Office of Inspector General

March 2007
Report No. 07-007

Examination Assessment of the Reliability of Appraisals and Sufficiency of Insurance Coverage for Real Estate Lending

AUDIT REPORT

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Background and Purpose of Audit

The reliability of appraisals and sufficiency of insurance coverage are key controls for ensuring real estate loans are safeguarded by underlying collateral. Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 required the FDIC and the other federal banking agencies to establish regulations on financial institution use of real estate appraisals. Further, the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 requires each federal banking agency to adopt uniform regulations that prescribe standards for extensions of credit related to real estate. The FDIC has addressed property insurance coverage as part of FDICIA implementation. Finally, the National Flood Insurance Act and Flood Disaster Protection Act govern the purchase of flood insurance in special flood hazard areas.

The audit objective was to determine whether FDIC examiners adequately consider the reliability of appraisals and sufficiency of insurance coverage for collateral as part of an assessment of an institution's lending policies, procedures, and practices related to real estate loans. This audit focused primarily on institution and examination guidance.

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Results of Audit

The FDIC's guidance to institutions and examiners on the reliability of appraisals and sufficiency of property and flood insurance for real estate loans was generally adequate. Specifically, the FDIC's Rules and Regulations that provide institution guidance address all three areas. Further, examination guidance for the three areas is contained in the related examination manuals and Examination Documentation Modules for planning and performing examinations.

Concerning the application of existing examination guidance, based on a limited sample of 11 institutions, we found that examiners had reviewed appraisal information as part of their assessment of a financial institution's residential real estate lending and loan portfolio management. We also found that examiners had considered the sufficiency of property and flood insurance for the 11 examinations. However, for 6 of the 11 examinations we reviewed, we found only limited evidence in the examination documentation that examiners had specifically considered the reliability of appraisals as part of an institution's real estate appraisal program. As a result, there was inadequate assurance that these institutions were complying with the minimum appraisal standards in the FDIC Rules and Regulations designed to ensure the reliability of appraisals. In our opinion, appraisal reliability relates to a number of important areas relevant to risk management, such as determining loan-to-value ratios and managing to internal loan-to-value limits as part of real estate lending and loan portfolio management, which collectively ensure that real estate collateral provides a sufficient source of repayment.

Overall, the examinations we reviewed adequately considered the sufficiency of property insurance and flood insurance coverage for collateral on real estate loans; however, we identified one area of concern. This area relates to ensuring that institutions have adequate controls to avoid flood insurance lapses in cases where escrowing is not performed. Both the borrowers and the institutions are exposed to a greater risk of an uninsured loss from flooding during a period of lapsed insurance.

Finally, we learned that a lapse in flood insurance coverage can occur in situations where a financial institution that is not escrowing for flood insurance premiums must purchase flood insurance because a borrower has not maintained such coverage. This lapse can occur because the required 45-day waiting period under the Flood Disaster Protection Act – after which a financial institution is required to purchase flood insurance on behalf of the borrower – is longer than the 30-day grace period, as set forth in National Flood Insurance Program guidelines, during which insurance coverage remains in effect after expiration. Thus, the borrower and financial institution may have no flood insurance coverage for 15 days or more until the institution is able to purchase flood insurance on behalf of the borrower. We are providing this information to assist the Congress in considering whether legislative action regarding flood insurance would help reduce the risk associated with flood insurance policy lapses.

Recommendations and Management Response

The report recommends that DSC (1) enhance guidance to clarify that, in the absence of Examination Documentation Module usage, examiners provide adequate documentation of examination coverage to ensure institution compliance with the provisions related to the reliability of appraisals, including the minimum appraisal standards; and (2) issue guidance to institutions addressing the need for adequate controls to avoid lapses in flood insurance coverage. DSC management concurred with the findings and recommendations. DSC will remind its examiners to ensure their evaluations are fully documented. The FDIC will provide staff with a reminder about the need for examiners to adequately notate the reliability of appraisals. Also, DSC indicated that the updated *Interagency Appraisal and Evaluation Guidelines* are to be released shortly. Further, DSC will prepare guidance for FDIC-supervised institutions, addressing the need for adequate internal controls to manage the risks associated with lapses in flood insurance coverage. Management's planned actions are responsive to our recommendations.

TABLE CONTENTS

ACRONYMS

C.F.R.	Code of Federal Regulations
CRE	Commercial Real Estate
DRO	Dallas Regional Office
DSC	Division of Supervision and Consumer Protection
ED	Examination Documentation
FDI	Federal Deposit Insurance
FDICIA	Federal Deposit Insurance Corporation Improvement Act
FEMA	Federal Emergency Management Agency
FIAT	Formal and Informal Action Tracking
FIL	Financial Institution Letter
FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act of 1989
GAO	Government Accountability Office
LTV	Loan-to-Value
NFIP	National Flood Insurance Program
OIG	Office of Inspector General
RD	Regional Directors
ROE	Report of Examination
SFHA	Special Flood Hazard Area
SOURCE	System of Uniform Reporting of Compliance and Community Reinvestment Act Examinations
STARS	Specialized Tracking and Reporting System
USPAP	Uniform Standards of Professional Appraisal Practice
ViSION	Virtual Supervisory Information on the Net

Federal Deposit Insurance Corporation
3501 Fairfax Drive, Arlington, VA 22226

Office of Audits
Office of Inspector General

DATE: March 30, 2007

MEMORANDUM TO: Sandra L. Thompson, Director
Division of Supervision and Consumer Protection

/Signed/

FROM: Russell A. Rau
Assistant Inspector General for Audits

SUBJECT: *Examination Assessment of the Reliability of Appraisals and Sufficiency of Insurance Coverage for Real Estate Lending* (Report No. 07-007)

This report represents the results of our audit of the FDIC Division of Supervision and Consumer Protection's (DSC) assessments of appraisals, property insurance, and flood insurance performed during risk management and compliance examinations. The objective of the audit was to determine whether FDIC examiners adequately consider the reliability of appraisals and sufficiency of insurance coverage for collateral as part of an evaluation of a financial institution's lending policies, procedures, and practices related to real estate loans. This audit focused primarily on institution and examination guidance. We performed limited testing of examinations performed by DSC's Dallas Regional Office (DRO) at 11 financial institutions, including institutions impacted by Hurricane Katrina,[1] to gain an understanding of how existing examination guidance was being applied. Appendix I of this report discusses our objective, scope, and methodology in detail.

BACKGROUND

As of September 30, 2006, the FDIC insured the deposits of over 8,700 institutions. The combined assets of these insured institutions totaled $11.8 trillion, including $7.2 trillion in loans, of which $4.5 trillion was for real estate loans.[2] Loans in default, including those with insufficient underlying collateral, traditionally have been the source of most credit losses incurred by financial institutions. When loans secured by real estate go into default, the institution may be exposed to loss, such as when security interest on the loan is not perfected, title insurance is not obtained, the appraised value of the collateral has declined, uninsured losses have occurred, or environmental factors have impaired collateral value.

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[1] Hurricane Katrina, which caused substantial damage in the Gulf Coast region, impacted 8 of the 11 financial institutions in our sample. The DRO developed a watch list to monitor and track the financial status of 43 FDIC-insured institutions that were impacted by hurricanes in 2005 (see details in Appendix II).

[2] Real estate loans include commercial real estate, residential real estate, construction and land development, and farmland loans.

Of the total number of insured institutions, the FDIC is the primary federal regulator for over 5,200 state-chartered institutions that are not members of the Federal Reserve System. Under section 10(d) of the Federal Deposit Insurance Act (FDI Act), all FDIC-insured institutions are required to undergo on-site risk management examinations every 12-18 months, depending on asset size and bank performance, to assess the safety and soundness of the financial institution. Further, DSC performs compliance examinations every 12-36 months for FDIC-supervised institutions to assess institution compliance with consumer protection laws and regulations. To promote stability and public confidence in the nation's financial system, DSC examines FDIC-supervised financial institutions to ensure they operate in a safe and sound manner, that consumers' rights are protected, and that FDIC-supervised institutions invest in their communities.

Real Estate Lending Standards

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) required each federal banking agency to adopt uniform regulations prescribing standards for extensions of credit related to real estate, including commercial, residential, and industrial real property, considering the risk posed to the Deposit Insurance Fund[3] by the extension of credit and the need for the safe and sound operation of insured depository institutions and the availability of credit.

In response to this FDICIA requirement, the FDIC issued Part 365 of the FDIC Rules and Regulations, *Real Estate Lending Standards*, which requires each FDIC-supervised institution to adopt and maintain written real estate lending policies that are consistent with sound lending principles and are appropriate for the size of the institution and the nature and scope of its operations. Within these general parameters, the regulation requires an institution to establish policies that include:

- portfolio diversification standards;
- prudent underwriting standards, including loan-to-value (LTV) limits;
- loan administration procedures;
- documentation, approval, and reporting requirements; and
- procedures for monitoring real estate markets within the institution's lending area.

In assessing the risks associated with loans secured by liens on real estate, the FDIC's Examination Documentation (ED) Modules for commercial/industrial and residential real estate lending direct examiners to review the loan files for:

- a recorded note and mortgage or deed of trust;
- an attorney's title opinion or title insurance;
- an appraisal or collateral evaluation; and
- evidence of appropriate insurance, such as property, liability, or flood insurance.

[3] This provision was added to the FDI Act, which was later amended by the Federal Deposit Insurance Reform Conforming Amendments Act of 2005 to include the reference to the Deposit Insurance Fund.

For the purposes of this audit, we focused our review on the reliability of real estate appraisals and sufficiency of insurance coverage, including property insurance and flood insurance.

Reliability of Real Estate Appraisals

Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) required the FDIC and the other federal banking agencies to establish regulations on financial institution use of real estate appraisals. Initially, Title XI required appraisals for all real estate loan transactions of $100,000 or more, but the FDIC raised this threshold to over $250,000 effective June 7, 1994.

Institution Guidance. As part of its implementation of Title XI of FIRREA, the FDIC issued institution guidance in FDIC Rules and Regulations, Part 323, *Appraisals,* on the reliability of appraisals. Specifically, FDIC Rules and Regulations, Section 323.4, *Minimum appraisal standards,* state that appraisals should meet the following minimum standards:

- conform to generally-accepted appraisal standards as evidenced by the Uniform Standards of Professional Appraisal Practice (USPAP) promulgated by the Appraisal Standards Board of the Appraisal Foundation;
- be written and contain sufficient information and analysis to support the institution's decision to engage in the transaction;
- analyze and report appropriate deductions and discounts for proposed construction or renovation, partially-leased buildings, non-market lease terms, and tract developments with unsold units;
- be based on the definition of market value set forth in appraisal regulations; and
- be performed by state-licensed or certified appraisers in accordance with requirements set forth in the regulations.

Examination Guidance. DSC's *Risk Management Manual of Examination Policies* (Risk Management Manual) and supplemental guidance advocate a risk-focused examination approach that focuses examination resources on those areas that pose the greatest risk to an insured institution. The level of analysis performed largely depends on the examiner's assessment of bank management's ability to identify, measure, monitor, and control risks. A key aspect of that assessment is the adequacy of management controls that may have an impact on the institution's real estate appraisal program, such as audit functions, loan policies, loan grading systems, and other similar controls. If management controls are properly designed and effectively applied, examiners can place greater reliance on the control systems and limit the scope of their review. The amount of transaction testing necessary to evaluate particular activities generally depends on the quality of the bank's management processes.

To provide examination coverage of the requirements in Part 323 on appraisals, DSC's Risk Management Manual outlines examiner procedures for reviewing real estate loans during a risk management examination. These examination procedures include reviewing loan files for inadequate or no collateral and for other loan documentation related to mortgages, appraisals, legal opinions, title insurance, property insurance, and loan applications.

Additionally, the FDIC's ED Modules provide examiners with a tool that focuses on risk management and helps to establish an appropriate examination scope. With respect to the reliability of appraisals, the *Real Estate Appraisal Programs* ED Module includes a step for examiners to determine if an institution's real estate appraisal program establishes the minimum appraisal standards as set forth in FDIC Rules and Regulations, Part 323. The ED Module, the use of which is discretionary by examiners, also contains steps related to appraisal reliability, such as:

- Determine that the bank has prepared a list of approved appraisers and that the list is reviewed and approved by the bank's board of directors at least annually.

- Determine that the real estate appraisal program provides for the independence of the appraisers. An appraiser should be independent of the loan and collection functions of the bank and have no interest, financial or otherwise, in the property or transaction.

- Verify that appraisal reports are prepared for the lender and by an approved appraiser.

- Verify that the appraisers' qualifications are appropriate for the types of properties being appraised.

- Determine that there is an annual independent evaluation of the real estate appraisal program and corresponding internal controls.

Sufficiency of Property Insurance Coverage

Although property insurance is not specifically discussed in the FDICIA section related to real estate lending or the FDIC's implementing regulations, interagency guidelines, as discussed below, require each institution to adopt a real estate lending policy with underwriting standards and loan administration requirements, which could include property insurance coverage. In addition, the FDIC has included coverage of property insurance in its examination guidance on residential real estate lending and loan portfolio management related to FDICIA implementation, as discussed below.

Institution Guidance. In response to FDICIA requirements, the FDIC issued Part 365, *Real Estate Lending Standards*, of the FDIC Rules and Regulations. Although Part 365 does not specifically reference property insurance, Appendix A, *Interagency Guidelines for Real Estate Lending Policies*, to Part 365 requires each insured depository institution to adopt and maintain a written real estate lending policy that is comprehensive and consistent with safe and sound lending practices. The interagency guidelines address, among other areas: loan portfolio management considerations such as loan origination, approval, and administration procedures; underwriting standards; and supervisory review of real estate lending policies and procedures. Regarding underwriting standards, the regulations require consideration of all relevant credit factors and any secondary sources of repayment, which could include the sufficiency of property insurance. Additionally, components of loan administration, such as those related to collateral, escrow, loan documentation (including documentation for mortgage insurance), and claims processing (including seeking recoveries through government guaranty or insurance programs), can include property insurance coverage.

Examination Guidance. To provide examination coverage of the requirements in Part 365 of the FDIC Rules and Regulations, DSC's *Loan Portfolio Management and Review* ED Module includes the coverage of insurance protection as part of loan documentation. The module includes steps for determining if an institution's real estate mortgage lending policies, procedures, and practices are adequate and appropriate for the size and nature of the bank's real estate lending activities. Another related ED Module, *Residential Real Estate Lending*, the use of which is discretionary by examiners, contains a specific step in the section on documentation for determining if evidence of appropriate insurance, including property and liability insurance, is in the loan files reviewed.

Sufficiency of Flood Insurance Coverage

The National Flood Insurance Act of 1968 established the National Flood Insurance Program (NFIP) as a means by which flood insurance would be made available on a nationwide basis through the cooperative efforts of the Federal Government and the private insurance industry. The Act enabled interested persons to purchase insurance against loss resulting from physical damage to or loss of real or personal property related to any flood occurring in the United States. The Act requires lending institutions -- as a condition of making, increasing, extending, or renewing any loan secured by improved real estate or a mobile home that is located in an area determined by the Federal Emergency Management Agency (FEMA) as having special flood hazards -- to notify the purchaser and servicer of the loan of such hazards before the purchase agreement is signed. The Flood Disaster Protection Act of 1973 expanded the NFIP by substantially increasing the limits of coverage and total amount of insurance authorized to be outstanding and by requiring known flood-prone communities to participate in the program. The National Flood Insurance Reform Act of 1994 made various amendments to the prior statutes and included new provisions such as the requirement that lenders purchase flood insurance for borrowers under certain circumstances.

Institution Guidance. FDIC Rules and Regulations, Part 339, *Loans in Areas Having Special Flood Hazards*, implements the requirements of the National Flood Insurance Act and Flood Disaster Protection Act, as amended. Part 339 applies to loans secured by buildings or mobile homes located or to be located in areas determined by FEMA as having special flood hazards. According to Part 339, generally, a bank shall not make, increase, extend, or renew any designated loan unless the building or mobile home and any personal property securing the loan are covered by flood insurance for the term of the loan. Further, Part 339 states that the amount of insurance must be at least equal to the lesser of the outstanding principal balance of the designated loan or the maximum limit of coverage available for the particular type of property under the National Flood Insurance Act. The amount of insurance cannot exceed the overall value of the property securing the designated loan less the value of the land on which the property is located.

In 2001, the FDIC issued additional guidance to FDIC-supervised institutions in Financial Institution Letter (FIL) 81-2001, *Strengthening Compliance with Federal Flood Insurance Requirements*, which emphasized the principal requirements of the National Flood Insurance Act and the FDIC's implementing regulation, Part 339, and contained a Flood Insurance Compliance Monitoring Checklist and information resources.

Examination Guidance. Key examination coverage of flood insurance requirements is provided as part of compliance examinations. DSC's *Compliance Examination Handbook*[4] outlines procedures for reviewing compliance with laws and regulations related to flood insurance. These procedures include reviewing the completion of the FEMA Standard Flood Hazard Determination form,[5] the notice to the borrower that the property securing the loan is located in a special flood hazard area (SFHA), and the sufficiency of the flood insurance coverage amount. In addition, DSC issued revised examination guidance for determining civil money penalties for violations of the National Flood Insurance Act and Part 339. From a risk management examination perspective, DSC's *Residential Real Estate Lending* ED Module, the use of which is discretionary by examiners, contains a specific step in the section on documentation for determining if evidence of appropriate insurance, including flood insurance, is in the loan files reviewed.

RESULTS OF AUDIT

The FDIC's guidance to institutions and examiners on the reliability of appraisals and sufficiency of property and flood insurance for real estate loans was based on the following regulations and was generally adequate. Specifically:

- Part 323, *Appraisals*, of the FDIC's Rules and Regulations provides institution guidance concerning the reliability of appraisals and, particularly, the minimum appraisal standards that must be met. Similarly, examination guidance is provided in the Risk Management Manual and the related *Real Estate Appraisal Programs* ED Module on the reliability of appraisals.

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[4] On October 24, 2006, DSC replaced the *Compliance Examination Manual* with the *Compliance Examination Handbook*. Audit work was performed under the Manual and there were no relevant changes in the Handbook.

[5] The form is completed by the institution, or its designee, to report whether a structure is located within a special flood hazard area.

- Part 365, *Real Estate Lending Standards*, of the FDIC's Rules and Regulations provides institution guidance on real estate lending but does not explicitly include institution requirements related to ensuring the sufficiency of property insurance. However, Appendix A to Part 365 provides interagency guidelines, such as those related to underwriting standards and loan origination, approval, and administration procedures, which – given references therein to mortgage insurance and government insurance programs – can also apply to the sufficiency of property insurance. Examination guidance in the related ED Modules, *Residential Real Estate Lending* and *Loan Portfolio Management and Review*, was adequate for purposes of ensuring the appropriateness of property insurance.

- Part 339, *Loans in Areas Having Special Flood Hazards*, of the FDIC's Rules and Regulations provides institution guidance concerning the sufficiency of flood insurance. However, as discussed below, we noted that institution guidance could be enhanced by addressing controls to avoid lapses in flood insurance, particularly in cases where insurance premiums are not escrowed. With respect to examination guidance, DSC's *Compliance Examination Handbook* outlines comprehensive procedures for reviewing compliance with laws and regulations related to flood insurance. Also, risk management examination guidance in the *Residential Real Estate Lending* ED Module was adequate for purposes of ensuring the appropriateness of flood insurance.

Concerning the application of existing examination guidance related to the reliability of appraisals and sufficiency of property and flood insurance on real estate loans, based on a limited sample of institutions, we found the following:

- Risk management Reports of Examination (ROE) and related examination documentation showed that examiners had reviewed appraisal information as part of their assessment of a financial institution's real estate lending and loan portfolio management at the program level and, in most cases, at the individual loan transaction level. However, for 6 of the 11 examinations we reviewed, we found only limited evidence in the examination documentation that examiners had specifically considered the reliability of appraisals as part of the institution's real estate appraisal program. As a result, there was inadequate assurance that these institutions were complying with the minimum appraisal standards in the FDIC's Rules and Regulations designed to ensure the reliability of appraisals. In our opinion, appraisal reliability relates to a number of important areas relevant to risk management, such as determining loan-to-value ratios and managing to internal loan-to-value limits as part of real estate lending and loan portfolio management, which collectively ensure that real estate collateral provides a sufficient, though secondary, source of repayment (see **Reliability of Appraisals**).

- Examinations considered the sufficiency of property insurance coverage for collateral. In some cases, examiners had assessed third-party reviews of the institutions' loan portfolios as part of the examination process which provided added assurance that property insurance coverage was sufficient (see **Property Insurance**).

- Examinations adequately considered the sufficiency of flood insurance coverage for collateral. Examinations included an evaluation of an institution's compliance management system, transactional testing of loans for compliance, and a determination of whether a civil money penalty should be assessed for violations of the National Flood Insurance Act (see **Flood Insurance**).

Although the examinations we reviewed had adequately considered the sufficiency of flood insurance coverage for collateral on real estate loans, we identified one area of concern. This area relates to ensuring that institutions have adequate controls to avoid flood insurance lapses in cases where escrowing is not performed. Both the borrowers and the institutions are exposed to a greater risk of an uninsured loss from flooding during a period of lapsed insurance (see **Lapses in Flood Insurance Coverage**).

We also identified a matter for congressional consideration. Differences between the waiting period under the Flood Disaster Protection Act for the purchase of flood insurance on a borrower's behalf and the grace period provided by the NFIP after insurance expires can lead to a lapse in flood insurance. This lapse can occur because the required waiting period **–** after which a financial institution must purchase flood insurance on behalf of the borrower who allows the flood insurance to expire **–** is longer than the grace period during which insurance coverage remains in effect after expiration. During this lapse, flood insurance coverage is not in place. We are providing this information to assist the Congress in considering whether legislative action regarding flood insurance would help to reduce the risk associated with flood insurance policy lapses (see **Matter for Congressional Consideration – Waiting Period for Placement of Coverage Under the Flood Disaster Protection Act**).

RELIABILITY OF APPRAISALS

The FDIC has issued guidance to both institutions and examiners regarding the reliability of appraisals. Specifically, the institution guidance in Part 323.4 of the FDIC Rules and Regulations provides the minimum standards for ensuring the reliability of appraisals. Further, examination guidance in the *Real Estate Appraisal Programs* ED Module provides for examination coverage of appraisal programs for ensuring compliance with appraisal standards and additional steps for ensuring that appraisals are reliable. Other details on the institution and examination guidance related to the reliability of appraisals are in the *Background* section of this report.

Examiner Consideration of the Reliability of Appraisals

For the 11 examinations sampled, we found that examiners had reviewed appraisal information as part of their assessment of the financial institutions' real estate lending and loan portfolio management at the program level and, in most cases, at the individual loan transaction level. However, for 6 of the 11 examinations we reviewed, we found only limited evidence in the examination documentation that examiners had specifically considered the reliability of appraisals as part of the institution's real estate appraisal program. For example, there was no documentation that the appraisers were independent and, if applicable, certified or licensed, or that the institution had implemented a real estate appraisal program established to meet the minimum appraisal standards set forth in Part 323.4 of the FDIC's Rules and Regulations. As a result, there was inadequate assurance that these institutions were complying with the minimum appraisal standards designed to ensure the reliability of appraisals. In our opinion, appraisal reliability relates to a number of important areas relevant to risk management, such as determining loan-to-value ratios and managing to internal loan-to-value limits as part of residential real estate lending and loan portfolio management, to ensure that real estate collateral provides a sufficient, though secondary, source of repayment if a borrower defaults on a real estate loan.

Examination of Financial Institution Appraisal Programs

Our review of 11 examinations conducted by two DRO field offices indicated that examiners had reviewed financial institution appraisal programs as part of their assessment of the institutions' real estate lending and portfolio management activities. Specifically, we noted 1 or more of the following elements in the documentation for the 11 examinations we reviewed:

- Completed Officer's Questionnaires that included a question related to the extension of credit to appraisers (11 examinations).

- Copies of institution loan and, in some cases, appraisal policies (9 examinations).

- Evidence of third-party reviews of institution loan portfolios (4 examinations).

- Completed Pre-Examination Planning memorandums citing appraisal issues (3 examinations).

- The financial institution's list of approved appraisers (2 examinations).

We also noted examiner line sheets or real estate line cards[6] that contained selected loan information such as the appraised value of the collateral. As a result, we concluded that examiners for these institutions had reviewed appraisal information as part of their assessment of the financial institution's real estate lending and loan portfolio management program during risk management examinations. However, as described below, this examination evidence at the appraisal program level and individual loan level was not sufficient in some cases to show that the examiners had specifically considered the reliability of appraisals as part of the institution's real estate appraisal program.

[6] Examiners prepare line sheets and/or real estate line cards to document their review of real estate loans, including information on appraisals and noncompliance with appraisal regulations.

Examination Documentation for Assessing the Reliability of Appraisals

Although DSC has issued institution and examiner guidance related to assessing the reliability of appraisals, the examination documentation for 6 of the 11 examinations we reviewed provided only limited support for an overall conclusion on the reliability of the real estate appraisals. Specifically, we found that DRO examiners had not used the *Real Estate Appraisal Programs* ED Module to conduct examination work related to appraisals. Although use of the ED module is discretionary, DRO examiners used Assignment Sheets, which are an alternative form of documentation approved by DRO and permitted by DSC policy,[7] but which did not include some steps the ED Module specified in order to conclude on the reliability of appraisals. The Assignment Sheets were used for each of the 11 examinations. However, in five cases, the ROEs provided evidence that examiners had considered the reliability of appraisals.

In assessing the procedures outlined on the Assignment Sheets, we determined that they did not include procedures that would be required to conclude on the reliability of appraisals. Specifically, the Assignment Sheets did not include any of the key examiner procedures, related to the reliability of appraisals, that are specified in the ED Module, such as:

- Determining if an institution's real estate appraisal program establishes the minimum appraisal standards as set forth in the FDIC Rules and Regulations, Part 323.

- Determining that the bank has prepared a list of approved appraisers and that the list is reviewed and approved by the bank's board of directors at least annually.

- Determining that the real estate appraisal program provides for the independence of appraisers.

- Verifying that appraisal reports are prepared for the lender and by an approved appraiser.

While DSC policy provides that examiner use of the ED Modules is discretionary, the underlying requirement to address the reliability of appraisals remains. Further, DSC has provided examiners with guidance on how to document work when core analysis procedures are not used. As stated in the Risk Management Manual, Section 1.1, *Basic Examination Concepts and Guidelines*, examination findings should be documented through a combination of brief summaries, bank source documents, report comments, and other examination documentation that addresses management practices. The manual also states that examination documentation should:

- demonstrate a clear trail of decisions and supporting logic within a given area,

[7] Regional Directors Memorandum 2001-039, *Guidelines for Examination Workpapers and Discretionary Use of Examination Documentation Modules,* September 25, 2001.

- provide written support for examination and verification procedures performed and conclusions reached, and

- support the assertions of fact or opinion in the financial schedules and narrative comments in the ROE.

However, the work papers for the examinations we reviewed documented only limited coverage of the reliability of appraisals because the Assignment Sheets the examiners used lacked key procedures in this area. As a result of the conditions we noted, there was inadequate assurance that 6 of the 11 institutions in our sample were complying with the minimum appraisal standards in the FDIC Rules and Regulations designed to ensure the reliability of appraisals.

Recommendation

We recommend that the Director, DSC:

(1) Enhance guidance to clarify that, in the absence of ED Module usage, examiners provide adequate documentation of examination coverage to ensure institution compliance with the provisions in FDIC Rules and Regulations, Part 323, *Appraisals,* related to the reliability of appraisals, including the minimum appraisal standards.

PROPERTY INSURANCE

The FDIC has issued guidance to both institutions and examiners regarding the sufficiency of property insurance. Specifically, the institution guidance contained in Part 365 of the FDIC Rules and Regulations addresses underwriting standards and loan origination, approval, and administration procedures that can include the sufficiency of property insurance coverage even though an explicit reference to property insurance is not made. Further, examination guidance in the ED Modules on *Residential Real Estate Lending* and *Loan Portfolio Management and Review* was adequate for purposes of ensuring the appropriateness of property insurance. Additional details on the institution and examination guidance related to the sufficiency of property insurance is in the *Background* section of this report.

Examiner Consideration of the Sufficiency of Property Insurance

Regarding the sufficiency of property insurance coverage for collateral on real estate loans, we focused on risk management examinations for 9 of the 11 financial institutions in our sample and found evidence in the examination documentation that the examiners had generally reviewed the sufficiency of property insurance coverage. Although examination documentation for each institution varied, available documentation enabled us to conclude that, overall, the examiners had considered the sufficiency of property insurance on collateral for real estate loans as part of their overall assessment of each institution’s loan portfolio management. For example, we observed that for most of the institutions in our sample, examiner line sheets or work papers identified property insurance amounts and expiration dates or instances when insurance had expired or was cancelled, indicating that a review of the sufficiency of insurance had been performed.

In addition, for three of the institutions in our sample, examiners documented third-party reviews of the institutions' loan portfolios for the sufficiency of insurance. For example, one such third-party review noted significant deficiencies such as no evidence of insurance in some loan files. In addition, the examination documentation for one institution contained the institution's board of directors' minutes, wherein property insurance coverage had been addressed. Overall, we determined that the examiners had documented their work in this area, and the available documentation enabled us to conclude that the examiners had considered the sufficiency of property insurance for collateral.

FLOOD INSURANCE

The FDIC has issued guidance to both institutions and examiners regarding the sufficiency of flood insurance. Specifically, Part 339 of the FDIC Rules and Regulations provides institution guidance concerning the sufficiency of flood insurance. DSC's *Compliance Examination Handbook* outlines comprehensive procedures for reviewing compliance with laws and regulations, including those related to flood insurance. These procedures include reviewing the sufficiency of the flood insurance coverage amount. Further, risk management examination guidance in the *Residential Real Estate Lending* ED Module was adequate for purposes of ensuring the appropriateness of flood insurance. Additional details on the institution and examination guidance related to the sufficiency of flood insurance is in the *Background* section of this report. However, as discussed below, we noted that institution guidance could be enhanced by addressing financial institution controls to avoid lapses in flood insurance, particularly in cases where insurance premiums are not escrowed.

Examiner Consideration of the Sufficiency of Flood Insurance

Compliance examinations are the primary means by which the FDIC determines whether an FDIC-supervised financial institution is meeting its responsibility to comply with consumer protection requirements. The *Compliance Examination Handbook* states that the purposes of compliance examinations are to:

- assess the quality of an FDIC-supervised institution's compliance management system for implementing consumer protection statutes and regulations,
- review compliance with relevant laws and regulations, and

- initiate effective supervisory action when an institution's compliance management system is deficient or when significant violations[8] of law are found.

The compliance examinations we reviewed showed evidence that examiners had adequately considered the sufficiency of flood insurance coverage for collateral supporting residential real estate loans. For each of the 11 institutions in our sample, the examiner's assessment of the institution's compliance with flood insurance regulations included: (1) an evaluation of the institution's compliance management system; (2) transactional testing of loans for compliance with the National Flood Insurance Act; and (3) a determination of when a civil money penalty should be assessed for violations of the National Flood Insurance Act. Also, for all 11 financial institutions, the examiners had documented their review of the institutions' internal or external compliance audit function. Because adequate examination coverage of the sufficiency of flood insurance had been provided as part of the compliance examinations, we did not separately assess risk management examination coverage.

Concerning transactional testing, examiners used either an overall summary or a real estate loan worksheet to document their reviews. The examiners focused on the accuracy of the completed Standard Flood Hazard Determination forms, which indicate whether the collateral property is located within an SFHA and therefore requires flood insurance. As a result of transactional testing, examiners identified significant flood insurance violations at 6 of the 11 institutions. The violations included:

- an insufficient amount of flood insurance coverage,
- failure of the financial institution to purchase insurance on behalf of borrowers when flood insurance policies had lapsed, and
- inaccurate Standard Flood Hazard Determination forms (for example, the form lacked the bank's lender identification number).

The FDIC assessed a civil money penalty against one of the six institutions because, according to the examiner, the institution's flood insurance violations represented a pattern in which the institution had identified lapsed coverage, but loan personnel had not corrected the lapses. This situation bears directly on the sufficiency of flood insurance coverage. DSC Regional Directors (RD) Memorandum 2005-029, *Revised Guidance About Civil Money Penalties for Flood Insurance Violations*, dated July 29, 2005, provides guidance on the process for determining when and in what amount a civil money penalty must or should be assessed for violations of the National Flood Insurance Act and flood insurance regulations. The guidance, consistent with the Flood Disaster Protection Act, indicates that a civil money penalty must be assessed against an institution when a pattern or practice of certain violations is discovered.

[8] Significant violations identified as such during the examination reflect deficiencies requiring prompt corrective action by the financial institution due to their serious nature, recurrent pattern, or system-wide impact.

From January 1, 2005 through August 31, 2006, the DRO conducted compliance examinations for 660 financial institutions. These DRO examinations identified 175 (26.5 percent) institutions with significant flood insurance violations. As of December 31, 2006, DSC's Formal and Informal Action Tracking (FIAT) system showed that DSC had assessed civil money penalties for flood insurance violations against 5 (3 percent) of those 175 institutions, which were deemed by DSC to have a pattern or practice of violations consistent with the statutory provisions.[9]

Lapses in Flood Insurance Coverage

Although the compliance examinations we reviewed adequately considered the sufficiency of flood insurance coverage for collateral in residential real estate loans, we identified one area of concern with regard to institution guidance. This area relates to ensuring that institutions have adequate controls to prevent flood insurance lapses in cases where escrowing by a financial institution is not performed. Compliance examination documentation indicated that institutions did not always have adequate controls to ensure required flood insurance did not lapse in cases where escrowing was not performed. Specifically, ROEs for 3 of the 11 institutions in our sample indicated that the institutions had allowed one or more flood insurance policies to lapse. As a result, both the borrowers and the institutions at issue were exposed to a greater risk of an uninsured loss from flooding during the period of lapsed insurance. As discussed earlier, one institution had been assessed a civil money penalty for a pattern of inaction on lapsed flood insurance.

The Flood Disaster Protection Act of 1973, as amended in 1994, requires an institution to escrow flood insurance premiums for loans secured by residential improved real estate if the institution requires the escrow of funds to cover other charges associated with the loan, such as taxes, premiums for hazard or fire insurance, or other fees. However, the escrow requirement for flood insurance does not apply if the institution does not require the escrowing of other charges. In these cases, the borrower is responsible for paying the premiums to renew the policy. According to the Flood Disaster Protection Act, as amended, if an institution determines that a designated loan is not covered by flood insurance, the institution is required to notify the borrower that the borrower should obtain flood insurance. If the borrower fails to obtain flood insurance within 45 days after notification by the institution, then the institution must purchase insurance on the borrower’s behalf. Such notification to a borrower that insurance may lapse is an important control to protect both the borrower and the institution from flood losses.

In the cases where flood insurance policies had lapsed, the ROEs are clear that the institutions’ controls were not adequate to have prevented the lapses. Specifically,

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[9] The DRO percentages are similar to the FDIC’s national statistics for flood insurance violations and civil money penalties for all FDIC-supervised institutions examined during the same period. Specifically, of the 3,339 financial institutions DSC examined from January 1, 2005 through August 31, 2006, DSC identified 836 (25 percent) institutions with significant flood insurance violations. As of December 31, 2006, DSC's FIAT system showed that DSC had assessed civil money penalties for flood insurance violations against 48 (6 percent) of those 836 institutions, which were deemed by DSC to have a pattern or practice of violations consistent with the statutory provisions.

examiners reported instances in which borrowers had not paid required flood insurance premiums in a timely manner, and institutions did not purchase insurance on behalf of the borrower, thus allowing flood insurance policies to expire. For example, for the 1 institution that was assessed a civil money penalty, examiners identified 97 loans for which flood insurance coverage had expired. In this case, the examiners provided three examples of insurance that had lapsed from 9 to 10 months. Another institution had to purchase insurance coverage on 14 loans. In this case, the examiners provided three examples of insurance that had lapsed from 4 to 5 months. The ROEs for these cases stated that the institutions had allowed flood insurance policies to lapse and that bank management promised corrective action. The examiners identified the following reasons for the lapses:

- inadequate procedures at the institution for tracking loans in flood hazard areas,
- lack of timely action by the institution's loan servicing personnel to address expired policies, and
- lack of institution board and senior management oversight.

The FDIC has placed increased attention on flood insurance coverage in view of the substantial damage caused by Hurricane Katrina. However, flood insurance premiums are required to be escrowed only when an institution escrows for other charges, as described earlier, and it is common for institutions in some parts of the country not to escrow for these charges. FDIC guidance does not presently require financial institutions to establish compensating controls to ensure flood insurance remains in effect in cases where a financial institution does not escrow for payment of the flood insurance premiums. Therefore, it would be prudent for the FDIC to provide guidance to institutions on establishing adequate controls to avoid lapses in flood insurance coverage.

Recommendation

We recommend that the Director, DSC:

(2) Issue guidance to institutions addressing the need for adequate controls to avoid lapses in flood insurance coverage.

MATTER FOR CONGRESSIONAL CONSIDERATION – WAITING PERIOD FOR PLACEMENT OF COVERAGE UNDER THE FLOOD DISASTER PROTECTION ACT

During the course of this audit, we learned that a lapse in flood insurance coverage can occur in situations where a financial institution that is not escrowing for flood insurance premiums must purchase flood insurance because a borrower has failed to maintain adequate coverage. This lapse can occur because the required waiting period under the Flood Disaster Protection Act – after which a financial institution must purchase flood insurance on behalf of the borrower who allows the flood insurance to expire – is longer than the grace period, provided under the NFIP, during which insurance coverage remains in effect after expiration. During this lapse, flood insurance coverage is not in place. According to DSC, the federal banking agencies have been aware of the potential for a lapse in flood insurance coverage in this manner, and the FDIC has previously raised the issue for congressional attention.

When an institution does not escrow for flood insurance premiums, the circumstances surrounding a lapse in flood insurance coverage can be explained as follows. When a borrower fails to pay a policy renewal premium in a timely manner, the guidelines in the NFIP *Flood Insurance Manual* allow a 30-day grace period after a policy expires during which insurance coverage remains in effect. However, under the provisions of the Flood Disaster Protection Act[10] a financial institution must provide the borrower with notice of the expiration; and if the borrower fails to obtain adequate insurance within 45 days of such notification, the institution must purchase insurance on the borrower's behalf. Furthermore, there may be delays between the time that the policy expires and the institution becomes aware of the expiration. Consequently, even under the best of circumstances, there is, at a minimum, a 15-day lapse in insurance coverage because the 45-day waiting period exceeds the 30-day grace period allowed under the policy renewal guidelines. Thus, when a borrower fails to pay flood insurance premiums, the borrower and the financial institution may have no flood insurance coverage for 15 days or more until the financial institution is able to purchase flood insurance on behalf of the borrower.

To address this concern, the FDIC made a legislative proposal, as part of the financial services regulatory relief proposals in 2003, addressing the issue of lapses in flood insurance. According to the agency's submission, lenders that want to ensure that collateral is protected during this 15-day period currently must seek private insurance, which is not widely available and is reportedly more expensive than flood insurance available through the National Flood Insurance Program. The FDIC's proposal would have allowed "regulated institutions to purchase coverage on behalf of a borrower when the borrower fails to purchase insurance within 30 days of notification of lack of coverage." The FDIC's position was that the amendment would allow a lender to place insurance at approximately the same time the grace period ends, reducing the risk of lapsed flood insurance. However, the FDIC withdrew the proposal in 2005, following Hurricane Katrina, with the understanding that flood insurance reform legislation was in process that would address this and other concerns. Such legislation, however, has not yet been enacted.

We are providing this information to assist the Congress in considering whether legislative action regarding flood insurance would help reduce the risk to financial institutions and consumers associated with flood insurance policy lapses.

[10] 42 United States Code § 4012a(e).

CORPORATION COMMENTS AND OIG EVALUATION

On March 29, 2007, the Director, DSC, provided a written response to the draft of this report. The DSC response is presented in its entirety in Appendix III. In its response, DSC concurred with our findings and recommendations. With regard to our recommendation to enhance guidance to clarify that examiners provide adequate documentation of examination coverage related to the reliability of appraisals, DSC will remind its examiners to ensure their evaluations are fully documented. Also, the FDIC will provide staff a reminder about the need for examiners to adequately notate the reliability of appraisals. Further, DSC stated that updated *Interagency Appraisal and Evaluation Guidelines* are to be released shortly. With regard to our recommendation to issue guidance to institutions, addressing the need for adequate controls to avoid lapses in flood insurance coverage, DSC will prepare guidance to FDIC-supervised institutions addressing the need for adequate internal controls to manage the risks associated with lapses in flood insurance coverage. DSC expects to complete these actions by December 31, 2007.

A summary of management's response to the recommendations is in Appendix IV. DSC's planned actions are responsive to our recommendations. Accordingly, the recommendations are resolved but will remain open until we have determined that the agreed-to corrective actions have been completed and are effective.

OBJECTIVE, SCOPE, AND METHODOLOGY

Objective

The objective of the audit was to determine whether FDIC examiners adequately consider the reliability of appraisals and sufficiency of insurance coverage for collateral as part of an evaluation of a financial institution's lending policies, procedures, and practices related to real estate loans. This audit focused primarily on institution and examination guidance. We performed limited testing of examinations performed by DSC's DRO at 11 financial institutions, including institutions the FDIC identified as affected by Hurricane Katrina, to gain an understanding of how existing examination guidance was being applied. Because we found generally sound controls related to examiners' review of appraisals and determinations concerning property and flood insurance, we decided to curtail further audit tests and procedures related to specific examinations. We performed our audit from July through December 2006 in accordance with generally accepted government auditing standards.

Scope and Methodology

We reviewed the ROEs and examination work papers for 11 sampled institutions examined by the DRO. We selected eight institutions, with appraisal and flood violations, that were supervised by the Baton Rouge Field Office and three institutions (two of which had flood violations) that were supervised by the Dallas Field Office.

We selected the 11 institutions from a list of risk management ROEs completed as of January 1, 2005 through August 31, 2006, and the most recent compliance examinations.

We performed the following steps to address the audit objective:

- Interviewed officials at DSC's DRO, the Dallas Field Office, and the Baton Rouge Field Office.

- Identified applicable criteria, including:

    - laws and regulations applicable to appraisals, property insurance, and flood insurance, as specified in the *Compliance With Laws and Regulations* section in this report;

    - DSC's *Risk Management Manual of Examination Policies;*

    - DSC's *Compliance Examination Manual*;

    - Regional Directors memoranda:

        - RD Memorandum 2005-029, *Revised Guidance about Civil Money Penalties for Flood Insurance Violations*

  - RD Memorandum 2006-001, *Hurricane Katrina Guidance*
  - RD Memorandum 2006-016, *Updated Standard Flood Hazard Determination Form*

- Financial Institution Letters:

  - FIL-13-1998, *Loans in Areas with Special Flood Hazards,* dated February 5, 1998
  - FIL-94-1999, *High Loan-to-Value Residential Real Estate Lending,* dated October 12, 1999
  - FIL-81-2001, *Loans in Areas Having Special Flood Hazards,* dated September 20, 2001
  - FIL-84-2003, *Independent Appraisal and Evaluation Functions,* dated October 27, 2003
  - FIL-20-2005, *Appraisal Regulations Frequently Asked Questions,* dated March 22, 2005
  - FIL-101-2005, *Regulatory Relief Information for Bankers in Hurricane Affected Areas*, dated October 7, 2005
  - FIL-12-2006, *Hurricane Katrina Examiner Guidance,* dated February 3, 2006
  - FIL-51-2006, *Updated Standard Flood Hazard Determination Form,* dated June 21, 2006
  - FIL-53-2006, *Appraisal Standards Revisions to USPAP,* dated June 23, 2006

- Examiner tools such as the ED Modules and Assignment Sheets.

• Accessed the Virtual Supervisory Information on the Net (ViSION)[11] system, used to track ROEs and obtained information on the most recent risk management and compliance examination information for banks supervised in the Baton Rouge and Dallas Field Offices.

• Accessed the System of Uniform Reporting of Compliance and Community Reinvestment Act Examinations (SOURCE)[12] to obtain information on flood insurance violations.

• Obtained a schedule of banks supervised by the DRO that had been cited for significant violations of flood insurance regulations since January 1, 2005.

[11] ViSION is a bank-supervision tracking and reporting database. DSC refers to ViSION as an "information workstation" – a programmed means of handling all the computerized data needed to properly supervise an institution throughout its organizational life.

[12] SOURCE is the system of record for the compliance and Community Reinvestment Act examination program and is extensively used by FDIC field supervisors, examiners, review examiners, and Washington Office policy staff.

- Reviewed risk management and compliance ROEs and applicable work papers for a total of 11 financial institutions examined by the Baton Rouge and Dallas Field Offices.

- Obtained information on consumer complaints and inquiries from DSC's Specialized Tracking and Reporting System (STARS)[13] and the Consumer Response Center relating to flood insurance.

- Reviewed prior FDIC OIG reports as well as those from the Board of Governors of the Federal Reserve System Office of Inspector General and Government Accountability Office (GAO).

- Reviewed the FDIC *2006 Annual Performance Plan* for performance measures related to safety and soundness and consumer protection.

- Consulted the FDIC's Counsel to the Inspector General for assistance in verifying applicable criteria and researching potential legal issues.

Internal Controls

We identified DSC's internal controls related to the risk management and compliance examinations, focusing on the examiners' review of loans for determining the reliability of appraisals and sufficiency of insurance. Our observations related to those controls are described in the body of this report. However, we did not assess the ratings assigned by the risk management and compliance examinations and did not determine whether DSC should have taken more stringent enforcement actions with respect to reported significant violations of applicable laws and regulations.

Reliance on Computer-based Data

Our audit objective did not require that we separately assess the reliability of computer-processed data. We accessed DSC's ViSION information system to identify a universe of risk management examinations performed by the Baton Rouge and Dallas Field Offices and the related ROEs. From this universe, we selected a non-statistical[14] sample of 11 institutions—some having reported appraisal or flood insurance violations and some having neither type of violation reported. For these institutions, we reviewed the risk management examinations for the period January 1, 2005 through August 31, 2006 and the most recent compliance examinations.

We accessed DSC's SOURCE information system for information on flood insurance violations. For purposes of the audit, we did not rely on computer-processed data to support our significant findings, conclusions, and recommendations. Our assessment

[13] STARS is DSC's system for tracking and reporting consumer complaints.
[14] The results of a non-statistical sample cannot be projected to the intended population by standard statistical methods.

centered on reviews of hardcopy ROEs, examination work papers, and other documents such as correspondence files.

Compliance With Laws and Regulations

We reviewed the following laws and regulations pertaining to examination coverage of appraisals and insurance:

- Federal Deposit Insurance Act (FDI Act) - Section 10(d);
- Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA)-Title XI;
- Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA)
- National Flood Insurance Act of 1968;
- Flood Disaster Protection Act of 1973;
- National Flood Insurance Reform Act of 1994;
- FDIC Rules and Regulations, 12 Code of Federal Regulations (C.F.R.) Part 323, *Appraisals*;
- FDIC Rules and Regulations, 12 C.F.R. Part 339, *Loans in Areas Having Special Flood Hazards*; and
- FDIC Rules and Regulations, 12 C.F.R. Part 365, Appendix A, *Interagency Guidelines for Real Estate Lending Policies*.

Government Performance and Results Act

The Government Performance and Results Act of 1993 directs Executive Branch agencies to develop a strategic plan that sets general goals and objectives for agency management. In fulfilling its primary supervisory responsibilities, the FDIC pursues two general (or strategic) goals: (1) FDIC-supervised institutions are safe and sound, and (2) consumers' rights are protected and FDIC-supervised institutions invest in their communities. Moreover, there are two strategic objectives related to our audit: (1) FDIC-supervised institutions appropriately manage risk and (2) FDIC-supervised institutions comply with consumer protection, the Community Reinvestment Act, and fair lending laws.

The FDIC's strategic goals are implemented through the Corporation's *2006 Annual Performance Plan*. The plan identifies performance goals, indicators, and targets for each strategic objective. For example, the plan contained one goal for the Risk

Management component of the Supervision Program related to the scope of our audit—conduct on-site risk management examinations to assess the overall financial condition, management practices and policies, and compliance with applicable laws and regulations of FDIC-supervised depository institutions.

Fraud and Illegal Acts

The objective of this audit did not lend itself to testing for fraud and illegal acts. Accordingly, our survey and audit programs did not include specific audit steps for this purpose. However, we were alert to situations or transactions that could have been indicative of fraud or illegal acts and discussed the potential for such acts with the assigned staff.

Summary of Prior Coverage

The FDIC OIG, Board of Governors of the Federal Reserve System OIG, and GAO and have performed audits regarding appraisals as follows.

- On March 24, 2004, the GAO presented testimony before the Subcommittee on Housing and Transportation, Committee on Banking, Housing, and Urban Affairs, U.S. Senate. GAO's statements were based on a report GAO issued in May 2003. In this testimony (GAO-04-580T), *Opportunities to Enhance Oversight of the Real Estate Appraisal Industry*, GAO states that the primary role of appraisals is to provide evidence that the collateral value is sufficient to avoid losses to the institution. According to the report, the most significant shortcoming of FIRREA's Title XI is that it allows each state to establish the criteria for licensed appraisers. The education and experience requirements differ from state to state. In 2002, one state passed legislation that eliminated the experience requirement for its licensed appraisers and, in 2001, another state revised its criteria to comply with Appraiser Qualifications Board requirements but at the same time, "grandfathered in" several hundred licensed appraisers. GAO stated that Title XI's intent was to ensure a minimum level of competency but to make licensing at the state level voluntary.

- On January 3, 2003, the FDIC OIG issued Audit Report No. 03-008, *Examiner Assessment of Commercial Real Estate Loans*. The report discusses whether the examiners fully assessed appraised value, cash flow, and lending policies in their examination of commercial real estate (CRE) loans. The audit found that examiners had not consistently: used the lesser of the acquisition cost or appraised value to compute the LTV ratios, used new financial information to update old appraisal assumptions, and documented the results of their review of appraisals. As a result, auditors found cases where the LTV ratio appeared to comply with the recommended supervisory limits, but when recalculated using the lesser of the acquisition cost or appraised value, the LTV ratios were actually in excess of the recommended supervisory limits.

- On March 31, 1995, the Federal Reserve's OIG issued Audit Report No. A9305, *Audit of Federal Reserve Examination Policies and Procedures for Commercial Real Estate Loans*. An audit of three Federal Reserve examination teams found they had not consistently ensured that bank CRE lending practices complied with the Federal Reserve Board rules implementing Title XI of FIRREA. Examiners had detected few of the apparent appraisal-related deficiencies that existed in the sample of CRE loans reviewed during the audit. The undetected deficiencies included appraisals that (1) had not been obtained when needed for loan renewal transactions, (2) had been ordered by the borrower instead of by the commercial bank, (3) had been received or reviewed after the loan was closed, or (4) did not meet USPAP standards.

HURRICANE KATRINA RESPONSE EFFORTS

Hurricane Katrina, a massive storm that made landfall on August 29, 2005 and caused substantial damage in the Gulf Coast region, impacted the eight banks whose examinations we reviewed at the DSC Baton Rouge Field Office. Although the storm's duration was short, the economic effects will be long-lasting, and many FDIC officials, including the Chairman, have toured the affected area. The FDIC was involved in extensive outreach efforts to the community and supervises the eight banks. Moreover, the FDIC has published numerous related articles, including one entitled, *Lessons Learned From Hurricane Katrina: Preparing Your Institution for a Catastrophic Event*.

On February 3, 2006, the federal banking, thrift, and credit union regulatory agencies and the state supervisory authorities in Alabama, Louisiana, and Mississippi jointly issued examiner guidance outlining the supervisory practices for assessing the financial condition of institutions affected by Hurricane Katrina. This guidance, *Interagency Supervisory Guidance for Institutions Affected by Hurricane Katrina*, describes examination procedures for institutions adversely affected by the hurricane. The guidance advises examiners to retain flexibility in their supervisory response, given the unique and long-term nature of the problems faced by affected institutions and to give appropriate recognition to the extent to which weaknesses are caused by external problems related to the hurricane and its aftermath.

Some of this guidance is pertinent to our audit. For example, examiners were advised to consult with their supervisors to determine what supervisory action, if any, should be taken, and a 3-year appraisal waiver from federal appraisal regulations was offered to institutions. These appraisal waivers for institutions affected by Hurricane Katrina are to end August 29, 2008. To qualify for the waiver, a financial institution needs to document that (1) the property involved was directly affected by the disaster, (2) there is a binding commitment to fund the transaction, and (3) the value of the real property supports the institution's funding decision to enter into the transaction. At the time of our visit, according to DSC's Baton Rouge Field Office Supervisor for Risk Management, the banks had not elected to take advantage of the appraisal waiver, primarily because there had not been a high volume of new business.

The FDIC has also worked cooperatively with state and federal banking agencies and other organizations to determine the status of the financial institutions located in the affected areas. For example, the FDIC's DRO developed a watch list to monitor and track the financial status of 43 FDIC-insured institutions that were impacted by hurricanes in 2005. According to an Assistant Regional Director for Risk Management, this was an attempt to capture the banks' posture—both financially and from an "up-and-running" perspective and is not a scientific approach but rather an "artful way of getting their arms around the situation." The information has been used to brief FDIC management and others on the health of the financial institutions and has helped focus the examination efforts that have taken place since the hurricane. Regional management has sent specific instructions to field examiners in special written memorandums to the Regional Director regarding each bank's condition.

For the eight banks in our sample that were in areas affected by Hurricane Katrina, according to the Baton Rouge Field Office Supervisor, the examiners had not modified their required detailed examination procedures. However, some scheduled examinations were initially delayed, and for some examinations, more loans were reviewed.

CORPORATION COMMENTS

FDIC
Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990
Division of Supervision and Consumer Protection

March 29, 2007

TO: Russell A. Rau
Assistant Inspector General for Audits

FROM: Sandra L. Thompson,
Director

SUBJECT: Response to Draft Report Entitled: ***Examination Assessment of the Reliability of Appraisals and Sufficiency of Insurance Coverage for Real Estate Lending*** **(Assignment No. 2006-024)**

This memorandum represents the Federal Deposit Insurance Corporation, Division of Supervision and Consumer Protection's (DSC) response to the draft report entitled *Examination Assessment of the Reliability of Appraisals and Sufficiency of Insurance Coverage for Real Estate Lending* (Assignment No. 2006-024) (Draft Report) prepared by the FDIC's Office of Inspector General (OIG). The Draft Report states, "The FDIC's guidance to institutions and examiners on the reliability of appraisals and sufficiency of property and flood insurance for real estate loans … was generally adequate." DSC concurs with the findings and recommendations in the OIG's Draft Report. With respect to the OIG's specific recommendations, DSC's response follows:

(1) Enhance guidance to clarify that, in the absence of ED Module usage, examiners provide adequate documentation of examination coverage to ensure institution compliance with the provisions in FDIC Rules and Regulations, Part 323, *Appraisals* (Part 323), related to the reliability of appraisals, including the minimum appraisal standards.

The Draft Report indicates that auditors found only "limited evidence" in the examination documentation that examiners had specifically considered the reliability of appraisals as part of the institution's real estate appraisal program in 6 of the 11 examinations reviewed. However, it also notes examiners had reviewed appraisal information as part of their assessment at all of the institutions sampled and did not cite any deficiencies in examiners' documentation of apparent violations of *FDIC Rules and Regulations Part 323-Appraisals*[1] in Reports of Examination.

[1] PART 323—APPRAISALS – Section 323.4 – Minimum appraisal standards, provides that: "For federally related transactions, all appraisals shall, at a minimum: (a) Conform to generally accepted appraisal standards as evidenced by the Uniform Standards of Professional Appraisal Practice (USPAP) promulgated by the Appraisal Standards Board of the Appraisal Foundation, 1029 Vermont Ave., NW., Washington, DC 20005, unless principles of safe and sound banking require compliance with stricter standards; (b) Be written and contain sufficient information and analysis to support the institution's decision to engage in the transaction; (c) Analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, non-market lease terms, and tract developments with unsold units; (d) Be based upon the definition of market value as set forth in this part; and (e) Be performed by state licensed or certified appraisers in accordance with requirements set forth in this part.

Further, the DSC regional offices forward several referrals to state appraisal certification agencies each year. These referrals, describe deficiencies found in certain appraisals through our supervisory processes. Referrals are used by the state certification agencies to support fines and other sanctions against appraisers. These actions are evidence that DSC's examination staff is considering the reliability of appraisals and ensuring that institutions are in compliance with Part 323.

DSC examiners are appropriately reviewing the reliability of an institution's appraisals during the examination process; nonetheless, DSC will remind our examiners to ensure their evaluation is fully documented. The FDIC will provide staff with a reminder about the need for examiners to adequately notate the reliability of appraisals. Further, the updated 2007 Interagency Appraisal and Evaluation Guidelines are to be released shortly. DSC expects to complete this recommendation by December 31, 2007.

(2) Issue guidance to institutions addressing the need for adequate controls to avoid lapses in flood insurance coverage.

DSC will prepare guidance to FDIC-supervised institutions addressing the need for adequate internal controls to manage the risks associated with lapses in flood insurance coverage by December 31, 2007.

MANAGEMENT RESPONSE TO RECOMMENDATIONS

This table presents the management response on the recommendations in our report and the status of the recommendations as of the date of report issuance.

Rec. No.	Corrective Action: Taken or Planned	Expected Completion Date	Monetary Benefits	Resolved:[a] Yes or No	Open or Closed[b]
1	DSC will remind examiners (a) to ensure their evaluation of the reliability of appraisals is fully documented and (b) to adequately notate the reliability of appraisals. Further, DSC indicated that updated *Interagency Appraisal and Evaluation Guidelines* are to be issued shortly.	December 31, 2007	$0	Yes	Open
2	DSC will prepare guidance for FDIC-supervised institutions, addressing the need for adequate internal controls to manage the risks associated with lapses in flood insurance coverage.	December 31, 2007	$0	Yes	Open

[a] Resolved – (1) Management concurs with the recommendation, and the planned corrective action is consistent with the recommendation.
(2) Management does not concur with the recommendation, but planned alternative action is acceptable to the OIG.
(3) Management agrees to the OIG monetary benefits, or a different amount, or no ($0) amount. Monetary benefits are considered resolved as long as management provides an amount.

[b] Once the OIG determines that the agreed-upon corrective actions have been completed and are effective, the recommendation can be closed.