the "A" note meets the following additional conditions:

- The "A" note yields a market rate of interest. To be considered a market rate of interest, the interest rate on the "A" note at the time of the restructuring must be equal to or greater than the rate the savings association is willing to accept for a new receivable with comparable risk.
- The "A" note performs in accordance with the modified terms.

Past Due Loans

Under interagency guidance, past due loans may be returned to accrual status, even though the loans are not fully current, and any previous charge-offs not fully recovered, provided the past due loans meet the following conditions:

- There is reasonable assurance of repayment within a reasonable period, of all principal and interest amounts contractually due (including amounts past due).
- There is a sustained period of repayment performance (generally a minimum of six months) in accordance with the contractual terms, involving payments of cash or cash equivalents.

However, savings associations would continue to disclose past due loans that meet the above conditions, until they are fully current.

LOANS TO ONE BORROWER

The restructuring of a troubled loan constitutes a renewal, but is not a new loan for purposes of the loans-to-one-borrower (LTOB) rule, 12 CFR § 560.93, provided that the savings association advances no additional funds to the borrower. In the case of a non-conforming loan, the savings association should take reasonable efforts, consistent with safety and soundness, to make the loan conforming. In addition, the savings association should document its efforts to bring the loan into conformance. If the efforts are unsuccessful, the savings association may renew, restructure, or modify the nonconforming loan with the following provisions:

- The transaction is not done with the purpose of evading the lending limits.
- There can be no substitution of borrowers.
- The association cannot advance additional funds.

CLASSIFICATION

As with all assets of savings associations, TDRs are subject to the classification requirements of 12 CFR § 560.160, Asset Classification. Restructured loans will not automatically result in adverse classification. Conversely, a loan accounted for as a TDR is not exempt from the classification process. When evaluating TDRs for possible classification, you should use the same

criteria as for all other loans. TDRs are probable candidates for adverse classification. As a practical matter, TDRs have demonstrated weakness and often require some loss recognition.

OTS will not criticize a savings association solely for refinancing or renegotiating a loan to a current market rate, even if the pledged collateral has declined in value. You will evaluate refinanced and renegotiated loans based on the borrower's creditworthiness and repayment capacity.

REFERENCES

Code of Federal Regulations (12 CFR)

§ 560.93	Lending Limitations
§ 560.160	Asset Classification
§ 560.172	Re-evaluation of Real Estate Owned
§ 563.170	Examinations and Audits; Appraisals, Establishment and Maintenance of Records
Part 564	Appraisals

Financial Accounting Standards Board, Statement of Financial Accounting Standards

No. 5	Accounting for Contingencies (as amended by No. 114)
No. 15	Accounting by Debtors and Creditors for Troubled Debt Restructurings (as amended by Nos. 114 and 121)
No. 114	Accounting by Creditors for Impairment of a Loan (as amended and superseded in part by No. 118; also amends Nos. 5 and 15, in part)
No. 118	Accounting by Creditors for Impairment of a Loan – Income Recognition and Disclosures (amends and supersedes, in part, No. 114)
No. 121	Accounting for Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of (amends No. 15)
EITF 96 22	Applicability of Disclosures Required By FASB Statement No. 114 When a Loan is Restructured in a Troubled Debt Restructuring Into Two (or More) Loans

American Institute of Certified Public Accountants (AICPA)

AICPA Audit and Accounting Guide for Banks and Savings Institutions (April 1, 1996).

Statement of Position (SOP) 92-3, Accounting for Foreclosed Assets (SFAS No. 121 supersedes significant portions of this SOP).

Other References

Revised Interagency Guidance on Returning Nonaccrual Loans to Accrual Status (June 10, 1993)

Troubled Debt Restructuring Program

Examination Objectives

To assess the savings association's policies, procedures, and controls on troubled debt restructurings (TDRs) and to determine whether the policies are adequate to ensure that TDRs benefit the savings association.

To determine if savings associations report TDRs and repossessions in substance in accordance with OTS policy and GAAP.

To assess the reasonableness of concessions granted to borrowers by management under TDR agreements.

To assess the risk that TDR policies and practices pose to the savings association and ultimately to the FDIC insurance funds, its members, and the public.

Examination Procedures

Level I

Wkp. Ref.

1. Evaluate the adequacy of the savings association's policies, procedures, and controls on troubled debt restructuring to ensure that the savings association structures TDRs to its benefit.

2. Review the preceding report of examination and all TDR-related exceptions noted and determine if management has taken appropriate corrective action.

3. Ascertain through review of minutes, audit reports, and other management reports whether the savings association properly approves TDRs in accordance with policy and reports pertinent information to the savings association's board of directors.

4. Obtain from management a current list of TDRs. Determine whether the savings association correctly reports TDRs in audited financial statements and in reports to the OTS. Discuss missing material disclosures with the regional accountant.

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5. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

Level II

6. If the effect of TDRs is material relative to regulatory capital or earnings, test TDRs for compliance with the savings association's policies and procedures and for compliance with GAAP. You may rely on the savings association's work papers and internal and external audit work as appropriate.

7. Ensure that your review meets the Objectives of this Handbook Section. State your findings and conclusions, and appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

Examiner's Summary, Recommendations, and Comments

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OTHER ASSETS

The term, other assets, represents a balance sheet category for miscellaneous assets not appropriately included in other major asset categories. Such assets are typically nonearning and often represent a small percentage of a savings association's total assets.

Other assets might include the following items:

- Federal Home Loan Bank (FHLB) stock.
- Stock in the Student Loan Marketing Association, or Farm Credit District Bank.
- Accrued FHLB dividends.
- Federal, state, or other taxes receivable.
- Net deferred tax assets per SFAS 109.
- Insured portion of real estate owned on VA or FHA-HUD loans while title is held pending conveyance.
- Prepaid deposit insurance premiums.
- Prepaid expenses.
- Value of margin accounts held for financial futures and options contracts.
- Deferred net gains and losses on asset hedges.
- Goodwill and other intangible assets.
- Capitalized organization costs.
- Purchased loan servicing rights.
- Excess loan servicing.
- Personal property owned by the savings association and leased to others.
- Accounts receivable.
- Prepaid expenses.
- Accrued income receivable.
- Suspense items.
- Miscellaneous items.
- Cash surrender value of life insurance policies.
- Claims and judgments where collection is likely.
- Premiums (gifts) for business promotions.

The Thrift Financial Report Instructions, Consolidated Statement of Condition, outlines the reporting of other assets. It is important to review a savings association's other assets and liabilities because you may find a significant level of poor quality assets in associations lacking adequate internal controls and accounting procedures.

Materiality and inherent risk assessments are the major factors in deciding which accounts to review in the examination of a savings association. You should not spend valuable time trying to analyze the nature and quality of each item. This is true especially for small items or assets with little inherent risk of loss and an insignificant effect on the safety and soundness or quality of earnings of the savings association. A savings association with good controls and review systems will periodically purge all uncollectible, unreconcilable suspense items. Depending on the level of risk, you may have to go beyond the general ledger control accounts and scan the underlying subsidiary ledgers. This allows you to determine that posting errors and the common practice of netting certain accounts against each other does not hide significant balances.

Savings associations should maintain sufficient supporting documentation for each item in the other assets category. You should thoroughly review stale or suspense items that remain in an account for extended periods of time. You should ensure that the savings association is following a consistent approach in managing its assets. Review the savings association's policies and

practices for the following unsafe and unsound actions:

- Failing to consistently administer adequate procedural controls over items categorized as other assets.
- Continuing to amortize assets after they have lost their value (savings associations should charge off such assets).
- Using suspense accounts to hide or postpone the proper booking of accounts.
- Establishing deferrals for assets that have no future value.
- Using recordkeeping procedures that result in unsupported original entries for asset acquisitions and unsupported amortizations or charge-offs.

In addition, you should review whether the savings association appropriately classifies other assets. Savings associations should charge off or establish a specific reserve for any asset or portion of an asset considered uncollectible. Savings associations should classify assets that exhibit weaknesses but not deemed uncollectible based on the criteria in Section 260, Classification of Assets.

You should also verify that the savings association accounts for net deferred tax assets and include them in regulatory capital, according to the limitations of SAS No. 109 and Thrift Bulletin 56.

Cash Value Life Insurance

Some savings associations purchase cash value life insurance to fill various business needs, including the funding of employee compensation plans, insuring loans against the death of a principle borrower, providing key-man coverage, etc. Savings associations should carefully evaluate large investments in cash value life insurance especially if policy expenses are material. See Appendix A for a discussion of and OTS guidance relating to thrift investments in cash value life insurance.

OTHER LIABILITIES

Other liabilities is a balance sheet category for those accounts that the savings association does not identify individually because of their relative insignificance. The anonymity of the caption may invite misuse, both inadvertent and deliberate. Other liabilities include the following items:

- Declared but unpaid cash dividends on stock.
- Deferred net gains and losses on liability hedges.
- Nonrefundable loan commitment fees.
- Balance in certain U.S. Treasury tax and loan accounts.
- Deferred gains on sale of real estate recorded under percent completion method pursuant to SFAS No. 66.
- Amounts payable under interest rate swap agreements.
- Amounts due brokers between trade and settlement dates on purchased securities.
- Unapplied loan payment that the savings association will credit to the customer's account as of the date of receipt.
- Other similar suspense item liabilities.
- Liability created when a servicer does not expect the benefits of a loan servicing contract to provide adequate compensation.

Refer to the Thrift Financial Report Instructions, Consolidated Statement of Condition, for a more complete list of other liabilities and their proper reporting.

As with other assets, the association should maintain sufficient supporting documentation for each item in the other liabilities category. Your major emphasis in the other liabilities area should be the adequacy of the controls and procedures used by the association to promptly record the proper amount of liability. If not properly supervised, the savings association or individuals may use other assets and liabilities to conceal shortages. When

examining this part of the balance sheet, you may detect the following unsafe and unsound practices or conditions:

- Savings association overdrafts.
- Defalcations.
- Inaccuracies in Thrift Financial Reports.
- Unresolved differences between the general ledger and supporting subsidiary records.
- Contingent liabilities for items such as taxes, legal services, employee compensation and pensions, equipment, and claims for damages.
- Manipulation of net income by recording income or improperly reporting or under-accruing other liabilities.
- Failure to record all material liabilities adequately and accurately.
- Failure to discharge liabilities according to their terms and requirements.

The following obligations or circumstances that the savings association may have incurred and not recorded on the association's books could result in direct or contingent liabilities:

- Planned payments of bonuses or special compensation to officers or directors.
- Unpaid federal and other taxes that the savings association disputes.
- Anticipated settlements of pending tax litigation in excess of recorded amounts of liability.
- Employment contracts.
- Inadequate insurance coverage for potential lawsuits or claims for damages.
- Equipment contracts.

REFERENCES

Code of Federal Regulations (12 CFR)

§ 560.160	Classification of Certain Assets
§ 563.41	Loans and Other Transactions With Affiliates and Subsidiaries
§ 563.42	Additional Standards Applicable to Transactions With Affiliates and Subsidiaries
§ 563.43	Loans by Savings Associations to Their Executive Officers, Directors, and Principal Shareholders
§ 563.200	Conflicts of Interest

Office of Thrift Supervision Bulletins

TB 56	Deferred Tax Assets: OTS Guidelines on Regulatory Reporting; Transition Rule

Financial Accounting Standards Board, Statement of Financial Accounting Standard

SFAS No. 106	Employers' Accounting for Post-Retirement Benefits Other Than Pensions
SFAS No. 109	Accounting for Income Taxes
SFAS No. 115	Accounting for Certain Debt and Equity Securities

Accounting Principles Board (APB) Opinions

APB No. 12	Deferred Compensation Contracts
APB No. 21	Interest on Receiveables and Payables

Other Accounting References

Technical Bulletin No. 85-4, Accounting for Purchases of Life Insurance

America's Community Bankers, Accounting Principles for Savings Associations

OCC Bulletin 2000-23 Bank Purchases of Life Insurance

Other Assets and Liabilities
Program

Examination Objectives

To determine and evaluate the institution's policies and procedures applicable to the recordkeeping and management of other assets and other liabilities.

To determine whether expenditures for other assets are appropriate to the needs of the association and consistent with its business plan.

To determine the extent of compliance with the savings association's stated policies, procedures, and controls, and with applicable state and federal regulations and restrictions.

To determine if the association has exposure to contingent liabilities and to evaluate its plans for addressing them.

To summarize findings and to initiate corrective action when deficiencies exist that could affect safety and soundness, or when you note violations of laws or regulations.

Examination Procedures

Level I

Wkp. Ref.

1. Review scoping materials applicable to this program. If another examiner(s) reviewed scoping materials, obtain a written or oral summary of the review(s) of items concerning this program. Scoping materials might include: the prior examination report, prior exception sheets and work papers, review of internal and external audit reports, review of OTS financial analysis reports, supervisory analysis, correspondence, etc.

_____ _____

2. Review the preceding report of examination and all other asset and other liabilities-related exceptions and determine if management has taken appropriate corrective action.

_____ _____

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Other Assets and Liabilities
Program

Wkp. Ref.

3. Determine the association's policies and procedures on other assets. Review policy statements, the internal asset review program, procedures manuals, the association's business plan, board and committee minutes, and external audit reports.

4. Ascertain through observation and interviews with management whether the savings association periodically reviews policies and procedures and communicates changes to the appropriate association personnel. Determine whether they are generally comparable in nature and scope with management's policies and practices on other balance sheet items. Review all asset-related suspense accounts.

5. Review correspondence with legal counsel handling litigation to determine if the savings association records contingent liabilities and that they appear reasonable.

6. Determine whether the savings association has policies and procedures for managing other liabilities and whether they are compatible with the findings of prior independent audits and examinations, and state and federal regulations. Determine if the savings association's policies and procedures prevent imprudent practices as discussed in this Handbook Section.

7. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

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Wkp. Ref.

Level II

8. Obtain (or prepare) a complete list of other assets. Obtain a reconciliation of the balancing of the association's subsidiary records to the general ledger. Ascertain whether the savings association reports other asset balances correctly on the Thrift Financial Reports. Correct as necessary.

9. Compare total investments between examinations and determine the reason for significant variances or unusual changes. Determine and evaluate management's justification for material overinvestment in other assets.

10. Review a selected sample of subsidiary ledgers and documentation supporting other assets. Determine whether the savings association appropriately writes down other assets the savings association deems uncollectible. The savings association should charge off or classify as Loss such assets in accordance with 12 CFR § 560.160.

11. Compare accounts receivable for the current reporting period with receivables 90 days prior. Scrutinize material accounts with unchanged balances over this period for possible write-off or classification.

12. Be alert to the existence of any unrecorded assets; for example, deficiency judgments obtained as a result of foreclosure, or assets charged off that still have substantial value. The savings association should record these items as other assets at nominal book value. Verify a selected sample of claims pending for FHA or VA guaranteed loans to determine that the claims are legitimate and that the savings association promptly submits them.

13. Determine if the other assets accounts include a significant investment in cash value life insurance. If so, determine the following:

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- Is the insurance amount reasonable?
- Does the savings association account for the cash value life insurance correctly?
- Is such insurance a permissible investment, in accordance with OTS policy? (See Appendix A.)

14. Review the adequacy of the Board's documentation justifying the amount of cash value life insurance.

15. Review whether the insurance arrangement complies with Federal Reserve Regulation O, as applicable.

16. Determine whether the insurance policy adequately protects the savings association's interests.

17. Determine if the savings association recorded improper payments between the savings association and affiliated companies under 12 CFR §§ 563.41 and 563.42 or if the payments present a conflict of interest under 12 CFR § 563.200.

18. Review subsidiary records and invoices supporting a selected sample of other liability account transactions. Determine if the savings association recorded all liabilities promptly. Determine and evaluate justifications for not doing so.

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19. For each obligation or circumstance identified that could result in direct or contingent liabilities, determine if management is aware of the problem and has developed plans for disposing of potential liabilities.

20. Obtain a listing of all accounts included in the other liabilities category. For major accounts included in this listing, determine if and why there were significant changes in these accounts since the previous examination and evaluate management's justification for these changes.

21. On a selected sample basis, determine the composition of large other liability accounts. Review the documentation supporting other liabilities. Determine and evaluate the justification for items that appear unusual.

22. Determine if the savings association has not paid any liabilities for an unreasonable length of time. If so, why? Evaluate management’s justification for nonpayment and determine when the association expects to make payment. Determine if the savings association has adequate controls to ensure the proper disposition of liabilities remaining unpaid for extended periods of time.

23. If applicable, determine that the tax payments to a parent holding company are in accordance with OTS policy. (Refer to the OTS Holding Company Regulatory Handbook.)

24. Ensure that your review meets the Objectives of this Handbook Section. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

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Level III

25. Review all evidence supporting significant income tax refund claims the savings association records as a receivable. Such evidence includes the actual claim document, a request for technical advice, protest, or any other material that provides additional support to the claim. You should take particular care when you look at tax refund claims where the amounts are significant relative to either net income or capital.

Examiner's Summary, Recommendations, and Comments

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Prepared By: _____
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INTERAGENCY POLICY STATEMENT: BANK OWNED LIFE INSURANCE

The following policy statement parallels the Office of the Comptroller of the Currency (OCC) Bulletin 2000-23, *Bank Purchases of Life Insurance*. OCC developed this guidance in coordination with the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Office of Thrift Supervision. Each agency agreed, in principle, to adopt similar guidance to that contained in Bulletin 2000-23. OTS's previous guidance is superceded by the following guidance.

BACKGROUND

Bank-owned life insurance (BOLI) includes all life insurance that a corporation, such as a savings association, purchases and owns or has a beneficial interest in. As with most financial instruments, BOLI can be complicated and is not without risk. Furthermore, BOLI transactions are unique and represent activities that differ greatly from the main business activity of most financial institutions. Some institutions have purchased BOLI without fully understanding the transaction and the associated risks. The second part of this appendix includes discussions of the most common uses of BOLI and the associated risks.

LEGAL AUTHORITY

While there is no specific statutory authority for the purchase of life insurance, the banking agencies consider it legally permissible if it is incidental to banking, that is, useful in connection with the conduct of the savings association's business. Life insurance might be useful for the following purposes:

- Key-person insurance.
- Life insurance on borrowers.
- Life insurance purchased in connection with employee compensation and benefit plans.
- Cash value life insurance taken as security for loans.

The authority to purchase life insurance is subject to supervisory considerations outlined in this appendix. State-chartered associations must also comply with any applicable state laws.

The purchase of cash value life insurance not incidental to banking is not permitted without OTS approval. OTS may approve other uses for bank-owned life insurance on a case-by-case basis. However, a purchase of life insurance must address a legitimate need of the institution for insurance. Life insurance may not be purchased to generate funds for the thrift's normal operating expenses, for speculation, or for the primary purpose of providing estate-planning benefits for thrift insiders unless it is part of a reasonable compensation package. In addition, the purchase of life insurance is subject to supervisory considerations, and life insurance holdings must be consistent with safe and sound banking practices.

Savings associations should complete a thorough analysis before purchasing material amounts of BOLI. The supervisory policy, set forth below, includes minimum standards for pre-purchase analyses applicable to such purchases by savings associations.

SUPERVISORY POLICY

The purchase of cash value life insurance is a long-term, illiquid, nonamortizing asset, and is an unsecured obligation of the insurance carrier. As such, it subjects the policyholder to credit, liquidity, and interest rate risks. Savings associations holding life insurance in a manner inconsistent with safe and sound banking practices may be subject to supervisory action. These supervisory actions may include but are not limited to partial surrender or divestiture of affected policies.

Pre-Purchase Analysis

The safe and sound use of cash value life insurance by savings associations depends on effective senior management and board oversight. Regardless of the institution's financial capacity and risk profile, the board must understand the role institution-owned life insurance plays in the overall business strategies of the institution. The board's role in analyzing and overseeing cash value life insurance should be commensurate with the size, complexity, and risk inherent in the transaction. Although the board may delegate decision-making

authority related to purchases of life insurance to management, the board remains responsible for ensuring that such purchases are consistent with safe and sound banking practices.

Institution management and the board of directors cannot rely solely on a third-party analysis of the benefits of BOLI, such as one that a vendor or carrier of the product may prepare. OTS considers this an inappropriate transfer of the fiduciary responsibilities of the board and management to an outsider with a vested interest in selling the insurance product. Institution management must thoroughly review any such third-party analysis and make its own determination as to whether the purchase of BOLI is appropriate for the savings association. Such a review should include a comparison of various products and investment alternatives, be well documented, and, prior to any purchase, approved by the board of directors.

The objective of the pre-purchase analysis is to help ensure that the savings association understands the risks, rewards, and unique characteristics of BOLI. At a minimum, the pre-purchase analysis should consider the following standards.

I. Determination of the Need for Insurance

The institution should determine the need for insurance by identifying the specific risk of loss or obligation against which it is insuring. The existence of a risk of loss or an obligation does not necessarily mean that a savings association can purchase or hold an interest in life insurance. For example, a savings association may not purchase life insurance on a borrower as a mechanism for recovering obligations that the savings association has charged off, or expects to charge off, for reasons other than the borrower's death. Also, a savings association should surrender or otherwise liquidate permanent life insurance acquired through debts previously contracted (DPC) within a short time, generally 90 days, of obtaining control of the policy.

Additionally, the purchase of insurance to indemnify a savings association against a specific risk does not relieve it from other responsibilities related to managing that risk. For example, a savings association may purchase life insurance to indemnify itself from the loss of a "key person." However, savings associations should not use "key-person" life insurance in place of, nor does it diminish the need for, adequate management or "key-person" succession planning.

The savings association's authority to hold life insurance on a key person lapses if the individual is no longer a key person for the association. Specifically, the key person's retirement, resignation, discharge, or a change in the person's responsibilities will cause the association to lose its insurable interest in a key person.

State law generally recognizes that a lender has an insurable interest in the life of a borrower to the extent of the borrower's obligation to the lender. Savings associations may protect themselves against the risk of loss from the death of a borrower. That protection may be provided through self-insurance in the form of debt cancellation contracts, or by the purchase of life insurance policies on borrowers. In some states, the lenders insurable interest may equal the borrower's obligation plus the cost of insurance and the time value money.

Holding cash value life insurance in amount in excess of the thrift's risk of loss may invalidate an insurance policy and may be an unsafe and unsound practice. Once a credit is repaid, otherwise satisfied in full, or charged off, the risk of loss has been eliminated. Therefore, savings associations may be required to surrender or otherwise dispose of life insurance on individual borrowers under these circumstances. For this reason, the economic consequence of terminating the insurance should be considered in selecting the type of insurance and the structure the policy.

There has been much debate over the legality of an institution holding life insurance on employees that are no longer employed, either because of termination or because of retirement. Certainly, it may be argued that an insurable interest no longer exists. Because state laws differ widely on the issue of insurable interest, savings associations should obtain competent legal advise relating to the amount, coverage, and duration of insurance.

II. Quantifying the Amount of Insurance Needed

The savings association should estimate the size of the obligation or the risk of loss and ensure that they do not purchase an excessive amount of insurance in relation to the estimate. For such estimates, savings associations may include the cost of insurance and the time value of money in determining the amount of insurance needed. The savings association should base the estimate of the amount of insurance needed on reasonable financial and actuarial assumptions. In situations where a savings association purchases life insurance on a group of employees or a homogenous group of borrowers, it can estimate the size of the obligation or the risk of loss for the group on an aggregate basis. The savings association can then compare the aggregate obligation or risk of loss to the aggregate amount of insurance purchased.

Purchasing or holding excessive permanent insurance may be an unsafe and unsound practice if it subjects the institution to unwarranted risks. Bank-owned life insurance subjects a savings association to several risks, which may be significant. The risks are explained in the "Risks Associated with BOLI" section of this bulletin.

III. Vendor Selection

The thrift does not have to use a vendor. In deciding whether or not to use a vendor or what type of vendor to use, the institution should consider the following items:

- The savings association's knowledge of BOLI.
- The resources the savings association can, and is willing to spend, servicing and administering the BOLI.
- The benefits a vendor may provide.

Depending on the vendor's role, the vendor's services can be extensive and critical to successful implementation and operation of a BOLI plan. If the institution uses a vendor, it should make appropriate inquiries to satisfy itself about the vendor's ability to honor its commitments, and its general reputation, experience, and financial capacity. The institution should base their review on the size and complexity of the potential BOLI purchase.

IV. Carrier Selection

BOLI plans are typically of long duration and may represent significant risks for the institution. Therefore, carrier selection is one of the most critical steps in a BOLI purchase. The institution should review the product design, pricing, and administrative services of the carrier(s) and compare them with the institution's needs. In addition, the institution should also review the carrier's ratings, general reputation, experience in the market place, and past performance. A broker or consultant, if used, may assist the institution in this regard.

Furthermore, before purchasing life insurance, the institution should perform a credit analysis on the selected carrier(s) in a manner consistent with safe and sound banking practices for commercial lending.

V. Review the Characteristics of the Available Insurance Products

There are a few basic types of life insurance products in the marketplace. However, providers can combine and modify these products in many different ways. The resulting final product can be quite complex. The institution should review the characteristics of the various insurance products available. It should select the product or products with characteristics that match the institution's objectives and needs. To do this, the institution should thoroughly analyze and understand the products under consideration.

When purchasing insurance on "key persons" and individual borrowers, the institution should consider that the institution's need for the insurance will likely disappear before the insured individual dies. In such cases, term or declining term insurance is often the most appropriate form of life insurance.

VI. Analyze the Benefits of BOLI

The institution should analyze the benefits of BOLI purchases under consideration. The analysis should include an assessment of how the purchase will accomplish the objective specified in (I), De-

termination of the Need for Insurance. It should also include an analysis of the anticipated performance of the insurance, including the interest crediting rate and the policy's net accumulation rate.[1] While the projected yield on some single-premium life insurance policies may seem attractive, the actual yield may be much lower. Also, insurance and administrative costs the issuer builds into the policy further reduce such yields and life insurance becomes more expensive as the insured person ages. Often insurance costs will greatly reduce a high stated yield on a cash value product.

VII. Determine the Reasonableness of Compensation Provided to the Insured Employee if the Insurance Results in Additional Compensation

Split-dollar insurance arrangements typically provide additional compensation and/or other benefits to the employee. Before a savings association enters into a split-dollar arrangement, it should identify and quantify the compensation objective, and ensure that the arrangement is consistent with the stated objective. Also, the institution should combine the compensation provided by the split-dollar arrangement with all other compensation to ensure that total compensation is not excessive. OTS prohibits excessive compensation as an unsafe and unsound practice. There are guidelines for determining excessive compensation in Appendix A to 12 CFR Part 570, Interagency Guidelines Establishing Standards for Safety and Soundness.

VIII. Analyze the Associated Risks and the Institution's Ability to Monitor and Respond to those Risks

Ownership of or beneficial interests in BOLI may subject a savings association to several risks. These risks include: transaction, credit, interest rate, liquidity, compliance, and price. A savings association's pre-purchase analysis should include a thorough evaluation of these risks. Furthermore, the pre-purchase analysis should allow a savings association to determine whether the transaction is consistent with safe and sound banking practices. In making this determination, a savings association should consider, among other things:

- The complexity of the transaction.
- The size of the transaction relative to the institution's capital.
- The diversification of the credit risk.
- The financial capacity of the institution.
- The financial capacity of the insurance carrier(s).
- The institution's ability to identify, measure, monitor, and control the associated risks.

In assessing the size of the transaction, a savings association should consider the cash surrender value (CSV)[2] relative to its capital levels at the time of purchase. The institution should also consider projected increases in the CSV and projected changes in capital levels for the duration of the contract.

Consistent with prudent risk management practices, a savings association should establish internal quantitative guidelines. These guidelines should generally limit the aggregate CSV of policies from any one insurance company and the aggregate CSV of policies from all insurance companies. A savings association must limit

[1] The interest-crediting rate refers to the gross yield on the investment in the insurance policy. That is the rate at which the cash value increases before considering any deductions for mortality cost, load charges, or other costs the issuer periodically charges against the policy's cash value. Insurance companies frequently disclose a current interest-crediting rate and a guaranteed minimum interest-crediting rate. The guaranteed rate may be less than the current rate. As a result, the potential exists for future declines in the interest-crediting rate. The net accumulation rate is the rate at which the policy increases after all costs are deducted, which may be materially less than the interest-crediting rate.

[2] The liquidation value of the insurance policy if the policyholder terminates it. In the first few policy years there may be a significant difference between the stated policy value and the cash surrender value due to early cancellation penalties.

investment in life insurance from any one issuer to the lending limits prescribed in 12 CFR § 560.93.

A savings association should also carefully evaluate its overall investment in life insurance to determine its own appropriate aggregate level. OTS generally considers a concentration to exist when a savings association invests more than 25 percent of its core capital in one industry or related group of companies or investments. Savings associations may not invest more than 25 percent of their total capital in bank-owned life insurance without first notifying and obtaining authorization from their OTS Regional Office. However, institutions should not automatically assume that a concentration level as high as 25 percent is acceptable, as any investment level must be justified and supported with proper underwriting, pre-purchase analysis, and board approval as discussed in this policy statement.

This limitation also applies to all BOLI, including separate account BOLI, even when the insurance carrier identifies such investments as separate accounts made up solely of high quality investments. This is because the control over the investment, and lack of liquidity associated with BOLI apply to both separate account and general account products.

LTOB Limits

For certain separate account BOLI, a savings association may look through to the underlying asset for determining applicability of OTS's loans-to-one borrower limitations of 12 CFR § 560.93.

To qualify for separate treatment of the investment under 12 CFR § 560.93, a thrift must evaluate the issuer's controls over its separate account assets (such as internal and external audits of the assets and activities of the separate accounts, segregation of duties for staff managing the accounts, and a review of fund reporting requirements) and determine that such controls are sufficient to prevent any accidental or illicit misuse of assets in the separate accounts. During their examinations, OTS examiners will review the thrift's documentation evidencing the legality and appropriateness of the underlying investments, and the institution's evaluation of the sufficiency of the insurance company's internal and external controls over the separate accounts. In the absence of a thorough review by the thrift demonstrating a reliable and bankruptcy remote separation of such accounts by a financially sound and well-managed issuer, the limitations of 12 CFR § 560.93 will apply.

The savings association should also obtain a legal opinion stating that such separate account assets are insulated by statute or otherwise from other unrelated liabilities of the insurance company.

IX. Evaluate Alternatives

Some BOLI purchases involve indemnifying the institution against a specific risk. For example, savings associations sometimes purchase BOLI to indemnify the institution against the potential for loss arising from the untimely death of a "key person." As an alternative to purchasing BOLI, an institution may choose to self-insure against this risk. Other uses for BOLI purchases are to recover costs or provide for employee benefits. In these cases, instead of purchasing BOLI, an institution may choose to invest the money in other assets. Regardless of the purpose of BOLI, a complete pre-purchase analysis will include an analysis of the alternatives.

X. Document Decision

A savings association should maintain documentation adequate to show that the institution made an informed decision. The institution should continue to monitor that decision based on the standards set forth in this Handbook Section.

FINANCIAL CONSIDERATIONS

Institution management should also understand and analyze how BOLI will affect the institution's financial condition. Given the anticipated performance of the insurance, management should analyze the effect on the institution's earnings, capital, cash flows, and liquidity. Management should also consider the impact on the institution's earnings and capital should the institution, for any reason, need to surrender the insurance (before maturity at the death of the insured). This might occur if the institution had a credit quality concern relating to the issuer, if the tax treatment changed, or if the institution had other needs or uses for the invested funds.

RISKS ASSOCIATED WITH BOLI

Examiners should assess risk relative to its effect on capital and earnings. The applicable risks associated with BOLI are: *Transaction, Credit, Interest Rate, Liquidity, Compliance, and Price.* An analysis of how each of these risks affects the decision to purchase and hold BOLI is set forth in the following paragraphs.

Transaction Risk

The degree of transaction risk associated with BOLI is a function of a thrift not fully understanding or properly implementing a transaction. In addition to following the other guidelines included in this bulletin, savings associations should take two additional steps to help reduce transaction risk. Thrift management should have a thorough understanding of how the insurance product works and the variables that dictate the product's performance. The variables most likely to affect product performance are the policy's interest-crediting rate, mortality cost,[3] and other expense charges. Typically, the most significant variable is the interest-crediting rate, followed by the mortality cost. Therefore, before purchasing BOLI, a thrift should analyze projected policy values (CSV and death benefits) from multiple illustrations provided by the carrier. Savings associations should consider using different interest-crediting rates and mortality costs assumptions for each illustration.

Thrift management should also understand and analyze how BOLI will affect the thrift's financial condition. Given the anticipated performance of the insurance, management should analyze the effect on the thrift's earnings, capital, and liquidity. Management should also consider the impact on the thrift's earnings and capital should the thrift, for any reason, surrender the insurance before maturity at the death of the insured.

[3] Mortality cost represents the cost imposed on the policyholder by the insurance company to cover the amount of pure insurance protection for which the insurance company is at risk.

Credit Risk

All life insurance policyholders are exposed to credit risk. The credit quality of the insurance company and duration of the contract are key variables. With term insurance, credit risk arises from the insurance carrier's contractual obligation to pay death benefits upon the death of the insured. Credit risk is primarily a function of the insurance carrier's ability (financial condition) and willingness to pay death benefits as promised. Credit risk may be reduced by the support provided by state insurance guaranty associations or funds. A thrift's credit exposure through the ownership of term life insurance is not reflected on the thrift's balance sheet.

With permanent insurance, credit risk arises from the insurance carrier's obligation to pay death benefits upon death of the insured and from its obligation to return the CSV to the policyholder upon request. The risk is similar to that with term insurance, but there are a few differences. With most permanent insurance BOLI plans, the expected time for collection of death proceeds is extremely long. Additionally, the CSV is an unsecured, long-term, and nonamortizing obligation of the insurance carrier. The risk inherent in the insurance company's failure to return the CSV value is reflected on the thrift's balance sheet.

Before purchasing life insurance, thrift management should evaluate the financial condition of the insurance company and continue to monitor its condition on an ongoing basis. In addition to reviewing the insurance carrier's ratings, the thrift should conduct an independent financial analysis consistent with safe and sound banking practices for commercial lending. As with lending, the depth and frequency of the analysis should be a function of the relative size and complexity of the transaction.

Interest Rate Risk

General account[4] products expose the policyholder to interest rate risk. The interest rate risk of these

[4] General account life insurance products include whole life insurance or annuities where the policyholder's cash value and any income is supported by the general assets and credit of the issuing insurance company.

products is primarily a function of the policy's interest-crediting rate. The insurance carrier establishes interest-crediting rates. Over the long term, interest-crediting rates are primarily a function of the carrier's investment portfolio performance. The policy's CSV grows at a slower rate with a declining interest-crediting rate. Since a thrift's investment in permanent insurance is recorded at the policy's CSV, the thrift's earnings decline as the policy's interest-crediting rate declines.

Due to the interest rate risk inherent in this product, it is particularly important that management fully understand the risk before purchasing the policy. Before purchasing permanent insurance, thrift management should:

- Review the policy's past performance over various business cycles.
- Analyze projected policy values (CSV and death benefits).
- Consider having the carrier use a different interest-crediting rate for each set of policy projections.

Variable or separate account[5] products may also expose the thrift to interest rate risk depending on the types of assets held in the separate account. For example, if the separate account assets consist solely of Treasury securities, the thrift is exposed to interest rate risk in the same way as holding Treasury securities directly in its investment portfolio. However, because the thrift does not control the separate account assets, it is more difficult for the thrift to control this risk. Therefore, before purchasing a separate account product, thrift management should thoroughly review and understand the instruments governing the investment policy and management of the separate account. Management should understand the risk inherent within the separate account and ensure that the risk is appropriate for the thrift. Also, the thrift should establish monitoring and reporting systems that will enable the thrift to monitor and respond to price fluctuations.

Liquidity Risk

Usually, life insurance policies are not marketable and are illiquid. A secondary market for life insurance does not exist. Although the CSV of policies can be accessed quickly, it typically involves substantial loss. To access the CSV, the thrift must withdraw from or borrow against the policy. This may subject the thrift to surrender charges, taxes on the gain, and a tax penalty. In addition, the policyholder generally does not receive any cash flow until the death benefit is paid. The lack of liquidity in the product is more significant given that savings associations normally purchase life insurance policies through a conversion of a liquid asset (cash or marketable securities).

Before purchasing permanent insurance, management should recognize the illiquid nature of the product and ensure the thrift has the long-term financial flexibility to hold this asset in accordance with its expected use. The inability of a thrift to hold the life insurance until maturity (collection of death benefits) may compromise the success of the BOLI plan.

Compliance Risk

Failure to comply with applicable laws, rules, regulations, and prescribed practices (including this bulletin) could compromise the success of a BOLI program and result in significant losses for the thrift as a result of fines, penalties, or loss of tax benefits. Because tax benefits are critical to the success of most BOLI plans, management of a thrift should exercise caution to ensure that its plans comply with all applicable tax laws. In addition, thrift management should ensure compliance with other applicable legal and regulatory standards. Other common legal and regulatory considerations include compliance with state insurable interest laws, the Employee Retirement Income Security Act of 1974 (ERISA), sections 23A and 23B of the Federal Reserve Act, 12 CFR

[5] Variable or separate account life insurance products may take the form of universal life insurance or annuities where the policyholder's cash value and income is supported by assets held by the insurance company in assets that are segregated from the general assets of the carrier. The policyholder assumes all investment and price risk, and the insurer serves to manage the assets for the policyholder and administer the policy. Generally, assets in separate accounts can only be used for payment of insurance and administration costs related to the policy and policyholder benefits.

Part 215 (Regulation O), and Appendix A to 12 CFR Part 30 - Interagency Guidelines Establishing Standards for Safety and Soundness. Due to the significance of the compliance risk, a thrift may want to seek the advice of qualified counsel.

Price Risk

Typically, price risk is associated with separate account BOLI. The policyholder selects an asset or group of assets to invest in and assumes all price risk associated with the investments within the separate account. In general, neither the CSV nor the interest-crediting rate on separate account products is guaranteed by the carrier. The amount of price risk is dependent upon the type of assets held within the separate account. With separate account BOLI, a savings association may elect to invest in very high quality assets or low quality assets. A savings association may only invest in separate account BOLI investments that the thrift may invest in directly.

Because the thrift does not have direct control the separate account assets, it is more difficult for the thrift to control the price or other risks. Therefore, before purchasing a separate account life insurance product, thrift management should thoroughly review and understand the instruments governing the investment policy and management of the separate account. Management should understand the risk inherent in the separate account and ensure that the risk is appropriate for the thrift. Also, thrift management should establish monitoring and reporting systems that will enable them to monitor and respond to price fluctuations.

Savings associations may purchase separate account insurance products that hold equity securities only for the purpose of hedging their obligations under employee compensation and benefit plans.[6] This lessens the effect of price risk on the thrift's financial statements because changes in the amount of the thrift's liability will be hedged by changes in the value of the separate account assets. An example of such a relationship would be where the amount of the thrift's deferred compensation obligation is measured by the value of a stock market index, and the separate account contains a stock mutual fund that mirrors the performance of that index. If the insurance cannot be characterized as an effective hedging transaction, the presence of equity securities in a separate account is impermissible.

In addition to the general considerations discussed above, which are applicable to any separate account product, further analysis should be performed when purchasing a separate account product involving equity securities. At a minimum, thrifts should:

- Analyze the thrift liability being hedged (e.g., deferred compensation) and the equity securities to be held as a hedge in the separate account. Such an analysis usually documents the correlation between the liability and the equity securities, expected returns for the securities (including standard deviation of returns), and current and projected asset and liability balances.
- Determine a target hedge effectiveness ratio and establish a method for measuring hedge effectiveness. Establish a process for altering the program if hedge effectiveness drops below acceptable levels. Consideration should be given to the potential costs of program changes.
- Establish a process for analyzing and reporting the effect of the hedge on the thrift's income statement and capital ratios. Such an analysis usually shows results both with and without the hedging transaction.

ACCOUNTING CONSIDERATIONS

Savings associations should follow generally accepted accounting principles (GAAP) for financial reporting and Thrift Financial Report purposes. Financial Accounting Standards Board (FASB) Technical Bulletin 85-4, Accounting for Financial Purchases of Life Insurance, discusses how to account for investments in life insurance. The guidance set forth in Technical Bulletin 85-4 is generally appropriate for all forms of BOLI.

The savings association should follow FASB Technical Bulletin No. 85-4 when accounting for

[6] An economic hedge exists when an institution offsets changes in the value of the liability or other risk exposure being hedged by counterbalancing changes in the value of the hedging instrument.

insurance policies where the association receives all the cash value benefits. Sometimes the association receives all the benefits, but separately agrees to provide those benefits to the employee as deferred compensation. In this case, the savings association should account for the cash surrender value in accordance with FASB Technical Bulletin No. 85-4. Also, they should record a deferred liability for the deferred compensation arrangements in accordance with Accounting Principles Board Opinion No. 12, as amended by SFAS No. 106.

Under employee benefit split-dollar policies, the association and the employee agree to share in the policy's cash surrender value and death benefits. In some circumstances, the savings association may not be accruing a separate liability for the employee benefit. In such instances, the association should record an asset for its investment in the policy equal to the lower of one of the following values:

- The policy's cash surrender value, determined in accordance with FASB Technical Bulletin No. 85-4.
- The present value of the future cash flow(s) the savings association expects to receive discounted at an appropriate interest rate in accordance with Accounting Principles Board Opinion No. 21.

The savings association should immediately record the amount exceeding the investment as an employee benefit expense. The savings association may also, where appropriate, record it in other assets as a deferred charge. The savings association must amortize the asset as an employee benefit expense in a systematic and rational manner over the time remaining until the employee's full eligibility date. The association should update its interest in the CSV at least quarterly.

OTHER CONSIDERATIONS

A savings association should evaluate the financial condition of the insurance company before purchasing a life insurance policy. The association should continue to monitor its condition while the policy is in force.

The association should consider the tax and economic consequences of surrendering a cash value insurance policy before its maturity should that become necessary. The savings association should also consider the effect of any significant holdings of cash value life insurance (considered a long-term investment) on its capital and liquidity.

In addition, savings associations should determine the applicability of, and ensure compliance with, 12 CFR §§ 563.41, 563.42, and 563.43. For example, split-dollar arrangements may be subject to 12 CFR § 563.41 when a savings association purchases an insurance policy and the beneficiary is its holding company or a management official of the holding company. You must consider this an unsecured extension of credit. This is because the association pays the holding company's portion of the premium and the holding company will not fully reimburse the savings association for its payment until some time in the future. Federal savings associations may not make unsecured loans to affiliates.

In other cases, the parent holding company may actually own the insurance policy and pay the entire premium. A subsidiary association may make annual loans to the holding company in an amount equal to the premiums paid or, equal to the annual increase in the cash surrender value of the policy, with the insurance policy serving as collateral for the loan. The holding company repays the loans upon either the termination of employment or death of the insured employee. These loans are subject to the quantitative restrictions of 12 CFR § 563.41, including the collateral requirements, 130 percent of the amount of the loan in this case. Therefore, the transactions must also comply with the provisions of 12 CFR § 563.42.

Because the holding company is the beneficiary of the insurance policy, it is a participant in a transaction between a savings association and a third party.

Moreover, certain insurance arrangements may be subject to Regulation O. In cases where the savings association purchases the insurance to provide a fringe benefit to an executive officer of the savings association and the association pays the cost of the policy, the officer should either:

- Reimburse the association for the amount of the premiums, or
- Report the economic value of the insurance benefit to IRS as additional taxable or deferred income.

If the officer is responsible to reimburse all or a portion of the value of the insurance benefit, the obligation represents a loan by the association to the executive officer and may be subject to Regulation O.

The savings association should ensure execution of the appropriate policy endorsements, assignments, and related agreements. The savings association should also ensure that the policy provides adequate safeguards and controls to protect its interest in the policy. Determine whether the association's share of any cash surrender value and death benefits was appropriately endorsed or assigned to the association.

Evaluate all significant holdings and future purchases of life insurance by savings associations in light of the above guidelines. Consider any formal or informal contracts with the executives for deferred compensation or other benefit payments linked to the insurance arrangements. Review related contracts with the insurance policies.

INTRODUCTION

When a savings association repossesses property, there is a distinct possibility of loss on the liquidation of the property otherwise the borrower would not have defaulted. Real estate owned (REO) is real property that a savings association holds as a consequence of defaults on loans. It is typically a poor or non-earning asset and a savings association's acquisition of a limited amount of REO is an unavoidable result of normal business operations.

REO includes real estate acquired in the following ways:

- Real estate in judgment.
- Real estate acquired through foreclosure.
- In-substance foreclosures. [1]
- Real estate acquired through deed in lieu of foreclosure.
- Any real property exchanged for foreclosed real estate.

If a question arises as to whether the savings association should report a parcel as REO, you should look to economic substance rather than to the legal form in which the property is held.

Other repossessed assets are non-real estate property the savings association takes possession of to satisfy some or all of a borrower's debt.

The usual types of other repossessed assets include the following properties:

- Personal property: vehicles, mobile homes, boats, airplanes, etc.
- Commercial goods: equipment, furniture, fixtures, inventories, accounts receivable, lease receivables, etc.
- Investments: stocks, bonds, certificates of deposit, etc.
- Other: intangible assets, cash surrender value of life insurance policy, etc.

Throughout this Section, we use the terms foreclosure and repossession (and other forms of those terms) interchangeably.

Supervisory Concerns

An increase in a savings association's REO and repossessed assets portfolios should serve as red flags to both you and management. Increases in these portfolios may indicate deteriorating economic conditions, lax adherence to loan underwriting standards, or deficient loan administration. The historical absence of REO may be indicative of overly restrictive loan underwriting criteria or a lax foreclosure policy.

You should perform the following steps:

- Review the savings association's internal asset review program.
- Evaluate the adequacy of internal controls.
- Interview management concerning:
  - the detection of potential problem credits.
  - the effectiveness of resolutions (workouts) and collection of problem loans.

[1] If the savings association does not expect full payment of all amounts due for an impaired, collateral-dependent loan, the savings association should measure the impairment based on the fair value of the collateral less costs to sell. Pursuant to SFAS No. 114, the lender should report the impaired loan as an in-substance foreclosure if it has physical possession of the collateral. Other collateral-dependent loans that the lender does not possess remain categorized as loans.

The savings association should evaluate the likelihood of repossessing an asset for all seriously delinquent loans. The savings association should also consider other alternatives to repossession. Prior to foreclosure or repossession, management should check with the proper authorities to verify the existence of a valid recorded lien. At that time, the savings association should determine the market value of the collateral. The savings association should also obtain sufficient insurance coverage on the asset after the savings association takes possession.

Appraisals

In accordance with 12 CFR §560.172, savings associations must appraise each parcel of REO at acquisition, consistent with the requirements of Part 564. A savings association must appraise each parcel of real estate owned at the earlier of an in-substance foreclosure or at the time of the savings association's acquisition of the property. Thereafter, prudent management policy dictates the timing of appraisals. The regional director (or designee) may require subsequent appraisals if they deem necessary under the circumstances. Savings associations must carry REO on the books at the lower of recorded cost or fair value less costs to sell. Therefore, OTS does not require an appraisal upon disposition of the property; however, the savings association's policies may require one.

Accounting at Foreclosure

Statement of Financial Standards No. 15 (SFAS 15), SFAS No. 114, and SFAS No. 121 generally provide the accounting treatment for REO including in-substance foreclosures.

Savings associations must initially record foreclosed assets deemed held for sale at the lower of one of the following amounts:

- Recorded investment (that is, carrying value before deduction for valuation allowances) in the loan.

- Fair value less costs to sell the foreclosed asset.

  The costs to sell an asset include the estimated incremental direct costs to transact the sale of the asset. This includes such costs as broker commissions, legal and title transfer fees, and closing costs. Costs to sell generally exclude insurance, security service, and utility costs.

Upon foreclosure (including in-substance foreclosure), the savings association must compare the recorded investment in the loan (carrying value before deduction for valuation allowances) to the fair value less costs to sell the foreclosed property.

The savings association must classify as Loss and charge off any amount in excess of recorded investment over fair value less costs to sell. The savings association cannot represent this Loss classification by a valuation allowance.

Savings associations must expense, as incurred, legal fees and direct costs of acquiring title to foreclosed assets.

Hold or Sell Decision

Once a savings association acquires a property through foreclosure or repossession, management should begin the decision-making process of whether to hold the property or sell it (possibly in an unfavorable market). A primary consideration when selling the asset is whether the savings association will have to make a loan to facilitate the sale. The savings association must consider the overall cost if it regains the property by later having to foreclose on the loan to facilitate. If a subsequent foreclosure becomes necessary, the condition of the property may be worse than when the savings association initially took possession. Moreover, if the most recent borrower failed to service the debt at all, the savings association has

sacrificed any income it could have received from an interim use of the property.

In making the decision when and if to sell the repossessed property at the least cost to the savings association, management should attempt to quantify, at a minimum, the following costs and benefits:

- Loss on an encumbered quick sale of property "as is."
- Cost of completing, restoring, and enhancing the project.
- Cost to prevent deterioration of the asset during the anticipated holding period:
  - Insurance
  - Physical security (fencing, security service, etc.)
  - Maintenance (mowing, utilities, structural repair, etc.)
  - Intangible (lost goodwill, etc.).
- Cost of selling the property (advertising, broker's commission, defects observed at inspection, etc.).
- Opportunity costs to the savings association, for example, based on the alternative uses of the sales proceeds.
- Cost of providing favorable financing (discount future and probable cash flows to present value).
- Anticipated appreciation or depreciation during the holding period.
- Benefit when property sold at end of holding period (discount proceeds to present value, determine yield based on current market rates).
- Benefit of interim use of the property in a lease or rental arrangement.
- Requirements imposed by 12 CFR § 567.1 to dispose of equity investments in real property within a specified time period to maintain capital rule treatment as REO. This period is generally five years unless OTS approves a longer period.

The above analysis should assist management in making an informed decision on the disposition of the savings association's REO and repossessed assets.

Five-Year Holding Period

OTS defines an equity investment in 12 CFR § 567.1 to exclude real property the savings association obtained in satisfaction of a debt or acquired under a judgment or mortgage. This is true if the savings association does not intend to hold the property for real estate investment purposes and plans to dispose of the property within five years. If requested, OTS may approve a longer period. OTS considers the extension of time a supervisory decision. For OTS to consider such extensions, the savings association should address the following items in its request letter:

- The term of the extension and the reason for the request.
- Whether the savings association, in good faith, tried to dispose of the property.
- How the accountants regard the property for GAAP purposes.

Internal Asset Review

As a sound banking practice, savings associations should conduct periodic reappraisals and reassessments of REO and other repossessed assets. We noted exceptions to this requirement in the Appraisals section presented earlier. The classification of assets regulation does not mandate that the institution automatically classify all foreclosed property. Handbook Section 260, Classification of Assets, discusses situations where savings associations need not classify REO. REO is sometimes an unsound asset even

when recorded at fair value. The savings association's acquisition of the property normally indicates a lack of demand. As time passes without disposition, the lack of demand becomes more apparent and the quality of the asset becomes more doubtful.

The savings association should consider each repossessed item on an individual basis and, if necessary, classify it adversely on the basis of facts supporting your evaluation. For instance, if a developed parcel of REO is receiving steady cash flows at a market yield, an adverse classification may not be necessary.

Accounting after Foreclosure

For periodic evaluations of REO for impairment, *after* foreclosure, the savings association must classify as Loss, and charge off or represent by a specific valuation allowance, any excess of recorded investment over current fair value less cost to sell. Savings associations must deduct valuation allowances from the recorded investment to arrive at carrying value.

OTS policy does not automatically require general valuation allowances (GVA's) on REO. The institution should establish GVAs when it is likely to experience losses when disposing of REO or is likely to incur holding costs that are not reflected in the fair value estimate. The savings association should base the level of any required GVAs on REO on its historical net loss experience, adjusted for current conditions and trends.

OTS does not recognize loss allowances (general or specific) on foreclosed (REO) assets held for sale as a component of Tier 1 (core) or Tier 2 capital. The regulatory capital standard only includes GVAs related to loans and leases in Tier 2 capital up to a certain limit.

Real Estate Owned (REO) Workouts

Management must assess the level of in-house expertise available to manage REO workouts. Management should consider the possibility of looking outside the association for the necessary level of expertise. This should include recruiting and employing real estate workout specialists and using real estate workout companies on a contract basis.

Management is responsible for reviewing the economic merits of out-sourcing REO disposition plans. If any savings association identifies any regulatory issues of concern during its process of selecting an outside REO workout program, it should raise these issues with the appropriate examination or supervisory personnel. They will provide advice on whether the vendor's proposal conforms with regulatory procedures and safe and sound practices. Savings associations should be aware that OTS neither approves nor endorses specific REO workout proposals. Savings associations should bring to OTS's attention any representations by any organization to the contrary.

Accounting for Sales of Real Estate

Accounting for the sale of real estate requires the determination of the following two issues:

- The point at which a sale actually occurs.
- How the savings association recognizes the gain on the sale.

When an association does not recognize a sale they should classify the asset as REO. Generally, the savings association may consummate a sale once the following events occur:

- The terms of a contract bind the parties.
- The exchange of all consideration.
- The seller, if responsible, arranges for any permanent financing.
- The parties perform on all conditions precedent to the closing.

See SFAS 66, Accounting for Sales of Real Estate, paragraph (6).

Gains

Generally, a savings association does not recognize a gain for accounting purposes if the seller retains some type of continuing involvement in the property without transferring the risks and rewards of ownership to the buyer. Continuing involvement includes any of the following situations:

- The seller makes an obligation to repurchase the property.
- The seller retains an equity interest in the property.
- The seller guarantees an investment return to the purchaser.
- The seller must initiate or support operations or continue to operate the property at the seller’s own risk.

If, after the transaction, the savings association retains some type of continuing involvement in the property, the transaction may not qualify for gain recognition. The savings association should defer any gain and credit to an account descriptive of unearned gain on the sale of real estate.

Savings associations must account for all gains under generally accepted accounting principles (GAAP). SFAS No. 66 specifies the amount and timing of gains the seller of real estate may recognize when the sale depends upon the seller's continuing involvement and retention of risks. The savings association may recognize all gains at the time of sale as long as the sale meets the following conditions:

- The savings association did not finance the sale.
- The savings association has no continuing involvement with the property.

In the more common situation where the savings association makes a loan to facilitate the sale of REO, the savings association may recognize the full gain if the sale meets all of the following conditions:

- The savings association and buyer consummate the sale.
- The buyer has adequate initial and continuing investments that demonstrate a commitment to pay for the property.
- The seller's receivable is not subject to future subordination.
- The seller transfers to the buyer the usual risks and rewards of ownership in a transaction that is, in substance, a sale and does not have a substantial continuing involvement with the property.

Loans to facilitate the sale of real estate do not fall under the loans to one borrower rule if the association takes a purchase money mortgage note from the purchaser and meets the following two conditions:

- The savings association does not advance any new funds to the borrower.
- The association is not in a more detrimental position as a result of the sale.

Handbook Section 211 describes circumstances where a savings association may use its salvage powers to exceed the Loans to One Borrower rules.

Losses

GAAP requires that if the sale of REO results in a loss, the savings association shall account for the loss in the period it sustained the loss. It is an unsafe and unsound practice for a savings association to fail to recognize losses from the sale of REO where the price is inflated above the market value. The inflated price may be a result of favorable terms the savings association provided in a loan to facilitate. GAAP requires discounting sales prices to reflect market interest rates for loans of similar terms and risk. You

should take exception and prompt supervisory action when savings associations finance significant amounts of their REO by loans at interest rates substantially below the current market rates.

REFERENCES

Code of Regulations (12 CFR)

§ 560.30	General Lending and Investment Powers
§ 560.93	Lending Limitations
§ 560.100-101	Real Estate Lending Standards
§ 560.160	Asset Classification
§ 560.172	Re-Evaluation of Real Estate Owned
§ 567.1(i)(4)	Definition of Equity Investment in Real Property

Financial Accounting Standards Board, Statement of Financial Accounting Standards

No. 5	Accounting for Contingencies (amended, in part, by SFAS No. 114)
No. 15	Accounting By Debtors and Creditors for Troubled Debt Restructurings (amended, in part, by SFAS No. 114 and SFAS No. 121).
No. 66	Accounting for Sales of Real Estate (amended, in part, by SFAS No. 121)
No. 114	Accounting by Creditors for Impairment of a Loan (amended and superseded, in part, by SFAS No. 118) (Amends SFAS No. 5 and SFAS No. 15, in part)
No. 118	Accounting by Creditors for Impairment of a Loan –Income Recognition and Disclosures (amends and supersedes, in part, SFAS No. 114)
No. 121	Accounting for Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of (amends, in part, SFAS No. 15 and SFAS No. 66)

Real Estate Owned and Other Repossessed Assets Program

Examination Objectives

To determine if the savings association's policies, procedures, practices, internal controls, and accounting treatment regarding REO and repossessed assets are adequate to maintain safe and sound operations at the following stages:

- Acquisition
- Valuation
- Management and maintenance
- Completion and improvement
- Disposition.

To determine the extent of the savings association's compliance with applicable state and federal regulations and its own policies.

To evaluate the quality of the saving association REO and repossessed assets.

To determine the adequacy of the internal asset review and audit functions in this area.

To determine whether the current or anticipated level of REO and repossessed collateral is consistent with the savings association's business plan and safe and sound banking practices.

To determine the extent of the repossessed assets' effect on operations.

To determine whether the savings association continues to pursue repayment from the borrowers after it sells the collateral.

To determine management's and the board's willingness and ability to initiate corrective action when policies, procedures, practices, and internal controls are deficient.

To summarize findings and to initiate corrective action when deficiencies exist that could affect safety and soundness, or when you note, and bring to their attention, violations of laws or regulations.

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Real Estate Owned and Other Repossessed Assets Program

Wkp. Ref.

Examination Procedures

Level I

1. Review scoping materials applicable to this program. If another examiner performed the review of scoping materials, obtain a written or oral summary of the information in the scoping materials relating to this program. Refer to the examiner in charge (EIC) or EIC-designee for instruction, if needed.

   Scoping materials might include the following items:

   - Prior examination report.
   - Exception sheets and work papers.
   - Internal/independent audit reports.
   - OTS financial analysis reports.
   - Supervisory analysis.
   - Correspondence.
   - Business plan.
   - Minutes of the meetings of the board of directors.
   - PERK information.
   - Review of market area economic conditions.

   _____ _____

2. Review the preceding report of examination and all REO and other repossessed asset-related exceptions and determine whether management has taken corrective action.

   _____ _____

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3. Determine the adequacy of the savings association's policies and procedures on REO and other repossessed assets by thoroughly reviewing pertinent items such as: policy statements, the internal asset review program, procedures manuals, the savings association's business plan, and board and committee minutes.

4. Conduct interviews with management and ascertain compliance with policies and procedures. Determine whether management reviews policies and procedures periodically and communicates changes to the appropriate savings association personnel.

5. Determine if the savings association's procedures, controls, and objectives in this area are safe and sound and in compliance with applicable laws and regulations.

6. Ascertain the major causes of repossessions and foreclosures (for example, inadequate credit or collection policies, loan concentrations, unsound construction lending procedures, poor appraisal policies or inadequate appraisal reports, depressed economic conditions, reacquisitions). Determine if management is aware of the underlying causes. Determine if they improve or correct policies and procedures when necessary.

7. Determine if the savings association has adequate staff to manage its current and projected levels of REO. Ascertain if management informs the employees responsible for managing these assets of relevant policies and procedures.

8. Determine if management has realistic plans for disposing of the REO and other repossessed assets portfolios. Determine whether management has considered the need for professional consulting or management firms to manage its more sophisticated acquisition, development, or construction type projects. If management is opting to retain the property, the analysis and documentation justifying such a decision should be on file.

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9. Determine whether the savings association's real estate workout personnel have sufficient expertise to effectively manage the savings association's REO. Additionally, consider whether the savings association uses REO workout consultants or other third-party professionals to assist in this area, and whether the savings association's management adequately scrutinized these arrangements.

10. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

Level II

11. Obtain a detailed listing of the assets and reconcile to the general ledger balances. Determine if the savings association correctly reports REO and other repossessed asset balances on the Thrift Financial Reports. Have the savings association make corrections to the Thrift Financial Reports (or correct reporting on the next Thrift Financial Report) if you determine that they incorrectly report REO and other repossessed asset balances.

12. Determine whether the savings association established any specific loss reserves and made charge-offs where warranted. In establishing valuation allowances, determine if management reviews the following considerations:

- Vandalism to the property.
- Anticipated demolition or razing.
- Additional construction costs to complete, restore, or improve.
- Obsolescence.
- Compliance with zoning requirements.
- Failure to sell at asking prices.

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- The costs of managing and maintaining REO.

13. Prepare the proposed asset classification write-ups (if warranted) and determine management's concurrence. Leave a list of all proposed REO and repossessed asset classifications with management.

14. Review a list of all loans to facilitate the sale of REO or significant other repossessed assets.

15. Determine if the terms of sale are realistic, and that the savings association structured the loan to a creditworthy borrower such that reacquisition is unlikely. Determine if the savings association overstates sales and prices to defer losses. Analyze the effective cost of below-market financing and whether the savings association recorded the proper profit or loss.

16. On a selected sample of asset files, check source documents (receipts, invoices, etc.) against general ledger entries. Ensure the association made accurate accounting entries to capitalize certain REO costs. Appropriate capitalizations limited to fair value might include the following items:

    - Unpaid loan balances, excluding accrued uncollected interest.
    - Taxes and assessments advanced and due, or those accrued up to the time of acquisition.
    - Insurance premiums advanced.
    - All other unpaid advances due at the time of acquisition.
    - Improvements or enhancements that add to value.

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17. Determine whether the savings association capitalizes expenses of REO operations in an attempt to defer operating losses. Have the savings association correct the entries where necessary.

18. From a selected sample, determine whether the savings association holds a valid title for REO and other repossessed assets.

19. Determine that the savings association paid any taxes due on REO parcels as required by local law.

20. Determine if the savings association obtained adequate hazard and public liability insurance for REO selected for review.

21. Review a selected sample of REO acquisition appraisal reports for conformance with the savings association's appraisal policies and determine whether the savings association obtained the appraisals promptly upon foreclosure. Ensure that the savings association obtains annual reappraisals when appropriate and in conformance with the savings association's appraisal policies. Calculate fair values when necessary.

22. Reconcile foreclosed and repossessed property totals for this examination to totals from the previous examination using the following documents:

- Current listing of foreclosed and repossessed assets.
- Summaries of assets sold.
- Attorneys' letters.
- Minutes of the board of directors and applicable committees.

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- Work papers from the previous examination.

23. Review the sales of all foreclosed and repossessed property since the previous examination. (A sampling is acceptable if there a large number of transactions.) Determine if management is pursuing personal liability judgments against borrowers, if allowed by law. Obtain management's response if it is not.

24. Prepare a summary income statement dealing only with REO operations to determine the carrying cost of the REO portfolio. The statement should cover the period since the previous examination and be comparable with similar analyses performed during prior examinations. Where significant, determine net operating income (NOI) (or net operating loss (NOL)) from REO operations. Note that the savings association must consider the cost of funds attributable to the average monthly balance of REO. Use the actual composite cost of money for the period being reviewed. That means apply the weighted average rate payable on deposits and borrowings to the balance of the REO account. Determine whether the savings association modified objectives, policies, and procedures for REO operations (acquisition, management, and disposition) based on the levels of income or loss reported.

25. Ascertain the effectiveness of management's efforts to prudently dispose of REO and other repossessed assets by determining if the savings association performs the following procedures:

- Sets reasonable sales (asking) prices compared with appraised values.
- Lists and advertises properties with brokers.
- Maintains reasonable selling expenses.
- Maintains sales volume commensurate with market conditions.
- Documents whether and why it holds properties off the market.

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- Analyzes the overall cost of previously sold REO now brought back into the portfolio, noting the increased cost, if any, to reclaim the property and restore it to its previous condition.
- Modifies disposition objectives (as stated in the business plan) and policies based on sales experience and market characteristics.

26. Ensure that your review meets the Objectives of this Handbook Section. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

Level III

27. Consider the following and determine the need for property inspections:

- Comparisons of book values and appraised values.
- A review of the asset files.
- Interviews with management.

Inspect appropriate properties to determine the following:

- Marketability.
- Reasonableness of appraised values.
- Quality of property maintenance.
- Whether OTS should require independent appraisals.

28. In the event the independent auditor's work papers are not available, you should take the following actions:

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- Test check accounting entries for any property disposed of since the previous examination.
- Review bids on sold assets for propriety.
- Review any transactions with insiders or affiliates.
- Ensure that the savings association properly recognized gains and losses on sales.
- Review sales made on the basis of loan terms that were unreasonably favorable to the purchaser or borrower.
- Determine whether the savings association gave excessive commissions, fees, or other preferential treatment to dealers, brokers, or attorneys involved in handling foreclosures or repossessions.

Examiner's Summary, Recommendations, and Comments

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Real Estate Owned and Other Repossessed Assets Questionnaire

General Questionnaire	Yes	No
1. Does the institution give proper notification to the borrower prior to foreclosure or repossession?		
2. Does the institution promptly foreclose or repossess to minimize the risk of loss?		
3. Does the institution hold valid title to REO?.		
4. Does the institution review REO it acquires by deed in lieu of foreclosure for encumbrances of prior liens?		
5. Does the institution appraise real estate it acquires subsequent to its acquisition?		
6. Does the institution use a current appraisal to establish the asking price of property?		
7. Are there maintenance procedures in effect to ensure that properties will retain their market value?		
8. Are procedures in effect to ensure that the institution maintains and updates hazard insurance as necessary?		

	Yes	No
9. Does the institution maintain separate subsidiary records and files for each parcel showing items capitalized, expenses, rentals, etc.?		
10. Does the institution reconcile subsidiary ledgers for the individual properties to the general ledger at least monthly?		
By whom? _____		
11. Does the institution control rental income received from REO?		
12. Do any unbonded agents collect rents and/or manage properties?		
13. Does the board of directors periodically review the status of each REO parcel and repossessed asset?		
How frequently? _____		
14. Does an officer that reports to the board of directors approve sales of REO and other repossessed assets?		

Comments

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INTRODUCTION

Fixed assets are investments in property and equipment that contribute indirectly to a savings association's operations and have economic lives of greater than one year. These assets usually consist of savings association offices, leasehold improvements, and equipment. Savings associations invest in fixed assets directly through the purchase of assets or indirectly by lease. A savings association may also combine these ownership techniques in a sale/leaseback arrangement.

Fixed assets do not constitute a large percentage of total assets, but they can involve the commitment of substantial dollar amounts. You should assess the propriety of the savings association's investment in premises and equipment and determine the effect of the related expenses on the savings association's operations.

This Section of the Handbook assists you in your review of a savings association's fixed asset policies, procedures, and transactions.

You should consider the following areas in your review of fixed assets:

- The policies, procedures, and controls used in the acquisition, management, and disposition of fixed assets.
- Any investments in real estate to establish offices and related facilities and subsequent capital deductions as required.
- Any shared office lease agreements.
- Any sale/leaseback arrangements.
- The valuation and accounting method used.

Policies, Procedures, and Controls

The savings association should establish policies, procedures, and controls to ensure that fixed asset investments are prudent. The association should also have controls to ensure that the association periodically conducts physical inventories and maintains adequate insurance coverage on all fixed assets. The board minutes should document the approval of material fixed asset acquisitions and dispositions. Policies should require documentary proof that acquisitions fulfill a demonstrated need, are cost effective, and fit the overall goals of the savings association. Procedures should contain controls to prevent insider dealings, conflicts of interest, and misappropriation of assets.

Sections 563.41 and 563.42 of the regulations place restrictions on the purchase, sale, and lease of assets to or from an affiliate. Such transactions generally must be at arm's length and based on market value. Quantitative limitations also apply with respect to purchases of assets.

Office Premises and Land Acquired for Future Use

Section 560.37 authorizes a federal savings association to invest in real estate for the purpose of establishing offices and related facilities or for rental or sale. The aggregate investment in office and related facilities, improved or unimproved, may not exceed the association's total capital without approval by the OTS.

The OTS capital regulation generally requires savings associations to deduct equity investments from capital. This rule does not cover interests in real property that the savings association, its subsidiaries, or its affiliates intend to use primarily as offices or related facilities for the conduct of its business. OTS considers a building to be a savings association's premises if it (or its subsidiaries or affiliates) uses 25 percent or more of the building.

On a case-by-case basis, regional directors may allow a savings association using less than 25 percent of a building to consider that building a premise.” In such instances, regional directors should consider whether the building is signifi-

cant to the operations of the savings association and any other extenuating circumstances that pertain to the use of the building.

The association should develop land acquired for future expansion of the association's facilities as its directorate intended within one to three years. You should be alert to any deviation from the intended use of land held for future expansion. Management should thoroughly explain any instances where the association holds property and does not develop it for the association's use beyond three years. You should include the explanation in the report of examination. Ordinarily, an association must file an application for an office or related facility before it develops the site.

An association that acquires real estate for an office(s) or related purpose(s), but no longer intends to use it for that purpose may no longer account for it as a fixed asset. The institution should account for the asset as REO and must dispose of the asset within five years, or longer period as approved by OTS, after any one of the following events:

- Management determines not to file an application for approval of a proposed facility.
- OTS disapproves an application, and the association decides not to reapply for a facility at the same site.
- The association does not develop the asset for its own use within three years of acquisition.

The asset then becomes a non-earning, nonproductive asset. See Handbook Section 251, Real Estate Owned and Repossessed Assets. An association must account for any subsequent sale of a savings association's former office property in accordance with GAAP. We describe the GAAP accounting treatment later in this Handbook Section under Valuation and Accounting Methods.

The Home Owners' Loan Act substantially limits a federally chartered savings association's direct equity investment authority. However, holding real estate for investment, development, or resale is a permissible activity for service corporations of federally chartered savings association. This activity is subject to the limitations of 12 CFR § 559.5. Many federally chartered savings associations use service corporations to invest in real estate. The Federal Deposit Insurance Act, at 12 USC § 1831e(c), limits state-chartered savings associations' real estate held for investment to the amount permissible for a federally chartered savings associations. See the Equity Investments and Real Estate Development Handbook Sections for additional guidance.

Sharing Office Quarters

A federal savings association may lease office space to a financial institution or other company. OTS does not consider the association engaged in the activities of that other institution or company if the lease agreement does not constitute a de facto joint venture. The nature of the lease payments can sometimes help to determine whether the association and the other company established a joint venture or bona fide lease. For example, in some instances, the lease may require that a portion of the rent be fixed and another portion calculated as a percentage of the lessees revenues. Because the sharing of revenues may indicate a joint venture, the amount of any rent based on the lessee's revenue should be substantially less than 50 percent of the lessee's revenues. OTS would generally consider a percentage of less than 25 percent to be reasonable. In addition, the association must receive regular fixed payments that are substantially equivalent to the fair rental value of the property for OTS to deem the agreement a bona fide lease.

Any savings association that shares office space with another financial institution should follow certain guidelines to avoid conflicts of interest and usurpation of corporate opportunity. Institutions sharing common quarters must implement the following criteria:

- Maintain separate identities to avoid customer confusion.
- Create physical separation between each institution's cash transactional areas.

- Maintain adequate controls to ensure the integrity of assets, records, computers, currency, checks, safes, and vaults of the institutions.

The potential for customer confusion is greater when employees have dual responsibilities and customer contact on behalf of both institutions in a sharing arrangement. Therefore, the association should impose appropriate safeguards to address such risk. Policies and employee training material should include activities, restrictions, and responsibilities that apply to both functions of dual employees. Both parties must make a conscious effort to demonstrate to the public their separate corporate existence.

Certain areas should not be accessible to the employees of the institution sharing office quarters. These areas include restricted office areas such as vaults or teller counters, and records or equipment with no security controls. Access by employees of an institution sharing office space should be no different from the limited access available to the general public.

Each entity that shares common quarters should also have a plan to avoid conflicts of interest and usurpation of corporate opportunity. Such plans should address the following issues:

- Specific areas where conflicts and abuses may occur.
- Policies and actions that avoid potential conflicts and abuse.
- Procedures to deal with individuals who violate such policies.

Any savings association that shares office space with another financial institution should follow these guidelines. The guidelines apply regardless of whether the other financial institution is an affiliate or the association engages in tandem branching or agent banking. If the institutions involved in the sharing arrangement are affiliates, they must comply with the provisions of 12 CFR §§ 563.41 and 563.42.

Similar guidelines apply to lease arrangements between savings associations and their subsidiaries. The Subordinate Organizations handbook section contains a detailed discussion of the regulations and restrictions that address the savings association/subsidiary relationship. This handbook section includes standards on the maintenance of separate corporate identities and how to avoid potential conflicts and the usurpation of corporate opportunity. In addition, the policy standards contained in Thrift Bulletin 23-2 (Interagency Statement on Sales of Nondeposit Investment Products) applies to savings associations that lease office space to companies engaged in securities brokerage or certain insurance activities. Refer to the Nondeposit Investment Sales and Insurance sections for additional information.

Sale/Leaseback

Management may consider a sale/leaseback arrangement when the savings association is experiencing cash flow or financing problems or the arrangement provides income or tax advantages. A sale/leaseback is an agreement whereby the savings association (seller-lessee) sells the property and immediately leases all or part of it back from the new owner (buyer-lessor). The savings association makes lease payments and continues to use the asset.

A sale/leaseback is a variation of a capital lease. Capital leases provide a lessee with many advantages associated with direct ownership. In a capital lease, the lessee must make a stream of payments to the lessor; the amount must equal or exceed the price of the asset leased. The period of the lease often approximates the remaining economic life of the asset. In effect, a capital lease provides a financing vehicle for the lessee and accountants regard it as an asset.

Financial Accounting Standards Board Statement of Financial Accounting Standards (SFAS) No. 13 stipulates that if the owner transfers substantially all the benefits and risks of ownership to the lessee, then the owner should record the lease as a capital lease. FASB considers that the owner substantially transferred the risks or benefits of ownership if the transaction meets any one of the following criteria:

- The lease transfers ownership of the property to the lessee by the end of the lease term.
- The lease contains a bargain purchase option.
- The lease term equals 75 percent or more of the estimated economic life of the leased property. In addition, the beginning of the lease term does not fall within the last 25 percent of the total economic life of the leased property.
- The present value of the minimum lease payments at the beginning of the lease term is 90 percent or more of the market value to the lessor less any investment credit retained by the lessor.

If the sale/leaseback agreement qualifies as a capital lease, generally accepted accounting principles (GAAP) require the lessee to record the leasehold improvement as an asset and the obligation to make payments under the lease agreement as a liability. OTS considers a lease recognized as a capital lease under SFAS No. 13 to be an investment in real estate for office and related facilities. See 12 CFR § 560.37. A capital lease obligation is subject to the borrowing limitations of 12 CFR § 563.80. The lessee should initially record a capital lease as an asset and an obligation at an amount equal to the present value at the beginning of the lease term, as described in SFAS No. 13. In addition, for other arrangements, such as a sale/leaseback, also refer to SFAS No. 13.

The minimum lease payments generally include the following items:

- The minimum rental payments.
- Any guarantee of the residual value made by the lessee.
- The penalty for failure to renew the lease, if applicable.

The discount rate in determining present value of the minimum lease payments is the interest rate implicit in the lease or the lessee's incremental borrowing rate.

Because the parties generally negotiate the terms of a sale and the terms of a leaseback as a package, the accounting treatment for a sale/leaseback is to treat the sale/leaseback as a single transaction. SFAS Nos. 13, 28, 66, 98, and 121 further discuss sale/leaseback transactions. If a lease agreement does not meet at least one of the four criteria specific to a capital lease, accountants classify it as an operating lease by the lessee. An operating lease is a month-to-month temporary rental of property.

The accounting treatment accorded an operating lease is relatively simple. Charge the rental payment to expense as the lessor makes the payments or as they become payable. This assumes that the lease payments are paid on a straight-line basis. There is no balance sheet recognition of the leased asset.

Management should compare the cost of a sale/leaseback arrangement with that of other acquisition or disposition strategies. In simplest terms, the after-tax cost of a leaseback is the present value of the payments to the lessor plus the present value of the reversion price. This means that as lease payments increase relative to the sale price, the cost of the lease transaction increases.

The lease accounting for book purposes can differ significantly from the lease accounting for tax purposes. Therefore, a prudent lease decision should consider the timing of the after-tax funds flow. Estimate cash flows on an after-tax basis by comparing book and tax income and expense.

Computer Software

The costs of computer software that the savings association develops or obtains for internal use should be capitalized and amortized pursuant to AICPA Statement of Position 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use.

The savings association should charge to expense as incurred costs specifically associated with modifying internal-use computer software for the year 2000 (regardless of whether such costs are external or internal). This treatment is outlined in EITF Issue No. 96-14, Accounting for the Costs

Associated with Modifying Computer Software for the Year 2000.

Valuation and Accounting Methods

The valuation of the fixed asset will rely in part on the accounting treatment that the savings association applies to the asset and such factors as depreciation, tax effects, and discounting to present values. (Refer to Thrift Activities Regulatory Handbook Section 440, Present Value Analysis.)

Investments in fixed assets that the savings association makes within regulatory limitations and valued properly on the savings association's books should be consistent with the association's earnings, capital structure, operations, and business plans and strategies. To properly value their fixed assets the savings association should consider the tangible ownership costs such as maintenance and depreciation. In addition, the savings association should consider the intangible opportunity costs that can result from the diversion of funds from alternative income-producing investments.

The acquisition of fixed assets should be for sound economic reasons. The savings association should consider the following items:

- Opportunity costs associated with investments in fixed assets after determining the method and direct costs of the acquisition.
- Income tax consequences.

The savings association should establish the following specific records at the time they acquire an asset:

- A record of all their fixed assets at cost as required by GAAP.
- Individual accounts of property and equipment with descriptive records for each item.
- An audit trail for property and equipment sold, exchanged, or otherwise disposed.

The savings association may use groupings within equipment such as furniture, fixtures, teller equipment, automated teller machines, and automobiles. The savings association, however, should segregate land records from building records, even if consolidated for reporting purposes, because land is a non-depreciable asset.

The institution should calculate the amortization of productive fixed assets, commonly referred to as depreciation, separately for financial reporting and tax purposes. The method of depreciation must result in the systematic and rational allocation of the cost of the asset, less its residual value, over the asset's expected useful life.

For financial reporting purposes, a savings association may use several methods of depreciation, such as straight-line, declining-balance, or sum-of-the-years-digits.

For tax purposes, savings associations with property acquired after December 31, 1980, and before January 1, 1987, must depreciate it in accordance with the Accelerated Cost Recovery System (ACRS). Savings associations with property acquired after December 31, 1986, must depreciate it in accordance with the Modified Accelerated Cost Recovery System (MACRS). The resulting difference between book and tax depreciation is a timing difference that will reverse over the depreciable life of the asset. ACRS and MACRS are generally quicker depreciation methods than the methods used for financial reporting. In addition to these tax deduction systems, some savings associations may also compute depreciation separately for the Alternate Minimum Tax and for Adjusted Current Earnings when it is applicable. For additional information on the methods of depreciation for tax purposes, you should consult a regional accountant or tax specialist.

When equipment is idle and no longer productive (and the remaining book value of the asset is material), the savings association should report the asset at the lower of carrying amount or fair value less cost to sell. The savings association should not depreciate the equipment while it is held for sale or abandoned. SFAS No.121 allows reclassification to other assets if the savings association meets certain disposal requirements.

When the savings association disposes of fixed assets, the association should eliminate the balance in both the asset account and the accumulated depreciation account, then record any value received in exchange. The savings association should record depreciation on the asset up to the earlier of the date the savings association sells it or takes it out of use as a productive asset. Savings associations should carry fully depreciated fixed assets on the general ledger at their residual value.

REFERENCES

Code of Federal Regulations (12 CFR)

§ 545.91	Home Office
§ 545.92	Branch Offices
§ 545.95	Change of Office Location/ Redesignation
§ 545.96	Agency
§ 556.5	Branching by Federal Savings Associations
Part 559	Subordinate Organizations
§ 560.37	Real Estate for Office and Related Facilities
§ 560.172	Re-evaluation of Real Estate Owned
§ 563.41	Loans and Other Transactions with Affiliates and Subsidiaries
§ 563.42	Additional Standards Applicable to Transactions with Affiliates and Subsidiaries
§ 563.80	Borrowing Limitations
Part 564	Appraisals
§ 563.200	Conflicts of Interest

Office of Thrift Supervision Bulletins

TB 23-2	Interagency Statement on Sales of Nondeposit Investment Products

Financial Accounting Standards Board, Statement of Financial Accounting Standards

No. 13	Accounting for Leases
No. 28	Accounting for Sales with Lease-backs
No. 66	Accounting for Sales of Real Estate
No. 98	Accounting for Leases
No. 121	Accounting for the Impairment of Long-Lived Assets and for Assets to be Disposed of Emerging Issues Task Force

Other Accounting References

Emerging Issues Task Force

EITF No. 96-14	Accounting For the Costs Associated with Modifying Computer Software for the Year 2000

Statement of Position

SOP 98-1	Accounting for the Costs of Computer Software Developed or Obtained for Internal Use, American Institute of Public Accountants (AICPA)

Other References

Chs. 6 & 12	Standard Accounting Manual for Savings and Loan Institutions

Fixed Assets
Program

Examination Objectives

To determine whether the savings association has adequate policies, procedures, and controls for the acquisition, maintenance, and disposition of fixed assets.

To determine whether the current and planned levels of fixed assets are consistent with the savings association's business plan.

To determine whether the current and planned levels of fixed assets are detrimental to the savings association.

To evaluate the scope and adequacy of accounting procedures and auditing functions for fixed assets.

To summarize findings and to initiate corrective action when deficiencies exist that could adversely affect safety and soundness or when you note violations of laws or regulations.

Examination Procedures

Level I

Wkp. Ref.

1. Review examination scoping material related to fixed assets.

_____ _____

2. Review the preceding report of examination and fixed asset-related exceptions noted and determine whether management has taken corrective action.

_____ _____

3. Analyze the savings association's policies and procedures regarding the acquisition and disposition of, and total investment in, fixed assets and the related annual expenditures. Determine the reasonableness relative to the following items:

   - Business plan
   - Capital structure
   - Earnings
   - Nature and volume of operations

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- Future goals and objectives
- Future earnings
- Conflicts of interest
- Affiliate or insider transactions.

4. Determine if the board of directors approved material acquisitions and dispositions.

5. Discuss major planned capital expenditures with management.

6. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

Level II

7. Obtain a schedule of fixed assets and their accumulated depreciation. Balance the schedule to the general ledger. Determine if association properly reported fixed assets on the Thrift Financial Report.

8. For major purchases, determine if the association obtained independent appraisals, or competitive bids, and whether the transactions meet regulatory requirements.

9. Determine whether accounting treatment and reporting of fixed assets are correct.

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10. Determine the adequacy of feasibility and cost analysis studies supporting the association's:

    - Investment in large new projects where the savings association will expect rental income to reduce substantially its cost of occupancy.
    - Branch operation expansions.

11. Review leases pertaining to fixed assets. (Update the Continuing Examination File (CEF), if applicable.)

    - Determine if lease terms are having an adverse effect on the savings association's profitability and operations.
    - Determine if the association granted affiliates or insiders favorable lease terms to the detriment of the institution.

12. Determine whether association personnel are improperly using the association's fixed assets for their own benefit.

13. For sales, determine if the association financed the sale consistent with the conditions and terms offered the general public; and if the association received market value for the property.

14. Review documentation and determine whether the savings association made prudent decisions regarding assets sold and subsequently leased back; use present value techniques to determine cost to the savings association. (Refer to Thrift Activities Regulatory Handbook Section 440 for a review of present value.) Ascertain the effectiveness of sale/leaseback agreements and whether the association accounts for them according to GAAP and OTS guidelines.

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15. Obtain an explanation for the extended holding period of the site(s) if the association acquired real estate for use as an office or related facility more than three years ago but has not developed it. Document the explanation in the examination report.

16. Determine if the association accounts for any real estate they no longer intend to develop for their own use as REO.

17. For savings associations that share facilities with other financial institutions, determine whether the association has adequate guidelines to avoid conflicts of interest and usurpation of corporate opportunity. This should include a plan that addresses the following items:

    - Specific areas where conflicts and abuses can occur.
    - Policies and actions that avoid potential conflicts and abuse.
    - Procedures to deal with individuals who violate such policies.

18. Ensure that your review meets the Objectives of this Handbook Section. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

Level III

19. For sales judged to be below fair market value, determine need for reappraisals.

20. Determine whether the association carries property and equipment being held for sale, or no longer in use, at the lower of adjusted cost or market value. If there is evidence the association does not expect to recover the adjusted cost of major facilities still in service

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(that is, items that the savings association uses and not held for sale) determine if the savings association has written down or classified such items.

21. Relate any funding commitments under lease agreements and fixed asset expenditures, if significant, to the review of liquidity.

22. Determine that the association makes adequate provision for the following items:

- Maintenance of adequate hazard insurance, public liability insurance, non-owner automobile protection insurance, and automobile property damage insurance, as applicable.
- Arrangements for sharing equipment or facilities (for example, electronic data processing) with others.
- Periodic physical inventories of other fixed assets and reconciliations to fixed asset records.

Examiner's Summary, Recommendations, and Comments

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Fixed Assets
Questionnaire

	Yes	No
General Questionnaire		
Acquisition, Disposal, and Record Keeping		
1. Does an officer who does not also control related disbursement or receipt of funds sign for the acquisition or disposal of property?.....		
• By whom? _____		
2. Does the association have procedures that require the board of director's approval for all major acquisitions or dispositions of property? (If so, indicate the dollar threshold that constitutes a major transaction.) Does the board of directors approve all major transactions?		
• Amount: $_____		
3. Do the association's procedures require an independent appraisal of an asset to determine the propriety of the proposed purchase or sale price?		
• Frequency? _____		
4. Do the association's procedures require that regular charges be made for depreciation expense?		
5. Does someone who does not also have sole custody of the property prepare, execute, post, and adequately review records for the acquisition, disposition, or depreciation of property?.....		
• By whom? _____		
6. Does someone who does not have sole custody of the property balance all applicable property and depreciation records to the appropriate general ledger accounts? (The association should do this at least quarterly.).....		
• By whom?_____		
• Frequency?_____		
7. Does someone who does not also have sole custody of the property post subsidiary property and applicable depreciation records?.....		
8. Does someone who does not also have sole custody of the property balance subsidiary property and applicable depreciation records to the appropriate general ledger accounts? (The association should do this at least quarterly.).....		
Association as Lessor (Association Premises and Association Equipment Only)		
9. Do association policies provide for division of the duties involved in billing, collecting, and posting of rental payments?.....		
10. Does the association monitor the lease agreement terms (that is, accounting of payments and tenant expenses)?.....		
11. Does the association perform credit checks on potential lessees?.....		
12. Do association policies provide for periodic review of lessees to identify concentrations of affiliated or related concerns?.....		
Association as Lessee (Association Premises and Association Equipment Only)		
13. Does the association have a clearly defined method of determining whether they should own or lease fixed assets? Does the association maintain supporting documentation?		
14. Does the association have procedures to determine whether a lease is a capital or an operating lease as defined by GAAP under SFAS 13?		

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Fixed Assets
Questionnaire

	Yes	No
15. Do the association's operating procedures for capital leases provide for the review of the amount recorded for accuracy?		
Shared Facilities		
16. Are the association's personnel aware of the existence of guidelines for shared facilities?		
• Do personnel adhere to these guidelines?		
17. Are the personnel of the other entity aware of the association's guidelines for shared facilities?		
• Do they have their own guidelines?		
• Do personnel adhere to both sets of guidelines?		
Other		
18. Do the association's procedures preclude persons who have access to property from having sole custody of property, in that:		
• Its physical character or use would make any unauthorized use or disposal readily apparent?		
• Inventory control methods sufficiently limit accessibility?		
19. Do the association's procedures require review of additions to fixed assets to determine whether they represent replacement? Does the association clear any replacement items from the accounts?		
20. Do the association's procedures require signed receipts for removal of equipment?		
21. Does the association periodically perform a physical inventory of association equipment?		

	Yes	No
• If so, does someone who does not also have sole custody of the property review any differences from inventory records?		
22. Do the association's procedures provide for serial numbering of equipment for inventory purposes?		
23. Does the association maintain separate property files that include invoices (including settlement sheets and bills of sale, as necessary), titles (on real estate, vehicles), and other pertinent ownership data as part of the required documentation?		
24. Does the association have adequate physical safeguards for the property?		
25. Does the association account for property and equipment individually?		
26. Do association personnel improperly use the association's fixed assets for their own benefit?		
27. Does the association have written procedures for selecting a seller, servicers, insurer, or purchaser of major assets (through competitive bidding, for example) to prevent any possibility of a conflict of interest or self-dealing?		
28. Does the association obtain the benefit of expert tax advice from internal or external auditors before making final decisions on material transactions involving fixed assets?		
29. Do officers and directors periodically review the adequacy of insurance coverage?		

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Fixed Assets
Questionnaire

Comments

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INTRODUCTION

The system of classification of assets is one of the tools used to evaluate asset quality to determine the adequacy of valuation allowances. Classification of assets serves several purposes for both the Office of Thrift Supervision (OTS) and savings associations. Asset classifications can be used as a management tool to identify and monitor portfolio risk. An analysis of a savings association's classified assets is essential to the proper evaluation of a savings association's asset quality, financial condition, and ultimately, the risk to the Savings Association Insurance Fund (SAIF). The level of asset problems, as evidenced by classifications, also serves as a reflection of management's abilities to implement sound operating policies and procedures and to comply with regulatory requirements.

All savings association assets are subject to classification. Additionally, Substandard and Doubtful classifications must be considered in the determination of an adequate level of an association's general valuation allowances. Loss classifications require either the establishment of a specific allowance or charge-off of 100% of the balance so classified. (Refer to Thrift Activities Regulatory Handbook Section 261, Adequacy of Valuation Allowances.)

Asset Quality Ratings

As fully developed in Thrift Activities Handbook Section 209, Sampling, regulators select a sample of assets for review and analysis to determine credit quality. Each asset reviewed is assigned a quality rating based on a regulator's best judgment of the likelihood of repayment or orderly liquidation. Asset quality ratings are divided into three groups: Pass (unclassified), Special Mention, and Classified (adverse classification).

Pass

A Pass asset is considered of sufficient quality to preclude a Special Mention or an adverse rating. Pass assets generally are well protected by the current net worth and paying capacity of the obligor or by the value of the asset or underlying collateral.

Special Mention

On June 10, 1993, the federal banking and thrift regulatory agencies issued uniform guidance to clarify the use of Special Mention for supervisory purposes. The four agencies adopted the following uniform definition for Special Mention assets:

> The Special Mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

Assets that could be included in this category include loans that have developed credit weaknesses since origination as well as those that were originated with such weaknesses. This includes loans the institution is unable to properly supervise because of an inadequate loan agreement, inadequate control over collateral (when such control is necessary to effect full repayment of the loan), or when a loan is made with significant deviations from prudent lending practices. An adverse trend in the obligor's operations or the obligor's highly leveraged balance sheet may warrant a Special Mention designation, provided that neither condition has deteriorated to the point that timely repayment is jeopardized. If timely payment is jeopardized, an adverse classification may be warranted.

Special Mention should not be used to identify an asset that has as its sole weakness credit data exceptions or collateral documentation exceptions that are not material to the timely repayment of the asset. For example, the failure of an institution to obtain current borrower financial statements on a performing loan does not, by itself, indicate a weakness in the loan and should not be cause for the loan to be automatically designated Special Mention. There may be cases, however, where borrowers fail to provide updated financial statements because they are reluctant to disclose their poor operating perform-

ance, which could justify Special Mention designation or adverse classification. For large dollar amount loans, where the decision as to whether to classify the loan is heavily dependent on the borrower's (or property's) cash flows, regulators should have the institution obtain current financial statements during the examination or initiate other verification measures.

The Special Mention designation may also be appropriate when the collateral agreement of a performing loan is not properly executed. In such a case, if the borrower is dependent on the sale of, or the cash flow from, the collateral to repay the loan in a timely manner, then a Special Mention designation is appropriate (or, if timely repayment is jeopardized, an adverse classification may be warranted).

On the other hand, regulators should not designate as Special Mention a performing construction loan where the institution has failed to inspect construction in progress. The lack of such inspections is a deficiency in the institution's loan administration function and does not (by itself) indicate a weakness in the loan that may result in deterioration of the repayment prospects of the loan.

Finally, the Special Mention designation should not include loans listed merely "for the record," such as when uncertainties and complexities, coupled with a large loan amount, create reservations about the quality of the loan. Regulators are not expected to identify all loans that will become troubled at some future date. If weaknesses or evidence of imprudent handling cannot be identified, inclusion of an asset as Special Mention is not justified.

Careful identification of assets that properly belong in this category is important to determine the extent of risk in the portfolio and to provide constructive criticism to management. Generally, Special Mention assets will not be individually detailed in the report of examination (ROE). When Special Mention assets are detailed in the ROE, however, the loans should be written up in a manner similar to that used for adversely classified assets per the instructions outlined under the subheading, "Classified Asset Comments," found later in this Section.

Regulators should not combine Special Mention assets with classified assets in the ROE or other reports. As appropriate, however, regulators should continue to consider the level and trends of Special Mention assets in their analysis of the institution's overall asset quality.

Adverse Classifications

As provided for in the regulations, there are three adverse classification:

Substandard: An asset classified Substandard is inadequately protected by the current net worth and paying capacity of the obligor or by the collateral pledged, if any. Assets so classified must have a well- defined weakness or weaknesses. They are characterized by the distinct possibility that the association will sustain some loss if the deficiencies are not corrected. [12 CFR § 563.160.]

Assets classified Substandard may be characterized by one or a combination of the following weaknesses:

- Primary source of repayment is gone or severely impaired and the association may have to rely upon the secondary source;
- Loss does not seem likely, but sufficient problems have arisen to cause the association to go to abnormal lengths to protect its position in order to maintain a high probability of repayment;
- Obligors are unable to generate enough cash flow to reduce their debts;
- Deterioration in collateral value or inadequate inspection or verification of value (if the collateral is expected to be the source of repayment);
- Flaws in documentation leave the association in a subordinated or unsecured position when the collateral is needed for the repayment of the loan.

The presence of one or more of these factors does not mandate that the asset be adversely classified if, in the regulator's judgment, the presence of such factors does not indicate a weakness that jeopardizes the timely liquidation of the asset or disposition of the collateral, at the asset's book value.

Doubtful: An asset classified Doubtful has the weaknesses of those 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. [12 CFR § 563.160.]

The likelihood of a loss on an asset or portion of an asset classified Doubtful is high. Due to important and reasonably specific pending factors, however, its classification as Loss is not appropriate. Factors that may result in a Doubtful rather than Loss classification include: real property collateral whose value is uncertain due to toxic waste cleanup; proposed merger, acquisition, or liquidation procedures; capital injection; perfection of a lien on additional collateral; or refinancing plans.

The Doubtful classification should not be used to defer the full recognition of an expected loss. Management should attempt to identify, then recognize, losses in a timely manner.

Loss: That portion of an asset classified Loss is considered uncollectible and of such little value that its continuance as an asset, without establishment of a specific valuation allowance or charge-off, is not warranted. This classification does not necessarily mean that an asset has absolutely no recovery or salvage value; but rather, it is not practical or desirable to defer writing off a basically worthless asset (or portion) even though partial recovery may be effected in the future. [12 CFR § 563.160.]

An asset may be subject to a "split classification," whereby two or more portions of the same asset are given separate classifications. For example, assume that an association has an unsecured loan to a company in liquidation. The bankruptcy trustee has indicated a minimum disbursement of 40% and a maximum disbursement of 65% to unsecured creditors. In this situation, estimates are based on liquidation value appraisals with asset values yet to be realized. A proper classification would show 40% Substandard, 25% Doubtful, and 35% Loss. Therefore, if an association uses specific valuation allowances in lieu of charge-offs, both specific and general allowances would be established on the same asset. (Refer to Thrift Activities Regulatory Handbook Section 261, Adequacy of Valuation Allowances.)

Self-Classification

Savings associations are required by § 563.160 to independently review, classify, and set aside appropriate valuation allowances for their assets. OTS's classification system encourages associations to identify weaknesses inherent in their lending strategies and practices in addition to quantifying current problems. It serves as an early warning system and is a crucial tool to reduce the risks of loss to both the association and the SAIF. It can reveal lending patterns or deficiencies in portfolio administration that consistently cause an association collection problems. Once the association identifies such patterns or deficiencies, management and the board of directors can avoid practices that have resulted in a higher level of classified assets. In this way, the classification process can serve as a preventive, as well as a protective, function.

Although associations are not required to use the same categories as presented above, the categories should correlate to the classification definitions. This will serve to facilitate the examination process and the preparation of quarterly reports to OTS of aggregate totals in each of the three asset classification categories.

The regulator's primary focus should be to highlight and correct weaknesses in the association's self-classification system. A well-organized, competent, and independent internal asset review department that encompasses the self-classification process will ultimately result in less regulator time spent on loan reviews and asset classifications. It would be expected that the asset review department will segregate problem and potential problem loans and other assets, and provide a comprehensive analysis of these and larger credits. In those associations with a qualified asset review department, a regulator's time may be spent in review and possible update of the work performed by that department. Internally prepared credit quality analyses should be reviewed to determine concurrence with the association's assigned ratings. Larger credits that have not been assigned an adverse classification should be sampled to determine concurrence with the Pass rating and the integrity of the system. (Refer to Thrift Activities Regulatory Handbook Section 210, Lending Risk Assessment, as well as Section 209, Sampling.)

Association management is expected to update classifications between examinations, based on improvements or deterioration that occurs. The proper monitoring of asset quality necessitates the association's ability to either upgrade or downgrade classifications. If it is

determined that an association abuses its privilege to upgrade classifications, the regional director has the authority to revoke such privilege. In this situation, the association would continue to report self-classifications; however, no regulator-accorded classifications could be upgraded between examinations unless the asset classified had been liquidated or the institution receives the prior approval of the OTS to upgrade a classification. It is expected that a regulator's classifications should closely parallel those of the association. Where they do not, a careful review of the association's self-classification procedures is warranted to determine the reasons for the disparity.

Classification Considerations

Presented below are considerations that should be kept in mind when specific asset portfolios are reviewed. (Refer to individual asset quality Sections of this Handbook for more detailed analysis considerations.)

Commercial Loans

In the analysis of commercial loans for classification purposes, consideration is given to the purpose of the loan and the risk inherent in the project; the nature and degree of collateral security; the character, capacity, financial responsibility, and performance record of the borrower; and the feasibility and probability of orderly repayment of the loan in accordance with specified terms. The willingness and ability of a debtor to perform as agreed is the primary measure of the risk of the loan. This implies that the borrower must have earnings or liquid assets sufficient to meet interest payments and provide for reduction or liquidation of principal as agreed at a reasonable and foreseeable date. It does not mean, however, that borrowers must at all times be in a position to liquidate their loans, for in many cases that would defeat the original purpose of extending credit.

Commercial real estate loans are often primarily dependent on the cash flows of the underlying security to meet scheduled debt service. Regulators should analyze historical and projected cash flows and underlying assumptions of the property to determine if there is a sufficient debt service coverage (the net cash flows of the property divided by the required debt service).

Secondary sources of repayment, such as guarantors or endorsers, must be evaluated for ability and willingness to provide debt service when the primary repayment source is unable to perform. Regulators should consider the association's track record. Has it been able to successfully collect on such guarantees or endorsements in the past? Secondary sources of repayment may mitigate the loss potential on commercial loans. Regulators should review the guarantor's current financial information and past payment history, and judge whether orderly repayment of the debt through a secondary source will continue.

When a troubled commercial real estate loan is analyzed for a possible Loss classification, the regulator must consider the likelihood of the association obtaining title to the property through either foreclosure or a deed in lieu of foreclosure. Loans that an association has restructured are neither automatically classified nor exempt from classification. The credit must be analyzed in the same manner as other loans to determine risk of nonpayment. (Refer to Thrift Activities Regulatory Handbook Section 240, Troubled Debt Restructurings.)

Commercial real estate loans that are adequately protected by the current sound worth and debt service capacity of the borrower, guarantor, or the underlying collateral are generally not classified. Similarly, loans to sound borrowers that are renewed or refinanced in accordance with prudent underwriting standards to creditworthy commercial borrowers should not be classified unless well-defined weaknesses exist that jeopardize repayment. An institution should not be criticized for continuing to carry loans having weaknesses that result in classification as long as the institution has a well-conceived and effective workout plan for such borrowers and effective internal controls to manage these loans.

In evaluating commercial real estate credits for possible classification, regulators should apply the standard classification definitions described in 12 CFR 563.160. In determining the appropriate classification, consideration should be given to all important information on repayment prospects, including information on the borrower's creditworthiness, the value of, and the cash flow provided by, all collateral that supports the loan, and any support provided by financially responsible guarantors.

The loan record of performance to date is important and must be taken into consideration. As a general principal, a performing commercial real estate loan should not automatically be classified or charged off solely because the value of the underlying collateral has declined to an amount that is less than the loan balance. It would be appropriate, however, to classify a performing loan when well-defined weaknesses exist that jeopardize repayment, such as the

lack of credible support for full repayment from reliable sources.

These principles hold for individual loans, even if portions or segments of the industry to which the borrower belongs are experiencing financial difficulties. The evaluation of each loan should be based on the fundamental characteristics that affect the collectibility of the particular loan. The problems broadly associated with certain segments of an industry should not lead to overly pessimistic assessments of individual loans that are not affected by the problems of the troubled sectors.

Valuation and Classification of Troubled, Collateral Dependent Loans[1]

Effective March 31, 1995, OTS's policy for troubled, collateral-dependent loans (where proceeds for repayment can be expected to come only from the operation and sale of the collateral) is as follows:

For a troubled, collateral-dependent loan where, based on current information and events, it is probable that the lender will be unable to collect all amounts due (both principal and interest), the amount classified Loss should be no less than any excess of the recorded investment in the loan over the fair value of the collateral, and the remainder should generally be classified Substandard**.**

For a troubled, collateral-dependent loan, it is probable that the lender will be unable to collect all amounts due when the expected future cash flows, on an undiscounted basis, from the operation and sale of the collateral over a period of time not to exceed the intermediate term (e.g., five years) are less than the principal and interest payments due according to the contractual terms of the loan agreement. The term "all amounts due" is based on the original contractual terms, except as discussed below.

For a troubled, collateral-dependent loan (whether or not restructured) where, based on current information it is probable, but not reasonably assured, that the lender will be able to collect all amounts due (both principal and interest), the amount classified Doubtful should be no less than any excess of the recorded investment in the loan over the fair value of the collateral, and the remainder should generally be classified Substandard.

For a troubled, collateral-dependent loan, it will be deemed probable, but not reasonably assured, that the lender will be able to collect all amounts due when the expected future cash flows, on an undiscounted basis, from the operation and sale of the collateral over a period of time not to exceed the intermediate term (e.g., five years) are equal to or greater than the principal and interest payments due according to the contractual terms of the loan agreement.

An exception to this policy is for a loan that was restructured in a troubled debt restructuring involving a modification of terms prior to September 30, 1993. For loans restructured before September 30, 1993, the evaluation for probability of collection may be based on the collectibility of principal and interest under the restructured contractual terms. For all restructured loans, including loans modified before and after September 30, 1993, that become impaired after modification, the loan should be measured at the fair value of the collateral as discussed above.

OTS does not allow savings associations to use general valuation allowances to cover any amount considered to be a Loss under the above policy; however, Specific Valuation Allowances (SVAS) may be used in lieu of charge-offs.

Mortgage Loans (One- to Four-Family, Owner-Occupied Dwellings)

The primary indicator for classifying owner-occupied home loans is the past payment history. As such, slow loans (§ 561.48) provide a good starting point to determine the mortgage loans to be adversely classified. Due to the volume of such loans in the thrift industry, a regulator's time should not be invested in individual review of all slow mortgage loans to determine if adverse classification is

[1] The policy described in this Section does not apply to smaller balance homogeneous loans (such as one- to four-family owner-occupied home mortgage loans) that are generally classified on the basis of delinquency status.

appropriate. Rather, all slow mortgage loans are presumed to be Substandard, with the burden placed on management to provide reasons for nonadverse classification of individual credits. Possible reasons for not adversely classifying a slow mortgage loan might be the imminent sale of the property (evidenced by a signed agreement) that will liquidate the loan, or payments received during the examination that eliminate the loan from a slow status.[2]

Loans or contracts to facilitate the sale of foreclosed mortgages, though generally of higher risk due to high loan-to-value ratios, are not, by definition, slow loans. These loans are not presumed Substandard. The loan should be evaluated on the borrower's perceived ability to service the debt. Loans should not be adversely classified merely due to high loan-to-value ratios. In those associations with a material volume of loans to facilitate, the regulator should sample such loans to assure that sound underwriting criteria are followed; if sound underwriting criteria are not followed, all such loans may be reviewed. If a review of these loans provides the regulator with a sufficient degree of confidence that loans to facilitate are granted to borrowers with an ability to service the debt, then adverse classification may be limited to those loans that are slow. Again, management has the opportunity to provide documentation to support a Pass classification.

Consumer Loans

Consumer loans are credits extended to individuals for personal, family, or household expenditures, as defined in 12 CFR § 561.12. Evidence of the soundness of a consumer loan is best indicated by the repayment performance demonstrated by the borrower. This consideration, coupled with the fact that consumer loans are typically small in size and large in number, mandate a different approach to classification. Regulators are to follow 12 CFR §§ 561.13 and 561.47 when open-end and closed-end consumer credit are classified.

These regulations provide that: closed-end consumer installment credit delinquent 120 days or more (five monthly payments) will be classified Loss, and loans delinquent 90 to 119 days (four monthly payments) will be categorized as Slow. Open-end consumer installment credit (credit cards) delinquent 180 days or more (seven zero billing cycles) will be classified Loss, and loans delinquent 90 to 179 days (four to six zero billing cycles) will be categorized as Slow. As with owner-occupied mortgage loans, Slow credits are presumed Substandard, subject to management providing documentation that such an adverse classification is not warranted.

If an association can clearly demonstrate that repayment will occur regardless of delinquency status, then such loan need not be classified as Substandard or Loss. Examples of such situations are: the loan is well-secured by collateral and is in the process of collection; the loan is supported by a valid guarantee or insurance; or it is a loan where claims have been led against a solvent estate. "Well-secured" implies collateralization by liens on or pledges of real or personal property, including securities, that have a realizable value sufficient to discharge the debt in full, or collateralization by the guarantee of a financially responsible party. "In the process of collection" infers collection is proceeding in due course either through legal action or, in appropriate circumstances, through collection efforts not involving legal action that are reasonably expected to result in repayment of the debt or its restoration to a current status. For the purpose of computing delinquency, a payment of 90% or more of the contractual payment will be considered a full payment.

OTS regulations at 12 CFR §§ 561.13 and 561.47 do not preclude the adverse classification of consumer credit delinquent for a lesser period, or not delinquent, when such classification is warranted.

[2] When computing whether a modified or re danced loan is Slow, "(t)he date on which the association obligates itself is the date on which the modification or re financing becomes effective. Such a transaction becomes effective when all conditions precedent have been met by the borrower, thereby binding the association. For example, in states having an escrow procedure, a modification or re financing would become effective when all conditions of the escrow had been met." (Based on an internal interpretation of the General Counsel issued January 4, 1966; formerly issued as FHLBB Memorandum T 16-1.)

Investment Securities

Classification of investment securities is based on credit risk, not interest-rate risk. A decline in the market value of a security simply due to interest-rate fluctuations is not a basis for adverse classification. Classification should be based on the credit risk and collectibility of interest and principal that the association has booked as an asset.

In assessing the credit quality of securities, associations and regulators will find the qualitative ratings provided by recognized investment advisory services to be helpful guides. Regulators should become familiar with the various rating services and the qualitative standards implicit in their respective rating systems. See Thrift Activities Regulatory Handbook Section 220, Investment Securities, for rating descriptions.

Securities that are currently rated in the first four rating categories by these investment advisory services are generally considered of investment quality and not adversely classified. Securities that are not rated but are considered of comparable quality to securities in the first four rating bands are also generally not adversely classified. Associations should maintain current credit information on securities to assist in the determination of credit quality.

Ratings accorded by investment advisory services should not be regarded as absolute evidence of overall credit quality; therefore, associations and regulators should not feel constrained from deviating from the published ratings. However, in those instances where the recognized rating services are unanimous in assigning a rating and the regulator assigned a conflicting, adverse classification, the facts, as presented in a detailed write-up, must clearly and demonstrably support the examiner's findings. The ultimate and conclusive test of investment quality is actual credit soundness. The principles underlying analysis of credit soundness are essentially the same as those applicable to loan analysis.

Regulators should contact their regional offices for guidance before they adversely classify any security.

Noninvestment-Grade Corporate Debt Securities: FIRREA mandates that savings associations divest of all noninvestment-grade corporate debt securities as soon as prudently possible and in all cases by July 1, 1994. OTS applies the "Uniform Agreement on the Classification of Assets" of the federal bank regulatory agencies to all noninvestment-grade corporate debt securities.

The "Uniform Agreement" states that, "Securities in grades below the four highest ratings grades and unrated securities of similar value (quality) will be valued at market price and the depreciation will be classified Doubtful; remaining book value will be classified Substandard. Depreciation in defaulted securities will generally be classified Loss; remaining book value will be classified Substandard." For noninvestment-grade corporate debt securities, any excess of amortized cost over fair value is classified Loss (specific allowance or charge-off) and the remaining book value is classified Substandard.

Real Estate Acquired by Foreclosure

At foreclosure, foreclosed assets, including real estate acquired by foreclosure, are to be reported at the lower of: (1) the recorded investment in the loan (i.e., cost) or (2) the fair value of the foreclosed asset. Any excess of recorded investment over fair value is to be classified Loss and is to be charged-off. This Loss classification may not be represented by a valuation allowance. Accordingly, the lower of: (1) the recorded investment in the loan or (2) the fair value of the foreclosed asset becomes the new recorded investment in the foreclosed asset. Legal fees and direct costs of acquiring title to foreclosed assets are to be expensed as incurred.

The recorded investment in the loan includes the balance of principal, accrued interest, deferred origination fees and costs, and purchase premium or discount. The recorded investment in the asset does not reflect any valuation allowances; the carrying value of the asset does reflect valuation allowances. Fair value is to include a reduction for the seller's disposition costs, and is to be substantiated by a current appraisal at the time of acquisition (see 563.172).

Subsequent valuations of foreclosed assets should follow the guidance provided in Handbook Section

251, "Real Estate Owned and Repossessed Assets."

Real estate acquired by foreclosure is often an unsound asset, even when recorded at fair value. The association's acquisition of the property is normally indicative of a lack of demand. As time lapses, the lack of demand becomes more apparent, and the soundness of real estate for which there is no demand (at least at the current "asking price") becomes more questionable. This is not to say that an adverse classification is mandatory. Each parcel of REO is to be reviewed and classified on its merits. In making that judgment, it is necessary to: identify the reason for the foreclosure of the property; determine the association's intentions as to disposition of the property; compare the property's carrying value to its current market value; find out the "asking price" and any offers the association has received; determine the length of time the property has been held and reasons it has not been sold; and review other pertinent factors, such as insurance coverage, additional liens, present occupancy, income, and expenses, etc. A careful evaluation of the relevant factors, many of which are mentioned above, should enable the regulator to make an accurate and reliable judgment with regard to classification. (Refer to Thrift Activities Regulatory Handbook Section 251, Real Estate Owned and Repossessed Assets, for additional detail.)

Debt and Equity Investments in a Subsidiary

An association's investment in a service corporation may take many forms, some of which are listed below:

- Debt investment through collateralized loans
- Unsecured loans
- Capital stock
- Capital infusions
- Guarantees of debt
- Retained earnings
- Letters of credit
- Assumption of debt
- Advances not typically documented as loans.

Associations are required to periodically evaluate their investments in service corporations and subsidiaries, and to make any appropriate adjustments to the carrying value based on that evaluation. An examiner should first determine that the association does this evaluation and adjustment. Also, the examiner should ascertain that the service corporation's assets reflect generally accepted accounting principles' (GAAP) valuation standards. Losses and allowances should be booked on the subsidiary's accounts for any asset deserving such treatment. The effect on the service corporation's financial statements of such losses and allowances may also be reflected in the association's investment in the subsidiary.

According to generally accepted accounting principles (GAAP), all consolidated losses (i.e., ownership exceeds 50% and control is exercised) of service corporations flow through to the parent association. Losses of service corporations that are accounted for by the equity method (i.e., ownership of 20% to 50% without control) decrease the book value of equity investments in service corporations and are run through the parent association's income statement. The equity investment is then adjusted for pro t/losses and can even be reduced below zero under certain circumstances. For example, if losses exceeding the amount of the investment are recorded and guarantees exist, or management continues to fund losses, the investment may be reduced below zero. Adjustments to the book value of an investment in service corporations accounted for by the cost method (i.e., less than 20% ownership without control) are made only when permanent impairments in value occur.

To illustrate, assume an association has a $1 million equity investment in ABC, a wholly owned subsidiary, that includes the retained earnings of ABC and represents all of ABC's net worth. The thrift has also guaranteed a $1 million loan from a third party to ABC, and has made $20 million in unsecured loans to ABC. ABC has a $10 million loan to a real estate developer that is secured by property recently appraised at $6 million.

Provided there are no other sources of repayment of the $10 million loan, ABC will probably have to recognize a $4 million loss on its loan to the devel-

oper. That would eliminate ABC's equity and result in a negative net worth of $3 million on ABC's books.

Reporting on an unconsolidated basis, the parent would write down its $1 million equity investment in ABC to zero. The parent would also write down its $20 million in unsecured loans to ABC to $17 million to recognize the diminution in value of those unsecured loans to ABC. Although ABC would have a net worth deficit of $3 million on its books, the parent would report its equity investment in ABC as zero on the quarterly Thrift Financial Report.

On the parent's GAAP financial statements, the $4 million loss on ABC's loan to the developer would be consolidated with the operating results of the parent, and the balance sheets of ABC and the parent would be consolidated. Intercompany transactions, such as the $20 million in unsecured loans to ABC, would be eliminated.

In terms of classification of assets, if the service corporation is not an "includable subsidiary" under 12 CFR 567, an examiner should first ensure that the association has evaluated its investments in and loans to the subsidiary and that any appropriate adjustments to the carrying value of such assets have been made. After ensuring this evaluation and appropriate adjustments have been made, an examiner should, in general, not classify either the assets of the service corporation or the savings association's loans to and investments in the service corporation. Due to the capital rule's "deduction from capital" of all such loans and investments, the association is insulated from the risk of the "nonincludable" service corporation.

An exception to this general policy on classification applicable to "nonincludable" subsidiaries is allowed for instances where the capital rule has not yet fully deducted all loans and investments (e.g., during the transition period). During the transition period, an examiner may classify the loans to and investments in these subsidiaries if the risk of loss associated with the loans and investments is not sufficiently covered by the GAAP-required adjustments and the amount subject to the deduction requirement. A second exception is for instances where a savings association has extended guarantees on behalf of a "nonincludable" subsidiary. If such guarantees subject the association to a sufficient degree of risk to warrant adverse classification, examiners should appropriately classify the guarantees.

For a service corporation that is both an "includable subsidiary" under 12 CFR 567 and an "operating subsidiary" under 12 CFR 545.81, an examiner should review and, where appropriate, classify the assets of the subsidiary. An operating subsidiary is generally treated as a department of the association and, for classification purposes, should be fully consolidated with the association (e.g., the assets of the operating subsidiary are combined with the assets of the association and all intercompany transactions are eliminated).

For a service corporation that is an "includable subsidiary" under 12 CFR 567 but that is not an "operating subsidiary," the examiner should review and, as appropriate, classify the association's loans to and investments in the subsidiary. Again, the examiner should first ensure that the association has evaluated its investments in and loans to the subsidiary and that any appropriate adjustments to the carrying value of such assets have been made. After ensuring this evaluation and appropriate adjustments have been made, the examiner should evaluate the assets of the subsidiary to determine the worth of an equity investment by the parent thrift and the ability of the subsidiary to repay debts owed to the parent. Like any other asset at the thrift level, for purposes of classifying an association's loans to or investments in these subsidiaries, the examiner should analyze the financial strength of the borrower and the quality and sufficiency of collateral to determine the orderly repayment of debt.

In those instances where the subsidiary is not being operated within an adequate degree of separation such that the parent is insulated from the operations of the subsidiary, the parent may be deemed liable for the obligations of the subsidiary as described in § 571.21, which describes attributes of corporate separateness. Section 563.37(a) requires that each association and service corporation thereof be operated in a manner that demonstrates to the public their separate corporate existence. Regulators should ensure that an association and its service corporation comply with § 563.37, applying the § 571.21 attributes.

Off-Balance-Sheet Items

All dollar amounts listed under an adverse classification heading for an off-balance-sheet item may be footnoted in the ROE to indicate that the adverse classification is contingent upon funding. However, the gross amount of the item is the basis for determining the balance of the classified asset. Specific allowances or charge-offs must be established for such items classified Loss. Off-balance-sheet items classified Substandard or Doubtful should be considered when assessing the adequacy of general valuation allowances.

Loan Commitments: A loan commitment may be classified if it is ascertained that the commitment is legally binding or management has provided assurance that funding will occur. The commitment should be evaluated as if it were a loan presently on the books of the association, and the portion classified should be based on the amount to be disbursed. Current financial statements of the prospective borrower, along with collateral, should be reviewed to determine risk of nonpayment.

Letters of Credit: Letters of credit (LOCs) should be reviewed and classified, as appropriate, based on the same criteria used for the classification of commercial loans. Letters of credit should be classified if disbursement is likely and a credit weakness exists with the account party. In such cases, regulators should determine the appropriate classification, and require valuation allowances for the particular circumstances. (Letters of credit are discussed in Section 215 of the Thrift Activities Regulatory Handbook.)

For example, an association issues a $1 million standby LOC as credit support to guarantee payment on a $10 million securitized pool of automobile loans on behalf of the investors (LOC beneficiaries). If the delinquency within the pool became so large that the seller/issuer of the pool was unable to meet the terms of the securities contract (partial default), the beneficiaries would be able to collect the $1 million from the LOC issuer, which in turn would attempt to collect from the seller. If the collateral was insufficient to satisfy the obligation, and repay the LOC issuer, a loss would result. Regulators should review the LOC agreement, and the performance of the collateral pool, to determine the appropriate classification. An example of a problem LOC follows:

Year 1: No significant problems, but LOC issuer has poorly documented the credit and financial capacity of the bond issuer and has inadequate documentation of the pool's performance. Delinquency begins to rise. The likelihood of payment under the LOC agreement cannot be determined. The LOC may be designated Special Mention if the regulator believes that the rising delinquencies and other problems may adversely affect the institution's credit position.

Year 2: Delinquencies become so large that the bond issuer must make payments from its own limited cash reserves. The LOC is classified Substandard, due to the likelihood of drawdown plus limited repayment sources.

Year 3: Bond issuer defaults, and the investors demand payment under the terms of the LOC agreement. During the course of the year, the full $1 million is paid to the investors. The payment by the association results in an extension of credit (loan) to the bond issuer. Since the collateral will primarily be used to repay investors, it is believed that the association will incur a significant loss. The loan is classified at least Doubtful.[3]

End of Year 3: Issuer files bankruptcy and bondholders stand to lose some of their investment. The LOC issuer charges off the $1 million advanced under the LOC.

Loans in Process, Including Lines of Credit: Similar to loan commitments, it should be ascertained that additional funding will occur. If losses are probable and estimable in loans where full funding has yet to occur, the appropriate amount classi able is the gross amount of a loan, rather than only the funds disbursed. For example, assume an association has funded $400,000 of a $1,000,000 construction loan. Despite a $700,000 current value, it has been ascertained that full funding will occur. If the loan is troubled and collateral-dependent, and the expected cash flow from the collateral is insufficient to meet required prin-

[3] The association or regulator might just as appropriately charge off the loan at this point, depending on the perceived likelihood of repayment.

cipal and interest payments, generally the appropriate classification for this loan is $700,000 Substandard and $300,000 Loss.

Litigation: Probable and estimable losses from litigation are generally accounted for by the establishment of a liability, as opposed to a contra asset account (specific or general allowance). If, however, an adverse ruling is expected from a litigious matter and such adverse ruling will result in the noncollection of an asset presently outstanding, an adverse classification of the asset is warranted, and a specific allowance or charge-off should be established.

Fixed Assets

Fixed assets used for business operations are depreciated and are generally not subject to adverse classification. Situations may arise, however, where such a classification is warranted. For instance, if property had been acquired for future expansion and it has since been determined that the expansion will not occur, the property should be reclassified as real estate held for development, investment, or resale. If held for resale, the property should be carried at the lower of cost or fair value. If the property is classified real estate held for development or investment, it should be carried at the lower of cost or net realizable value (NRV). For example, an association holds a trailer that had formerly been used as a branch office and has ceased business operations at the facility. The asset should be classified as a property held for resale and carried at the lower of cost or fair value.

Other Assets

Deposits in Other Associations: Pursuant to Resolution No. 88-184 and the Federal Home Loan Bank (FHLB) As-Agent Program implemented by a district bank, investments in deposits of associations shall be exempt from the asset classification system set forth at § 563.160. The resolution further indicated that all district banks are authorized to proceed with As-Agent Programs to place deposits in associations designated by a regional director as being under supervisory control. Associations investing in such deposits need not be located in the same region as the association in which the deposits are placed.

Repossessions: A repossession should be booked at the lower of the recorded investment in the loan satisfied or the property's fair value on the date the association takes clear title and possession of the property. Any excess of the recorded investment in the loan over fair value must be first charged against a specific allowance, if any. Any remaining loss amount should be charged against the general allowance. Generally, repossessions should be disposed of in a reasonably short period of time. As noted with REO, the longer an asset remains in the repossession account, the more suspect is the demand for and value of the asset. (Refer to Thrift Activities Regulatory Handbook Section 251, Real Estate Owned and Repossessed Assets, for additional detail.)

Accrued Interest Receivable: Accrued interest is considered a part of the investment in the loan that must be evaluated for collectibility by considering the value of the collateral and any other sources of repayment. Any accrued interest where collection is less than probable should be classified Loss. Otherwise, accrued interest should be accorded the same classification as the underlying loan.

Differences in Accounts and Stale Items: Any unreconciled difference in accounts should be accorded a Loss classification if the difference cannot be located in a reasonable period of time. Types of other assets frequently found in associations are the various temporary holding accounts such as suspense, inter-office, teller, transit, and bookkeeping differences having debit balances. These accounts should be used only for temporary recording until the offsetting entry is identified and posted to the proper account. Nothing should be allowed to remain in those accounts for any significant length of time, normally no more than a few business days. All differences in accounts should be closed out at least quarterly. Unreconciled differences in "Due From Banks" accounts should be reviewed, with long outstanding and undocumented differences considered for a Loss classification. Other stale items, such as returned checks and overdue accounts receivable deemed uncollectible, should also be reviewed for possible adverse classification.

Treatment of Guarantees in the Classification Process: The original source of repayment and the borrower's intent and ability to fulfill the obliga-

tion without reliance on third-party guarantors should be the primary basis for the review and classification of assets. Regulators should, however, consider the support provided by guarantees in the determination of the appropriate classification treatment for troubled loans. The presence of a guarantee from a " financially responsible guarantor" as described below, may be sufficient to preclude classification or reduce the severity of classification.

A guarantee from a " financially responsible guarantor" has the following attributes:

- The guarantor must have both the financial capacity and willingness to provide support for the credit;
- The nature of the guarantee is such that it can provide support for the remaining indebtedness, in whole or in part, during the remaining loan term; and
- The guarantee should be legally enforceable.

The above characteristics generally indicate that a guarantee may improve the prospects for repayment of the debt obligation.

Considerations Relating to the Guarantor's Financial Capacity: The lending institution must have sufficient information on 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. Also, it is important to consider the number and amount of guarantees currently extended by the guarantor in order to determine that the guarantor has the financial capacity to fulfill all such contingent claims.

Considerations Relating to a Guarantor's Willingness to Repay: Regulators should normally rely on their analysis of the guarantor's financial strength and assume a willingness to perform unless there is evidence to the contrary. This assumption may be modified based on the guarantor's "track record," including payments made on the asset under review and those made on the guarantor's other financial obligations.

Regulators should give due consideration to those guarantors who have demonstrated their ability and willingness to fulfill previous obligations in their evaluation of current guarantees of similar assets. An important consideration will be whether previously required performance under guarantees was voluntary or the result of legal or other actions by the lender to enforce the guarantee. Regulators should give little credence, if any, however, 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.

Regulators should also consider the economic incentives for performance from guarantors:

- Who have already partially performed under the guarantee or who have other significant investments in the project;
- Whose other sound projects are cross-collateralized or otherwise intertwined with the loan; or
- Where the guarantees are collateralized by readily marketable assets that are under control of a third party.

Other Considerations: In general, only guarantees that are legally enforceable will be relied upon. All legally enforceable guarantees, however, may not be acceptable. In addition to the guarantor's financial capacity and willingness to perform, it is expected that the guarantee will not be subject to significant delays in collection, or undue complexities or uncertainties about the guarantee.

The nature of the guarantee should also be considered by regulators. For example, some guarantees for real estate projects pertain only to the development and construction phases of the project. As such, these limited guarantees would not be relied upon to support a troubled loan after the completion of those phases.

Regulators should also consider the institution's intent to enforce the guarantee and whether there are valid reasons to preclude an institution from pursuing the guarantee. A history of timely enforcement and successful collection of the full amount of the guarantees should be a positive consideration in the classification process.

Conclusive Presumption of Worthlessness of Debts Held by Savings Associations

The following policy was issued by OTS on November 23, 1992 as Regulatory Bulletin 29:

Background

In 1992, the IRS issued new regulations that relate to the deductibility of loan charge-offs by financial institutions. Under these regulations, institutions may elect to conform their tax accounting for bad debts with their regulatory accounting. Institutions that make this election will automatically be allowed to deduct charge-offs of loss assets for federal income tax purposes in the same year the charge-offs are taken for regulatory purposes.

The new regulations require the institution to maintain loan loss classification standards that are consistent with the standards established for loan charge-offs by its primary federal supervisory agency. If the institution meets these requirements, its loan charge-offs are conclusively presumed worthless for federal income tax purposes. These regulations are effective for taxable years ending on or after December 31, 1991.

Election Requirements

To be eligible, an institution must file a conformity election with its federal tax return. The IRS regulations also require the institution's primary federal supervisory agency to expressly determine that the institution maintains and applies classification standards for loan charge-offs that are consistent with regulatory requirements.

Procedures

The savings association is responsible for requesting an Express Determination Letter (Appendix A). When requested by a savings association that has made or intends to make the election under IRS regulation section 1.166-2(d)(3), the regulator may issue the Express Determination Letter, provided the savings association maintains and applies loan loss classification standards that are consistent with regulatory requirements.

The Express Determination Letter should be issued only at the completion of an examination that covers the association's loan review process, and for which the regulator has concluded that issuance of the Express Determination Letter is appropriate. Regulators should not alter the scope or frequency of examinations merely to permit savings associations to use this new regulation.

The Express Determination Letter should be signed and dated by the examiner in charge and provided to the savings association for its files. The Express Determination Letter is not part of the examination report. The regulator should document in examination work papers his/her conclusions regarding the association's loan loss classification standards.

OTS standards for loan charge-offs and classification standards are set forth in Section 217 (Consumer Lending), Section 218 (Credit Card Lending) and this Section of the Thrift Activities Regulatory Handbook.

The Express Determination Letter should be issued only if:

- The examination indicates that the savings association maintains and applies loan loss classification standards that are consistent with OTS standards regarding the identification of losses and charge-off of loans.
- There are no material deviations from regulatory standards. Minor criticisms of the savings association's loan review process or immaterial individual deviations from regulatory standards should not preclude issuance of the Express Determination Letter.

The Express Determination Letter should not be issued if:

- The savings association's loan review process relating to charge-offs is subject to significant criticism.
- Loan charge-offs for Thrift Financial Report purposes are consistently overstated or understated.
- There is a pattern of loan charge-offs not recognized in the appropriate year.

Revoking the Election

The savings association's election of the new method is revoked automatically if the regulator does not issue an Express Determination Letter at the end of an examination that covers the loan review process. The OTS is not required to rescind any previously issued Express Determination Letters.

A regulator's decision to withhold the Express Determination Letter generally revokes the election for the current year. However, it does not invalidate a savings association's election for any prior year(s). Withholding the Express Determination Letter places the burden of proof on the association to support its tax deductions for loan charge-offs.

Interregion Classifications

Classification of an asset held by associations in more than one region is the primary responsibility of the region in which the lead association is located (lead region). When the lead region has determined the appropriate classification, the classification write-up, as presented in the ROE, and documentation on how the classification was determined, should be distributed to the regions that have associations participating in the asset (participating regions). The documentation should include the calculations used to determine any Loss classification accorded the asset. A Pass classification should also be communicated to the participating regions.

Regional directors may direct associations in their region, or their affiliates or service corporations, to adjust the book value of an asset. Where participants are regulated by another region, the regional director of the lead lender will provide key information to other regional directors, including the adjustment to the book value and a copy of the appraisal report, if applicable. The regional directors of the out-of-region participants should, in turn, communicate the appropriate adjustments to the asset's book value to their associations. Loss allowances and charge-offs should be established in accordance with OTS policy.

The lead lender or any participant has the option to file a request for an informal review pursuant to Regulatory Bulletin 4a as a result of a classification, an appraised value, or a directive to establish allowances.

Regional directors of the lead lender and all participants should ensure that within 30 days of being notified to establish an allowance or charge-off, all associations, service corporations, or affiliates have taken appropriate action or have submitted a written explanation concerning why allowances or charge-offs were not established. In absence of an explanation, or the establishment of an allowance or charge-off, the regional director should initiate necessary supervisory action.

If the lead region has yet to review an interregion asset, the participating region, pursuant to an examination, should review the asset and determine an appropriate classification. If adversely classified, the write-up should be forwarded to the lead region. The write-up may also be sent to other participating regions for informational purposes. This same procedure should be followed in those instances where information has been received subsequent to a lead region's classification, which renders such classification dated and inappropriate.

Work Paper Documentation

Examination findings must be adequately documented in the examination work papers. As with all examination work papers, Classification of Assets work papers should contain clear conclusions and concise analysis, provide sufficient documentation of findings, be properly indexed, and reference all pertinent information sources. In addition, documentation supporting classification of assets must include:

- clear documentation of the examiner's reason(s) for classification decisions;
- a comparison, by classification category (Substandard, Doubtful and Loss), of the examiner's total classified assets with the institution's total classified assets; and
- a clear conclusion concerning the adequacy of the institution's self-classification policies and procedures.

REFERENCES

Code of Federal Regulations (12 CFR)

Subchapter C: Regulations for Federal Savings Associations

§ 545.82	Finance Subsidiaries

Subchapter D: Regulations Applicable to All Savings Associations

§ 561.12	Consumer Credit
§ 561.13	Consumer Credit Classified as Loss
§ 561.44	Security
§ 561.47	Slow Consumer Credit
§ 561.48	Slow Loans
§ 563.37	Operation of Service Corporations; Liability of Savings Association for Debt of Service Corporation
§ 563.160	Classification of Certain Assets
§ 563.172	Re-Evaluation of Real Estate Owned
§ 564	Appraisals
§ 571.18	Accounting for Troubled Debt Restructuring
§ 571.21	Separate Corporate Existence of a Service Corporation

Office of Thrift Supervision Bulletins

RB 4a	Supervisory Review Process
RB 29	Conclusive Presumption of Worthlessness of Debts Held by Savings Associations
TB 16	Environmental Risk and Liability

Financial Accounting Standards Board, Statement of Financial Accounting Standards

No. 5	Accounting for Contingencies
No. 13	Accounting for Leases
No. 15	Accounting by Debtors and Creditors for Troubled Debt Restructurings
No. 65	Accounting for Certain Mortgage Banking Activities
No. 114	Accounting by Creditors for Impairment of a Loan

Other

OTS Notice No. 90-1432, Public Disclosure of Reports of Condition

OTS Transmittal No. 28, Review and Classification of Commercial Real Estate Loans

SEC FRR 28, Accounting for Loan Losses by Registrants Engaged in Lending Activities

AICPA SOP 92-3, Accounting for Foreclosed Assets

Classification of Assets Program

Examination Objectives

To determine the adequacy of the association's policies and procedures for self-classification and its compliance with such policies and procedures.

To evaluate the association's self-classification and monitoring of its assets, and to assess management's ability and willingness to correctly identify problem and potential problem assets in a timely manner.

To identify subinvestment-quality assets that represent an inordinate risk to the association and ultimately to the SAIF.

To determine if the association maintains adequate records to substantiate its asset classification system.

Examination Procedures

Level I

Wkp. Ref.

1. Review the preceding report of examination and asset classification-related exceptions noted and determine whether management has taken appropriate corrective action.

_____ _____

2. Determine the adequacy of the association's written policies for self-classification of assets.

_____ _____

3. Determine the reasonableness of the association's internal asset rating system, and ascertain that internal ratings correlate to regulatory classifications.

_____ _____

4. Determine whether the board of directors reviews and approves the self-classification reports.

_____ _____

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Wkp. Ref.

5. Determine how frequently the association reviews its assets.

6. Compute the following ratio and compare with ratio from previous examinations:

   Adversely classified assets to total capital plus general valuation allowances that are not already included in total capital.

7. Reconcile the list of adversely classified assets with those disclosed on financial statements and OTS reports to determine accuracy of reporting.

8. After analyzing internal records and discussing asset quality issues with management, conduct a review of a sample population and determine the appropriate classification for assets reviewed. (For details on Sampling, refer to Section 209 of the Thrift Activities Regulatory Handbook.) Prepare detailed write-ups for those assets where necessary.

9. Provide a list of any additional adverse classifications to the regulator assigned to the Capital Adequacy section.

10. Compare the list of regulator-classified assets with the association's self-classification list to determine the extent of management's knowledge of asset problems.

11. Provide management with a copy of the classifications and write-ups to assure that information presented in the write-up is correct, and determine management's concurrence with the classifications.

Exam Date: _____
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12. Ensure that the Objectives of this Handbook Section have been met. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

Examiner's Summary, Recommendations, and Comments

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

EXPRESS DETERMINATION LETTER

Date

Express Determination Letter for IRS Regulation Section 1.166-2(d)(3)

In connection with the most recent examination of [NAME OF SAVINGS ASSOCIATION], by the Office of Thrift Supervision, as of [EXAMINATION DATE], we reviewed the institution's loan review process as it relates to loan charge-offs. Based on our review, we concluded that the bank, as of that date, maintained and applied loan loss classification standards that were consistent with regulatory standards regarding loan charge-offs.

This statement is made on the basis of a review that was conducted in accordance with our normal examination procedures and criteria, including sampling of loans in accordance with those procedures and criteria. It does not in any way limit or preclude any formal or informal supervisory action (including enforcement actions) by this supervisory authority relating to the institution's loan review process or the level at which it maintains its allowance for loan and lease losses.

_____

OTS Examiner in Charge

INTRODUCTION

A valuation allowance is a contra account, established and maintained through charges against current earnings to absorb losses inherent in an institution's portfolio. Valuation allowances established to absorb unidentified losses inherent in an institution's overall loan and lease portfolio are referred to as the allowance for loan and lease losses (ALLL); those established to absorb losses identified for specific assets are referred to as specific valuation allowances (SVAs).

Since 1986, OTS has used the term "general valuation allowances" (GVAs) to denote allowances for losses inherent in an institution's portfolio of loans, investments and other assets. The federal bank regulatory agencies use the term ALLL. The main difference between the two terms is that the ALLL is for losses inherent in a bank's loan and lease portfolio, not other assets. In order to promote regulatory uniformity among the OTS and the federal bank regulatory agencies, effective on June 30, 1994, OTS has: (1) adopted the term ALLL in lieu of GVAs for an institution's loan and lease portfolio; and (2) removed the requirement that general allowances be held on non-loan and lease assets, including real estate owned (except as noted below). With respect to allowances for losses inherent in an institution's loan and lease portfolio, the ALLL is equivalent to and should be accounted for and reported just as GVAs were accounted for and reported prior to the policy change. The ALLL also receives the same capital treatment as GVAs for loans and leases.

OTS expects thrift institutions to carry non-loan and lease assets on their balance sheets in accordance with OTS policy and generally accepted accounting principles as appropriate for the asset. If significant problems with an institution's valuation methodologies for such assets are noted, however, general allowances may be required for these assets until the problem is corrected.

Section 563.160, Classification of Certain Assets, requires savings associations to classify all assets[1] and establish prudent valuation allowances to absorb losses. The regulation specifies that, for assets classified Substandard or Doubtful, savings associations shall establish prudent general allowances for losses. For assets or portions thereof classified Loss, savings associations shall either establish an SVA for 100% of the portion classified Loss or charge off such amount. The rule further specifies that adequate valuation allowances, consistent with generally accepted accounting principles (GAAP), be established for classified assets and that allowances consistent with the practices of the federal banking agencies may be used for supervisory purposes.

Because of the uncertainty surrounding the likelihood of repayment or realization of classified assets, the determination of the adequacy of valuation allowances requires considerable judgment. Further, when economic conditions change, valuation allowances that once may have been considered adequate may prove inadequate. Understandably, disagreement between examiners and institution management over the amount of valuation allowances considered adequate is not uncommon.

To ameliorate such disparities and to provide uniform guidelines on the determination of the adequacy of the allowance, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Office of Thrift Supervision (the agencies) issued the Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL)[2] on December 21, 1993. The Policy Statement is provided in Appendix A.

[1] Thrift Activities Regulatory Handbook Section 260, Classification of Assets, presents a discussion on asset classification.

[2] The ALLL must not include the portion of loans and leases classified Loss regardless of whether the Loss

Additional OTS Guidance on the Interagency Policy Statement

Below is additional information to aid examiners in their implementation of the Interagency Policy Statement.

Quantitative Guidance

The quantitative guidance discussed in the Interagency Policy Statement should be viewed as an analytical tool—not the ending point—for the quantitative analysis of the adequacy of allowances, after a review of an institution's asset review system and allowance methodology. The guidance is not intended to be used as a "ceiling." The appropriate level of allowances must be based on institution-specific factors. As discussed in footnote 10 of Appendix A, an allowance level greater than or less than the percentages used in the quantitative guidance for Substandard and Doubtful assets may be appropriate, based on institution-specific factors. For example, if an institution can demonstrate, based on an analysis of its historical net loss experience, adjusted for current conditions and trends, that its single-family home loans classified Substandard are expected to experience a net loss rate of less than 15%, both the institution and examiners should use this information—rather than the general 15% guidance—in their analysis of the adequacy of allowances.

Similarly, the general guidance of 15% for Substandard assets may not be appropriate for loans where losses have been recognized in accordance with Thrift Activities Regulatory Handbook Section 260, "Valuation and Classification of Troubled, Collateral-Dependent Loans." The ALLL for these assets should focus on losses that result from the use of an inappropriate value methodology or assumptions that persistently result in overvaluation. The ALLL should be based on the association's historical loss experience for similarly valued assets, adjusted for current conditions and trends.

As discussed in the Interagency Policy Statement, in analyzing the adequacy of allowances, institutions are encouraged to segment their portfolios into components that have similar risk characteristics, such as risk classification and type of loan. For example, as illustrated above, Substandard assets should not be assessed as a single pool of assets if they have substantially different credit risk characteristics or are subject to different accounting standards.

Other Issues in the Policy Statement

The following notes provide clarification and guidance on issues discussed in the Interagency Policy Statement:

- In the first bullet under the "Responsibility of the Board of Directors and Management" section of the Policy Statement, reference is made to the "remaining effective lives of the loans." The remaining effective life of a classified asset is considered by OTS to be the estimated time necessary for the resolution of the asset, i.e., the asset's disposal or its return to a performing status.
- This same section makes reference to the "imprecision inherent in most estimates of expected credit losses." It is OTS's position that if an association's loss allowance has historically been sufficient to cover actual losses, then the margin for imprecision can be minimal.
- Regarding the reference to the "nature and volume of the portfolio" in the section on "Factors to Consider in the Estimation of Credit Losses," nature refers to the type and risk profile of the loans in a portfolio. Volume refers to the mix of such loans. If an institution has typically maintained loan volumes of 55% of its single-family mortgage portfolio in fixed-rate, 30-year loans, 10% in adjustable-rate loans and 5% in construction loans, and then went to a 40%, 20%, and 10% mix, its analysis of its historical loss experience should change accordingly. Similarly, within a portfolio of credit card loans, if an institution with a historical loss experience of only 1% for its credit card portfolio changes from a policy of individually underwriting each account to a mass mailing campaign, the institution's historical loss rate should not be applied to the new credit card accounts. In-

amount was measured in an aggregate analysis or on an individual loan basis.

stead, an industry average rate would be more appropriate until the institution had established a historical loss rate for the new accounts.

- The seventh bullet in the same section indicates that the existence or changes in credit concentrations should be considered in the ALLL evaluation process. OTS does not consider it to be an adverse concentration of credit for an institution to have a high percentage of its portfolio in residential and consumer loans made in the institution's primary lending area.
- Also, the discussion on ratio analysis in this section of the Policy Statement does not mean that if an institution has a lower level of allowance to loans, or allowance to classified or past-due loans, than similar-sized institutions, that its allowance is inadequate. Institutions with primarily low-risk loans in their portfolio, such as one- to four-family residential mortgage loans, generally experience a lower level of net losses and would therefore require a smaller allowance than an institution with high concentrations of commercial, nonresidential, and construction loans.
- Footnote 9 of the Policy Statement states that if an institution has an insufficient basis for determining its historical net charge-off rate for nonclassified loans, the examiner may use the industry average net charge-off rate. This could occur if there were no available data, as in cases where the institution offered a new product and had no historical loss data, or if the institution had substantially changed its underwriting such that old historical data would not accurately reflect losses expected within the next 12 months.

Guidelines Specific To Certain Asset Types

While the policy guidelines for the assessment of the ALLL in the Interagency Policy Statement are generally useful for all types of assets, the following guidelines, specific to certain types of unique or high-risk assets, should also be used.

Real Estate Owned (REO). Since foreclosure generally becomes necessary only when the security property can not be sold by the borrower for an amount sufficient to satisfy the loan, foreclosure generally indicates a lack of demand for the property at that price. Further, if the association holds the property for a long period of time, it may indicate a reluctance to sell the property for a loss. In any event, the property should be carried at its fair value and a Substandard classification is often appropriate. Thrift Activities Regulatory Handbook Section 251, Real Estate Owned and Repossessed Assets, and Section 260, Classification of Assets, provide guidance on the classification of REO.

In 1992, the American Institute for Certified Public Accountants (AICPA) issued Statement of Position No. 92-3 (SOP 92-3), which held that there is a rebuttable presumption that foreclosed assets are held by financial institutions for sale and, thus, should be carried (maintained with quarterly adjustments as necessary) at the lower of (1) cost or (2) fair value minus the estimated cost to sell.

OTS policy does not automatically require general allowances on REO. However, general allowances should be established when the association is likely to experience losses on the disposition of REO or is likely to incur costs during the holding period for REO that are not reflected in the carrying value. The level of any required general allowances on REO should be based on the association's historical net loss experience, adjusted for current conditions and trends.

Noninvestment Grade Corporate Debt Securities. FIRREA mandated the divestiture of all noninvestment grade corporate debt securities from savings associations as soon as prudently possible, but in all cases by July 1, 1994. Such securities held by a savings association that mature after that date should be carried at the lower of cost or market value (LOCOM). Amounts in excess of market value are classified Loss, and the remaining book value should be classified Substandard.

Securities that mature before July 1, 1994 are not automatically subject to LOCOM; however, any depreciation in book value over market price should be classified Doubtful. The remaining book value should be classified Substandard.

Securities subject to LOCOM accounting treatment do not ordinarily require additional general allowances, except for private placements and other thinly traded securities where the quoted market price cannot be independently confirmed.

Letters of Credit. Letters of credit (LOCs) should be reviewed and classified, as appropriate, based on the same criteria used for the classification of commercial loans. Letters of credit should be classified if disbursement is likely and a credit weakness exists with the account party.

In such cases, examiners should determine the appropriate classification and require valuation allowances for the particular circumstances. Letters of credit are discussed in Section 215 of the Thrift Activities Regulatory Handbook.

For example, an association issues a $1 million standby LOC as credit support to guarantee payment on a $10 million securitized pool of automobile loans on behalf of the investors (LOC beneficiaries). If the delinquency level within the pool became so large that the seller/issuer of the pool was unable to meet the terms of the securities contract (partial default), the beneficiaries would be able to collect the $1 million from the LOC issuer, which in turn would attempt to collect from the seller. If the collateral was insufficient to satisfy the obligation and repay the LOC issuer, a loss would result. Examiners should review the LOC agreement and the performance of the collateral pool to determine the appropriate classification. An example of a problem LOC follows:

Year 1: No significant problems have surfaced, but LOC issuer has poorly documented the credit and financial capacity of the bond issuer and has inadequate documentation of the pool's performance. Delinquency levels begin to rise. The likelihood of payment under the LOC agreement cannot be determined. The LOC is listed as Special Mention. The ALLL is set at the institution's historical loss experience for similar credits, which is 3% ($30,000).

Year 2: Delinquency levels become so large that the bond issuer must make payments from its own limited cash reserves. The LOC is classified Substandard, and an ALLL of 15% ($150,000) is required.

Year 3: Bond issuer defaults and the investors demand payment under the terms of the LOC agreement. During the course of the year, the full $1 million is paid to the investors. The payment by the association results in an extension of credit (loan) to the bond issuer. Since the collateral will primarily be used to repay investors, it is believed that the association will incur a significant loss. The loan is classified Doubtful with an ALLL of 50% ($500,000). The association or examiner might just as appropriately charge off the loan at this point, depending on the perceived likelihood of repayment.

End of Year 3: Issuer files bankruptcy and bondholders stand to lose some of their investment. Because the LOC issuer has no security and his interest was subordinate to the bondholders, the issuer charges off the $1 million advanced under the LOC.

Migration Analysis

One method to determine the adequacy of valuation allowances is migration analysis. Generally, problem assets either improve or deteriorate over time. If a classified asset is not paid off or upgraded, it often deteriorates (or migrates) to a worse classification. If corrective action is not successful, a loss is often incurred. Migration analysis uses the association's net loss data to track such movements in order to estimate the percentage of losses that are likely to be incurred from different categories of assets within the current portfolio.

Migration analysis incorporates many of the important factors that relate to an association's historical loss experience: collection efficiency, historical area economic conditions, management effectiveness, and overall asset quality. It does not, however, factor in changes that may affect the association's future losses. If an association experiences changes in underwriting, loan volume, or in area economic conditions, etc., adjustments must be made. Another disadvantage of migration analysis is that it requires an accurate and fairly detailed breakdown of the association's portfolio by asset category. If this information is

not available, it must be generated before such analysis can be performed. Finally, the analysis must span a meaningful time period.

Appendix B offers guidelines on migration analysis. This method is not mandatory, but it is offered as a tool to help determine the adequacy of valuation allowances. The decision to use this method should be based on factors such as:

- the availability of historical loss data;
- the amount of adjustments that have to be made;[3] and
- whether other methods to assess the adequacy of the ALLL would be more accurate, or would be at least as accurate, but could be derived more efficiently.

Deficiencies in Valuation Allowances

The examination procedures at the end of this Section can be simplified into two steps. The examiner will: (1) assess management's valuation allowance policies and calculation methodology and (2) perform his/her own analysis to assess the adequacy of the association's allowances. If the examiner's estimate of the appropriate ALLL departs significantly from the institution's ALLL, the examiner must thoroughly review the process and methodology used by the association to determine its ALLL. The examiner should discuss the association's process with management and come to a conclusion as to what is appropriate given the findings.

Unless otherwise instructed by the OTS regional office, the examiner in charge (EIC) should obtain his/her field supervisor's concurrence as to the amount of and reasons for any recommended increases in the ALLL prior to any discussions with management. This is to ensure that any requirements for additional allowances are reasonable and justified.

Examiner Documentation

The report of examination (ROE) comment must reasonably support the examiner's conclusions about the association's ALLL. Examination findings must also be adequately documented in the examination work papers. As with all examination work papers, ALLL work papers should contain concise analysis and clear conclusions, provide sufficient documentation of findings, be properly indexed, and reference all pertinent information sources. In addition, documentation supporting the ALLL must include:

- clear documentation of the examiner's calculation methodologies;
- a comparison of the examiner's estimate of an adequate ALLL with the institution's actual ALLL and an analysis of the reason(s) for any difference; and
- a well-defined conclusion as to whether the institution's ALLL is adequate.

REFERENCES

Code of Federal Regulations (12 CFR)

Subchapter D: Regulations Affecting all Savings Associations

§ 561.13	Consumer Credit Classified as a Loss
§ 563.160	Classification of Certain Assets
§ 563.172	Re-Evaluation of Real Estate Owned

OTS Thrift Activities Regulatory Handbook

Section 240	Troubled Debt Restructuring
Section 251	Real Estate Owned and Repossessed Assets
Section 260	Classification of Assets

[3] For example: an association had previously experienced an annual net loss rate of 6 basis points in its portfolio of one- to-four-family mortgage loans. Then, possibly due to a change in credit administration or a decline in economic conditions, losses increased to 12 basis points. The historical loss data must be adjusted to reflect current trends and economic conditions. At some point, adjustments may become so large that the usefulness of the resulting data becomes suspect.

Financial Accounting Standards Board, Statement of Financial Accounting Standards (SFAS)

No. 5	Accounting for Contingencies
No. 15	Accounting for Debtors and Creditors for Troubled Debt Restructuring
No. 114	Accounting by Creditors for Impairment of a Loan

Adequacy of Valuation Allowances Program

Examination Objectives

To determine if the institution's policies, procedures, and methodologies regarding the establishment of valuation allowances are adequate and consistent with OTS policies including the Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL).

To determine if management is operating in conformance with the institution's own policies and procedures and applicable laws and regulations.

To determine if the institution's internal controls are adequate to ensure compliance with the institution's own policies and procedures and applicable laws and regulations.

To determine if the ALLL is accurately reported on the Thrift Financial Report (TFR) and internal reports prepared for management and the board of directors.

To determine if the existing ALLL is adequate to cover losses inherent in the portfolio.

Examination Procedures

Level I

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1. Review the preceding report of examination and ALLL-related exceptions noted and determine whether management has taken appropriate corrective action.

_____ _____

2. Obtain and review the association's written policies and procedures for the establishment and maintenance of adequate valuation allowances. If no written policies and procedures exist, determine from management the methods and procedures used to determine the adequacy of valuation allowances.

_____ _____

3. Complete the Valuation Allowance Questionnaire. Determine whether the institution's allowance policies conform to the guidelines in the Interagency Policy Statement on the Allowance for Loan and Lease Losses.

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4. Evaluate the institution's actual (versus stated) practices and the adequacy of internal controls that relate to ALLL.

5. Obtain copies of reports prepared by the institution for management and the board of directors. Determine the adequacy and accuracy of the institution's reports. Determine whether (and how) the reports are used to make strategic and operating decisions.

6. Review the institution's documentation related to ALLL. Determine if these documents adequately reflect an analysis of all significant factors, and whether they indicate compliance with the institution's written ALLL guidelines.

7. Consider reviewing internal and external audit reports and work papers to determine compliance with written ALLL guidelines. Have instances of noncompliance been noted and corrected by management?

8. Based on a review of the institution's records and documentation pertaining to the allowance, and through discussion with the EIC and examiners assigned to the loan portfolio evaluation function of the examination, determine if management has:

   - maintained effective systems and controls for identifying, monitoring and addressing asset quality problems in a timely manner;
   - analyzed all significant factors that affect the collectibility of the portfolio in a reasonable manner; and
   - established an acceptable ALLL evaluation process.

9. Using TFR net charge-off data from Schedule VA, determine the institution's historical net loss experience. (Any SVAs established on such assets will have to be added as they are not included in Schedule VA.) Make a preliminary evaluation as to the adequacy of

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the institution's ALLL. This evaluation should be made in light of the guidelines in the Interagency Policy Statement on the Allowance for Loan and Lease Losses. If, based on this preliminary analysis, the institution's ALLL appears inadequate, perform a more detailed review of management's analysis to determine whether it is reasonable and supportable by the weight of reliable evidence and that all relevant factors have been appropriately considered.

10. Test the association's compliance with its own stated policies and procedures. Determine if any previously cited deficiencies have been corrected.

11. If management has made any large or unusual provisions to the ALLL that occurred during the review period, determine the events giving rise to such provision(s) and whether the provision(s) should have been recognized in prior periods.

12. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

Level II

13. Review the following reports submitted to the board of directors:

- delinquent and classified assets,
- charge-offs, and
- valuation allowance adequacy.

Comment on a lack of or inaccurate reporting.

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14. Identify and evaluate factors causing any changes in loss trends, such as an increase in delinquencies and classified or other problem assets that may have been brought about by a worsening of economic conditions or changes in underwriting. Assess whether such factors and trends are likely to continue to affect delinquencies and losses.

15. Obtain a list of all additional classified assets arising from the examination that were not classified by the institution. Consider these assets in the analysis of the adequacy of the current ALLL.

16. Determine if any assets (or portions thereof) classified Loss during the examination exceed the SVAs (or charge-offs) established for such assets by management. Determine the effect that either additions required to specific allowances or charge-offs will have on the ALLL.

17. Considering all pertinent factors, determine the adequacy of the institution's ALLL.

18. After consulting with the EIC and appropriate regional staff, discuss findings with management, including inadequate valuation allowances and any weaknesses in, or nonconformance to, policies, practices, and procedures. If necessary, request that management make any appropriate adjustments during the examination to increase SVAs or the ALLL to levels considered adequate. Determine management's agreement or opposition to such request.

19. Discuss with the examiners reviewing Earnings and Capital Adequacy the amount of any additional SVAs or ALLL that the institution will have to record based on examination findings.

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20. Ensure that the Objectives of this Handbook Section have been met. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages. The ROE comments should indicate if management's concurrence with any requested adjustments has not been obtained in order to facilitate follow-up supervisory action.

Examiner's Summary, Recommendations, and Comments

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Adequacy of Valuation Allowances Questionnaire

	Yes	No
General Questionnaire		
Review the association's internal controls and policies and procedures that relate to the determination of the adequacy of valuation allowances. These policies and procedures should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, copies of forms used, and other pertinent information.		
Valuation Allowance Policies and Methodology		
1. Has the board of directors, consistent with its duties and responsibilities, adopted written valuation allowance policies?.....		
2. Does the board of directors review/approve the policies at least annually?.....		
3. Do the institution's policies:		
• Address all asset types, including binding commitments to lend and off-balance sheet credit instruments?.....		
• Require that the ALLL be reviewed for adequacy at least quarterly?.....		
• Require that the ALLL allocated to loan and lease losses, including binding commitments to lend and off-balance sheet credit instruments, should be no less than the sum of the following items as of the evaluation date (after deduction of all portions of the portfolio classified Loss):		
— for loans and leases classified Substandard or Doubtful, whether analyzed and provided for individually or as part of pools, all estimated credit losses over the remaining effective lives of these assets?		
— for components of the loan and lease portfolios are not classified, all estimated credit losses over the following 12 months?.....		

	Yes	No
• Provide for a conservative analysis such that the overall ALLL reflects a margin for the imprecision inherent in estimates of expected credit losses?		
• Provide a complete description of the methodologies used for each portfolio type, including (but not limited to) the following information, accompanied by supporting documentation:		
— The calculations used and how the factors are derived?		
— The number of years' data and the date of the information included in the analysis?.....		
— Complete descriptions/ definitions of items used in the analysis?.....		
— The stratification of assets and the rationale for the stratification?.....		
— The reliability of the data used?.....		
4. Does the institution's ALLL methodology give adequate consideration to:		
• Past loss experience and other pertinent historical data?.....		
• Assessment of the effectiveness of lending policies and procedures?.....		
• Identification, on an individual loan basis, of significant potential weaknesses within the portfolio and an estimate of loss?		
• Changes in the character of the portfolio?.....		
• Current economic conditions and trends?.....		

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Adequacy of Valuation Allowances Questionnaire

	Yes	No
• Amount of past-due loans on which interest is not collected in accordance with the terms of the loans, and loans whose terms have been modified by reduced interest rates or deferred payments?		
• Other information appropriate to the circumstances (if so, explain briefly)?.....		
5. Does the institution's ALLL methodology consider the level, severity, and trend of classified assets, delinquent and nonaccrual loans, real estate owned, and other problem assets?		
6. Does the institution's ALLL methodology appropriately track credit losses by segmenting the portfolios as appropriate for the institution (for example, by asset classification, collateral type and geographic location, loan-to-value ratios, year of origination, loan officer, product type, etc.)?		
Is adequate supporting documentation maintained?		
7. Does the institution's ALLL methodology consider any additional risk of loss due to concentrations of credit?.....		
8. Does the institution's ALLL methodology require an adjustment to the ALLL to reflect economic conditions and trends, and describe how adjustments for these factors are quantified?		
9. Does the institution's ALLL methodology consider applicable qualitative factors such as the adequacy of the Internal Asset Review (IAR) system and lending policies and procedures, etc. and ascribe quantifiable measurements to these factors?		

	Yes	No
10. Does the institution's ALLL methodology consider:		
• changes in national and local economic and business conditions;		
• changes in the nature and volume of the portfolio;		
• changes in the experience, ability, and depth of lending management and staff;		
• the effect of external factors such as competition; and		
• legal and regulatory requirements on the level of estimated credit losses?		
11. Are all general and specific valuation allowances and charge-offs reviewed and approved by the board of directors as evidenced by the minutes of board meetings?		
12. Does management review the adequacy of the allowance and make necessary adjustments before Thrift Financial Reports and public financial statements are prepared (at a minimum, on a quarterly basis)?		
13. Does management retain documentation of its review?.....		
14. Is accrued interest on loans charged off also charged off against the allowance account or reversed against interest income, as appropriate?		
Charge-Offs		
15. Does management provide accurate charge-off reports to the board of directors for their review and approval?		
16. Are collection efforts continued for assets charged off until the potential for recovery is fully exhausted?.....		

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Adequacy of Valuation Allowances Questionnaire

	Yes	No
17. Are periodic progress reports prepared and reviewed by appropriate management personnel for all assets charged off for which collection efforts continue?		
18. Are adequate internal control procedures in effect to safeguard and properly record funds received as recoveries?		
19. Is the preparation and posting of any subsidiary records of assets charged off performed or reviewed by persons who do not also:		
• Issue checks and drafts?		
• Handle cash?		
20. Are notes for loans charged off maintained under dual custody?		
21. Are collectors rotated so that they do not work on the same accounts over an extended period?		

Comments

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Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board
Office of Thrift Supervision

Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL) [1]
December 21, 1993

Nature and Purpose of the ALLL

Federally-insured depository institutions ("institutions") must maintain an ALLL at a level that is adequate to absorb estimated credit losses associated with the loan and lease portfolio, including all binding commitments to lend. [2] To the extent not provided for in a separate liability account, the A.LLL should also be sufficient to absorb estimated credit losses associated with off-balance sheet credit instruments such as standby letters of credit. [3]

For purposes of this policy statement, the term "estimated credit losses" means an estimate of the current amount of the loan and lease portfolio (net of unearned income) that is not likely to be collected; that is, net charge-offs that are

[1] This policy statement applies to all depository institutions insured by the Federal Deposit Insurance Corporation except for federally-insured branches and agencies of foreign banks. Federally-insured branches and agencies of foreign banks continue to be subject to any separate guidance that has been issued by their primary supervisory agency.

For savings associations, the ALLL is included in "general valuation allowances" (GVAs). GVAs may also be required on assets other than loans and leases.

[2] In the case of binding commitments to lend and off-balance sheet credit instruments, such losses represent the amount of loans and leases that will likely not be collected (given facts and circumstances as of the evaluation date) and, thus, will be charged off. For purposes of this policy statement, the loan and lease portfolio, binding commitments to lend and off-balance sheet credit commitments are referred to as "loans," "loans and leases," the "loan and lease portfolio" or the portfolio."

[3] Recourse liability accounts (that arise from recourse obligations for any transfers of loans that are reported as sales for regulatory reporting purposes) should be reported as liabilities that are separate and distinct from the ALLL.

likely to be realized for a loan or pool of loans given facts and circumstances as of the evaluation date. These estimated credit losses should meet the criteria for accrual of a loss contingency (i.e., a provision to the ALLL) set forth in generally accepted accounting principles (GAAP). When available information confirms specific loans and leases, or portions thereof, to be uncollectible, these amounts should be promptly charged off against the ALLL.

Estimates of credit losses should reflect consideration of all significant factors that affect the collectibility of the portfolio as of the evaluation date. For individually-analyzed loans, these estimates should reflect consideration of the facts and circumstances that affect the repayment of such loans as of the evaluation date. For pools of loans, estimated credit losses should reflect consideration of the institution's historical net charge-off rate on pools of similar loans, *adjusted for changes in trends, conditions, and other relevant factors* that affect repayment of the loans in these pools as of the evaluation date. Methodologies for the determination of the historical net charge-off rate on a pool of loans can range from a simple average of an institution's net charge-off experience over a relevant period of years -- coupled with appropriate adjustments as noted above for factors that affect repayment -- to more complex techniques, such as migration analysis.

As discussed more fully below, for analytical purposes, an institution may attribute portions of the ALLL to individual loans or groups of loans. However, the ALLL is available to absorb all credit losses that arise from the loan and lease portfolio and is not segregated for, or allocated to, any particular loan or group of loans.

Responsibility of the Board of Directors and Management

Adequate ALLL Level. It is the responsibility of the board of directors and management of each institution to maintain the ALLL at an adequate level.[4] For pur-

[4] When Financial Accounting Standards Board (FASB) Statement No. 114, *Accounting by Creditors for* Impairment of a Loan, becomes effective, an "allowance for credit losses" must be calculated on a present value basis when a loan is impaired. FASB Statement No. 114 states that it "does *not* address how a creditor should assess the *overall adequacy* of the allowance for credit losses" (emphasis added), and that, in addition to the allowance for credit losses calculated under FASB Statement No. 114, a creditor should continue to recognize an ALLL necessary

poses of the Reports of Condition and Income (Call Report) and the Thrift Financial Report (TFR) an adequate ALLL should be no less than the sum of the following items *given facts and circumstances as of the evaluation* date (after deduction of all portions of the portfolio classified loss):

(1) For loans and leases *classified substandard or doubtful*, whether analyzed and provided for individually or as part of pools, all estimated credit losses over the remaining effective lives of these loans.

(2) For components of the loan and lease portfolio that are *not classified*, all estimated credit losses over the upcoming 12 months.[5]

(3) Amounts for estimated losses from transfer risk on international loans.

Furthermore, when determining the appropriate level for the ALLL, management's analysis should be conservative so that the overall ALLL appropriately reflects a margin for the imprecision inherent in most estimates of expected credit losses. This additional margin for imprecision might be incorporated into the ALLL through the amounts attributed for analytical purposes to individual loans or groups of loans or in a portion of the ALLL that is not attributed to specific components of the loan portfolio. [6]

to comply with FASB Statement No.5, *Accounting for Contingencies*. Furthermore, the guidance in FASB Statement No. 114 only applies to a subset of the loan and lease portfolio as the term is used in this policy statement (e.g., the FASB standard does not apply to leases, binding commitments to lend, and large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment).

In contrast, this policy statement provides guidance on assessing the *overall adequacy* of the ALLL. At a later date, the federal bank and thrift regulatory agencies may issue further guidance on the application of FASB Statement No. 114 in the ALLL evaluation process.

[5] In certain circumstances, subject to examiner review, a net charge-off horizon of less than one year from the balance sheet date may be employed for components of the portfolio that have not been classified. For institutions with conservative charge-off policies, a charge-off horizon of less than one year might be appropriate for pools of loans that are neither classified, nor subject to greater than normal credit risk, and that have well-documented and highly predictable cash flows and loss rates, such as pools of certain smaller consumer installment or credit card loans. On the other hand, a net charge-off horizon of more than one year for loans that have not been classified might be appropriate until an institution's loan review function and credit grading system results in accurate and timely assessments of the portfolio. In such situations, an institution should expeditiously correct deficiencies in its loan review function and credit grading system.

[6] As discussed later in this policy statement, institutions are encouraged to segment their loan and lease portfolios into as many components as practical when analyzing the adequacy of the ALLL. Therefore, institutions are encouraged to reflect the margin for imprecision in amounts attributable for analytical purposes to these components of the portfolio, to the extent possible.

The adequacy of the ALLL should be evaluated as of the end of each quarter, or more frequently if warranted, and appropriate provisions made to maintain the ALLL at an adequate level as of each Call Report or Thrift Financial Report date. This evaluation will be subject to review by examiners.

Related Responsibilities. In carrying out their responsibility for maintaining an adequate ALLL, the board of directors and management are expected to:

- Ensure that the institution has an effective loan review system and controls (which include an effective credit grading system) that identify, monitor, and address asset quality problems in an accurate and timely manner. To be effective, the institution's loan review system and controls must be responsive to changes in internal and external factors affecting the level of credit risk in the portfolio.

- Ensure the prompt charge-off of loans, or portions of loans, that available information confirms to be uncollectible.

- Ensure that the institution's process for determining an adequate level for the ALLL is based on a comprehensive, adequately documented, and consistently applied analysis of the institution's loan and lease portfolio that considers all significant factors that affect the collectibility of the portfolio and supports the range of credit losses estimated by this process.

As discussed more fully in Attachment 1, it is essential that institutions maintain effective loan review systems, although smaller institutions would not be expected to maintain separate loan review departments. An effective loan review system should work to ensure the accuracy of internal credit grading systems and, thus, the quality of the information used to assess the adequacy of the ALLL. The complexity and scope of the institution's ALLL evaluation process, loan review system, and other relevant controls should be appropriate in view of the size of the institution and the nature of its lending activities, and provide for sufficient flexibility to accommodate changes in the factors that affect the collectibility of the portfolio.

Analysis of the Loan and Lease Portfolio

In determining the appropriate level of the ALLL, the institution should rely primarily on an analysis of the various components of its portfolio, including all significant credits on an individual basis. When analyzing the adequacy of the ALLL, institutions should segment their loan and lease portfolios into as many components as practical. Each component would normally have similar characteristics, such as risk classification, past due status, type of loan, industry or collateral. A depository institution may, for example, analyze the following components of its portfolio and provide for them in the ALLL:

- AR significant credits on an individual basis that are classified doubtful (or the institution's equivalent).
- All other significant credits reviewed individually. If no allocation can be determined for such credits on an individual basis, they should be provided for as part of an appropriate pool below.
- All other loans and leases that are not included by examiners or by the institution's credit grading system in the population of loans reviewed individually, but are delinquent or are classified or designated special mention (e.g., pools of smaller delinquent, special mention and classified commercial and industrial loans, real estate loans, consumer loans, and lease financing receivables).
- Homogeneous loans that have not been reviewed individually, or are not delinquent, classified, or designated as special mention (e.g., pools of direct consumer loans, indirect consumer loans, credit card loans, home equity lines of credit, and residential real estate mortgages).
- All other loans that have not been considered or provided for elsewhere (e.g., pools of commercial and industrial loans that have not been reviewed, classified, or designated special mention, standby letters of credit, and other off-balance sheet commitments to lend).

In addition to estimated credit losses, the losses that arise from the transfer risk associated with an institution's cross-border lending activities require special consideration. Over and above any minimum amount that is required by the Interagency Country Exposure Review Committee to be provided in the Allocated Transfer Risk Reserve (or charged against the ALLL), the institution must determine

that the ALLL is adequate to absorb all estimated losses from transfer risk associated with its cross-border lending exposure. (See Attachment 2 for factors to consider.)

Factors to Consider in the Estimation of Credit Losses

As previously mentioned, estimates of credit losses should reflect consideration of all significant factors that affect the collectibility of the portfolio as of the evaluation date. While historical loss experience provides a reasonable starting point for the institution's analysis, historical losses, or even recent trends in losses are not, by themselves, a sufficient basis to determine the appropriate level for the ALLL. Management should also consider any factors that are likely to cause estimated credit losses associated with the institution's current portfolio to differ from historical loss experience, including but not limited to:

- Changes in lending policies and procedures, including underwriting standards and collection, charge-off, and recovery practices.
- Changes in national and local economic and business conditions and developments, including the condition of various market segments. [7]
- Changes in the nature and volume of the portfolio.
- Changes in the experience, ability, and depth of lending management and staff.
- Changes in the trend of the volume and severity of past due and classified loans; and trends in the volume of nonaccrual loans, troubled debt restructurings and other loan modifications.
- Changes in the quality of the institution's loan review system and the degree of oversight by the institution's board of directors.
- The existence and effect of any concentrations of credit, and changes in the level of such concentrations.
- The effect of external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the institution's current portfolio.

[7] Credit loss and recovery experience may vary significantly depending upon the business cycle. For example, an over reliance on recent credit loss experience during a period of economic growth will not result in realistic estimates of credit losses during a period of economic downturn.

Institutions are also encouraged to use ratio analysis as a supplemental check or tool for evaluating the overall reasonableness of the ALLL. Ratio analysis can be useful in identifying divergent trends (compared with the institution's peer group and its own historical practices) in the relationship of the ALLL to classified and non-classified loans and leases, to past due and nonaccrual loans and leases, to total loans and binding commitments, and to historical gross and net charge-offs. However, while such comparisons can be helpful as a supplemental check of the reasonableness of management's assumptions and analyses, they are not, by themselves, a sufficient basis for determining the adequacy of the ALLL. In particular, such comparisons do not obviate the need for a comprehensive analysis of the loan and lease portfolio and the factors affecting its collectibility.

Examiner Responsibilities

Examiners will assess the asset quality of an institution's loan and lease portfolio and the adequacy of the ALLL. In the review and classification of the loan and lease portfolio, examiners should consider all significant factors that affect the collectibility of the portfolio, including the value of any collateral. In reviewing the adequacy of the ALLL, examiners will:

- Consider the quality of the institutions loan review system and management in identifying, monitoring, and addressing asset quality problems. This will include a review of the institution's credit grading system and loan review function. [8]

- Evaluate the ALLL evaluation process that management has followed to arrive at an overall estimate of the ALLL, and the related assumptions made by management, in order to ensure that the institution's historical loss experience and all significant factors that affect the collectibility of the portfolio (including changes in the quality of the institution's loan review function, and other factors previously discussed) have been appropriately considered.

[8] The review of an institution's loan review system (including credit grading) by an examiner will usually include tests involving a sample of the institution's loans. If differences noted between examiner credit grades and those of the institution's loan review system indicate problems with the loan review system, especially where the credit grades assigned by the institution are more liberal than those assigned by the examiner, the institution would be expected to make appropriate adjustments to the assignment of its credit grades to the loan and lease portfolio and to its estimate of the ALLL. Furthermore, the institution would be expected to improve its loan review system. (Attachment 1 discusses effective loan review systems.)

- Review the overall level of the ALLL and the range of credit losses estimated by management for reasonableness in view of the factors discussed in the prior sections of this policy statement.

- Perform a quantitative analysis (e.g., using the types of ratio analysis previously discussed) as a check of the reasonableness of the ALLL.

- Review the adequacy of the documentation that has been maintained by management to support the adequacy of the ALLL.

After analyzing an institution's policies, practices, and historical credit loss experience, the examiner should further check the reasonableness of management's ALLL methodology by comparing the reported ALLL (after the deduction of all loans, or portions thereof, classified as loss) against the sum of the following amounts:

(a) 50 percent of the portfolio that is classified doubtful;

(b) 15 percent of the portfolio that is classified substandard; and

(c) For the portions of the portfolio that have not been classified (including those loans designated special mention), estimated credit losses over the upcoming twelve months *given facts and circumstances as of the evaluation date* (based on the institution's average annual rate of net charge-offs experienced over the previous two or three years on similar loans, adjusted for current conditions and trends). [9]

This amount is neither a "floor" nor a "safe harbor" level for an institution's ALLL. However, examiners will view a shortfall relative to this amount as indicating a need to more closely review management's analysis to determine whether it is reasonable and supported by the weight of reliable evidence, and that all relevant factors have been appropriately considered. [10]

[9] In cases where the institution has an insufficient basis for determining this amount, the examiner may use the industry-average net charge-off rate for nonclassified loans and leases.

[10] The weights of 50 percent and 15 percent for doubtful and substandard loans, respectively, are estimates of the industry's average loss experience over time on similarly classified credits. Because they represent the average industry experience, these weights do not take into account idiosyncratic factors that may be important for estimating expected credit losses for a particular institution, such as the composition of its portfolio; the quality of underwriting, collection, and loan review systems; and current economic conditions and trends. *Nor do these weights incorporate any* additional margin *to reflect the imprecision* inherent in *estimates of expected credit losses.*

In assessing the adequacy of the ALLL, it is important to recognize that the related process, methodology, and underlying assumptions require a substantial degree of judgment. Even when an institution maintains sound loan administration and collection procedures and effective internal systems and controls, the estimation of credit losses will not be precise due to the wide range of factors that must be considered. Further, the ability to estimate credit losses on specific loans and categories of loans improves over time as substantive information accumulates regarding the factors affecting repayment prospects. Therefore, examiners will generally accept managements estimates in their assessment of the adequacy of the ALLL when management has: (i) maintained effective systems and controls for identifying, monitoring and addressing asset quality problems in a timely manner, (ii) analyzed all significant factors that affect the collectibility of the portfolio in a reasonable manner, and (iii) established an acceptable ALLL evaluation process that meets the objectives for an adequate ALLL.

After the completion of all aspects of the ALLL review described in this section, if the examiner does not concur that the reported ALLL level is adequate or if the ALLL evaluation process is deficient or based on the results of an unreliable loan review system, recommendations for correcting these problems, including any examiner concerns regarding an appropriate level for the ALLL, should be noted in the report of examination.

ALLL Level Reflected in Regulatory Reports

The agencies believe that an ALLL established in accordance with this policy statement will fall within the range of acceptable estimates developed in accordance with GAAP. When an institution's reported ALLL does not meet the ob-

Due to such institution specific factors, including an institution's historical loss experience adjusted for current conditions and trends, in many cases an ALLL exceeding the sum of (a), (b), and (c) above might still be inadequate, while in other cases, the weight of evidence might indicate that an ALLL less than this amount is adequate. In all circumstances, for purposes of the Call Report or Thrift Financial Report, the reported ALLL should meet the standard for an adequate ALLL set forth in the section entitled "Responsibility of the Board of Directors and Management."

jectives for an adequate ALLL, the institution will be required to increase its provision for loan and lease losses expense sufficiently to restore the level of the ALLL reported on its Call Report or TFR to an adequate level as of the evaluation date.

Attachment 1

Loan Review Systems

The nature of loan review systems may vary based on an institution's size, complexity, and management practices. For example, a loan review system may include components of a traditional loan review function that is independent of the lending function, or it may place some reliance on loan officers. In addition, the use of the term "loan review system" can refer to various responsibilities assigned to credit administration, loan administration, problem loan workout, or other areas of an institution. These responsibilities may range from administering the internal problem loan reporting process, to maintaining the integrity of the credit grading process (e.g., ensuring that changes are made in credit grades as needed) and coordinating the information necessary to assess the adequacy of the allowance for loan and lease losses (ALLL). Regardless of the structure of the loan review system in an institution, at a minimum, an effective loan review system should have the following objectives:

- To promptly identify loans having potential credit weaknesses and appropriately classify loans with well-defined credit weaknesses that jeopardize repayment so that timely action can be taken and credit losses can be minimized;
- To project relevant trends that affect the collectibility of the portfolio and isolate potential problem areas;
- To provide essential information to determine the adequacy of the ALLL;
- To assess the adequacy of and adherence to internal credit policies and loan administration procedures and to monitor compliance with relevant laws and regulations;
- To evaluate the activities of lending personnel;
- To provide senior management and the board of directors with an objective and timely assessment of the overall quality of the loan portfolio; and

- To provide management with accurate and timely information related to credit quality that can be used for financial and regulatory reporting purposes.

Credit Grading Systems

The foundation for any loan review system is accurate and timely credit grading, which involves an assessment of credit quality and leads to the identification of problem loans. An effective credit grading system provides important information on the collectibility of the portfolio for use in the determination of an adequate level for the ALLL.

Regardless of the particular type of loan review system employed, an effective credit grading framework generally places primary reliance on loan officers to identify emerging loan problems. However, given the importance and subjective nature of credit grading, a loan officer's judgment regarding the assignment of a particular credit grade to a loan may be subject to review by: (a) peers, superiors, or loan committees; (b) an independent, qualified part-time or full-time person(s); (e) an internal department staffed with credit review specialists; or (d) outside credit review consultants. A credit grading review that is independent of the lending function is the preferred approach because it typically provides a more conservative and realistic assessment of credit quality. Because accurate and timely credit grading is a critical component of an effective loan review system, each institution should ensure that its loan review system includes the following attributes:

- A formal credit grading system that can be reconciled with the framework used by the federal regulatory agencies; [11]
- An identification or grouping of loans that warrant the special attention of management;
- Documentation supporting the reason(s) why a particular loan merits special attention;
- A mechanism for direct, periodic and timely reporting to senior management and the board of directors on the status of loans identified as meriting special attention and the action(s) taken by management; and
- Appropriate documentation of the institution's credit loss experience for various components of its loan and lease portfolio. [12]

An institution should maintain a written description of its credit grading system, including a discussion of the factors used to assign appropriate credit grades to loans. Loan credit grades should reflect the risk of credit losses.

In addition, the loan review program should be in writing and reviewed and approved at least annually by the board of directors to evidence their support of and commitment to the system.

Loan Review System Elements

The following discussion refers to the primary activities comprising a loan review system that were previously addressed, ranging from the credit administration function to the independent internal loan review function. An institution's written policy and documentation for its loan review system should address the following elements:

[11] An institution may have a credit grading system that differs from the credit grading framework used by the federal banking agencies. However, each institution that maintains a credit grading system that differs from the agencies' framework should maintain documentation that translates its credit grading system into the pass-special mention-substandard-doubtful-loss credit grading framework used by the federal regulatory agencies. This documentation should be sufficient to enable examiners to reconcile the totals for the various credit grades under the institution's system to the agencies' categories listed above.

[12] Institutions are encouraged to maintain records of net credit loss experience for credits in each of the following categories: items not classified or designated as special mention, special mention, substandard, doubtful and loss.

- Qualifications of loan review personnel;
- Independence of loan review personnel;
- Frequency of reviews;
- Scope of reviews;
- Depth of reviews;
- Review of findings and follow-up; and
- Workpaper and report distribution, including distribution of reports to senior management and the Board of Directors.

Qualifications of Loan Review Personnel

Persons involved in the loan review function should be qualified based on level of education, experience, and extent of formal credit training; and should be knowledgeable in both sound lending practices and the institution's lending guidelines for the types of loans offered by the institution. In addition, these persons should be knowledgeable of relevant laws and regulations affecting lending activities.

Independence of Loan Review Personnel

An effective loan review system utilizes both the initial identification of emerging problem loans by loan officers, and the credit review of loans by individuals independent of the credit approval decisions. An important element of an effective system is to place responsibility on loan officers for continuous portfolio analysis and prompt identification and reporting of problem loans. Because of their frequent contact with borrowers, loan officers can usually identify potential problems before they become apparent to others. However, institutions should be careful to avoid over-reliance upon loan officers for identification of problem loans. Institutions should ensure that loans are also reviewed by individuals that do not have control over the loans they review and are not part of, or influenced by anyone associated with, the loan approval process.

While larger institutions typically establish a separate department staffed with credit review specialists, cost and volume considerations may not justify such a system in smaller institutions. In many smaller institutions, an independent committee of outside directors may fill this role. Whether or not the institution has an independent loan review department, the loan review function should report *directly* to the board of directors or a committee thereof (though senior management may be responsible for appropriate administrative functions so long as they do not compromise the independence of the loan review function).

Frequency of Reviews

Optimally, the loan review function can be used to provide useful continual feedback on the effectiveness of the lending process in order to identify any emerging problems. For example, the frequency of review of significant credits could be at least annually, upon renewal, or more frequently when internal or external factors indicate a potential for deteriorating credit quality in a particular type of loan or pool of loans. A system of ongoing or periodic portfolio reviews is particularly important to the ALLL determination process, which is dependent on the accurate and timely identification of problem loans.

Scope of Reviews

The review should cover all loans that are significant. Also, the review typically includes, in addition to all loans over a predetermined size, a sample of smaller loans; past due, nonaccrual, renewed and restructured loans; loans previously classified or designated as special mention by the institution or by its examiners; insider loans; and concentrations and other loans affected by common repayment factors. The percentage of the portfolio selected for review should provide reasonable assurance that the results of the review have identified the major problems in the portfolio and reflect its quality as a whole. Management should document that the scope of its reviews continues to identify major problems in the portfolio and reflect the portfolio's quality as a whole. The scope of loan reviews should be approved by the

institution's board of directors on an annual basis or when any significant changes to the scope of reviews are made.

Depth of Reviews

These reviews should analyze a number of important aspects of selected loans, including:

- Credit quality;
- Sufficiency of credit and collateral documentation;
- Proper lien perfection;
- Proper approval by the loan officer and loan committees;
- Adherence to any loan agreement covenants; and
- Compliance with internal policies and procedures and laws and regulations.

Furthermore, these reviews should consider the appropriateness and timeliness of the identification of problem loans by loan officers.

Review of Findings and Follow-up

Findings should be reviewed with appropriate loan officers, department managers, and members of senior management, and any existing or planned corrective action should be elicited for all noted deficiencies and identified weaknesses, including the time frames for correction. All noted deficiencies and identified weaknesses that remain unresolved beyond the assigned time frames for correction should be promptly reported to senior management and the board of directors.

Workpaper and Report Distribution

A list of loans reviewed, the date of the review, and documentation (including summary analyses) to substantiate assigned classifications or designations of loans as special mention should be prepared on all loans reviewed. A report that

summarizes the results of the loan review should be submitted to the board of directors on at least a quarterly basis.[13] In addition to reporting current credit quality findings, comparative trends can be presented to the board of directors that identify significant changes in the overall quality of the portfolio. Findings should also address the adequacy of and adherence to internal policies, practices and procedures, and compliance with laws and regulations so that any noted deficiencies can be remedied in a timely manner.

[13] The board of directors should be informed more frequently than quarterly when material adverse trends are noted.

Attachment 2

International Transfer Risk Considerations

With respect to international transfer risk, an institution should support its determination of the adequacy of its allowance for loan and lease losses by performing an analysis of the transfer risk, commensurate with the size and composition of the institution's exposure to each country. Such analyses should take into consideration the following factors, as appropriate:

- The institution's loan portfolio mix for each country (e.g., types of borrowers, loan maturities, collateral, guarantees, special credit facilities and other distinguishing factors);
- The institution's business strategy and its debt management plans for each country;
- Each country's balance of payments position;
- Each country's level of international reserves;
- Each country's established payment performance record and its future debt servicing prospects;
- Each country's socio-political situation and its effect on the adoption or implementation of economic reforms, in particular those affecting debt servicing capacity;
- Each country's current standing with multilateral and official creditors;
- The status of each country's relationships with bank creditors; and
- The most recent evaluations distributed by the Interagency Country Exposure Review Committee (ICERC) of the federal banking agencies.

Migration Analysis

Generally, problem assets will either deteriorate or improve over time. If a classified asset is not paid off or upgraded, it often deteriorates to a worse classification. If corrective action is not successful, a loss ultimately occurs. Migration (to loss) analysis uses association-specific data to track the movement of assets through the various asset classifications to Loss in order to estimate the percentage of losses that are likely to be incurred from the various categories and classifications of assets currently in the association's portfolio.

To be meaningful, the time period used for the analysis should be at least four quarters.

The steps to perform a migration analysis are as follows:

1. Stratify the portfolio into asset type and risk categories.

   The following stratifications may be useful:

   - Doubtful assets (or portions);
   - Substandard assets (or portions);
   - Special Mention assets;
   - Pass assets reviewed; and
   - Unreviewed and other assets stratified by risk or type.

   The Doubtful, Substandard, Special Mention, Pass, and unreviewed asset subcategories can be further stratified into categories such as commercial real estate, commercial business-secured and unsecured, etc. This is very important because certain asset types have different loss histories, such as one- to four-family residential mortgages as opposed to commercial real estate loans.

   Assets should be assigned to the category where they appeared at the beginning of the period analyzed, regardless of how they were subsequently categorized during the review period. For example, an asset designated as Special Mention at the beginning of the period should be assigned to that category because the examiner needs to determine the percentage of Special Mention assets that became Loss during the period. Examiners should not include in this analysis any assets that did not exist at the beginning of the period under review.

2. Determine the net loss percentage for each category of assets selected in step (1) that occurred during the review period. The net loss percentage is calculated by dividing the amount of charge-offs and SVAs that occurred on assets in each category by the amount of the assets in the category at the beginning of the review period. For example, if an institution had $50 million in Special Mention assets at the beginning of the review period and, for these assets, there were $1 million in charge-offs or SVAs during the review period, the net Loss percentage would be 2% ($1 million/$50 million).

3. Review all factors that would affect a change in the historical net loss data and make adjustments to the percentage as necessary.

4. Multiply the respective adjusted net loss percentages by the current outstanding balance of the assets in each category to derive the total allocations for each category. The analysis should also consider losses and risks of loss from off-balance-sheet exposure.

   The period being analyzed should move forward each quarter and will change the percentage for each category each quarter.

Note: An ineffective problem-loan identification, classification, or charge-off system will materially distort historical net loss percentages and make migration analysis difficult to apply.

Below is an example of migration analysis performed for a savings association based on its net loss performance over a one-year review period.

Portfolio	(1) Begin. Bal. $	(2) Loss Amt. $	(3) Loss Pct. %	(4) Curnt. Assets $	(5) Est. ALLL Requirement $
1-4 First Mortgage					
-Fixed LTV < 90	300	.50	0.17	350	0.58
-Fixed LTV > 90	100	.25	0.25	150	0.38
-ARM LTV < 90	90	.32	0.36	150	0.53
-ARM LTV > 90	80	.50	0.63	100	0.63
-Construction	30	.90	3.00	20	0.60
MBS	60	.00	0.00	100	0.00
Consumer:					
-Auto	20	.30	1.50	30	0.45
-Credit cards	10	.40	4.00	15	0.60
Commercial:					
-Secured	15	.23	1.53	25	0.38
-Unsecured	5	.15	3.00	5	0.15
-Special Mention	10	.30	3.00	13	0.39
-Substandard	5	.90	18.00	9	1.62
-Doubtful	3	1.00	33.00	5	1.67
Totals	728	5.75	0.79	972	7.98 (6)

(All dollar amounts are in millions.)

(1) Balance of the portfolio at the beginning of the review period.
(2) Losses experienced (both charge-offs and SVAs) in the portfolio during the review period.
(3) Percentage loss in the portfolio during the review period (column 2 divided by column 1).
(4) Current balance of the portfolio.
(5) The loss expected over the next review period (usually 12 months) based on the current level of assets in the portfolio (column 3 x column 4).
(6) The total is the amount of ALLL that may be appropriate for the association to have for loans. The ALLL for off-balance-sheet items is then added to arrive at the total ALLL.

INTRODUCTION

To be a Qualified Thrift Lender (QTL), an institution must either meet the Home Owners' Loan Act (HOLA) QTL test or the Internal Revenue Service (IRS) tax code Domestic Building and Loan Association (DBLA) test.

Savings associations may use either test to qualify and may switch from one test to the other. OTS has placed no limitations on the election except to require that the association must meet the time requirements of the respective test, that is, nine out of the last twelve months or the taxable year. According to the IRS, a taxable year may be either a calendar or fiscal year.

QUALIFIED THRIFT LENDER TEST

Under the QTL test, an institution must hold Qualified Thrift Investments (QTI) equal to at least 65 percent of its portfolio assets. The ratio of an institution's QTI divided by its portfolio assets is the institution's actual thrift investment percentage (ATIP). QTI must fall into one of the two following categories:

- Assets that are includable in QTI without limit.
- Assets limited to 20 percent of portfolio assets.

Portfolio assets are total assets minus goodwill and other intangible assets, office property, and liquid assets not exceeding 20 percent of total assets. An institution ceases to be a QTL when its ratio of QTI (numerator) divided by its portfolio assets (denominator) falls, at month end, below 65 percent for four months within any 12-month period.

<u>Assets that are includable as QTI without limit:</u>

- Loans (including qualifying real estate owned as a result of such loans) to purchase, refinance, construct, improve, or repair domestic residential or manufactured housing.
- Home equity loans.
- Educational loans.
- Small business loans.
- Loans made through credit cards or credit card accounts.
- Securities backed by or representing an interest in mortgages on domestic residential or manufactured housing.
- FHLB stock.
- Obligations of the FDIC, FSLIC, RTC, and the FSLIC Resolution Fund (depending on the date of the issue of such obligations).

<u>Assets that are includable as QTI up to 20 percent of portfolio assets:</u>

- Fifty percent of the amount of domestic residential housing mortgage loans originated and sold within 90 days. An institution may, on a consistent basis, include as QTI either the sales amounts from a previous quarter or the previous rolling 90 days or three-month period.
- Investments in a service corporation that derives at least 80 percent of its gross revenues from activities related to domestic or manufactured residential housing.
- Two hundred percent of the amount of loans and investments in "starter homes."
- Two hundred percent of the amount of certain loans in "credit-needy areas."
- Loans for the purchase, construction, development, or improvements of "community service facilities" not in credit-needy areas.
- Loans for personal, family, or household purposes (other than those reported in the assets includable without limit category).
- FNMA and FHLMC stock.

Domestic Building and Loan Association Test

To be a QTL under the DBLA test (IRS regulation 26 CFR § 301.7701-13A), an institution must meet a "business operations test" and a "60 percent of assets test."

The business operations test requires the business of a DBLA to consist primarily of acquiring the savings of the public and investing in loans. An institution meets the public savings requirement when it meets one of two conditions:

- The institution acquires its savings in conformity with OTS rules and regulations.
- The general public holds more than 75 percent of its deposits, withdrawable shares, and other obligations. The general public may not include family or related business groups or persons who are officers or directors of the institution.

An institution meets the investing in loans requirement when more than 75 percent of its gross income consists of interest on loans and government obligations, and various other specified types of operating income that financial institutions ordinarily earn.

The 60 percent of assets test requires that at least 60 percent of a DBLA's assets must consist of assets that thrifts normally hold, except for consumer loans that are not educational loans. The DBLA test does not include, as the QTL test does to a limited or optional extent, mortgage loans originated and sold into the secondary market and subsidiary investments.

See Appendix A for the Internal Revenue Code statutory definition of domestic building and loan association (26 USCA § 7701(a)(19)). See Appendix B for the IRS's implementing regulation defining domestic building and loan association (26 CFR § 301.7701-13A).

BACKGROUND

Congress first established the QTL test as part of the Competitive Equality Banking Act of 1987 (CEBA). Effective January 1, 1988, the Federal Home Loan Bank Board implemented the CEBA provisions. This required all thrift institutions to invest at least 60 percent of their tangible assets in certain housing and related investments to maintain QTL status.

Congress amended the QTL test as part of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) and raised the required ATIP to 70 percent. The statute phased in the changes over a two-year period. On August 9, 1990, new penalty provisions for failing the QTL test became effective and on July 1, 1991, the remainder of the FIRREA changes became effective.

The Federal Deposit Insurance Corporation Improvement Act of 1991 lowered the required ATIP to 65 percent and changed the computation period from a required weekly average to a required maintenance period of 9 out of 12 immediately preceding months.

The Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA) amended the QTL requirements to give thrifts a choice of tests. A thrift must qualify either by meeting the HOLA QTL test, as amended by the EGRPRA, or by meeting the IRS's DBLA tax code test. The EGRPRA amended the QTL test to allow:

- Educational loans, small business loans, and credit card loans to count as QTIs without limit.
- Loans for personal, family, or household purposes (other than those included in the without limit category) to count as QTI in the category limited to 20 percent of portfolio assets.

Exceptions

Section (m)(2) of the HOLA authorizes the OTS to grant temporary and limited exceptions from compliance with the QTL test. OTS may grant exceptions when extraordinary circumstances exist, or to significantly facilitate an acquisition under §13(c) or §13(k) of the Federal Deposit Insurance Act (FDIA).

Section (m)(2)(A) of the HOLA presents an example of an extraordinary circumstance: when the effects of high interest rates reduce mortgage demand to such a degree that an insufficient

opportunity exists for a savings association to meet the QTL requirement. Also, Thrift Bulletin 71, Serving Communities Affected by Natural Disasters, explains that within the constraints of safety and soundness and statutory requirements, the OTS will facilitate savings association efforts to assist communities affected by a natural disaster. In doing so, the OTS may temporarily waive the QTL requirement to allow capital compliant institutions to help rebuild non-QTL businesses.

Section 13(c) of the FDIA authorizes the FDIC to provide financial assistance to facilitate a merger or consolidation of a troubled insured depository institution. Section 13(k) of the FDIA sets forth criteria for such emergency acquisitions of troubled institutions. When granting an exception to significantly facilitate a § 13(c) or §13(k) acquisition, the OTS must determine the following:

- The acquired association will comply with a 51-month incremental phase-in transaction period (see §§(m)(2)(B)(ii) and (m)(7)(B) of the HOLA).
- The exception will not have an undue adverse effect on competing savings associations in the relevant market and will further the purposes of the QTL test.

DEFINITIONS OF QTL TERMS

An institution must be able to demonstrate that items being counted as QTI meet the specific definitions set forth below:

Acquisition, Development, and Construction (ADC) Loans

Associations may include ADC loans in QTI without limit provided the association is reasonably certain the property will become domestic residential housing. Moreover, to count as QTI, an ADC loan must meet at least one of the following criteria:

- The loan is for property zoned exclusively for residential use.
- The loan is for property zoned to permit residential use and there are restrictions in the deed to the property that limit its use to primarily residential dwellings.
- The borrower will construct dwellings immediately on nearly all the residentially zoned property.

Community Service Facilities

Community service facility means churches or other places of worship, schools, nursing homes, hospitals, and facilities serving similar functions within a community.

Domestic Housing

This term refers to housing located within the 50 states, the District of Columbia, Puerto Rico, the Virgin Islands, Guam, and the Pacific Islands.

Loans To Credit-Needy Areas

A credit-needy area is a geographic area or neighborhood in which the credit needs of the low- and moderate income residents are not being adequately met. This includes any census tract or block numbering area delineated by the United States Bureau of the Census where median income is less than 80 percent of the area median income. Area median income means the median family income for a Metropolitan Statistical Area (MSA), or the statewide non-metropolitan area if located outside an MSA.

A credit-needy area may also be an area that meets either of the following criteria:

- An area targeted for redevelopment by a federal, state, tribal or local government that also receives some form of financial assistance from the federal, state, tribal or local government.
- Identified as credit-needy through consultations with local government and community representatives. These determinations will be subject to review for reasonableness during examinations.

In addition, if the loan is for a small business or a “community service facility” the association may

classify it as a loan to a credit-needy area if it meets one of the following criteria:

— The loan is to a community service facility or a small business within the credit-needy area.

— The loan is to a small business owned by an individual whose home address is within the credit-needy area.

— The loan is to a community service facility that primarily serves individuals whose homes are within the credit-needy area.

For example, under the first criteria, a loan to a community center, school, or small business in a credit-needy area would qualify. Under the second, a small business loan to a person living in a credit-needy area but whose business is not within such an area would qualify. Finally, under the third criteria, loans to hospitals, churches or school dormitories that have clientele, the majority of who live in credit-needy areas, would qualify.

Manufactured Housing

Manufactured housing has the same meaning as defined by the National Manufactured Home Construction and Safety Standards Act in 42 USC Section 5402(6):

> A structure, transportable in one or more sections, that in traveling mode measures at least eight feet by forty feet, or when erected is at least 320 square feet, and that is built on a permanent chassis and designed to be used as a dwelling with or without a permanent foundation when connected to the required utilities, and includes the plumbing, heating, air-conditioning, and electrical systems contained therein.

Mutual Funds

An institution may count mutual fund investments as QTI on a pro rata basis to the same extent that the underlying investments are eligible as QTI if the institution invested directly in the underlying investments. The mutual funds must also meet the other standards set forth in HOLA § 5(c)(1)(Q).

Residential Housing

For QTL purposes, residential housing includes OTS's regulatory 12 CFR Part 541 definitions of "residential real estate" and "dwelling unit." Section 541.23 also defines residential real estate (or residential real property):

- Homes (including condominiums and cooperatives).
- Combinations of homes and business property.
- Other real estate used for primarily residential purposes other than a home (but which may include homes).
- Combinations of such real estate and business property involving only minor business use.
- Farm residences and combinations of farm residences and commercial farm real estate.
- Property to be improved by the construction of such structures.
- Leasehold interests in the above real estate.

Section 541.10 defines dwelling unit to mean, "The unified combination of rooms designed for residential use by one family, other than a single-family dwelling."

Small Business Loans

OTS Definition

OTS's definition of a small business loan is in 12 CFR § 560.3: Small business loans and loans to small businesses include any loan to a small business as defined in this section; or a loan that does not exceed $2 million (including a group of loans to one borrower) and is for commercial, corporate, business, or agricultural purposes. The following guidelines also apply:

- Generally, the original amount of a loan is the total amount of the loan at origination or the amount of the loan balance outstanding, whichever is larger.
- For loan participations and syndications, the original amount of the loan participation or

syndication is the entire amount of the credit the lead lender originated.

- For loans drawn down under lines of credit or loan commitments, the original amount of the loan is the amount when the lender most recently approved, extended, or renewed the line of credit or loan commitment before the report date. However, if the amount currently outstanding as of the report date exceeds this size, the original amount is the amount currently outstanding.
- Institutions should combine multiple loans to one borrower and report them on an aggregated basis.

Small Business Administration (SBA) Definition

OTS regulation 12 CFR § 560.3 also cites the SBA definition of small business loans. Savings associations familiar with the SBA standards may prefer to use the eligibility criteria established by the SBA. See section 3(a) of the Small Business Act (Act), 15 USC 632(a), as implemented by SBA's regulations at 13 CFR Part 121.

Section 3(a) of the Act states that a small business concern must be independently owned and operated and not dominant in its field of operation. The Act provides that the definition shall vary from industry to industry in determining what a small business is to the extent necessary to properly reflect industry differences. In addition, the SBA is to make a detailed definition of the term based on, among other criteria, a business's number of employees and dollar amount of business.

The SBA size standards at 13 CFR Part 121 define the maximum sizes to be eligible as a small business concern. Two principal maximum size standards are 500 employees for most manufacturing and mining industries, and $5 million in average annual receipts for most manufacturing industries. However, many exceptions exist and the SBA periodically changes size standards for different industries. Reference to the regulations is necessary to determine size eligibility requirements for a specific business concern.

Starter Home Loans

To be defined as a starter home loan for QTL purposes, a loan must meet certain criteria:

- Be secured by a one- to four-family home or multifamily residential dwelling; or by a development where 75 percent or more of the value of the development consists of such homes. In developments, up to 25 percent of the loan amount may be for facilities serving the community such as community centers or shopping malls.
- Be appraised at the time of loan origination at 60 percent less than the median value of newly constructed one- to four-family houses in the community where the starter home is located.

If no median figures are available for the local community, there are three permissible methods for estimating the median housing price in the community.

- Federal Housing Finance Board (FHFB) Method. An institution may rely on the most recent annual statewide housing value data generated by the FHFB. OTS regional offices will make the FHFB data available.
- National Association of Home Builders (NAHB) Method. NAHB publishes median housing prices monthly for 190 metropolitan areas as part of its Housing Opportunity Index. Associations may use the most recent NAHB data if it includes the local community in which the starter home is located.
- Private Method. An institution may rely on figures generated by a private company that has substantial experience conducting market surveys. The association may use the data on newly constructed housing values for one year after the date of the survey. The survey methodology will be subject to review during examinations.

CONSOLIDATION OF SUBSIDIARIES

In determining an institution's portfolio assets in the calculation of its ATIP, the institution must consolidate its assets with a subsidiary's assets in the following situations:

- The institution consolidates the subsidiary's assets with the institution's assets in determining its QTI.
- The association includes the subsidiary's residential mortgage loans originated and sold within 90 days of origination to determine the institution's QTI.

Except for these circumstances, an institution has the option to consolidate or not, and may make such a decision as frequently as monthly.

PENALTIES

Statutory penalty provisions require an institution that fails to remain a QTL to either become a national bank or be prohibited from the following:

- Making any new investments or engaging in any new activity not allowed for both a national bank and a savings association.
- Establishing any new branch office unless allowable for a national bank.
- Paying dividends unless allowable for a national bank.

Any company that controls a savings association that fails to regain its QTL status within one year must register as and be deemed to be a bank holding company.

Three years from the date a savings association should have become or ceases to be a QTL, by failing either to meet the QTL test or the DBLA test, the institution must comply with the following restriction:

- Dispose of any investment or not engage in any activity unless the investment or activity is allowed for both a national bank and a savings association.

REQUALIFICATION

A savings association may requalify as a QTL only once. Failure to maintain QTL status after requalification permanently subjects a savings association to the penalties described above.

MONITORING QTL COMPLIANCE

You are responsible for reviewing an institution's policies and procedures for maintaining QTL or DBLA status. You must also review documentation with the primary focus on the following:

- Evaluate the eligibility of qualifying investments and to reconcile the amounts recorded.
- Ensure that calculations reported on Schedule SI of an institution's Thrift Financial Report are correct.
- Confirm that the institution's QTL or DBLA status is correct.

REFERENCES

United States Code (12 USC)

§ 1430(e)	Reduced Eligibility for Advances
§ 1467a(m)	Qualified Thrift Lender Test

United States Code (15 USC)

§ 632(a)	Small Business Act

United States Code (26 USC)

§ 7701(a)(19)	Domestic Building and Loan Association Test

United States Code (42 USC)

§ 5402(6)	National Manufactured Home Construction and Safety Standards Act

Code of Federal Regulations (13 CFR)

Part 121	Small Business Regulations

Code of Federal Regulations (26 CFR)

§ 301.7701-13A	Post-1969 Domestic Building and Loan Association

Office of Thrift Supervision Bulletins

TB 71	Serving Communities Affected by Natural Disasters

Qualified Thrift Lender Status Program

Examination Objectives

To evaluate the institution's policies, procedures, and controls for achieving or maintaining QTL or DBLA status.

To confirm the institution's QTL or DBLA status.

To ensure that the institution observes any consequent limitations or penalties for QTL or DBLA failure.

Examination Procedures

Wkp.Ref.

Level I

1. Determine if the institution observes the QTL or DBLA test. If it is the DBLA test, determine if the institution meets applicable DBLA criteria.

_____ _____

2. Review and assess the accuracy of the Qualified Thrift Lender Worksheet or records of compliance with the DBLA test.

_____ _____

3. Determine whether the institution met the requirements of the QTL or DBLA test since the last examination.

_____ _____

4. Review the previous examination report to determine the presence of any QTL-related issues. Determine if management has corrected the deficiencies.

_____ _____

5. Assess the institution's policies, procedures, and controls relating to achieving or maintaining QTL or DBLA status.

_____ _____

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6. Determine whether any exceptions to the QTL requirement exist, such as extraordinary circumstances.

7. Determine if the institution records all investments correctly.

8. Determine if all investments counted as QTI meet the applicable standards.

9. Review documentation supporting the inclusion of any investments that are not clearly eligible.

10. If the institution failed the QTL or DBLA test, perform Level II procedures.

Level II

11. When the institution has failed the QTL or DBLA test, determine if the failure is the first one.

12. Determine how long the failure has lasted and if the institution has complied with the appropriate penalties.

13. Interview management to determine if the institution intends to change the composition of its balance sheet to re-qualify as a QTL or DBLA.

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14. Determine management's plan for maintaining QTL or DBLA status once regained, stressing the consequences of a second failure.

15. State in the examination report if the institution has not complied with QTL penalties since failure, or if the review uncovers a second or third failure. Outline the actions the institution needs to take to comply with the applicable penalty provisions.

16. Ensure that your review meets the Objectives of this Handbook Section. State your findings, conclusions, and appropriate recommendations for any necessary corrective measures on the appropriate work papers and report pages.

Examiner's Summary, Recommendations, and Comments

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Internal Revenue Code Definition of "Domestic Building and Loan Association"

26 U.S.C.A. § 7701(a)(19)

(19) *Domestic building and loan association*. - The term "domestic building and loan association" means a domestic building and loan association, a domestic savings and loan association, and a Federal savings and loan association –

(A) which either (i) is an insured institution within the meaning of section 401(a) of the National Housing Act (12 U.S.C., sec. 1724(a)), or (ii) is subject by law to supervision and examination by State or Federal authority having supervision over such associations;

(B) the business of which consists principally of acquiring the savings of the public and investing in loans; and

(C) at least 60 percent of the amount of the total assets of which (at the close of the taxable year) consists of –

(i) cash,

(ii) obligations of the United States or of a State or political subdivision thereof, and stock or obligations of a corporation which is an instrumentality of the United States or of a State or political subdivision thereof, but not including obligations the interest on which is excludable from gross income under section 103,

(iii) certificates of deposit in, or obligations of, a corporation organized under a State law which specifically authorizes such corporation to insure the deposits or share accounts of member associations,

(iv) loans secured by a deposit or share of a member,

(v) loans (including redeemable ground rents, as defined in section 1055) secured by an interest in real property which is (or, from the proceeds of the loan, will become) residential real property or real property used primarily for church purposes, loans made for the improvement of residential real property or real property used primarily for church purposes, provided that for purposes of this clause, residential real property shall include single or multifamily dwellings, facilities in residential developments dedicated to public use or property used on a nonprofit basis for residents, and mobile homes not used on a transient basis,

(vi) loans secured by an interest in real property located within an urban renewal area to be developed for predominantly residential use under an urban renewal plan approved by the Secretary of Housing and Urban Development under part A or part B of title I of the Housing Act of 1949, as amended, or located within any area covered by a program eligible for assistance under section 103 of the Demonstration Cities and Metropolitan Development Act of 1966, as amended, and loans made for the improvement of any such real property,

(vii) loans secured by an interest in educational, health, or welfare institutions or facilities, including structures designed or used primarily for residential purposes for students, residents, and persons under care, employees, or members of the staff of such institutions or facilities,

(viii) property acquired through the liquidation of defaulted loans described in clause (v), (vi), or (vii),

(ix) loans made for the payment of expenses of college or university education or vocational training, in accordance with such regulations as may be prescribed by the Secretary,

(x) property used by the association in the conduct of the business described in subparagraph (B), and

(xi) any regular or residual interest in a REMIC, but only in the proportion which the assets of such REMIC consist of property described in any of the preceding clauses of this subparagraph; except that if 95 percent or more of the assets of such REMIC are assets described in clauses (i) through (x), the entire interest in the REMIC shall qualify.

At the election of the taxpayer, the percentage specified in this subparagraph shall be applied on the basis of the average assets outstanding during the taxable year, in lieu of the close of the taxable year, computed under regulations prescribed by the Secretary. For purposes of clause (v), if a multifamily structure securing a loan is used in part of nonresidential purposes, the entire loan is deemed a residential real property loan if the planned residential use exceeds 80 percent of the property's planned use (determined as of the time the loan is made). For purposes of clause (v), loans made to finance the acquisition or development of land shall be deemed to be loans secured by an interest in residential real property if, under regulations prescribed by the Secretary, there is reasonable assurance that the property will become residential real property within a period of three years from the date of acquisition of such land; but this sentence shall not apply for any taxable year unless, within such three-year period, such land becomes residential real property. For purposes of determining whether any interest in a REMIC qualifies under clause (xi), any regular interest in another REMIC held by such REMIC shall be treated as a loan described in a preceding clause under principles similar to the principles of clause (xi); except that, if such REMIC's are part of a tiered structure, they shall be treated as one REMIC for purposes of clause (xi).

Internal Revenue Service's Regulatory Definition of "Domestic Building and Loan Association"

26 CFR Ch. 1 (4-1-96 Edition)

§ 301.7701-13A. Post-1969 domestic building and loan association.

(a) In general. For taxable years beginning after July 11, 1969, the term "domestic building and loan association" means a domestic building and loan association, a domestic savings and loan association, a Federal savings and loan association, and any other savings institution chartered and supervised as a savings and loan or similar association under Federal or State law which meets the supervisory test (described in paragraph (b) of this section), the business operations test (described in paragraph (c) of this section), and the assets test (described in Paragraph (d) of this section). For the definition of the term "domestic building and loan association" for taxable years beginning after October 16, 1962, and before July 12, 1969, see § 301.7701-13.

(b) Supervisory test. A domestic building and loan association must be either (1) an insured institution within the meaning of section 401(a) of the National Housing Act (12 USC 1724(a)) or (2) subject by law to supervision and examination by State or Federal authority having supervision over such associations. An "insured institution" is one the accounts of which are insured by the Federal Savings and Loan Insurance Corporation.

(c) Business operations test –

(1) In general. An association must utilize its assets so that its business consists principally of acquiring the savings of the public and investing in loans. The requirement of this paragraph is referred to in this section as the business operations test. The business of acquiring the savings of the public and investing in loans includes ancillary or incidental activities which are directly and primarily related to such acquisition and investment, such as advertising for savings, appraising property on which loans are to be made by the association, and inspecting the progress of construction in connection with construction loans. Even though an association meets the supervisory test described in paragraph (b) of this section and the assets test described in paragraph (d) of this section, it will nevertheless not qualify as a domestic building and loan association if it does not meet the requirements of both paragraphs (2) and (3) of this paragraph (c), relating, respectively, to acquiring the savings of the public and investing in loans.

(2) Acquiring the savings of the public. The requirement that an association's business (other then investing in loans) must consist principally of acquiring the savings of the public ordinarily will be considered to be met if savings are acquired in all material respects in conformity with the rules and regulations of the Federal Home Loan Bank Board or substantially equivalent rules of a State law or supervisory authority. Alternatively, such requirement will be considered to be met if more than 75 percent of the dollar amount of the total deposits, withdrawable shares, and other obligations of the association are held during the taxable year by the general public, as opposed to amounts deposited or held by family or related business groups or persons who are officers or directors of the association. However, the preceding sentence shall not apply if the dollar amount of other obligations of the association outstanding during the taxable year exceeds 25 percent of the dollar amount of the total deposits, withdrawable shares, and other obligations of the association outstanding during such year. For purposes of this paragraph, the term "other obligation" means notes, bonds, debentures, or other obligations, or other securities (except capital stock), issued by an association in conformity with the rules and regulations of the Federal Home Loan Bank Board or substantially equivalent rules of a State law or supervisory authority. The term "other obligations" does not

include an advance made by a Federal Home Loan Bank under the authority of section 10 or 10b of the Federal Home Loan Bank Act (12 USC 1430, 1430b) as amended and supplemented. Both percentages specified in this paragraph shall be computed either as of the close of the taxable year or, at the option of the taxpayer, on the basis of the average of the dollar amounts of the total deposits, withdrawable shares, and other obligations of the association held during the taxable year. Such averages shall be determined by computing each percentage specified either as of the close of each month, as of the close of each quarter, or semiannually during the taxable year and by using the yearly average of the monthly, quarterly, or semiannual percentages obtained. The method selected must be applied uniformly for the taxable year to both percentages, but the method may be changed from year to year.

(3) Investing in loans –

(i) In general. The requirement that an association's business (other than acquiring the savings of the public) must consist principally of investing in loans will be considered to be met for a taxable year only if more than 75 percent of the gross income of the association consists of –

(a) Interest or dividends on assets defined in paragraphs (1), (2), and (3) of paragraph (e) of this section,

(b) Interest on loans,

(c) Income attributable to the portion of property used in the association's business, as defined in paragraph (e)(11) of this section,

(d) So much of the amount of premiums, discounts, commissions, or fees (including late charges and penalties) on loans which have at some time been held by the association, or for which firm commitments have been issued, as is not in excess of 20 percent of the gross income of the association,

(e) Net gain from sales and exchanges of governmental obligations, as defined in paragraph (e)(2) of this section, or

(f) Income, gain or loss attributable to foreclosed property, as defined in paragraph (e)(9) of this section, but not including such income, gain or loss which, pursuant to section 595 and the regulations thereunder, is not included in gross income. Examples of types of income which would cause an association to fail to meet the requirements of this paragraph if, in the aggregate, they equal or exceed 25 percent of gross income, are: The excess of gains over losses from sales of real property (other than foreclosed property); rental income (other than on foreclosed property and the portion of property used in the association's business); premiums, commission, and fees (other than commitment fees) on loans which have never been held by the association; and insurance brokerage fees.

(ii) Computation of gross income. For purposes of this paragraph, gross income is computed without regard to –

(a) Gain or loss on the sale or exchange of the portion of property used in the association's business as defined in paragraph (e)(11) of this section.

(b) Gain or loss on the sales or exchange of the rented portion of property used as the principal or branch office of the association, as defined in paragraph (e)(11) of this section, and

(c) Gains or losses on sales of participations, and loans, other than governmental obligations defined in paragraph (e)(2) of this section.

For purposes of this paragraph, gross income is also computed without regard to items of income which an association establishes arise out of transactions which are necessitated by exceptional circumstances and which are not undertaken as recurring business activities for profit. Thus, for example, an association would meet the investing in loans requirement if it can establish that it

would otherwise fail to meet that requirement solely because of the receipt of a nonrecurring item of income due to exceptional circumstances. For this purpose, transactions necessitated by an excess of demand for loans over savings capital in the association's area are not to be deemed to be necessitated by exceptional circumstances. For purposes of paragraph (c)(3)(ii)(c) of this section, the term "sales of participations" means sales by an association of interest in loans, which sales meet the requirements of the regulations of the Federal Home Loan Bank Board relating to sales of participations, or which meet substantially equivalent requirements of State law or regulations relating to sales of participations.

(iii) Reporting requirement. In the case of income tax returns for taxable years beginning after July 11, 1969, there is required to be led with the return a statement showing the amount of gross income for the taxable year in each of the categories described in paragraph (c)(3)(i) of this section.

(d) 60 Percent of assets test. At least 60 percent of the amount of the total assets of a domestic building and loan association must consist of the assets defined in paragraph (e) of this section. The percentage specified in this paragraph is computed as of the close of the taxable year or, at the option of the taxpayer, may be computed on the basis of the average assets outstanding during the taxable year. Such average is determined by making the appropriate computation described in this section either as of the close of each month, as of the close of each quarter, or semiannually during the taxable year and by using the yearly average of the monthly, quarterly, or semiannual percentage obtained for each category of assets defined in paragraph (e) of this section. The method selected must be applied uniformly for the taxable year to all categories of assets, but the method may be changed form year to year. For purposes of this paragraph, it is immaterial whether the association originated the loans defined in paragraphs (4) through (8) and (10) of paragraph (e) of this section or purchased or otherwise acquired them in whole or in part from another. See paragraph (f) of this section for definition of certain terms used in this paragraph and in paragraph (e) of this section, and for the determination of amount and character of loans.

(e) Assets defined. The assets defined in this paragraph are –

(1) Cash. The term "cash" means cash on hand, and time or demand deposits with, or withdrawable accounts in, other financial institutions.

(2) Governmental obligations. The term "governmental obligations" means –

(i) Obligations of United States,

(ii) Obligations of a State or political subdivision of a State, and

(iii) Stock or obligations of a corporation which is an instrumentality of the United States, a State, or a political subdivision of a State, other than obligations the interest on which is excludable from gross income under section 103 and the regulations thereunder.

(3) Deposit insurance company securities. The term "deposit insurance company securities" means certificates of deposit in, or obligations of, a corporation organized under a State law which specifically authorizes such corporation to insure the deposits or share accounts of member associations.

(4) Passbook loan. The term "passbook loan" means a loan to the extent secured by a deposit, withdrawable share, or savings account in the association, or share of a member of the association, with respect to which a distribution is allowable as a deduction under section 591.

(5) Residential real property loan. [Reserved]

(6) Church loan. [Reserved]

(7) Urban renewal loan. [Reserved]

(8) Institutional loan. [Reserved]

(9) Foreclosed property. [Reserved]

(10) Educational loan. [Reserved]

(11) Property used in the association's business–

(i) In general. The term "property used in the association's business" means land, buildings, furniture, fixtures, equipment, leasehold interests, leasehold improvements, and other assets used by the association in the conduct of its business of acquiring the savings of the public and investing in loans. Real property held for the purpose of being used primarily as the principal or branch office of the association constitutes property used in the association's business so long as it is reasonably anticipated that such property will be occupied for such use by the association, or that construction work preparatory to such occupancy will be commenced thereon, within 2 years after acquisition of the property. Stock of a wholly owned subsidiary corporation which has as its exclusive activity the ownership and management of property more than 50 percent of the fair rental value of which is used as the principal or branch office of the association constitutes property used in such business. Real property held by an association for investment or sale, even for the purpose of obtaining mortgage loans thereon, does not constitute property used in the association's business.

(ii) Property rented to others. Except as provided in the second sentence of paragraph (11)(i) of this paragraph (e), property or a portion thereof rented by the association to others does not constitute property used in the association's business. However, if the fair rental value of the rented portion of a single piece of real property (including appurtenant parcels) used as the principal or branch office of the association constitutes less than 50 percent of the fair rental value of such piece of property, or if such property has an adjusted basis of not more than $150,000, the entire property shall be considered used in such business. If such rented portion constitutes 50 percent or more of the fair rental value of such piece of property, and such property has an adjusted basis of more than $150,000, an allocation of its adjusted basis is required. The portion of the total adjusted basis of such piece of property which is deemed to be property used in the association's business shall be equal to an amount which bears the same ratio to such total adjusted basis as the amount of the fair rental value of the portion used as the principal or branch office of the association bears to the total fair rental value of such property. In the case of all property other than real property used or to be used as the principal or branch office of the association, if the fair rental value of the rented portion thereof constitutes less than 15 percent of the fair rental value of such property, the entire property shall be considered used in the association's business. If such rented portion constitutes 15 percent or more of the fair rental value of such property, an allocation of its adjusted basis (in the same manner as required for real property used as the principal or branch office) is required.

(12) Regular or residual interest in a REMIC –

(i) In general. If for any calendar quarter at least 95 percent of a REMIC's assets (as determined in accordance with § 1.860F-4(e)(1)(ii) or § 1.6049-7(f)(3) of this chapter) are assets defined in paragraph (e)(1) through (e)(11) of this section, then for that calendar quarter all the regular and residual interests in that REMIC are treated as assets defined in this paragraph (e). If less than 95 percent of a REMIC's assets are assets defined in paragraph (e)(1) through (e)(11) of this section, the percentage of each REMIC regular or residual interest treated as an asset defined in this paragraph (e) is equal to the percentage of the REMIC's assets that are assets defined in paragraph (e)(1) through (e)(11) of this section. See §§ 1.860F-4(e)(1)(ii)(B) and 1.6049-7(f)(3) of this chapter for information required to be provided to regular and residual interest holders if the 95 percent test is not met.

(ii) Loans secured by manufactured housing. For purposes of paragraph (e)(12)(i) of this section, a loan secured by manufactured housing treated as a single family residence under section 25(e)(10) is an asset defined in paragraph (e)(1) through (e)(11) of this section.

(f) Special rules. [Reserved]

QTL Worksheet for the Month of _____

	Line	Amount *(in thousands)*
PORTFOLIO ASSETS		
Total Assets	**1**	
20% of Total Assets *(Line 1 X .20)*	**2**	
Office Building	**3**	
Liquidity (cash and marketable securities)	**4**	
Goodwill and Other Intangibles	**5**	
Deductions from Total Assets *(Sum of Lines 3, 4, and 5)*	**6**	
PORTFOLIO ASSETS *(Lines1 Minus Line 6)*	**7**	
20% OF PORTFOLIO ASSETS *(Line 7 X .20)*	**8**	
QUALIFIED THRIFT INVESTMENTS (QTI)		
ASSETS INCLUDABLE WITHOUT LIMIT		
Mortgage Loans	**9**	
Real Estate Owned (Residential)	**10**	
Home Equity Loans	**11**	
Mortgage-Backed Securities	**12**	
Educational Loans	**13**	
Small Business Loans	**14**	
Credit Card Loans	**15**	
Obligations of Deposit Insurance Agencies (Prior to 7/1/89)	**16**	
Obligations of Deposit Insurance Agencies (On or After 7/1/89)	**17**	
Federal Home Loan Bank Stock	**18**	
TOTAL QTI INCLUDABLE WITHOUT LIMIT *(Sum of Lines 9 through 18)*	**19**	
ASSETS INCLUDABLE UP TO 20% OF PORTFOLIO ASSETS		
50% Of Residential Mortgage Loans Originated and Sold Within 90 Days	**20**	
80% Service Corporations	**21**	
200% of 1-4 Family Residence Loans (Starter Homes <60% Median)	**22**	
200% of Certain Loans in Credit-Needy Areas	**23**	
Community Service Facility Loans (Purchase, Construction, Improvement)	**24**	
Loans for Personal, Family, or Household Purposes	**25**	
FNMA or FHLMC Stock	**26**	
FOR PUERTO RICAN AND VIRGIN ISLAND INSTITUTIONS ONLY		
Loans for Personal Family or Household Purposes	**27**	
Community Service Facility Loans (Purchase, Construction, Improvement)	**28**	
200% of 1-4 Family Residence Loans (Starter Homes<Median)	**29**	
Total QTI Includable Up to 20% of Portfolio Assets *(The Lesser of the Sum of Lines 20-26 or Line 8)*	**30**	
TOTAL QUALIFIED THRIFT INVESTMENTS *(Sum of Lines 19 and 30)*	**31**	
ACTUAL THRIFT INVESTMENT PERCENTAGE *(Line 31 Divided by Line 7)*	**32**	%

OTS Form 1427

Instructions for QTL Worksheet

To calculate the actual thrift investment percentage (ATIP), follow the instructions below and refer to the QTL worksheet. Each institution that elects to comply with the QTL test must perform these calculations on a monthly basis.

Part 1 – Portfolio Assets

Line 1 – Total Assets

Enter total assets. Consolidate a subsidiary if the association counts as a qualified thrift investment any of the subsidiary's assets, or mortgages originated and sold within 90 days of origination. Also, if the institution counts its investment in an 80% mortgage-related revenue subsidiary as qualified thrift investment on Line 21, it must include that investment in total assets.

Line 2 – 20% of Total Assets

Multiply Line 1 by 0.20.

Line 3 – Office Building

Enter the depreciated carrying value of the property, furniture, fixtures, and equipment that the institution uses to conduct its business.

Line 4 – Liquidity

Enter the lesser of the institution's liquid assets (cash and marketable securities) or the amount on Line 2. Do not include as liquidity any securities entered on Line 12.

Line 5 – Goodwill and Other Intangibles

Enter the current unamortized balance of goodwill and other intangibles (including mortgage loan servicing rights).[1]

Line 6 – Deductions from Total Assets

Enter the sum of Lines 3, 4, and 5.

[1] While OTS does not consider servicing assets intangibles for regulatory capital purposes, our policy is to deduct mortgage servicing assets for QTL.

Line 7 – Portfolio Assets

Subtract Line 6 from Line 1.

Line 8 – 20% of Portfolio Assets

Multiply Line 7 by 0.20.

Part 2 – Qualified Thrift Investments

Note: For all calculations use the outstanding principal balance and add accrued interest and premiums; deduct specific valuation allowances, charge-offs, deferred loan fees, loans in process and unearned discounts.

A. Assets Includable Without Limit

Line 9 – Mortgage Loans

Enter loans held that were made to purchase, refinance, construct, improve, or repair domestic residential housing or manufactured housing. *Note*: The term "domestic" refers to units within the 50 states, the District of Columbia, Puerto Rico, the Virgin Islands, Guam, and the Pacific Islands.

Line 10 – REO (Residential)

Enter property acquired through foreclosure, deed in lieu of foreclosure, or in-substance foreclosure that if it had remained as a loan would have been a qualified thrift investment reported on Lines 9, 11, or 14. Include real estate in judgment.

Line 11 – Home Equity Loans

Enter home equity loans. *Note*: Include here any consumer receivables secured in part by lien on domestic residential housing. If entered here do not include on Line 25.

Line 12 – Mortgage-Backed Securities

Enter securities backed by or representing an interest in domestic residential housing or manufactured housing. Institutions should include securities purchased and exclude securities sold from qualified thrift investments on their trade dates. *Note:* This item encompasses mortgage-

pool securities, mortgage-pool pass-through securities, mortgage-backed bonds, and mortgage-backed pay-through bonds. This item also encompasses any derivative mortgage-related security created by disaggregating and repackaging the cash flows received as payments on mortgages and traditional mortgage-pool securities. The underlying assets of such securities must be domestic residential housing. Bonds, including FHLB, FHLMC, FNMA and GNMA bonds, count only if they are backed by mortgages. Do not include as a qualified thrift investment Resolution Funding Corporation (REFCO) bonds.

Line 13 – Educational Loans

Enter education loans.

Line 14 – Small Business Loans

Enter small business loans. Generally, small business loans are $2 million or less at origination. See the definition in 12 CFR § 560.3.

Line 15 – Credit Card Loans

Enter loans made in conjunction with the issuance or extension of credit through a credit card. This includes loans made to consolidate credit card debt (including credit card debt that other lenders previously held), participation certificates, securities and similar instruments secured by credit card receivables.

Line 16 – Obligations of Deposit Insurance Agencies Issued Prior to July 1, 1989

Enter obligations of the FDIC or FSLIC issued before July 1, 1989, for a period not to exceed ten years past the issue date.

Line 17 – Obligations of Deposit Insurance Agencies Issued On or After July 1, 1989

Enter obligations of the FDIC, the FSLIC, the FSLIC Resolution Fund, or the RTC issued on or after July 1, 1989, for a period not to exceed five years past the issue date.

Line 18 – Federal Home Loan Bank Stock

Enter Federal Home Loan Bank stock.

Line 19 – Total Qualified Thrift Investments Includable Without Limit

Enter the sum of Lines 9 through 18.

B. Assets Includable up to 20% of Portfolio Assets

Line 20 – 50% of Residential Mortgage Loans Originated and Sold Within 90 Days

Enter 50% of loans on domestic residential housing that the association originated and sold within 90 days of origination, provided that the association sold these mortgage loans during the quarter for which this calculation is being made. Associations may use either the previous quarter's figures or a rolling 90-day period.

Line 21 – 80% Service Corporations

Enter the investment (capital stock, loans, advances, and securities) in service corporations that derive 80% of their gross revenues from dealing in domestic residential housing or manufactured housing. *Note*: Institutions that consolidate such subsidiaries in Line 1 (Total Assets) and count any service corporation assets as qualified thrift investments may not report the institution's investment on this line.

Line 22 – 200% of One- to Four-Family Residence Loans (Starter Homes Less than 60% Median)

Enter 200% of loans and investments in domestic residential housing (if not entered on Line 9), the price of which is, or is guaranteed to be, less than 60% of the median price of comparable housing in the community where the housing is located. *Note*: To use this line item, institutions must maintain records demonstrating that the housing meets the 60% of median value test. See definition of starter home loans.

Line 23 – 200% of Certain Loans In Credit-Needy Areas

Enter 200% of loans on domestic residential housing, community service facilities, and to small businesses in credit-needy areas. Do not include any small business loans here if entered on Line 14.

Line 24 – Community Service Facility Loans (Purchase, Construction, Improvement)

Enter loans for community service facilities except those included on Line 23.

Line 25 – Loans for Personal, Family, or Household Purposes

Enter personal, family, household, or share loans, except those included on Lines 11, 13 and 15.

Line 26 – Stock of the FNMA or the FHLMC

Enter FNMA and FHLMC stock that the institution holds.

Puerto Rican and Virgin Island Institutions Only – All Other Thrifts Go to Line 30.

Note: For Lines 27 and 29, the amounts that Puerto Rican thrifts enter may only be for investments in Puerto Rico. Similarly, the amounts that Virgin Islands thrifts enter may only be for investments in the Virgin Islands.

Line 27 – Loan for Personal, Family or Household Purposes

Enter personal, family, household, or share loans made to persons residing or domiciled in Puerto Rico or the Virgin Islands. Do not include loans entered on Lines 11 or 25.

Line 28 – Community Service Facility Loans (Purchases, Construction, Improvement)

Enter loans for community service facilities and loans to small businesses in Puerto Rico or the Virgin Islands, except those included on Lines 23 and 24.

Line 29 – 200% of One- to Four-Family Residence Loans (Starter Homes Less than Median)

Enter 200% of loans and investments in domestic residential housing in Puerto Rico and the Virgin Islands, the price of which is, or is guaranteed to be, less than the median price of comparable housing in the community where the housing in located. Do not include loans entered on Line 22. *Note:* To use this line item, institutions must maintain records demonstrating that the housing meets the median value test.

Line 30 – Total Qualified Thrift Investments Includable Up to 20% of Portfolio Assets

Enter the lesser of the sum of Lines 20 through 26 or Line 8.

Part 3 – Total Qualified Thrift Investments and Actual Thrift Investment Percentage

Line 31 – Total Qualified Thrift Investments

Enter the sum of Lines 19 and 30. This is a savings association's total qualified thrift investment figure. If you are a Puerto Rican or Virgin Island savings association, also add Lines 27 through 29.

Line 32 – Actual Thrift Investment Percentage (ATIP)

Divide Line 31 by Line 7.

INTRODUCTION

This Handbook Section briefly describes Regulation U requirements and offers guidelines to you as the regulator in determining compliance with Regulation U.

The Federal Reserve Board (FRB) issued this regulation pursuant to the Securities Exchange Act of 1934 to prevent the excessive use of credit when purchasing or carrying margin stock. The regulation sets out certain requirements for banks and others including savings associations who extend or maintain credit secured directly or indirectly by margin stock. Regulation T governs the extension of credit by brokers and dealers. The reporting requirements and lending restrictions of Regulation U apply only to those institutions required to register.

Until April 1, 1998, 12 CFR Part 207 - Securities Credit by Persons other than Banks, Brokers, or Dealers (Regulation G) governed savings associations. The National Securities Markets Improvement Act of 1996 (“NSMIA”) repealed section 8(a) of the Securities Exchange Act of 1934 (the ’34 Act). Section 8(a) of the ’34 Act mandated a distinction between bank and nonbank lenders with respect to loans to broker-dealers. Regulation U prior to April 1, 1998, applied exclusively to banks. The FRB concluded that with repeal of Section 8(a) of the ’34 Act there was no longer a need to distinguish between Regulations G and U. With certain exceptions, the FRB incorporated provisions of Regulation G into amended Regulation U under the revised title: Credit by Banks and Persons Other than Brokers or Dealers for the Purpose of Purchasing or Carrying Margin Stock (Regulation U).

Registration

Any savings association that extends credit, directly or indirectly secured by margin stock, and that meets either of the following two requirements must register with the Federal Reserve Board:

- extending margin-stock-secured credit in any calendar quarter equaling $200,000 or more, or
- maintaining margin-stock-secured credit outstanding at any time during a calendar quarter totaling $500,000 or more.

Margin stock consists primarily of equity securities, convertible debt, and mutual funds.

Federal Reserve Form FR G-1 (OMB Control Number 7100-0011) (see Appendix B)[1] is the vehicle a savings association uses to register. The savings association mails the form to the Federal Reserve Bank serving the area of the savings association's principal office. A savings association must register within 30 days after the end of the calendar quarter in which it becomes subject to Regulation U. Registration under Regulation U sets both lending restrictions and reporting requirements on savings associations.

Lending Restrictions

Regulation U prohibits lenders from extending credit in excess of the maximum loan value if the purpose of the credit is to buy or carry margin stock. Credits of this nature are "purpose loans." The maximum loan value of any margin stock is 50 percent of its current market value. Regulation U thus prohibits savings associations from lending on more than 50 percent of the current market value of margin stock if the purpose of the loan is to buy or carry margin stock.

Each purpose credit extended to a customer, including revolving credit or multiple draw agreements, is subject to the "single credit rule.” All purpose credit extended to a customer is a single credit. Compliance includes aggregation of all collateral. Withdrawal provisions of the Regulation consider all secured and unsecured credit.

The maximum loan value is the good-faith basis, not to exceed 100 percent of the current fair market value of the collateral, if the proceeds of a

margin-stock-secured loan are for a purpose other than to purchase or carry margin stock. Good-faith basis is the amount that a lender would be willing to lend without regard to any other assets of the borrower. Credits of this nature are "non-purpose loans."

The Regulation allows lenders to permit any withdrawal or substitution of cash or collateral by the customer if the withdrawal or substitution would not cause the credit to exceed the maximum loan value of the collateral or increase the amount by which the credit exceeds the maximum loan value of the collateral.

Margin stock has good faith loan value if it secures directly or indirectly credit extended by a plan lender under an eligible plan. Credit extended by plan lenders on the basis of eligible plans secured by margin stock is separate from other credit secured by margin stock, except for registration and reporting requirements. A plan lender includes any corporation (including any thrift organization whose members are employees and former employees of the organization) that extends or maintains credit to finance the acquisition of margin stock of the organization under an eligible plan. Any stockholder approved employee stock option, purchase or ownership plan adopted by a corporation that provides for the purchase of margin stock of the corporation, its subsidiaries or affiliates are eligible plans. Savings associations also may extend and maintain purpose credit to qualified ESOPs under Regulation U, subject only to the regulation's registration and reporting requirements.

Lenders other than broker-dealers may extend 50 percent loan value against listed options; such options qualify as margin stock. Except for options that qualify as margin stock, puts, calls and combinations thereof have no loan value. Regulation U permits savings associations to extend and maintain special purpose credit to brokers and dealers without regard to the general purpose credit requirements and maximum loan value of margin stock and other collateral restrictions. The types of special credit include: hypothecation loans, temporary advances in payment-against-delivery transactions, loans for securities in transit or transfer, intra-day loans, arbitrage loans, market maker and specialist loans, underwriter loans, emergency loans, capital contribution loans and credit to clearing brokers or dealers.

Exempted Borrowers

Regulation U provides that certain borrowers are exempt. Exempted borrowers consist of national securities exchange members and certain brokers and dealers whose business consists of transactions with persons other than brokers or dealers. There are a number of accounts and dollar and percentage of gross revenue tests to determine eligibility of such borrowers for exemption.

Reporting and Regulatory Requirements

Registered lenders file with the Federal Reserve Bank an Annual Report, on Federal Reserve Form FR G-4 (OMB Control Number 7100-0011) (see Appendix E)[1] showing their lending activities secured by margin stock. Registered lenders file this form for the year ended June 30. This form contains the amount of such credit outstanding and extended during a calendar year. Registered savings associations file this report along with a copy of their balance sheet.

Federal Reserve Form FR G-3 entitled "Statement of Purpose for an Extension of Credit Secured by Margin Securities by a Person Subject to Registration Under Regulation G" must accompany each credit secured by margin securities. (OMB Control Number 7100-0018.) (See Appendix D)[1]. Both the borrower and the lender complete the purpose statement for every margin-stock-secured loan extended, except for employee stock purchase plans. The lender obtains a current list of collateral that adequately supports all credit extended under the agreement. The collateral list remains with the executed FRB Form G-3. Neither OTS nor the FRB receives FRB Form G-3. Rather, the savings association keeps the form for three years after the credit is paid-off. The Office of Thrift Supervision is responsible for monitoring compliance with Regulation U by savings associations. The Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Reserve Board, National Credit Union Administration,

and Farm Credit Administration are responsible for Regulation U compliance by entities under their supervision.

Deregistration

A registered savings association may apply to terminate its registration, by filing Federal Reserve Form FR G-2 (OMB control number 7100-0011) (see Appendix C)[1], with its district Federal Reserve Bank, if the savings association has not, during the preceding six calendar months, had more than $200,000 of margin-stock-secured credit outstanding. A savings association is deregistered upon approval by the FRB.

REFERENCES

Code of Federal Regulations (12 CFR)

Part 221 Credit by Banks and Persons Other Than Brokers or Dealers for the Purpose of Purchasing or Carrying Margin Stock (Regulation U)

United States Code (15 USC)

Part 78 Securities Exchange Act of 1934

Federal Reserve Board - Rulings and Interpretations of Regulation U

1 OMB granted the FRB an extension of time to use this form beyond the printed expiration date.

Margin Securities (Regulation U) Program

Examination Objectives

To determine that the savings association has procedures in place to comply with Regulation U.

To determine that the savings association is in compliance with the registration, reporting, and lending requirements of the regulation.

Examination Procedures

Level I

Wkp. Ref.

1. Ascertain whether the savings association is subject to Regulation U. Determine whether the savings association has recently registered or deregistered.

2. Ascertain whether the savings association has procedures in place to maintain accurate records and ensure compliance with the reporting, lending limitation, and withdrawal requirements of the regulation.

3. Ascertain whether the savings association's internal audit program provides adequate coverage to monitor Regulation U. Ensure that the internal audit system regularly monitors data collection, reporting requirements, and lending restrictions.

4. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

Level II

5. If the savings association recently deregistered, verify that the savings association was eligible to deregister.

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Wkp. Ref.

6. Ascertain the accuracy of the two most recent annual reports (FR-G4).

7. Determine whether the savings association corrected previous violations.

8. Review a sample of loan files for margin-stock-secured credits to check that loan purpose statements exist and that the credits are within margin-stock-credit limitations. Review a sample of loans to savings association service corporations that serve as broker-dealers to determine if such loans qualify as *special purpose loans* to brokers and dealers (12 CFR 221.5).

9. Ensure compliance with the Objectives of this Handbook Section. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

Level III

10. Determine if an improper registration or deregistration exists. Determine if all organizations required to register did so. Report exceptions to the regional director who will then contact the appropriate Federal Reserve Bank.

Examiner's Summary, Recommendations, and Comments

Exam Date: _____
Prepared By: _____
Reviewed By: _____
Docket #: _____

Federal Reserve Bank - Questions and Answers About Nonbank Lenders Under Regulation U

The following questions and answers on nonbank[1] lenders under Regulation U are intended to provide an introduction to the basic areas covered by the regulation. This is not a complete discussion of all the requirements of the regulation and is therefore not a substitute for the regulation itself.

1. *Q. What is Regulation U?*

A. Regulation U is a Federal Reserve Board regulation (12 CFR 221) that sets out certain requirements for lenders other than brokers and dealers extending credit secured by margin stock. (See question 9 for the definition of "margin stock.")

2. *Q. What types of lenders are typically covered by Regulation U?*

A. Regulation U covers not only commercial banks, but also savings and loan associations, federal savings banks, credit unions, production credit associations, insurance companies, and companies with employee stock option plans.

3. *Q. When does a lender become subject to Regulation U?*

A. A commercial bank is always subject to Regulation U when it extends credit secured by margin stock. A nonbank lender becomes subject to Regulation U when it meets either one of the following threshold tests for the amount of margin-stock-secured credit extended or outstanding.

Test 1: Has $200.000 or more in credit secured directly or indirectly by margin stock been extended in the last calendar quarter? If the answer is yes, the lender is subject to Regulation U.

Test 2: At any time in the last quarter has the amount of margin-stock-secured credit outstanding equalled $500,000 or more? If yes. then the lender is subject to Regulation U.

4. *Q. If margin stock is taken as additional collateral on a loan, is the loan considered in applying the two tests above?*

A. Yes.

5. *Q. What happens when one of these tests is met?*

A. The lender must register with the Federal Reserve Bank in whose District it is located by filling out and sending in Form G-1 (available by calling the local Federal Reserve Bank) within 30 days of the end of the

[1] For purposes of Regulation U, the Federal Reserve Board classifies savings associations as nonbank lenders.

calendar quarter in which one of the two tests is met. Sending in the registration statement Form G-1 is a one-time requirement.

6. *Q. Must such a lender register with the appropriate Federal Reserve Bank even though it is regulated by the Office of Thrift Supervision?*

A. Yes, all nonbank, nonbroker lenders must register with the Federal Reserve. Compliance with Regulation U by savings and loans and federal savings banks has, since October 8, 1989, been monitored by the Office of Thrift Supervision.

7. *Q. What is the Form G-1 and what information does it require to be disclosed?*

A. The Form G-1 is a simple four-page form that must be filled out and submitted to the appropriate Federal Reserve Bank by a lender in fulfillment of its requirement to register as a nonbank lender whenever one of the tests mentioned above is met (see question 3). The Form G-1 requires the registrant-lender to provide the following information:

· name of registrant
· address of registrant
· principal lines of business
· form of business (corporation, partnership, etc.)
· names of personnel responsible for maintaining company records
· purpose of credit extended
· balance sheet

8. *Q. What responsibilities does a lender take on once it registers with a Federal Reserve Bank as a nonbank lender?*

A. Regulation U has three important postregistration requirements:

1. The nonbank lender must obtain from the borrower and complete a purpose statement (Form G-3) for each loan secured by margin stock.

2. The nonbank lender must adhere to margin requirements (currently 50 percent) for purpose loans secured by margin stock (see question 10 for the definition of "purpose loan").
3. The nonbank lender must file an annual report of stock-secured lending (Form G-4) as of each June 30.

9. *Q. What is margin stock?*

A. "Margin stock" is defined in Regulation U (§ 221.2(i)) and includes (1) any equity security registered on a national securities exchange, such as the New York Stock Exchange or American Stock Exchange; (2) any OTC security trading in the National Market System; (3) any warrant or right to purchase a stock described in 1, 2, or 3 above; (4) any debt security convertible into a stock described in 1, 2, or 3 above; or (5) most mutual funds.

10. *Q. What is a purpose loan?*

A. A purpose loan is a loan whose proceeds are used to buy or carry margin stock. A loan to carry margin stock is one that enables borrower to maintain, reduce, or retire indebtedness originally incurred to purchase margin stock.

11. *Q. What are the Regulation U requirements for purpose loans secured by margin stock?*

A. The first requirement is that the borrower complete the Form G-3 statement of purpose, which must be signed by the borrower and a representative of the lender. Second, a lender may not extend credit in excess of the maximum loan value as specified in Regulation U. The maximum loan value is now 50 percent of the current market value of the stock, except for plan-lender loans, which are discussed in question 15. In other words, the largest purpose loan a lender could extend would be one-half the current market value of the margin stock securing the loan (assuming the loan is secured only by margin stock). If a purpose loan is initially in compliance with Regulation U, no action is required by the lender if the market value of the stock changes or if the maximum loan value as prescribed by Regulation U changes. It should be noted that the stock securing the loan may be a different stock from the stock that is purchased.

Other rules in Regulation U cover situations such as withdrawals and substitutions of collateral, loan renewals, extensions of maturity, and loan transfers. For these requirements, a lender should consult the regulation or contact a Federal Reserve Bank.

12. *Q. What is a nonpurpose loan under Regulation U?*

A. A nonpurpose loan is a loan made for any purpose other than purchasing or carrying margin stock.

13. *Q. What are the requirements of Regulation U for nonpurpose loans?*

A. The only Regulation U requirement is that the borrower complete Form G-3 or Form U-1 if the loan is secured (directly or indirectly) by margin stock. Regulation U places no restriction on the amount of credit that may be extended on nonpurpose loans secured by margin stock.

14. *Q. What is Form G-3?*

A. Form G-3 is a two-page form wherein the borrower must disclose (1) the use to which the loan proceeds will be put, (2) the amount of the loan, and (3) the collateral for the loan. The form is signed by both the borrower and an authorized representative of the lender and must be kept in the lender's records for at least three years after the termination of the credit.

15. *Q. What is a plan-lender?*

A. A plan-lender is a corporation (including a wholly owned subsidiary, or a thrift organization whose membership is limited to employees and former employees of the corporation, its subsidiaries, or affiliates) that extends credit to its employees, under an employee stock option plan approved by the shareholders, to purchase stock of that corporation, its subsidiaries, or affiliates. Loans under such a plan may be for any amount up to 100 percent of the current market value of the stock. A G-3 purpose statement is not required for these loans.

16. *Q. Does Regulation U contain any special rules for employee stock ownership plans (ESOPs)?*

A. ESOPs qualified under section 401 of the Internal Revenue Code are entitled to exempt credit. A nonbank lender may extend purpose credit to an ESOP without regard to Regulation U, as long as the lender complies with the registration requirements and files annual reports.

17. *Q. Under Regulation U, what reports must be filed with the Federal Reserve Bank?*

A. The registration form, Form G-1, is discussed in question 7. An annual report, Form G-4, must be filed within 30 days of June 30. This form will be supplied by the Reserve Bank prior to June 30. The statement of purpose, Form G-3, should be maintained in each borrower's file. When a lender wants to deregister and is eligible to do so, Form G-2, the deregistration statement, must be filed with the Reserve Bank.

18. *Q. When is a lender eligible to deregister?*

A. A registered lender may deregister if, during the preceding six calendar months, no more than $200,000 of credit secured by margin stock is outstanding.

19. *Q. What is the effect of deregistering?*

A. When a nonbank lender is eligible to deregister and does so by filing a Form G-2, it ceases to become subject to the requirements of Regulation U. Of course, if the lender extends margin-stock-secured credit above the threshold amount, it would again have to register with the Federal Reserve Bank.

20. *Q. Where can a lender get more information?*

A. Copies of Regulation U and Forms G-1, G-2, G-3, and G-4 may be obtained by writing or calling the Federal Reserve Bank offices listed below:

1. Atlanta:
Consumer Affairs Section
Federal Reserve Bank of Atlanta
104 Marietta Street
Atlanta, Georgia 30303
(404) 589-7200

2. Boston:
Regulations Unit
Federal Reserve Bank of Boston
600 Atlantic Avenue
Boston, Massachusetts 02106
(617) 973-3000

3. Chicago:
Division of Consumer and Community Affairs
Federal Reserve Bank of Chicago
230 South LaSalle Street
Chicago, Illinois 60690
(312) 322-5322

4. Cleveland:
Division of Supervision & Regulation
Federal Reserve Bank of Cleveland
1455 East Sixth Street
Cleveland, Ohio 44101
(216) 293-8000

5. Dallas:
Supervision and Regulation Department
Federal Reserve Bank of Dallas
2200 N Pearl St.
Dallas, Texas 75201
(214) 744-7484

6. Kansas City:
Division of Bank Supervision & Structure
Federal Reserve Bank of Kansas City
925 Grand Avenue
Kansas City, Missouri 64198
(816) 881-2000

7. Minneapolis:
Division of Supervision & Regulation
Federal Reserve Bank of Minneapolis
90 Hennepin Avenue
Minneapolis, Minnesota 55401
(612) 340-2345

8. New York:
Compliance Examinations Division
Federal Reserve Bank of New York
33 Liberty Street
New York, New York 10045
(212) 720-5000

9. Philadelphia:
Community and Consumer Affairs Department
Federal Reserve Bank of Philadelphia
Ten Independence Mall
Philadelphia, Pennsylvania 19106
(215) 574-6000

10. Richmond:
Bank Supervision and Regulation
Federal Reserve Bank of Richmond
P.O. Box 27622
Richmond, Virginia 23261
(804) 697-8000

11. San Francisco
Consumer Affairs Section
Federal Reserve Bank of San Francisco
101 Market Street
San Francisco, California 94105
(415) 974-2000

12. St. Louis:
Division of Supervision & Regulation
Federal Reserve Bank of St. Louis
P.O. Box 442
St. Louis, Missouri 63166
(314) 444-8444

FR G-1
OMB No. 7100-0011
Approval expires July 31, 1998

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Registration Statement For Persons Who Extend Credit Secured by Margin Stock (Other Than Banks, Brokers or Dealers) (Federal Reserve Form G-1)

This registration statement is required by law (15 U.S.C. 78g and 78w; 12 C.F.R. 207).

The Federal Reserve Board regards the information provided by each respondent as confidential. If it should be determined subsequently that any information collected on this form must be released, respondents will be notified.

Public reporting burden for this collection of information is estimated to average 2.5 hours per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing this burden, to Secretary, Board of Governors of the Federal Reserve System, 20th and C Streets, N.W., Washington, D.C. 20551; and to the Office of Management and Budget, Paperwork Reduction Project (7100-0011), Washington, D.C. 20503.

Name of registrant: _____
IRS Identification No.*

Name under which business is conducted, if different from above: _____

Address of principal place of business:
(Do not use P.O. Box No.)
Street _____ County _____
City _____ State _____ ZIP Code _____

Mailing address, if different from above:
Street _____
City _____ State _____ ZIP Code _____

GENERAL INSTRUCTIONS

Who must file: Section 207.3(a) of Federal Reserve Regulation G requires that FR Form G-1 be completed by every person (other than commercial banks, brokers or dealers) who during any calendar quarter extends a total of $200,000 or more, or has outstanding a total of $500,000 or more, in credit secured directly or indirectly, in whole or in part, by collateral that includes any margin stock.

When and where to file: The form should be filed *in duplicate* with the Federal Reserve Bank of the district in which the principal office of subject person is located within 30 days following the end of such quarter in which credit has been extended or is outstanding in accordance with Section 207.3(a). This registration statement will remain in effect until a FR Form G-2 (deregistration statement) is approved by the Board of Governors of the Federal Reserve System.

What to file: All persons subject to the registration requirements of Section 207.3(a) should (i) supply the background information specified below; (ii) complete Schedule A; and (iii) sumbit *two copies* of a balance sheet, certified by an independent public accountant, for the registrant's latest fiscal year. If the registrant is subject to supervision by a State or Federal regulatory authority, a copy of the latest balance sheet filed with such authority may be used. If neither is available, the registrant should complete Schedule B on page 4.

*A registrant who is an individual is not required to disclose his or her Social Security number.

Registration forms will be returned to registrants for corrections if all items have not been answered in the manner required or if the forms are otherwise unacceptable for filing.

DEFINITIONS

Terms used in this form are explained below. Precise definitions may be found in Section 207.2 of Regualtion G.

Person: Any individual, corporation, partnership, association, joint stock company, business trust, or unincorporated organization.

Purpose credit: Credit extended for the purpose of purchasing or carrying margin stock, or to reduce or retire indebtedness previously incurred for that purpose.

In the ordinary course of business: Occuring or reasonably expected to occur from time to time in the course of any activity of a person for profit or the management and preservation of property or, in the case of a person other than an individual, carrying out or in furtherance of any business purpose.

Margin stock: Includes (1) stocks registered on a national securities exchange, stocks on the Federal Reserve Board's List of Marginable OTC Stocks, or any OTC security designated for trading in the National Market System, (2) debt securities that are convertible into, or carry a warrant or right to subscribe to or purchase margin stock, (3) any such warrant or right, and (4) shares of most mutual funds.

Indirectly secured: In general, credit is indirectly secured by margin stock if there is an understanding between the borrower and the lender (1) which is designated to make the margin stock more available to the lender in case of default than to the borrower's other creditors, or (2) which limits the borrower from exercising full dominion over the margin stock to sell, pledge, or donate them, or determining where they shall be placed physically.

Background Information

1. Principal lines of business:

2. Registrant is: (check one)

   ☐ Sole proprietorship ☐ Private investor
   ☐ Partnership ☐ Other (specify)
   ☐ Corporation

   a. If registrant is a sole proprietor, private investor, or other, state full residence address:

   b. If registrant is a corporation, state date and place of incorporation:

   Date: _____ Place: _____

   c. Person responsible for maintaining records in connection with Regulation G:

   Name: _____ Title: _____

   Telephone Number (include area code): _____

3. If any of the accounts or records of registrant are kept or maintained by anyone other than the person named in 2(c), furnish the name and address of the other individual, firm, or organization:

4. a. Does any person not named in items 2(c) or 3 above exercise or have power to exercise a controlling influence over the management or policies of registrant, directly or indirectly, through stock ownership, agreement, or otherwise?

   ☐ Yes ☐ No

   b. If "yes", state the name of such person and describe the agreement, arrangement, or nature of the controlling influence:

5. a. Does the registrant extend credit in connection with an employee stock option or stock purchase plan pursuant to the special "plan-lender" provision set forth in Section 207.5(a) of Regulation G? If so, submit two copies of documents establishing the plan, a prospectus, and other information which supports adherence to plan-lender limitations.

   ☐ Yes ☐ No

5. b. Does the registrant extend credit to an employee stock ownership plan (ESOP) qualified under section 401 of the Internal Revenue Code (26 U.S.C. 401), as set forth in Section 207.5(c) of Regulaiton G? If so, submit two copies of documents establishing the plan and any other pertinent supporting information.

   ☐ Yes ☐ No

Schedule A — Securities Credit
As of _____, 19_____

	I[1] Total credit outstanding as of June 30, ____ (dollars)			II[2] Credit extended during reporting period (dollars)		
	Mil	Thou	Dollars	Mil	Thou	Dollars
A. Credit to purchase or carry margin stock (Purpose Loans):						
1. Secured directly by margin stock:						
a. Listed stocks and OTC margin stocks						
b. Debt securities convertible into margin stock						
c. Mutual funds and other margin stock						
2. Secured indirectly by margin stock						
3. TOTAL (Purpose Credit)						
B. Other credit (Nonpurpose Loans)						
1. Secured directly by margin stock:						
a. Listed stocks and OTC margin stocks						
b. Debt securities convertible into margin stock						
c. Mutual funds and other margin stock						
2. Secured indirectly by margin stock						
3. TOTAL (Nonpurpose Credit)						

[1] "Credit outstanding: (Column I) includes credit extended by the registrant during the year covered by this report, and during previous years, that has not been extinguished before the end of the year covered by this report.

[2] "Credit extended" (Column II) is credit extended at any time during the year covered by this report. Column II includes all new credit extended during the year regardless of whether such credit was extinguished at the end of the year. An increase in an existing loan is new credit.

Schedule B—Balance Sheet

As of _____, 19_____

This schedule is to be completed only by lenders not submitting corporate balance sheets certified by an independent public accountant or used to meet reporting requirements of a State or Federal regulatory authority.

($ Thousands)

ASSETS		LIABILITIES AND NET WORTH	
Cash and bank deposits	_____	Short-term bank borrowings	_____
Trade accounts and notes receivable (net allowance for bad debts of _____)	_____	Other notes and accounts payable	_____
		Long-term debt	_____
Other accounts and notes receivable (include credit to executives and employees)	_____	All other liabilities	_____
		TOTAL LIABILITIES	_____
Marketable securities	_____	Capital stock	_____
Inventories	_____	Additional paid-in capital	_____
Investments in non-consolidated subsidiaries	_____	Retained earnings/undivided profits	_____
		Total Equity Capital[1]	_____
Fixed assets (net of depreciation)	_____		
All other assets	_____		
TOTAL ASSETS	_____	TOTAL LIABILITIES AND EQUITY CAPITAL	_____

1. Registrants not reporting capital stock, additional paid-in-capital or retained earnings/undivided profits must nevertheless indicate total equity capital.

Certification

The registrant filing this registration form and any attachments thereto and the person by whom it is executed represent hereby that all information contained therein is true and complete.

_____
Date

_____
Signature of sole proprietor, general partner, managing agent, or principal officer

_____
Telephone number (including area code)

_____
Print or type name

_____
Title

This mandatory report is needed to elicit certain background and financial information about a Regulation G lender and the types and amount of credit activities engaged in that are secured by margin stock.

Honest, accurate, and timely statements are required by law
(15 U.S.C. §78ff; 18 U.S.C. §1001)

FR G-2
OMB No. 7100-0011
Approval expires July 31, 1998

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Deregistration Statement For Persons Registered Pursuant to Regulation G (Federal Reserve Form G-2)

A. For use by Noncorporate Registrants

This deregistration statement is required by law (15 U.S.C. 78g and 78w; 12 C.F.R. 207).

Public reporting burden for this collection of information is estimated to average 15 minutes per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing this burden, to Secretary, Board of Governors of the Federal Reserve System, 20th and C Streets, N.W., Washington, D.C. 20551; and to the Office of Management and Budget, Paperwork Reduction Project (7100-0011), Washington, D.C. 20503.

Certificate

I (We), doing business under the name _____

_____

_____
IRS Identification No.*

hereby certify that I (we) have not, during the preceding six calendar months, had a total of $200,000 or more of credit outstanding secured directly or indirectly by margin stock.

I (We) understand that if I (we), in the future, extend a total of $200,000 or more during any calendar quarter, or have outstanding at any time during a calendar quarter a total of $500,000 or more, in credit that is secured directly or indirectly by collateral that includes any margin stock, I (we) shall within 30 days following the end of such calendar quarter reregister and remain registered for at least six months with the Board of Governors of the Federal Reserve System by filing Federal Reserve Form G-1 with the Federal Reserve Bank of the district in which my (our) principal office is located.

This certification is given in connection with an application for termination of registration pursuant to Section 207.3(a) of Regulation G of the Board of Governors of the Federal Reserve System.

_____
Signature(s)

_____

_____
Print or type name(s) and title(s)

_____

_____
Name of firm

_____
Telephone number (including area code)

_____
Date

*A registrant who is an individual is not required to disclose his or her Social Security number.

Honest, accurate, and timely statements are required by law (15 U.S.C. §78ff; 18 U.S.C. §1001)

FR G-2
OMB No. 7100-0011
Approval expires July 31, 1998

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Deregistration Statement For Persons Registered Pursuant to Regulation G (Federal Reserve Form G-2)

B. For use by Corporate Registrants

This deregistration statement is required by law (15 U.S.C. 78g and 78w; 12 C.F.R. 207).

Public reporting burden for this collection of information is estimated to average 15 minutes per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing this burden, to Secretary, Board of Governors of the Federal Reserve System, 20th and C Streets, N.W., Washington, D.C. 20551; and to the Office of Management and Budget, Paperwork Reduction Project (7100-0011), Washington, D.C. 20503.

Officer's Certificate

I hereby certify that _____
Name of corporation

_____

_____
IRS Identification No.

("Corporation") has not, during the preceding six calendar months, had a total of $200,000 or more of credit outstanding secured directly or indirectly by margin stock.

It is understood that if the Corporation shall, in the future, extend a total of $200,000 or more during any calendar quarter, or has outstanding at any time during a calendar quarter a total of $500,000 or more, in credit that is secured directly or indirectly by collateral that includes any margin stock, the Corporation shall within 30 days following the end of such calendar quarter reregister and remain registered for at least six months with the Board of Governors of the Federal Reserve System by filing Federal Reserve Form G-1 with the Federal Reserve Bank of the district in which the principal office of the corporation is located.

This certification is given in connection with an application for termination of registration pursuant to Section 207.3(a) of Regulation G of the Board of Governors of the Federal Reserve System.

_____
Signature of duly authorized officer

_____
Date

_____
Print or type name

_____
Title

_____
Telephone number (including area code)

Honest, accurate, and timely statements are required by law (15 U.S.C. §78ff; 18 U.S.C. §1001)

FR G-3
OMB No. 7100-0018
Approval expires July 31, 1998

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Statement of Purpose for an Extension of Credit Secured by Margin Stock by a Person Subject to Registration Under Regulation G (Federal Reserve Form G-3)

_____
Name of Lender

This form is required by law (15 U.S.C. 78g and 78w; 12 C.F.R. 207).

Public reporting burden for this collection of information is estimated to average 10 minutes per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing this burden, to Secretary, Board of Governors of the Federal Reserve System, 20th and C Streets, N.W., Washington, D.C. 20551; and to the Office of Management and Budget, Paperwork Reduction Project (7100-0011), Washington, D.C. 20503.

Instructions

1. This form must be completed when a lender subject to registration under Regulation G extends credit secured directly or indirectly, in whole or in part, by any margin stock.

2. The term "margin stock" is defined in Regulation G (12 CFR 207) and includes, principally: (1) stocks that are registered on a national securities exchange, stocks that are on the Federal Reserve Board's List of Marginable OTC Stocks, or any OTC security designated for trading in the National Market System; (2) debt securities (bonds) that are convertible into margin stock; and (3) shares of most mutual funds.

3. Please print or type (if space is inadequate, attach separate sheet).

Part I To be completed by borrower(s)

1. What is the amount of the credit being extended? _____

2. Will any part of this credit be used to purchase or carry margin securities? ☐ Yes ☐ No

If the answer is "no," describe the specific purpose of the credit _____

_____

_____

_____

I (We) have read this form and certify that to the best of my (our) knowledge and belief the information given is true, accurate, and complete.

Signed:

_____
Borrower's signature Date

_____
Print or type name

Signed:

_____
Borrower's signature Date

_____
Print or type name

This form should not be signed if blank.

A borrower who falsely certifies the purpose of a credit on this form or otherwise willfully or intentionally evades the provisions of Regulation G will also violate Federal Reserve Regulation X, "Borrowers of Securities Credit".

FR G-3
Page 2 of 2

Part II To be completed by lender only if the purpose of the credit is to purchase or carry margin securities (Part I(2) answered "yes")

1. List the margin stock securing this credit; do not include debt securities convertible into margin stock. The maximum loan value of margin stock is 50 per cent of its current market value under the current Supplement to Regulation G.

No. of shares	Issue	Market price per share	Date and source of valuation (See note below)	Total market value per issue

2. List the debt securities convertible into margin stock securing this credit. The maximum loan value of such debt securities is 50 per cent of the current market value under the current Supplement to Regulation G.

Principal amount	Issue	Market price	Date and source of valuation (See note below)	Total market value per issue

3. List other collateral including non-margin securities securing this credit.

Describe briefly	Market price	Date and source of valuation (See note below)	Good faith loan value

Note: Lender need not complete "Date and source of valuation" if the market value was obtained from regularly published information in a journal of general circulation or automated quotation system.

Part III To be signed by an authorized representative of the lender in all instances

I am a duly authorized representative of the lender and understand that this credit secured by margin stock may be subject to the credit restrictions of Regulation G. I have read this form and any attachments, and I have accepted the customer's statement in Part I in good faith as required by Regulation G*; and I certify that to the best of my knowledge and belief, all the information given is true, accurate, and complete.

Signed:

Date

Authorized representative's signature

Title

Print or type name

* To accept the customer's statement in good faith, the authorized representative of the lender must be alert to the circumstances surrounding the credit and, if in possession of any information that would cause a prudent person not to accept the statement without inquiry, must have investigated and be satisfied that the statement is truthful. Among the facts which would require such investigation are receipt of the statement through the mail or from a third party.

This form must be retained by the lender for three years after the credit is extinguished.

FR G-4
OMB No. 7100-0011
Approval expires July 31, 1998

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Annual Report
(Federal Reserve Form G-4)

For the year ended June 30, 19 _____

This report is required by law (15 U.S.C. 78g and 78w; 12 C.F.R. 207).

The Federal Reserve Board regards the information provided by each respondent as confidential. If it should be determined subsequently that any information collected on this form must be released, respondents will be notified.

Public reporting burden for this collection of information is estimated to average 2 hours per response, including the time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing this burden, to Secretary, Board of Governors of the Federal Reserve System, 20th and C Streets, N.W., Washington, D.C. 20551; and to the Office of Management and Budget, Paperwork Reduction Project (7100-0011), Washington, D.C. 20503.

Name of registrant: _____

IRS Identification No.*

Address of principal office: _____
Street

_____
City County

_____
State ZIP Code

GENERAL INSTRUCTIONS

Who must file: Section 207.3(o) of the Federal Reserve Regulation G requires a report on Form G-4 to be filed by every person subject to the registration requirement of Section 207.3(a) of the rule. Any person registered under the regulation may apply for termination of registration by filing FR Form G-2 [see Section 207.3(a)], if such person has not, during the preceding six calendar months, had a total of $200,000 or more of credit outstanding secured directly or indirectly by margin stock.

When and where to file: Form G-4 shall be filed, *in duplicate*, with the Federal Reserve Bank of the district in which the registrant's principal place of business is located, within 30 days following June 30 of each calendar year.

What to file: The registrant is required to file with this report two copies of the registrant's balance sheet, certified by an independent public accountant, as of the end of its most recent fiscal year. If a certified balance sheet is not available, registrant should file with this report a balance sheet in the form prescribed by Schedule B on FR Form G-1, or if subject to supervision by a State or Federal regulatory agency, the latest balance sheet filed with such agency.

*A registrant who is an individual is not required to disclose his or her Social Security number.

DEFINITIONS

Terms used in this form are explained below. Precise definitions may be found in Section 207.2 of Regualtion G.

Person: Any individual, corporation, partnership, association, joint stock company, business trust, or unincorporated organization.

Registrant: Any person who is subject to the registration requirement of Section 207.3(a).

Purpose credit: Credit extended for the purpose of purchasing or carrying margin stock, or to reduce or retire indebtedness previously incurred for that purpose.

Margin stock: Includes (1) stocks registered on a national securities exchange, stocks on the Federal Reserve Board's List of Marginable OTC Stocks, or any OTC security designated for trading in the National Market System, (2) debt securities that are convertible into, or carry a warrant or right to subscribe to or purchase margin stock, (3) any such warrant or right, and (4) shares of most mutual funds.

Indirectly secured: In general, credit is indirectly secured by margin stock if there is an understanding between the borrower and the lender (1) which is designated to make the margin stock more available to the lender in case of default than to the borrower's other creditors, or (2) which limits the borrower from exercising full dominion over the margin stock to sell, pledge, or donate them, or determining where they shall be placed physically.

Instructions for Completing Schedule of Securities Credit

A. Report all Purpose Credit secured by margin stock extended during the reporting period, as well as all purpose credit secured by margin stock outstanding as of June 30, on Part A of the Schedule of Securities Credit.

B. Registrants reporting Purpose Credit secured by margin stock in Part A must also complete Part B if any nonpurpose credit was extended during the reporting period or is outstanding as of June 30.

C. Registrants *not* reporting Purpose Credit in Part A must complete Part B if any nonpurpose credit was extended during the reporting period or is outstanding as of June 30.

D. Registrants who maintain records based upon fiscal quarters that do not coincide with calendar quarters have an option of reporting credit outstanding and extended in a slightly different manner. These registrants may report the annual data requried by FR Form G-4 as of the year ended on either April 30 or May 31. A registrant reporting in this manner should change the date in Column I of the Schedule of Securities Credit to reflect the year end date used.

Employee Stock Option, Purchase, and Ownership Plan Credit

1. Is part or all of the credit extended pursuant to an employee stock option, purchase, or ownership plan?

   ☐ Yes ☐ No

2. A. If "yes," does the credit qualify under the special provisions set forth in Section 207.5 of Regulation G?

   ☐ Yes ☐ No

   B. If credit reported in Column I of the Schedule of Securities Credit includes outstanding employee stock option, purchase, or ownership plan credit, please report the following:

   i. Outstanding "Plan-Lender" credit pursuant to Section 207.5(a) $ _____

   ii. Outstanding credit to an ESOP pursuant to Section 207.5(c) $ _____

3. Has any of the credit reported above been extended pursuant to a plan adopted since the submission of the last annual report?

   ☐ Yes ☐ No

   If yes, please submit two copies of the plan and any supporting documents.

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Schedule of Securities Credit

	I[1] Total credit outstanding as of June 30, ____ (dollars)			II[2] Credit extended during reporting period (dollars)		
	Mil	Thou	Dollars	Mil	Thou	Dollars
A. Credit to purchase or carry margin stock (Purpose Loans):						
1. Secured directly by margin stock:						
a. Listed stocks and OTC margin stocks						
b. Debt securities convertible into margin stock						
c. Mutual funds and other margin stock						
2. Secured indirectly by margin stock						
3. TOTAL (Purpose Credit)						
B. Other credit (Nonpurpose Loans)						
1. Secured directly by margin stock:						
a. Listed stocks and OTC margin stocks						
b. Debt securities convertible into margin stock						
c. Mutual funds and other margin stock						
2. Secured indirectly by margin stock						
3. TOTAL (Nonpurpose Credit)						

[1] "Credit outstanding: (Column I) includes credit extended by the registrant during the year covered by this report, and during previous years, that has not been extinguished before the end of the year covered by this report.

[2] "Credit extended" (Column II) is credit extended at any time during the year covered by this report. Column II includes all new credit extended during the year regardless of whether such credit was extinguished at the end of the year. An increase in an existing loan is new credit.

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Changes in Background Information

For material included in background information, see the second page of FR Form G-1 Registration Statement

Have there been any changes in background information since the previous G-4 report (G-1 report for a registrant filing its first G-4 report)?

☐ Yes ☐ No

If yes, describe any such changes pertaining to name, address, IRS Identification No., organizational structure (e.g., a sole proprietorship becoming incorporated), name of person responsible for maintaining Regulation G records, control, or location of records.

Certification

The registrant filing this annual report and any attachment thereto and the person by whom it is executed represent hereby that all information contained therein is true and complete.

Date

Signature of sole proprietor, general partner, managing agent, or principal officer

Telephone number (including area code)

Print or type name

Title

This mandatory report is needed to elicit certain background and financial information about a Regulation G lender and the types and amount of credit activities engaged in that are secured by margin stock.

Honest, accurate, and timely statements are required by law
(15 U.S.C. §78ff; 18 U.S.C. §1001)